Issue Brief

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National Energy Policy Legislation – A Comprehensive Approach to Ensuring Energy Security
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Summary: A confluence of events involving rising prices and supply shortages in several energy sectors has focused public and political attention on the need to update the nation's energy policy and to provide for increased production of domestic energy sources. President George W. Bush made this central point in his campaign platform on energy issues and has designated an Administration team under the leadership of Vice President Cheney to develop specific recommendations in this regard. House and Senate leaders have similarly indicated that this will be a top priority for the 107th Congress, with Senate Energy and Natural Resources Committee Chairman Murkowski (R-AK) having introduced the National Energy Security Act of 2001 (S. 388 and S. 389), and the House Commerce Subcommittee on Energy and Air Quality is expected to consider these matters during the coming weeks.

APPA supports the concept of national energy policy legislation, and agrees that there are a number of areas where Congress could act to boost overall production of electricity, maintain or enhance the viability of traditional fuels used to generate electricity, promote the commercialization of new, alternative sources of electricity, increase energy conservation, and provide adequate energy assistance to low-income households. Whether or not all of these elements move together in a single piece of legislation is a not a critical issue, and APPA seeks to work with congressional leaders to implement a legislative strategy that would achieve results on each of these elements.

Background: Energy supply problems that started first in the oil sector last year, and resulted in high gasoline prices, have crossed over to other energy sectors including natural gas and electricity. A scarcity of supplies and transportation has increased home-heating costs this winter, a situation compounded by unusually cold weather in the South. These price increases in natural gas have also contributed to the expanding crisis in electricity. In the West, California's rolling blackouts, and severe shortages in other regions, have served as a painful reminder that, among other factors, an imbalance exists between energy demand and supply.

While this situation has worsened sharply in the past few months, energy supply and deliverability problems have been under discussion on Capitol Hill since early last year. Both the House and Senate have begun to hold hearings on various aspects of energy supply policy. Today, these matters are receiving much-deserved attention both within the Administration and Congress, and recent energy events have generated public attention and thus increased political support to act on comprehensive energy legislation.

APPA

The American Public Power Association is the national service organization representing the nation's more than 2,000 local publicly owned electric utilities.

Legislative Principles: There is general agreement among consumers, producers, marketers and policymakers that certain fundamental elements should form the basis for comprehensive energy policy legislation. APPA concurs on these elements, particularly as they relate to energy supply and consumption:

- Legislation should emphasize *fuel diversity*. There is growing recognition that all traditional fuel sources for generating electricity need to be maintained and enhanced and that new sources should be encouraged.
- Comprehensive legislation should highlight as one of its major goals the need to *increase domestic energy supplies* and provide for *energy security*.
- Energy legislation should be current with today's environmental challenges and opportunities. Thus, decisions should be made that *integrate energy, environment and economic goals*.
- Policies, whether they are administrative or legislative, should treat all electricity generators and suppliers on a *comparable basis*. As consensus grows to spur the development of domestic energy supplies, including alternative renewable energy resources, *incentives and credits must be developed on a basis that provides equal treatment* to all stakeholders, regardless of their tax and financial structures.
- Taken alone or separately, most elements of previously drafted electricity restructuring legislation should not be included in energy legislation unless they serve to *remove barriers to transmission and ensure reliability*. This type of comprehensive energy policy bill should not include stand-alone repeal of the Public Utility Holding Company Act (PUHCA).

Specific Issues to be Addressed in Energy Legislation: APPA is less concerned as to whether important elements of an energy policy bill are addressed in a comprehensive measure or handled in a series of proposals. Of greater importance is ensuring that final approaches to creating and deploying a national energy strategy is done from an informed and consumer-based orientation. The critical issues APPA would like to see included in any legislative approach include, but are not necessarily limited to, the following:

1. Mobilize funds and deployment of clean coal technologies for existing and future coal-generation units. Incentives designed to spur the use of such technologies should provide comparable benefits and ease of administration to all electricity generators, despite their tax or financial structure.

2. Provide incentives, tradable tax credits or offsets to all electric generators or suppliers for electricity generated from eligible renewable energy resources including wind, solar, geothermal, hydropower, biomass, and landfill-gas-to-energy projects.

3. Fully fund, reauthorize and reform to provide certainty and multiple year funding for the U.S. Department of Energy Renewable Energy Production Incentive Program (REPI).

4. Reform the Federal Energy Regulatory Commission (FERC) process for licensing and relicensing hydroelectric power plants. Such reforms should create balance in the process without diminishing environmental standards; establish a consistent and objective review procedure for mandatory conditions; and codify existing FERC deadline authority for submission of such conditions.

5. Increase funding for the Low-Income Home Energy Assistance Program.

6. Enact nuclear waste storage legislation that would create a permanent repository for spent nuclear fuel and reauthorize the Price-Anderson Act addressing liability of nuclear power plants.

7. Increase supplies of natural gas and provide transportation of such supplies for electricity generation.

8. Increase investments in energy technology research and development of all domestic energy resources to ensure the development of a balanced portfolio of energy sources and fuels. Technologies should spur the development of the next generation of clean-burning technologies, improve energy delivery and ensure reliability.

9. Promote the increased development and commercialization of alternative vehicles, including electric vehicles.

10. Promote energy conservation and efficiency.

APPA Position: APPA supports the development and implementation of a national energy bill or, alternatively, a package of energy proposals that promotes the increased production, supply, transportation, and conservation of domestic energy resources. Elements necessary to carry forward a balanced energy portfolio are described above. These provisions promote the development of traditional and alternative energy resources, use of energy production and investment incentives that provide comparable benefits to all electricity suppliers, improve energy delivery and ensure electricity reliability. Energy legislation, however, should not contain on a piece-meal basis select elements of previous electricity restructuring measures, particularly provisions that would repeal the Public Utility Holding Company Act on a stand-alone basis.

California

The Facts About Municipal Utilities' Participation In The California Electricity Market

The failure of retail electricity competition in California has multiple causes requiring corrective action at both the state and federal levels. The crisis in California resulted in exorbitant retail rates for residents of San Diego County and an unreliable supply of electricity for millions of customers throughout the state. At the same time, while millions of customers served by publicly owned utilities (municipal utilities and utility districts) continued to receive a reliable supply of electricity at low rates, other public systems faced rate increases of their own. In addition, publicly owned utilities sometimes had surplus electricity they were able to provide to the state's investor owned utilities and their customers.

In return for their foresight, good planning, efficient operations, customer responsiveness and ability to make surplus power available to other utilities and their customers, publicly owned utilities in California are coming under attack. Unsubstantiated charges of profiteering, illegal sales of federal hydropower, and other erroneous charges have surfaced. While these false charges are of concern, they are not surprising. Critics of public power and the federal power program find it difficult to acknowledge that these institutions have provided an invaluable service to their consumers and to all consumers in California and throughout the west.

This paper is designed to set the record straight about the performance of publicly owned utilities in the California market. It explains the status and level of participation by publicly owned utilities in the retail competition program and its related institutions. It also refutes the unfounded allegations that have been leveled recently against publicly owned utilities. More information is available on the American Public Power Association's (APPA's) website www.appanet.org, or by calling the APPA Legislative Department at 202-467-2900.

Public power participation in California restructuring (AB 1890)

In 1996 the California Legislature enacted its electricity restructuring plan, AB 1890, which fundamentally changed the state's electric utility industry. The law required California's three investor owned utilities (IOUs), all of whom are regulated by the state Public Utility Commission, to provide "direct access," that is, to offer their customers the ability to choose their own electricity supplier.

Throughout the debate over AB 1890 California municipal utilities – which are closely and carefully regulated by various locally elected utility boards and city councils – insisted on provisions that allowed them to retain local control over power purchases, construction of facilities, energy contracts, and all other decisions regarding conditions of

Recently, the state PX was shut down, and a new system is now in place. Due to several factors, the state's electricity prices reflect changing conditions. For example, nothing in the Los Angeles Department of Water and Power's pricing methodology has changed. When natural gas prices rise in the spot market, their costs increase commensurately. They do not, of course, sell energy to the state at a loss, but base their bids on their costs. Unfortunately, critics continue to make charges that public power is "profiteering" with this new system. The fact is those prices simply reflect the actual cost of providing electricity at that time. In addition to natural gas prices, which have recently quadrupled, other factors in pricing include the cost of purchasing additional pollution credits in line with air quality requirements, costs for transmission tariffs, unit start up costs, and labor and maintenance costs for each facility. Further, Los Angeles has maintained a policy of selling its excess generation to "California first" – during any Stage 1, 2, or 3 emergency alert called by the state ISO, the utility only sells its power to entities inside the state.

Public power, "preference power," and California

Some have accused California's municipal utilities of making large profits by re-selling "preference power" (federal hydropower that is sold on a right of first refusal to governmental units and non-profit cooperatives) into the state's PX and ISO. This assertion is absolutely not true. Public power is, in fact, legally prohibited from doing so. All power that is received from federal hydro projects is required to serve the customers of the consumer-owned utility purchaser. This is true for the Western Area Power Administration, which serves California, and other power marketing administrations as well, including the Bonneville Power Administration, Southeastern, and Southwestern Power Administrations.

Under federal law all hydro resources are held in the public trust. Licenses are issued by the Federal Energy Regulatory Commission to operate hydro projects that generate power from water power resources that in fact belong to the public. Both PG&E and Southern California Edison have substantial federally licensed hydropower generation, enough to serve 17 percent and 6.5 percent of their total customers, respectively. Publicly owned utilities receive hydropower from federal facilities, including the Boulder Canyon Project (Hoover Dam). Federal hydropower also goes to other recipients, including military installations, federal labs, and universities, all in the "public good."

While many municipal utilities in California do receive federal hydropower, it is a relatively low percentage of their electricity mix, or load. The Los Angeles Department of Water and Power, for example, receives roughly 500 MW of power from Hoover Dam. That sounds significant, but Los Angeles' daily load is approximately 3,500 MW, with peak loads as high as 5,500 MW. Still, when it comes to the state's electric grid, due to the physics of electricity it remains impossible to track these electrons from federal hydro projects when thrown on the grid. While you can't trace the electrons, you can follow the financial benefits of this federal power. These financial benefits go directly to the intended beneficiaries – the citizens of Los Angeles.

Public power's first and only purpose is to provide excellent, efficient electric service to its citizens. Unlike private power companies, public power systems do not have to serve stockholders as well as customers. Public power's measure of success is how much money they can keep within their communities through low rates and reliable service, not how much can be taken out to send to distant stockholders who are not part of the community.

As California is learning, electric prices drive local economies. For years, public power has had a proven track record of providing customers with lower-cost electric rates than private power companies on a national average. For instance, residential rates for public power systems are nearly 18 percent lower than for private companies, while commercial rates are approximately nine percent lower for public power. Several factors help explain this product efficiency,

including local control, where public power systems are regulated by local, citizen-controlled boards. Public systems also operate in the sunshine and typically have much lower administrative costs, including management and other overhead costs.

But these factors explain only some of the advantages public power customers enjoy when it comes to low rates and better efficiency. A key factor is that public power utilities charge no profit – they are not-for-profit entities. As such, they pay no dividends to stockholders and pay no federal income taxes, since there is no "income." And since they are public service oriented, public utilities tend to be more responsive to the local community.

California's renewed interest in public power

Public power systems today serve one in four Californians. Their outstanding performance over the last few months has led many people to pursue the "public power option." Tired of price shocks and unreliable service, the San Marcos city council last summer approved a resolution to study further their options to create a municipal utility for the community. San Diego County has also moved forward and is reviewing city options through a Local Agency Formation Commission. In addition, some county supervisors have encouraged state elected officials to draft legislation in the Assembly that would amend state law to allow the county to establish a public utility district.

Other cities are similarly interested. For example, high prices have prompted the city of Berkeley to look at public power. A proposal to explore the possibility of creating a city-owned utility was suggested by the Berkeley Commission on Aging and presented to the city council in December. Most recently the San Francisco Board of Supervisors in February placed a measure on the November ballot that could create a municipal utility district for the entire city and the adjacent community of Brisbane, its neighbor to the south. The official move followed a grassroots effort that culminated in 24,000 signatures on a petition calling for the formation of a city-owned public utility. Other California communities continue to study their options.

Conclusion

California's flawed electricity restructuring experiment and a dysfunctional wholesale market have created serious problems for the West's consumers, utilities, regulators, and elected officials. No industry sector, including public power, has been unaffected. But the overall performance of publicly owned utilities has clearly shown that the traditional concept of "local control" works. Critics' earlier conclusions that public power would never survive seem absurd at this point. Today, renewed interest in public power is a testament to the solid performance of California's municipal utilities. Local control and community ownership remain viable options. Public power in California continues to do what it does best: provide low-cost, reliable electric service to their communities.

While attention has been focused on California and the West, this is clearly a national problem – and federal government action is required. Congress must take steps to not only address the scarcity problem, but must act to fix the market structure problem. The wholesale market structure as it currently exists is simply incapable of producing the results expected of competitive markets. Congress should direct FERC to create appropriately configured, independent regional transmission organizations that can ensure fair and nondiscriminatory access to the nation's transmission grid. Until they do, federal regulators need to implement cost-based rates on an interim basis to provide relief for all customers. The solutions are there, and the federal government has the tools.

Testimony of Richard Ferreira
on behalf of the
Sacramento Municipal Utility District
before the
United States Senate Committee on Energy and Natural Resources
January 31, 2001

Introduction and Summary

Mr. Chairman and Members of the Committee, thank you very much for the opportunity to appear before you today. The fact that you have convened this hearing shows that you understand how important resolution of the current energy crisis is for California, and the entire Western United States.

Frankly, the current situation is bleak. We are experiencing outages in the middle of January. Utility operators are dreading what might happen in a few months when we near our summer peak. We face razor-thin reserve margins on a daily basis, and routine plant or transmission line failures can trigger rotating outages. In the wholesale power markets, the apparent floor for spot market energy prices is higher than peak prices of the not-so-distant past. Manufacturers have already postponed planned expansions due to energy price and reliability concerns, adding to fears of an economic downturn. And there are no easy solutions. Based on our best estimates, it will take years to get the needed transmission and generation facilities built to support a competitive market.

The current situation in California has national import as well, as Federal Reserve Chairman Greenspan has already recognized. I was pleased to hear this week that President Bush has formed a Task Force under the leadership of Vice President Cheney to tackle what has become a regional problem. California will take certain steps to ameliorate the current crisis, but many of the problems must be addressed on a regional basis. Only the federal government can accomplish regional solutions.

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By way of introduction, let me tell you a little about the Sacramento Municipal Utility District, or SMUD, on whose behalf I appear before you today. SMUD is a consumer-owned municipal utility that serves approximately 1.5 million persons in the greater Sacramento area. During debates on AB 1890, California's restructuring law, SMUD and other municipal utilities fought for and retained local control over our energy choices in the competitive market.

This local control has significant practical manifestations. Because of local control, SMUD retained its obligation to plan for and serve the electricity needs of our consumer-owners. It has never been SMUD's belief that competition relieved SMUD of its responsibility to ensure that its customers had sufficient electric supply at stable prices. As a consequence, SMUD and other municipal utilities retained their power plants dedicated to serve native load customers. This is in direct contrast to our investor-owned colleagues in California who, because of regulatory orders and business decisions, sold a high percentage of their generation assets and declined to build new generation. We have also not transferred away rights to use regional transmission facilities, built at great expense, to deliver economic energy from other parts of the Western region to our customers. This has given us further ability to mitigate market risk for our customer-owners.

All things considered, SMUD has been able to weather the market volatility and high prices relatively well as compared to our investor-owned neighbors. However, there is no escaping the market forces that have been unleashed. SMUD, like most businesses and consumers in California, is exposed to high market prices. Today, SMUD is about to commence a rate proceeding due to high market prices for both electricity, and the natural gas that powers our local power plants.

As I will discuss in more detail later in my remarks, there are steps California can take to help itself. A series of well-chronicled events, exacerbated by well intentioned but mistaken market experiments in California, have contributed to the current situation.

However, the solution will not arrive overnight, just as the problem did not arise overnight. Needed investments and market improvements will take some time to bear fruit. Further, the one overarching lesson from the California experiment is that a piecemeal, state-by-state approach to market development and market oversight will simply not work. A regional approach to markets is required, and only the federal government can make this happen. Therefore, SMUD believes that the federal government does have a role to:

- help stabilize the current regional wholesale market until needed investment in generation and transmission is made;
- act as the steward for regional market reforms that have the best chance to make the promise of competition a reality; and
- encourage investment in energy efficiency and supply through a reinvigorated national energy policy.

Background - A Road Paved with Good Intentions

As I stated above, we have a regional energy crisis on our hands. Actions taken by California have exacerbated the situation. You have no doubt read and heard much about California's failure to build new generation and transmission in the face of growing demand. This is certainly true. What is also true is that investment in generation and transmission has not kept pace with demand throughout the West. Lack of facility investment is not a uniquely California phenomenon. What we did in California, however, is adopt market structures that laid the infrastructure inadequacies bare for market participants to exploit. I would make the following additional observations regarding the road to competition in California.

First, California opened up its markets at a time when reserve margins throughout the Western United States were dropping. It has been well chronicled that increased demand in the growing West has caused surpluses in regions such as the Pacific Northwest and Desert Southwest to diminish. California was already a net importer of electricity,

and it saw its traditional suppliers with less power to export to California during peak summer periods. At the same time, as California demand grew, less power could be returned from California to the Pacific Northwest during California's off-peak winter periods, as had been the traditional practice. Therefore, tighter reserve margins affected the entire Western region. On occasion this year, prices outside California have exceeded prices inside California, due to several factors. In a regional market, if the highest price in the West is in California, buyers in Portland and Phoenix will be forced to pay close to the California price. Likewise, if the price in the Northwest is the highest, that price is likely to prevail throughout the West.

The difference is that California adopted a market design that paid all bidders the highest, or marginal, price paid for electricity. This raised the overall amount paid for energy exponentially. Elsewhere in the region, markets worked the "old fashioned" way, and the highest price was only paid for that last increment of energy needed. Thus, the overall affect on consumers in California was much greater. The lesson that was reinforced over the past year is that California is not a "gated community" when it comes to electrical supply. What we have also learned is that no other individual state is likely to succeed in building a fence at its borders due to West-wide supply tightening and overall market forces. Price is a regional matter, and remedies for high prices must be regional in scope.

Second, California's road to restructuring can be characterized as a "Wait, Then Hurry Up" approach. This had an adverse affect on utility infrastructure investment. Serious restructuring discussions began in California in the early 1990's. Over a period of years, California regulators issued Yellow Books and then Blue Books after entertaining endless comments from stakeholders. The state legislature then joined the fray, and AB 1890 was signed into law in 1996. Already California had endured several years of regulatory uncertainty, contributing to the lack of investment in both needed generation and transmission facilities.

Once AB 1890 was enacted, however, it seemed things could not be done fast enough. The law directed that the entire industry, from trading of power to operation of transmission, be radically altered in less than eighteen months. Since the March 1998 start-up of the markets, there have been over forty filings at the Federal Energy Regulatory Commission making major or minor changes to market rules. Uncertainty due to regulatory inaction was, therefore, followed by instability of market rules, further dampening investment in a capital-intensive industry. Thus, California managed to combine the worst of regulatory delay and inaction, with the worst of hasty implementation. This approach exacerbated already poor market fundamentals of short supply.

Third, California implemented radical changes to the rules of wholesale power trading that ignored prevailing regional practices. Instead of the old model of an industry based on relatively predictable behavior by buyers, sellers, and operators of the Grid, California implemented a system that encouraged last minute trading of electricity in an effort to extract efficiencies from the market. Attractive on the chalkboard, it did not work when put into practice. The inability of customers to say "no" when prices were too high gave more leverage to suppliers in an already tight market, because buyers were looking to meet their needs in real time, rather than locking in supply months or years in advance, as had traditionally been done. The rest of the Western region also resisted California's approach. The result is that rules governing trading and grid operation vary greatly between California and the rest of the West. In hindsight, this could have been easily avoided. It also points to the need for regional solutions.

Thus, California made several errors that contributed to the market dysfunction witnessed today. We not only have a crisis brought on by a supply/demand imbalance, but we unintentionally aided and abetted this fundamental imbalance by the manner in which we implemented restructuring, despite the best intentions of California stakeholders.

Avoiding California's Mistakes - Lessons Learned

Other states can try to avoid the mistakes of California. I would make the following observations on lessons learned from our painful experience.

First, competition in the electric utility industry will not just happen with a wave of the so-called "invisible hand." Workable competition requires certain preconditions be met before markets can be relied on to reach competitive outcomes. There must be sufficient, and probably a surplus, reserve margin of supply in order to discipline price. In a tight market, because of the essential nature of the commodity and the inability to effectively store electricity, demand behavior is predictable and sellers can essentially name their price. Without adequate reserve margins, it may be virtually impossible to discipline prices charged by suppliers. Lesson Number One from California may be that, in a competitive era, we need much more generation on line ready to serve consumers than we built in a vertically integrated, regulated industry, in order to maintain price discipline in markets. This lesson must work its way into how we examine regional markets when determining the potential for the exercise of market power by suppliers.

Second, markets will not work if, no matter what the price level is, demand remains almost the same. Demand responsiveness is taken for granted in most other markets. Implementation of demand responsiveness in electricity markets presents a greater challenge. I have not seen great strides in this area in California or elsewhere. While regulators, including FERC, talk about customers bidding their demand into markets just like suppliers bid their output, these programs are in their infancy and are far from fruition. The California ISO continues to try to implement such programs, with limited success. We are a little closer to making demand responsiveness a reality today than before our troubles began. Yet everyone agrees that demand responsiveness is necessary to control prices, especially during periods of tight supply. Common sense would indicate that other regions contemplating a market approach should carefully consider whether they have meaningful demand-side approaches in place before they move forward.

Third, someone must be responsible for serving customers, and that responsibility must be well defined. I mentioned earlier that SMUD and other California municipals never wavered from the obligation to serve their customers, and they planned accordingly. We can argue about whether our investor-owned utilities were relieved of the legal obligation to serve; it was certainly hinted at. Many expected that new Energy Service Providers would be climbing over each other fighting for IOU customers. At a minimum, the existing IOUs were not given clear direction about whether or not their obligation to serve remained in full force. This mistake simply cannot be repeated.

Fourth, it is important to take the time necessary to ensure the fundamental components of a workable market, like those cited above, are in place before proceeding with full-fledged competition. Progress should be made in measured steps. In California, we turned operation of the utilities and wholesale markets inside out in less than eighteen (18) months. In retrospect, it should not come as a surprise that it did not work precisely as planned. We have spent the last three (3) years in a vain attempt to correct flaws in the system exposed by market participants. We learned that regulators and market makers couldn't keep pace with power marketers and brokers when it comes to closing loopholes in system design. Given the importance of the electricity industry to the well being of the nation, the final lesson to be learned from California is that a measured pace of change may be preferable to an overnight overhaul.

"California Only" Solutions Will Be Band-Aids

There are immediate steps that can be taken in California, without federal assistance. However, these will merely be band-aids until regional solutions are forthcoming.

First, California must take all practicable measures to lessen demand for the coming summers. The most promising means to ensure reliability and mitigate high prices in the immediate future is to reduce the demand for electricity. Frankly, it is our only

option, because generation planned to come on line in the next two years will allow California to keep up with demand growth, and little more. At SMUD, this week our elected Board will consider augmenting our demand-management efforts, including a more flexible and aggressive air conditioning cycling program that allow us to cut demand from our summer peak usage. We are also discussing how our largest industrial and commercial customers can change manufacturing process and work schedules to allow energy conservation during peak periods. In the very near term, demand side efforts such as these hold the most promise of reducing the threat of outages due to insufficient supply, as well as mitigating price spikes during periods of high usage.

Second, we must overcome the NIMBY (Not in My Back Yard) and NOPE (Not on Planet Earth) syndromes so that both generation and transmission can be built. I am hopeful this can be accomplished without abandoning environmental goals. New generation facilities have much smaller footprints than old units currently in place. Physically they are much smaller. They are more efficient, and their affect on air quality is much less than existing units that they would replace. New generating units would not only bring more supply to electricity markets, they would also improve air quality, and their relative efficiency would lessen demands on natural gas supply caused by older, less efficient units.

Transmission system improvements may be more difficult, but are no less necessary. The current transmission system was built to be part of a vertically integrated utility run as a cohesive whole. It was not built to support a disaggregated competitive industry, a so-called "interstate highway" approach to transmission access and competition. Not only is more transmission necessary to ensure reliability, but it is also necessary to ensure suppliers cannot exercise market power, or charge rates above competitive levels for sustained periods, because inadequate transmission limits access to supplies from competitors in localized areas.

One factor overlooked when examining siting reforms is that fellow competitors are often the most vocal opponents of siting new generation or transmission projects. A new generator may cut into profits of existing facilities, and will therefore be ardently opposed. Likewise, a new transmission line can reduce the monopoly power a generator has on serving customers in a constrained area of the grid, and therefore will also be opposed. We have seen both examples in California. It is simply not fair or accurate to lay frustrations of siting delays solely at the feet of environmentalists or intransigent residents.

Third, we must stabilize wholesale rates. As has been much publicized, suppliers and buyers, with the help of the State of California, are currently in the process of attempting to negotiate long-term contracts. If successful, these contracts have the promise of being able to avoid immediate rate shock for California consumers by locking in lower-than-spot-market prices through contracts with longer terms. I would caution, however, that long-term contracts and low prices for electricity are not necessarily synonymous.

Long-term contracts for electricity can ensure stable prices, but they cannot ensure low prices. In fact, the ability to enter into long-term contracts at reasonable rates is predicated on functioning short-term wholesale markets. One cannot be accomplished without the other. You can be sure that a supplier will only enter into a contract if it believes the return on the contract will be favorable as compared with spot market outcomes for the length of the contract. I cannot emphasize strongly enough that long-term contracts are not a substitute for properly functioning wholesale energy markets. They are a merely a "deodorant" to mask dramatic retail rate hikes.

Regional and National Solutions Are Essential

While California has received the bulk of the attention, it is merely the "canary in the coal mine." California has its own unique set of problems, but California may be the

first indicator of a broader national energy crisis. As your hearing indicates, California market problems have already contributed to high prices and economic dislocation in the rest of the West. Other energy markets, such as those in New York, appear to be on the brink of supply inadequacy and price volatility, perhaps this coming summer. Thus, the energy crisis is a federal concern. Moreover, some things, such as regulation of wholesale energy markets, are exclusively federal. Here are things the federal government can do.

An Interim Regional Price Cap

First, and for the shorter term, the federal government, through FERC or Congress if necessary, can stabilize markets in the West with an interim regional price cap.

A regional price cap is necessary to stabilize market conditions and allow time for generation and transmission investment, and market improvements, to bear fruit. Today, prices in wholesale markets are persistently at levels that are 3-5 times what retail customers are used to paying for energy. A crisis mentality has developed, and this mentality does not allow constructive discussion on meaningful market reforms. SMUD is concerned that if prices don't stabilize, political leaders in the West will simply end the move to competitive markets. We need help from leaders in Washington, D.C. to implement a regional approach to bring order to wholesale markets.

SMUD would be the first to admit that price caps are not an ideal solution. Managing competitive markets is exceedingly difficult. However, we must face facts; the alternative is run away high prices for a significant period of time. While additional generation is planned, only a small percentage will come on line this year. There continue to be barriers to entry for new supply and transmission. Indeed, the entire planning process for the Western United States has eroded due to competitive pressures. Suppliers are much less willing to share information regarding planned generation that they regard as commercially sensitive, as compared to the close voluntary coordination that characterized the regulated industry. Meanwhile, demand continues to grow at a considerable rate.

Transmission additions are also needed, not only in regional transmission corridors that have been identified as bottlenecks, but also in highly populated areas to deliver the electricity to consumers. Even if permitting and related concerns were solved tomorrow, it will literally take years to build the necessary transmission. Until then, the ability of new supply to get to consumers will be thwarted.

Finally, we have learned that the ability of the consumer to say "no" to high prices is a prerequisite to a functioning competitive market. Facilitating demand responsiveness will take federal investment in technologies such as real-time metering and pricing, as well as changes in consumer behavior to become more attuned to when energy is consumed. These three things, new supply, new transmission, and demand responsiveness, are necessary for workably competitive markets. Yet they are not on the near-term horizon. The consequences of allowing unfettered price levels without meaningful competitive discipline are unconscionable consumer hardship, and economic dislocation to small and large consumers alike.

There are valid objections to price caps. For example, it is argued that caps will inhibit new supply, or will not fully compensate suppliers. SMUD believes a price cap can be fashioned to address this objection by allowing exemptions for certain higher priced suppliers that are necessary for reliability, and by implementing a flexible cap that allows for changes in input prices, such as increases and decreases in the price of natural gas.

Further, the cap can be designed so that marginal costs of new efficient units fall well below the cap, thus providing additional incentives for new generation to replace old. SMUD has advocated such a price cap before the Federal Energy Regulatory Commission. A more detailed description of the SMUD proposal is attached to my remarks.

Again, remedies such as price caps are not the ideal solution. However, we are long past ideal solutions. Interim price caps can be made consistent with the goal of

continuing to move the industry forward on the path toward real competition, while ameliorating the certain consumer hardship that will be felt if no action is taken and prices remain at record high levels.

A New Look at Policing Market Behavior and Identifying Market Power

Competitive markets still need policing. For the past decade, the electric utility industry, at the urging of regulators, has developed increasingly complex markets. With a market the size of California, tens of millions of dollars are now won or lost in hourly trading. A billion dollars can change hands in a week when market participants exploit market rules during periods of tight supply.

Complex markets require active monitoring and a vigilant policing. The old regulatory structure of months-long proceedings followed by after-the-fact refunds is not well suited for the new market. Traditional measures of market power may not suffice to protect consumers from the exercise of market power in product markets that were never contemplated as part of integrated utility operation.

Markets must be examined for the potential exercise of market power before they are implemented. FERC and other regulators must have the expert staff necessary to monitor energy markets and identify abuses, and regulators must have the authority to impose penalties if anticompetitive practices are uncovered. These reforms may or may not require changes to current law, but they certainly require increased attention from responsible regulators. Competitive markets cannot be relied upon to police themselves.

Reform the Existing Hydroelectric Licensing Process

Hydropower is critical to the entire West. SMUD strongly supports the efforts of the Committee to streamline the licensing process for hydroelectric facilities. SMUD recommends, at a minimum, the following legislative reforms in the relicensing process to ensure protection of existing, reasonably priced hydroelectric generating resources.

First, federal and state agencies should adopt least cost alternatives to meet environmental objectives identified in relicensing. Recognizing the value of existing hydro resources, federal and state agencies should avoid, where possible, imposing operating conditions through relicensing that would result in reductions of capacity. Second, environmental review of federal and state agencies under various statutory authorities should be coordinated and streamlined. Third, there should be a statutory requirement that all license conditions be supported by sound science and subject to appropriate administrative review.

National Energy Policy Emphasizing Energy Efficiency, Diversity, and Supply

There is a desperate need for a national energy policy. The nation has enjoyed a long period of relative energy surplus. During that period, we lost focus on investment in energy efficiency, conservation, and new supply technologies. SMUD is a leader in this area, investing considerably more than the national average. Yet, even at SMUD the fear of competitive pressures in California resulted in reductions in the level of funding for these activities. Aggressive financing programs for efficient appliances have been scaled back. Appliance standards have stagnated while technologies are available to improve energy efficiency. While high market prices have allowed certain existing renewable technologies such as wind energy to look more competitive, investment in other technologies such as fuel cells and solar has lagged.

Federal energy policy must provide incentives for investment in energy efficiency and new supply. We are losing fuel diversity. In California and elsewhere, natural gas is virtually the only fuel choice for new generation. As we saw in California, electricity prices have become dependent on the price of one commodity, natural gas. The lack of fuel diversity also jeopardizes reliability due to an over dependence on the delivery of natural gas to fuel electric generators. Right now in California, there are threats of disruption of gas supply to electric generators, due to a lack of pipeline capacity, or to the

inability of the utility to buy enough gas to keep pipelines full. Electric generators are near the front of the line when gas curtailments are necessary, which means the electric supply shortage will be exacerbated.

These are matters of national concern. Scattered state or local programs cannot generate enough momentum to move new technologies forward, or to make significant strides in energy efficiency. A cohesive national energy policy is the best way to make meaningful improvements in these areas.

Conclusions

California's energy crisis has already caused significant economic dislocation in California, and has affected the entire Western region. Certain solutions are within California's grasp and responsibility. Long-term and more effective remedies require Federal action. In the short-term, SMUD advocates adoption of a regional price cap on an interim basis in order to stabilize regional wholesale markets. A regional price cap will provide the breathing room necessary in order for new generation and transmission to come on-line, so that the goal of a workably competitive market can be realized. In the longer-term, Congress can use the attention generated by the current crisis in California to highlight the need for a national energy policy, with increased emphasis on energy efficiency, conservation, and development of alternative energy sources to ensure greater fuel diversity.

If we take the opportunity to learn from mistakes made in California, we can emerge from the current crisis in a stronger position than when we entered.

Sacramento Municipal Utility District
Sliding Scale Regional Price Cap Proposal
FERC Docket No. EL00-95-000 etal
December 6, 2000

SMUD is concerned the FERC recommended soft-price cap proposal, while well intentioned will create more reliability problems for California then it will solve. This is because California is not an electric island, but rather a fully integrated electric participant in the Western States Coordinating Council (WSCC) grid comprising most of the western United States. Imposing a cap on a portion of the integrated grid creates arbitrage opportunities within the WSCC and could encourage power to be exported from California to other areas within the WSCC that are not encumbered with any price cap. Yet, as the Commission has found it is important to deal with the energy crisis in California and to take proactive steps to ensure such problems do not spread to other states within the WSCC. At the same time it is critical to provide sufficient monetary incentive to encourage development of much needed generation resources in the WSCC. Accordingly, SMUD offers for consideration the following conceptual proposal which builds upon the good ideas in the FERC Order and upon the load differentiated price cap evaluated by the ISO Board, in an attempt to balance the competing interests for just and reasonable consumer prices with sufficient incentive to encourage generation resource development.

SMUD's proposal is as follows:

1. The following price caps would only apply to transactions for the sale and purchase of electric energy for terms less than one month in duration and would apply until 12/31/2002, unless extended by the FERC. These price caps would apply to the entire WSCC

2. FERC approved Cost of Service Rates would be adopted for all thermal generation having a heat-rate (HHV) equal or greater than 14,000. Additionally, peaker plants under a 14,000 heat-rate could elect to apply for either a FERC approved Cost of Service Rate or play the market subject to the price caps. This election would be made for at least a one-year period and recognizes that peaker units often purchase gas supply in the daily spot market at prices that often are higher than the monthly Henry Hub index price used in determining the price caps. It is anticipated that if a peaker plant desires to pursue the cost of service rate approach, that the requested rate would be derived from a formula that includes a daily gas price index.

3. Two price caps would be adopted for all thermal units having a heat-rate less than 14,000 (HHV). One cap would be an On-peak price cap applying to all on-peak hours (as defined by the WSCC or their successor) and a different Off-peak price cap for all other hours.

4. The On-peak price would be calculated as follows:

   ((The product of the NYMEX Henry Hub gas price for the applicable delivery month (based upon the average of the closing price for the last three days of trading) times an imputed heat-rate of 20,000 Btu/kWh) plus $10/MWh.

   For example, if the January 2001 Henry Hub gas price was $7.00/MMBtu, the On-peak price cap for January 2001 would be:
   ($7 * 20) + $10 = $150/MWh

5. The Off-peak price would be calculated as follows:

   ((The product of the NYMEX Henry Hub gas price for the applicable delivery month (based upon the average of the closing price for the last three days of trading) times an imputed heat-rate of 14,000 Btu/kWh) plus $10/MWh.

   For example, if the January 2001 Henry Hub gas price was $7.00/MMBtu, the Off-peak price cap for January 2001 would be:
   ($7 * 14) + $10 = $108/MWh

The rationale for this approach is as follows:

- The cost of service rate is necessary to ensure the older more inefficient thermal units run during the approximate 5% of the hours when needed to meet peak load conditions and are able to recoup marginal costs including a reasonable rate of return. These units need to be differentiated from the newer more efficient units and should not be the "tail wagging the dog" for purposes of setting the market price.

- The imputed heat-rates of 20,000 and 14,000, on-peak and off-peak, respectively, provide significant margin above the actual heat rate for new units, which have actual heat-rates ranging from 6,800 to 8,500. This plus the adder of $10/MWh should be more than enough monetary incentive to encourage development of new generation, while at the same time providing some minimal price protection for consumers for a two year period.

- FERC precedent exists for establishing a region-wide price cap for power. The FERC has previously approved the Western State Producing Pool Agreement (WSPP), which used to establish a maximum rate that could be charged for short-term energy.

- Having the price cap apply only to energy transactions less than one month in duration creates further incentive for parties to negotiate longer-term agreements, supporting the Commission's Order to move most the energy transactions into the forward bilateral markets. This should also assist generation developers in obtaining financing by providing more price

certainty through negotiation of these forward contracts.

- The region-wide application of these price caps better parallels the physical reality of how power actually flows and should simplify scheduling between control areas by eliminating "ping-pong" and similar gaming schemes. This also facilitates locating generation where needed from a physical flow perspective rather than have localized price cap issues determine where new plants are sited.

- Utilizing Henry Hub as the gas variable, captures the variability of gas price in determining the price cap. It does not matter that gas at this location is not utilized to actually fuel plants in the WSCC. Sufficient heat-rate margin has been built in to the price-cap to capture the difference in gas price among regions, particularly when recognizing that nearly all baseload plants use a portfolio of gas contracts. These portfolios typically include multi-year, multi-month and monthly block purchases, with minimal purchases of gas in the daily spot market. The price differential between these longer term contracts and the Henry Hub prices are much less pronounced than daily spot prices, in fact in many months, portfolio prices are likely lower than the Henry Hub monthly index price. This Henry Hub contract is widely traded and generally recognized as the proxy for gas price in North America. This proposal also recognizes that peaker plants, by the unpredictable nature of their load, rely much more on daily spot gas purchases. This is equitably addressed by offering peaker plants, irrespective of heat-rate, the option of seeking a FERC approved Cost of Service rate which includes the cost of gas purchased on a daily basis.

Please contact Tom Ingwers of SMUD at (916)732-5704, or Jim Tracy of SMUD at (916)732-6492, if you have questions or comments about this Sliding Scale Regional Price Cap Proposal.

Clean Coal Technology

DOE003-0172

Resolution: 01-5
Sponsor: Richmond Power and Light

Support for Clean Coal Technology Research and Development

Our quality of life is inextricably linked to an abundant, reliable and affordable supply of energy. Americans, on whole, have lived prosperous lives largely due to a booming economy powered by electricity. Electricity powers the tools and machinery of our factories that make up the old and current economy and the computers and services that drive the new economy.

Today, more than one half of U.S. electricity is generated from coal-based power plants. As the modern technology economy grows, so goes electricity demand. By the year 2020, the Energy Information Administration projects that U.S. electricity consumption will grow on average 1.8% annually, and coal will continue to generate half of all the electricity produced.

In the wake of the ongoing energy supply shortages and reliability concerns occurring in various regions of the country, there is increasing recognition that new electric capacity is needed. Due to its availability and affordability, coal offers numerous advantages over other fuel sources in meeting these energy demands. The challenge facing future coal use is to convert it into a cleaner, more efficient resource. While overall emissions for U.S. coal-based generating plants have been reduced by over 20% over the last 30 years, electricity produced from coal has tripled and pressure exists to further reduce emissions.

Congress and the Administration should promote programs and initiatives to preserve a diversity of fuel supply through affordable and reliable electricity. An important step toward meeting this goal is the creation of advanced coal technology programs to improve the emissions from coal-based generating plants. Legislation has been introduced to provide incentives to develop advanced clean coal technologies. S. 60, "National Electricity and Environmental Technology Act" by Senators Robert Byrd (D-WV) and Mitch McConnell (R-KY), among others, would authorize the Department of Energy to develop and deploy clean coal technology programs for both existing and new coal-generating facilities. Specifically, the bill would:

- Accelerate technology research and development for new and existing coal-based generation facilities.
- Provide tax incentives to privately-owned utilities and their equivalent in the form of tradable or refundable credits for not-for-profit utilities to pursue clean coal technologies for emission reductions and efficiency improvements in existing facilities.
- Similar financial incentives would be provided for early commercial application of advanced coal-based generating technologies

NOW, THEREFORE, BE IT RESOLVED: That APPA urges Congress and the administration to stimulate the development and use of advanced technologies that will allow the U.S. to utilize its most abundant energy resource, coal, to help meet the growing demand for clean, affordable, and reliable electricity; and

BE IT FURTHER RESOLVED: That APPA supports legislation that provides incentives to encourage the retrofitting and repowering of existing coal-based generating units with state-of-the-art emission control technologies. Such legislation should include tax credits for private electric utilities and their equivalent in the form of tradable or refundable credits for not-for-

profit electric utilities, for emission reductions and efficiency improvements in existing coal-based generating facilities and for early commercial applications of advanced coal-based generating technologies; and

BE IT FURTHER RESOLVED: That APPA supports the pursuit of accelerated technology R&D programs for the development of the next generation advanced clean coal based generation facilities, and will encourage the Department of Energy, EPA, EPRI, and other related organizations to increase their support in these activities.

Approved by the APPA Legislative and Resolutions Committee, February 5, 2001.

Energy and Environmental Principles

Resolution: 01-3
Sponsor: APPA's Energy and Environment Task Force

Public Power's Energy and Environmental Principles

In the 21st century, how we achieve our environmental goals will have a tremendous effect on energy supply and security as well as economic growth. The American Public Power Association (APPA) feels strongly that we should not lessen or compromise our commitment to environmental quality. As a nation, however, we should not be required to choose either environmental protection or energy security. Public power believes that we must find solutions that address both of these priorities without sacrificing either.

Our past approaches both to regulation and resource development have been inconsistent with today's challenges and opportunities. Often we make environmental, economic, or energy policy decisions to accomplish single-purpose objectives, with little regard to the impact on other national priorities. The key to success is to establish a balanced approach. If our decision-makers will take a broader, global and modern perspective to environmental and energy concerns, America can establish and pursue strong environmental policies while sustaining a cleaner, but diversified generation resource mix.

APPA is proud of its long-standing support for attainment of our national environmental goals. As locally controlled entities, our members are highly responsive to community and consumer needs. A priority concern shared by all consumers is the desire to protect and enhance America's environment. We share this concern and have consistently supported those policies that will lead to development of cleaner fossil generation and renewable energy.

We call upon Congress and the Administration to address environmental concerns on an inclusive basis, with a full understanding and evaluation of the impacts and opportunities that decisions have on energy supply, energy security, and economic growth. In this regard, APPA has prepared a set of overarching principles designed to guide the development of energy and environmental policy.

NOW, THREFORE, BE IT RESOLVED: That APPA calls for the development of energy and environmental policies that provide for achieving both environmental quality and energy goals by taking into account, among other considerations, the following factors:

- Human health
- Environmental protection
- Electric reliability
- Energy costs
- Technology-based and incentives-driven solutions; and

BE IT FURTHER RESOLVED: That America's economic well-being depends on a diverse, balanced, cleaner, more efficient and economical energy mix that promotes energy conservation and includes coal, oil, gas, nuclear, hydropower and other renewable sources of energy; and

BE IT FURTHER RESOLVED: That proper implementation of environmental goals must be based on sound science, include cost-effective approaches, and provide quantifiable benefits; and

BE IT FURTHER RESOLVED: That in the interest of consumers, local and state governments should be afforded maximum flexibility in devising strategies to meet environmental standards.

Approved by the APPA Legislative and Resolutions Committee, February 5, 2001.

Multi-pollutant Strategy

DOE003-0178

THE WHITE HOUSE

WASHINGTON

March 13, 2001

The Honorable Larry E. Craig
United States Senate
Washington, D.C. 20510

Dear Senator Craig:

Thank you for your letter of March 6, 2001, asking for the Administration's views on global climate change, in particular the Kyoto Protocol and efforts to regulate carbon dioxide under the Clean Air Act. My Administration takes the issue of global climate change very seriously.

As you know, I oppose the Kyoto Protocol because it exempts 80 percent of the world, including major population centers such as China and India, from compliance, and would cause serious harm to the U.S. economy. The Senate's vote, 95-0, shows that there is a clear consensus that the Kyoto Protocol is an unfair and ineffective means of addressing global climate change concerns.

As you also know, I support a comprehensive and balanced national energy policy that takes into account the importance of improving air quality. Consistent with this balanced approach, I intend to work with the Congress on a multipollutant strategy to require power plants to reduce emissions of sulfur dioxide, nitrogen oxides, and mercury. Any such strategy would include phasing in reductions over a reasonable period of time, providing regulatory certainty, and offering market-based incentives to help industry meet the targets. I do not believe, however, that the government should impose on power plants mandatory emissions reductions for carbon dioxide, which is not a "pollutant" under the Clean Air Act.

A recently released Department of Energy Report, "Analysis of Strategies for Reducing Multiple Emissions from Power Plants," concluded that including caps on carbon dioxide emissions as part of a multiple emissions strategy would lead to an even more dramatic shift from coal to natural gas for electric power generation and significantly higher electricity prices compared to scenarios in which only sulfur dioxide and nitrogen oxides were reduced.

This is important new information that warrants a reevaluation, especially at a time of rising energy prices and a serious energy shortage. Coal generates more than half of America's electricity supply. At a time when California has already experienced energy shortages, and other Western states are worried about price and availability of energy this summer, we must be very careful not to take actions that could harm consumers. This is especially true given the incomplete state of scientific knowledge of the causes of, and solutions to, global climate change and the lack of commercially available technologies for removing and storing carbon dioxide.

Consistent with these concerns, we will continue to fully examine global climate change issues – including the science, technologies, market-based systems, and innovative options for addressing concentrations of greenhouse gases in the atmosphere. I am very optimistic that, with the proper focus and working with our friends and allies, we will be able to develop technologies, market incentives, and other creative ways to address global climate change.

I look forward to working with you and others to address global climate change issues in the context of a national energy policy that protects our environment, consumers, and economy.

Sincerely,

George W. Bush

Resolution: 01-4
Sponsor: APPA Energy and Environment Task Force

In Support of a Multi-pollutant/Integrated Approach to Air Quality and a Greenhouse Gas Strategy

Air quality and other environmental issues are likely to play a prominent role in the 107th Congress. In addressing air quality, there is considerable discussion over taking a comprehensive, incentives-based approach to tougher regulation of air emissions. Key elements include an integrated program for controlling multiple air pollutants (NOx, SO_2, and mercury), using market-based mechanisms, and reform of existing regulations to achieve emission reductions at lower costs while assuring electric reliability, reasonable electric costs, and energy security.

Some advocate the inclusion of greenhouse gas emissions controls as part of a multi-pollutant emissions reduction approach. In contrast, the American Public Power Association (APPA) believes that a greenhouse gas strategy should be developed as a separate program that considers both the discrete characteristics of greenhouse gases (as distinct from identifiable public health consequences of pollutants) and the need to address greenhouse gases. Unlike health-based pollutants that have measurable cost/benefit ratios and emissions reduction technologies that take these into account, there are no similar benchmarks by which to measure the costs and benefits of carbon capture technologies available to assist industry and policy makers in establishing policies for the reduction of these gases.

Given this uncertainty, APPA believes the Federal government should evaluate and develop an incentive program for greenhouse gas emissions reduction, and work with all industries to develop carbon capture, sequestration and avoidance technologies. The technological challenges posed by carbon dioxide (CO_2) reductions, the fact that CO_2 is not a pollutant that poses imminent health risks, and the fact that CO_2 emissions and reduction policies are directly coupled to electricity generation and energy policy, strongly suggest placing any federal oversight or management responsibility of such gases within the U.S. Department of Energy.

NOW THEREFORE, BE IT RESOLVED: That the American Public Power Association will actively participate in the ongoing air quality debate in order to emphasize the need to develop energy and air quality policies that assure achievement of both environmental quality and energy security goals; and

BE IT FURTHER RESOLVED: That Congress and the Administration should address simultaneously environmental, energy and air quality goals by pursuing a multi-pollutant approach for regulated pollutants with maximum flexibility. For controlling health-based air emissions, air regulation should continue to move away from unit-by-unit, command and control approaches to approaches that integrate flexible programs such as emissions cap and trade programs; and

BE IT FURTHER RESOLVED: That climate change programs should include all greenhouse gases, be based on sound science and take into account that emissions that might affect climate change are distinct from emissions characterized as pollutants, which have a clearly defined and well understood effect on public health. Greenhouse gas emission reduction programs should focus on commercializing existing greenhouse gas emissions reduction technologies, which are

limited in their ability to reduce all greenhouse gases, and on developing the next generation technologies for producing electricity and reducing all greenhouse gas emissions; and

BE IT FURTHER RESOLVED: That any federal climate change program designed either to address greenhouse gas concerns or to promote the development of technology or competitively neutral incentive-based solutions should be administered by the U.S. Department of Energy.

Approved by the APPA Legislative and Resolutions Committee, February 5, 2001.

Issue Brief

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Air Quality Proposals
March 2001

Summary: There is growing recognition and increasing support for the need to take a holistic approach to energy supply and air quality as Congress begins reviewing proposals to reauthorize the Clean Air Act. Proposals under serious consideration would provide for a comprehensive, incentives-based approach to tougher regulation of air emissions. Key elements include regulation of multiple air pollutants (NOx, SO_2 and mercury), using market-based mechanisms and reforming existing regulations.

At the same time, there is increasing interest in developing strategies for reducing greenhouse gases (ghgs) to address climate change concerns. Under discussion are plans that would provide targeted incentives for entities that voluntarily reduce emissions and a federal incentives program for research and development for technologies to capture or sequester ghgs. Another strategy that has attracted some congressional interest and industry criticism is a proposal to include CO_2 in a multi-pollutant cap and trade program.

Regulatory and Congressional Action: In addition to the numerous requirements imposed by the Clean Air Act on electric utilities to tighten emissions of criteria pollutants, a number of congressional proposals introduced in the 106th Congress would limit CO_2 emissions. Both Democrats and Republicans in the House and Senate introduced legislation to cap carbon emissions at 1990 levels. One proposal by Rep. Henry Waxman (D-CA) was supported by over 100 cosponsors. Also under consideration was a multi-pollutant cap and trade bill that would include CO_2. It is likely that Senator Smith (R-NH), Chairman of the Senate Environment and Public Works Committee, will sponsor similar proposals in the 107th Congress. Already this year, new House Science Committee Chair Boehlert (R-NY) introduced H.R. 25, legislation that would require emission reductions of sulphur dioxide and nitrogen oxide from 50 to 70 percent of 1990 levels.

Background: The primary driver of this legislative activity is private electric utility concern over new source review (NSR) litigation with the U.S. Environmental Protection Agency (EPA). Some companies are seeking to resolve their current NSR litigation with EPA through a multi-pollutant bill including SO_2, NOx, mercury and CO2, a non-pollutant greenhouse gas. Potential fines amount to hundreds of millions of dollars for some of these companies. In addition, these companies see an opportunity to obtain both a competitive advantage and to gain financially under this legislative approach. It is instructive to note that high SO_2 emitting utilities received the vast majority of SO_2 allowances in the initial Acid Rain Title of the 1990 Clean Air Act. These same companies probably see a similar opportunity in a multi-pollutant cap and trade system with CO_2 that will award the greatest number of allowances to coal plants.

APPA

The American Public Power Association is the national service organization representing the nation's more than 2,000 local publicly owned electric utilities.

APPA Position: APPA is proud of its long-standing support for attainment of our national environmental goals. As locally controlled entities, our members are highly responsive to community and consumer needs. A priority concern shared by all consumers is the desire to protect and enhance America's environment. We share this concern and will support policies that will result in the development of cleaner fossil generation and renewable energy.

In a recent report it was found that public power systems, across the board, have lower emissions of pollutants. It is also true that public power generating utilities own a proportionately higher number of scrubbed units. Therefore, public power systems, as a whole, have invested more in cleaner energy resources and technology than other electric utility sectors.

APPA calls upon Congress and the Administration to develop air quality proposals in concert with energy policy goals. On this basis, decision-makers will have an opportunity to fully understand and evaluate the impact and opportunities decisions made for one set of goals will have on other objectives. Along these lines, Congress should pursue multi-pollutant approaches for regulated pollutants with maximum flexibility afforded local and state decision-making authorities. Air regulation in general should move away from a unit-by-unit, command and control approach to one that integrates flexible programs.

On the question of including ghg controls in a multi-criteria pollutant approach, APPA believes that ghg reduction strategies should be developed as a separate program that recognizes ghg emission impacts. This approach recognizes both the discrete characteristics of ghg from health-based pollutants and the need to address ghg emissions. In general, Congress should develop voluntary and incentives-based climate change proposals that include all greenhouse gases and focus on providing greater federal support for research and development. Specific incentives should be developed both to help deploy existing technologies for carbon capture and to develop the next generation technologies for producing electricity.

Other Issue Briefs

Issue Brief

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Existing "Private Use" Tax Laws Inhibit Electricity Competition and Development of Stronger, More Reliable Markets

March 2001

Summary: The evolution of the electric utility industry, rapidly changing developments in wholesale electricity markets and increased competition have created a situation where the federal tax code private use restrictions hamper public power's ability to adjust to emerging energy policies and adapt to a more volatile energy market. These private use restrictions decrease the flexibility that public power systems need to respond to wholesale competition at the federal level and improve the reliability of regional markets and the national bulk-power grid. In addition, as community-owned electric utilities in states that have restructured their retail electric utility markets take steps to conform their operations to these new state policies, they are immediately confronted with greater challenges from the federal tax code.

Collectively, public power has approximately $72 billion in outstanding tax-exempt bonds. In most cases, implementation of state restructuring plans—and even Federal Energy Regulatory Commission (FERC) policies designed to provide open transmission access for competitive wholesale markets—will jeopardize the financial standing of these public power communities and harm millions of bondholders across the U.S. Specifically, if community-owned utilities participate in competitive markets and violate private use restrictions, their outstanding tax-exempt bonds could become retroactively taxable to the date of issuance.

Three years ago, the Internal Revenue Service (IRS) issued temporary rules to attempt to address some of the private use problems and provide clarity, but instead of finalizing the rules, a slightly modified and temporary version of the rules was reissued in January 2001. The lack of permanent rules hinders the ability of public power systems to develop long-term strategies necessary to participate fully in the fast-moving electricity marketplace. Legislation is needed to remedy the situation and provide the necessary certainty for systems to make decisions about how new facilities may be financed and how to operate in today's electric utility market.

The Private Use Problem Clearly Defined: Under current federal tax law, electric utilities owned and operated by units of state and local government ("community-owned utilities") issue tax-exempt bonds to finance their capital investments. These bonds are subject to the private use rules in the federal tax code designed to prevent private parties from benefiting from lower-cost tax-exempt financing. These private use rules impose two significant restrictions on community-owned utilities with tax-exempt financed transmission and generation facilities:

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1. The private use rules severely limit the ability of community-owned electric systems to sell power (from tax-exempt financed generation facilities) to individual customers on negotiated terms; and

2. The rules severely restrict the use of community-owned utilities' transmission facilities by private businesses, including investor-owned utilities and power marketers, and could prevent the transfer of control of these facilities to third party, independent grid management organizations.

Both problems discourage community-owned utilities from embracing electricity restructuring and form a barrier to open and efficient electricity markets at both the wholesale and retail level. These problems, and the need for flexibility from private use restrictions, make it impossible for community-owned utilities to compete, even for their own existing customers, or to open up their transmission and distribution facilities to third parties.

Financial Implications are Severe: If community-owned utilities permit too much "private use," bondholders will retroactively lose the tax-exempt status of their investments and the utilities will be forced to redeem some or all of the bonds. Hundreds of communities nationwide will have to reimburse bondholders for their losses in addition to suffering increased financing costs for both existing facilities and future borrowings.

Legislative Status and History: The ***Bond Fairness and Protection Act (BFPA)*** was bipartisan legislation introduced on behalf of public power in the first session of the 106th Congress by Senators Slade Gorton (R-WA) and Bob Kerrey (D-NE) and Representatives J.D. Hayworth (R-AZ) and Bob Matsui (D-CA). Although the bill was not enacted into law during the 106th Congress, support for the BFPA grew considerably during the session, reaching 34 Senate co-sponsors and 131 House co-sponsors. The House Energy and Power Subcommittee included provisions of the BFPA in its comprehensive electricity restructuring legislation, H.R. 2944, and a hearing on energy tax issues was held in the Senate Finance Long-Term Growth, Debt and Deficit Reduction Subcommittee in October 1999. In addition, a wide variety of other entities publicly endorsed the BFPA, including seniors organizations, environmental groups, investor-owned utilities, state and local organizations, as well as individual companies such as Alcoa, Praxair, and Enron Corporation.

The BFPA would preserve local decision making about how to use tax-exempt bonding authority. It would allow each community owned electric system to "elect" to obtain relief from private use limits, but only if it also elects to forego the right to issue tax-exempt bonds for new generation facilities in the future. The bill provides each community two choices:

1. Lift the private use test on outstanding bonds (i.e., grandfather existing bonds), but only if the utility agrees to never again issue tax-exempt bonds to build new generation facilities, or

2. If no private use relief is needed, the utility can continue to issue tax-exempt debt under a clarified version of the existing private use rules.

This legislation was crafted to accomplish two objectives: a) permanently clarify existing tax laws and regulations regarding the private use rules so that they will work in a new competitive marketplace, and b) provide public power utilities the ability to open their transmission or distribution systems if they choose or as may be required by law. Both of the above would provide for more competition, prevent existing tax-exempt bonds from becoming retroactively taxable and keep rates low.

Throughout the 106th Congress, other sectors of the electric utility industry were also advancing legislative proposals related to their transitional tax needs. For example, the investor-owned utilities sought resolution of problems associated with the transfer of nuclear decommissioning funds and the formation of regional transmission organizations (RTOs). These issues, including private use and the BFPA, were the cause of substantial contention within the electricity industry. Realizing that the opportunity for legislative success would be greatly improved by resolving differences on the most contentious issues, representatives of public power and investor-owned utilities reached an agreement that allowed the two groups to combine these issues in a single bill that all could support.

This new legislation was introduced in July 2000 as the ***Electric Power Industry Tax Modernization Act*** by a large bipartisan delegation of House and Senate members, including Representatives J.D. Hayworth, Phil English, Jerry Weller, Bob Matsui and Richard Neal and Senators Frank Murkowski, Slade Gorton, Bob Kerry and James Jeffords. The bill gained quick support from members of the tax-writing committees in Congress, but ultimately fell victim to end-of-session wrangling over the size and scope of a major tax package. The bill will be reintroduced in the 107th Congress, probably during February 2001, with minor changes. This legislation offers a balanced approach to a fair and open marketplace by addressing four major issues:

- private use relief
- nuclear decommissioning transition
- promotion of sales or spin-offs of transmission assets to FERC-approved RTOs/Transcos
- equal treatment for Contributions in Aid of Construction (CIAC)

APPA Position: Greater volatility and competition in wholesale and retail electricity markets has created a situation where public power systems need more flexibility to adapt to changing circumstances. A balanced marketplace will include a variety of electricity suppliers, and each type of market participant (private utilities, electric cooperatives and community-owned electric providers) faces barriers to participation in competitive markets. Municipal financing concerns and private use restrictions are barriers that must be addressed as part of a reasonable approach to a fair and open marketplace. The ***Electric Power Industry Tax Modernization Act*** is a legislative solution that makes political and economic sense. This legislation, along with the rural cooperatives' 85/15 rule, should be packaged together and enacted by the 107th Congress.

Issue Brief

Reliability
March 2001

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Summary: The United States has the most reliable electric system in the world, but recent events in California have demonstrated the delicate balance between reliability and markets that the electric grid must operate within. These events have also shown how unsettling the results can be if that balance is upset because to most consumers, reliability, knowing that the power will be there when they need it, is as important as low prices. Consequently, great care needs to be taken to ensure that the current level of reliability is not sacrificed in any restructuring of the industry. A competitive marketplace means many more participants will be executing an increasingly larger number of transactions every day, and most of these will focus on short-term costs rather than system stability. The current voluntary system of compliance with reliability standards worked reasonably well in the regulated environment in which the industry has operated, but will not provide the necessary safeguards is a competitive market. APPA urges Congress to require mandatory involvement by all industry participants in a national compliance program to ensure continued reliability.

It's More Than Just Turning on the Lights: The commodity of electricity is provided and consumed in virtually an instantaneous process. There are no large storage facilities scattered across the countryside for electricity already generated (as is the case with our water supply). Instead, the industry consists of a series of generating plants, high-voltage transmission wires and substations with transformers that reduce the voltage to levels that consumers can use. Operating a reliable electric system requires that two simultaneous conditions be present: adequacy and security. *Adequacy* is a measure of the capacity of the power supply facilities (generation and transmission) relative to the electrical load (demand) that they serve. A system with adequate operating reserves will have the strength to withstand system disturbances. *Security* refers to the balanced operating state of the system in terms of stability and loadings. Planners make protective decisions designed to limit the extent of system disturbances, and operators watch real-time conditions to ensure that an outage of a critical system component does not cause a sequential series of malfunctions. These necessary technical limits constrain the maximum capacity of the system and restrict the scope of the market available to suppliers and customers to that which is safe and reliable.

NAERO and the Evolving Reliability Structure: To ensure the reliability of the industry, the electricity delivery system of the United States (actually North America) is divided into ten regional reliability councils operating within three large interconnected grids. The ten regions are politically organized and represent the heart of the voluntary reliability system that currently operates. The three interconnected grids are differentiated along engineering lines and distinguish the large areas in which generated electricity can flow. The regional councils together form the North American Electric Reliability Council (NERC).

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NERC is a non-profit, voluntary organization whose staff and activities are directed by a Board of Trustees. The Board currently is comprised of 38 electric industry executives, including the Board's officers, two representatives from each Regional Council, two electricity customer representatives, and others as needed to ensure at least two representatives from Canada and at least two representatives from each sector of the electric industry. NERC monitors the electric utility industry's voluntary compliance with policies, standards, principles, and guides, and assesses the future reliability of the bulk electric systems.

The NERC Board has approved and begun the transformation of NERC to the North American Electric Reliability Organization (NAERO), in which participation and acceptance of standards and practices would be mandatory. Federal legislation is required to give NAERO the enforcement tools necessary to ensure compliance and achieve a system that properly balances reliability and market pressures and decisions. An industry-wide effort to forge compromise on such legislation resulted in a proposal that was adopted by NERC's Board of Trustees and was advanced to Congress.

Reliability and the Evolving Markets: Deregulation of the wholesale electricity market has increased pressure on the transmission system in order to facilitate the trades and contracts that often span large areas across the 10 NERC regional councils. During each of the last two summers, severe price spikes occurred in the Midwest during peak demand season. Similar incidents took place in California ancillary markets. Some market participants point to the deregulated wholesale market and incomplete transition of the industry as reasons for the spikes, and argue that increased retail competition will solve pricing problems. However, most industry analysts believe generation problems (such as plants being placed off-line) and transmission limitations have had a greater influence. Others believe that market power abuses limiting access to certain transmission lines have also played a role.

The same forces that are driving NERC to change to NAERO and institute more definitive standards with enforcement powers are also driving the formation and use of Regional Transmission Organizations (RTOs) in state restructuring efforts and among regional operation councils to ensure a fair transmission/market relationship. Independent System Operators (ISOs) are a form of RTOs that operate on a non-profit basis to serve as impartial electricity "traffic cops" working to make sure that electricity promised through market agreements can be delivered without disruption to the regional transmission system the RTO serves. In an ISO, the existing owners of the infrastructure continue to own the lines, but cede operational and scheduling control to the ISO. Instead of ISOs, some private utility companies are pushing for the creation of "transcos," or for-profit transmission companies created through spin-offs or mergers of the transmission assets of private companies. Presumably separate boards would govern the transcos, but the level of independence from the parent company is, at times, questionable.

Whether it be an ISO or a transco, the creation of regional transmission authorities must be approved by the Federal Energy Regulatory Commission (FERC), which oversees and regulates the transmission and wholesale market activity of the industry. The issuance of

FERC Order 2000 in December 1999 provides further guidance as to how FERC intends to act in the approval of RTOs. While participation in RTOs is voluntary, FERC strongly encourages all participants to enter or form an RTO, and it intends to approve RTOs that meet strict criteria for independence, geographic scope, proper size, and that are able to address and maintain the highest reliability standards. FERC may also use mandatory participation in an RTO as a condition of merger approval.

Further evidence of the need to use RTOs to assist in maintaining grid reliability is offered by a recent report from the U.S. Department of Energy. The report found that "development of reliability management tools, technologies and operating procedures has lagged behind economic reforms in the electric industry." Properly created, independent RTOs can perform many of the basic scheduling and planning functions that the report indicated were critical in maintaining the reliability of a regional system. This was supported by findings in the report that "responsibility for comprehensive planning has become blurred during the electric power industry's transition (to competition), and consequently planning has been inadequate," and that the necessary innovations in grid management have not kept pace with economic developments.

Congressional Action: Reliability concerns were a significant part of the legislative discussions that took place within the development of H.R. 2944, the restructuring bill passed in October 1999 by the House Energy and Power Subcommittee. The industry consensus legislative language to form NAERO was included in this legislation as Title II. Senator Slade Gorton (R-WA) and Representative Al Wynn (D-MD) also introduced the consensus language in the 106th Congress as free-standing bills, S. 2071 and H.R. 2602, respectively. After deliberations by the Senate Energy and Natural Resources Committee, S. 2071 emerged as the only electricity policy measure for which consensus could be achieved, and the bill eventually was passed unanimously on the Senate floor, only to stall in the House.

During the development of H.R. 2944, state utility commissioners and related groups brought up several issues (in the form of amendments) that work against national standards and reserve too much authority at the state level, such as establishing a single-state Affiliated Regional Reliability Entity (ARRE). Other language that was not a part of the original industry consensus related to FERC's ability to establish interim procedures and standards, is also problematic. Negotiations occurred between supporters of the NERC/NAERO legislation, including APPA, and state and regional interests, but despite progress, final agreement was not reached on how to resolve some of these issues. Legislative text that embodies the negotiations was later included in a version of the bill that Representative Wynn reintroduced as H.R. 4941.

Early in the 107th Congress, the text of last year's S. 2071 was introduced by Senator Gordon Smith (R-OR) on a stand-alone basis as S. 172. Representative Wynn re-introduced his version of the package this year as H.R. 312. In addition, Senate Energy and Natural Resources Committee Chairman Frank Murkowski (R-AK) has included the Wynn Bill in his broad, energy policy package.

APPA Position: APPA believes that reliability issues are paramount in any restructuring legislation. Toward that goal, APPA participated in the development of and supports the NERC/NAERO transition legislation. At the same time, APPA believes that federal legislators should address a number of interrelated issues critical to effective wholesale restructuring in order to address broader reliability concerns. APPA can support passage of stand-alone NERC/ NAERO transition legislation if it is clear that no more comprehensive restructuring legislation will pass. APPA supports continued attempts to resolve the few remaining differences related to the proper role of regional transmission organizations.

Issue Brief

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Clean Air Act – Significant Regulatory Activities
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Summary: Environmental regulatory activities under the Clean Air Act are going in the direction of significantly tighter emission limitation standards. Recent court actions have delayed the implementation schedule for some of these tighter standards but as a practical matter have not changed the overall direction of the regulations. EPA also is becoming increasingly aggressive in taking enforcement actions against electric utilities it believes are violating CAA requirements. For example, in November 1999 EPA initiated seven lawsuits against electric utilities and issued an administrative order against the Tennessee Valley Authority for alleged violations of the CAA New Source Review requirements.

In addition to new requirements for further emission reductions, EPA also has increased monitoring and reporting requirements for electric utilities. For example, the agency required additional mercury sampling and reporting in 1999, placed electric utilities with coal or oil-fired generating plants under its Toxic Release Inventory (TRI) reporting program, and significantly lowered the TRI reporting thresholds for some chemicals.

New and proposed regulatory requirements will result in increased pressure on all sources to reduce emissions – including APPA members with large and small electric generators. The problems faced in complying with new emission reduction requirements are made more difficult by the fact that the formal regulatory process is proceeding down several parallel but independent paths. The results likely will be an incremental ratcheting of emission reduction requirements over time with no assurance that the high cost of installing new emission control equipment will be fully recovered before becoming insufficient to meet future needs.

Regulatory Action: EPA currently is in the process of developing several new stringent standards and other emission reduction requirements under the Clean Air Act. The final outcome of these rulemaking proceedings will affect the extent to which utility power plant emissions are targeted for further reductions. Below is a list of some of the major ongoing environmental regulatory activities under the CAA.

In July 1997, EPA issued stringent new **National Ambient Air Quality Standards (NAAQS)** for particulate matter and for ozone. In May 1999, the U.S. Court of Appeals remanded the rule back to the agency for further justification of the levels at which the standards were set. The case has been appealed to the U.S. Supreme Court and a decision is expected sometime in the first half of 2001. Meanwhile, the agency has been directed to justify why it did not adopt a 5-minute standard for SO_2 and has been threatened with litigation if it does not proceed with

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regulation of CO_2 as a danger to the public health and welfare. Each of these actions may lead to more stringent standards and further requirements for additional emission reductions from power plants. While states have the ability to meet the requirements by reducing emissions from the sources they choose, utilities and large non-utility point sources are the most likely targets.

Regarding **pollution transport issues**, in December 1999 EPA issued a revised final rule granting petitions filed by four Northeastern states seeking to reduce ozone pollution through reductions in NOx emissions from upwind sources. The petitions, filed under Section 126 of the CAA, allow downwind areas to seek relief across state boundaries. As a result of EPA's action, 392 utility and industry facilities in 12 upwind states will have to significantly reduce annual emissions of NOx by 2003. The agency said it also plans to address four other outstanding petitions in a separate action in the near future.

In 1998 EPA issued tough new requirements on 22 states and the District of Columbia that also are designed to address the **regional transport of ozone** in the Eastern part of the U.S. The agency's new regulations set a NOx budget for each state that will have the effect of significantly reducing NOx emissions from sources in that state, including affected electric generating sources. The regulations called for the states to submit state implementation plans (SIPs) by October 2000 that describe how they will achieve the reductions by May 2004. The rule is controversial because it is based on a collective contribution theory that set very low air quality impact levels (as little as 2 parts per million) and used a $2000 per ton cost threshold for establishing uniform reduction levels. Last June, the U.S. Court of Appeals upheld the rule and affirmed EPA's authority to implement the reduction obligations.

In April 1999 EPA issued its **final regional haze rule** creating a regulatory program that dramatically expands the previous visibility program. Under the new rule, all 50 states must establish goals for improving visibility and develop long-term strategies for reducing emissions of air pollutants that cause haze. States are required to conduct analyses aimed at reaching natural background conditions by 2064. EPA is encouraging states to subject existing large stationary sources (including utility boilers) to additional emission controls and place tight controls on new sources as a way of achieving the required reductions. In January of this year, EPA proposed amendments to its rule that would help states determine how to set limits for a number of older, large utility plants. The proposal also provides guidance for states to use in determining which plants must install emission controls and the type of controls they must use.

In July 1998, EPA proposed **New Source Review (NSR) regulations** that would broaden significantly the applicability of NSR requirements to major stationary sources of pollution. In addition, through a series of administrative and enforcement actions over the past two years – and without giving any opportunity for public comment – EPA has been reinterpreting the NSR rules so as to impose NSR requirements on many existing facilities that heretofore were not subject to the requirements. In November 1999, the Justice Department, acting on behalf of EPA, filed seven lawsuits against electric utility companies in the Midwest and the South and issued an administrative order against TVA. The agency also issued notices of violations to eight other facilities. EPA is alleging that the utilities violated the CAA NSR provisions by making major modifications to their plants without installing the equipment required to control emissions. Two of the utilities subject to the enforcement actions have since reached settlement agreements that reportedly will require billions of dollars in expenditures to install additional control equipment and make other changes to reduce emissions from their facilities.

Meanwhile, the agency is gathering additional information from other utilities. EPA's actions likely are in anticipation of issuing additional notices of violations and possibly also filing additional lawsuits.

After completing several major studies, on December 15, 2000, EPA finalized its **determination that the risks associated with mercury emissions from fossil fuel-fired power plants warrant additional controls**. In July 2000 the National Academy of Sciences issued a report supporting EPA's reference dose, the subject of much controversy, as scientifically justifiable for protecting the health of the vast majority of Americans. Also, in November 1998, in an effort to address some of the remaining uncertainties in its studies, EPA required electric generating facilities to collect and report on the mercury content of coal burned at their facilities, and required 84 plants to perform stack testing to measure mercury emissions. The agency now is developing alternative control strategies for reducing mercury emissions from power plants and will propose regulatory requirements by November 2003.

APPA Position: APPA fully supports the public's right to clean air and endorses the goals and objectives of the Clean Air Act to protect human health and the environment. APPA believes that this fundamental commitment to the environment, however, must be balanced by the responsibilities and obligations that public power has to the local citizens that own and are served by its electric systems. APPA urges EPA, therefore, to avoid implementing new emissions reduction requirements that cause substantial resource expenditures wholly incommensurate with any anticipated human health benefits.

In addition, APPA is concerned that EPA has not fully considered the affects of implementing its CAA regulatory programs on small municipal electric systems with small generating units. EPA's new programs may adversely and disproportionately affect small communities by requiring costly and unnecessary new emissions reduction equipment to be installed on small units or by imposing significant additional administrative burdens without providing meaningful environmental benefit. APPA believes that small communities should be able to use their small units efficiently and contribute to congressional and regulatory efforts to create a more competitive electric utility industry – if doing so will not result in any environmental detriment.

APPA also supports efforts to bring a rational approach to what currently is an uncoordinated patchwork of new Clean Air Act regulatory requirements. APPA believes that additional ways of minimizing the potential for stranded investments and reducing the uncertainties of incremental ratcheting of emission reduction requirements must be identified and implemented wherever reasonably practical. Furthermore, APPA believes that EPA's regulatory process under the CAA should not proceed in a vacuum. It must be an integral part of a national energy strategy that addresses such diverse issues as environmental impact minimization, electric utility industry restructuring efforts, and the potential for carbon reduction requirements due to climate change considerations.

Finally, APPA fully supports the public's right to have access to accurate and meaningful information regarding the presence and release of toxic substances – as well as any other emissions that may reasonably pose risks to the public health and environment. APPA believes that requirements for reporting such information, however, must have the effect of improving public knowledge and not lead to grossly erroneous conclusions about the impacts of these emissions –causing unwarranted concerns by the public.

Issue Brief

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Hydropower Licensing and Relicensing Regulation
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Summary: Hydropower is the nation's leading renewable energy resource. In addition to providing emission-free, reliable and domestic-based energy, hydropower contributes non-power benefits such as recreation, irrigation, flood control and water supply. Despite these numerous benefits, hydropower is at risk today due to the existing regulatory scheme for licensing and relicensing projects. Unless Congress and the federal agencies reexamine their policies toward this important energy resource, hydropower will not fare well in a restructured electricity industry designed to promote greater competition. Loss of hydropower generation would deprive the country and electricity consumers of a low-cost energy source and numerous other environmental and other non-power benefits associated with these projects.

Facts and Benefits of Hydropower: Hydropower represents approximately 12 percent of the energy produced in the U.S. and 85 percent of all renewable energy generation. Among its many uses and benefits, hydropower, and the multipurpose water projects that depend on this resource, provide clean, efficient and renewable electric power, operational flexibility for maintenance of system reliability, drinking water, flood control, fish and wildlife habitat improvement, irrigation support, transportation, recreation and environmental enhancement funding. Also, due to its unique load-following capability, peaking capacity and voltage stability attributes, hydropower can provide unparalleled reliable service in a market driven industry.

Background: By the year 2015, over half of all federally regulated hydroelectric capacity – 284 projects in 39 states – will be up before the Federal Energy Regulatory Commission (FERC) for license renewals. This group, which includes many large and complex projects, has a combined capacity of approximately 29,000 MW, or 20 percent of the nation's installed hydroelectric capacity. By the year 2010, 16,000 MW of publicly-owned hydro capacity will be up for license renewal. This represents nearly 50 percent of all hydro capacity subject to the relicense renewal process.

The regulatory process involves input not only from FERC and a variety of interest groups but also from numerous federal and state natural resource agencies concerned with environmental protection. Under this scheme, federal and state agencies take full advantage of their statutory authorities to impose conditions on hydropower project licenses, frequently without regard for project economics. In one recent case, a hydropower owner has been given the choice of operating at an economic loss or shutting down the project.

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Overall, the concern with the present regulatory structure involves the loss of hydropower capacity. Studies are showing that there will be an average 8 percent loss of hydropower generation per project resulting from new conditions imposed on existing projects up for relicensing in the next 20 years. At this rate, nearly 2,400 MW of total hydro capacity may be lost. In the 2000 edition of its annual Energy Outlook report, the Energy Information Administration – the Department of Energy's statistical agency – for the first time projects that hydropower generation will decline through 2020, "as regulatory actions limit capacity at existing sites."

The relicensing process has brought into focus the costs and conflicts of this process at a time when the electric utility industry at both the wholesale and retail levels is experiencing increased competition. Utilities are under increasing pressure to lower prices or risk losing customers. The ability of hydro licensees to pass to their customers ever-increasing costs of environmental compliance will be limited by the market. These increasing costs threaten to significantly reduce hydropower's economic viability.

Congressional and Regulatory Action: The hydropower industry brought focus to the problems of relicensing and licensing process in 1996 by formally petitioning the FERC to reform its procedures. Specifically, the industry recommended changes to streamline the decision-making process and to require condition-setting recommendations to occur early in the application timeline. FERC rejected most of the recommendations and opted, instead, for modest reform aimed at encouraging voluntary settlements instead of litigation. While FERC agreed that every effort should be made to lessen the burden of such proceedings on the participants, the Commission indicated that it lacked statutory authority to go much beyond the changes it did make.

During the last two years, Senate and House energy panels sponsored oversight hearings on FERC's hydropower licensing and relicensing process. Testimony was taken from hydropower industry representatives, including public power, FERC, federal agencies, and environmental groups. When former FERC Chair James Hoecker testified before the Senate during the 105th Congress he said legislative action is necessary to reform the licensing process. This examination of the issue resulted in the introduction of legislation sponsored by Senator Larry Craig (R-ID) and Representative Eldophus Towns (D-NY), the "Hydroelectric Licensing Process Improvement Act of 1999."

Reintroduced this year as S. 71, Sen. Craig proposes amending the Federal Power Act by requiring the FERC to set a date certain of no more than one year of intra-agency review, thus limiting the amount of time federal agencies have to intervene in the relicensing process. Importantly, the proposal would not directly remove the conditioning power from the various agencies; however, it would impose a greater degree of responsibility and accountability on these agencies by ensuring that they consider various factors before imposing mandatory conditions on a licensee.

The need to reform the hydro licensing process is generating broad support especially in light of the energy supply problems in the West. In seeking a solution to the crisis in the West, decision-makers must come to terms with the need to preserve existing capacity. Unless licensing reform is enacted, the Western region's 25,000 MW of non-federal hydro capacity will continue to decline as a result of a broken regulatory process. Licensing process improvements are needed. Industry is not alone in advocating reform, a large number of

non-industry interests have joined together as *WaterPower: The Clean Energy Coalition* to support the call for congressional action to improve the hydro licensing process. The coalition consists of 500 hydro producers and suppliers, municipalities, businesses and environmental, consumer, labor, recreational, and farming groups from nearly every state.

APPA Position: APPA supports legislative and regulatory changes to improve and clarify FERC's ability to make balanced and rational licensing decisions, such as those contained in S. 71. These decisions should ensure that low cost, renewable hydropower resources continue to operate in an environmentally friendly manner. Among the reforms needed to federal hydropower regulation are changes that would: make the process more certain, consistent, and less time-consuming; evaluate the value of project economics; require the involvement of appropriate decision-makers of all affected parties early in the process; commit resources to the protection of the environment; and eliminate duplicative overlapping jurisdictions. In addition, as the federal government pursues the restructuring of the electricity industry, excessive regulatory impediments to hydropower's competitive position in the new market that cannot be addressed administratively should be evaluated and resolved by federal legislation.

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Facilitating Distributed Resources Through Federal Interconnection Policies
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Summary: There is wide recognition that distributed resources, typically small generation units located close to the load they serve, offer a variety of benefits for consumers, communities, the environment, and utilities. As a result, multiple efforts are underway to develop new distributed generation technologies, enhance existing technologies, and address various technical and policy issues that may be hindering the deployment of distributed resources. Congress has taken an active interest in this issue and several industry restructuring proposals have included provisions to give the Federal Energy Regulatory Commission (FERC) additional authority to order interconnection of distributed resources to transmission and distribution facilities using a uniform technical standard. Public power supports efforts to promote greater use of distributed resources so long as those efforts respect local authority and recognize the diverse characteristics of local electric systems.

Background: The market prospects for distributed resources have grown substantially in recent years for several reasons: 1) generating reserve levels are declining and load shedding and rolling brownouts are becoming more common; 2) transmission constraints and line load relief events are also increasingly frequent occurrences; 3) new transmission is more difficult to site and build than new generation; 4) recent price spikes call into question the predictability of cost and availability; and 5) polls show that local reliability and service rank equal with, and often above, price regarding what customers want and expect. All of these facts and more are pushing the market to provide new power supply options and creating the incentive to pursue them. Distributed resources can help meet the needs that exist in the electricity industry today, and provide many benefits to municipal utilities, electricity consumers and their communities throughout the country.

First, these facilities can make significant contributions to system reliability. Public power systems not only have sensitive customers -- hospitals, city water services and others -- for whom reliability is essential, but also customers that cannot withstand even the shortest disruption in service. Some computer networks cannot withstand disruptions longer than eight-thousandths of a second. Enhanced reliability to protect the health, safety and economic prosperity of the communities they serve is now or will soon drive publicly owned utilities to rely increasingly on distributed generation.

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Moreover, distributed resources help to promote important environmental objectives by enabling utilities to increase their use of new renewable and low-or no-emission generation to meet their communities' needs. Finally, distributed resources enhance local control and decision making by reducing our dependence on external sources of power supply, allowing for increased reliance on fuel sources that are available locally, thus providing benefits to local economies.

Along with all of the benefits, distributed resources offers come challenges and practical problems that must be considered. With a multitude of distributed generation facilities connected to the grid, smaller generators connected at distribution voltage, existing hazards of routine line maintenance, and emergency services restoration activities have to be taken into account. Power quality is another important factor. Federal policies governing interconnection of distributed resources must provide municipal utilities with the ability to exercise their discretion to account for such matters with local impacts.

APPA Position: APPA supports increased use of distributed resources and efforts at the federal level to promote such use. To that end, Congress should adopt transmission and distribution interconnection policies that provide FERC the authority to order the use of standardized technical interconnections. At the same time, Congress must preserve local authority to require any additional measures necessary for system reliability, safety, or other factors deemed to be in the public interest.

Congress should also adopt competitively neutral policies that promote the safe and cost-effective commercial deployment of distributed generation technologies, including smaller generators connected at distribution voltages. Such policies should be adopted in order to increase generation capacity in applications where they alleviate transmission constraints, improve air quality and protect the environment, and enhance reliability while maintaining safe working practices.

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Congress Must Act to Solve the Wholesale Electricity Market Crisis
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Summary: The failure of California's electricity industry restructuring plan has made clear the important role that wholesale markets have in determining the effectiveness of the retail competition plans enacted by the states. For several years, consumer organizations have emphasized that state objectives for retail competition will only succeed if supported by a workable wholesale marketplace. While many factors have contributed to the rolling blackouts and high prices in California's electricity market, it is apparent that improvements in the structure of the interstate electricity marketplace would go a long way toward helping to avoid such problems in the future. In fact, other state restructuring plans are likely to cause the same problems in other regions of the country if they are advanced without Congress first addressing the serious problems that exist in the wholesale marketplace. What is happening in California is not simply just that state's problem. Consumers throughout the West are directly affected, and there will be ripple effects throughout the economy. Regardless of its origin or cause, the solution requires federal legislative and regulatory action to address shortcomings of the wholesale market.

In the end, Congress must act to finish the job it started in 1992 when it enacted the Energy Policy Act to create competitive wholesale markets. Necessary improvements include policies designed to: 1) create truly independent Regional Transmission Organizations (RTOs); 2) allow for federal siting authority to encourage construction of new transmission facilities where needed; 3) provide the necessary authority and support for rigorous Federal Energy Regulatory Commission (FERC) oversight of the wholesale market to prevent market abuses; and 4) assure FERC approval of market rates for wholesale sales only in markets that can be defined as competitive, requiring only cost-based rates in those that are not. Moreover, in light of market conditions today that are very similar to those that led to the enactment of the Public Utility Holding Company Act (PUHCA) over 65 years ago, stand-alone PUHCA repeal should not be enacted absent the development of new consumer protections in its place.

Development of Truly Neutral Regional Transmission Organizations: The lack of effective Regional Transmission Organizations that can ensure truly neutral management of the nations' transmission facilities is the single biggest obstacle to a properly functioning interstate electricity market. Private utilities that control vast amounts of the nation's transmission systems have a long history of denying access to their systems, or providing access at highly discriminatory rates and unfair terms. It is vitally important that federal policies encourage the development of independent RTOs.

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Despite actions to open up the nation's transmission grid and produce a competitive bulk power market, such as passage of the Energy Policy Act of 1992 and the issuance of FERC Orders 888 and 889, private transmission owners continue to operate essential transmission facilities in ways designed to prevent competition. They are able to exercise control over these facilities to favor their own generation resources, thereby blocking competitors and sometimes forcing bulk power purchasers, including consumer-owned utilities, to purchase power at a higher cost.

In an effort to remedy these problems, FERC issued Order 2000 to encourage all transmission owners to participate in RTOs. In the order, FERC acknowledges it has authority to mandate participation in RTOs for jurisdictional utilities, but chooses to pursue a voluntary industry and stakeholder-led approach to the development of such organizations. Order 2000 outlines minimum standards and functions for critical RTO elements such as independence, geographical scope, and operations, and requested that utilities submit applications for RTOs before October 15, 2000. Those applications are currently under review by the Commission.

Order 2000, issued in December 1999, represents a very important step toward preventing transmission market power abuses and establishing effective interstate wholesale competition. **Congress should do nothing to reverse or undermine the RTO framework established by FERC in Order 2000 or its underlying authority to pursue such a course of action.**

In addition to addressing the need for neutral management of existing transmission lines, federal policies must account for the need for the construction of new transmission facilities to allow for a transition to effective competition. Construction of new much-needed transmission facilities must be aided by the creation of federal authority of eminent domain where necessary. Federal siting authority is necessary to encourage construction of new power lines to accommodate growth in the industry and address barriers to competition created by existing transmission constraints.

FERC Has an Important Role to Play in Creating Effective Markets: Many of the market problems in California can be attributed to policymakers both at the state and federal level assuming that market forces alone would be sufficient to forge competition out of an industry structure that had been monopolistic in nature since inception. Consumers have paid the price for the consequences of premature decisions by federal regulators to allow a transition to market-based rates without first requiring the existence of a competitive market structure. The California experience makes clear that FERC should permit wholesale sales at market rates only in regional markets that meet predetermined criteria that define the characteristics of workable competitive wholesale markets. Only cost-based rates should be allowed in those markets that do not meet that definition.

Moreover, as a transition toward competitive markets occurs, FERC must play an active role in relying on existing authority to monitor wholesale electricity markets to prevent and correct market abuses such as those that are subject to investigation in California. Specifically, FERC must be directed to monitor the wholesale market, given the resources necessary to do so and the responsibility and the authority to provide remedies and impose penalties as appropriate.

Such changes in federal policies are necessary to maintain adequate consumer protection and will *not* create an entirely new regulatory regime or increase the size of the federal government. They instead implement an alternative, clarified and limited type of federal oversight that can address the problems that clearly exist in interstate markets today, and allow for an effective transition to a competitive marketplace. That is the appropriate federal role and should be the ultimate focus of federal legislation.

Stand-alone PUHCA Repeal: The Public Utility Holding Company Act (PUHCA) established passive restraints on the structure of the electric utility (and natural gas) industry in order to mitigate the accumulation and exercise of market power; preclude practices abusive to consumers, shareholders and competitors; and facilitate effective regulation. Many of the fundamental protections included in PUHCA are relevant to the changing structure of the industry today and must be preserved in some fashion.

In fact, there are numerous parallels that can be drawn between the market conditions that existed in 1935 that led to the enactment of PUHCA – and the market conditions that exist today that highlight its continued importance. Now, as then, there are dramatic corporate reorganizations underway. As in 1935, there are trends toward the formation of many new holding companies. For example, the number of registered holding companies has expanded from 14 to 30 in the last eight years. In fact, during that time, both the number of registered holding companies and the number of electricity customers served by registered holding company subsidiaries more than doubled. Secondly, now as then, there has been a proliferation of new company affiliates and subsidiaries that complicate the abilities of regulators to oversee transactions, and create increased opportunities for market abuses. The 150 registered and unregistered holding companies today have a combined total of 240 utility subsidiaries, and 4,200 non-utility subsidiaries.

The increased emphasis on the creation of new subsidiaries and affiliates of private utilities is leading to a dramatic shifting of funds between regulated and unregulated activities that is sure to create substantial new costs for American consumers. A clear example of such problems can be seen in recent actions taken by Pacific Gas and Electric Company and Southern California Edison in California to shift billions of dollars in revenues to their parent companies for payout to shareholders while they are simultaneously calling for a bailout from the electricity customers and the state government to avoid bankruptcy.

Yet another parallel between the markets that gave rise to PUHCA and today's industry conditions is the ongoing rapid consolidation of the marketplace as evidenced by 54 mergers completed or announced during the past two years alone – in addition to 24 mergers of U.S. utilities with foreign companies over that same period of time. This consolidation limits the number of potential competitors, and requires additional oversight to prevent market power abuses that put consumers at risk.

Stand-alone repeal of PUHCA will unleash vast multi-state holding companies from public accountability before the structure of a competitive market is developed. It will enable these existing monopolies to garner even greater amounts of market power through mergers and widespread diversification, and escape effective regulatory oversight. Stand-alone PUHCA repeal will only further consolidate control in the hands of a small number of existing monopolists, undermine wholesale and retail competition, and leave consumers at risk of severe market power abuses.

Merger Review: Rapid consolidation due to mergers only increases the difficulty of creating new competitive markets, as we are starting from a point where the nation's regional electricity markets are already characterized by a highly concentrated monopoly industry structure. Given the existing levels of concentration, coupled with the rapid pace of mergers today, it is important that FERC's merger review process lead to an approval of only those mergers shown to promote competition and bring net savings and benefits to consumers.

Congressional Action: With the inception of the 107th Congress, House and Senate policymakers have begun to focus on the development of national energy supply legislation designed to increase domestic production of energy resources. At this writing, it is largely unclear whether Congress will also attempt to address industry restructuring matters as part of this debate. The first step in this regard is not encouraging – Senate Energy and Natural Resources Committee Chairman Frank Murkowski (R-AK) has introduced a comprehensive energy supply measure that includes stand-alone PUHCA repeal, but omits the consumer protections that must be enacted in its place. A new freestanding PUHCA repeal bill (S. 206) has also been introduced by Senator Richard Shelby (R-AL), and is expected to be considered by the Senate Banking Committee early this Congress. The Chairman of the Senate Banking Committee, Senator Phil Gramm (R-TX), continues to oppose enactment of PUCHA repeal outside of a more comprehensive industry restructuring package.

Since the 107th Congress convened, both the House and Senate have held hearings regarding the California energy crisis which have provided opportunities for public power testimony regarding the need for federal action to address problems in the wholesale marketplace. With regard to the California markets, and potential abuses that have occurred there, APPA supports legislation (S. 287) that has been introduced by Senator Dianne Feinstein (D-CA) calling on FERC to impose cost-based rates in the Western energy market on an interim basis. A hearing on this and other related bills was held in the Senate Energy and Natural Resources Committee on March 15, 2001.

APPA Position: The essential purpose of federal restructuring legislation should be to establish a structure for interstate commerce in electricity that promotes effective wholesale competition. Truly effective wholesale competition benefits every consumer in America and, without it, consumers that live in states adopting retail competition will not see the full benefits of customer choice.

Thus, federal legislation should:

1. **Support and enhance FERC's Order 2000 regarding establishment of RTOs.**
2. **Allow for federal siting authority for the construction of new transmission facilities necessary for effective competition.**
3. **Assure a strong role for FERC to serve as a market monitor to prevent market abuses and ensure a transition to market-based rates only where a competitive market is known to exist. Toward this end, APPA supports pending Senate legislation calling on FERC to impose cost-based rates in the Western energy market on an interim basis.**
4. **Modify or repeal PUHCA only if combined with alternative consumer protections.**
5. **Require that federal merger review include consideration of the effect on consumers and competition.**

Issue Brief

American Public Power Association
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Transmission Policies Needed to Promote Wholesale Competition in the Electricity Industry
March 2001

Summary: Competition in the electricity industry will not develop unless the nation's transmission facilities are managed in a truly neutral and independent manner. Toward that end, federal restructuring legislation must ensure that the nation's transmission facilities cannot be manipulated to give one competitor an unfair advantage over another. Achieving this end will require federal legislation that assures the development of competitively neutral and broad Regional Transmission Organizations (RTOs), and assures comparability in the rates, terms, and conditions and rates for transmission to prevent transmission market power abuse. APPA believes that new selective Federal Energy Regulatory Commission (FERC) review authority over public power transmission rates also is necessary to achieve this objective.

Regional Transmission Organizations Must be Independent and Broad in Scope: The lack of effective RTOs that can ensure truly neutral management of the nation's transmission facilities is the single biggest obstacle to a properly functioning interstate electricity market. Private utilities that control vast amounts of the nation's transmission systems have a long documented history of denying access to their systems, or providing access at highly discriminatory rates and unfair terms. It is vitally important that federal policies encourage the development of independent RTOs.

Despite actions to open up the nation's transmission grid and produce a competitive bulk power market, such as passage of the Energy Policy Act of 1992 and the issuance of FERC Orders 888 and 889, private transmission owners continue to operate essential transmission facilities in ways designed to prevent competition. They are able to exercise control over these facilities to favor their own generation resources, thereby blocking competitors and sometimes forcing bulk power purchasers, including consumer-owned utilities, to purchase power at a higher cost.

In an effort to remedy these problems, FERC issued Order 2000 to encourage all transmission owners to participate in RTOs. In that order, FERC acknowledges it has authority to mandate participation in RTOs for currently jurisdictional utilities, but chooses to pursue a voluntary industry and stakeholder-led approach to the development of such organizations. Order 2000 outlines minimum standards and functions for critical RTO elements such as independence, geographical scope, and configuration, and requested that utilities submit applications for RTOs by October 15, 2000. Those applications are currently under review by the Commission.

APPA

The American Public Power Association is the national service organization representing the nation's more than 2,000 local publicly owned electric utilities.

Order 2000, issued in December 1999, represents a very important step toward preventing transmission market power abuses and establishing effective interstate wholesale competition. Congress should do nothing to reverse or undermine the RTO framework established by FERC in Order 2000 or its underlying authority to pursue such a course of action.

FERC RTO Authority Must Preserve Local Control and Account for the Unique Characteristics of Public Power Systems: Public power systems are owned and managed by their citizens at the local level, and are for that reason expressly exempt from FERC jurisdiction. Cooperatively-owned utilities with outstanding Rural Utility Service loans also are not under FERC jurisdiction. In addition, federal power systems are not subject to FERC jurisdiction over their transmission facilities. Public power systems recognize that RTOs serve as the underpinning of effective wholesale competition, and it is clear most of them will join RTOs on a voluntary basis – just as public power systems have voluntarily complied with the open access requirements of Order 888 by filing tariffs with the Commission.

As noted above, it is the private FERC-jurisdictional utilities, however, that have a demonstrated history of transmission market power abuses that must be addressed before effective wholesale competition is possible. Unfortunately, the proposed RTO filings by these utilities that were required under Order 2000 fall far short of what is needed to achieve this goal. It is clear that further action by Congress and FERC is necessary to bring about RTOs that are truly independent and broad enough in scope to support competition.

Legislative proposals that address RTOs and call for extended FERC jurisdiction over public power systems in this regard will be unworkable unless the distinct characteristics of the public sector of the industry are taken into account. Specifically, there are key differences between investor-owned utilities and public power systems that warrant distinctions in regulation. FERC does not regulate public power's rates today because public power systems (unlike investor-owned utilities that are operated to maximize returns to stockholders) are nonprofit public entities whose rates have been set by public officials for over 110 years. As community-owned systems, public power utilities are already subject to extensive public accountability requirements and sunshine laws at the local level that do not apply to investor-owned utilities. In addition, public power systems, unlike investor-owned utilities, are financed by bonds containing covenants regarding various debt to equity ratios and revenue requirements. Issuers of those bonds are responsible for the enforcement of these covenants. FERC jurisdiction over rates would undermine this responsibility.

The electricity industry restructuring bill approved by the House Subcommittee on Energy and Power during the 106th Congress included provisions that accounted for these differences by carving out new limited FERC authority to ensure that public power systems' transmission rates are comparable and not unduly discriminatory or preferential while preserving local control of the transmission rate-setting. The proposed extension of FERC authority over public power systems to allow for a review of the rates, terms and conditions under which transmission services are provided, while creating a process where FERC can review public power transmission rates and remand those that are not approved back to the utility for revision, is referred to as "FERC-lite". Given the differences among private utilities and the other sectors of the industry, an extension of FERC authority over public power transmission systems – or those of cooperative and federal utilities as well – would be warranted only if FERC is allowed to compel RTO participation by a non-jurisdictional utility based upon a finding that the local utility has engaged in undue discrimination in the provision of

transmission service, or abused its control over transmission so as to disadvantage competitors, and open access transmission tariffs in place are not likely to remedy the problem. Such orders must accommodate and take into account tax code restrictions and/or bond covenants.

Congressional Action: Transmission-related issues are now recognized as critical components of comprehensive electricity restructuring legislation, and there is broad support among a number of industry stakeholders for the creation of effective Regional Transmission Organizations, FERC jurisdiction over all transmission facilities and FERC-lite. At this writing, comprehensive restructuring legislation that incorporates such proposals has not yet been introduced in the 107th Congress. However, transmission-related matters could be addressed as House and Senate Energy Committees proceed with their consideration of energy supply policy.

APPA Position: Concentration of control over transmission assets presents opportunities for dominant players in the electric utility industry to undermine competition through the exercise of market power. Congress must prevent transmission market power abuses by enacting policies to:

1) **Support and enhance FERC's Order 2000 regarding establishment of truly independent and geographically broad RTOs by jurisdictional utilities.**
2) **Ensure FERC authority to order RTO participation by a non-jurisdictional utility only after a finding that the utility has engaged in undue discrimination in the provision of transmission service, or abused its control over transmission so as to disadvantage competitors, and existing open access transmission tariffs are not likely to remedy the problem. In the case of public power, such orders must accommodate and take into account tax code restrictions and/or bond covenants.**

Letter to Vice President Cheney

American Public Power Association

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December 21, 2000

The Honorable Richard Cheney
Vice-President Elect
Bush-Cheney Transition
1800 G Street, NW 2nd Floor
Washington, D.C. 20270

Dear Vice-President Elect Cheney:

On behalf of the American Public Power Association, APPA, I write to offer our assistance to you, President-Elect Bush and the transition team as you work through policy and personnel decisions related to national energy policy and environmental issues. APPA represents the interests of the nation's over 2,000 state and municipal, locally-owned and locally-controlled, not-for-profit electric utilities that provide for the electric power needs of nearly 45 million Americans. While several of our members are located in some of the largest cities in the country, such as the Los Angeles Department of Water and Power, the Sacramento Municipal Utility District, and City Public Service of San Antonio, most APPA member utilities are in small to medium-sized towns in all regions of the country.

Public power utilities serve roughly fifteen percent of the nation's electricity consumers, are community-focused, and provide valuable balance to the private sector in the increasingly competitive electric utility marketplace. It is not an accident that customers served by our member utilities in California are faring relatively well in comparison to those served by private power companies. Their success is due in large part to their continued commitment to their communities and customers and to prudent decision-making in a restructured environment.

We share many of the energy policy objectives President-Elect Bush articulated during the campaign. Chief among these are developing a balanced national energy policy, integrating energy issues with environmental concerns, supporting the development of clean coal technologies, storage of nuclear waste and hydropower license reform. APPA also has a well-developed set of policies regarding electricity restructuring legislation. The Congress and the Administration must focus on creating a more competitive market for wholesale sales of electricity, protecting consumers from wildly fluctuating prices throughout the transition, establishing mandatory reliability enforcement standards, ensuring fair, equitable and non-discriminatory access to transmission, guarding against the undue concentration of control over power generation and transmission facilities, and addressing forcefully market manipulation and abuse of market power.

APPA has been and will remain actively engaged in a constructive effort to restructure the nation's electric utility industry. There are many experienced and knowledgeable energy professionals in the public power arena that could serve and assist in your transition

efforts, as well as in the future Administration. Please do not hesitate to have anyone in the transition operation contact me at 202-467-2901, if I can answer any questions or provide additional information about our arena of the electric utility sector or energy policy in general. We look forward to working with your Administration and hope that we can be of assistance to you.

Alan H. Richardson

Sincerely,
Alan H. Richardson
Executive Director

AHR/sd

Tradeable Tax Credits

DOE003-0211

Tradable Tax Credits for Renewable Energy or Environmentally Sound Energy Technologies—Providing Comparable Incentives to Public Power

In light of ongoing energy supply shortages and environmental challenges throughout the nation, Congress and the Administration are reviewing legislative options to promote the production of domestic, low-cost, efficient and clean energy supplies. Tax and investment credits made available to investor-owned utilities and privately-owned energy production companies do not create incentives for publicly-owned electric utilities. Publicly-owned electric utilities do not have a federal income tax liability against which to apply credits. In order to provide publicly-owned electric utilities with useful tax incentives comparable to those available to private sector market participants, public power entities must be permitted to sell the tax credits to private entities that can utilize them. The proceeds from the tax credit sales provide the incentive for public power investment in renewable and clean energy production.

Benefits of Providing Tradable Tax Credits

As the electricity market opens to competition, public power utilities need to generate and obtain electricity, derived from inexpensive and clean sources, to the same degree as their competitors. Because renewable energy sources and environmentally clean, advanced technologies usually are more expensive to operate than traditional alternatives, public power utilities may not be able to afford to invest in them unless they receive investment incentives comparable to those made available to their private sector counterparts. With comparable incentives and the strong public policy rationales of cleaner and renewable resources, energy security and independence, and energy diversity, Congress and the Administration can expect greater investment from publicly-owned utilities than its competitors.

Nature of a Tradable Tax Credit Program

A publicly-owned electric utility would build a renewable energy facility and would be authorized to receive a federal tax credit that would be comparable in amount to that made available to its private counterpart. The utility would be permitted under the Internal Revenue Code to sell, transfer, assign or otherwise dispose of the credits directly or indirectly to any taxpayer. For a non-profit entity, neither the credits nor the proceeds derived from their disposition would result in federal taxable income. Taxpayers receiving the credits will not have their alternative minimum income taxes increased as a result of their use. Tax-exempt municipal bonds can continue to be used for project financing, but renewable energy production incentive program funds may not.

It is anticipated that publicly-owned utilities will net a smaller amount from the credits than their private counter parts. Investor-owned utilities will be able to use the full amount of the credits assuming they have sufficient tax liability. Publicly-owned utilities will have to offer them at a discount to encourage their purchase by taxpayers and will have to incur transaction costs to effect the disposition.

Landfill Gas to Energy

Landfill Gas-to-Energy Projects – Providing the Mutual Benefit of Energy Production and Greenhouse Gas Reduction

Landfills have the potential to be an important source of energy and have long been understood to be a major source of methane – one of the most potent greenhouse gas. Methane is approximately 21 times more potent than carbon dioxide. If captured, this gas has the potential to be a sustainable source of energy that actually reduces greenhouse gas emissions.

Landfill gas –problems and opportunities

Landfills are the largest single human source of methane emissions in the United States (USEPA 1993). In 1995, landfills emitted over 11.1 million tons of methane gas. Based on methane's higher heat trapping potential, the level of methane emission is equivalent to releasing over 233 million tons of carbon dioxide (CO2) into the atmosphere or 56 million metric tons carbon equivalent – almost 5% of the net annual CO2.[1]

Currently, there are over 300 landfill sites that use technology to capture and/or use the emitted gas. These projects developed primarily because of the existence of a federal tax credit for development of non-conventional fuels. If this now expired tax credit were reinstated along with a credit available to projects that use the gas for electricity, communities with landfills could benefit from a new stream of revenue from the sale of gas or electricity from the projects and the nation as a whole would benefit from the reduction of a critical greenhouse gas. It is estimated that between 500 and 600 additional landfill gas to energy projects (LFGTE) could be developed if an incentive were provided.

Landfill gas to energy project inventory and potential *(based on a USEPA analysis of 31 states)*

- 317 LFGTE projects already exist and 54 are under construction;
  - Of these projects, 195 are on private landfills and 176 are on public landfills;
- The EPA has already identified 561 undeveloped landfills that could produce economically viable LFGTE projects;
  - Of these undeveloped landfills, 241 are privately owned and 320 are publicly owned;
- *New LFGTE projects could add 1741 MW of new capacity;*
- *New LFGTE projects could produce 15.2 million MWh of electricity annually*
- All landfills with over 2.5 million megagrams of capacity that emit 50 or more megagrams of landfill gas must flare the gas and would not be eligible as a source of alternative energy.

Potential to reduce greenhouse gas emissions through landfill gas-to-energy projects

The decay of organic matter creates significant amounts of greenhouse gases. These gases can be captured and used for LFGTE projects. In fact landfills:

- produce approximately 56 million metric tons carbon equivalent (mmtce) each year;
- represent approximately 3 percent of all human sources of greenhouse gas emissions;
- that have developed LFGTE projects remove over 12 mmtce of methane annually;
- could develop LFGTE projects to remove much of the remaining 56 mmtce of methane

[1] To understand this number in context electric utilities in 1999 emitted approximately 523 million metric tons of carbon equivalent, accounting for about a third of all human induced carbon emissions.

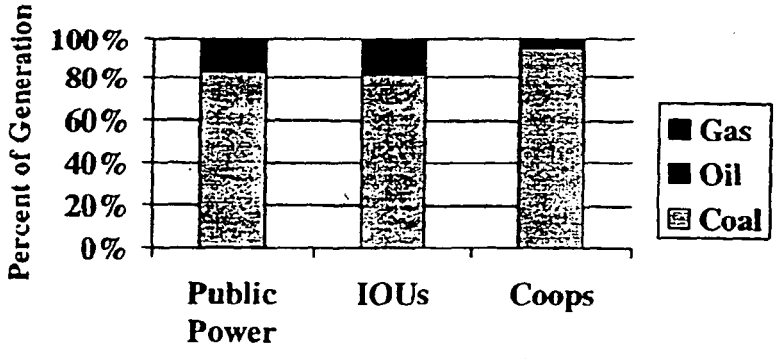
Public Power Is Green
Summary

Based on a new report profiling public power's emissions and green program activities, below are select graphs showing results

Profile of Fossil Fuel Generation

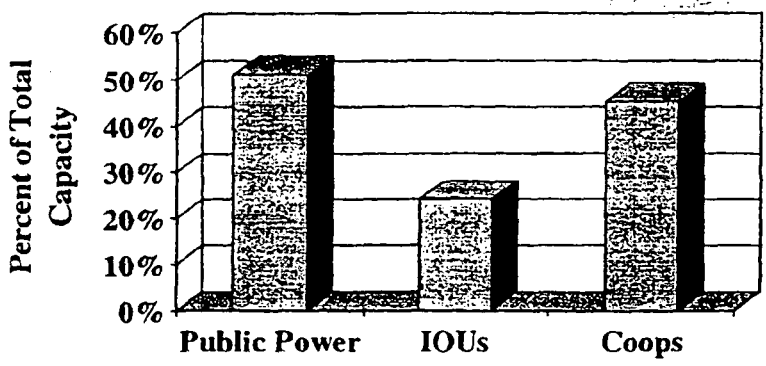
- Public power leads the industry in minimizing SO_2 and NO_x emissions
  - Better control technology
- Public power is even with CO_2 emissions
  - No available control technology for CO_2
  - Must switch fuels or retire plants

Fossil Fuel Generating Sources



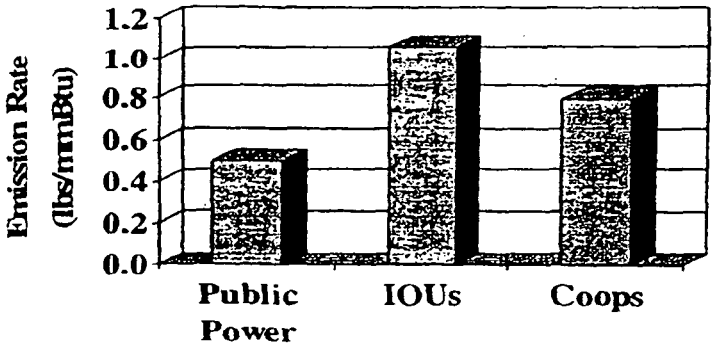
Source: EGRID 97 database

Percent of Coal Capacity with Scrubbers



Source: 1999 EIA data table named "Table 30:
Flue Gas Desulfurization (FGD) Capacity in Operation at U.S. Electric Utilities

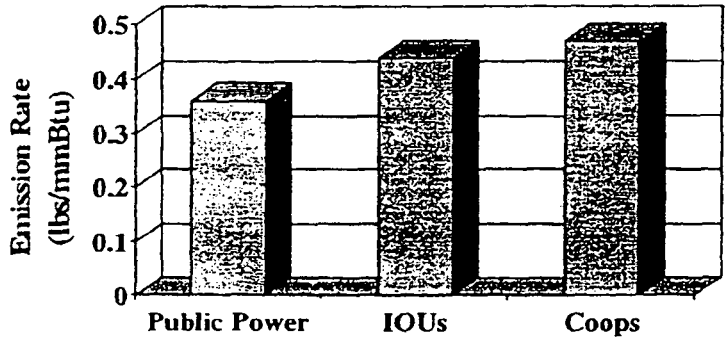
Sulfur Dioxide Emission Rates for Fossil Fuel Generation



Source: EPA 1999 Emissions Scorecard

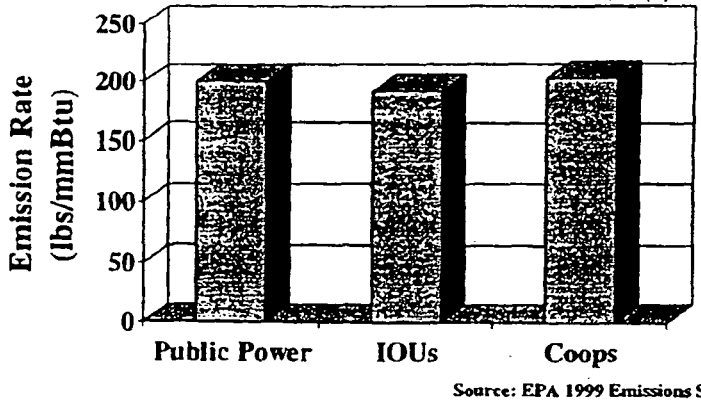
1573

Nitrogen Oxide Emission Rates for Fossil Fuel Generation

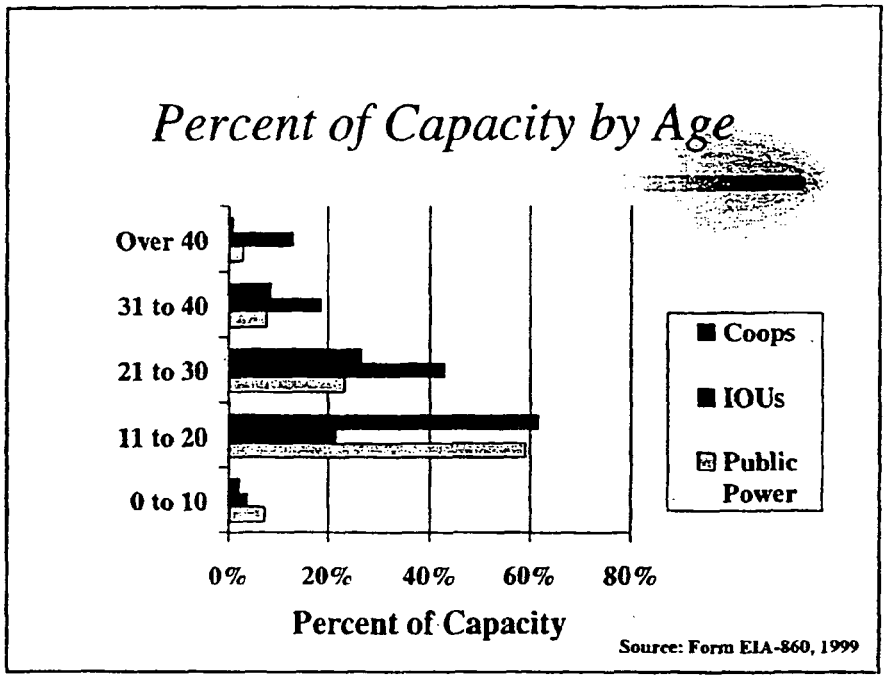


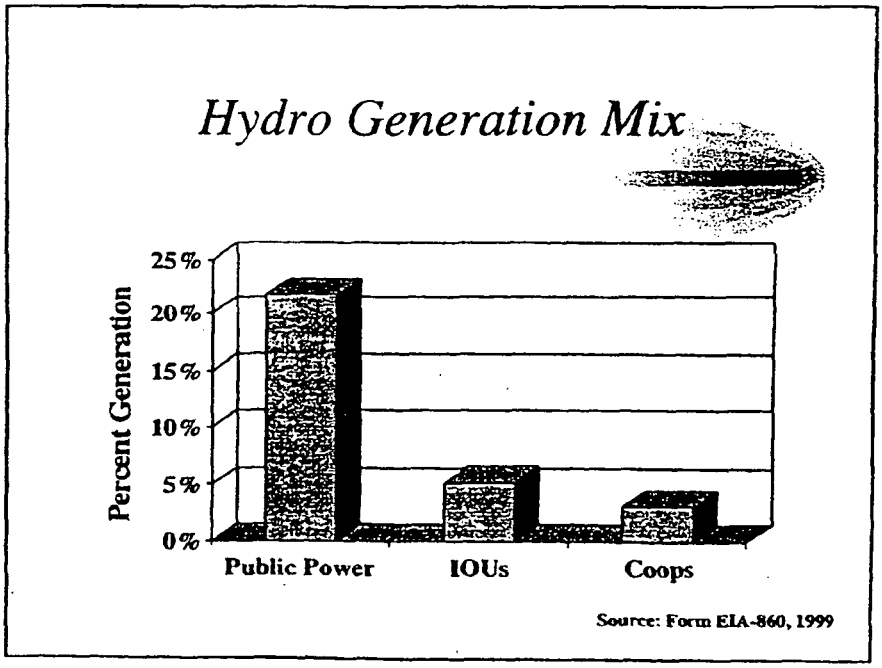
Source: EPA 1999 Emissions Scorecard

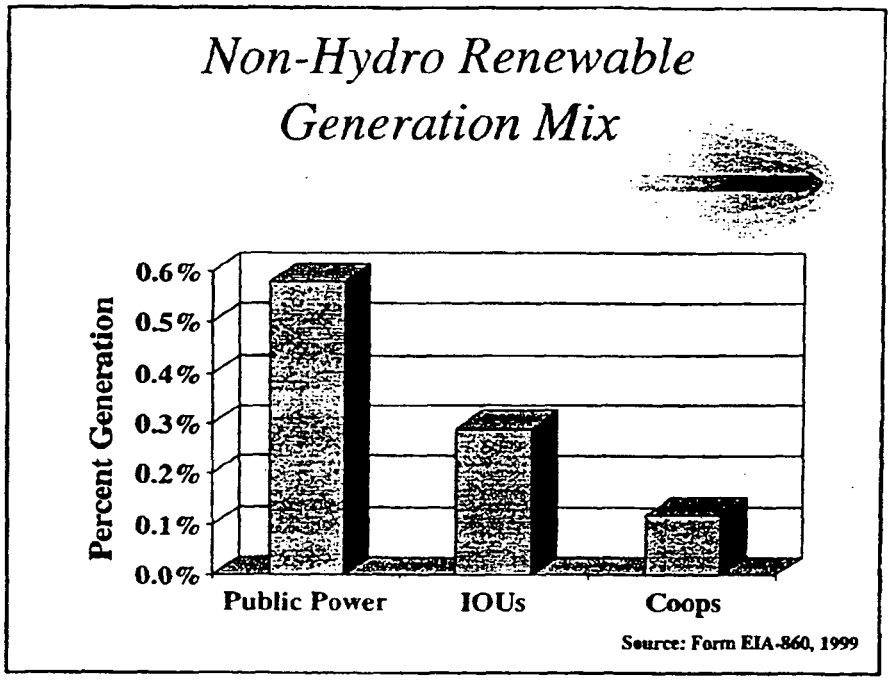
Carbon Dioxide Emission Rates for Fossil Fuel Generation



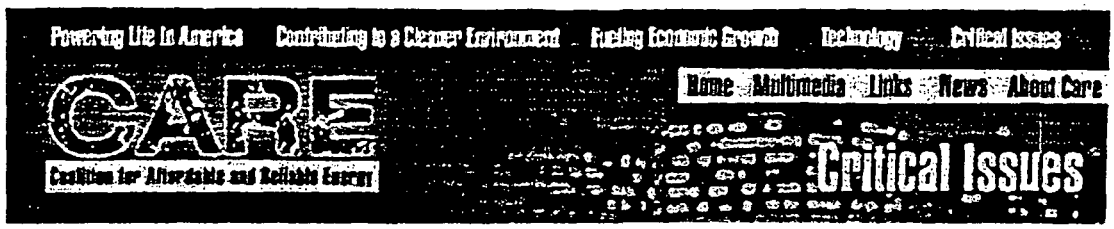
Source: EPA 1999 Emissions Scorecard


Percent of Capacity by Age
Over 40
31 to 40
21 to 30
11 to 20
0 to 10
0%
20%
40%
60%
80%
Percent of Capacity
Coops
IOUs
Public Power
Source: Form EIA-860, 1999


Hydro Generation Mix
25%
20%
15%
10%
5%
0%
Percent Generation
Public Power
IOUs
Coops
Source: Form EIA-860, 1999


Non-Hydro Renewable Generation Mix
Percent Generation
0.6%
0.5%
0.4%
0.3%
0.2%
0.1%
0.0%
Public Power
IOUs
Coops
Source: Form EIA-860, 1999

1576



CARE Supports S.60 National Electricity and Environmental Technology (NEET) Act

February 22, 2001
The Coalition for Affordable and Reliable Energy (CARE) seeks support for S. 60, an important bill that would significantly advance our nation's energy and environmental objectives.

CARE is a broad-based coalition – representing nearly 40 business organizations and associations, labor unions, agricultural, transportation and healthcare groups, and other interests – that was formed last Spring to build support for an energy policy that strikes a sensible balance among social, economic, national security, environmental and energy goals.

With the news filled with stories about rising gasoline prices, high heating oil bills, and rolling electricity outages, the United States needs a comprehensive and balanced energy policy now more than ever.

A bipartisan group of senators, led by Senator Robert Byrd, have just introduced S. 60, the "National Electricity and Environmental Technology (NEET) Act." This bill recognizes the vital role domestic energy sources, such as coal, must have to enable the United States to meet its energy needs, especially with electricity consumption expected to grow by 35 percent over the next 20 years.

Coal is an abundant domestic fuel resource. The United States is a coal-rich nation, with a supply of coal that could last 250 years. Coal reserves in this country are 34 times more than the total known domestic reserves of natural gas and 45 times the known reserves of oil. In addition, electricity from coal is increasingly clean, as emissions from coal-fired plants have been reduced by nearly a third since 1970, even as the use of coal for generating electricity has nearly tripled.

S. 60 seeks to stimulate research and deployment of advanced technologies to further reduce emissions and improve efficiency in coal-based power generating systems. It provides incentives for retrofitting, repowering and replacement of coal-based electricity generating plants with state-of-the-art emission control technologies. The bill also offers incentives for the initial deployment of advanced technologies that will meet more stringent efficiency and environmental standards.

This bill can serve as a roadmap for research and development of the new coal technologies of the future. It will allow use of coal to help meet the growing need in

the U.S. for generation of reliable and affordable electricity.

The NEET Act is exactly the kind of legislation we need to provide a more secure energy future for our country. Please write your Senator and express your support for its passage.

Sincerely,

Paul Oakley
Executive Director
Coalition for Affordable and Reliable Energy

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Electricity from COAL

Essential
Affordable
Increasingly Clean

AMERICANS FOR BALANCED ENERGY CHOICES

1579

DOE003-0223

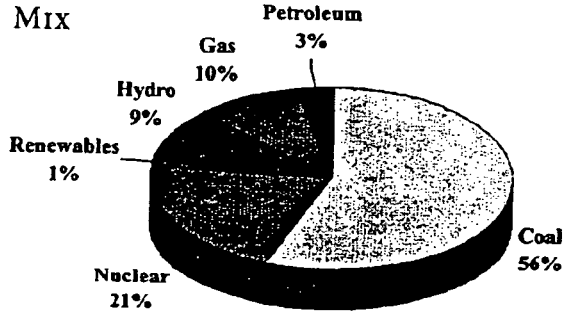
Power

Why electricity from coal?

Over 50 percent of the electricity that powers our homes and businesses comes from coal, more than all other energy sources combined.

Coal is an American resource found in 38 states. Coal is domestically abundant — U.S. reserves are plentiful enough to last the next 250 years.

U.S. Electricity Mix



Source: U.S. Energy Information Administration, 1998

The use of coal for generating electricity has nearly tripled over the last 30 years, allowing America's electric utilities to provide the added electricity needed to sustain our daily lives while still protecting the environment.

Whether it's by cooking, reading by lamplight or surfing the Internet . . . most of the time we are using electricity from coal. In fact, the average American uses about 20 pounds of coal per day, all in the form of reliable electricity.

The innovative use of technology will allow electricity from coal to be an important part of our lives for years to come. The U.S. Energy Information Administration predicts that coal will continue to be the leading energy source used for generating electricity at least through the year 2020.

DOE003-0224

Affordable

Whether you support a family, are a senior living on a fixed income, or run a small business, low-cost electricity matters.

Because coal is a domestically abundant fuel source, using it to generate electricity helps keep utility rates low.

Advanced technology also makes electricity from coal affordable. From the mine to the power plant, and to the switch plate in your home, the coal-based electricity industry is a showcase of technology.

Using state-of-the-art equipment, today's workers produce an average of 48 tons of coal in an 8-hour shift, a three-fold increase from nearly 30 years ago.

Once mined, coal is shipped to power plants, in many cases by rail. Since 1980, the freight railroad industry in America has invested $230 billion in its infrastructure, creating a national transportation system that is the envy of the world. Along with barges and trucks, this vast transportation infrastructure travels thousands of miles to bring power, in the form of coal that will be converted into electricity, to the American people.

America's electric utilities have also invested in advanced technologies that not only reduce emissions, but increase efficiency, meaning more power from a quality fuel source.

What does this mean to consumers?

It's there to brighten the day.

It's there when we need it most, and it improves the quality of our lives.

It makes us more productive . . .

. . . and it lights the way for future generations.

It's electricity, and in America
more than half of it comes from coal.

Electricity from coal . . .

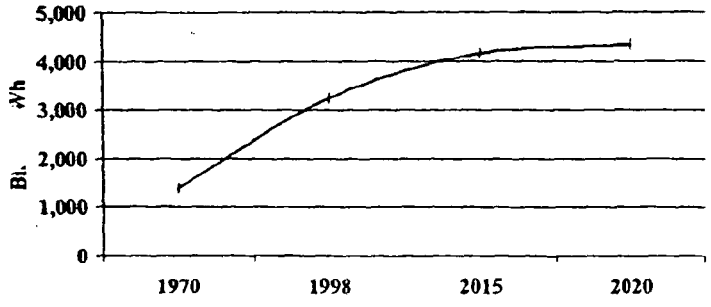
Essential, Affordable, Increasingly Clean

1582

Essentia

Electricity . . . it powers our daily lives. It's in our homes; it's where we work; and it's with us just about everywhere we go. Electricity fuels our economy and improves the quality of life in America.

U.S. ELECTRICITY CONSUMPTION



Source: U.S. Energy Information Administration

America has a growing demand for electricity. According to the U.S. Energy Information Administration, between 1970 and 1998, electricity consumption in the United States grew by 133 percent, and is projected to be 34 percent higher in 2020 than it was in 1998.

Electricity and food are the two largest commodities bought and sold in America, with electricity sales amounting to more than $200 billion annually. Like food, electricity has become a basic necessity in sustaining the quality of life that Americans have come to enjoy.

Think about it . . .
how have you used electricity today?

Your alarm clock woke you up; you perked a pot of coffee. When you got to work, you powered up your computer and ran some copies. After work, you helped your children with their homework, and then flipped on the television to watch the evening news. These are just a few things, powered by reliable electricity, that empower our lives.

The bottom line is that America runs on electricity . . . and more than half of it comes from coal.

DOE003-0227

Power

Because of its commitment to using high technology, the coal-based electricity industry has not only been able to comply with strict federal clean air laws, but in some cases it has exceeded compliance.

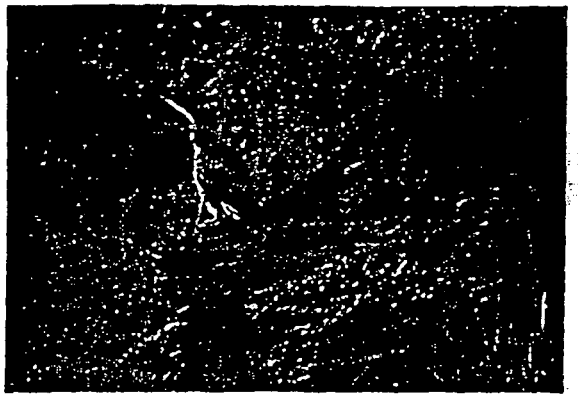
But the industry's commitment goes beyond merely complying with the law.

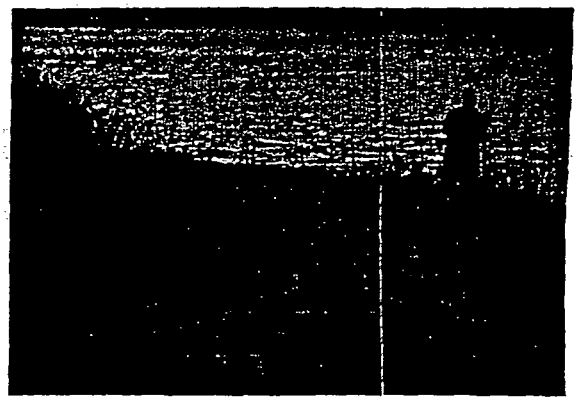
America's electric utilities are participating in voluntary programs that protect the environment in cost-effective ways without the added burden of increased government regulation. America's electric utility industry agreed to voluntarily reduce greenhouse gas emissions (either through emissions reductions, avoidance or sequestration) by over 170 million metric tons in the year 2000. That is more than four times the goal set by the federal government when this program was launched in 1993.

Improving the quality of the air we breathe is just part of the equation. The coal-based electricity industry has also demonstrated a profound respect for the land.

In accordance with strict federal laws, once coal is mined, the land must be restored. Employing hundreds of scientists and biologists, the coal-based electricity industry has worked with federal and state officials over the last 20 years to restore over two million acres of land once used for mining. In many cases, the land is restored to be more useful than it was originally, creating wildlife refuges and wetlands in areas where they previously did not exist.

This is just the beginning. The federal government predicts that these environmental improvements will continue well into the future, leaving a lasting legacy for generations to come.





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Looking to the Future

The coal-based electricity industry has changed a lot since most people last thought about it. Through investments in technology, the coal-based electricity industry provides you with the affordable power that is essential to your daily life, and it's doing so while protecting the environment.

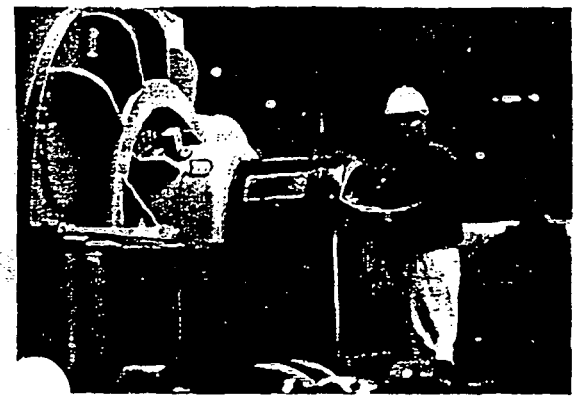
Today's coal industry is looking to the future. With enough coal in the United States to last the next 250 years, the coal-based electricity industry is building upon its past record of success, and demonstrating that it is able to provide essential electricity needed to meet America's growing demands while still protecting the environment.

Despite this remarkable record of achievement in protecting the environment while still enabling our economy to grow, electricity from coal continues to have its critics.

Some want to use government regulation to remove coal-based electricity from America's energy mix, a move that would definitely come at great cost to American consumers and the U.S. economy.

In this debate, those who advocate against electricity from coal do so with too little regard for how we will meet our increased electricity demand without the energy source that is currently providing over half of our electricity. They lose sight of the fact that restricting the use of coal for generating electricity will mean increased reliance on more expensive or imported energy sources.

Electricity from coal represents the right balance between meeting America's demand for affordable electricity and protecting the environment.



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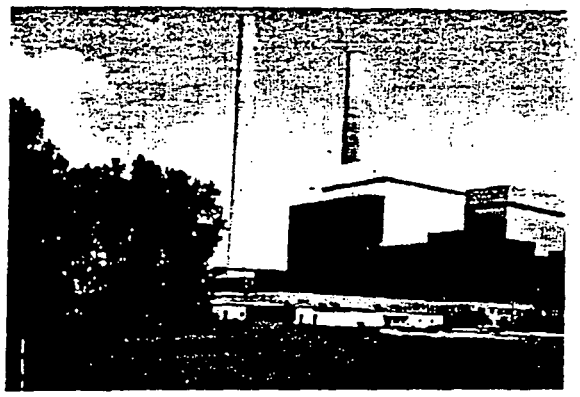
Power



On average, electricity from coal costs much less than power generated from other energy sources.

Using a quality fuel at a fair price makes electricity from coal a bargain.

For businesses, affordable electricity is a key to success. Energy costs rank very high in determining whether a business will be profitable. Profitable businesses can expand, creating new jobs in the community. If electricity prices are too high, businesses will seek locations that have cheaper electricity, taking with them the jobs that provide a living wage for American working families.

For working families, affordable electricity is even more important. Less money spent on electricity means more for housing, food, health insurance and a quality education for their children.

Senior citizens and those living on low or fixed-incomes are among the most vulnerable to higher energy costs. Affordable electricity means more money for medicines and other things that improve the quality of life for American Seniors.

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Increasingly Clean

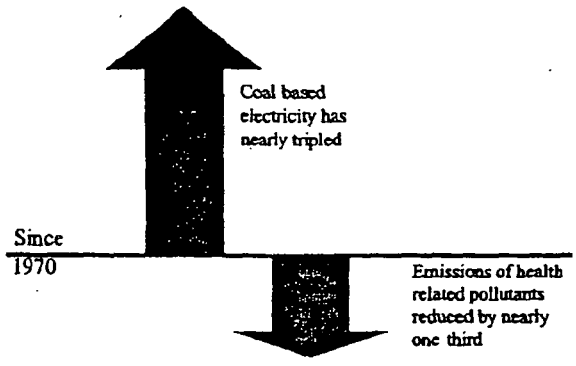
Passing along a cleaner world to the next generation is an obligation . . . not a option. The people who produce America's electricity with coal share this commitment.

America's coal-based electricity industry has invested over $50 billion in new cutting-edge technologies that clean the air we breathe and protect our environment.

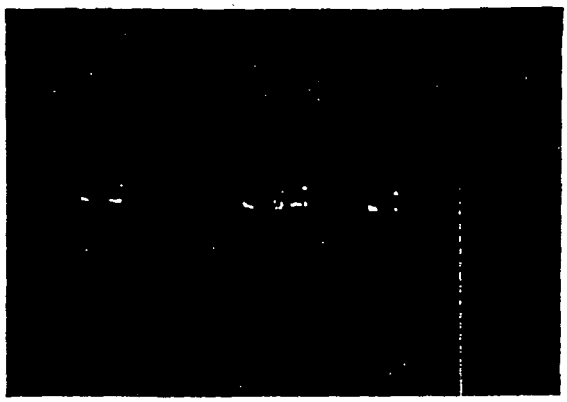
And that investment has paid off. Between 1970 and 1998, the U.S. population increased by 32 percent, and the use of coal for generating electricity has nearly tripled. During this same time period, America made dramatic improvements in air quality. Emissions of Clean Air Act criteria air pollutants (those related to human health) decreased by 31 percent.

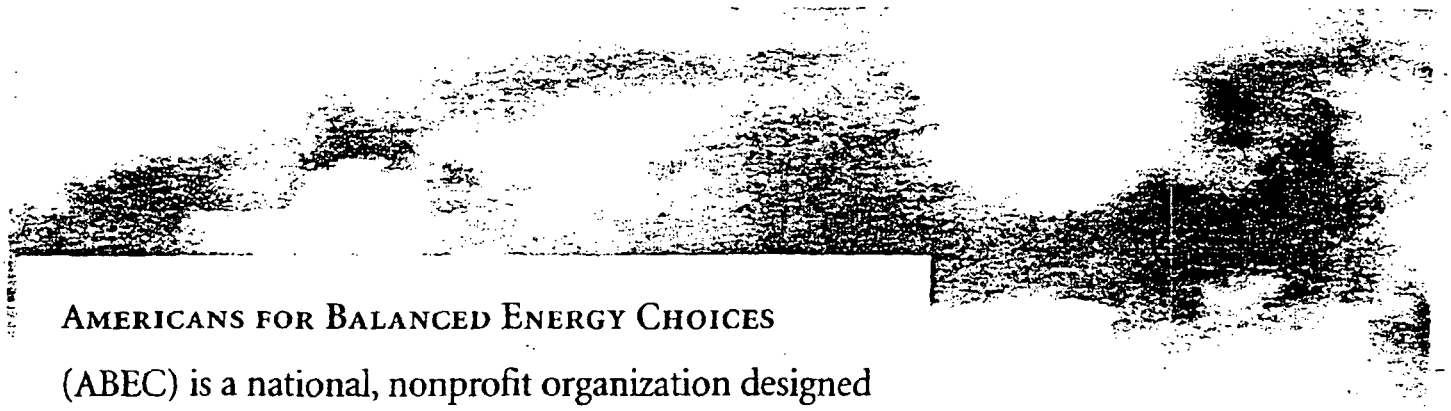
Using advanced technologies, the coal-based electricity industry has improved its environmental efficiency by nearly 70 percent. The U.S. Environmental Protection Agency projects that emissions of criteria air pollutants from coal-based generation will be one-third less in 2000 than they were in 1970, despite a three-fold increase in the use of coal.

In fact, sulfur dioxide (SO_2) emissions, the only criteria air pollutant of which coal-based generation is the primary source, have been cut by 21 percent since 1970 to their lowest level since the 1920's.



Source: U.S.Department of Energy and Environmental Protection Agency





AMERICANS FOR BALANCED ENERGY CHOICES (ABEC) is a national, nonprofit organization designed to promote a dialogue with community leaders across the United States on issues involving America's growing demand for electricity. ABEC will advocate in support of a national energy strategy that strikes the proper balance between protecting the environment and providing for continued economic growth and prosperity for America's working families.

Because they recognize the essential role that electricity from coal plays in protecting the environment while providing over half of the electricity used each day in the United States, America's coal-based electricity industry (producers, transporters, and electricity generators) has provided the primary initial funding for this worthwhile project.

All Americans have a part to play in charting a balanced energy policy for the 21st century. Through ABEC, you can lend your voice and support toward achieving this important goal.

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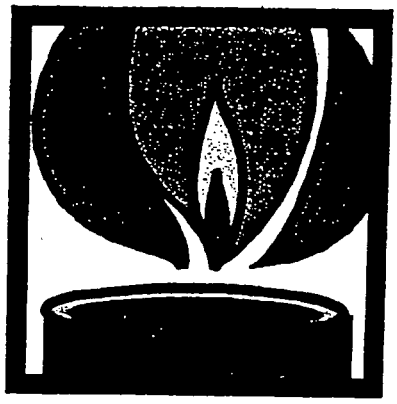
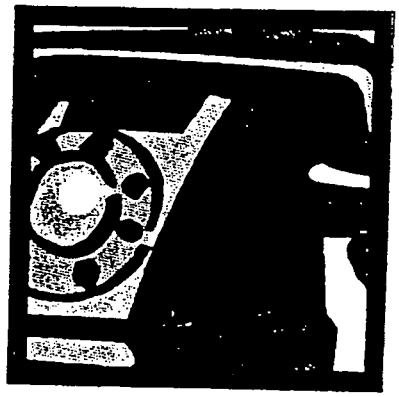
THE CHALLENGES AND CHANGING MISSION OF UTILITY CONSUMER ADVOCATES





AARP

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The Challenges and Changing Mission of Utility Consumer Advocates

by
Scott Rubin,
Public Utility Consulting

for
AARP

AARP is the nation's leading organization for people age 50 and older. It serves their needs and interests through information and education, advocacy, and community services which are provided by a network of local chapters and experienced volunteers throughout the country. The organization also offers members a wide range of special benefits and services, including Modern Maturity magazine and the monthly Bulletin.

Any views expressed in this publication are for information, debate and discussion, and do not necessarily represent formal policies of AARP.

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Abbreviations used in this report

CAB	Civil Aeronautics Board
CFA	Consumer Federation of America
CLEC	Competitive Local Exchange Carrier
CUB	Citizens Utility Board
DOT	Department of Transportation
FCC	Federal Communications Commission
FERC	Federal Energy Regulatory Commission
FTC	Federal Trade Commission
GAO	General Accounting Office
ICC	Interstate Commerce Commission
LTL	Less-than-truckload
NAAG	National Association of Attorneys General
NACAA	National Association of Consumer Agency Administrators
NASUCA	National Association of State Utility Consumer Advocates
NRRI	National Regulatory Research Institute
OCA	Office of Consumer Advocate
OCC	Office of Consumers' Counsel
OPC	Office of People's Counsel
PUC	Public Utilities Commission
PULP	Public Utility Law Project
TURN	The Utility Reform Network

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Executive Summary

Background and Purpose

Many organizations that represent the interests of utility consumers were created during the 1970s. These consumer advocacy organizations include agencies within state government, independent consumer groups (ranging from local groups to nationwide alliances representing millions of consumers), and legal services organizations representing low-income consumers. For the past 20 years, participating in state and federal cases involving all aspects of regulating electric, gas, and telecommunications utilities has been a major focus for these consumer advocates.

Now, there is an increasing trend toward the partial deregulation of, and the introduction of competition in, these utility industries, and numerous questions arise from these massive structural changes in the industry: What is the role of consumer advocacy organizations in this new utility market? How do they need to change to respond to these forces in the utility industry? What types of expertise do they need? What should be the source of their funding?

Methodology

This report is based on in-depth interviews with representatives of ten consumer advocacy organizations from throughout the United States and on research into the effects of deregulation on other industries. In addition, the report has been guided by a project advisory committee, consisting of researchers and utility consumer advocates from across the country.

Key Findings

Deregulation in the airline, trucking, and savings and loan industries gives some indication of what may lie ahead for utility consumers. Deregulation in these industries has led to increased choices and lower prices for large consumers and large communities, but in some cases, it has led to decreased choices and higher prices—or even the complete elimination of service—for some smaller communities and consumers.

Deregulation also has produced confusion over who protects consumers. The federal and state governments have not always seen eye to eye on who has the responsibility to protect consumers from fraud, unfair trade practices, or other improper practices. This confusion has raised concerns about public safety and the quality of service that consumers receive.

Thus far, none of the efforts at deregulation have been able to ensure the availability and quality of service to all consumers. Some communities and consumers have lost service as a result of deregulation; others continue

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to receive service but at higher prices or lower levels of quality. At the same time, some consumers benefit from new services and lower prices. The challenge is to find a balance between price deregulation and the continued regulation of safety and service.

Telecommunications

On paper, the market for long-distance telecommunications services is highly competitive. Hundreds of companies sell long-distance service to consumers. A closer look at the industry, however, reveals that just three companies—AT&T, MCI, and Sprint—provide most of the service within the industry.

The transition from a monopoly (AT&T) in 1984 to an oligopoly in the late 1990s has had some advantages for consumers. Long-distance prices have fallen, and pricing options have increased. At the same time, though, the average cost of residential local telephone service nationwide has increased by about 64 percent. The net effect has been a sustained price reduction for consumers who make a large number of long-distance calls and a net price increase for consumers who make relatively few long-distance calls. Overall, the average total residential phone bill increased by about 60 percent from 1983 to 1994.

Meanwhile, local phone service for residential consumers and for most business consumers remains a virtual monopoly everywhere in the United States. In fact, the local phone monopolies are getting larger through mergers.

Electricity

Several states with high electricity costs are embarking on efforts to open their electricity markets to competition. In the electric industry, restructuring refers to the process of making the generation and/or the supply of electricity competitive.

The biggest single issue pertaining to electricity restructuring is the recovery of "stranded costs" (or above-market costs) by electric utilities. Stranded costs are the difference between the market value of the utility's assets and the amount that the utility has been including in its regulated rates (typically, the actual cost of the assets). In the case of some very expensive assets, like nuclear power plants, the actual cost of the asset is much higher than its market value. It appears that until these stranded costs are recovered, substantial reductions in electric rates will be difficult to achieve.

Natural gas

A few states are beginning the process of restructuring the natural gas market. In the mid-1980s, the wholesale market for natural gas was deregulated on the federal level. Since that time, large gas consumers have had the ability to buy gas directly from gas producers and have it transported directly to their place of business. Current efforts to restructure the gas industry are aimed at giving smaller consumers, including individual residential consumers, that same right. Large-scale test programs are underway or will begin shortly in several states to give consumers the right to buy gas from their supplier of choice.

Effects of restructuring on utility consumer advocates

The movement toward deregulation is changing the traditional role of consumer advocacy organizations. Where utility industry restructuring is occurring, consumer organizations are dealing with new challenges, particularly in the areas of consumer education, consumer complaint handling and consumer protection, market oversight and merger review, and coalition building. The changing focus of consumer advocates is a function of changes in the utility industry and the need for consumers and policy makers to ensure that this transition does not adversely affect consumers. These roles are in addition to continuing regulatory responsibilities for the distribution of electric and gas service, ensuring the provision of universal telephone service, and other ongoing regulatory issues.

The complexity of utility industry restructuring should not be underestimated. It is not simply a matter of enacting legislation or changing commission policy and watching a free market develop. The process is extremely complicated and time-consuming, and it can seriously strain the resources of a consumer organization.

Utility consumer advocacy organizations tend to rely on their own expertise, coupled with outside consultants who regularly work for consumer advocates. Most of these consultants have experience on the more traditional issues involved in utility regulation. While many are developing the expertise needed to help consumer advocates deal with restructured utility industries, many gaps still remain in the available expertise. The lack of readily available expertise makes it more difficult for them to participate in negotiations or litigation involving these highly complex issues.

Consumer advocacy organizations will need to develop new ways to explain the benefits that they provide and encourage the continued funding of the organization. Historically, these organizations relied on their success in saving money for consumers to justify their budget requests or to encourage consumers to join their organizations. During the 1970s and

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1980s when utilities were filing for unprecedented, multi-million dollar rate increases, the need to fund a consumer advocate was clear. However, the issues involved in utility industry restructuring are much more amorphous than the dollars and cents involved in a rate case.

Most state agencies that perform a utility consumer advocacy function are funded through an assessment on each utility that operates in the state, though some receive funding from the state's general fund. Legal services organizations receive funding from several sources, including the federal government, state governments, the United Way, or Interest on Lawyer Trust Accounts (IOLTA) programs. Nonprofit consumer organizations receive most of their funding from the contributions of individual consumers, sometimes supplemented by grants from foundations and other private charities. The restructuring of the utility industry could have a major impact on the funding of all types of consumer advocacy organizations.

As the structure of the utility industry changes, traditional relationships among consumer advocacy organizations will need to change as well. It will be increasingly important to recognize shared interests, keep open the lines of communication, and develop coalitions and working groups to ensure that scarce resources are being used in the most effective way possible.

Consumer advocacy organizations can increase their effectiveness by better coordinating their efforts on a national level. There are several organizations that work on a national level to represent the interests of utility consumers, but they do not always coordinate their efforts or pool their resources.

Many consumer advocates are not just waiting to see how utility industry restructuring will affect their organizations. Instead, they are actively transforming their organizations to deal with the new structure of the utility industry. Throughout the country, advocacy organizations are finding ways to do more with their existing resources. Organizations are redefining their mission, putting more emphasis on consumer education, working with other organizations that have different expertise, and finding ways to assist consumers that do not involve litigation before the utility commission.

Conclusions

The transition from the current, regulated utility industry to a less-regulated industry structure will be complex and difficult. Consumer advocates are needed to ensure that the new industry structure contains protections for consumers and that educational programs allow consumers to become smart shoppers in the new market. The workload will be enormous, the issues will be complex, funding sources will change, and coalitions will shift. There can be little doubt, however, that strong consumer advocates will be needed to make sure that the new utility industry continues to provide safe and reliable service to all consumers at affordable prices.

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Chapter 1: Introduction

Background and Purpose

Throughout most of the history of the public utility industry, utilities were declining-cost companies. Each generation of equipment—whether telephone switching equipment, natural gas production equipment, or electric utility power plants—was more efficient than the earlier generation. The cost per unit of production declined, and as a result, prices fell. For example, from 1940 through 1970, the average price of electricity in the United States declined steadily from 3.84 cents per kilowatt-hour to 2.10 cents per kilowatt-hour.[1] (20).

[1] These figures, taken from *Moody's Public Utility Manual*, are expressed in nominal dollars. After accounting for the effects of inflation, the result would be an even more dramatic decline in utility prices during this period.

Starting in the late 1960s and continuing through the late 1980s, this trend has reversed. Electric utilities invested in the next generation of power plants—nuclear power plants and fossil-fuel plants—with the expectation that prices would continue to decline and that demand would grow by several percentage points each year. The oil crisis and double-digit inflation of the 1970s, together with massive cost overruns at nuclear power plants, the accident at Three Mile Island, and more stringent air pollution control requirements, caused these predictions to dramatically miss the mark. During the 1970s and early 1980s, telecommunications utilities continued to improve their efficiency as the next generation of equipment— microwave transmission— became available. Neither the telecommunications industry or regulators apparently realized that this new, lower-cost technology, would enable competitors to enter the market for long distance telecommunications service at much less than the average embedded cost of the existing service. It was easy to think of AT&T as "the phone company," but large telecommunications consumers were looking for alternatives, and new market entrants, like Microwave Communications, Inc. (now known as MCI), were looking for opportunities to compete against AT&T. Presumably, if AT&T had realized the very real threat that was posed by this new technology, it could have taken action to better serve its large customers and possibly avert the threat from new entrants. Its failure to do so led to the eventual development of a competitive market for long distance communication services. Natural gas utilities improved their efficiency as well and were forecasting rapid increases in the demand for gas. This industry, too, was deeply affected by the oil crisis and massive inflation of the 1970s, coupled with federal price controls which made new drilling uneconomical.

In general, the 1970s were a time of turmoil in the utility industry. For example, during the last five years of the 1960s the total amount of rate increases awarded to electric utilities nationwide was just $200 million. In the first five years of the 1970s, electric rate increases totaled more than

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$5.5 billion. The second half of the 1970s saw total electric rate increases of about $15 billion throughout the United States. That level of rate increases was then equaled in just the next two years: 1980 and 1981 combined saw nationwide electric utility rate increases of another $15 billion.[2] (20) The same type of trend is apparent in the natural gas industry, where total nationwide rate increases totaled less than $200 million from 1965 through 1969, while in 1979 alone rate increases exceeded $2 billion. (20)

[2] These figures are expressed in nominal dollars. If they were adjusted for inflation, the difference would become smaller but still would show dramatically higher levels of rate increases during the later 1970's and early 1980's than had ever existed in the history of the utility industry. Further, these figures *exclude* rate increases that were caused by automatic fuel adjustment clauses, where much of the impact of inflation was reflected in utility rates.

By the late 1960s and early 1970s, utility rates were increasing, large consumers were asking for special rates to alleviate the impact of the overall increases, and utility commissions were coming under increased scrutiny. Utilities' construction plans and rates were becoming front-page news, open and accountable government was being advocated, and state legislatures were coming under increased pressure to do something about the rising cost of utility services. Open meeting laws were passed, which required government to make decisions in public, many utility commissions were required to hold formal hearings on rate increase requests; and utility commissioners were made full-time employees and their professional staff grew by several orders of magnitude. For example, between 1967 and 1983, many state utility commissions saw their budgets increase by anywhere from 400 percent to 1000 percent or more. (25)

In order to deal with these massive changes in the utility industry and in order to respond to the needs of consumers, many states created an agency within state government to represent the interests of consumers before the utility commission. These agencies, typically known as a public counsel, public advocate, or consumer advocate, became widespread. By the mid-1970s, more than 40 states had appointed state-authorized consumer advocates, and the District of Columbia had established a similar office. Most of the public advocates are funded, either directly or indirectly, by utility consumers, often through an annual assessment on each utility that is then passed on to consumers through the utility bill. (19)

These public advocates hired or contracted with attorneys, accountants, economists, and other analysts to participate in utility rate cases and other matters. Public advocates and their consultants became an integral part of the regulatory process and helped to give consumers a voice during the turbulent period when all of the major utility industries were undergoing tremendous pressure.

At the same time, independent consumer groups also became much more involved in utility issues. Ranging from local consumer groups with a few members to nationwide alliances representing millions of consumers, numerous organizations arose to represent specific segments of the population in utility cases — environmental activists, advocates for low-income

consumers, groups focused on the process of government, and small business alliances, to name just a few.

The 1980s and early 1990s saw the resolution of many highly contentious issues. By the end of the 1980s, all of the nuclear power plants were either canceled or included in rates; natural gas prices had been deregulated at the wellhead, and large gas users could purchase gas directly from producers; and the AT&T monopoly had been broken up into separate companies to provide local, long-distance, and equipment services. By the mid-1990s, utility rate cases were becoming rare events, prices were stable and starting to decline again, and large consumers of utility services had competitive options available to them. These options include cogeneration technologies that provide electricity and heat, direct purchases of natural gas from dozens of suppliers, and hundreds of companies that sell long-distance telecommunications services. In addition, during the 1990s, several utility commissions adopted alternative regulation plans designed to keep rates stable without requiring periodic rate cases.

With the ever-decreasing cost of computer technology (leading to greatly reduced costs in telecommunications and increased efficiency in all utility industries), advances in natural gas drilling equipment, and combined cycle power plants that produce electricity at less than most utilities' average cost of production, it appears that we are back to "business as usual" in the utility industry. That is, it looks like we are again in a declining-cost era, where utility rates will be stable or decline as new technologies replace older, less-efficient plant and equipment.

Yet, all is not normal in the utility industry. Rather than settling back and watching rates decline, the utility industries are seeing new issues emerge: competition and deregulation. Instead of suggesting a return to the first 60 years of utility regulation (infrequent rate cases usually leading to a decline in rates), the industry and many consumers are following the path of other previously regulated industries—trucking, airlines, railroads, savings and loans—and seeking to deregulate portions of the utility industries.

The Energy Policy Act of 1992 went a long way to opening up the wholesale electricity market to competition. Subsequent orders of the Federal Energy Regulatory Commission (FERC) all but deregulated that market. The price of natural gas at the wellhead was deregulated in the late 1970s. By the mid-1980s, FERC had restructured and deregulated nearly all portions of the wholesale gas market, allowing large consumers to purchase their own gas and have it transported to their business. The interstate long-distance telecommunications market has become increasingly competitive during the past ten years and is now largely deregulated. The Telecommunications Act of 1996 encourages states to follow suit and

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bring competition to and deregulate intrastate, and even local, telecommunications services. The utility industry in the late 1990s looks very different than the industry of the 1970s and 1980s. The purpose of this report is to investigate the role of utility consumer advocacy in this new era of deregulation and competition. Specifically, this report seeks answers to the following questions: What are the roles of consumer advocacy organizations in this new utility market? How do consumer advocacy organizations need to change to respond to these new forces in the utility industry? What types of expertise do they need? What should be the source of their funding?

Organization and Methodology

This report is based on in-depth interviews with representatives of ten consumer advocacy organizations from throughout the United States and on research into the effects of deregulation on other industries. In addition, the report has been guided by a project advisory committee, consisting of researchers and utility consumer advocates from across the country.

Chapter 2 of this report reviews deregulation in the airline, trucking, and savings and loan industries, focusing on consumer-protection issues that arose as a result of deregulation in these industries and the effect of deregulation on consumer groups. This section of the report is based on a review of relevant economic, public policy, and legal literature.

Chapter 3 provides an overview of competition and deregulation activities in the telecommunications, electricity, and natural gas industries, based on interviews with representatives of consumer advocacy organizations in several states. This section examines what restructuring means in each industry, what has happened so far, and what activities can be anticipated during the next few years.

Chapter 4 focuses on utility consumer advocacy organizations and the impact utility industry restructuring may have on these organizations. Chapter 4 also discusses ways in which these organizations have been changing to meet the different needs of a partially deregulated utility industry. It includes a discussion of a number of issues that consumer advocates will confront as the nature of the industry and regulatory process change over the next several years. This section is based primarily on in-depth interviews that were conducted with representatives of ten consumer advocacy organizations throughout the United States.

Chapter 5 discusses the implications for the future of utility consumer advocacy. More specifically, this section addresses a number of changes that consumer advocacy organizations will need to undertake to assure that the new utility industry provides safe and reliable service to all consumers at affordable prices.

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Chapter 2: Deregulation of Previously Regulated Industries

A brief review of deregulation in three industries— airlines, trucking, and savings and loans—is a useful starting point for examining potential issues in utility deregulation. The focus in reviewing these industries is on the impact of deregulation on consumers and the way in which consumer protection and consumer advocacy have changed as a result of deregulation. In attempting to assess what the experiences of the airline, trucking, and savings and loan industries mean for the coming deregulation of the utility industries, it is first important to recognize that most utility deregulation proposals involve the *partial* deregulation of an industry. This leads to a series of issues that were not present in other industries (such as concerns with cross-subsidization and unfair dealing between regulated and unregulated portions of the same corporation).

Airline Industry

Beginning in 1975, the Civil Aeronautics Board (CAB) began lessening restrictions on the airline industry. In this regard, the CAB focused on regulations pertaining to route changes, the review of airline fares, and the entry of new carriers into the market. The movement toward deregulation was a function of many factors, including economic theory about the benefits of competition, and pressure from entrepreneurs who saw an opportunity to provide better service at lower cost than the existing airline companies.

Since 1978, the effects of deregulation in the airline industry have been studied by dozens of economists and policy analysts (1, 2, 4, 7, 12, 16, 23-24, 26-28, 34, 35, 39). With 20 years of experience under deregulation, the airline industry offers an interesting case study of the impact of deregulation on consumers and the ways in which consumer protection and consumer advocacy change when a previously regulated industry becomes deregulated.

At the outset, it is important to note that the airline industry was not fully deregulated in 1978. Concern for the immediate impact of deregulation on small communities prompted the U.S. Congress to include special provisions to subsidize and protect air service to small communities. (2) In addition, the federal government continues to regulate safety, some aspects of consumer protection (such as deceptive advertising), and mergers within the industry.

Analysts disagree about the effect of competition on airline consumers. In the aggregate, it appears that deregulation and increased competition was beneficial for many consumers. Average airfares have declined in most

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parts of the country, the number of people flying has increased tremendously, and most measures of the quality of service show that service is improving. (1, 16, 26) However, these results are not true for *all* consumers. Some small communities have lost air service completely, while in many other communities, prices have increased, and the frequency of service has declined. (2, 32, 34) In fact, in the first six years after deregulation, 114 small communities lost all air service. (34) While average fares throughout the country declined between 1979 and 1994, several communities saw average fares increase by more than 20 percent (as measured in constant dollars) during this same period. (1, 32) During the first ten years after deregulation, some of the fare changes were even more dramatic. Although fares were generally falling, the fares on several routes—even those involving some large cities—doubled or tripled during this period. (2) Moreover, these calculations do not consider the dramatic decline in fuel prices since 1978, which would have resulted in fare decreases, even under regulation. (7)

The results of deregulation have also varied significantly by region of the country. Areas of the country experiencing high levels of growth tend to see benefits from competition: more airlines providing service, more flights, and lower fares. In contrast, those parts of the country declining in population or economic activity are not benefiting from deregulation: fewer airlines provide service and fares tend to be higher. (1, 32) As the General Accounting Office (GAO) concluded in 1996: "the largest decreases [in fares] occurred at airports serving communities of various sizes in the West and Southwest. In contrast, . . . the airports serving several communities—particularly small and medium-sized communities in the Southeast and Appalachian region—have experienced sharp increases in fares since deregulation." (32)

One public opinion expert has stated the problem succinctly: "For the American public, the litmus test of deregulation is a pragmatic one: Has deregulation produced the benefits it promised? The standard used to judge is, frankly, self-interest: have lower prices, more choices, and greater convenience been the outcome? According to these criteria, the verdict on deregulation is a mixed one. Americans perceive both successes and failures . . ." (14) Indeed, while the public originally supported airline deregulation, by 1988, 45 percent of the public thought that deregulating airline routes was working against the public interest, and only 51 percent believed that the deregulation of airline fares was working. (14) Similarly, a 1995 study revealed consumers' express concern about the "reduction in services, or higher costs, to smaller cities and rural areas" as well as concerns about airline safety. (9)

The deregulation of the airline industry provides useful information about the effect of deregulation on consumer protection in general and on the process of protecting the consumers' interest in particular. When airlines were deregulated, nothing was done to ensure that the consumer protection functions previously performed by the CAB would be carried on by the federal government. The 1978 legislation gradually phased out the responsibilities of the CAB and completely abolished the CAB effective January 1, 1985. In fact, it was believed by some analysts that "consumer protection may actually improve with less regulation." (24) This was based on replacing airline tariffs with more traditional consumer protection activities such as lawsuits. Airlines' tariffs, similar to the tariffs of public utilities, often limited the airlines' liability or imposed conditions on consumers, such as requirements to reconfirm flights several hours before departure. It was believed that these kinds of restrictions would not survive in a free market and that consumers would receive more protection as a result.

By 1984, however, it became apparent that this approach would not work. In June of that year, the GAO recommended that Congress enact legislation that would clearly provide for a continuation and transfer of the CAB's consumer protection functions. (35) The GAO concluded that the failure to provide for a strong consumer protection function within the government "could well lead to an increase in expensive and unnecessary litigation and a reduction in consumer protection." Specifically, it concluded that in the absence of Congressional action, "a decline in consumer protection is likely to occur," and increased litigation would result "as consumers and airlines attempt to determine their respective rights and obligations."

Congress responded by passing the CAB Sunset Act of 1984, which transferred the consumer protection responsibilities of the CAB to the Department of Transportation (DOT). (31) These responsibilities include policing fraud and other deceptive trade practices as well as reviewing mergers.

In subsequent reports, GAO reviewed consumer protection issues resulting from airline deregulation. (30, 31) Those reports found that several new kinds of consumer protection issues arose from deregulation. Among the most significant were misrepresentations and outright fraud in the tour industry (essentially resellers of airlines' services) and misleading advertising. The GAO found that the federal government was ill-equipped to deal with some of these abuses and other consumer advocates—primarily state attorneys general—were attempting to resolve some of the concerns. Airlines were arguing, however, that the states did not have the legal authority to deal with these issues. The airlines asserted that Congress had given the federal government the exclusive right to regulate these aspects

of the airline industry. For example, several state attorneys general challenged airline advertising that quoted very low fares between cities but in fine print stated that the fares covered the price of a one-way ticket and were available only if a round-trip ticket were purchased. The airlines successfully challenged the states' authority to review their advertising because DOT had some authority in this area. (15, 30) GAO also found that DOT's enforcement efforts were lax in some areas, particularly in regulating tour operators. Coordination between the federal and state governments, and even between DOT and the Federal Trade Commission (FTC), also were noted as enforcement problems in this area. In several areas, it was unclear whether the state or federal governments had jurisdiction to resolve a consumer complaint, and the communication between DOT and states was very poor. (30) In other cases, particularly in the area of telemarketing of tours, the FTC was exercising jurisdiction, even though federal auditors later found that DOT should have been made aware of the problems and taken action to resolve them. (31)

Trucking Industry

The interstate trucking industry was deregulated by the Motor Carrier Act of 1980. The interstate trucking industry is really two separate industries: the truckload industry (that is, shipments where the shipper fills an entire truckload) and the less-than-truckload, or LTL, industry (where numerous small shipments must be aggregated to fill a truck). The truckload industry provides for point-to-point shipping — that is, a truck is loaded in one location and delivers the load directly to its destination. The LTL industry takes the shipment to a terminal, where it is consolidated with other shipments bound for a nearby location. The effects of deregulation on large (truckload) and small (LTL) shippers have been very different.

While deregulation has increased competition within the truckload industry by allowing small, independent businesses to enter this segment of the industry, competition in the LTL industry has all but disappeared. (8, 22) The key difference between these segments of the industry appears to be the amount of infrastructure that is required. To compete successfully in the LTL market, a company must have a large network of trucks and terminals so that shipments can be aggregated efficiently. In the nearly two decades since deregulation, it has become increasingly difficult for new companies to enter this market. Before deregulation, the four largest LTL carriers controlled about 20 percent of the market. Within five years of deregulation, they controlled 35 percent of the market, and by the early 1990s, they had roughly 40 percent of the market. (22) In fact, in the first six years after deregulation, "more than 54 percent of the LTL trucking companies went out of business," and there have been no new entrants into this market. (22) Another study of the industry summarizes the effect of deregulation in the LTL market in this way: By 1986, "the ten largest LTL carriers accounted for 60 percent of LTL shipments and 90 percent of its

profits." (8)

While the truckload market appears to be very competitive, that industry has problems as well. Excess capacity in the market (that is, too many trucks) has created a large disparity between the prices paid by very large shippers (such as large factories that ship thousands of truckloads per year) and those paid by smaller shippers (such as small factories that might ship a few truckloads per week). In fact, some analyses show that very large shippers are demanding, and getting, below-cost rates just so that trucking companies can generate some cash and keep their fleets in business. (8) The result is that many smaller truckload shippers pay higher rates than they would otherwise so that trucking companies can recover some of the losses they incur on the business from large shippers. (8)

Evidence of rising safety concerns within the industry is also mounting. The truck fleet is aging, maintenance is being deferred, and drivers are pressured to drive for long hours. (8, 13) Since deregulation, accident rates are increasing, and the overall level of safety is decreasing. (8, 13)

Savings and Loan Industry

The savings and loan crisis of the 1980s was caused, at least in part, by the relaxation of regulations over the financial integrity of those institutions, coupled with incentives for them to pay higher interest rates to depositors. This, in turn, led them to lend money to riskier enterprises that would pay higher interest rates. Many of those riskier loans involved real estate development. When the recession of the early 1980s led to a decline in demand for real estate and a decline in real estate values, many savings and loans saw the value of their assets decline enough to put them in partial or total default. (22, 37)

It would be improper, though, to blame deregulation for the entire problem. Deregulation of interest rates and the costs of financial services was designed to provide more choices to consumers and to help savings and loans retain business that they were losing to brokerage firms that could sell "money market" accounts. Up until the late 1970s, savings and loans were prohibited from paying interest on checking accounts and were strictly regulated in the amount of interest they could pay on other accounts. With interest rates reaching 15 percent or more, brokerage firms were attracting savings and loan customers by offering "money market" accounts that paid market interest rates and worked very much like checking accounts. Deregulation of interest rates and other services was seen as a way to keep savings and loans viable by allowing them to compete more effectively with brokerage accounts. (22, 33, 37)

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Deregulation did have the intended effect. It enabled savings and loans to retain business and compete more effectively for deposit accounts. The downside, however, was that savings and loans engaged in riskier activities in order to generate enough funds to pay those higher interest rates. When those riskier investments failed, a crisis resulted.

It is too easy to say that deregulation was a failure. Savings and loans might have failed in even greater numbers had they been unable to attract and retain depositors. What is clear, however, is that the combined deregulation of interest rates and relaxation of regulatory controls on safety (the adoption of more lenient rules for valuing assets, among other factors) created an unstable business environment. The relaxation of controls on safety also made it more difficult to detect outright fraud and other criminal activities.

Another important question about savings and loan deregulation, and one that is often overlooked, is the impact on consumers. Before the crisis occurred, the GAO examined the effect of deregulation on the prices that consumers paid for banking services. (33) In 1987, the GAO concluded that low-income consumers (those with annual incomes under $10,000 per year) were paying significantly more for banking services than they were before deregulation. In contrast, higher-income consumers (those with annual incomes above $50,000) were receiving much higher interest rates on deposits, which more than offset any fee increases. (33)

The results of the GAO study and other studies led many to seek federal legislation to require financial institutions to offer "lifeline" services to low-income and older consumers. (33) Efforts to adopt legislation were not successful, but they did draw attention to the concern that some segments of the population were having trouble affording basic financial services.

There is every indication that since the GAO study in 1987, the problem is worsening. Banks are reporting ever higher earnings from the fees that they charge, while interest rates on basic accounts have declined to under 2 percent. (17)

Lessons Learned

Consumers and consumer advocates can learn from the experiences of other industries. Obviously, if there is deregulation in an industry, it means that rates and the other terms of service will no longer be regulated. For large consumers and large communities, choices are likely to increase and prices to decline, but for small communities and small or low-income consumers, choices may decrease and prices rise; some areas have suffered the complete elimination of the service.

Once there is deregulation, the typical consumer protection function in a regulated industry (trying to keep rates low and ensuring that the terms of service are reasonable) no longer apply. Fraud and misrepresentation will become important issues, not only among resellers and other new entrants into the industry but also among established industry participants. The federal and state governments have not always seen eye-to-eye on who has the responsibility to protect consumers from fraud, unfair trade practices, or other improper practices. At least in the case of airline deregulation, Congress did not make it clear who has the responsibility to provide needed services to low-income consumers, small communities, and others whom the market may not protect. Further, even within the federal government, there has been some confusion over which agencies have the responsibility to perform some of these functions. Similar confusion has occurred in some states over the jurisdiction of state agencies to deal with consumer protection concerns.

If the utility industries follow the path of other once-regulated industries, major mergers among large utility companies will continue, and some large companies will seek protection from the bankruptcy courts or even go out of business completely. These actions raise additional consumer protection concerns, such as the consumers' recourse when a supplier defaults on a promise to deliver a certain service.

Finally, deregulation also can lead to additional concerns about public safety and the quality of service that consumers receive. Airline deregulation has been handled in such a way that the safety of service has been retained or even enhanced, in large measure because the federal government continues to regulate the safety of airline service. On the other hand, deregulation in the trucking and savings and loan industries has led to very serious concerns about safety and quality of service within those industries.

Thus far, none of the efforts at deregulation have been able to ensure the availability and quality of service to all consumers. Despite promises at the outset that consumers would benefit and that neither public safety nor the quality of service would decline, deregulation has, in fact, led to increased concerns about public safety and a diminution in the quality or availability of service for at least some customers. Some communities and consumers lost service as a result of deregulation; others continue to receive service but at higher prices or lower levels of quality. At the same time, some consumers benefit from new services and lower prices. (5)

The complete deregulation of an industry does not appear to be consistent with the protection of public safety. The experience in the airline industry shows that it is possible to deregulate an industry financially while maintaining regulations over the safety of the service that is provided. The result can be the provision of enhanced levels of service for many consumers.

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The challenge is to strike an appropriate balance between price deregulation and regulation of safety and service. (5) This challenge has been described as follows: "If deregulation is not carried out carefully, disaster—such as the savings and loan crisis—will result. On the other hand, regulatory reform can unleash a torrent of creativity, innovation, and increased competition. The challenge for regulators is to craft regulations that will yield these outcomes." (22)

Efforts to deregulate portions of the telecommunications, electricity, and natural gas industries are well underway throughout the United States. A complete review of the status of deregulation is beyond the scope of this report and would

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be out of date before the report could be printed. Instead, this chapter will provide a brief overview of the ways in which deregulation is being pursued in these industries and how consumers may be affected by deregulation within the next few years.

Telecommunications

The telecommunications industry is really two industries: interstate long-distance service and local service. Interstate long-distance service is under the jurisdiction of the federal government, while local service is regulated by each state Public Utilities Commission (PUC). The federal government has largely deregulated long-distance service, while local service remains a regulated monopoly in all states.

Long Distance

The market for long-distance telecommunications services, on paper, is highly competitive. Hundreds of companies sell long-distance service to consumers. Different pricing plans, "dial around" services, on-peak rates, off-peak rates, flat rates, and week-end discounts are just some of the options offered to consumers.

A closer look at the industry, however, reveals that just three companies — AT&T, MCI-WorldCom, and Sprint — provide most of the service within the industry. Depending on the measure used (revenues, number of minutes, or number of telephone lines), AT&T controls between 55 percent and 70 percent of the market. (11) Collectively, the "big three" control between 82 percent and 91 percent of the long-distance market.[3] (11) Thus, while the market for long-distance telecommunications appears to be a highly competitive, in fact, the market is an oligopoly, dominated by three large firms.

[3] These figures are based on market shares before the merger of MCI and WorldCom. That merger is expected to slightly increase the share of the combined company, but MCI was required to divest its Internet assets before the merger, which could lead to a loss of some long-distance customers.

Much of the apparent competition within the long-distance industry is the result of companies' buying services at wholesale prices from the big three and then reselling those services to retail customers. There are hundreds, perhaps even thousands, of telecommunications resellers, but in reality nearly every consumer in the United States is purchasing long-distance service from one of three companies.

It does not appear likely that a fourth major provider of residential long-distance service will develop any time soon. While companies continually enter and leave the market, most new entrants that install their own facilities and begin to develop a substantial market share quickly become

candidates for a merger or acquisition. Other companies enter the market with facilities, but focus their efforts on large business customers.

Going from a monopoly (AT&T) in 1984 to an oligopoly in the late 1990s has had some advantages for consumers. Long-distance prices have fallen, and pricing options have increased. Offsetting these changes, though, has been the increase in the cost of local telecommunications service, prompted in large part by the reallocation of costs from long-distance companies to local consumers. For example, from 1984 through 1994, the price that long-distance companies had to pay for one minute of access on a local telephone network dropped from an average of 17 cents per minute to an average of 6 cents per minute. (11) The local phone companies passed on the difference to local residential consumers. The charge for local phone service has risen from a nationwide average for residential consumers of $11.58 in 1983 to $19 in 1994[4]. (11) The net effect has been a sustained price reduction for consumers who make a large number of long-distance calls and a net price increase for consumers who make relatively few long-distance calls. Overall, during the period from 1984 (when the AT&T system was broken up by order of a federal court) until 1994, the average monthly telephone bill for a residential consumer increased from approximately $38 to about $61 – a 60 percent increase in 11 years. (11)

[4]These figures represent the average monthly charge for a private line (i.e. one party) service with unlimited local calling . Subscriber line charges and taxes are included in these rates.

The advent of competition in the long-distance market also has given rise to consumer fraud. One of the most common types of fraud created by telephone utility industry competition is "slamming"—the unauthorized change of a utility service provider. Slamming often occurs in the context of high-pressure and deceptive marketing telephone contacts or as part of "contests" in which participants are not fully informed that they have authorized a change in their service provider. As a direct result of deregulation, slamming has become a major consumer-protection problem in the long-distance telecommunications industry.

Local Telecommunications Service

Local phone service for residential consumers and for most business consumers remains a virtual monopoly everywhere in the United States. The only exception is for business consumers in some of the country's largest cities, where Competitive Local Exchange Carriers (CLECs) are beginning to install their own facilities. In a few places, CLECs have successfully entered the market and taken large business customers away from the local phone company. Few markets in the country have CLECs serving individual residential consumers in other than token numbers. (3) The Telecommunications Act of 1996 was supposed to change this. That law was designed to enhance the level of competition for local phone service and, at

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the same time, allow local phone companies to enter the market for long-distance services. The expectation was that this would improve the level of competition in both markets simultaneously.

In reality, though, the law has not accomplished these objectives. The long-distance market continues to be dominated by the three major companies. The local phone market—particularly for residential consumers—remains a monopoly, and those monopolies are getting larger through mergers. In 1996, there were eight large "local" telephone companies. If the currently pending mergers between SBC-Ameritech and Bell Atlantic-GTE are approved, there will be just four in the near future. Further, cable television systems, which were believed to be the natural competitors of the local phone monopolies, have largely decided not to compete against the local phone companies. While this may change with the proposed merger of AT&T and TCI, the extent and timing of that competition remains a matter for much speculation.

In several states and at the federal level, movements are underway to introduce vigorous competition in the local market. So far, these efforts have turned into massive regulatory battles between the local phone monopoly and the long-distance oligopoly. Little has changed, and as of mid-1998, the prospects for vigorous local phone competition and the entry of the regional phone companies into the long-distance market appear to be months, if not years, into the future.

One serious consequence of the movement towards local phone competition already is apparent. The proliferation of CLECs, cellular telephone companies, paging companies, and other entrants into specific segments of the local phone market have led to the proliferation of new area codes. Each new entrant is assigned telephone numbers for an entire exchange (the first three digits of the telephone number after the area code). Each exchange consists of 10,000 phone numbers, but each area code has fewer than 1,000 exchanges available. Thus, even if a paging company needs only 100 telephone numbers, it is assigned 10,000 numbers. This highly inefficient allocation of telephone numbers has resulted in the premature "exhaustion" of available phone numbers in many area codes. This practice, in turn, has led to either the division of area codes, forcing consumers to expend substantial resources to notify others of their new area code (printing new stationery, notifying friends and customers, reprogramming telephone equipment and fax machines, etc.), or the creation of area-code overlays (multiple area codes serving the same area, with new competitors being assigned to the new area codes), leading to confusion among consumers and discrimination against new competitors who must convince potential customers to change their phone number as well as their phone company.

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Several states with high electricity costs are embarking on efforts to restructure the electric utility industry to make it more competitive. At the forefront of this effort are states in the West (California, Nevada, and Arizona), Midwest (Illinois and Michigan), and Northeast (Maine, New Hampshire, Massachusetts, Rhode Island, Connecticut, New York, and Pennsylvania). Several other states also are looking for ways to open their electricity markets to more competition.

Electricity

The status of electricity restructuring changes almost daily, as each state studies the possible effects of restructuring in that state and various interest groups continue to reassess their options. Two years ago, New Hampshire conducted the country's first test in electric competition and enacted the nation's first comprehensive restructuring legislation. This experiment, however, got bogged down in court challenges and New Hampshire is only now getting back to the task of designing and implementing an electricity choice program. So, rather than attempting to review the status of competition in each state, a few general observations will be made about what it means to restructure the electricity market and what is likely to occur over the next few years.

Competition for the generation or supply of electricity is the issue. No state so far is even considering the possibility of deregulating the distribution of electricity. For the foreseeable future, the electricity industry will likely consist of two distinct markets: the generation of electricity, which may become largely unregulated, and the distribution of electricity (the wires, transformers, and substations that are needed to get electricity to the consumer), which will remain regulated. It is for this reason that most people are referring to the "restructuring" of the electric industry, rather than to its deregulation. While a portion of the industry may be deregulated (the supply side of the industry), the distribution, or "wires," side of the industry will remain a regulated monopoly.

For the past 20 years, the national policy has been to encourage the production of electricity by independent companies rather than by the local utility. That policy has given rise to many independent power producers in some regions of the country as well as many large commercial and industrial consumers that generate at least some of their own electricity. Since the passage of the Energy Policy Act of 1992, competition has emerged in the wholesale electricity market, making it easier for utilities to buy power from the lowest-cost source in the market.

The latest step in this process is giving these diverse generating companies direct access to retail consumers. Rather than being required to sell only to large utilities, electricity-generating companies would be allowed to sell directly to consumers. In addition, companies (and even cities and nonprofit organizations) are being encouraged to buy electricity at wholesale and resell it to retail

consumers as a way of further broadening the electricity market. The hope is that by giving consumers direct access to the electricity generator, consumer choice will increase, the quality of service will improve, and prices will decline.

It is too soon to tell whether electric industry restructuring will be able to achieve these objectives. At this writing, a few states have begun to set the rules and establish the framework for retail competition, while others are in varying stages of investigating their options. Thus far, the biggest single issue is the recovery of "stranded costs" (or above-market costs) by electric utilities. Stranded costs are the difference between the market value of the utility's assets and the amount that the utility has been including in its regulated rates (typically, the actual cost of the assets). In the case of some very expensive assets, like nuclear power plants, the disparity between the asset's market value and its actual cost is large. The issue becomes what to do with the difference: Does it get recovered from the utility's customers? If so, over what period of time? Should the utility's investors be required to absorb some of the cost and, if so, how much?

It appears that until these stranded costs are recovered, achieving substantial reductions in electric rates will be difficult. While some states are hoping for 10 to 15 percent reductions in rates in the early years of restructuring, the larger savings—some analysts estimate on the order of 40 percent or more—will not be achievable until stranded costs are removed from the utility's bills. That could take from five to ten years.

Restructuring also raises questions about what portions of the industry should remain regulated. Are billing and metering services part of the distribution of electricity (a regulated service) or part of the supply of electricity (a competitive service)? Is the presence of generation near large groups of customers part of the supply of electricity or part of the safety and reliability of the distribution network? Added to these questions are concerns about the potential for cross-subsidization between parts of the same company that perform services for both regulated and unregulated businesses.

Restructuring the electricity industry is not a simple task. If the experiences of California, Pennsylvania, Illinois, and Maine are any indication, once the state legislation is passed, restructuring could involve on the order of 15 or 20 separate proceedings in each state to establish the basic ground rules for restructuring. In addition, each electric utility will need to file a new set of rates to separate the costs of supplying electricity from the costs of distributing that electricity to consumers. A wide variety of interests can be expected to be represented in those proceedings, among them utilities, various consumer groups,

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environmental organizations, labor unions, independent power producers, marketing companies, local governments, and rural electric cooperatives.

A few states also are beginning the process of restructuring the natural gas market. In the mid-1980s, the wholesale market for natural gas was deregulated on the federal level. Since then, large gas consumers have been able to buy gas directly from gas producers and have it transported directly to their place of business. Current efforts to restructure the gas industry are aimed at giving smaller consumers, including individual residential consumers, the same right.

Natural Gas

As this is being written, large-scale test programs are underway or will begin shortly in several states to give consumers the right to buy gas from their supplier of choice. In addition, a few states (Georgia, Montana, and Oklahoma) have enacted legislation that would restructure the retail gas industry in those states, and other states are studying the issue. In each instance, the local gas utility would remain a regulated monopoly and would deliver the gas to the customer, ensure that enough gas is available to meet demand during the winter, and otherwise oversee the safety and reliability of the local gas system.

It appears that restructuring the gas industry will result in much smaller savings to consumers than are possible from restructuring the electricity industry. Much of the savings in natural gas was achieved ten years ago or more, when large consumers were allowed to shop for their own gas supplies. In fact, between 1990 and 1995, the average national price of gas paid by electric utility and industrial gas consumers declined by 36 and 24 percent respectively. (10) By now, large gas producers and marketing companies are selling gas directly to virtually every large gas user in the country. Further, the presence of competition for those large gas supplies put increased pressure on gas utilities to shop for the best prices to serve the remaining small consumers.

This combination of a well-developed gas market and few large consumers who are not already purchasing gas from their supplier of choice makes it unlikely that large savings will result from further restructuring the gas market. Early results from some of the test states appear to have created some savings for consumers, at least during the relatively mild winter of 1997-98, but it is difficult to assess the long-term effect of these programs on the price and supply of natural gas.

If these early programs show signs of success, it is likely that other states will follow suit, particularly in those states that are restructuring their electricity industries. If consumers can successfully purchase one form of

energy in a competitive market, it is likely that they will want to purchase other forms of energy in the same manner or from the same supplier.

Although utility industry deregulation is just beginning in most places, utility consumer advocates are already examining their future roles. This chapter focuses on the changing roles of three types of consumer advocacy organizations: state consumer agencies authorized to represent the interests of consumers before the public utility commission (PUC); private, nonprofit organizations representing consumers on utility-related issues; and legal services organizations representing the interests of low-income consumers. Traditionally, each of these types of organizations plays a distinct role in the regulatory process.

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Chapter 4: Effect of Deregulation on Utility Consumer Advocates

State agencies usually have the responsibility to represent the consumer interest in general. Often, state consumer agencies act without consulting individual consumers; rather, they use professional judgment to determine the actions that are in the best interests of consumers collectively. This approach may lead to particular groups of consumers being affected differently. State agencies usually have substantially greater resources than most other consumer organizations involved in a utility case (except organizations of large industrial consumers)—professional staff (attorneys, accountants, engineers, consumer specialists, and others) and a budget to hire consultants with expertise for a particular case.

Private organizations usually represent a specific membership base. This base may include consumers with specific characteristics (such as AARP's representation of older persons), those who live in a relatively small geographic area (neighborhood associations), or those who share some common interest (such as environmental organizations). The resources of these organizations vary tremendously, from the small community group with no professional staff and a limited budget to highly sophisticated national organizations with professional staffs and multi-million dollar budgets. These private organizations usually educate their members about utility issues and often become formally involved on specific issues of concern to their members in cases before a PUC.

Legal services organizations represent the interests of low-income consumers. Legal services organizations tend to have relatively few resources to devote to utility issues, perhaps one or two attorneys for a city or a small office to cover an entire state. However, these organizations often have much greater expertise in a broad range of consumer protection issues, expertise which may prove invaluable as the utility industry becomes less regulated and begins to look more like other consumer services industries. Legal services organizations usually represent individual consumers with utility problems but also become formally involved on issues affecting low-income consumers in cases before a PUC.

The movement toward deregulation is changing the traditional role of utility consumer advocacy organizations. In states where utility industry restructuring is occurring, the issues with which consumer organizations must deal are increasing, particularly in the following areas:

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1. Consumer education,
2. Consumer complaint handling and consumer protection,
3. Market oversight and merger review, and
4. Coalition-building.

New and Increased Responsibilities

These changes in the focus of consumer advocacy organizations are a function of the proposed changes in the utility industry and the need for consumers and policymakers to ensure that the transition to a different market structure does not adversely affect consumers. These activities are in addition to continuing regulatory responsibilities for the distribution of electric and gas service, ensuring the provision of universal telephone service, and other ongoing regulatory issues.

Moreover, while some consumer advocacy organizations play a role in serving as watchdogs over the quality of utility service, the importance of this responsibility will increase significantly. Traditionally, the quality of utility services has been monitored by many consumer advocates to ensure that utilities are maintaining the safety and reliability of their systems and are remaining focused on the needs of their customers. In a more competitive environment, however, there will be tremendous pressures on utilities to shift resources from their regulated operations to their unregulated operations. Consequently, consumer advocates will need to focus carefully on any change in resource allocation to ensure that such action will not have an adverse effect on the safety, reliability, and overall quality of utility services. Organizations that have not focused on these issues in the past may find that it is now necessary to do so. Organizations that have developed some expertise on quality of service issues may find that they will need to enhance their capabilities in this important area.

1. Consumer education

Consumers are not used to shopping for electricity, natural gas, or local telephone services. Numerous questions will arise about how to determine the best deal, how to evaluate offers that are not expressed in comparable terms, and how to evaluate the value of bundles or packages of services. In the past, many consumer advocates have not found it necessary to expend significant resources on educating consumers, but that is changing.

One of the best ways to protect consumers in a competitive market is to educate the consumer about how to participate in the market. Consumer advocates now find it necessary to educate consumers about their utility bills and services. Most consumers have no idea what it means to use a kilowatt-hour of electricity or a cubic foot of gas. They do not understand how the prices of gas and electricity in the marketplace vary during certain times of the year, or even during certain times of day. Advocates must

make these concepts clear to consumers. Consumer advocates will need to spend much more time and money educating consumers, using various media—brochures, newsletters, and meetings with community organizations.

In California and Pennsylvania, PUCs are directing massive, statewide education efforts designed to inform consumers about the opportunity to choose electricity providers. Those multi-million dollar efforts have focused on consumer "awareness" that electric choice is available. They have not yet provided the basic information that consumers will need to understand what competition involves (such as what a kilowatt-hour means, how utility bills can be lowered through conservation, and what the risks are of having energy prices vary with the time of day or season of the year). Whether and how this information will be provided remains to be seen.

2. Consumer complaint handling and consumer protection

Everything does not always go according to plan. That unfortunate truism means that problems will arise between consumers and utility companies or other suppliers. Whether the problems are the result of honest mistakes or dishonest activities or consumer confusion, consumers need a place to turn.

In most states, that place has been the PUC consumer complaint division. However, as utility services become deregulated, the PUC may lose jurisdiction to deal with many complaints. In other states, PUCs find their consumer staff ill-equipped to deal with the volume and nature of consumer inquiries that arise as utility industries are becoming more competitive.

Consumer advocacy organizations, small and large, are attempting to fill this gap by increasing their ability to respond to consumer complaints and questions. The problem, of course, is that this can be an expensive proposition, requiring additional staff, telecommunications resources, and a commitment to providing timely, responsive service to consumers. Many consumer advocacy organizations do not have the budget or the staff to provide service to a large number of consumers.

Smaller organizations are trying to fill this need by establishing better links with other organizations. These networks of consumer advocacy organizations may include several state agencies (attorney general, PUC, governor's office), nonprofit organizations, local governments, and the utility companies themselves. Larger organizations are increasing their consumer complaint handling capability

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so that they can respond to more consumer inquiries directly. They are not only increasing the staff and physical equipment of the office but also expanding the ability of the office to respond to inquiries in languages other than English.

3. Market oversight and merger review

Helping ensure that a new market becomes and remains competitive is one of the most difficult and complex tasks that a consumer advocacy organization can undertake. Traditionally, utility consumer advocates did not need to worry about these issues at all—by definition, the utility was a natural monopoly. It did not have any competition. With restructuring, however, assurance that the market is competitive and is not being abused is needed. Part of this assurance is the review of proposed mergers to ensure that consumers and competitors will not face higher prices or poor service as a result of the combination.

Within the past two years, the merger activity in the utility industry has been overwhelming. If all currently pending mergers are consummated, the telecommunications industry will have gone from eight major local telephone companies to four, all within the two years since the Telecommunications Act was enacted in 1996. At the same time, numerous mergers are being proposed in the energy industry, further draining the resources of utility consumer advocates.

Overseeing the market requires more than reviewing proposed mergers. Mechanisms need to be created to deal with allegations of unfair competition and policies and procedures need to be developed to prevent cross-subsidization between regulated and unregulated operations within the same company. Consumer representatives will find themselves negotiating with utility companies, independent marketing companies, marketing affiliates of the utility, and local businesses (such as fuel oil dealers). Each interest has a different set of issues that concerns them, and each wants to ensure that the new market begins on a level playing field, rather than one slanted to the benefit of one participant or another.

4. Coalition-building

Restructuring utility industries is neither simple nor straightforward. Tradeoffs and inter-relationships are often complex and not always readily apparent. Is it better to achieve immediate rate decreases or to provide incentives for consumers to shop for utility services? Should a utility be prohibited from entering the market for competitive services if it has a monopoly on other related services or should it be allowed to compete and encouraged to provide the best deal that it can for consumers? Should stringent consumer protection requirements be put in place, or should marketers be given the flexibility to develop products and services that meet the needs of certain portions of the market?

There are no easy answers to these types of questions. Each involves a series of tradeoffs that ultimately will determine whether a competitive market can work for consumers. No one organization can be expected to figure out all of these complex inter-relationships or decide what is in the best interest of all consumers in an entire state. The result, in many states, is that utility restructuring provides a magnet to attract organizations that often have been on opposite sides of the table in utility cases, such as industrial plants, low-income consumers, and small businesses. The task of building a coalition among these groups is difficult, time-consuming, and not always successful.

Typically, the state consumer agency provides the catalyst for bringing together these diverse groups to develop a set of principles to which they can all agree. Forming the coalition, finding a set of common principles, keeping the organization on task, and allowing differences to get resolved can be a full-time job. From the experience of consumer advocates in several states, however, it appears that coalition-building is a critically important component of a restructuring process that protects consumers while developing a competitive market.

In those states where utility industry restructuring is occurring, consumer advocates will almost certainly find that they have an increased work load, a need for different expertise, new incentives to coordinate with other consumer advocates, and inadequate funding. An advocacy organization's effectiveness will depend on its ability to cope with these three issues.

Work load

The complexity of utility industry restructuring should not be underestimated. It is not simply a matter of enacting legislation or changing commission policy and watching a free market develop. The process is time-consuming and can seriously strain the resources of a consumer organization.

Issues Associated with New Responsibilities

California, Pennsylvania, Maine, and Illinois are each in various stages of restructuring their electricity industries. All four states have enacted restructuring legislation, but that is just the beginning. In each state, there have been, or will be, at least two dozen separate proceedings covering topics as diverse as the licensing requirements for electricity suppliers, metering standards, electronic data exchange requirements, permissible activities of utility affiliates, codes of conduct for relationships between utilities and their unregulated affiliates, and utility bill formats. In addition to these generic proceedings, each electric utility is required to start a highly complex legal and financial proceeding so that the utility's charges can be divided between its regulated

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services (the transmission and distribution of electricity) and its unregulated services (the sale of kilowatt-hours of electricity) and its "stranded costs" can be determined.

In essence, then, in the space of a year or two in these states, consumer advocacy organizations are faced with an unprecedented workload: 20 or more nearly simultaneous generic proceedings coupled with complex cases for every electric utility in the state.

On top of these statutory mandates to implement restructuring is the unprecedented level of merger activity in the energy and telecommunications industry. Nearly every state has had at least one major utility merger during the past two years; many states have faced several such cases. Evaluating a merger, determining its impact on consumers and the marketplace, and developing recommended solutions to any problems are not easy tasks. A major utility-industry merger can be as complex as a multimillion dollar rate case. Every state also is dealing with the requirements of the federal Telecommunications Act of 1996. That law requires each local telephone utility to go through numerous proceedings in each state in an attempt to open up the market for local telephone service and to provide local telephone companies with the ability to offer long-distance services. In addition, some states have separate legislation that governs the regulation of telephone utilities. In Pennsylvania, for example, 19 small local telephone companies recently filed plans to modernize their networks and change the way in which they are regulated. These applications came at the same time that the state is restructuring its electricity industry and evaluating pilot programs to allow consumers to purchase natural gas directly from suppliers. At the same time, the state is evaluating a proposed merger between two of its largest energy companies and another merger that involves its two largest telephone companies.

Simply put, many utility consumer advocacy organizations are busier than they have ever been. Their responsibilities are expanding and changing, but their old work is not going away. Expectations are rising that consumer organizations will help educate consumers about utility markets and the effects of restructuring. In addition, many of these same organizations are expected to help consumers resolve problems they have with utilities.

Need for Different Expertise

Changing the structure of the utility industry, breaking apart utility rates into separate components, writing rules for consumer protection in a competitive market, and evaluating mergers and acquisitions in a competitive market are new responsibilities for most consumer advocates. Finding and developing expertise in these new areas is not a simple task.

Utility consumer advocacy organizations tend to rely on their internal expertise, coupled with a relatively small number of outside consultants who regularly work on utility-related issues for consumer advocates. As an example, the National Association of State Utility Consumer Advocates lists just 50 consulting organizations in the entire country that advertise their services to utility consumer advocates. (18) Most of these consultants have experience on the more traditional issues involved in utility regulation (such as estimating the cost of capital, determining the appropriate levels of investment and expenses, estimating future revenues, and designing rates to recover the utility's revenue needs). While many consultants are developing the expertise needed to help consumer advocates deal with restructured utility industries, many gaps remain in the available expertise.

Jim Hurt, the director of the Utility Consumers' Counsel in Georgia, states that on issues like market power and antitrust, "we're flying by the seat of our pants. Most consultants are still thinking in terms of traditional ratemaking. There are not many consultants who understand these issues. We're finding out about issues before the consultants are. It's hard to find consultants who understand these issues and are out in front of them." This concern is echoed by several other consumer organizations. It seems that as each state begins dealing with these new issues, consumer organizations are left to develop some or all of the necessary expertise in house. Hiring a consultant is not sufficient. Mr. Hurt suggests that it would be worthwhile for consumer advocates who deal with issues first to help other consumer advocates, not just in an informal way, but actually as consultants and expert witnesses.

The lack of readily available expertise poses several problems for consumer advocacy organizations. It makes it more difficult for them to participate in negotiations or litigation involving these highly complex issues. Even after identifying a consultant, more time is needed to develop positions, strategy, and testimony. Often, time is something that is in very short supply in many of these cases.

As more states go through utility industry restructuring, it is anticipated that some of the issues will become more routine and that consultants will be available who have been through these issues in other states. It may take several years, however, for this to occur. In the meantime, it will continue to be difficult for consumer organizations to find and develop the expertise that they need to participate fully in many of these proceedings.

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Coordination with Other Organizations

The significant changes in the utility industry have highlighted areas where consumer advocacy can be improved and strengthened. One of those areas is the coordination and communication among organizations with similar interests.

In Maine and the District of Columbia, this has involved the creation of coalitions of consumer organizations. In Maine, the formation of a coalition was prompted by the introduction of legislation to restructure the electric utility industry. In the District of Columbia, the driving force was the proposed merger of the local electric utility, Potomac Electric Power Company (PEPCO) with a neighboring utility, Baltimore Gas and Electric Company (BG&E). In both instances, these major policy and consumer protection issues resulted in usually disparate consumer groups (including industrial customers, other small and large business groups, low-income consumers, labor unions, and others) coming together, putting aside their differences, and finding a common set of issues on which they could agree. Betty Noël, the People's Counsel for the District of Columbia, highlights the strength of the consumer alliance that was formed: "We have seen an alignment of consumer interests across the spectrum—business, government, labor, consumer groups, and others were aligned against the PEPCO merger. This was the first time that we had a chance to appreciate how powerful the alliance was. Utilities were very surprised by the strength of the alignment, too." She is hopeful that the coalition will be able to remain in place for other important issues, including the potential restructuring of the electric industry in the District.

This type of concerted effort has not occurred in other states. Instead, each group of consumers has taken its own approach, with large consumers of utility services seeking to reduce their expenses, either at the cost of the utility or at the cost of smaller utility consumers. For example, in California, there is no permanent consumer alliance following electric restructuring activities. As different issues arise, the coalitions shift such that groups may support one another on some issues but oppose each other on different issues. Nettie Hoge, the executive director of The Utility Reform Network (TURN) in California, explains the problem this way: "It's becoming harder to put together a coalition. The issues aren't as clear cut and the utilities are working harder to divide and conquer. Agendas for various groups are different than they once were (for example, small business interests may not coincide with residential interests anymore) because of the complexity of the issues."

The relationship between consumer advocates and PUCs also is changing. In some states, consumer advocates and PUCs have a very cooperative relationship, while in others the relationship is much more confrontational. Proposals to restructure the utility industry and to change the nature of regulation have placed additional strain on some of these relationships. In

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some states, tension has increased between consumer advocates and the PUC, as both attempt to figure out how they fit into a new industry structure. For example, in Ohio there has been a good deal of tension between the PUC and the Office of Consumers' Counsel (OCC), as the PUC attempts to determine what role it will play in consumer protection and consumer education in a restructured utility marketplace. Rob Tongren, the Consumers' Counsel, describes the source of the tension: "There is a question of who should handle residential consumer complaints. The PUC has been moving more into that area, but its charge is to protect the public interest (that is, to act as the judge). OCC's enabling statute gives it the authority to take 'appropriate action with respect to residential consumer complaints' whereas the PUC lacks similar specific statutory authority."

Maine has taken a more cooperative approach toward ensuring that the PUC and the Public Advocate are not duplicating their efforts. Under the direction of the State Planning Office, the PUC and the Public Advocate have worked together to redefine the roles of both organizations. Under this new structure, which has yet to receive legislative approval, the PUC would focus on regulation of utilities and the market and would no longer perform an advocacy function. The Public Advocate would be primarily responsible for serving as a watchdog over emerging markets, seeking to protect competition, giving consumers tools to make informed choices, and protecting consumers from market abuses.

In redefining the role of consumer advocacy organizations, it is important to recognize the inter-relationships and synergies that exist between organizations. For example, smaller consumer organizations may be dependent on the large state consumer agency to provide certain information, expertise, and other support in complex cases. If the state consumer agency reorganizes, care is needed to ensure reorganization does not have an adverse effect on smaller organizations. Ellis Jacobs, from the Legal Aid Society of Dayton, Ohio, discussed this concern: "My effectiveness will depend on the availability of OCC and other groups. We need to share the work and have the ability to bounce ideas off of others. OCC seems to be moving more into the consumer education function and away from litigation. If that happens, we will have to beef up our litigation ability (we may need as many as five people, rather than our current 1½ doing utility-related work)."

Finally, consumer advocacy organizations need to better coordinate their efforts on a national level. Several organizations work on a national level to represent the interests of utility consumers, including the National Association of State Utility Consumer Advocates (NASUCA), the National Association of Attorneys General (NAAG), the Consumer Federation

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of America (CFA), AARP, the National Association of Consumer Agency Administrators, Consumers Union, and the National Consumer Law Center. These and other organizations have worked together on some issues, but they do not always take advantage of opportunities to work together when their interests converge. Fred Schmidt, the director of the consumer protection bureau for the Nevada Attorney General, readily acknowledges that "there has not been good communication between NAAG and NASUCA." With a restructured utility industry, however, that communication will be more important than ever. Mr. Schmidt explains, "NASUCA members tend to view the PUC as the way to solve problems. In a restructured world, that won't necessarily be the case."

As an example, one of the most pernicious problems that has been created by utility industry competition is "slamming," the unauthorized change of a consumer's utility service provider. Within the telecommunications industry, there are thousands of complaints each year regarding slamming. In Nevada and Oregon, slamming complaints are being handled by prosecutors in the attorneys general offices as consumer fraud cases, which has proven to be effective in combating the problem. Utility consumer advocates, also trying to find ways to deal with this problem, may not be aware of the efforts that have been undertaken by attorneys general.

In summary, as the structure of the utility industry changes, traditional relationships among consumer advocacy organizations will need to change as well. It will be increasingly important to keep open the lines of communication and to develop coalitions and working groups to ensure that scarce resources are being used in the most effective way possible.

Funding

Consumer advocacy organizations are funded in several different ways. Most state agencies that perform a utility consumer advocacy function are funded through an assessment on each utility operating in the state, though some receive funding from the state's general fund. Legal services organizations receive funding from the federal government, state governments, the United Way, or from Interest on Lawyer Trust Accounts (IOLTA) programs. Nonprofit consumer organizations receive most of their funding from the contributions of individual consumers, though foundations and other private charities may provide grants. The restructuring of the utility industry could have a major impact on funding for all three types of consumer advocacy organizations.

Most organizations will need additional resources to make the transition from a fully regulated utility industry to a partially deregulated industry. The number and complexity of proceedings that are necessary to do the job

properly means that additional staff and/or outside consultants will need to be hired. As an example, the Maine Public Advocate received a 50 percent increase in its budget for fiscal year 1998-1999, primarily for consulting costs associated with electric industry restructuring. This additional funding is being provided during the transition period to a competitive utility industry. It remains to be seen whether the Public Advocate receives additional responsibilities as a result of changes in the utility industry, which might lead to increased funding requirements in the future.

Historically, utility consumer advocates have relied on their success in saving money for consumers to justify their budget requests or to encourage consumers to join their organizations. During the 1970s and 1980s, when utilities were filing for unprecedented, multi-million dollar rate increases, the need to fund a consumer advocate was clear. However, the issues involved in utility industry restructuring are much less concrete than the dollars and cents involved in a rate case. For example, restructuring involves questions about market power, rules for corporate affiliates dealing fairly with each other, guidelines for communicating with consumers, requirements for utility bill formats, and numerous other consumer-protection issues that do not have an immediate effect on the amount of the monthly utility bill. How does an organization explain the benefit of participating in a proceeding to determine the rules for participating in a competitive market? Will consumers readily contribute to an organization if they cannot discern the effect on their utility bill? Will legislators be as understanding of budget requests when the state consumer agency can no longer quantify the savings on utility bills from their advocacy efforts?

The answers to these questions are far from clear. It remains to be seen whether legislatures, foundations, and individual consumers will be willing to contribute to consumer advocacy organizations when the issues move from the pocketbook to public policy and market structure.

For those organizations funded through an assessment on utility companies, there is a serious question of the fairness and adequacy of that funding method. If consumer advocates are spending more of their time dealing with competitive-market issues, then a portion of their funding arguably should come from companies that are participating in that market. It would not seem fair to require regulated utility companies to bear the entire burden of supporting these organizations, while relieving competitors of that same responsibility.

Moreover, if funding remains tied to utilities' regulated revenues, then the level of funding can be expected to decline as more of the utilities' activities take place in the unregulated market. For example, if the only portion of an electric bill that is regulated are the transmission and distribution charges, that

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would remove about one-half of the utility's revenues from the regulated side of the business. If the consumer advocate's funding is based on the utility's regulated revenues, then the funding could decrease by 50 percent or more.

Strategies for Changing and Adapting

Many consumer advocates are actively transforming their organizations to deal with the new structure of the utility industry. The following case studies provide examples of some of the changes taking place.

Case Study 1: Building a Network

Consumers in Maine will not be able to buy electricity on the open market until March 2000. By that time, a statewide coalition of consumer groups expects to be in its fifth year.

Legislation to restructure the electric industry in Maine was negotiated during countless meetings involving utilities, consumers, legislators, and the PUC. Early in the process, the various consumer interests (large industries, low-income consumers, small businesses, and residential consumers) recognized that they needed to find a way to put aside their differences and work toward a common, consumer-oriented position.

Steve Ward, Maine's Public Advocate, started the effort to organize the Maine Electric Consumers Coalition but did not expect it to last very long. Past efforts to get various consumer groups together had not been very successful. This time, however, the group had a clearly defined mission to counteract the lobbying clout of the utilities in the debate over restructuring the electric industry. Members of the coalition recognized the need to find common ground and develop a consumer alternative to utility-industry restructuring proposals. The coalition developed a common set of consumer principles and met frequently to compare notes and discuss strategy. Mr. Ward thinks that the coalition will continue through the implementation phase of the electric restructuring legislation and may work on other utility issues as well. "Above all, form a consumer coalition," he advises. "The coalition provides us with information from real consumers speaking from various perspectives."

Case Study 2: Educating the Consumer

The District of Columbia Office of the People's Counsel (OPC) has placed a great emphasis on consumer education. Betty Noël, the People's Counsel, has taken a number of actions to help ensure that utility consumers are informed about the benefits and drawbacks of competition. For example, prompted by the public's concern with a lessening of service quality, OPC filed a request for a quality-of-service investigation, covering all three utilities that serve the District. Subsequently, OPC held a public hearing focusing on quality of service, creating a public record of consumer concerns and allowing utilities to hear those concerns.

OPC also is actively involved in a Washington Gas Company working group that is evaluating educational materials about customer choice. Recently, OPC convened a consumer focus group to review and comment on these educational materials. The group provided valuable input and recommendations that the utility incorporated into its revised materials.

Case Study 3: Helping the Consumer

From its community outreach efforts and work with other consumer organizations, the Ohio Office of Consumers' Counsel (OCC) recognized the need to provide better service to Ohio's residential utility consumers. OCC is one of the largest state agencies in the nation that represents utility consumers, with more than 60 employees and an annual budget in excess of $6 million.

In 1996, OCC responded to about 1,300 inquiries from utility consumers. During the next year, OCC increased its complaint-handling staff and began to publicize its toll-free number. The level of inquiries received by OCC increased more than forty-fold. OCC received 35,635 inquiries from consumers and expects that number to be eclipsed in 1998. Through July 1998, OCC received 35,251 customer contacts and anticipates total inquiries for 1998 to exceed 72,000. Today, as a result of OCC's negotiations with companies, many utility bills in Ohio list OCC's toll-free number for consumers to discuss any questions or complaints with their utility service.

Rob Tongren, the Consumer's Counsel, explains that with the possibility of competition in the utility industry, "the demands on OCC are increasing dramatically, particularly in the area of complaint handling and consumer protection." In order to meet the demand for these services from all consumers, Mr. Tongren is devoting more resources to these activities and "making an effort to hire people with skills in other languages."

Case Study 4: Reorganization

The Nevada Office of Consumer Advocate (OCA) is one of about 20 in the country that is part of the state attorney general's office. In 1997, the attorney general's office was reorganized, making the OCA part of the Public Protection Bureau. Now, the utility consumer advocates work side by side with experts on consumer education, fraud, and antitrust.
Fred Schmidt, Nevada's Consumer Advocate and the new director of the Public Protection Bureau, sees major advantages to this new structure: "We have brought together expertise in telemarketing, consumer fraud,

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antitrust, and utility advocacy. Our reorganization is providing the resources and expertise that is needed to deal with changing issues involving utilities." Mr. Schmidt also noted the benefits of having prosecutors, investigators, and consumer education specialists available for help on utility-related matters.

Case Study 5: Helping Low-Income Consumers

Low-income consumers may have the most to lose when utility industries are restructured. A new program in New York is finding ways to help these consumers without resorting to costly litigation.

Several years ago, the federal government established a "lifeline" program to help low-income consumers afford basic telephone service, but in order for lifeline to work, consumers need to be informed that this program is available, and the local phone company must agree to administer the program and receive the approval of the state PUC. After years of fighting about the lifeline program, the Public Utility Law Project (PULP) in New York reached an agreement with the largest local phone company in the state (NYNEX, now part of Bell Atlantic) and the state Department of Family Assistance. NYNEX now has access to state social service records so that it can automatically enroll eligible consumers in the lifeline program. The result: enrollment has increased by more than 250,000 people in two years, and more than 100,000 people who are no longer eligible have been dropped from the program. Gerry Norlander, a senior attorney at PULP, explains that they now have about 750,000 people statewide on the lifeline program which is "probably 60-70 percent of the eligible population, compared to most states where less than 25 percent of the eligible households participate in lifeline."

Case Study 6: Finding New Ways to Protect Consumers

Consumer advocates' focus on litigation is changing. As utilities file fewer rate cases, consumer advocacy organizations have realized that they need to find new ways to protect consumers and enhance the quality, affordability, and availability of utility services. In California, The Utility Reform Network (TURN) participated in a statewide ballot initiative on electric restructuring. TURN's network of volunteers gathered more than 720,000 signatures to place the initiative on the ballot. In addition, while TURN contin-

ues to be actively involved in litigation, it is looking for ways to provide information to consumers, such as becoming a resource for cities and towns that want to buy electricity for their residents. Nettie Hoge, TURN's executive director, explains: "We want to help local governments understand their options and become educated about electric restructuring."

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Chapter 5: Conclusions / Implications

The utility industry is changing, and utility consumer advocacy organizations must change along with it. The issues are changing, the work load is increasing, and responsibilities are being redefined. Old funding sources may no longer be available, and new sources may be difficult to find. Organizations that used to share the same points of view may become adversaries but old enemies may become allies.

When other industries were deregulated, the transition often resulted in a loss of important protection for the consumer. Large consumers received better service and lower prices but often at the expense of small or low-income consumers. Deregulation in other industries also has raised concerns about the safety, reliability, and overall quality of service. It is still early enough in the restructuring of the utility industries to learn from these experiences.

Utility consumer advocates must increase their effectiveness. A theme that recurred in discussions with consumer advocates throughout the country was the need to form coalitions and networks of consumer organizations on the local, state, regional, and national levels. Utility companies are getting much bigger, and consumer advocates need to increase their impact as well. This does not necessarily mean that an individual organization needs to grow; rather, growth can come by sharing resources and expertise across many organizations. Each consumer organization has a different core competency and a different constituency. Bringing these groups together not only increases resources but also makes each organization more sensitive to the particular interests of the others.

Consumer education and consumer protection will be increasingly important functions for consumer advocates. If utility services are purchased in a competitive market, then consumers will need to be educated about how to make wise decisions. As utilities are deregulated, consumer advocacy organizations must be vigilant about consumer fraud and other marketing abuses.

Consumer organizations need to take a hard look at their structure and function. They need to explore and understand the relationship between their organization and others, both within state government and in the private sector. They need to forge ties with organizations in other states and perhaps even other countries as utility companies expand their operations throughout the world. With competition and restructuring come mergers and acquisitions. The telecommunications industry now has just a handful of companies that control local telecommunications services and three companies that control the long-distance market. The

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energy industry has seen an unprecedented number of proposed mergers during the past year, and more are likely to occur as restructuring spreads throughout the country. More issues will be decided on a regional or national—or even international—level rather than in an individual state. Consumer advocacy organizations need to have structures in place to deal with these much larger, regional utilities.

In doing this, consumer advocacy organizations cannot just rely on what might have worked in another state or for another organization. While those experiences may provide some useful insight into strategies that should be explored, one state's experience is not always directly transferable to another. Each state, each organization, and each national association may need to reexamine its role, form new networks, and evaluate issues as they emerge.

Consumer advocacy organizations cannot rely solely on experiences from other deregulated industries. One factor that separates the utility industry from other previously regulated industries is that the utility industry has a number of highly skilled, institutionalized consumer advocacy organizations. Restructuring the utility industry provides a unique opportunity for consumer advocacy institutions to make a transition to dealing with competitive businesses in less-regulated markets. Their experience in making this transition may help show the need for similar types of consumer advocacy organizations to protect consumers in other competitive markets.

It is possible that over time, at least in some states, the functions of utility consumer advocates will be a routine part of a larger consumer protection and consumer education organization, but the transition from the current, regulated utility industry to a less-regulated industry structure will be complex and difficult. Consumer advocates are needed to ensure that the new industry structure contains protections for consumers and that educational programs promote smart shopping in the new market. The work load will be enormous, the issues will be complex, funding sources will change, and coalitions will shift. Strong consumer advocates can help assure that the new utility industry provides safe and reliable service to all consumers at affordable prices.

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Private and Public Utilities Agree . . .

Federal "Private Use" Tax Rules Prevent Community-Owned Utilities From Fully Participating in the Competitive Electricity Marketplace

Problem

Community-owned utilities currently face outdated federal tax law barriers which prevent their full participation in the rapidly-changing electricity marketplace. Existing Federal tax rules ("private use" rules) will limit the ability of public power systems to continue to provide electricity to consumers in a restructured electricity market, where flexibility is the key to survival. Attempting something as basic as retaining their existing customers could cause the tax-exempt bonds that public power systems used to finance their infrastructure to become retroactively taxable, resulting in a very costly and problematic situation for both the cities and their bondholders. Current private use rules inhibit community-owned utilities from joining Regional Transmission Organizations (RTOs), which will hamper critical transmission grid and system reliability.

Solution

In order to allow community-owned utilities the ability to fully participate in the emerging deregulated electricity marketplace, industry stakeholders, both public and private systems, have agreed that the following modest modifications to the private use rules are warranted:

- Election and Grandfather for Generation — Public power systems, as entities of state and local governments, will have the ability to make a local choice on future generation operations. If relief from private use restrictions is needed, these utilities can gain the necessary relief from private use restrictions on outstanding tax-exempt debt, but must agree to refrain from issuing tax-exempt bonds to build most new

generation facilities. If no relief is needed, these systems can continue operating under a clarified version of the existing private use tax rules.

- Transmission and Distribution Facility Limitations — New tax-exempt bonds may be issued to finance transmission facilities if those facilities are, or will be, necessary to serve wholesale or retail native load. The use of new tax-exempt debt for transmission is also permitted where the utility is ordered or permitted by a regional transmission organization or state agency to build such facilities. The agreement includes a straight prohibition on using tax-exempt bonds to build "merchant" transmission facilities.

- No New Restrictions on Distribution Facilities — No new limitations are imposed on the use of tax exempt-bonds by existing community-owned utilities to finance construction of distribution facilities. As a transition mechanism, newly formed public systems; however, are subject to a 10-year moratorium on the use of tax-exempt bonds to acquire or construct such facilities.

These changes, in conjunction with necessary tax code changes for shareholder-owned electric utilities, form the basis of a reasonable compromise that retains important concepts included in bipartisan legislation (H.R. 721 and S. 386), which has been cosponsored by more than 30 Senators and 130 Representatives. Important concepts retained from these bills are:

- Clarification — of how the existing private use rules will work in a competitive marketplace;
- Choice — provide a statutory mechanism by which public power systems can make an election on whether (a) to lift the private use test on existing generation facilities financed with tax-exempt bonds, or (b) remain subject to private use rules.
- Open Access — encouragement and incentives for community owned utilities to open up their transmission and distribution facilities, thereby providing more electricity choices to consumers.

Background

Community-owned utilities, as entities of state and local governments, have used tax-exempt debt to finance their utility infrastructure in much the same way any city would to finance schools, roads and bridges. Public power systems cannot issue stock to raise capital and have no other real source of financing these large capital projects other than municipal bonds. In exchange for the use of tax-exempt debt, public power systems are required to adhere to a strict set of federal tax rules and regulations designed to limit the amount of power that they can sell to private entities. These rules limit a community-owned utility's ability to negotiate contracts with existing customers, resell excess power resulting from competition ("lost load"), and discourage the opening of transmission lines — which were financed with tax-exempt debt.

Like many rules and regulations currently in effect, yesterday's private use rules are not suitable for today's competitive environment. What might have been manageable and appropriate in an era of strict regulation is proving to be wholly unworkable in a restructured marketplace. In fact, as more and more states implement their own electricity restructuring plans independent of federal legislation, the private use rules have begun to hamstring community-owned systems' ability to adapt to the changing business environment. Equally important is the problem that these rules present for community-owned utilities to participate in progressive energy policy developments that are necessary to provide continued high levels of reliable and affordable electric service for all electricity consumers.

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September 2000

APPA American Public Power Association

EEI EDISON ELECTRIC INSTITUTE

LPPC

Private and Public Utilities Agree . . .

Tax Law Changes Are Urgently Needed to Smooth the Transition to Electric Competition and Protect Reliability

Problem

Action is needed now to bring the Internal Revenue Code (Code) into line with changes in the electricity industry so that electric competition can grow and the reliability of the electric system will be maintained. Action is urgently needed because of two approaching deadlines: October 15, 2000, for the formation of regional transmission organizations (RTOs) under an order issued by the Federal Energy Regulatory Commission (FERC), and January 23, 2001, when temporary Treasury Department regulations expire. These regulations are intended to enhance electric competition by allowing competitive power suppliers to use the distribution and transmission facilities of community-owned utilities. Tax law changes are needed now as a result of these government directives, and to allow efficient markets to develop in the 24 states and the District of Columbia that have adopted electric competition. Resolution of these issues will also help additional states to adopt competition in the near future.

A fully competitive electricity market will include a variety of electricity suppliers. Among those suppliers will be for-profit, taxable entities; public power providers (that are not-for-profit); and local agencies. Each type of market participant faces tax barriers to participate in competitive markets. Congress should enact "The Electric Power Industry Tax Modernization Act" (H.R. 4971, S. 2967), legislation which offers a balanced approach to a fair and open marketplace. This legislation, which needs the urgent attention of the 106th Congress, addresses four major issues.

Solution

Private Use Relief: Tax-exempt financed generation, transmission, and distribution facilities of community-owned electric utilities are subject to "private use" limitations. These limitations make it difficult or impossible for such utilities to permit open access to transmission and distribution facilities as required or encouraged by state and federal laws and regulations. This inability to provide open access to transmission inhibits competition and poses significant reliability problems for the electricity grid, because it limits the amount of electricity reserves that can be transferred to areas with high demand. The U.S. Treasury Department issued temporary and proposed regulations to address these problems. However, the regulations provide insufficient relief, and they expire on January 23, 2001. Only Congress can provide a complete and permanent solution.

Transmission Tax Relief: Under FERC Order No. 2000, issued in December 1999, all transmission-owning electric companies are required by October 15, 2000, to articulate their plans to join an RTO or to explain why they cannot, and set forth a plan for further action. Under current tax laws, transmission-owning utilities that sell or spin-off their transmission assets to form RTOs would incur a substantial federal income tax liability.

The solution to this dilemma, which arose from a government mandate, is to amend Section 1033 of the tax code to permit sales of transmission assets on a tax-deferred basis if these sales occur in conformance with FERC Order No. 2000 (or related state mandates), and the proceeds of the sales are reinvested in certain utility assets. Similarly, Code Section 355(e) should be amended as an alternative to permit a non-taxable spin-off of transmission assets, even if the assets are to be combined with neighboring transmission assets in conformance with Order No. 2000. These tax law changes will further diminish tax barriers to wholesale and retail competition by creating truly independent transmission organizations.

Contributions in Aid of Construction (CIAC): Under current federal tax law, the costs of building new transmission and distribution facilities for homes, commercial properties, and

industrial sites — indeed, any kind of property where connection costs are paid by a developer or interconnecting third party to a utility — are treated as "contributions in aid of construction" ("CIACs") and are considered as taxable income to the utility. CIACs typically involve reimbursing a utility for those expenses related to expanding or upgrading utility services, such as distribution and transmission lines, to serve new development. The result is that a developer or interconnecting third party must reimburse a utility for construction costs plus a federal income tax of about 31 percent.

By treating the reimbursement of costs of interconnections to transmission and distribution facilities as non-taxable, policymakers would remove a barrier to competition by making it less costly to provide services. This would help increase the supply of power and improve electric reliability. It would also help to eliminate any barriers to the construction of new distribution facilities on behalf of third parties, such as developers of housing and commercial and industrial projects.

Nuclear Decommissioning Funds: Owners of nuclear power plants make contributions to external trust funds to ensure that monies are available to decommission plants when they are retired. Congress added Section 468A to the Code in 1984 to permit owners of nuclear plants to currently deduct a portion of the contributions that are made to the external funds. Section 468A, when enacted, was designed to operate within the structure of regulated rates. It depends on public service commissions authorizing specifically identified costs (such as decommissioning expenses) that an electric utility can charge its customers.

Congress should adapt Section 468A of the Code to the structure of competitive markets. "The Nuclear Decommissioning Restructuring Act" (H.R. 2038 and S. 1308), contained in "The Electric Power Industry Tax Modernization Act" (H.R. 4971 and S. 2967), will adapt Section 468A of the Code to competitive markets, while preserving the original intent. Moreover, this legislation would also facilitate the transfer of nuclear facilities to new owners in compliance with state and federal directives.

Background

Over the last four years, Congress has considered comprehensive electric utility restructuring legislation. This is a complex and controversial issue, and no federal legislation has been enacted to date. Nevertheless, 24 states have adopted competition, and FERC is moving ahead with the formation of RTOs to facilitate the formation of competitive markets. The problems under the federal tax code facing electric utilities are immediate, and they are the direct result of restructuring activities that have already occurred. They must be addressed now, so that the effects of the tax code will help — not hinder — the development of electric competition and the maintenance of a reliable electric system.

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September 2000

Private and Public Utilities Agree . . .

Remove the Tax on "Contributions In Aid of Construction" to Facilitate Electric Reliability, Increased Electric Supply, and Competition in Electricity Markets

Problem

Federal tax law currently raises the cost of connecting new electric generation systems and other types of facilities, when they are connected to an electric utility's transmission or distribution system, by treating the reimbursement of costs of interconnections as taxable income to the utility.

Solution

Treat the reimbursement of interconnections for transmission and distribution facilities as non-taxable contributions to capital. With this tax law treatment, a barrier to competition would be removed by making it less costly to provide electric services. This would help increase the supply of power and improve electric reliability. It also would help to eliminate any barriers to the construction of new distribution facilities on behalf of third parties, such as developers of housing and commercial and industrial projects.

Background

Under current federal tax law, the costs of building new transmission and distribution facilities for homes, commercial properties, and industrial sites — indeed, any kind of property where connection costs are paid by a developer to a utility — are treated as "contributions in aid of construction" ("CIACs") and are considered as taxable income to the utility. CIACs typically involve reimbursing a utility for those expenses related to expanding or upgrading utility services, such as distribution and transmission lines, to serve new development. The result is

that a developer must reimburse a utility for construction costs plus an additional tax cost of about 31 percent.

In addition, third parties seeking to interconnect new generation facilities to a utility's transmission or distribution system may be required to reimburse utilities for the construction fees associated with the interconnection. The tax law should be clarified that such a reimbursement does not result in an additional 31 percent in taxes. Eliminating the tax on CIACs helps improve reliability by lowering the costs of enhancing distribution and transmission systems through reducing the costs of interconnections.

In an effort to find new sources of revenue, the Tax Reform Act of 1986 changed tax law to treat CIACs as taxable income to the utility that receives the contribution. In many states, the state regulatory commission requires that developers reimburse the utility for the construction costs (i.e., the CIAC) and the tax costs imposed on the CIAC. It is appropriate to remove the income tax on CIACs because, under the principles of utility ratemaking, the utility is not entitled to earn any return on the property that was constructed. Thus, a CIAC really has more in common with a contribution to capital than with revenue resulting from providing utility services.

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Private and Public Utilities Agree . . .

Remove the Tax Penalty for Compliance with Federal Regulations to Facilitate Formation of Competitive Electricity Markets

Problem

Under Order No. 2000 (Order), issued by the Federal Energy Regulatory Commission (FERC) in December 1999, all transmission-owning electric companies, subject to FERC jurisdiction, are required by October 15, 2000, to articulate their plans to join a regional transmission organization (RTO), or to explain why they cannot and set forth a plan for further action. RTOs must be operating by December 15, 2001, and would operate the combined transmission systems of most or all of the electric utilities in a region. The Order also provides that an RTO must not be controlled by any of the companies that comprise the RTO or use its transmission facilities. Companies that comprise RTOs and other market participants may initially own up to 5 percent of an RTO, but ownership by a class of participants is limited to 15 percent. Companies that comprise RTOs and other market participants may have unlimited passive ownership.

Under current tax laws, transmission-owning utilities that sell or spin-off their transmission assets to form RTOs would incur a substantial federal income tax liability. Utilities can avoid the tax consequences if they become passive owners of transmission facilities by relinquishing control of their facilities to others. However, passively separating ownership from control undermines efficient transmission operations and provides no incentive for owners to invest in new facilities. Passive ownership is a poor substitute for true independence. It requires complex and inefficient corporate structures. Recent experience shows that the value of assets will decline, and operating costs will increase under such structures. In addition, because companies

would have little incentive to upgrade transmission facilities, reliability could be harmed. Thus, resorting to passive control does not really solve the problems of utilities that must form an RTO.

Solution

Amend Internal Revenue Code (Code) Section 1033 to permit sales of transmission assets on a tax-deferred basis if these sales occur in conformance with FERC Order No. 2000, providing that the proceeds of the sales are reinvested in certain utility assets. Similarly, Code Section 355(e) should be amended to allow for a tax-free spin-off of transmission assets, even if they are to be combined with neighboring transmission assets in conformance with the Order.

Background

FERC believes that RTOs will facilitate competition by expanding and simplifying markets for electricity. Thus, in December 1999, FERC issued Order No. 2000 to encourage formation of RTOs. Under an RTO, transmission-owning utilities in a given geographic area that can do so would place their transmission facilities under the control of the RTO. If utilities sell or spin-off their transmission facilities to form an RTO, the transaction would be taxable. A company should not incur a tax liability for complying with government policies seeking to restructure an industry. Public policy should ensure that neither the utilities which comply with FERC's Order, nor the customers, who do business with new RTOs, suffer economically from imposition of federal income taxes on compliance transactions.

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Private and Public Utilities Agree . . .

Amend the Nuclear Decommissioning Tax Law to Adapt It to the Competitive Electricity Industry

Problem

Current tax law allows for the accumulation of funds in external trusts that are needed to pay for the decommissioning and safe retirement of nuclear power plants. Section 468A of the Internal Revenue Code (Code), which was designed to operate within the structure of a regulated electric utility industry, allows owners of nuclear power plants to make tax deductible contributions to the external trusts. However, the federal government is encouraging the movement of the industry to competition, and half of the states have adopted or endorsed such competition, which uses market-based prices to pay for power rather than regulated rates.

Solution

Congress should adapt Section 468A of the Code to the structure of competitive markets. "The Nuclear Decommissioning Restructuring Act" (H.R. 2038 and S. 1308), contained in "The Electric Power Industry Tax Modernization Act" (H.R. 4971 and S. 2967), would adapt Section 468A of the Code to competitive markets while preserving the original intent. Moreover, this legislation would also facilitate the transfer of nuclear power facilities to new owners in compliance with state and federal directives. The Act would:

- operate independently of cost of service ratemaking to permit taxpayers to continue to receive tax deductions for accumulating properly identified nuclear decommissioning costs in external trusts;
- provide flexibility to taxpayers to allow accelerated funding of nuclear decommissioning costs to these external trust funds where allowed by regulators, in order to accommodate a wide variety of state restructuring initiatives;

- allow accelerated funding of nuclear decommissioning costs, where required, in connection with the transfer of a nuclear power plant;
- eliminate a discriminatory feature of current law so taxpayers can accumulate additional funds needed for decommissioning on a tax-deductible basis irrespective of the age of their plants;
- define "nuclear decommissioning costs" and acknowledge that they are currently deductible when they are paid or incurred; and
- discontinue the requirement that taxpayers obtain a ruling from the IRS before making deductible contributions to the external trust funds.

Collectively, these changes should preserve the ability of taxpayers, in today's competitive electricity industry, to accumulate funds necessary for decommissioning the country's nuclear power plants.

Background

Owners of nuclear power plants make contributions to external trust funds to ensure that monies are available to decommission plants when they are retired. Congress added Section 468A of the Code in 1984 to permit owners of nuclear power plants to currently deduct contributions that are made to the external funds. Section 468A, when enacted, was designed to operate within the structure of regulated rates. It depends on public service commissions authorizing specifically identified costs (such as decommissioning expenses) that an electric utility can charge its customers. The annual contributions to the external trust funds typically extend over the period of years that the public service commission authorizes the utility to recover its capital investment and operating costs (including decommissioning costs) of a nuclear power plant from its customers.

As a result of the Energy Policy Act of 1992, restructuring laws in almost half of the states, and Federal Energy Regulatory Commission policies, the electric utility industry is in the process of deregulating. In the future, an electric utility may not be in a situation where decommissioning costs are included in its regulated and recoverable costs of service. Rather, such costs could be left to the plant owner to provide through revenues from market-based, or competitive prices.

As now structured, Section 468A requires that deductible contributions be determined by the amount of decommissioning costs included in a company's cost of service. If the law is not changed, taxpayers who sell power based on market rates may be unable to deduct amounts identified for future decommissioning costs. Therefore, funds collected for decommissioning may be depleted needlessly by income taxes that would be incurred under current tax law because of the failure to meet the connection required by Section 468A to traditional cost of service ratemaking.

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September 2000

Alliance of Energy Suppliers

A Division of the Edison Electric Institute

EDISON ELECTRIC INSTITUTE

THE NEED FOR FASTER TAX DEPRECIATION FOR ELECTRIC GENERATION ASSETS

1654

DOE003-0298

Alliance of Energy Suppliers

A Division of the Edison Electric Institute

Taxing Electric Generating Assets:

The Need to Reduce the Depreciation Period

The Alliance of Energy Suppliers is leading a significant tax initiative to enact federal tax legislation to lower the depreciable lives of electric power assets – saving the industry many millions of dollars. Today, the depreciation period for electric generating assets for tax purposes is far in excess of the recovery periods for other capital-intensive industries. Remedying this significant disparity would greatly benefit the growing number of power suppliers operating or purchasing these facilities. To accomplish this goal, the Alliance of Energy Suppliers has established the Coalition of Depreciation Equity (CODE) to lead the charge for an accelerated depreciation period. It's time for change.

What's at Stake

The deregulation of the electric utility industry has led to the unbundling of services and the sale of many generation assets. This transformation of electric generation to a competitive and unregulated industry has put energy suppliers at a competitive disadvantage compared with other capital-intensive industries that can depreciate assets at a much quicker rate.

The current tax law profoundly impacts a generator's bottom line, making it difficult to compete. The current 15-year and 20-year cost recovery period for these assets also discourages the formation of much needed capital investment, compared with other industries' 7-year cost recovery period.

For information on participating in this effort, contact Theresa Sanders at 202/508-5183 or at tsanders@eei.org.

Join the Coalition of Depreciation Equity (CODE) for electric generation equity.

Reasons for Change

• Encouraging New Investment to Assure Reliability

Determining the reliability of the nation's electric power system are the adequacy of generation supply and declining capacity margins. As deregulation is implemented and markets become competitive, the need for new investment to maintain the reliability has become critical. The price spikes and major power outages of 1999 brought this issue home to millions of people. In addition, The National Energy Reliability Council ("NERC") has identified several NERC regions that will have dangerously narrow capacity margins within the next decade. *These national interests must be met by new business incentives to improve and to construct new electric generation facilities.*

• Other Capital Intensive Industries: Shorter Depreciation Lives

In sharp contrast to the 15-20 year depreciation lives for electric generation assets, other capital-intensive manufacturing processes such as pulp and paper mills, steel mills, lumber mills, foundries, automobile plants and shipbuilding facilities are depreciable for Federal income tax purposes over seven years. Chemical plants,

(over)

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for example, can depreciate their assets over five years! There is no justification for these distinctions. *Generation assets must be treated as assets of other heavy industries.*

• New Investments to Comply with Environmental Laws

New environmental requirements on electric generation can seriously impair the value and useful life of existing assets. Compliance requirements, such as those relating to the Clean Air Act amendments, new source performance review, state implementation plans, National Ambient Air Quality Standards, and the Environmental Protection Agency's toxic release inventory are requiring significant new investment in mitigation technologies. In some cases, existing plants will have to be effectively abandoned and new generation plants constructed. *This will require new capital investment, investment that the tax laws should encourage, not discourage as under current law.*

• Technological Improvements

Deregulation of electric generation is already fostering innovation. Facilities constructed a generation ago were nuclear or coal-fired facilities. Today, many power plants are gas turbine facilities, often operated in combined-cycle or as co-generation facilities that produce steam for sale as well as electricity. These new combined-cycle generators operate at energy conversion efficiency levels of 70% compared to 40% – 50% a decade ago. *However, tax laws discourage the construction of these more efficient units* – while regular gas turbine facilities are depreciable over 15 years, combined-cycle units are depreciable over 20 years.

Rapid technological changes also threaten the longer-lived generation assets. Distributed generation could render these facilities functionally obsolete. The use of fuel cells, micro turbines or other small scale generating equipment can eventually displace power generated by a central station generating unit. These rapid changes in the industry make it unlikely that electric generation facilities will have the same useful lives as they have had in the past.

• Uncertain Cost Recovery

Congress suggested in the legislative history to the Tax Reform Act of 1986 that one reason why electric assets are depreciated over longer periods is because of the certainty of utility cost recovery through rates. As the market for electric energy becomes competitive, this rationale is obsolete – there will be no more such certainty. Investors will demand a return of, and a return on, their investments over much shorter periods of time. This new reality is inconsistent with the current tax rules that allow cost recovery only over 15-20 years.

• The Need for Certainty in Tax Compliance

Just as the electric industry is rapidly changing, the IRS must recognize that electric generation cost recovery must also change. By changing these assets from a 15 or 20 year depreciable life to a 7-year life, disputes with the IRS will be minimized. The question of whether certain costs should be expensed or capitalized (recovered over an extended number of years) can be resolved without the need for expensive litigation costs incurred by the taxpayer and the government.

• Join the Coalition of Depreciation Equity

A competitive electric industry must have the same ability as other industries to rapidly depreciate assets for Federal income tax purposes. The Alliance of Energy Suppliers and the industry coalition are strongly supporting changes in federal tax laws to allow electric generation facilities to be depreciated over 7 years – not 15 or 20 years!

And your support is needed!

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106TH CONGRESS
2D SESSION

H. R. 4959

To amend the Internal Revenue Code of 1986 to modify the depreciation of property used in the generation of electricity.

IN THE HOUSE OF REPRESENTATIVES

JULY 25, 2000

Mr. THOMAS (for himself, Mr. JEFFERSON, and Mr. ENGLISH) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1986 to modify the depreciation of property used in the generation of electricity.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. DEPRECIATION OF PROPERTY USED IN THE GENERATION OF ELECTRICITY.

(a) DEPRECIATION OF PROPERTY USED IN THE GENERATION OF ELECTRICITY.—

(1) IN GENERAL.—Subparagraph (C) of section 168(e)(3) of the Internal Revenue Code of 1986 (relating to 7-year property) is amended by striking "and" at the end of clause (i), by redesignating

DOE003-0301

clause (ii) as clause (iii), and by inserting after clause (i) the following new clause:

"(ii) any property used in the generation of electricity, and".

(2) 10-YEAR CLASS LIFE.—The table contained in section 168(g)(3)(B) of such Code is amended by inserting below the item relating to subparagraph (C)(i) the following new item:

"(C)(iii) ..... 10".

(b) DEFINITION OF PROPERTY USED IN THE GENERATION OF ELECTRICITY.—Subsection (i) of section 168 of such Code is amended by adding at the end the following new paragraph:

"(15) PROPERTY USED IN THE GENERATION OF ELECTRICITY.—The term 'property used in the generation of electricity' means property used in nuclear power production of electricity for sale, property used in hydraulic power production of electricity for sale, property used in steam power production of electricity for sale, and property used in combustion turbine production of electricity for sale."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to property placed in service after the date of the enactment of this Act.

○

PROPOSAL TO MODIFY THE DEPRECIATION OF PROPERTY USED IN THE GENERATION OF ELECTRICITY

PRESENT LAW

A taxpayer generally recovers the cost of property used in a trade or business through depreciation or amortization deductions over time. Tangible personal property generally is depreciated under the Modified Accelerated Cost Recovery System ("MACRS") under section 168, which applies specific recovery periods and depreciation methods to the cost of various types of depreciable property.

The MACRS recovery periods for property used in the generation of electricity are outlined in Rev. Proc. 87-56, 1987-2 C.B. 674. Assets used in the nuclear power production of electricity for sale are provided a recovery period of 15 years. Assets used in hydraulic power production of electricity for sale are provided a recovery period of 20 years. Assets used in steam power production of electricity for sale are provided a recovery period of 20 years. Assets used in combustion turbine production of electricity for sale are provided a recovery period of 15 years.

In order for public utility property, including property used in the generation of electricity, to be eligible for depreciation under MACRS, the tax benefits of accelerated depreciation must be normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account.

REASONS FOR CHANGE

The electric industry has begun a transformation from a regional, vertically integrated, rate-regulated business to a national (or international) industry consisting of three components: generation, transmission, and distribution. As a result of this restructuring, most generation plant investments no longer will be regulated. Already, 24 States have passed restructuring legislation, and nearly all others are considering such legislation.

As an initial matter, the 15-year and 20-year recovery periods for electricity generation assets are much longer than the recovery periods provided with respect to other capital-intensive industries. For example, seven-year recovery periods are provided for pulp and paper mills, steel mills, lumber mills, foundries, automobile plants, and shipbuilding facilities.

The present-law recovery periods for electricity generation assets also are out of step with the innovation being forced by industry restructuring. New electricity generation technology is being developed and deployed at a rapid pace. For example, new "cogeneration" facilities being placed in service operate at energy conservation levels that are far higher than older plants. Other new developments – such as "distributed generation," where electricity is produced on a customer's site using fuel cells, micro turbines, or other small scale generating equipment that can displace power generated by a central station generating unit – could render longer-lived generation assets obsolete. In addition, clean-air regulations are requiring development of new environmental mitigation technologies. Present-law recovery periods for electricity generation property may act as a significant disincentive for taxpayers to invest in these new technologies.

Finally, the rationale for longer cost recovery in the electric industry is no longer applicable. In the legislative history underlying the 1986 Tax Reform Act, Congress suggested that one reason why electric industry assets are depreciated over longer periods is because of the certainty of cost recovery through rates. As electricity markets become deregulated, there will be no such certainty.

DESCRIPTION OF PROPOSAL

Property used in the generation of electricity generally is provided a seven-year recovery period and a ten-year class life for MACRS purposes. Such property includes property used in nuclear power production of

electricity for sale, property used in hydraulic power production of electricity for sale, property used in steam power production of electricity for sale, and property used in combustion turbine production of electricity for sale, as these terms are described in asset classes 49.11, 49.12, 49.13, and 49.15 in Rev. Proc. 87-56, 1987-2 C.B. 674.

EFFECTIVE DATE

The proposal is effective for property placed into service after the date of enactment.

Alliance of Energy Suppliers
A Division of the Edison Electric Institute

EDISON ELECTRIC INSTITUTE

NEW TREASURY REPORT FINDS THAT PRESENT DEPRECIATION LAW OF UTILITY ASSETS DOES NOT REFLECT THE IMPACT OF INDUSTRY DEREGULATION

TREASURY FINDS THAT UTILITY DEPRECIABLE LIVES FOR GENERATION MAY BE TOO LONG IN A COMPETITIVE ENVIRONMENT

The Department of the Treasury has issued a 132 page "Report to the Congress on Depreciation Recovery Periods and Methods," July 2000. The Report agrees with information provided to Treasury by the Alliance of Energy Suppliers, a division of the Edison Electric Institute, that the depreciable lives of public utility assets are decreasing as a result of deregulation and other new developments in the industry. In relevant part, the Report states:

> "Electric, gas, water, and telephone utilities were all generally regulated at the time the current class lives were established. Under rate of return regulation, utilities were not theoretically concerned with depreciation and tax expense, because rate structures were based on cost-plus pricing. A utility's rate of return on equity was largely independent of its tax or depreciation expenses. Consequently, for public utilities, it is unclear that existing class lives truly represent the actual useful lives of the property involved.
>
> Class lives may be expected to be different in the current more competitive environment. Producers must maintain state-of-the-art equipment, which might mean shorter lives and more rapid depreciation. For example, new generations of combined cycle gas turbine generators are more efficient today than previously, leading to a more rapid retirement of such equipment than would have occurred under regulation." [At page 97.]

The Alliance previously submitted information to Treasury, including a "Rationale for More Rapid Depreciation of Electric Generation Assets." The Rationale noted that while the preponderance of new generation facilities constructed a generation ago were nuclear or coal-fired facilities, many power plants built today are gas turbine facilities, often operated in combined-cycle or as co-generation facilities that produce steam for sale as well as electricity. These new combined cycle generators operate at energy conversion efficiency levels of 70% compared to 40%-50% a decade ago.

Clearly, the Report was influenced by the Rationale in concluding that output facilities will be more rapidly retired in the future than would have occurred under regulation.

The Rationale also described how the end of rate regulation will shorten the time horizon over which utilities will seek the return of, and a return on, their investments. The first paragraph of language quoted above largely paraphrases from this section of the Rationale.

BACKGROUND

The Report was completed based on a directive to the Secretary of Treasury in the "Tax and Trade Relief Extension Act of 1998" to conduct a comprehensive study of the recovery periods and depreciation methods under section 168 of the Internal Revenue Code and to provide recommendations for determining those periods and methods in a more rational manner.

In the Report, the Treasury states that the current depreciation system is dated. It continues:

> "The asset class lives that serve as the primary basis for assignment of recovery periods have remained largely unchanged since 1981, and most class lives date back at least to 1962. Entirely new industries have developed in the interim, and manufacturing processes in traditional industries have changed. These developments are not reflected in the current cost recovery system, which does not provide for updating depreciation rules to reflect new assets, new activities, and new production technologies. As a consequence, income may be mismeasured for these assets, relative to the measurement of the income generated by properly classified existing assets. . . .
>
> The current depreciation system has been constructed using an ambiguous classification criterion. Most assets receive depreciation allowances that are determined by the length of their 'class lives.' However, current class lives have been assigned to property over a period of decades, under a number of different depreciation regimes serving dissimilar purposes, and with changed definitions of class lives. The ambiguous meaning of current class lives contributes to administrative problems and taxpayer controversies. It also makes difficult the rational inclusion of new assets and activities into the system, and inhibits rational changes in class lives for existing categories of investments." [At pages 2 and 3.]

Testimony of

Theodore Vogel, Vice President and Tax Counsel for

DTE Energy Company

on behalf of

Edison Electric Institute

regarding Federal Tax Laws and the New Economy

before the

Oversight Subcommittee

Committee on Ways and Means

United States House of Representatives

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My name is Ted Vogel and I am the Vice President and Tax Counsel for DTE Energy Company, the parent holding company of Detroit Edison Company. Detroit Edison is an integrated electric utility serving greater southeastern Michigan with non-regulated subsidiaries active throughout the United States. DTE has 2.1 million customers, generates and sells over 50 million MWH of electric energy per year, has approximately 9,000 employees and annual revenues in excess of $4.7 billion. I am responsible for tax planning and tax compliance for DTE Energy. I am testifying today on behalf of the Edison Electric Institute (EEI), specifically the energy supply division of EEI, the Alliance of Energy Suppliers. Ron Clements, Director of Governmental Relations at EEI, is accompanying me today.

EEI, through its Alliance of Energy Suppliers, serves the needs and advances the commercial interests of power producers and power marketers throughout the United States by advancing public policy positions that enhance the competitiveness and effectiveness of the regulated and unregulated producers, distributors and sellers of electric energy.

THE CRISIS IN ENERGY SUPPLY

The recent headlines that describe the energy supply crisis in the San Diego region of southern California are a vivid example of the need to construct additional generation and transmission capacity in many areas of the United States. Responding to market demand, almost 52,000 megawatts of merchant generation – that is, unregulated generating plants selling energy for resale, not to end-use customers – are scheduled to come on-line by the end of 2001. This increase in generating capacity comes far too late, however, to provide relief from the situation caused by current shortfalls in generating and transmission capacity.

The San Francisco Bay area also experienced several blackouts this summer as a result of insufficient generating capacity in, or availability for import into, the state of California. Not only was in-state generation in too short of supply, but, even worse, the California Independent System Operator, the quasi-public operator of the transmission grid in California, could not import enough power from neighboring states to fuel California's high demand for electricity. Rolling blackouts were instituted in the San Francisco Bay area on June 14 this summer. Many employees at Silicon Valley technology companies like Hewlett Packard worked in near darkness with limited air conditioning. Hewlett Packard's energy manager told Dow Jones News Service that a blackout in Silicon Valley would cost companies there as much as $75 million dollars a day in lost revenues.[1]

The investment firm, J.P. Morgan, reported earlier this month that U.S. demand for electricity is likely to grow at more than 5% a year, driven largely by the spread of information technology

[1] Dow Jones News Wire, September 20, 2000

and telecommunications infrastructure. Information technology and telecommunications presently account for 16% of U.S. energy consumption, according to the report.

CONGRESSIONAL ACTION IS NEEDED NOW

Energy shortages have been severe across California, as the state's expanding economy has out-stripped the construction of new power plants. To quote President Clinton[2], "The wholesale price of electricity has risen sharply in California this summer as a result of tight supplies and growing demand. This is having a particularly heavy impact where the price hikes are being passed on to consumers, as they are in the San Diego region." The President released $2.6 million in emergency funds for low-income families to cope with higher energy costs. He also directed the Small Business Administration to set up a program for small businesses to apply for loans to pay their electricity bills. Acknowledging California's "power-crunch," he renewed his calls to Congress to take up his Energy Budget initiatives and tax incentives.

The explosive growth in electronic equipment, computers, telecommunications, and bandwidth content has produced a dramatic increase in the demand for electricity. All elements of this new energy intensive information-based economy have two things in common. All the equipment and content utilized in this trend incorporate silicon-based microprocessors and electricity. Everything is plugged in to an electrical outlet. Personal computers and servers are nothing more than electron conversion devices that accept kilowatts though a power source and convert, create, store, and transmit those kilowatts into digital bits of information. This new information economy is powered exclusively by electricity. The Internet is becoming more electricity intensive. Wireless Internet and telecommunications applications are growing at an even faster rate than basic Internet growth.

Congress must act now. The most efficient manner for Congress to act is to legislate incentives to encourage the construction of new or more efficient electric generation facilities. The demand for power in this country is staggering and, with 16% of all electric energy being used to support e-commerce and computers generally, annual growth is outstripping new capacity by an alarming rate. The inability to provide sufficient generating capacity will have dire impacts for virtually all sectors of the country's economy.

IMPACT OF ELECTRICY INDUSTRY RESTRUCTURING

Until the mid-1990's, the investor-owned electric industry was composed entirely of single state or regional companies that were closely regulated by the various state public utility commissions. Companies were vertically integrated: they generated power, transmitted the power across their regions and then distributed the power to each customer. The companies operated as highly regulated monopolies and had an obligation to serve all customers.

In this regulated market, utilities were given an opportunity by regulators to recover their investment much differently than companies that operate in a more competitive marketplace. A regulated company had little incentive to retire its assets before the end of their useful life in order to deploy new technology. To have done so may have resulted in increased costs to customers that would have been unpalatable to state commissions and, therefore, not recoverable in rates paid for regulated services. This regulated status explains, in part, why electric assets have historically had such long recovery periods. This no longer is the state of the industry today.

[2] Power Marketing Association, Online Daily Power Report, August 23, 2000

Nationwide, the structure of the electric industry is rapidly changing from vertically-integrated, regulated monopolies to unbundled and fully competitive generation services. Currently, 24 states and the District of Columbia, encompassing some 70% of the Nation's population, have either passed electric industry restructuring legislation or enacted regulatory orders to implement unbundling and competitive customer choice. In these states, this choice in electric generating service supplier is either currently available, awaiting a phase-in implementation or part of a "big-bang" implementation in which all customers have the choice of electric energy supplier all at once. Because of the introduction of competition, previously applicable rules regarding the cost recovery of capital simply do not apply any longer.

There also is no regulatory certainty in a deregulated electricity market. This is one of the clear contributing factors at play in the San Diego situation described above. Uncertainty has stifled the interest of competitive generators to build new plants. In a regulated environment, predictable dividend payments to utility investors permitted them the opportunity to earn a return commensurate with the return they would earn in industries with similar risk profiles. In a newly competitive electricity environment, however, investors will demand a return of, and a higher return on, their investments over a much shorter period of time to reflect the vastly increased risks of an unregulated environment. Shorter capital recovery periods are a key element in attracting these investors.

The electric industry is one of the most capital-intensive industries in this country, requiring nearly four dollars in investment for each dollar of annual revenue. Cost recovery, including the federal income tax rules providing for depreciation and amortization of assets, is of vital importance. The present 15-20 year depreciation requirement for generating assets discourages badly needed investment in the construction of new electric generation facilities and in the repowering of currently mothballed facilities.

NEW TECHNOLOGY REQUIRES IMPROVED AND ADDITIONAL CAPITAL INVESTMENT

Energy producers must build and maintain state-of-the-art equipment to accommodate our nation's new technology. Competitive pressures that arise through the unbundling of retail electric service requires that all competitors be as efficient as possible. Because the competitiveness of wholesale markets is now an established feature of the industry's business landscape, sales for resale must also be generated as cost-effectively as possible. The advances in technology require that all new construction be more efficient in terms of the engineering measurements than equipment manufactured just a few years ago. These measurements include capacity factor, heat rate and availability factor. New combined cycle gas turbine generators are much more efficient today, resulting in more rapid obsolescence of older less efficient generating equipment.

Many of the power plants constructed a generation ago were coal-fired or nuclear. Power plants being built today are much more likely to be gas turbine facilities, often operated in a combined-cycle or as cogeneration facilities that produce steam for industrial process use as well as electricity. Gas-fired turbine technology has made stunning advances over the last decade. These new combined-cycle generators operate at energy conversion efficiency levels of 70% compared to 40-50% only a decade ago. Energy conversion efficiency measures the efficiency with which one type of fuel is converted to electric energy, which, in turn, is capable of providing the light, heat or work that consumers expect. As these advances continue, electric generation equipment suffers much quicker economic obsolescence than in prior decades when the current depreciation rates were set.

In addition to new generation facilities, existing electric generation facilities require massive amounts of investment in order to retrofit these facilities and bring them into compliance with environmental regulations. The Clean Air Act Amendments, new source review, the National Ambient Air Quality Standards, and the related state implementation plans all require significant new capital investment in environmental mitigation technologies in order to improve air quality and maintain compliance with federal and state directives. Again, this advanced technology supports the need for shorter capital recovery periods.

THE INEQUITIES OF CURRENT DEPRECIATION RULES

The recovery periods permitted under section 168 of the Internal Revenue Code for assets used to produce and distribute electricity are much longer than the recovery periods allowed to other capital intensive industries. As in every other instance of a heavily regulated industry undergoing deregulation, new technology is being developed and deployed at a much more rapid pace and makes obsolete many prior investments in property, plant and equipment. With most of our industry's assets placed in the 15-year and 20-year recovery period, the present cost recovery system unjustly penalizes investors in electric generation and makes raising necessary capital much more difficult.

The disparity between electric industry recovery periods and the recovery periods of other industries is highlighted upon review of asset class 00.4, Industrial Steam and Electric Generation and/or Distribution Systems. This asset class includes equipment identical to that used by the electric industry except that the energy generated is used in industrial manufacturing processes instead of being sold to others. This asset class is given a 15-year life. The same asset in the hands of an electric company has a 20-year life. No rationale reasonably supports this distinction.

By contrast to the 15-20 year depreciation lives for electric generation assets, depreciation lives for other capital intensive manufacturing processes – such as pulp and paper mills, steel mills, lumber mills, foundries, automobile plants and shipbuilding facilities – are depreciable for Federal income tax purposes over just 7 years. Chemical plants and facilities for the manufacture of electronic components and semiconductors can be depreciated over only 5 years. The power plants that generate electricity have useful lives that are similar to this production equipment that have recovery periods in the 7-year range.

Another area of concern are the restrictions contained in the description of class life 00.12, Information Systems, that further compounds the disadvantage suffered by investors in electricity generation, transmission and distribution facilities. The description excludes computers that are an integral part of other capital equipment, thus, giving computers used in a power plant control room a 15 or 20-year life and a 150% declining balance method. A computer used to run a highly sophisticated nuclear power plant cannot be expected to be less susceptible to obsolescence than one used in a cigarette factory, for example, which currently is recovered within 7 years. The economic life of a process control computer is not closely related to economic life of the manufacturing equipment it operates. It belies common sense to treat a process control computer any differently than a computer used to administer normal business transactions, yet these computers perform much more sophisticated "high technology" processes than normal business computer applications.

Mr. Chairman, to more fully explain the inequities inherent in current depreciation rates and methods, we have attached a copy of a letter we submitted to Treasury last November that we hope can be incorporated into this Subcommittee's formal record.

CONCLUSIONS AND RECOMMENDATIONS

We applaud this Subcommittee's efforts to take a long overdue look at the current federal income taxation system with respect to capital recovery periods. We agree with the conclusions of a recent Treasury report and urge you to act on its findings. The Treasury Report (Report to the Congress on Depreciation Recovery Periods and Methods) states:

> "Electric, gas, water, and telephone utilities were all generally regulated at the time the current class lives were established. Under rate of return regulation, utilities were not theoretically concerned with depreciation and tax expense, because rate structures were based on cost-plus pricing. A utility's rate of return on equity was largely independent of its tax or depreciation expenses. Consequently, for public utilities, it is unclear that existing class lives truly represent the actual useful lives of the property involved.
>
> Class lives may be expected to be different in the current more competitive environment. Producers must maintain state-of-the-art equipment, which might mean shorter lives and more rapid depreciation. For example, new generations of combined cycle gas turbine generators are more efficient today than previously, leading to a more rapid retirement of such equipment than would have occurred under regulation." [At page 97].

Congressional action is needed to cure the power supply emergency facing our country. We encourage you to modernize the tax treatment of new electric generating capacity to reflect the technical, environmental and economic realities of the current structure of the electric industry. Doing so would greatly advance the public interest by insuring against the dire economic consequences that necessarily accompany electricity shortfalls. Failing to do so would benefit no one.

In recognition of the need to modernize the capital cost recovery system for electric generation assets, we wish to commend Ways and Means Committee members Thomas, Jefferson and English for their leadership in introducing H.R. 4959 to modify the depreciation of property used in the generation of electricity. We believe this is a significant first step in helping our nation avoid an electric supply crisis which would harm all segments of our economy.

We would be pleased to provide this Committee with more information about our industry's views on depreciation rates and methods for facilities used in the generation, transmission and distribution of electricity, and how the current system discourages investment in badly needed new generation capacity that is necessary to fuel economic growth in this country. We thank you for the opportunity to participate in this process.

November 1, 1999

Department of the Treasury
Office of Tax Analysis
Room 4217, Main Treasury Building
1500 Pennsylvania Avenue, NW
Washington. DC 20220

Re: Notice 99-34; 1999-35 IRB 1; Depreciation Study

Dear Sir or Madam:

The Edison Electric Institute ("EEI") is pleased to offer the following comments in response to Notice 99-34; 1999-35 IRB 1 which requested public comment and recommendations for possible improvements to the current depreciation system under section 168.

EEI is the association of U.S. investor-owned electric utilities, their affiliates and associated members worldwide. EEI is serving approximately 75 percent of the nation's electric customers and generate approximately three-quarters of all the electricity generated by all electric utilities in the country.

EEI is concerned that the recovery periods permitted under section 168 for assets used to produce and distribute electricity are much longer than the recovery periods allowed to other capital intensive industries. Indeed, this disparity has been present in nearly every depreciation or cost recovery regime since the 1970's. While there *may* have been a justification for this difference a number of years ago, today we believe that the industry has much more in common with other capital intensive industries. In the last five years, the electric industry has begun a transformation from a regional, vertically integrated, rate regulated business to a national (or international), industry consisting of three components: generation, transmission and distribution. Most generation plant investments will be non-regulated. As in every other instance of a heavily regulated industry undergoing deregulation, new technology is being developed and deployed at a much more rapid pace that competes with and makes obsolete many prior investments in property, plant and equipment. With most of our industry's assets placed in the 15-year and 20-year recovery period, the present cost recovery system unjustly penalizes our investors and makes capital formation much more difficult.

MACRS Cost Recovery Periods

Under section 168, the cost recovery period of assets is generally determined by reference to the midpoint class life for the asset guideline class in which such property is classified under Rev. Proc. 83-35, 1983-1 C.B. 745. Section 168 (e)(1) specifies (in relevant part) that property shall be treated as

> 10-year property if such property has a class life of 16 through 19 years,
> 15-year property if such property has a class life of 20 through 24 years, and
> 20-year property if such property has a class life of 25 or more years.

Section 168 (b)(1) sets the applicable depreciation method as the 200 percent declining balance method except that section 168 (b)(2) allows only the 150 percent declining balance method for any 15-year or

20-year property. The application of these rules results in the following depreciable lives for assets used in the electric industry as published in Rev. Proc. 87-56:

Hydraulic Production Plants, Steam Production Plants, and Transmission and Distribution Plant (asset classes 49.11, 49.13, and 49.14 respectively) have 20-year lives.

Nuclear Production Plants and Combustion Turbine Production Plants (asset classes 49.12 and 49.15) have 15-year lives,

Nuclear Fuel Assemblies (asset class 49.121) have 5-year lives.

Thus, the lion's share of the investment in the electric industry must be depreciated over 20 years using the 150 percent declining balance method.

One can scan Rev. Proc. 87-56 and note that very few asset classes have a 20 year life; aside from electric industry assets there are only twelve.[3] Indeed, out of 133 asset classes identified in the Revenue Procedure only fifteen have even a 15-year life. The only manufacturing assets included among the fifteen are assets used to manufacture cement. As a matter of fact, most manufacturing assets have a 7-year depreciable life and are permitted use of the 200 percent declining balance method. For example, the following manufacturing categories have assigned lives that are less than half as long as most electric industry assets:

7-year cost recovery

Pulp and paper mills, Steel mills, Manufacture of locomotives and railcars, Lumber mills Foundries, Auto plants, Ship building

5-year cost recovery

Chemical plants, Manufacture of electronic components and semiconductors

The disparity between electric industry recovery periods and the recovery periods of other industries is highlighted upon review of asset class 00.4 Industrial Steam and Electric Generation and/or Distribution Systems. This asset class includes equipment identical to that used by the electric industry except that the energy generated is used in an industrial manufacturing process instead of being sold to others. This asset class is given a 15-year life. The same assets in the hands of an electric company would have a 20-year life.

Another area of concern for our industry are the restrictions contained in the description of class life 00.12 Information Systems that further compounds the disadvantage suffered by our investors. The description excludes computers that are an integral part of other capital equipment, thus, giving computers used in a power plant control room a 15 or 20-year life and a 150% declining balance method. A computer used to operate a highly sophisticated nuclear plant cannot be expected to be less susceptible to obsolescence than one used in a cigarette factory or a textile mill which currently is recovered within 7 years. The economic life of a process control computer is not closely related to economic life of the manufacturing equipment it operates. It belies common sense to treat a process control computer any differently than a computer

[3] They are:
class 01.3 Farm Buildings,
class 40.2 Railroad Structures classified as Public Improvements Construction,
classes 40.51, 40.53, and 40.54 Railroad Electric Generation Equipment,
class 48.11 Telephone Central Office Buildings,
class 48.33 TOCSC-Cable and Long-line Systems,
classes 49.21 and 49.221 Gas Utility Distribution and Manufactured Gas Production Facilities,
class 49.3 Water Utilities,
class 49.4 Central Steam Utility Production and Distribution, and
class 51 Municipal Sewers.

used to administer normal business transactions, yet these computers perform much more sophisticated "high technology" processes than normal business computer applications.

The power plants that manufacture electricity have lives that are similar to the production equipment listed above that have recovery periods in the 7 year range. The advantageous recovery periods allowed by Congress were given to encourage modernization of the nation's industrial base and to improve productivity. As discussed below, the electric industry is entering a period of great change. It is now appropriate to reexamine the traditional electric utility recovery periods and bring them in line with other industries.

The Present and Future State of the Electric Industry

Until the 1990's the investor-owned electric industry was composed entirely of single state or regional companies that were closely regulated by the various state public utility commissions. Companies were vertically integrated in that they generated power, transmitted the power across their region and then distributed the power to each customer. The companies operated as monopolies and had an obligation to serve all customers.

In this sort of market utilities may have had a greater expectation of recovery of their investment than in a more competitive marketplace. Furthermore, a regulated company had little incentive to retire its assets before the end of their technological life in order to deploy new technology. To have done so might have resulted in increased costs to customers that would have been unpalatable to state commissions. This monopoly status *may* explain why electric assets have historically had such long recovery periods. Such is not the state of the industry today.

One by one states are unbundling the electric industry and introducing competition. Generally, three distinct businesses are formed: generation, transmission, and distribution. In order to keep incumbent utilities from enjoying an early market advantage, states are often structuring market rules such that the incumbent utilities sell off large numbers of their generation plants. For example, California utilities sold off half of their fossil fuel plants as part of that state's restructuring plan. With the proceeds of these sales, many utilities (or former utilities) are investing in non-regulated generation plants in other regions of the country. This newly competitive marketplace is encouraging the introduction of newer technology. Cleaner burning natural gas plants are being built to compete with coal fired plants. As many nuclear plants are shut down, replacement energy is being generated by new, non-regulated plants. In this marketplace, investors in electric generation have no guarantee of recovery. As in any other business they will have no control over other, cheaper sources of supply that will attract away their customers.

An example of the effect of technological innovation is the rapidly increasing deployment of combined cycle gas turbine generators. Combined cycle generators increase efficiency by producing electricity from otherwise lost waste heat. Today's state-of-the-art combined cycle generators operate at energy conversion efficiency levels of 70% compared to 40% to 50% a decade ago. Competitive pressure is forcing owners of units less than a decade old to make costly improvements to increase operating efficiency.

In addition to the competitive threats facing the generation segment of the electric industry, transmission and distribution are facing competitive threats from gas pipelines and the location of generation along gas pipelines. Not only is gas a competitive energy source, but gas pipelines with capacity to serve generating plants can substitute for portions of transmission lines. Locating new generation along gas pipelines is, in effect, a mechanism for transporting electrons by moving gas. Longer term, numerous threats are emerging to place transmission owner revenues at risk. These include the location of generation nearer to loads, changes in electricity consumption patterns, and new technology.

In fact, one rapidly emerging new technology is Distributed Generation. Distributed Generation refers to electric power produced using fuel cell technology or on-site small scale generating equipment that can displace power generated by a central station generating unit. Because they can be sited on a customer's premise, their widespread use would effect the economic life of transmission and distribution assets as well as generating plants.

In EEI's view, the fundamental changes taking place in the electric industry must be acknowledged and taken into account in the current cost recovery system. We note that recently many industry groups have publicly expressed a need for shorter recovery periods. In *every* case, these industries already have recovery periods of 5-years, 7-years or 10-years. Although we don't seek to diminish the arguments put forward by other industries, we do believe that our industry is bearing the biggest penalty under the present system. The disparity is so great that we believe that shortening electric industry lives must be acted upon before adjusting any other industry's lives. We believe the current system provides incentives that direct capital formation *away* from our industry. As a matter of fundamental fairness, the cost recovery system must take into account marketplace changes that radically effect the economic useful lives of assets.

We would be pleased to provide you with any other information that you might find helpful. Please feel free to contact Mr. Cary Flynn of Duke Energy at 704/382-5918. We would also welcome the opportunity to meet with you personally to further discuss our views.

Sincerely,

David K. Owens
Executive Vice President
Business Operations Group

FT FINANCIAL TIMES Energy

Wednesday, October 4, 2000

MegawattDaily's GenerationWeek

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EEI IRC

Depreciation tax change sought

The energy supply wing of the Edison Electric Institute (EEI) told Congress last week that federal tax laws discourage investment in new power plants.

Testifying before the Oversight subcommittee of the House Ways and Means Committee, the Alliance of Energy Suppliers suggested that federal tax laws should be changed to allow a seven-year depreciation of investments in power plants, instead of the current 15 to 20 years.

The changes that have struck the electric power industry because of competition have changed investor expectations, testified DTE Energy Vice President Theodore Vogel.

"Previously applicable rules regarding the recovery of capital simply do not apply any longer," he said. "Investors will demand a return of, and a higher return on, their investments in building and maintaining power plants over a much shorter period of time."

With demand for electricity growing at an estimated 5% a year in the United States, tax policy should encourage, not discourage, investment in new facilities, Vogel said.

"Congress must act now," he said. "Congress should legislate incentives to encourage the construction of new or more efficient electric generation facilities. By doing so, members can advance the public interest and help solve the power supply problems that are facing our country."

Bush unveils power plans

Republican Presidential candidate George W. Bush's comprehensive energy policy announcement last week included some provisions for power generation. The plan advocates:

- Investing $2 billion over 10 years to fund research in "clean coal" technologies;
- Investing $1 billion over 10 years to establish clear rules to help efficient utilities purchase nuclear plants;
- Streamlining the re-licensing process for hydroelectric projects;
- Opposing the breaching of dams; and
- Supporting federal legislation restructuring the electric utility industry.

The plan also would include legislation to require electric utilities to reduce harmful emissions and would support tax credits for electricity produced from renewable and alternative fuels at a cost of $1.4 billion over 10 years.

Consultants see electric supply tsunami

Power plant overbuilding will occur in several regional markets, while shortages could cr up in other markets, a noted research group forecasts.

Volatility is the rule rather than the exception in restructured North American pow markets, and the bumpy transition to electric competition will be "prolonged and muddlec according to a recently released report by Cambridge Energy Research Associates (CERA) a consultant Arthur Andersen.

Intended to be a mid-course examination of the impacts of restructuring since Californ opened its markets two years ago, *Electric Power Trends 2001*, provides a compilation industry data and an analysis of challenges facing the industry and policy makers.

The report also notes that previously abnormal prices and volatility are becoming the non

Further, rather than running up stranded costs, coal and nuclear plants are found have value.

In prepared remarks, John Wierda, a partner with Arthur Andersen, said the "electu supply tsunami" will drive up supply in certain markets where there is little demand, causi a downward pressure on power prices. The consultants acknowledge that at least sor

(Continued on page

Financial analysts: most projects not viable

While 250,000 MW of new power plant development has been proposed, prominent equi research analysts say most development projects aren't viable and plant developers are likely to add plants at the planned rate.

"Most development projects are not viable, in our view," said Salomon Smith Barne "They are constrained by difficulties in siting, financing, and securing natural gas supplies

The availability of gas supplies will be a critically limiting factor, according to the financi analysts' report.

"We believe natural gas supplies will be able to fuel at most about 25,000 MW of annu development over the next six or seven years."

Even at this rate, gas production would have to grow at an aggressive 5% annual rate.

Taking a jab at consultants who predict too many plants will get built, Salomon Smi Barney calls that hyperbole instead of reality.

"Numerous industry consultants and analysts are suggesting a 'tsunami' of new electu generation capacity," the financial analysts say. "Many of these studies conclude that the U. faces excess generating capacity over the next few years. We disagree...

"Many of these observers are assuming that nearly all of the development projects pendi

(Continued on page

PJM plans competitive spinning reserves marke

PJM is developing business rules to establish a competitive market in spinning reserves about 15 months with the aim of providing incentives to relieve a shortfall in capacity f that service.

"The Operations Reserve Working Group has developed a strawman proposal which t Energy Markets Committee approved... and now they'll start moving forward to explore th proposal and look at creation of that market," PJM spokesperson Melissa Singleton Josef sa

"Now a new Spinning Reserve Working Group has been formed out of that process. I expected that the spinning reserve market would open sometime around [the] beginning of 200

PJM has determined that in order for a competitive market in spinning reserves to be viab the market needs to be broadened.

In addition to promoting more competition, PJM organizers say that the interconnectior objectives for the market would include compensating providers of spinning capacity on t basis of a clearing price rather than cost as well as inducing response by on-line, margi resources through compensation.

Costs of spinning reserves would be allocated to load serving entities by load ratio sha Load serving entities would be allowed to enter bilateral agreements to buy spinning reserv

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the Electricity Daily

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Shaw Pours Cold Water on Hot Market

The distributed generation market in the U.S. in the last nine months has undergone "a sea change such as I have never seen and I go back in this business to 1985," **Bob Shaw**, a venture capitalist, told a conference in Washington this week. He thinks that there might be a touch of irrational exuberance here.

Shaw of New Hampshire-based **Arete Ventures** some years ago was one of the first to spot the potential of distributed generation and to invest heaviily and successfully in it. That the market has followed his lead was evident from the fact that the three-day conference organized by **Intertech** of Portland, Me., attracted almost 200 paying customers, a relatively huge figure in today's competitive and overcrowded energy conference universe.

Paradoxically, though, Shaw now believes that the distributed generation investment market may be over-heating (he compares it to dot.com stocks) and that it may be time to step away from it, for the moment at any rate. Shaw argues that there is now far too much money chasing far too few investment opportunities.

Shaw credits **John Markham**, a little-known journalist for Microsoft's financial network, with setting off the feeding frenzy by writing a piece in January this year predicting that **PlugPower**'s (a fuel cell company) shares would increase in value by 10,000 percent in the next decade. Plug shares rocketed, reaching a market capitalization finally of $6.5 billion. Fuel cell-maker **Ballard Power** and other shares, such as **AstroPower**, **American Superconductor**, **Avista Energy**, and **Superconductivity Inc.**, rode along on the coat-tails. Some shares gained more than 800 percent in less than a year. "We used to think that 20 percent was good for one year," Shaw noted wryly.

Shaw pointed to economic journalist **George Gilder** and consultants **Mark Mills** and **Peter Huber** as others who have added fuel to the frenzy. "The *Venture Capital Journal*," he said, "declared power technology 'the next big thing' and writers around the world have picked up the theme."

"Every investment bank has discovered this space now," Shaw added. "A year ago, it didn't have the attention of anyone in the financial community. The private offerings of companies that a year ago were struggling to raise money now are oversubscribed."

Shaw has lost none of his faith in distributed generation energy technology (microturbines, fuel cells, advanced batteries, and the like), which he believes will transform a computerized world ever more dependent on reliable electricity supply. He just worries that there is too much "dumb money" and "herd effect" out there today.

A somber audience listened to him silently but applauded loudly at the end.

Let Us Write Plants Off Faster, EEI Tells Congress

Accelerate tax depreciation of power plants and watch more plants being developed, a group from the **Edison Electric Institute** has told **Congress**. EEI's **Alliance of Energy Suppliers** told the **House Ways and Means Committee** this week that federal tax laws should be changed to allow depreciation of generation assets over seven years, instead of the 15-20 years that is now the practice.

"Previously applicable rules regarding the recovery of capital simply do not apply any longer," said **Theodore Vogel**, tax counsel for **DTE Energy**, parent of **Detroit Edison**. "Investors will demand a return of, and a higher return on, their investments in building and maintaining power plants over a much shorter period of time." This is no longer your father's utility business, said the executive. There is no longer much regulatory certainty that allows for predicable dividend policies and the concomitant policy of longer-term depreciation.

Among other things, the New Economy of computers and telecommunications is driving a substantial growth in demand for power, said Vogel. He noted that 16 percent of U.S. energy consumption can be attributed to increases in information technology and telecommunications. U.S. demand for electricity is likely to grow at more than 5 percent per year, he said. The recent California contretemps, Vogel said, is a symptom of the need for new investments in generating capacity. Demand for power in the Golden State has been growing at 4-6 percent annually in recent years, driven by the rise of the dot.com companies and their hefty demands for power.

"Congress must act now," Vogel concluded. "Congress should legislate incentives to encourage the construction of new or more efficient electric generation facilities." But it is unlikely that Congress will do so in the next few weeks, according to veteran observers of the political scene. "It's between slim and none," said one, "and Slim just left the room."

Computer Climate Models Debunked on El Niño

Claims that computer climate models successfully predicted the 1997-98 **El Niño** phase of the **El Niño Southern Oscillation** are

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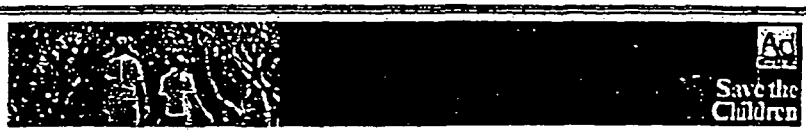

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DJ EEI Asks Congress For Accelerated Pwr Plant Depreciation

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WASHINGTON (Dow Jones)--Accelerating the depreciation of electricity generation units will enhance competition by encouraging investment in new power plants, the Edison Electric Institute told Congress Tuesday.

Given the competitive changes roiling the U.S. $215 billion electricity sector, "previously applicable rules regarding the recovery of capital simply do not apply any longer," said Theodore Vogel, vice president and tax counsel for DTE Energy Co. (DTE).

"Investors will demand a return of, and a higher return on, their investments in building and maintaining power plants over a much shorter period of time," said Vogel.

He testified before the House Ways and Means Committee's oversight panel on behalf of EEI's Alliance of Energy Suppliers, which represents the competitive power interests of the investor-owned utility trade group.

The tax code currently requires power plant investments to be depreciated over a 15- to 20-year timeframe. Vogel called for shortening that to seven years.

Rapid technological change means that generation equipment becomes obsolete more quickly than when the depreciation schedule was originally established, he said.

The shorter depreciation schedule will encourage investment in new generation technologies that are more efficient than the portfolio of coal-fired plants that dominates U.S. supply today, he said.

"Congress should legislate incentives to encourage the construction of new or more efficient electric generation facilities," Vogel testified, citing chronic energy-supply problems in various regions of the U.S., and projections that U.S. electricity demand will grow at a more than 5% annual rate.

"Congress must act now," Vogel said, citing the depreciation issue as a barrier to investments in power plants in regions such as California, which has confronted the prospect of blackouts this summer.

Vogel supported congressional passage of H.R. 4959, sponsored by three members of the tax-writing Ways and Means Committee, to accelerate depreciation for electric generation assets.

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CHIEF EXECUTIVE LETTER

EDISON ELECTRIC INSTITUTE

Summary

EEI Asks Congress for Accelerated Power Plant Depreciation.

Action Needed By	EEI Contact	Phone Number	Other Areas of Interest
For Information Only	Theresa Sanders	(202) 508-5183	Tax, Federal Affairs

October 4, 2000

Chief Executive
Member Company

EEI's energy supply division, the Alliance of Energy Suppliers, is aggressively seeking to change Federal tax laws by shortening the depreciable lives of generating assets from 15-20 years under current law to seven years. Last week, Mr. Ted Vogel, Vice President and Tax Counsel for DTE Energy Company, testified on behalf of EEI before the Oversight Subcommittee of the Ways and Means Committee in support of the proposed accelerated depreciation legislation for generation assets, H.R. 4959.

At this critical transition period for the industry, with regions of the nation facing power supply emergencies, the industry must step forward with proactive policies that reflect the technical, environmental, and economic realities of the marketplace that will promote new electric generating capacity. EEI has led the industry's effort to enact H.R. 4959, introduced by Representatives Bill Thomas (R-CA), Bill Jefferson (D-LA), and Phil English (R-PA) that would shorten the tax depreciation lives of generating assets to seven years. Mr.Vogel called on Congress to pass this legislation to encourage investment in urgently needed new generation facilities. The complete text of Mr. Vogel's testimony is available on our website at www.eei.org.

Enclosed is information describing the EEI-led coalition to promote the enactment of H.R. 4959 called the Coalition of Depreciation Equity (CODE). We look forward to your active participation in CODE. For more information on the Coalition, please ask your staff to call Theresa Sanders at the Alliance of Energy Suppliers at the above number.

Sincerely,

Thomas R. Kuhn
President

TRK:ts
cc: Washington Representatives

TENNESSEE VALLEY AUTHORITY RESTRUCTURING

BRIEFING BOOK

January 28, 2000
Washington, DC

1678

DOE003-0322

CONTENTS

DOE003-0324

OVERVIEW OF THE NEED FOR TVA RESTRUCTURING LEGISLATION

In 1992, Congress made wholesale electric competition possible with the passage of the Energy Policy Act, legislation that was designed to remove the barriers to wholesale competition in the electric industry. Subsequent policy initiatives by the Federal Energy Regulatory Commission ("FERC"), including Order No. 888, further facilitated and encouraged the development of a nationwide competitive bulk power market. Wholesale electric competition is now a reality almost everywhere in the United States, with the exception of the Tennessee Valley region, where the Tennessee Valley Authority ("TVA"), the largest electric utility in the United States, continues to operate as a self-regulated monopoly.

Under existing law, TVA is the exclusive supplier of power within its statutorily defined service territory, an 80,000 square-mile area that includes virtually the entire state of Tennessee and parts of Kentucky, Mississippi, Alabama, Georgia, North Carolina, and Virginia. TVA is not permitted to sell power outside its service area, but it is also not required to transmit power from other suppliers to its customers inside the Valley. Nor are TVA's rates subject to review. As a result, TVA's customers are "captive" customers in the truest sense of the word; they have no opportunity to challenge TVA's rates before an independent regulator, they cannot choose to purchase power from a supplier other than TVA, and they have virtually no bargaining power with which to influence TVA's services or business practices.

Congress should act now to extend the benefits of wholesale competition to the residents of the Tennessee Valley. One of the obvious benefits of competition is downward pressure on rates. Outside the Valley, wholesale competition has already yielded lower prices. In Kentucky, for example, the wholesale rates charged by FERC-regulated utilities decreased significantly over the last several years, while TVA's wholesale rates increased by 7.5% systemwide. As a result, TVA's captive ratepayers in Kentucky will pay $250 million more for their power over the next five years than will Kentucky customers of Kentucky Utilities, a FERC-regulated investor-owned utility. The competitive pressures brought to bear by market forces have also encouraged efficiencies in operations and administration and innovations in marketing and technology throughout the industry. In fact, the success of wholesale competition thus far recently led the FERC to issue a rule on Regional Transmission Organizations designed to encourage competition at the wholesale level even further.

Yet, due to existing statutory and commercial barriers, there will never be wholesale electric competition in the Tennessee Valley unless Congress takes action. Only Congress has the power to introduce wholesale competition to the Tennessee Valley; FERC cannot do it, the States cannot do it, and the marketplace

cannot do it -- because federal law prohibits it. It simply will not happen until Congress acts affirmatively to make it possible.

Because nationwide electric restructuring is a daunting task, there are those who say retail competition is already taking hold through the efforts of individual States, and that it will gradually spread across the country even if this Congress does nothing. Accordingly, many conclude that doing nothing in Congress is the best approach, at least for the time being. However, there is a huge difference between taking this wait-and-see approach for the rest of the country and taking it for TVA. The question in the Tennessee Valley in not whether to implement *retail* competition, but whether the Valley should be opened to *wholesale* competition, which the rest of the country has enjoyed since 1992. If Congress does nothing, many States will continue to move forward with retail competition, but the existing wholesale market will continue to evolve, too. As a result, if Congress does nothing, the rest of the country will continue to move forward -- and the Tennessee Valley will be left behind.

If the Valley is ever really going to "catch up" with the rest of the country, Congress must act, and it must act now. To open the Valley to competition, Congress has to make some changes to TVA and the way it does business. First, the statutory barriers to competition in the Valley must be repealed. Second, TVA cannot continue to be self-regulated once the Valley is opened to competition. Instead, TVA should be subject to the same degree of regulatory oversight applicable to other utilities competing in the wholesale marketplace. In particular, FERC should have jurisdiction over TVA transmission, wholesale power sales, and stranded costs. Third, TVA must be subject to the antitrust laws to the same extent as other governmental entities. Other changes would also be necessary to ensure a smooth transition to competition in the Tennessee Valley. The various changes that are necessary, and the reasons why they are necessary, are set forth in the legislation that follows.

ELECTRIC RESTRUCTURING LEGISLATION AND THE TENNESSEE VALLEY AUTHORITY

106th CONGRESS

COMPARATIVE SUMMARY

November 29, 1999

DOE003-0327

FERC - Federal Energy Regulatory Commission
FPA - Federal Power Act
KUB - Knoxville Utilities Board
MLGW - Memphis Light, Gas and Water Division
PURPA - Public Utilities Regulatory Policies Act
TVA - Tennessee Valley Authority

ISSUE	EXISTING LAW	H.R. 2050 (LARGENT-MARKEY)	S. 1047/ H.R. 1828 (ADMINISTRATION)	H.R. 2944 (COMMITTEE PRINT)	S. 1323 (McCONNELL)	H.R. 3130 (BAKER)	S. 1273 (BINGAMAN)	S. ___ (MURKOWSKI)	KUB/MLGW PROPOSAL
TVA LEGAL STATUS	Under the FPA & PURPA, TVA is a: 1. Transmitting Utility. (16 U.S.C. Sec. 796(23)) 2. Nonregulated Electric Utility. (16 U.S.C. Sec. 2602(8)). 3. State Regulatory Authority. (16 U.S.C. Sec. 796(21); Sec. 2602(17)). TVA is *not* a: Public Utility. (16 U.S.C. Sec. 824(e)).	Sec. 407(b) expressly repeals TVA's status as a state regulatory authority. Sec. 406 gives FERC jurisdiction over the TVA transmission system. Sec. 403(c) gives FERC jurisdiction over wholesale sales outside, but not inside, the Tennessee Valley region.	Sec. 602 gives FERC limited jurisdiction over the TVA transmission system but does *not* subject TVA's wholesale sales to FERC jurisdiction under Secs. 205 & 206 of the FPA.	Sec. 607(d) expressly repeals TVA's status as a state regulatory authority. Sec. 606 gives FERC jurisdiction over the TVA transmission system. Sec. 603(c) gives FERC jurisdiction over TVA wholesale sales outside, but not inside, the Tennessee Valley region.	Sec. 2 (a) amends the FPA to bring TVA within the FPA definition of "public utility."	Sec. 6(a) amends the TVA Act to provide that TVA shall be considered a "public utility" within the meaning of the FPA.	Sec. 2(a) amends FPA definition of "public utility" to include TVA, "but only with respect to determining, fixing, and otherwise regulating the rates, terms and conditions for the transmission of electric energy in interstate commerce" under FPA Part II.	Sec. 101 amends FPA definition of "public utility" to include TVA, "but only with respect to determining, fixing, and otherwise regulating the rates, terms and conditions for the transmission of electric energy in interstate commerce" under FPA Part II.	Repeals TVA's status as a state regulatory authority. Gives FERC the same FPA jurisdiction over TVA transmission rates, terms, and conditions that applies to public utilities. Subjects TVA to FERC jurisdiction over wholesale sales and stranded costs.
WHOLESALE TRANSMISSION ACCESS	FERC may order TVA to transmit the power of other utilities unless it would be consumed within TVA's service area (i.e., within the TVA "Fence"). (16 U.S.C. Secs. 824j, 824k(j)). TVA must grant reciprocal transmission access to public utilities from which it receives open access transmission service. FERC Order 888	Sec. 406(a) makes most of Parts II and III of the FPA (and FERC's regulations and policies promulgated thereunder) applicable to TVA transmission and local distribution to the same extent that such provisions apply to public utilities.	Sec. 602 makes most of Parts II and III of the FPA applicable to TVA's transmission facilities and transmission of electric energy and the provision of necessary associated services over the TVA transmission system, *except* that FERC determinations pursuant to such application are expressly limited by other laws applicable to TVA, including the TVA Act's requirement that TVA recover its costs.	Sec. 606 makes most of Parts II and III of the FPA (and FERC's regulations and policies promulgated thereunder) applicable to TVA transmission and local distribution to the same extent that such provisions apply to public utilities.	Sec. 2(a) defines TVA as a public utility; open access requirements of FERC Order No. 888 would be applicable to TVA. However, without repeal of the anti-cherrypicking provision, FERC cannot mandate open access to the TVA transmission system where the power to be transmitted would be consumed within the Fence.	Sec. 6(a) defines TVA as a public utility; open access requirements of FERC Order No. 888 would be applicable to TVA. However, without repeal of the anti-cherrypicking provision, FERC cannot mandate open access to the TVA transmission system where the power to be transmitted would be consumed within the Fence.	Sec. 2(a) subjects TVA transmission system to FERC jurisdiction; open access requirements of FERC Order No. 888 would be applicable to TVA. However, without repeal of the anti-cherrypicking provision, FERC cannot mandate open access to TVA transmission system where power to be transmitted would be consumed within the Fence.	Sec. 101 subjects TVA transmission system to FERC jurisdiction; open access requirements of FERC Order No. 888 would be applicable to TVA. However, without repeal of the anti-cherrypicking provision, FERC cannot mandate open access to TVA transmission system where power to be transmitted would be consumed within the Fence.	Subjects TVA's transmission rates, terms and conditions to FERC jurisdiction, including the open access requirements of FERC Order No. 888.

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ISSUE	EXISTING LAW	H.R. 2050 (LARGENT-MARKEY)	S. 1047/ H.R. 1828 (ADMINISTRATION)	H.R. 2944 (COMMITTEE PRINT)	S. 1323 (McCONNELL)	H.R. 3130 (BAKER)	S. 1273 (BINGAMAN)	S. ___ (MURKOWSKI)	KUH/MLGW PROPOSAL
ANTI-CHERRY PICKING PROVISION	FPA sec. 212(j) mandates that FERC cannot force TVA to provide transmission service to another entity if the power will be consumed within the TVA Fence. (16 U.S.C. Sec. 824k(j))	Explicitly repealed by Sec. 402(a)(2)	Explicitly repealed by Section 807(2).	Explicitly repealed by Section 602(a)(2).	Not addressed.	Not addressed.	Not addressed.	Not addressed.	Explicitly repealed. Wholesale electric competition in the Tennessee Valley will never be possible unless and until this provision is repealed.
THE FENCE	Sec. 212(f) of FPA and Sec. 15d(a) of TVA Act prevent TVA from making contracts having the effect of making TVA or its distributors a source of power supply outside the Fence (16 U.S.C. Secs. 824k(f), 831n-4(a)).	Explicitly repealed by Sec. 402(a)(1), but Sec. 402(b)(1) limits TVA wholesale power sales for use outside the Tennessee Valley to "excess electric energy."	Explicitly repealed by Sec. 807(2). Sec. 804(b)(1) specifically authorizes TVA to sell power at wholesale to any person as of 01/01/2003.	Explicitly repealed by Secs. 602(a)(1) & 602(b), but Sec 603(b)(1) limits TVA wholesale power sales for use outside the Fence to "excess electric power."	Not addressed.	Not addressed.	Not addressed.	Not addressed.	Explicitly repealed. Wholesale electric competition in the Tennessee Valley will never be possible unless and until these provisions are repealed.
REVIEW OF TVA TRANSMISSION RATES	None.	Sec. 406(a) gives FERC the same FPA authority over TVA transmission rates, terms and conditions as over any public utility.	Sec. 802 gives FERC FPA rate review responsibility over TVA transmission rates, subject to other laws applicable to TVA, including the TVA Act's requirement that TVA recover its costs.	Sec. 606 gives FERC the same FPA authority over TVA transmission rates, terms and conditions as over any public utility.	Sec. 2(a), which makes TVA a public utility, gives FERC implicit authority over TVA transmission rates, terms and conditions. Under the FPA, FERC has jurisdiction over the rates, terms and conditions of public utilities' transmission services	Sec. 6(a), which makes TVA a public utility, gives FERC implicit authority over TVA transmission rates, terms and conditions. Under the FPA, FERC has jurisdiction over the rates, terms and conditions of public utilities' transmission services.	Sec. 2(a) gives FERC authority over TVA's transmission rates, terms and conditions.	Sec. 101 gives FERC authority over TVA's transmission rates, terms and conditions.	Applies FERC jurisdiction to TVA's transmission rates to the same extent that such jurisdiction applies to public utilities. Repeal of the Fence and the anti-cherry picking provision will permit open access to the TVA transmission system, and TVA's transmission rates, terms and conditions should thereafter be subject to the same regulatory authority that applies to public utilities.

DOE003-0329

ISSUE	EXISTING LAW	H.R. 2050 (LARGENT-MARKEY)	S. 1047/ H.R. 1828 (ADMINISTRATION)	H.R. 2944 (COMMITTEE PRINT)	S. 1323 (McCONNELL)	H.R. 3130 (BAKER)	S. 1273 (BINGAMAN)	S. ___ (MURKOWSKI)	KUB/MLGW PROPOSAL
REVIEW OF TVA WHOLESALE POWER RATES	None.	Sec. 402(c) gives FERC jurisdiction over TVA wholesale sales outside—but not inside—the Tennessee Valley region.	Not addressed.	Sec. 603(c) gives FERC jurisdiction over TVA wholesale sales outside—but not inside—the Tennessee Valley region.	Sec. 2(a) gives FERC implicit authority over TVA's wholesale power rates. FERC has jurisdiction over the rates charged by public utilities for the sale of electric energy pursuant to FPA Sec. 205. Sec. 5(b) directs TVA to file its existing rates and contracts with FERC within 180 days of enactment.	Sec. 6(a) gives FERC implicit authority over TVA's wholesale power rates. FERC has jurisdiction over the rates charged by public utilities for the sale of electric energy pursuant to FPA Sec. 205.	Not addressed.	Not addressed.	Gives FERC FPA jurisdiction over rates, terms and conditions of TVA wholesale power sales. TVA should be subject to same FERC authority to regulate wholesale power rates that applies to public utilities. If not, TVA could pre-recover anticipated stranded costs or otherwise circumvent FERC Order 888 stranded cost recovery principles.
WHOLESALE STRANDED COST RECOVERY BY TVA	None, absent triggering of FERC Order 888 reciprocity provisions by TVA.	Sec. 408 directs FERC to promulgate regulations governing stranded cost recovery by TVA and to employ a methodology consistent with that used by FERC in determining public utilities' wholesale stranded costs. No stranded cost charge may be imposed after 9/30/2007.	Sec. 806 directs FERC to promulgate regulations regarding TVA's recovery of stranded costs as defined by FERC. Sec. 806 specifically prohibits cost-shifting among distributors but would not require FERC to apply the same stranded cost methodology it uses for public utilities to TVA. No stranded cost charge may be imposed after 9/30/2007.	Sec. 608(a) directs TVA, within six months of enactment, to make a "good faith effort" to reach agreement with distributors with respect to stranded cost recovery. Sec. 608(a) also (1) directs TVA and the distributors to submit a joint stranded cost plan (or in the event of disagreement, separate plans) to FERC; and (2) directs FERC to "approve, reject, or modify" such plan or plans within one year of enactment. TVA may not recover stranded costs after 9/30/2007.	Sec. 2(a), which amends the FPA to make TVA a "public utility," implies that FERC's Order No. 888 stranded costs provisions apply to TVA. Sec. 5(a) directs FERC to hold a hearing to determine the value of TVA's prudently incurred assets. Sec. 5(a) also authorizes FERC to issue an order awarding to TVA "recovery of costs rendered uneconomic by competition."	Sec. 6(a), which amends the TVA Act to make TVA a "public utility" within the meaning of the FPA, implies that FERC's Order No. 888 stranded costs provisions apply to TVA	Not addressed.	Not addressed.	Allows TVA to recover stranded costs, as determined by FERC, from customers that terminate their long-term TVA power contracts or reduce purchases thereunder. Provides that TVA may not recover stranded costs for any period beyond September 30, 2007. FERC, the federal body with the most significant expertise in this regard, has already struggled with the issue of how best to deal with costs "stranded" as a result of the transition to competition in the electric industry. Order No. 888 represents FERC's conclusions as to the most fair and efficient mechanism for calculating and assessing wholesale stranded costs. There is no reason for departing from this mechanism when determining TVA's stranded costs.

DOE003-0330

1686

ISSUE	EXISTING LAW	H.R. 2050 (LARGENT-MARKEY)	S. 1047/ H.R. 1828 (ADMINISTRATION)	H.R. 2944 (COMMITTEE PRINT)	S. 1323 (McCONNELL)	H.R. 3130 (BAKER)	S. 1273 (BINGAMAN)	S. ___ (MURKOWSKI)	KUB/MLGW PROPOSAL
REFORM OF LONG-TERM TVA CONTRACTS WITH DISTRIBUTORS	None	Sec. 405 requires TVA to renegotiate its existing long-term distributor contracts within one year of enactment, including provisions with respect to term, termination notice, purchases from other suppliers, and stranded cost recovery. Upon expiration of the one-year period, any outstanding issues would be submitted to FERC for final resolution.	Sec. 805 requires TVA to renegotiate its existing long-term distributor contracts within one year of enactment, including provisions with respect to term, termination notice, purchases from other suppliers, and stranded cost recovery. Upon expiration of the one-year period, any outstanding issues would be submitted to FERC for final resolution.	Sec. 006 requires TVA to renegotiate its existing long-term distributor contracts within one year of enactment, including provisions with respect to term, termination notice, purchases from other suppliers, and stranded cost recovery. Upon expiration of the one-year period, distributors have the option to terminate their TVA contracts upon three years' notice.	Not addressed.	Not addressed.	Not addressed.	Not addressed.	Allows distributors to terminate or reduce purchases under existing contracts with TVA on two years' notice. KUB/MLGW's long-term TVA contracts were entered into under entirely different regulatory regime and with vastly disparate bargaining power. These contracts renew automatically each year and require 10 years' notice of termination. Congress should modify these contracts to shorten the length of notice for termination. A two-year notice period would both 1) provide distributors with meaningful bargaining power in negotiations for replacement contracts; and 2) afford sufficient time for TVA to market the power no longer purchased by distributors giving notice of termination.
REGULATORY AUTHORITY BY TVA OVER DISTRIBUTORS	TVA Act Secs. 10 and 12 allow TVA to exercise regulatory authority over distributors through power supply contracts. (16 U.S.C. Secs. 831i, 831k).	Sec. 407(a) allows distributors to opt out of regulation by TVA. Upon a distributor's election, the provisions of Secs. 10 and 12 of the TVA Act that allow TVA to regulate distributors through power supply contracts will not apply to future sales by TVA to that distributor.	Sec. 807(3) specifically repeals the provisions of Secs. 10 and 12 of the TVA Act that allow TVA to exercise regulatory authority over distributors through power supply contracts.	Sec. 007(a) allows distributors to opt out of regulation by TVA. Upon a distributor's election, the provisions of Secs. 10 and 12 of the TVA Act that allow TVA to regulate distributors through power supply contracts will not apply to future sales by TVA to that distributor.	Not addressed.	Not addressed.	Not addressed.	Not addressed.	Terminates regulation of distributors by TVA and transfers regulatory authority to their local governing bodies. As a general matter, it is inappropriate, in a competitive market, for a wholesale supplier to regulate a retail distributor.

DOE003-0331

ISSUE	EXISTING LAW	H.R. 3050 (LARGENT-MARKEY)	S. 1047/ H.R. 1828 (ADMINISTRATION)	H.R. 2944 (COMMITTEE PRINT)	S. 1323 (McCONNELL)	H.R. 3130 (BAKER)	S. 1273 (BINGAMAN)	S. ___ (MURKOWSKI)	KUB/MLGW PROPOSAL
ANTITRUST	Not addressed.	Sec. 410 makes the federal antitrust laws applicable to TVA but insulates TVA from civil damages liability for antitrust violations.	Sec. 803 makes the federal antitrust laws applicable to TVA but insulates TVA from civil damages liability for antitrust violations.	Sec. 609 makes the federal antitrust laws applicable to TVA but insulates TVA from civil damages liability for antitrust violations.	Sec. 7 makes the antitrust laws fully applicable to TVA. Sec. 7 specifically provides that TVA shall be deemed a person, and not a government, for purposes for the antitrust laws, thereby subjecting TVA to full treble damages liability.	Sec. 3 makes the antitrust laws fully applicable to TVA. Sec. 3 specifically provides that TVA shall be deemed a person, and not a government, for purposes for the antitrust laws, thereby subjecting TVA to full treble damages liability.	Not addressed.	Not addressed.	**Makes the federal antitrust laws applicable to TVA without civil damages liability for violations. Because TVA is a governmental entity, damages for antitrust violations would ultimately be borne by taxpayers. Thus, TVA should enjoy the same immunity as other governmental entities.**
RETAIL SALES	The Fence prohibits TVA from selling power at retail or wholesale outside the Valley. No statutory limit on TVA's ability to make retail sales inside the Valley, but TVA's contracts with its distributors prevent TVA from competing with them for retail customers.	Sec. 402 authorizes TVA to sell at retail to existing retail customers *only*. Thus, Sec. 402 grandfathers existing retail customers inside the Fence but prevents TVA from expanding its retail customer base inside or outside the Fence.	Permits TVA to make certain retail sales inside, but not outside, the Fence. Sec. 804 authorizes TVA to make retail sales to existing retail customers and to retail customers within a distributor's service area if the distributor: (1) consents to the sale; or (2) purchases more than 50 percent of its power from a supplier other than TVA.	Permits TVA to make certain retail sales inside, but not outside, the Fence. Sec. 603(a) authorizes TVA to make retail sales to existing retail customers and to retail customers within a distributor's service area if the distributor: (1) consents to the sale; or (2) purchases more than 50 percent of its power from a supplier other than TVA.	Permits TVA to make certain retail sales inside, but not outside, the Fence. Sec. 5 authorizes TVA to make retail sales to existing retail customers and to retail customers within a distributor's service area if the distributor: (1) consents to the sale; or (2) purchases more than 50 percent of its power from a supplier other than TVA.	Permits TVA to make certain retail sales inside, but not outside, the Fence. Sec. 4 prohibits TVA from making retail sales except for sales to pre-existing retail customers: (1) located within the service area of a distributor purchasing fifty percent or more of its power needs from a supplier other than TVA; and (2) that elect to continue power purchases from TVA.	Not addressed.	Not addressed.	**Authorizes TVA retail sales to existing TVA retail customers and those within a distributor's service area if the distributor consents.** **KUB/MLGW strongly oppose permitting TVA to compete at retail only with distributors purchasing more than 50 percent of their power from a supplier other than TVA. This penalizes distributors for taking advantage of the very competitive market opportunities that underlie federal electric restructuring legislation.**
WHOLESALE SALES OUTSIDE THE VALLEY	The TVA Act permits TVA, subject to certain restrictions, to sell outside the Fence within an area extending not more than five miles beyond the Fence. 16 U.S.C. § 831n-4.	Sec. 402(b)(1) permits TVA to sell at wholesale outside the Valley, but limits TVA power sales for use outside the Tennessee Valley to "excess electric energy."	Sec. 804 permits TVA to sell power at wholesale to "any person" as of January 1, 2003.	Sec. 603(b)(1) permits TVA to sell at wholesale outside the Valley, but limits TVA power sales for use outside the Tennessee Valley to "excess electric power."	Not addressed.	Not addressed.	Not addressed.	Not addressed.	**Not specifically addressed, but KUB/MLGW support permitting TVA to sell at wholesale outside the Valley. TVA's participation in competitive markets should not be restricted unnecessarily, especially where any revenues generated by any TVA power sales will mitigate TVA's stranded costs.**

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ISSUE	EXISTING LAW	H.R. 2050 (LARGENT-MARKEY)	S. 1647/ H.R. 1828 (ADMINISTRATION)	H.R. 2944 (COMMITTEE PRINT)	S. 1523 (McCONNELL)	H.R. 3150 (BAKER)	S. 1273 (BINGAMAN)	S. ___ (MURKOWSKI)	KUB/MLGW PROPOSAL
NEW GENERATION CAPACITY	Sec. 4(f) of the TVA Act authorizes TVA to "purchase or lease" such real property "as it deems necessary or convenient in the transaction of its business." 16 U.S.C. § 831c(f). Sec. 5(f) of the TVA Act authorizes the TVA Board to "make alterations, modifications, or improvements in existing plants and facilities, and to construct new plants." 16 U.S.C. § 831d(f). Secs. 15 and 15d of the TVA Act authorize TVA to issue bonds to finance, among other things, the construction, acquisition, enlargement, improvement, or replacement of power generating plants. 16 U.S.C. §§ 831n & 831n-4.	Sec. 404 prohibits TVA from acquiring new generating resources unless the customer(s) on whose behalf the resource is acquired commit(s) to bear the cost of acquisition. Sec. 404 further provides that TVA may not acquire any new generating resource that would contribute to its stranded costs.	Not addressed.	Sec. 604 provides that TVA may construct, acquire, improve, enlarge, or replace any new generation plant or facility that TVA determines to be necessary to supply the demands of distributors or direct-serve retail customers.	Sec. 5(a) prohibits TVA from constructing or acquiring any additional generation capacity unless FERC issues a certificate of public convenience and necessity authorizing construction or generation. Sec. 5(a) prescribes criteria FERC is to use to issue such a certificate. FERC must hold an evidentiary hearing and may only issue the certificate if: (1) TVA's reserve power margin for customers inside the Fence is less than 15 percent and is expected to continue below 15 percent for a period of at least one year; (2) EIA certifies that the new generation is the only commercially reasonable means to meet distributor demand; (3) the new generation will not result in violations of the Fence; and (4) the new generation is fully subscribed in advance by customers inside the Fence.	Sec. 8(a) prohibits TVA from constructing or acquiring any additional generation capacity unless each of the following is met: (1) the new resource is completely subscribed in advance by distributors and the output will be consumed only within the Fence; (2) the distributors on whose behalf the new resource is acquired commit to pay its full cost; (3) the new resource is not expected to increase TVA's stranded costs; (4) any bonds issued as to the resource's construction or acquisition clearly state that such bonds are the exclusive obligations of TVA alone, and not the United States; (5) TVA yields to the taxing authority of local, county and state governments where the new resource is located; and (6) at least 51% of the capital requirements of any such venture is provided in the form of equity.	Not addressed.	Not addressed.	Not specifically addressed. KUB/MLGW oppose express statutory limitations on TVA's ability to construct or acquire new generation facilities, which could interfere with TVA's ability to meet its customers' demand. However, TVA would not need to build new generation facilities if TVA would permit its customers to provide for their own load growth, whether by generating power or by purchasing power from other suppliers on the wholesale market. Neither of these options is barred by existing law but both would probably require the consent of TVA. First, TVA would likely argue that the distributors' TVA contracts prohibit self-generation. Second, unless or until the anti-cherrypicking provision is repealed, purchases from other suppliers would require that TVA voluntarily provide access to its transmission system for transmitting power to distributors inside the Fence. TVA is not likely to agree to provide this access unless or until the Fence is repealed, thereby giving TVA the opportunity to market power outside the Tennessee Valley.

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PROPOSED DRAFT TITLE
ON THE
TENNESSEE VALLEY AUTHORITY

SEC. 1 DEFINITIONS.

Except as otherwise expressly provided, the following definitions shall apply for the purposes of this title:

(a) DISTRIBUTOR – The term "distributor" means a cooperative organization, municipal, or other publicly owned electric power system (or any successor in interest thereto) which on January 2, 1998, purchased substantially all of its wholesale power requirements at wholesale from TVA pursuant to a long-term power sales agreement.

(b) TENNESSEE VALLEY – The term "Tennessee Valley" means the geographic area in which TVA was providing wholesale power to distributors on January 2, 1998.

(c) TVA – The term "TVA" means the Tennessee Valley Authority.

(d) COMMISSION -- The term "Commission" means the Federal Energy Regulatory Commission or any successor agency.

SEC. 2 REMOVAL OF RESTRICTIONS ON ELECTRIC ENERGY SALES BY TVA AND ITS DISTRIBUTORS OUTSIDE OF THE TVA SERVICE AREA.

The first paragraph, from the beginning of the third sentence through the end, the second paragraph, and the third paragraph of Section 15d(a) of the Tennessee Valley Authority Act of 1933 (16 U.S.C. § 831n-4(a)) are repealed.

SEC. 3 OPEN ACCESS TRANSMISSION BY TVA.

(a) The rates, terms, and conditions of transmission service provided by TVA shall be regulated by and under the jurisdiction of the Commission in the same manner and to the same extent as the rates, terms, and conditions of transmission service provided by all transmission owners and/or operators, provided that the preference granted in Section 10 of the Tennessee Valley Authority Act (16 U.S.C. § 831i) to States, counties, municipalities, and cooperative organizations of citizens or farmers within the Tennessee Valley shall include access to transmission capacity on the TVA transmission system.

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SEC. 7 POWER SALES BY TVA.

(a) Nothing in this title shall be construed to modify or alter the existing obligations of TVA under the Tennessee Valley Authority Act (16 U.S.C. § 831 et seq.) to give preference in the sale of power to States, counties, municipalities, and cooperative organizations of citizens or farmers within the Tennessee Valley.

(b) No person or entity shall duplicate the facilities of a distributor for the purpose of serving a retail customer. TVA shall not deliver power to retail customers without the consent of the distributor that would otherwise provide distribution service to such customer, provided that TVA may continue to make those retail sales it was making on the date of enactment, provided that distributors retain all their rights to pursue any legal claims they may have that a retail sale being made by TVA on the date of enactment violated applicable provisions of law or contracts.

SEC. 8 EXISTING WHOLESALE POWER CONTRACTS.

(a) DISTRIBUTOR CONTRACT TERMINATION OR REDUCTION RIGHT.--- TVA shall allow any distributor that had a contract to purchase wholesale electric energy from TVA in effect on the date of enactment of this title to terminate its contract or reduce the quantity of its wholesale power requirements thereunder by or to either a specific amount of power or a percentage of its requirements, upon two years' notice, which notice may be given at any time and from time to time from the date of enactment.

(b) RENEGOTIATION OF CERTAIN WHOLESALE POWER CONTRACTS.--- If a distributor elects to reduce the quantity of its purchases from TVA pursuant to subsection (a) of this Section 8 but not to terminate its contract, such distributor and TVA shall, within one year following the date of such election, renegotiate the remaining terms of their existing contract under which TVA will continue to provide wholesale power to the distributor, provided that such contract shall preserve the distributor's right under subsection (a) to elect further reduction(s). If the distributor and TVA are not able to reach agreement on such remaining terms of their contract within the one-year period, either the distributor or TVA may submit the matter to the Commission which shall have jurisdiction to and shall establish such terms.

SEC. 9 RECOVERY OF STRANDED COSTS.

TVA may recover any wholesale stranded costs that may arise from the exercise of rights by a distributor pursuant to Section 8 of this title to the extent authorized by the Commission based on application of the same rules and principles the Commission applies to wholesale stranded cost recovery by other electric utilities within its jurisdiction, provided that TVA shall not be authorized to recover

from any distributor any wholesale stranded costs related to loss of sales or revenues by TVA, or its expectation of continuing to sell electric energy, for any period after September 30, 2007. Any stranded cost recovery charge authorized by the Commission to be assessed by TVA shall be unbundled from the otherwise applicable rates and charges to such customer and separately stated on the bill of such customer. TVA shall not recover wholesale stranded costs from any customer through any other rate, charge, or mechanism.

SECTION ONE: DEFINITIONS

Proposed Legislative Language:

SEC. 1 DEFINITIONS.

Except as otherwise expressly provided, the following definitions shall apply for the purposes of this title:

(a) DISTRIBUTOR – The term "distributor" means a cooperative organization, municipal, or other publicly owned electric power system (or any successor in interest thereto) which on January 2, 1998, purchased substantially all of its wholesale power requirements at wholesale from TVA pursuant to a long-term power sales agreement.

(b) TENNESSEE VALLEY – The term "Tennessee Valley" means the geographic area in which TVA was providing wholesale power to distributors on January 2, 1998.

(c) TVA – The term "TVA" means the Tennessee Valley Authority.

(d) COMMISSION -- The term "Commission" means the Federal Energy Regulatory Commission or any successor agency.

Rationale:

In the interest of clarity and brevity, this section defines several of the terms or abbreviations used throughout the title.

The term "distributor," as used in the title, refers to a member of a particular class of TVA customers. TVA sells power to two different classes of customers in the Tennessee Valley: (1) end-use retail customers directly served by TVA; and (2) wholesale distributors that re-sell TVA power to their own retail customers. At present, there are 159 "distributors" of TVA power, all of which are publicly-owned, not-for-profit electric distribution systems. Section 1(a) defines the term "distributor" so as to include all 159 distributors, including electric cooperatives as well as municipal electric systems, to the exclusion of all other TVA customers.

The term "Tennessee Valley," as used in the title, refers to the geographic area within which TVA is permitted to sell power under existing law. The 1959 amendments to the TVA Act generally restricted TVA's service territory to the geographic area it was serving on July 1, 1957. See 16 U.S.C. § 831n-4(a). This territorial restriction is commonly referred to as the "TVA Fence" (or simply the

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"Fence"). As used in the TVA title, the term "Tennessee Valley" means the geographic area bounded by the Fence.

As used in this title, the "Commission" means the Federal Energy Regulatory Commission ("FERC"). The FERC is the federal agency with regulatory authority over, among other things, natural gas and electric utilities operating in interstate commerce.

SECTION TWO: THE TVA FENCE

Proposed Legislative Language:

SEC. 2 REMOVAL OF RESTRICTIONS ON ELECTRIC ENERGY SALES BY TVA AND ITS DISTRIBUTORS OUTSIDE OF THE TVA SERVICE AREA.

The first paragraph, from the beginning of the third sentence through the end, the second paragraph, and the third paragraph of Section 15d(a) of the Tennessee Valley Authority Act of 1933 (16 U.S.C. § 831n-4(a)) are repealed.

Background:

Before 1959, there were no statutory barriers limiting TVA power sales to any particular region. Pursuant to the TVA Act, TVA's primary purpose was (and still is) to serve the Tennessee Valley region, see 16 U.S.C. § 831, but TVA was technically free to sell electricity anywhere in the U.S. See Alabama Power Co. v. TVA, 948 F. Supp. 1010, 1023 (N.D. Ala. 1996). However, the 1959 amendments to the TVA Act restricted TVA power sales to a defined geographic area. See 16 U.S.C. §831n-4(a). Section 15d(a) of the TVA Act generally prohibits TVA from selling or delivering power, directly or indirectly, outside the geographic area within which it was the primary source of power on July 1, 1957. See id. This statutory provision is known as the "TVA Fence" because it "fences" TVA in, limiting TVA power sales to a defined service area.

The primary purpose of the Fence was to protect private utilities from TVA competition. See Hardin v. Kentucky Utilities Company, 390 U.S. 1, 7 (1968). Prior to the 1959 amendments to the TVA Act, TVA had been dependent on annual appropriations from Congress to finance capital expenditures for its power program. In the mid-1950s, however, TVA began to seek authority to issue bonds to finance such expenditures. Although TVA assured Congress at the time that its objective was not to expand its territory but to improve facilities within its existing service area, many Members of Congress were skeptical of TVA's professed intentions. They insisted that legislation giving TVA bond authority should also include some mechanism aimed at preventing TVA from expanding its territory. In the late 1950s, several bills combining the grant of borrowing power with provisions prohibiting territorial expansion were introduced in Congress. One of these bills was ultimately enacted as the 1959 amendments to the TVA Act.

Rationale:

Section 2 repeals the TVA Fence, thereby permitting TVA to sell power outside the Tennessee Valley. Repeal of the Fence is necessary if the Valley is to be opened to competition. In fairness, if other suppliers are to be permitted to compete with TVA inside the Tennessee Valley, then TVA should be permitted to compete outside the Fence. In addition, permitting TVA to sell power outside the Fence will enable TVA to mitigate stranded costs that could result from the transition to wholesale competition in the Tennessee Valley.

For these reasons, TVA, TVPPA, Knoxville Utilities Board ("KUB"), and Memphis Light, Gas and Water Division ("MLGW") all support legislation repealing the TVA Fence. TVA Watch, however, generally opposes repeal of the Fence, at least until such time as TVA Watch is satisfied that TVA would be competing with its members and other investor-owned utilities (IOUs)[1] on a "level playing field." TVA Watch is particularly concerned about TVA's unique status as a wholly unregulated entity operating in interstate commerce. TVA Watch argues that TVA enjoys artificial competitive advantages—including exemptions from antitrust laws, FERC regulation, and state and local taxes—that would give TVA an unfair advantage in a competitive market.

Under the legislation, TVA would not enjoy an unfair competitive advantage over IOUs in the wholesale power market. In addition to repealing the Fence, the legislation subjects TVA to most of the laws that apply to public utilities. For example, the legislation provides for full FERC jurisdiction over TVA's transmission,[2] wholesale rates,[3] and stranded costs.[4] Section 5 of the legislation also subjects TVA to the antitrust laws to the same extent that such laws apply to other governmental entities.[5] These measures assure that TVA will not have an unfair advantage over IOUs in the wholesale power market. Therefore, Tennessee Valley stakeholders do not advocate a simple repeal of the Fence in the absence of other changes to TVA and the way it does business. Instead, they support repeal of the Fence as one essential element of comprehensive TVA restructuring legislation.

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1 IOUs, as distinguished from "public power entities" such as TVA and the distributors, are for-profit entities owned by their shareholders.

2 See Section 3 (TVA Transmission).

3 See Section 4 (Regulation of TVA Wholesale Sales).

4 See Section 9 (Stranded Costs).

5 See Section 5 (Antitrust).

SECTION THREE: TVA TRANSMISSION

Proposed Legislative Language:

SEC. 3 OPEN ACCESS TRANSMISSION BY TVA.

(a) The rates, terms, and conditions of transmission service provided by TVA shall be regulated by and under the jurisdiction of the Commission in the same manner and to the same extent as the rates, terms, and conditions of transmission service provided by all transmission owners and/or operators, provided that the preference granted in Section 10 of the Tennessee Valley Authority Act (16 U.S.C. § 831i) to States, counties, municipalities, and cooperative organizations of citizens or farmers within the Tennessee Valley shall include access to transmission capacity on the TVA transmission system.

(b) Sections 212(f) and 212(j) of the Federal Power Act (16 U.S.C. §§ 824k(f) and 824k(j)) are repealed.

Background:

Transmission lines have been called "the highways of electricity commerce." Jeffrey D. Watkiss & Douglas W. Smith, The Energy Policy Act of 1992—A Watershed for Competition in the Wholesale Power Market, 10 Yale J. on Reg. 447, 455 (1993). Without open access to transmission lines, a competitive bulk power market would not be possible. Therefore, provisions expanding FERC's authority over transmission were a fundamental feature of the Energy Policy Act of 1992 ("EPAct"), the omnibus energy legislation that "became the vehicle for addressing the obstacles to competition in the electric industry." Id.

Prior to the EPAct, access to transmission lines was controlled primarily by utilities that were also the dominant suppliers of electricity and that could retain their power and status in the market for electricity either by simply denying others access to their transmission lines or by offering access at rates that were so high as to be cost-prohibitive to competitors. In an effort to facilitate the development of a competitive wholesale market for the sale of electricity as a commodity, Congress in the EPAct increased FERC's authority over transmission owners and operators. The EPAct authorizes FERC to order transmitting utilities to provide transmission service to any electric utility (or other person or entity generating electric energy for sale for resale) requesting such service. See 16 U.S.C. § 824j. TVA is a "transmitting utility" within the meaning of the FPA and the EPAct's amendments thereto. See 16 U.S.C. § 796(23) (defining a "transmitting utility" as "any electric utility . . . or Federal power marketing agency which owns or operates electric power transmission facilities . . . for the sale of electric energy at wholesale"); 16

U.S.C. § 796(22)(expressly including TVA within the FPA definition of "electric utility").

However, although the EPAct expanded FERC's authority over TVA transmission, the legislation also included an important exception that seriously limits the extent of FERC's power to order TVA to provide transmission service. See 16 U.S.C. § 824k(j). The exception is commonly referred to as the "anti-cherrypicking provision" because it prevents potential TVA competitors from selling power to customers inside the Fence (i.e., "cherrypicking") without TVA's consent. Specifically, the anti-cherrypicking provision provides that FERC may not issue an order requiring TVA to provide transmission service to another entity if the electricity to be transmitted would be consumed within the Fence. Therefore, pursuant to the EPAct, FERC has the power to order TVA to transmit power of other suppliers *through*—but not *into*—the Tennessee Valley. As a result, under existing law, power suppliers other than TVA could reach customers inside the Tennessee Valley (where TVA owns virtually 100% of the transmission lines) only if TVA were to voluntarily agree to provide the necessary access to its transmission system. To date, TVA has shown no willingness to volunteer to provide such access.

Rationale:

TVA and all the distributors support legislation that repeals the anti-cherrypicking provision and brings TVA transmission under FERC jurisdiction. Section 3(a) gives FERC regulatory authority over the rates, terms and conditions of TVA transmission service, while Section 3(b) repeals the anti-cherrypicking provision. By repealing the anti-cherrypicking provision, Section 3 gives FERC the authority to order TVA to provide transmission service to power suppliers seeking to use TVA's transmission lines for the purpose of delivering power to wholesale customers inside the Valley. Section 3 also specifically provides for FERC jurisdiction over TVA transmission because under existing law, FERC does not have general jurisdiction over TVA's transmission rates or the terms and conditions of TVA transmission service. FERC jurisdiction will ensure the smooth and fair operation of the TVA transmission grid, thereby promoting the development of an efficient bulk power market in the southeastern United States.

Section 3(a) further clarifies that the TVA Act's preference provision extends to capacity on the TVA transmission system as well as to TVA's power supply. Section 10 of the TVA Act provides that TVA shall give preference in the sale of power to "States, counties, municipalities, and cooperative organizations of citizens or farmers, not organized or doing business for profit, but primarily for the purpose of supplying electricity to its own citizens or members." 16 U.S.C. § 831i. Absent this clarification, not-for-profit distributors choosing to purchase their power from a supplier other than TVA might be denied access to TVA's available transmission capacity. This clarification is therefore necessary to remove any disincentive that

TVA might otherwise have, when allocating its available transmission capacity, to prefer customers that continue purchasing their power from TVA over those seeking to take advantage of competitive market opportunities by purchasing from other power suppliers.

SECTION FOUR: REGULATION OF TVA WHOLESALE SALES

Proposed Legislative Language:

SEC. 4 REGULATION OF SALES OF ELECTRIC ENERGY AT WHOLESALE BY TVA.

The rates, terms, and conditions of wholesale sales of electric energy by TVA shall be subject to the Federal Power Act (16 U.S.C. §§ 796 et seq.) and regulated by and under the jurisdiction of the Commission. All such rates shall be cost-justified unless the Commission finds that TVA possesses no market power in connection with a particular sale.

Background:

Under the FPA, FERC has jurisdiction over public utilities' wholesale power sales in interstate commerce, including the rates, terms, and conditions of such sales. See 16 U.S.C. 824d(a). In addition to providing that FERC has jurisdiction over wholesale sales of electricity, Section 205 of the FPA requires that the rates for such sales be just and reasonable and not unduly preferential or discriminatory. See 16 U.S.C. § 824d(a)-(b). Pursuant to FPA Section 205, public utilities subject to FERC jurisdiction must file with FERC all rates and contracts for the transmission or wholesale sale of power in interstate commerce. See 16 U.S.C. § 824d(c). In addition, public utilities must give FERC and the public at least 60 days' notice of any proposed rate increase. See 16 U.S.C. § 824d(d). Pursuant to the FPA, customers have the right, under section 206, to file a complaint with FERC challenging particular rates or contracts as unjust, unreasonable, or unduly discriminatory or preferential. See 16 U.S.C. §824e(a).

Unlike public utilities, TVA is not subject to any regulatory oversight under existing law. Instead, TVA is entirely self-regulated; its discretion to determine the rates, terms, and conditions of its wholesale sales of electric energy in interstate commerce is virtually unfettered. Under existing law, TVA answers only to Congress, a body that has neither the time nor the resources to devote to reviewing TVA's power rates. In addition, while congressional oversight theoretically affords TVA customers some protection from unjust, unreasonable, or unduly discriminatory power rates, there is simply no established procedure through which TVA customers could seek review of TVA's rates before Congress. In practice, congressional oversight of TVA is generally limited to budgetary issues.

Rationale:

Section 4 would bring TVA's wholesale sales under FERC jurisdiction. In a competitive market, it simply would not be appropriate for TVA to continue to set

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its own rates without *any* regulatory oversight. If TVA is going to be a market participant, then it should be subject to the same statutes, rules, and regulations that apply to other market participants of similar size, including sections 205 and 206 of the FPA. There is no sound public policy justification for exempting TVA from these provisions of the FPA.

It has been suggested by some that TVA's wholesale rates should merely be subject to judicial review in the federal district courts, or to compulsory arbitration proceedings in the event of a dispute. However, these are not viable alternatives to FERC regulation. Unlike state and federal courts and arbitration panels, which are ill-suited to the task of reviewing power rates, FERC has decades of expertise in regulating utilities' wholesale rates. In addition, FERC's many years of experience with wholesale rate regulation have produced a well-developed body of law to guide FERC in the exercise of its power. Thus, common sense and efficiency dictate that FERC, the entity best suited to the task, be given responsibility for reviewing, modifying, and approving TVA's wholesale rates.

It should be noted that the extent to which FERC regulates utilities' wholesale power rates is on the decline. FERC regulation of bulk power sales has become increasingly light-handed since the advent of wholesale competition. One consequence of the transition to competition in the electric industry has been increased reliance on market forces to accomplish what had, in the past, necessitated government regulation. Because open access to interstate transmission lines has largely dissipated most utilities' generation market power, FERC has granted many utilities' applications for authority to charge market-based rates. In the Tennessee Valley, however, TVA continues to have a monopoly on generation as well as transmission facilities. It is reasonable to believe that TVA's generation market power will recede over time, but protection from market power abuses by TVA will be particularly important during the early years of the transition to competition.

Absent oversight by a neutral body, TVA could use its market power to the detriment of customers inside the Valley. For example, TVA could increase wholesale rates for the purpose of cross-subsidizing other aspects of its power program, such as its transmission system. In addition, federal electric restructuring legislation giving FERC regulatory authority over certain aspects of TVA's power program but not over wholesale rates could seriously impair FERC's exercise of jurisdiction over TVA. For example, TVA has assented to limited FERC jurisdiction over its stranded costs, but such jurisdiction would be virtually meaningless unless FERC also has jurisdiction over TVA's wholesale rates as well. To illustrate, if TVA continues to have unfettered authority to set its wholesale rates, then TVA could circumvent FERC stranded cost determinations by increasing rates in the event of any perceived shortfall in FERC's stranded costs orders. To

prevent these and other potential abuses, TVA's rates must be subject to review by FERC.

For all of the foregoing reasons, Section 4 gives FERC regulatory authority over the rates, terms, and conditions of TVA's wholesale sales of electricity. Section 4 further requires that TVA's rates be based on its cost of service unless or until FERC finds that TVA has no market power in connection with a particular sale. In essence, this language directs FERC not to grant TVA the authority to charge market-based rates until FERC determines that TVA no longer possesses market power.

TVA Position

The prospect of FERC regulation of TVA's rates is anathema to TVA. TVA argues that there is no need for one body of presidential appointees (the FERC Commissioners) to review the rates set by another group of presidential appointees (the TVA Board). This argument, however, is flawed in several respects. First, FERC already has ultimate authority over the rates established by the Administrator of the Bonneville Power Administration (BPA), who is also a presidential appointee. Second, and more importantly, the issue is not so much which presidential appointees should have ultimate authority over TVA's rates, but whether TVA customers should be entitled to challenge the justness and reasonableness of TVA's rates. Under existing law, TVA customers do not have the ability to challenge TVA's wholesale rates. The TVA Board is not even remotely accountable to TVA's ratepayers, who have no recourse whatsoever in the event of an unwarranted or unreasonable rate increase. TVA customers also do not have access to information about their rates or the cost components thereof. Thus, even if distributors had a forum in which to challenge TVA's rates, they lack the information necessary to evaluate the justness and reasonableness of the rates charged by TVA. If TVA were subject to FERC jurisdiction, however, TVA would have to file its rates publicly at FERC and would be required to provide more information about its costs.

TVA, the only utility in the United States with a AAA bond rating, also argues that FERC regulation of TVA would destroy its bond rating and harm its investors. TVA insists that its bond rating is attributable primarily to its captive customer base and its unilateral authority to establish its own rates. However, TVA's bond rating is a function of a number of factors, including the widespread but inaccurate belief that TVA's bonds are backed by the federal government. TVA should not be permitted to escape FERC jurisdiction (or the consumer-protection mechanisms that such jurisdiction entails) on the basis of an illogical argument that its bond rating is somehow solely attributable to its unregulated status.

TVPPA Position

TVPPA's most recent legislative proposal is silent as to who should have jurisdiction over TVA's wholesale sales. However, TVPPA had earlier been advocating limited FERC jurisdiction over TVA's wholesale power sales in the event of rate disputes that cannot be resolved through mandatory arbitration proceedings. As noted above, however, arbitrators lack the experience and expertise necessary to engage in the hyper-technical process of evaluating the justness and reasonableness of electric rates. In any event, FERC jurisdiction and alternative dispute resolution are not mutually exclusive concepts. Distributors who would prefer to not become involved in FERC proceedings could avoid such involvement in a number of ways. For example, such distributors could seek to include, in their TVA contracts, language providing that the distributors are required to arbitrate rate disputes with TVA prior to seeking FERC review. Parties are permitted to "contract around" their FPA rights, and FERC will generally respect parties' private contractual agreements. Under Section 4, then, distributors preferring arbitration can arbitrate any disputes with TVA in the Valley, while distributors preferring more structured, formal dispute resolution proceedings can submit their disputes to FERC.

SECTION FIVE: ANTITRUST

Proposed Legislative Language:

SEC. 5 APPLICABILITY OF ANTITRUST LAWS TO TVA.

Notwithstanding any other provision of law, TVA shall be subject to all antitrust laws of the United States, including but not limited to the Sherman Antitrust Act (15 U.S.C. §§ 1 et seq.), the Clayton Act (15 U.S.C. §§ 12 et seq.), and the Federal Trade Commission Act (15 U.S.C. §§ 41 et seq.), and amendments thereto, including all injunctive remedies and criminal penalties applicable thereunder, but neither TVA nor its officers, attorneys, employees, agents, or representatives shall be held liable for civil damages, including treble damages, or for attorneys' fees.

Background:

The broad purpose of the antitrust laws is to deter anticompetitive conduct, to outlaw illegal monopolies, and to provide a vehicle for recovery for economic injury resulting from antitrust violations. Traditionally, electric utilities in the United States were lawful, government-regulated monopolies with clearly defined service territories. There was little competition among electric utilities and, therefore, antitrust violations were not a significant concern in the electric industry. However, with the rise of electricity competition in the 1990s, the importance of antitrust issues in the electric industry has grown exponentially.

Rationale:

Under existing law, TVA is not subject to the federal antitrust laws. If the Tennessee Valley is opened to competition, however, TVA must be required to conform its behavior to the antitrust laws. TVA has enormous market power and it would be a terrible mistake to dismantle the TVA Fence without offering TVA customers and competitors some protection from potential TVA antitrust violations. Therefore, Section 5 clearly provides that TVA is subject to the full body of federal antitrust laws.

Nevertheless, all stakeholders in the Tennessee Valley agree that because TVA is a governmental entity with no shareholders, TVA should not be subject to civil damages liability for antitrust violations. In the event of a large damage award against TVA, any damages payable by TVA would ultimately be borne by ratepayers or by taxpayers. Accordingly, Section 5 exempts TVA from liability for damages and attorneys' fees to the same extent that other governmental entities are exempt from such penalties.

TVA Watch position:

TVA Watch supports subjecting TVA to the full panoply of federal antitrust regulation, including liability for civil damages, treble damages, and attorneys' fees. TVA Watch insists that subjecting TVA to the antitrust laws to the same extent that such laws apply to IOUs is a prerequisite to a "level playing field" in the bulk power market. However, TVA differs from IOUs and traditional public utilities in ways which justify treating TVA differently under the antitrust laws.

If an IOU violates the antitrust laws, any resultant damages award is ultimately borne by the shareholders to whom the IOU's Board is accountable. Because an IOU's decisionmakers are accountable to its investors, it is thought that the investors' financial interest in avoiding damages liability for antitrust violations will deter such violations. However, because publicly-owned electric utilities have no shareholders, publicly owned utilities are generally exempt from damages liability. Subjecting TVA, which has no shareholders, to civil damages liability for antitrust violations will not deter TVA from committing such violations because any damages award would simply be passed through to TVA's ratepayers or to taxpayers (in the form of inability, on the part of TVA, to meet its obligations to the U.S. Treasury). Therefore, the theory behind the availability of monetary relief for violations of the antitrust laws does not apply to TVA with the same force that it applies to IOUs. For these reasons and for the protection of TVA ratepayers, TVA's liability for antitrust violations should be limited to injunctive relief and criminal penalties.

SECTION SIX: TVA REGULATION OF DISTRIBUTORS

Proposed Legislative Language:

SEC. 6 REGULATION OF DISTRIBUTORS THAT PURCHASE ELECTRIC ENERGY FROM TVA.

(a) REPEAL OF TVA REGULATION OF DISTRIBUTORS.--- Notwithstanding any other provision of law or contract, TVA shall not be authorized to regulate, by means of rules, contract provisions, resale rate schedules, contract termination rights, or any other method, any rates, terms, or conditions imposed on the resale or distribution of electric energy by a distributor that purchases electric energy from TVA. Any regulatory authority currently exercised by TVA over any distributor shall be exercised by the governing body of such distributor.

(b) REMOVAL OF PURPA RATEMAKING AUTHORITY.--- Section 3(17) of the Public Utility Regulatory Policies Act of 1978 (16 U.S.C. § 2602(17)) is amended by striking ", and in the case of an electric utility with respect to which the Tennessee Valley Authority has ratemaking authority, such term means the Tennessee Valley Authority".

Background:

In most states, municipal electric systems are regulated by local governing bodies or by state public service commissions. In contrast, pursuant to the TVA Act, distributors in the Tennessee Valley are regulated by TVA. Section 10 of the TVA Act authorizes TVA to include in its contracts with distributors any rules and regulations or terms and conditions, "including resale rate schedules," that TVA deems necessary. 16 U.S.C. § 831i. Section 12 of the TVA Act also mandates the inclusion of certain language in all of TVA's contracts with distributors, including language permitting TVA to void its contract with a particular distributor if TVA finds that such distributor's rates are discriminatory. See 16 U.S.C. § 831k. In addition, the Public Utility Regulatory Policies Act of 1978 ("PURPA") explicitly defines TVA as a "State Regulatory Authority." See 16 U.S.C. § 2602(17).

In practice, TVA regulation of distributors means that TVA controls distributors' business relationships with their retail customers. For example, it is TVA -- not distributors -- that determines which industrial and/or commercial customers are eligible for certain bulk rate discounts. Interestingly, the rates TVA charges its own direct-serve retail customers are significantly lower than the rates TVA requires distributors to charge even their largest retail customers.

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Rationale:

In a competitive electricity marketplace, regulation of retail distributors by a wholesale supplier simply does not make sense. Therefore, Section 6(a) expressly prohibits TVA from directly or indirectly regulating distributors in the Valley, and Section 6(b) revises PURPA so as to remove TVA from that statute's definition of the term "State regulatory authority." TVA, KUB, and MLGW support legislation terminating TVA regulation of distributors on the date of enactment.

TVPPA position:

TVPPA supports permitting distributors to opt out of regulation by TVA in favor of regulation by their local governing body. Some TVPPA members are concerned that, in the absence of TVA control of their relationships with their customers, funds from their power programs would be diverted to other programs funded by their local governing bodies. Thus, TVPPA generally supports an opt-out approach to TVA regulation of distributors such that distributors that would prefer to be regulated by TVA can avoid, simply by not opting-out of TVA regulation, regulation by their local governing bodies. For reasons of consistency and administrative ease, however, TVA regulation of distributors should simply terminate on the date of enactment of federal electric restructuring legislation.

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SECTION SEVEN: TVA POWER SALES

Proposed Legislative Language:

SEC. 7 POWER SALES BY TVA.

(a) Nothing in this title shall be construed to modify or alter the existing obligations of TVA under the Tennessee Valley Authority Act (16 U.S.C. § 831 et seq.) to give preference in the sale of power to States, counties, municipalities, and cooperative organizations of citizens or farmers within the Tennessee Valley.

(b) No person or entity shall duplicate the facilities of a distributor for the purpose of serving a retail customer. TVA shall not deliver power to retail customers without the consent of the distributor that would otherwise provide distribution service to such customer, provided that TVA may continue to make those retail sales it was making on the date of enactment, provided that distributors retain all their rights to pursue any legal claims they may have that a retail sale being made by TVA on the date of enactment violated applicable provisions of law or contracts.

Background:

Under existing law and current market conditions, TVA is primarily a wholesaler of power. The vast majority of TVA's power is sold to distributors for re-sale to retail customers in the Tennessee Valley. However, TVA has a number of direct-serve retail customers, most of which are large end-use industrial customers that consume the power they purchase in the course of their own business operations. In contrast to the distributors, each of which is a non-profit, publicly-owned electric distribution system,[6] most of TVA's direct-serve customers are for-profit entities.

Under the TVA Act, TVA's non-profit customers have "preference" in the TVA power supply. See 16 U.S.C. § 831i. Section 10 of the TVA Act provides that TVA "shall give preference [in the sale of power] to States, counties, municipalities, and cooperative organizations of citizens or farmers, *not organized or doing business for profit, but primarily for the purpose of supplying electricity to its own citizens or members.*" Id. (emphasis added). Thus, the Act authorizes TVA to sell to for-profit entities only such power that is in excess of what is required to meet the needs of distributors. In this way, the TVA Act limits, albeit incompletely and indirectly, TVA's ability to sell power directly to retail customers.

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[6] See Section 1(a) (defining the term "distributor" within the meaning of the Act).

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TVA is further restricted from selling at retail in two other ways as well. First, the "industrial service policies" in TVA's contracts with distributors expressly limit the extent of TVA's retail sales inside the Tennessee Valley. Second, the TVA Fence prevents TVA from selling power at retail outside the Valley because it prohibits *all* TVA power sales outside the Fence. This blanket prohibition includes both retail and wholesale power sales.

Rationale:

TVA should remain, as it is today, primarily a wholesaler of power. TVA's size, in terms of its generation capacity, is already virtually unparalleled, and at a time when there is growing support for the proposition that the federal government should not be in the power business at all, it would be unwise to permit TVA to expand its power program to include new retail customers. Therefore, TVA should not be permitted to acquire new direct-serve retail customers in the Valley without the consent of the distributor that would otherwise serve the retail customer in question.

Under Section 7, TVA would continue to be primarily a wholesaler of power. Section 7(b) permits TVA to continue to sell power to its existing retail customers but prohibits TVA from selling power to retail customers in a distributor's service area unless the distributor consents to the sale. Section 7(b) also clarifies that the language grandfathering existing TVA retail customers does not preclude distributors from arguing that particular retail sales violate the industrial service policies ("ISPs") in their existing TVA contracts. The lawfulness of certain recent TVA retail sales arguably violates the provisions of the ISPs. The clarifying language in Section 7(b) is therefore necessary to preserve distributors' legal rights to challenge the lawfulness of such sales. Section 7(b) also expressly prohibits the duplication of existing distribution facilities by any "person or entity." This prohibition is intended to preempt any attempts by TVA to circumvent the purpose of Section 7 by "cherrypicking" prime retail customers through the use of intermediaries.

Section 7(a) preserves the power sales preference afforded to Tennessee Valley distributors under existing law. To insure the reliability of distributors' service to their own customers, it will be necessary to preserve their existing preference in the TVA power supply, at least during the early years of the transition to competition. During those early years, most distributors probably will not have the option of purchasing one hundred percent of their power from non-TVA sources because other suppliers will be unlikely to have sufficient excess power to meet distributors' needs. Therefore, preservation of the existing preference is necessary to ensure the adequacy of the power supply available to Tennessee Valley consumers during the transition.

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TVA/TVPPA position:

TVA and TVPPA support legislation preserving the distributors' existing power preference. TVA and TVPPA also favor permitting TVA to continue to serve its existing retail customers and retail customers within the service area of a distributor that affirmatively consents to the sale. However, TVA and TVPPA would also permit TVA to compete for retail customers with any distributor that purchases less than 50 percent of its power from TVA. This proposal is grossly anticompetitive and inexplicably punitive. No discernible public policy would be served by a law that penalizes the same customers it is intended to benefit and protect: those exercising their right to choose their own power supplier. In an era of wholesale competition and customer choice, the threat of having to compete with TVA for retail customers should not be a factor in a distributor's choice of wholesale power suppliers. Under the TVA/TVPPA proposal, however, that threat would be clear and present. Because few (if any) distributors could afford to compete with TVA for retail customers, this proposal would essentially guarantee TVA at least a fifty-percent share of the wholesale market in the Tennessee Valley, thereby disadvantaging TVA customers and competitors alike.

SECTION EIGHT: EXISTING CONTRACTS WITH DISTRIBUTORS

Proposed Legislative Language:

SEC. 8 EXISTING WHOLESALE POWER CONTRACTS.

(a) DISTRIBUTOR CONTRACT TERMINATION OR REDUCTION RIGHT.--- TVA shall allow any distributor that had a contract to purchase wholesale electric energy from TVA in effect on the date of enactment of this title to terminate its contract or reduce the quantity of its wholesale power requirements thereunder by or to either a specific amount of power or a percentage of its requirements, upon two years' notice, which notice may be given at any time and from time to time from the date of enactment.

(b) RENEGOTIATION OF CERTAIN WHOLESALE POWER CONTRACTS.--- If a distributor elects to reduce the quantity of its purchases from TVA pursuant to subsection (a) of this Section 8 but not to terminate its contract, such distributor and TVA shall, within one year following the date of such election, renegotiate the remaining terms of their existing contract under which TVA will continue to provide wholesale power to the distributor, provided that such contract shall preserve the distributor's right under subsection (a) to elect further reduction(s). If the distributor and TVA are not able to reach agreement on such remaining terms of their contract within the one-year period, either the distributor or TVA may submit the matter to the Commission which shall have jurisdiction to and shall establish such terms.

Background:

Every distributor has an existing long-term power sales contract with TVA. Perhaps because they were entered into between parties with radically disparate bargaining power at a time when the possibility that TVA's monopoly in the Tennessee Valley might someday come to an end was extremely remote, the terms and conditions of TVA's contracts with individual distributors are remarkably uniform. One of the few individualized aspects of these contracts is the contract term provision. The termination date of each varies in accordance with its effective date, which varies from distributor to distributor depending on precisely when the contract was signed. In general, however, with respect to contract term, there are three types of contracts: (1) the "5 + 5"; (2) the 10-year rolling term; and (3) the 15-year rolling term.

Most of TVA's contracts with distributors fall into the "5 + 5" category. Distributors with a 5 + 5 agreement can terminate their contracts on five years' notice but cannot give notice during the first five years of the contract term. Thus, a 5 + 5 agreement signed in 1997 will continue in effect through at least 2007 and

will continue in effect indefinitely unless or until the distributor elects its option to terminate the agreement.

A substantial minority of distributors, including KUB and MLGW, have a long-term TVA contract with a ten-year rolling term. These contracts were typically entered into in the early 1980s and are terminable only on ten years' notice. Since none of the distributors has given notice under one of these agreements, all of these contracts will remain in effect (absent an Act of Congress) through at least 2010. Only a few existing distributor contracts have a 15-year rolling term. These agreements are similar to those with a ten-year rolling term but are terminable only on fifteen years' notice.

Due to the unusually long notice of termination provisions contained therein, distributors' existing contracts with TVA are a formidable obstacle to the prompt implementation of electricity competition in the Tennessee Valley.

Rationale:

Section 8 guarantees that distributors who so choose will be able to begin purchasing power from other suppliers within two years of enactment (or sooner in the event of a negotiated arrangement with TVA). Section 8(a) expressly gives distributors the right to terminate their existing contracts, or to reduce purchases thereunder by a specific quantity or percentage, on two years' notice.

Absent modification of the existing contracts, no distributor would be able to begin purchasing power from other suppliers immediately upon enactment. Due to pre-existing contractual obligations, unless Congress modifies the existing distributor contracts (or TVA voluntarily agrees to shorten the contract terms), the benefits of wholesale electricity competition will not be realized in the Tennessee Valley for at least seven years. To accelerate the process of opening the Valley to competition, some have proposed that Congress require TVA to renegotiate its existing contracts with distributors. The right to renegotiate without the right to terminate, however, is no right at all.

Distributors lack the bargaining power necessary to bring TVA to the bargaining table in a serious manner. The exceedingly long notice provisions and the perpetual nature of the current contracts give TVA too much bargaining power. TVA is the largest electric utility in the United States, and in the current monopolistic environment, even MLGW, TVA's largest customer, can bring little pressure to bear on TVA to obtain meaningful concessions during the course of renegotiations. Distributors such as KUB and MLGW have, in fact, been engaged in contract renegotiations with TVA for four long years, with few, if any, results.

Some have argued that giving distributors a statutory right to terminate their contracts early would violate the sanctity of private contracts. However, congressional modification of the term of the existing contracts would not constitute unconstitutional interference with private contracts because one of the parties to the contracts in question is itself an agency of the federal government. Surely the federal government has the power to modify its own contracts where the other parties to the contracts in question do not object to the modification. In fact, where Congress is able, through a permissible contract modification that is wholly consistent with the public as well as private interests, to further the policies of the federal government, Congress should do so.

Only a right of contract termination exercisable in the short term will give distributors the bargaining power they need to successfully renegotiate their contracts with TVA. Therefore, Section 8 provides that distributors may, on two years' notice to TVA: (1) terminate their existing contracts; or (2) reduce purchases thereunder for the purpose of purchasing power from other suppliers. Section 8(b) recognizes that the contracts of distributors electing the second option may require adjustments to contractual provisions other than the contract quantity provision. Under Section 8(b), TVA has one year within which to renegotiate its contracts with distributors electing to purchase a portion of their power from sources other than TVA. In the event that TVA and distributors electing to reduce contract purchases are unable to reach agreement within the one-year period, disputes will be submitted to FERC for final resolution.

TVA/TVPPA position:

TVA and TVPPA have agreed to termination of existing contracts on three years' notice, but only after a mandatory one-year contract renegotiations period. Their position properly recognizes the need to shorten the notice of termination period in distributors' existing TVA contracts. However, a three-year notice of termination period is neither necessary to protect TVA nor sufficient to serve the purpose of the shortened notice period. First, a three-year notice period is simply not sufficiently short to induce TVA to make the renegotiations period productive, especially if distributors are permitted to give notice only after a one-year waiting period. Second, given the fluidity of today's wholesale market, TVA would not need three years to re-market the power no longer purchased by departing distributors. No single distributor accounts for much more than 10% of TVA's total load, and none of the distributors is expected to leave the TVA system altogether. Thus, two years should be more than sufficient for TVA to find another buyer or buyers for the small amount of power made available as a result of distributors' choosing to purchase a portion of their requirements from another supplier.

SECTION NINE: TVA STRANDED COSTS

Proposed Legislative Language:

SEC. 9 RECOVERY OF STRANDED COSTS.

TVA may recover any wholesale stranded costs that may arise from the exercise of rights by a distributor pursuant to Section 8 of this title to the extent authorized by the Commission based on application of the same rules and principles the Commission applies to wholesale stranded cost recovery by other electric utilities within its jurisdiction, provided that TVA shall not be authorized to recover from any distributor any wholesale stranded costs related to loss of sales or revenues by TVA, or its expectation of continuing to sell electric energy, for any period after September 30, 2007. Any stranded cost recovery charge authorized by the Commission to be assessed by TVA shall be unbundled from the otherwise applicable rates and charges to such customer and separately stated on the bill of such customer. TVA shall not recover wholesale stranded costs from any customer through any other rate, charge, or mechanism.

Background:

FERC Order No. 888 was designed "to remove impediments to competition in the wholesale bulk power marketplace and to bring more efficient, lower cost power to the Nation's electricity consumers." Order No. 888 at 31,634. In Order No. 888, FERC: (1) required all public utilities that own or operate interstate transmission facilities to file open access non-discriminatory transmission tariffs; and (2) authorized public utilities and transmitting utilities to seek recovery of legitimate, prudent, and verifiable costs "stranded" as a result of the transition to wholesale competition in the electric industry. Id. at 31,636.

FERC recognized that its open access rule would give utilities' historical wholesale requirements customers "greatly enhanced opportunities to reach new suppliers." Id. at 31,785. During the course of the Order No. 888 rulemaking proceedings, FERC noted that the electric industry had invested billions of dollars in assets and contracts that might become uneconomic as a result of the transition to a competitive wholesale power market. See Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, FERC Stats. & Regs. ¶ 32,514 at 33,101 (Notice of Proposed Rulemaking). FERC observed that such costs could potentially become "stranded" unless utilities were given an opportunity to recover them from the departing customers or from other customers. Id. FERC acknowledged that there had always been some risk that utilities might lose customers. FERC also recognized, however, that that risk had been greatly increased by "significant statutory, regulatory, technological, and structural changes, including [Order No. 888], that utilities may not have reasonably foreseen

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at the time their investments were made." Id. On the basis of these findings, FERC concluded that "equity requires that utilities have an opportunity to recover legitimate and verifiable stranded costs associated with the development of competitive wholesale [electric] markets." Id.

In Order Number 888, FERC set forth the following formula for calculating the stranded cost obligation ("SCO") of a departing generation customer: SCO = (Revenue Stream Estimate – Competitive Market Value Estimate) x Length of Obligation. See Order No. 888 at 31,839. In addition to setting forth the applicable formula, FERC also defined each of the formula's components and made both its application and the collection of stranded costs subject to a number of conditions. See Order No. 888 at 31,839-40; Order No. 888-A at 30,425. Each of the variables is discussed in more detail below, but calculation of a departing customer's stranded cost obligation under Order No. 888 is essentially a two-step process.

The first step entails determining the average annual stranded cost occasioned by a particular customer's departure, a value which is represented by (RSE – CMVE) in the calculus. Average annual stranded cost is arrived at by subtracting the average annual competitive market value of the power no longer taken by the departing customer (CMVE) from the average annual revenues that the customer would have paid had it remained a generation customer of the utility (RSE). See Order No. 888 at 31,839. The second step involves multiplying the average annual stranded cost by "L," which represents the length of the period over which the utility could reasonably have expected to continue to serve the departing customer had the contract not been subject to early termination pursuant to Order No. 888 (the "reasonable expectation period"). See Order No. 888-A at 30,425 n.737.

Revenue Stream Estimate (RSE)

The revenue stream estimate is the approximate amount of generation-related revenues that a utility could have expected to receive from the departing customer on an annual basis. "Generation-related revenues" are the portion of the customer's rates attributable to the selling utility's generation costs. Order No. 888 required public utilities to "unbundle" their rates so as to state the generation, transmission, and other components thereof separately. Under Order No. 888, the value of RSE is equal to the average annual revenues from the departing generation customer over the three years prior to the customer's departure, less the average transmission-related revenues that the utility would have received from that customer over the same three-year period. See Order No. 888 at 31,839. However, if the customer's rates or contract demand amounts changed during the three-year period prior to the termination of the existing requirements contract, then RSE is calculated using the most recent twelve-month period of customer revenue. See Order No. 888 at 31,840.

Competitive Market Value Estimate (CMVE)

CMVE can be determined in two ways, and the customer has the option of choosing which method of calculation is used. See Order No. 888 at 31,839. One option involves the utility estimating, through performance of a market analysis, the average annual revenues it can expect to receive during the reasonable expectation period (represented by "L" in the calculus) by selling the released capacity and energy. Id. The second option consists of using the average annual cost to the customer, as set forth in the customer's contract with a new supplier, of replacement capacity and associated energy. Id. This second option is only available to a customer whose contract with a new supplier either runs concurrent with "L" or contains rates that do not fluctuate over the duration of the contract. See Order No. 888 at 31,840. In addition, Order No. 888 requires a customer electing Option Two to demonstrate that the new contract is for service equivalent to the released capacity and to identify the rates to be paid for the replacement service. Id.

Length of Obligation (L)

Length of Obligation, or "L," refers to the period of time the utility could reasonably have expected to continue to serve the departing customer. See Order No. 888 at 31,839. In Order No. 888, FERC rejected a "one-size-fits-all approach" and declined to establish absolute limits or presumptions regarding what period of time qualifies as "reasonable." See Order No. 888 at 31,839. However, the fact that a customer had a contractual obligation to incur costs for a definite time period would be strong evidence that a utility had a reasonable expectation of continuing to serve that customer for the contractual period. See Order No. 888-A at 30,435.

Conditions

As noted above, in Order No. 888, FERC made both application of the formula and collection of stranded costs subject to various conditions. See Order No. 888 at 31,840. For example, Order No. 888 establishes a "cap" on stranded cost recovery. Id. The quantity RSE minus CMVE cannot exceed the average annual contribution to "fixed power supply costs," which FERC defines as "RSE less variable costs," that would have been made by the departing customer but for its departure. Id.

In addition, in Order Nos. 888 and 888-A, FERC declined to adopt a prescribed method or term for repayment of stranded costs, instead determining that while these issues should be resolved through negotiations between the parties, the method and term of repayment are "ultimately left to the customer's discretion." Id. (listing various payment options, including "a lump-sum payment, an amortization of a lump-sum payment over a reasonable period of time, or a surcharge on the customer's transmission rate"); see also Order No. 888-A at 30,435

(noting that "the period of reasonable expectation, L, is unrelated to the repayment period").

The departing customer may also, at its sole discretion, choose to market or broker the released capacity and associated energy, and may elect to remain a requirements customer for the duration of L.[7] Id. at n.865. To ensure that customers have the necessary information when deciding whether to market or broker released capacity, Order No. 888 requires utilities requesting stranded cost recovery to indicate the amount of released capacity and associated energy used in their calculations of lost revenues.

The formula discussed above is the embodiment of FERC's determination that stranded cost recovery should approximate, as closely as possible without sacrificing efficiency, the revenues lost by a utility when it loses a particular generation customer as a result of the transition to competition. In Order Number 888, FERC declared the formula it adopted therein to be "the fairest and most efficient way to balance the competing interests of those involved." Order No. 888 at 31,839; see also Order No. 888-A at 30,425 (characterizing the revenues lost approach as the "fairest and most efficient way to make this determination during the transition to a competitive wholesale bulk power market"). FERC further indicated that the SCO formula was intended to balance a number of competing interests and to satisfy several FERC "goals," including the following:

> (1) ensuring full recovery of legitimate, prudent and verifiable stranded costs; (2) requiring the utility to mitigate stranded costs; (3) providing certainty for departing generation customers; and (4) creating incentives for the parties to renegotiate their existing requirements contracts or otherwise settle stranded cost claims without resort to litigation.

See Order No. 888 at 31,840.

In addition, FERC elected to adopt a formula that employs present values, rather than a forward-looking approach, with a view toward efficiency and administrative ease. See Order No. 888-A at 30,428 ("[W]e believe that the use of present revenues as the basis for calculating stranded cost appropriately balances precision and efficiency for what is fundamentally a transition period policy."). In FERC's opinion, the use of present revenues in the calculus is superior to other methods because the use of present revenues: (1) eliminates disputes over estimates

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[7] Under Order No. 888, utilities are not entitled to recover stranded costs from customers who continue as customers for the duration of L.

of future revenues, thereby providing certainty to the calculation; and (2) eliminates the need for a detailed listing and litigation of includable costs. See Order No 888-A at 30,427. In support of its decision to rely on present revenues in calculating stranded costs, FERC noted that a formula in which RSE is based on estimates of future revenues would "engender countless disputes . . . . with little, if any, added accuracy." Id. FERC further observed that the use of present values is preferable to estimates of future revenues because the fact that the rates which produce present revenues have been approved by regulators indicates that the costs included in such rates are "prudent, legitimate and verifiable." Id.

Rationale:

Recognizing that some of TVA's costs may become stranded as a result of the implementation of wholesale electricity competition in the Tennessee Valley, Section 9 gives TVA the right to recover any stranded costs caused by a distributor's election to terminate its contract early or to reduce purchases thereunder. Section 9 further directs FERC to use the Order No. 888 methodology (i.e., "the same rules and principles the Commission applies to wholesale stranded cost recovery by other electric utilities within its jurisdiction") for TVA's stranded costs. In addition, because TVA has privately agreed not to attempt to recover stranded costs from distributors after September 30, 2007 (the end of TVA's Ten-Year Business Plan), Section 9 makes it clear that TVA may not recover stranded costs for any period beyond that date. In other words, TVA has no reasonable expectation of recovering such costs beyond September 30, 2007.

TVA/TVPPA position:

TVA and TVPPA have proposed legislative language relating to TVA's entitlement to recover "stranded costs." TVA and TVPPA also agree that TVA may not recover stranded costs beyond September 30, 2007. Unlike KUB and MLGW, however, TVA and TVPPA do not support use of the Order No. 888 methodology for calculating TVA's stranded costs. Instead, TVA and TVPPA support giving TVA a broad, amorphous right to recover "all of the TVA power system investments made as of the effective date . . . which may become economically stranded and unrecoverable as a result of TVA's serving less than all requirements of all distributors and retail loads served directly by TVA in the TVA service area through September 30, 2007, due to wholesale and retail competition or to contract renegotiation or early contract termination." See TVA/TVPPA Joint Draft, TVA Power System Provisions at § 004 (Sept. 20, 1999). This language fails to clearly define the concept of stranded costs, and the TVA/TVPPA proposal conspicuously avoids prescribing the proper methodology for calculating TVA's stranded costs.

The TVA/TVPPA proposal seemingly but opaquely gives FERC ultimate jurisdiction to determine TVA's stranded costs; the proposal makes reference to "an order of the Commission." Id. at § 004(c). However, the TVA/TVPPA proposal is

not at all consistent with FERC's existing stranded costs rules and policies. For example, the TVA/TVPPA proposal directs TVA to "complete [stranded costs] negotiations with distributors [within six months of enactment] and make a good faith attempt to reach agreement for recovery by TVA and distributors for their respective costs for investments which may be economically stranded and unrecoverable as a result of wholesale or retail competition[8] in the TVA service area." Id. at § 004(d). The proposal further provides that "TVA and distributors shall submit jointly, of if they disagree, then submit separately, an initial stranded investment recovery plan to the Commission for review and make [sic] a determination to either approve, reject, or modify the plan and issue an order setting forth the approved plan." As a threshold matter, it is unrealistic to expect that 160 parties (TVA and the 159 distributors) will be able to reach a negotiated agreement regarding stranded costs in a mere six months; FERC stranded cost proceedings between two parties can last several years. More importantly, however, the TVA/TVPPA proposal's very suggestion of a joint, aggregate plan for systemwide stranded cost recovery is patently inconsistent with Order No. 888's customer-specific "direct assignment approach" to wholesale stranded cost recovery.

In Order No. 888, FERC explained its reasons for opting to assign stranded costs directly to departing customers, as opposed to employing a more broad-based approach. See Order No. 888 at 31,795-803. In Order No. 888, the Commission observed that its final stranded costs rule reflected the Commission's judgment that "it is appropriate that the departing generation customer, and not the remaining generation or transmission customers (or shareholders), bear its fair share of the legitimate and prudent obligations that the utility undertook on that customer's behalf." Id. at 31,798. The Commission further observed that it had "carefully weighed" the arguments in favor of a direct assignment approach against the arguments supporting "a more broad-based approach, such as spreading stranded costs," and that it had concluded that "for both legal and policy reasons," direct assignment was the preferable approach. Id.

Among the reasons supporting the Commission's decision to incorporate a direct assignment approach to stranded costs into its final rule was the fact that such an approach is consistent with "the well-established principle of cost causation, namely, that the party who has caused a cost to be incurred should pay it." Id. The Commission noted that a broad-based approach would violate the cost causation principle "by shifting costs to customers . . . that had no responsibility for stranding the costs in the first place." Id. Another of the Commission's reasons for preferring a direct assignment approach was that direct assignment, in the Commission's view, would yield a more accurate determination of a utility's stranded costs than a

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[8] Of course, the issue of retail stranded costs is an issue best left to resolution by individual states in the Tennessee Valley.

"one-time, up-front estimate of stranded costs." Id. The Commission specifically rejected an "up-front" broad-based transmission surcharge on the grounds that such an approach "would charge customers for costs before the costs are incurred (i.e., before customers have even decided to leave the utility's generation system) and could charge for costs that may never be incurred (e.g., some customers may decide to stay on the utility's system as requirements customers)." Id. Finally, the Commission noted that adopting a direct assignment approach would avoid creating an incentive that utilities might otherwise have, under a broad-based stranded cost regime, "to try to recover the costs of all of its uneconomic assets whether or not they were prudently incurred." Id. at 31,799.

The direct assignment approach specifically sought to avoid cost-shifting among customers, yet TVA/TVPPA's proposed stranded costs language expressly authorizes cost-shifting among customers. See TVA/TVPPA Joint Proposal at § 4(d). Specifically, the TVA/TVPPA proposal provides that "in the event that any stranded investment recovery charge assessed by TVA . . . is not collectable as a result of . . . bankruptcy . . . or other inability to recover such charges after good faith efforts to do so, the total amount of the uncollected sum plus the amounts of charges which would otherwise have been charged to said customer . . . shall be reallocated among, charged to, and recovered from all customers of TVA and distributors in the same proportion as the total stranded investment recovery charges assessed by TVA are to be charged to said customers." This provision is patently inconsistent with Order No. 888 in that it would require TVA customers to do more than pay their fair share of stranded costs; in fact, it could be construed as requiring TVA customers to shoulder the burden of TVA's debt alone. Some of the responsibility for preparing TVA for the competitive era, however, must lie with TVA. Order No. 888 does not permit investor-owned utilities simply to apportion their debt among their customers on a pro rata basis. Instead, as explained above, it authorizes public utilities to recover, on a case-by-case basis, *from individual customers taking advantage of competitive market opportunities*, the costs actually stranded *as a result of a particular customer's departure.* In fairness, TVA deserves no more than this.

As illustrated by the foregoing, the TVA/TVPPA proposal represents a complete departure from the stranded cost recovery rules and procedures established by FERC in Order No. 888. FERC has already struggled mightily with this subject as to all public utilities under its jurisdiction. During the course of the Order No. 888 rulemaking proceeding, which lasted several years, FERC received literally tens of thousands of pages of commentary from all segments of the industry, consumers, and state and federal agencies. There is no sound reason for departing from the Order No. 888 mechanism for stranded cost recovery as to TVA and to do so would likely entail further contentious administrative and court proceedings and ground rules for TVA that are incompatible with other utility systems and competitive electric markets generally.

TVA argues that application of the Order No. 888 methodology to TVA's stranded costs is not appropriate. In particular, TVA argues that Order No. 888 was developed to address the stranded costs of utilities with a mix of retail and wholesale customers and that the Order No. 888 formula is therefore ill-suited for application to TVA, which is primarily a wholesaler of power. On the contrary, however, when detailing the benefits of its approach to stranded costs in Order No. 888, FERC noted that one of the strengths of the Order No. 888 stranded costs approach was its adaptability. See Order No. 888, FERC Statutes and Regulations ¶ 31,036 at 31,799 (noting that FERC's direct assignment approach to wholesale stranded costs "can be readily applied to both wholesale and retail-turned-wholesale departing customers" and "can be adapted for retail customers" as well). Notably, despite TVA's criticism of the FERC formula, TVA has not proposed an alternative formula for calculating its stranded costs.

U.S. Senator for Kentucky

MITCH McCONNELL

EMBARGOED UNTIL 10:00 a.m. EST
July 1, 1999
99-211

SENATOR McCONNELL INTRODUCES BILL TO MAKE TVA ACCOUNTABLE TO ITS RATEPAYERS

WASHINGTON, D.C – U.S. Senator Mitch McConnell (R-KY) today introduced a bill designed to "shine the light" on Tennessee Valley Authority's (TVA) power rates. "The Tennessee Valley Customer Protection Act," will provide TVA ratepayers with a clear picture of TVA's rates and for the first time make the agency accountable for its charges and costs.

"We all grew up thinking if you had TVA power, you were lucky," said McConnell. "Unfortunately, the nearly 212,000 Kentucky families in over 30 counties who receive power from TVA are finding out that's not the case."

Despite operating as a monopoly, TVA has racked up **$26 billion in debt** and provides power at rates higher than that of regulated utilities in Kentucky. Since 1988, power rates of Kentucky's other regulated utilities have steadily fallen, while TVA has maintained the same level until 1997, when TVA raised its rates by 7 percent.

"TVA would like Kentuckians to believe that membership has its privileges," said McConnell. "However, over the next five years, TVA's Kentucky ratepayers will pay a whopping **$250 million more** for their power than if they were served by Kentucky Utilities, which is federally regulated."

"TVA is currently $26 billion in debt," said McConnell. "As a self-regulated monopoly, TVA has not been accountable to its captive ratepayers. As a result, TVA has accumulated a mountain of debt that has forced TVA rates upward. TVA should be accountable to the people they serve, and my bill will provide the relief to those who are forced to pay TVA's uncompetitive rates."

The bill will require TVA to fully disclose and justify all rates, charges and costs as "just and necessary" as required under the Federal Power Act – just as Kentucky's other regulated utilities must do.

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FOR MORE INFORMATION CONTACT ROBERT STEURER, PRESS SECRETARY, (202) 224-8288, FAX (202) 228-3416. SR-361A, WASHINGTON, D.C. 20510-1702.

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TVA would also become a "public utility" subject to the authority of the Federal Energy Regulatory Commission (FERC). This would result in TVA customers enjoying the same independent regulatory protections as customers of other large utilities. For instance, TVA customers could challenge rates, rather than be forced to accept rates set by the TVA board.

Finally, it would protect the TVA ratepayers from financing TVA's international forays. So the ratepayer will no longer be charged for trips that are not consistent with TVA's mission.

TVA, the nation's largest power producer, provides power to all of Tennessee and parts of six other states covering over 80,000 square miles and serving eight million consumers. In Kentucky, there are over 211,000 households served by TVA in over 30 counties.

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Restructure TVA: Why the Tennessee Valley Authority Must Be Reformed

by Richard Munson

The Tennessee Valley Authority is a political creation facing its most serious challenge. The nation's largest electric utility suffers an enormous debt, mismanagement, and falling political support at the very time that lawmakers are restructuring the nation's electric utility industry and transforming the way consumers buy electricity. Sixty-five years after it was created, this giant federal agency can no longer justify its existence.

TVA has accumulated a whopping $29 billion debt, largely because of its inaccurate predictions of future electricity demand, its failure to control the costs of constructing nuclear power plants, and its unwillingness to impose rate increases in order to meet those costs. Other signs of mismanagement were revealed in a recent report from TVA's own Inspector General (IG), who criticized the agency's six-figure bonuses and secret retirement funds for top executives, non-competitive consulting contracts to cronies of those officials, and expensive building leases with well-connected developers.

The IG's report highlights perhaps TVA's most serious problem -- its unaccountability. This federal institution is run by a board of three individuals appointed to staggered nine-year terms by the president, often as a favor to political supporters from the region. Board members are not answerable to the voters. Their decisions are not reviewed by state regulators or federal agencies, and until recently, Congress provided little oversight. TVA also enjoys a monopoly in its service territory, so it's not accountable even to market forces. As one critic charged, "Three good ol' boys, with no adult supervision, have been given total control of a $6-billion corporation, and they've made a mess of it."

TVA has been propped up by enormous taxpayer subsidies -- which can no longer be justified or countenanced. The giant utility is exempt from hundreds of federal and state laws and regulations, it pays no federal or state taxes, and it obtains low-cost loans. These benefits raise an obvious question: Why should 242 million Americans be forced to subsidize the electricity rates of the 3 percent of Americans who happen to live in the Tennessee Valley?

There's little doubt that TVA has become a burden to the nation's taxpayers. What's becoming increasingly apparent is that the status quo also harms the very Tennessee Valley residents that TVA is supposed to serve. Some of the region's politicians, of course, continue to defend the agency and its subsidies, but TVA's functions could be provided more effectively and less expensively by other corporations or agencies.

Subsidies

TVA officials often repeat a mantra about their power operations being supported solely by electricity sales, but in this era when subsidies are suspect the giant utility remains the beneficiary of enormous taxpayer largess. It pays no taxes, enjoys access to low-cost capital, and avoids scores of federal laws and state regulations. Perhaps Wendell Wilkie,

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former presidential candidate and private utility executive, gave the most succinct description of TVA's relationship to federal taxpayers: "The Tennessee River flows through seven states and drains the nation."

/ rding to the study by Putnum, Hayes & Bartlett, a respected consulting firm hired by investor-owned utilities, TVA's tax and cost-of-capital subsidies in 1993 totaled a whopping $1.2 billion. Included in that figure, TVA avoids more than $570 million annually in federal and state income taxes that would be paid by a comparable-sized private utility. It also escapes more than $450 million annually in state and local ad valorem and other taxes. TVA counters that it contributes more than its share of local taxes through its 5-percent "payments in lieu of taxes," but shareholder-owned utilities pay state and local taxes that amount to 8.3 percent of operating revenues, plus federal taxes that equal 4 percent of operating revenues. In short, for every dollar of revenue collected, TVA pays only 5 cents while investor-owned utilities pay some 12.3 cents in taxes.

Other benefits are substantial but not quantifiable. Unlike other power companies, for instance, TVA avoids ratemaking oversight by the Federal Energy Regulatory Commission and state public utility commissions. It is free from the financia oversight of the Securities and Exchange Commission. It is exempt from federal and state antitrust laws. It doesn't have to worry about strikes by its employees. It benefits from government purchasing programs. It doesn't have to comply with numerous environmental regulations.

TVA is literally above the law. It is exempt from at least 137 federal statutes, ranging from workplace safety and hydroelectric licensing. It is immune from civil liability for its wrongful acts, yet it enjoys far-reaching federal eminent domain authority. TVA also claims immunity from an array of state legislation and regulations, including at least 165 in Alabama alone.

TVA's bond rating is a particularly odd -- but very generous -- benefit. Despite having a massive debt of $29 billion (and a negative net worth after subtracting unproductive assets), TVA enjoys a AAA bond rating, the highest available. No s holder-owned utility, despite much better balance sheets, has such a rating. Even though federal legislation specifically declares that taxpayers do not guarantee TVA bonds, the rating agencies assume such backing is implied. According to Moody's Investors Service, "Although TVA's debt is not an obligation of the U.S. government, the company's status as an agency and the fact that the government explicitly is TVA's only shareholder, indicates strong 'implied support' (that) would afford assistance in times of difficulty. This implied support provides important bondholder protection. TVA's extensive nuclear risk, average competitive position, and high level of debt would make it unlikely to maintain its current (AAA) status." TVA's chairman, in fact, promotes the agency's bonds as having "an obvious, implied" guarantee from the federal government. (It should be noted that if the government did guarantee TVA bonds, taxpayers would be left holding the bag if the agency defaulted on any portion of its multi-billion-dollar debt.) Several analysts suggest that TVA's large debt and low cash flow should cause its bonds to be rated as junk. TVA's artificially high credit rating, therefore, allows the giant utility to issue large levels of debt at low cost. According to the Department of Energy, if TVA were to lose its AAA rating, its annual interest cost could increase by some $270 million. This indirect federal subsidy would be even higher if TVA bonds were rated as junk, or below investment grade.

TVA officials like to suggest that the utility *can* compete in a deregulated electricity market. But the more important question is whether TVA, armed with its subsidies and other competitive advantages, *should be allowed* to compete.

Changing Justifications

T' ' always has been a creature of politics. It was established in 1933 only after a lengthy legislative battle. Debates had fi. d late in the 19th Century, as Americans settled the West and sought economic development, over what to do with the nation's rivers and whether dams should be privately or publicly owned. The most heated controversy focused on a site near the town of Sheffield in northern Alabama, where the Tennessee River becomes shallow and falls rapidly. As

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World War I began, President Woodrow Wilson decided to build a dam at this prime hydroelectric site in order to power an air nitrate factory. This Muscle Shoals facility, said Wilson, would help make munitions during the war and fertilizer during peacetime. By the 1918 armistice, the federal government had spent millions of dollars on the 100-foot-high, [illegible] long dam, but it remained only half complete.

The political climate changed dramatically in 1920 as Warren Harding's smashing victory launched a decade of open and unashamed support for capitalism. The new president offered the nitrate plant and dam to the highest bidder. Henry Ford offered to purchase the Muscle Shoals facilities, but he abandoned the project amid complaints from both public power advocates and the private utilities. Alabama Power Company subsequently advanced the highest bid, but the power company met formidable opposition from Senator George Norris, a Republican from Nebraska who believed that America's electricity development must "be under public control, public operation, and public ownership." Blocking Norris's public power advocacy was President Herbert Hoover, who had directed the Northeastern Super Power Committee which cleared the way for investor-owned power companies throughout New England to interconnect their lines and pool their power. Like utility executives, Hoover supported "strict regulation" but opposed public ownership, and he vetoed Norris's bill to keep the Wilson Dam in the government's hands.

The stock market crash and economic depression tilted the political dynamics again. Franklin Roosevelt, who claimed the nation was confronting a menace of "highly centralized industrial control," stopped immediately after his 1932 election at Muscle Shoals, where he talked with Senator Norris about the Tennessee Valley's plight. Poverty engulfed the region, recurrent floods had washed away valuable topsoil, and lumber companies had clearcut the thin forests. Residents enjoyed only half the national average income, and just 2 percent of the farmers utilized electricity. According to Norris, the best promise for economic revitalization were the region's abundant hydroelectric sites.

Only one month into his presidency, FDR proposed legislation to create a Tennessee Valley Authority that would be "a corporation clothed with the power of Government but possessed with the flexibility and initiative of a private enterprise." It would be, according to FDR, a cornerstone of his New Deal and "the widest experiment ever conducted by a Government," but 19 shareholder-owned utilities called it an "unconstitutional competitor with private businesses." The power companies sued, but the Supreme Court in 1936, which just one month before had ruled that the New Deal's Agricultural Adjustment Act and the National Recovery Act were unconstitutional, upheld TVA and the government's right to sell power from its dams. A headline in the Knoxville paper declared: "TVA Wins Complete Victory."

The victors, however, continued arguing about TVA's mission. Of the original three-member board, the chairman saw TVA as a model for regional economic development, another member felt the agency should avoid development activities and simply provide low-cost power to southern commercial farmers, while the third director saw TVA as a model by which to beat back private power companies. FDR finally had to intercede and fire the social-planning chairman. By 1941, TVA had become the nation's largest producer of electricity.

Private power companies never accepted TVA's "victory," and they attracted powerful allies. President Dwight Eisenhower, for instance, wanted to sell TVA, referring to the agency as a prime example of what he called "creeping socialism." Eisenhower in 1954 proposed that private utilities supply power to the federally-funded "Atomic City" in Oak Ridge, Tennessee, and other nuclear facilities in Paducah, Kentucky, which at the time consumed 60 percent of TVA's entire output. Private utility presidents Edgar Dixon and Eugene Yates organized a consortium of power companies to build a plant in West Memphis, Arkansas, that would sell electricity to these government installations. The Dixon-Yates plan, however, became a scandal when opponents uncovered that a Bureau of Budget official who drafted the plan was also an executive of First Boston Corporation, a financial backer of the deal. Eisenhower made the mistake of denying any connection between his staffer and the deal's beneficiaries, but TVA's allies in 1959 exploited the mistake and forced the president to retract his denial and to cancel the Dixon-Yates contract.

TVA may have survived the Dixon-Yates challenge, but it faced severe financial constraints because of Eisenhower's unwillingness to approve federal appropriations. Billing itself as a key component of the nation's defense infrastructure,

the agency sought -- and obtained -- more political and economic freedom through 1959 amendments to the TVA Act. Rather than rely on annual appropriations for its capital, the federal institution now could sell bonds on TVA's credit alone. Yet to assuage fears that TVA would continue to expand its territory, lawmakers put a "fence" around the agency beyond which TVA could not sell electricity.

Profile of TVA

TVA serves some 7 million people, mostly in Tennessee, but also parts of Mississippi (supplying approximately 30 percent of the state's electricity), Alabama (20 percent), Kentucky (10 percent), North Carolina (5 percent), Virginia (3 percent), and Georgia (1 percent). It provides power to 159 municipal and cooperative distributors (85 percent of TVA's total), 53 industries (mostly aluminum firms) with large or unusual loads (8 percent), and ten federal agencies (6 percent). TVA in 1997 produced nearly 152 billion kilowatt-hours of electricity. With headquarters in Knoxville, Tennessee, it employs some 14,000 individuals.

Although only half the population of Tennessee lives in the Tennessee River watershed -- the state also being drained by the Cumberland and Mississippi river systems -- almost the entire state receives TVA power.

The president appoints three TVA directors, who are confirmed by the Senate and serve staggered nine-year terms. That Board of Directors has sole authority for determining the rates that TVA and its distributors charge for power. TVA is not subject to oversight by state public utility commissions or the Federal Energy Regulatory Commission.

Although TVA was formed to build dams and tame the river, only 11 percent of its installed capacity comes from 114 hydropower units. The bulk, some 65 percent, is provided by 59 coal-fired power plants. Another 24 percent comes from nuclear reactors. The small remainder is derived from gas turbines.

TVA values its property, plant, and equipment at $29.3 billion. Its debt totals $29.8 billion, and it has deferred assets of $6.3 billion. TVA's estimated 1998 electricity sales are $6.3 billion.

Success or Hype?

TVA officials and their supporters hold that FDR's giant experiment cleared the rivers, replenished the soil, rebuilt the forests, delivered cheap electricity, and brought new life and hope to the depressed Tennessee Valley. David Lilienthal's *Democracy on the March* and the TVA staff's *TVA: The First Twenty Years* boast of enormous progress resulting from TVA. No doubt the agency's payroll -- which averaged 13,000 workers in its early years -- boosted the region's economy, but the long-term benefits of TVA's investments are less clear. According to William Chandler, author of *The Myth of TVA* and a researcher with Battelle National Laboratory, those investments performed poorly when compared to development in adjacent regions. Chandler, for instance, concluded:

- Per-capita income growth in surrounding, non-TVA areas equaled or exceeded that in the TVA region, despite they're being equal at the beginning of the TVA experiment.
- Manufacturing employment grew more slowly in the TVA area than in surrounding non-TVA areas.
  Rural electrification progressed more slowly in the Tennessee Valley region than in comparable surrounding areas
- The installation of piped running water in households and the utilization of home electric appliances proceeded less rapidly than in non-TVA states.

In its defense of appropriations for TVA's non-power programs, the Clinton administration repeats the myth that "TVA i: a tremendous success," citing statistics that per-capita income increased ten-fold in the TVA service territory, well above the national average. Yet such statistics are misleading, in large part because the Tennessee Valley started from such a low base in the 1930s that any gain looks substantial in percentage terms. When comparing instead the growth in per-capita income between Tennessee, where TVA supplies virtually all the power, to neighboring states that also suffered economic hardship in the 1930s, TVA's "success" is less clear. In fact, per-capita income increased more substantially in non-TVA Georgia, Kentucky, and Virginia than it did in Tennessee.

TVA customers for many years certainly benefitted from electricity rates that were about half the national average. Such benefits, however, were made possible by substantial (if unwitting) subsidies from taxpayers across the country and by TVA's failure to pay for cleaning up its own pollution.

Environmental Steward or Threat?

One of TVA's original missions was to manage the region's natural resources, but the agency long has invoked the ire of e· onmentalists. TVA, for instance, was the leading promoter of destructive coal strip-mining, ruining vast tracts of l. and debilitating Appalachia's underground coal industry. Its reclamation efforts were minimal and only marginally effective. Aubrey Wagner, who directed the agency for almost two and one-half decades, voiced an attitude that sent chills up the spines of conservationists: "Strip mining, while it is going on, looks like the devil," Wagner declared, "but ... if you look at what these mountains were doing before this stripping, they were just growing trees that were not even being harvested."

TVA still remains the nation's worst violator of the Clean Air Act. The agency, in fact, is the largest emitter among eastern utilities of nitrogen oxide (NOx), which causes smog. It is the third largest emitter of sulfur dioxide (SO_2) and carbon dioxide (CO_2), which has been identified as the leading cause of global warming.

TVA's nuclear program has been so plagued with safety and economic problems that consumer activist Ralph Nader in 1998 declared: "The TVA is by any measure the worst nuclear project in the country, has the most expensive set of nuclear reactors, has a debt of $29 billion, has the poorest safety record with TVA reactors spending more time on the Nuclear Regulatory Commission's watch list than any other utility."

Like many private utilities, TVA from the mid 1960s through the mid 1980s continually overestimated the future demand for electricity. Unlike most other companies, however, TVA went whole hog for nuclear power to meet that projected demand. The agency in the mid 1970s announced plans to build 17 reactors at seven sites. It completed only six, and one of those was shut down in 1985.

The now-closed reactor, Browns Ferry Unit #1, experienced one of the nation's worst nuclear power accidents. For s· .l hours on March 22, 1975, TVA's reactor burned perilously out of control as a result both of workers negligently try..g to identify air leaks with a candle and of numerous safety features failing. Employees subsequently stated that a major release of radiation was avoided only "by sheer luck."

Public Citizen recently highlighted "a lack of quality assurance in the construction and operation of TVA's nuclear reactors." Although TVA managers have increased the efficiency of their reactors in the past few years, the anti-nuclear [illegible] notes that TVA's power plants are aging and their major components are degrading, posing, as a result, future threats.

Rather than promote energy efficiency, TVA has used promotional campaigns and subsidized rates to encourage its consumers to be wasteful guzzlers. The average Tennessee resident uses more electricity than consumers in any other state, more than 50 percent above the national average. The other six states partially electrified by TVA also rank among the most energy intensive. Decrying TVA's early promotion of electric heating rather than less-expensive, more-efficient and less-polluting natural gas, former TVA Director David Freeman observed that TVA customers were "snookered into using so much electricity." If a Tennessee homeowner in the 1950s had installed a natural gas furnace instead of an electric heater, he or she would have saved more than $300 each year in energy bills. TVA, at the same time, would have avoided the need to build expensive and polluting power plants.

Perhaps TVA's most renowned environmental controversy centered on the Tellico Dam, which the agency decided in 1963 to build on the Little Tennessee River down the Valley from Knoxville. Although TVA projected the project would create 40,000 jobs and an annual benefit of $3.76 million (1967 dollars), it faced fierce opposition from fishermen, the Tennessee State Planning Commission, and the Cherokee Indians (who would have had their sacred capital and ancient burial grounds flooded). While TVA was using its right of eminent domain to buy up adjacent land, an ichthyologist performing a study required by the National Environmental Policy Act discovered the snail darter, a tiny fish which subsequently was listed as an endangered species protected by federal law. TVA steadfastly proceeded with the dam's construction and refused to discuss alternatives that might preserve the darter. The struggle became the focus of national media attention and it reached the U.S. Supreme Court in 1978, when the justices voted to enjoin TVA from completing the dam.

The following year, the so-called "God Committee" -- composed of seven presidential cabinet secretaries who had life-or-death power over species -- voted unanimously to reject the Tellico Dam. The group concluded that the project was ill-conceived and that although 95 percent complete, most of the $116 million expended on land purchases and road construction would remain valuable even without the use of the dam.

TVA and its political supporters, however, were not about to be stopped by the mere Supreme Court or the God Committee. The Tennessee congressman representing the district in which the dam is located proposed a "rider" on the Energy and Water Appropriations Act of 1980 that exempted Tellico from all federal laws, including the Endangered Species Act, and mandated the dam's completion. According to congressional rules, such "riders" are to be noncontroversial and must obtain unanimous consent of all those present on the floor of the House of Representatives. Yet the Tennessee lawmaker introduced his measure when few other members were on the floor and claimed the amendment was noncontroversial.

The Tellico Dam, as result of that maneuver, was completed. The snail darter vanished from the region. TVA demonstrated its political clout. Yet the experience demonstrated to many that the arrogant agency was beyond control.

Arrogance

Ignoring billions of federal subsidies, one Tennessee lawmaker recently asserted: "The people of the Tennessee Valley o[illegible] TVA. We have paid for the construction of the assets of TVA -- the plants, transmission lines, and infrastructure -- lock, stock, and barrel. We should determine the future of TVA."

This leave-us-alone-and-keep-sending-the-subsidies attitude reflects a welfare culture that lacks accountability. With all its exemptions, TVA doesn't have to worry about federal or state regulators. With its long-term and guaranteed contract it is immune from competition and normal market forces.

Craven Crowell, TVA's current chairman who was appointed by President Clinton in 1993, when asked about the agency's future, declared proudly, "You can't ignore us, you can't leave us behind, you can't break us up, and you can't sell us."

TVA constantly seems to be trying to wriggle out from under the "fence" imposed by Congress in 1959. A federal court in August 1996 ruled that the federal agency was using a marketer to create "interchange arrangements" that illegally sol power outside the fence. In 1997, TVA was forced to settle a similar suit, and it promised to try harder to adhere to federal law.

Despite the arrogance, TVA can be thin skinned. When private utilities and other critics in 1997 seemed to be gaining ground in the public debate about the agency's future, TVA asked the Attorney General to determine if those utilities were guilty of "undermining TVA's ability to compete." TVA alleged a "conspiracy" and noted that the recommended punishment would be a $5,000 fine and up to five years in jail. Many critics found it ironic that a federal agency exempt from antitrust laws would try to use those very laws to silence its critics. What appeared to some as a publicity stunt by TVA managers to distract attention from their poor political decisions, appears to others as a scene from George Orwell's *1984*.

Luring Business

Members of the Northeast-Midwest Congressional and Senate Coalitions are concerned about the regional inequities posed by TVA. Taxpayers in northeastern and midwestern states, who pay some of America's highest electrical rates, unwittingly subsidize power bills in the Tennessee Valley. Yet at the same time, TVA uses those very subsidies and the promise of cheap electricity to lure away businesses and jobs from those same taxpayers.

TVA director Johnny Hayes, for instance, wrote personalized letters encouraging CEOs to relocate their firms to the Valley. Boasted Hayes: "The TVA economic development region is the best place in the United States to locate your business, no matter what its size."

TVA also has developed and placed slick advertisements, complete with an image mixing a fish hook and electric plug, proclaiming: "TVA Lures Business." The agency's credit program offers significant savings to new commercial and industrial customers. Even TVA's distributors get into the act. In web-site and other advertisements, the city of Chattanooga, Tennessee, tries to attract firms by noting that "power distributors throughout the region distribute electricity from TVA and provide a high level of reliable, low-cost service throughout the Chattanooga region."

Lobbyists and Cronies

TVA long was blessed with powerful political allies. Howard Baker, Howell Heflin, James Sasser, Jamie Whitten, Tom Bevill, Albert Gore, Jr., and others defended the agency's benefits in Congress against all attacks. Yet as these politicians retired, were defeated, or moved on to national office, TVA could no longer count on senior, well-placed champions on Capitol Hill. To make up for that political loss, TVA has been spending substantial sums on high-priced lobbyists, despite a law prohibiting such lobbying by federal employees.

To supplement TVA's own $8.8-million in-house communications and governmental affairs staff (a euphemism for in-house lobbyists), the agency in April 1998 signed a $1.2 million public relations contract with Hill & Knowlton, the New York-based giant. Four months earlier, it approved a $240,000 no-bid contract with Lent & Scrivner, a Washington lobbying firm with strong Republican connections. It also provided at least $181,000 to Baker Donelson Bearman & Caldwell, where former Senate Republican leader Howard Baker Jr. is a partner. To cover its Democratic bases, TVA has paid $500,000 a year to Jack Quinn, former White House counsel and chief of staff to Vice President Albert Gore, and it has provided Peter Knight, former manager of the Clinton-Gore reelection campaign, with about $600,000.

No doubt having the vice president hail from Tennessee benefits TVA politically, and the connections between the agency and Gore are substantial. Johnny Hayes, whom the Clinton-Gore administration nominated to a second term as a TVA director, was Gore's chief fundraiser for his past campaigns for U.S. representative, senator, and president. Peter Knight, who registered as a TVA lobbyist, was manager of the Clinton-Gore 1996 reelection campaign, director of Gore's 1992 vice presidential campaign, national finance director of Gore's 1988 presidential campaign, and legislative assistant from 1977 to 1989 for Gore when he served in the House and Senate. Mark McNelly, another former Clinton-Gore campaign aide, has received more than $100,000 for public relations consulting. Joseph Trapasso, a former White House associate counsel, also is registered with Congress as a TVA lobbyist.

Gore family members, in fact, have been long-time TVA defenders. The vice president's father, Albert Gore, Sr., defended TVA on the Senate floor in the 1950s when the Eisenhower administration sought to limit the utility's expansion. When he himself was a senator, Albert Gore, Jr. attacked the Reagan administration's efforts to cut TVA's nonpower programs as being "so unreasonable that it would represent the destruction of TVA."

Rep. Zach Wamp (R-TN), chairman of the TVA Caucus on Capitol Hill, refers to Gore as TVA's "ace in the hole." According to Wamp: "With his support, TVA can come away losing some fingers and some toes, but we'll have all of our major extremities intact. His support is absolutely crucial."

The vice president's office, although trying to keep a low profile, recently spearheaded lobbying efforts to maintain federal appropriations for TVA, launched a failed effort by the Department of Energy to reduce disagreements among Valley constituents about TVA's future, and rallied support for a bailout of TVA's incomplete Bellefonte nuclear reactor. According to TVA critics, the vice president's support of TVA, despite the agency's mismanagement and debt, presents political problems for his future campaigns. Former New Hampshire Governor Steve Merrill already is arguing in his early presidential primary state that Gore is trying to tax New Hampshire residents so that Tennessee consumers can enjoy subsidized electricity.

Even TVA's defenders in Congress question some of the agency's lobbying contracts. Senator Mitch McConnell (R-TN) cited the Hill & Knowlton arrangement as an example of how TVA is "an inefficient and costly power provider." Rep. John Duncan (R-TN) complained, "I feel that TVA spends too much money on lobbying when they have staff people and directors who are supposed to be doing that kind of work."

TVA critics are even more harsh, suggesting that TVA chairman Crowell is using the agency to support his cronies. "It's a mess," said Jim Ricciocq of Public Citizen, "Basically, Craven Crowell is running a little fiefdom and serving his friends."

TVA, for instance, paid at least $300,000 for "strategic" and "communications" advice to Ingram Group, which employs James Pratt, the press secretary to former Democratic Senator James Sasser when Crowell served as Sasser's chief of staff. It provided at least $1.1 million to Sieganthaler Public Relations whose head, Tom Sieganthaler, is a longtime Crowell friend. The agency even contracted for $123,000 with former TVA chairman John Waters, who once was Crowell's boss.

Crowell also provided $50,000 to Louis Gwin, who was TVA's assistant director of information when Crowell was information director. Tom Seigenthaler, brother of Crowell's former boss at *The Tennessean* newspaper in Nashville, received $300,000 for public relations support. Wendell "Sonny" Rawls, another friend and former co-worker at *The Tennessean*, obtained $400,000 to research economic development opportunities in China. The *Knoxville News Sentinel* subtly mocked Rawls' qualifications for such international work by quoting a TVA spokesman: Rawls was chosen "because of his background in winning a Pulitzer Prize for reporting. His winning entry was on nursing home abuses in Philadelphia."

Bonuses and Questionable Contracts

Crowell and other senior TVA officials also seem to treat themselves and their colleagues well. So well, in fact, the TVA's Inspector General in early 1998 lambasted agency operations, including secret retirement accounts, six-figure bonuses, and non-competitive consulting contracts. Perhaps the best description of the charges comes from an editorial by the *Chattanooga Times*, a key Valley newspaper that usually defends TVA. "One of the most egregious abuses is in the area of compensation," commented the paper. "TVA secretly established a Senior Executive Retirement Plan (SERP) in 1996 and funneled almost $5 million in previously undisclosed contributions through it to 24 high-ranking managers over the past two years. Neither the agency's Inspector General, nor congressional leaders, nor the general public, knew about the SERP until the IG discovered it last month."

The Inspector General also attacked TVA's end-of-the-year bonuses to key managers. According to *Electricity Daily*, "The Tennessee Valley Authority sweetened the holidays for some of its top executives, but the agency's decision to award six-figure bonuses has soured a Tennessee congressman. Rep. John Duncan Jr. (D-TN) said ... he was disgusted that TVA paid out $1.9 million to 84 of its top executives in year-end bonuses. The Knoxville congressman said he believed the agency was using the bonuses to dodge a salary cap imposed by Congress."

The generous consulting contracts noted in the previous section also were lambasted by the Inspector General. Again in the words of the *Chattanooga Times:* "TVA's free-flowing millions on consulting contracts (631 consulting and training contracts with 350 different vendors totaling $145.1 million, with an average of $29 million per year over five years) are equally disturbing. Excessively generous contracts are given to cronies or friends of top managers without bids or acceptable oversight. The practice suggests responsible fiscal management is not being applied and undermines TVA's integrity and its pending request for federal appropriations."

Playing Hard Ball

While TVA is quite generous to its managers and their friends, it maintains a rather domineering relationship with its own customers. TVA consumers, in fact, are burdened with long-term, all-requirements contracts which they can terminate only by providing a ten-year notice. These are not ten-year contracts that expire; they are rolling provisions that after each new day cannot be terminated for another ten years. The municipal utilities and rural electric cooperatives that buy power from TVA, as a result, are restricted from the benefits of competition; they cannot even obtain realistic price quotations for power to be supplied in ten years. The Federal Energy Regulatory Commission does not allow private utilities to use similar anti-competitive provisions.

Tombigbee Electric Power Association, wanting lower rates, notified TVA in December 1993 that it would be seeking another power supplier. Earl Weeks, the Mississippi association's general manager, subsequently received some 30 bids from other electric generators, several of which would have saved the association more than $7 million annually in

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wholesale power costs. TVA, unwilling to lose a customer, responded aggressively. According to Weeks, TVA lobbied 4-County's biggest customers "to put pressure on us to rescind that notice." More troubling to the association manager, TVA representatives "questioned my integrity" by suggesting to customers that perhaps Earl Weeks didn't know what h doing. But TVA's most effective tactic was to threaten cancellation of a lignite-burning power plant and eliminatio of the associated construction jobs and economic development in that employment-hungry region. Not surprisingly, 4-County Electric buckled under the pressure.

The Bristol Utility Board in southwest Virginia met similar resistance when it notified TVA that it, too, wanted to leave Angry about high industrial electricity rates, the municipal utility gave TVA "years of forewarning" that it wanted to enc its 52-year relationship and to seek bids from other suppliers. TVA's price offer turned out to be the very highest of 20 bids. Therefore, Bristol in 1997 signed a contract to purchase electricity for its 15,000 residents from Cinergy of Cincinnati, Ohio, saving the local government $70 million over seven years, double the city's annual budget. TVA responded by secretly trying to sell power directly to Bristol's industrial customers for 2 percent less than the best bid (and well below what TVA had previously been charging, and well below the agency's recent bid). TVA also promptly charged Bristol $54 million for "stranded costs" investments the federal agency claimed it made with the expectation tha it would continue to supply power to Bristol. Rep. Rick Boucher (D-VA), the local congressman, reacted with angry letters and volatile hearings. He complained that TVA was using tactics "to punish a former customer for exercising its legal right to obtain power from a less expensive supplier. TVA is seeking to make an example of the city of Bristol so a to discourage any other community presently served by TVA from considering the purchase of power from a TVA competitor." After a Boucher-inspired hearing before the House Judiciary Committee, at which die-hard liberals such as Reps. Barney Frank (D-MA) and John Conyers (D-MI) asserted that TVA's arrogant ways and monopolistic practices would make "FDR turn over in his grave," and after it appeared that the Federal Energy Regulatory Commission would not allow the agency to recover these costs, TVA backed down, announcing that it would no longer seek stranded cost recovery from Bristol.

T s other customers took hope from Bristol's victory. Representatives of the "Big Five" (municipal utilities in Nashville, Chattanooga, Huntsville, Memphis, and Knoxville), which constitute 30 percent of TVA's market, began meeting to discuss strategies. Larry Fleming, general manager of the Knoxville Utilities Board, which is about ten times larger than Bristol, said other distributors want a deregulated industry in which they can purchase less expensive power in a competitive market without having to pay TVA for "stranded investment costs."

The Valley's municipal utilities and rural cooperatives are making progress, albeit slowly. TVA recently said these distributors can avoid paying stranded costs if they sign new ten-year service contracts that include a five-year cancellation notice (reducing by five years the current notice requirement).

Yet TVA is not welcoming competition. It defends vehemently its right to restrict other power suppliers from moving or "wheeling" electricity over TVA's grid to customers inside the fence. That effectively leaves Valley residents with just one option: Pay what TVA charges or go dark.

Few Benefits Within the Valley

Valley residents, as a result, seem to have a love-hate relationship with TVA. Many remember the federal agency as having battled poverty. Yet TVA's arrogance is running thin. It has polluted the region and forced thousands to leave their homes to make ways for dams and parks. Despite enormous taxpayer subsidies, years of mismanagement and bad decisionmaking have resulted in TVA's rates no longer being a bargain; many Valley residents see surrounding private u es offering cheaper rates, and new competitors promising even lower costs.

Residents also have little control over TVA's actions. Private utilities are at least regulated by elected officials at the

state, federal, and even local levels. Competitive enterprises also face the rigors of the market. But according to auth William Chandler, "Until TVA is regulated as other utilities are, and until it is required to obtain congressional authorization for its projects, the citizens of the Tennessee Valley will remain subject to the whims of three directors appointed for long terms without being accountable either to voters or to politicians who are accountable to voter

Valley residents, moreover, are trapped without options to TVA. The agency's distributors are locked into long-term contracts that have been virtually impossible to break. TVA now wants exemptions from any utility restructuring law leaving ordinary consumers without the ability to shop freely for better prices or improved services.

A Multi-Purpose Agency?

"If envisioned in its entirety," FDR said when proposing legislation in 1933, "TVA transcends mere power developmer it enters the wide fields of flood control, soil erosion, afforestation, elimination from agricultural use of marginal lands and distribution and diversification of industry." TVA, however, has become little more than a power company, devotir only 1 percent of its resources to helping Valley residents with flood control, soil erosion, or afforestation.

"The myth is that the TVA is a multipurpose regional development authority working for and in touch with the (Tennessee Valley's) grass-roots community," says Erwin Hargrove, a TVA scholar at Vanderbilt University. "That still may have been true in the forties and fifties, but that's probably not true today."

Craven Crowell, however, doesn't miss the old days, and he likes TVA being a straightforward power company. In fact, the chairman dubs TVA "America's Power Company." In an effort to curtail the image of TVA being a subsidized power company and to prepare TVA for competing head-to-head with other power companies, Crowell decided in 1997 to abandon the $106 million in congressional appropriations for the agency's nonpower programs. Stated the chairman, "This proposal would help TVA focus on our core business of generating and selling electricity."

The chairman faced months of intense criticism over his proposal, particularly from the Valley's congressional delegation, which for years had spent enormous energy lobbying for those very appropriations. Crowell subsequently stated that his previous proposal had been "misinterpreted."

Congressional Criticism

The House of Representatives in 1997 voted to eliminate appropriations for TVA's non-power programs. In a rather scathing critique for a congressional report, House appropriators wrote:

"Rather than concentrate on the continued growth of its power business, the Committee has concluded that it is far more appropriate for TVA to plan for its immediate downsizing and eventual elimination. ...

[TVA's] continued exploitation of these [direct and indirect competitive] advantages in furtherance of the Authority's naked ambition to compete can be reconciled with neither basic tenets of free enterprise nor the appropriate role of a limited federal government.

The Committee recommendation includes no appropriated funding for the Tennessee Valley Authority (TVA) in fiscal year 1998. The bill does,

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however, provide for the funding of essential nonpower activities with power and nonpower revenues and programmatic savings. ...

The Committee parenthetically observes that the costs of the nonpower programs are dramatically lower than the financial liability TVA would face if it were subject to federal income taxation.

The Committee also observes that, compared to multi-purpose projects managed by other Federal agencies...taxpayers bear a disproportionate share of the costs to operate and maintain TVA dams and reservoirs. ...

Although it applauds TVA's initiative in proposing the elimination of appropriated programs, the Committee is disappointed that the agency did not include its power production operations among those federally subsidized activities it proposes to terminate. To the contrary, the agency has made it clear that its proposal to shed appropriated programs is motivated by a desire to concentrate on its 'core business' of electricity production and sale. ...

The Committee is concerned that a federal agency would reinvent itself as a business opportunist. Furthermore, the Committee vigorously disagrees that TVA should be loosed to participate as a full competitor in the domestic electricity industry. By virtue of its status as an agency of the federal government, TVA enjoys a broad range of competitive advantages, both direct and indirect. These advantages have operated to facilitate the transformation of the Authority into an electric utility of massive dimensions and enormous debt. ...

The conditions that prevailed in 1933 to justify the Authority's involvement in power production no longer apply in 1997. With the electrification of the Tennessee Valley, the incipient deregulation of the electric utility industry, and the development of industries and national agencies capable of providing traditional TVA services, the rationale for the perpetuation of this New Deal agency has steadily eroded."

Congressional appropriators, however, took Crowell at his word, cut TVA's non-power programs for fiscal 1998 by more than 30 percent, and ordered an end to any future appropriation. Noting that TVA receives enormous taxpayer subsidies for its power programs, Congress directed the agency to pay for its mosquito control, economic development activities, and navigation expenses from electricity sales.

Sensing that change, Rep. Edward Whitfield (R-KY) and Senator Mitch McConnell (R-KY) proposed that Land Between the Lakes, a 170,000-acre recreational area on a peninsula in Kentucky isolated by TVA and Corps reservoirs, be transferred from TVA to the Forest Service. Unfortunately, few other officials within the Valley spent the year considering new arrangements, perhaps reviewing how interstate river basin commissions in other parts of the country address water issues. TVA officials blatantly ignored the congressional directive and spent their time trying to change the minds of appropriators. Although the Senate provided $70 million in its fiscal 1999 proposed funding, the House rejected the previous agreement -- no additional appropriations for TVA's non-power programs; conference negotiations are expected in September 1998.

Members of the Tennessee delegation may be lobbying intensely to sustain the utility's non-power appropriations, but the TVA chairman continues to undermine those efforts. The *Chattanooga Free Press* in July 1998 revealed an internal TVA document noting Crowell's support for managing the non-power programs with either appropriations or funds from electricity sales. According to the utility's chairman, "We never have to worry about a crisis in our non-power program if we didn't receive any (congressional) funding for some reason."

The case against more taxpayer subsidies is compelling. TVA may rhetorically argue that eliminating the appropriation would be unfair, but the only injustice is that 97 percent of American taxpayers are unwittingly subsidizing the electricity rates of the fortunate few who live within the Tennessee Valley. TVA officials also claim that power rates must rise if these appropriations are cut, but the appropriation represents just 0.0116 of the company's annual revenue, and, more importantly, TVA would still enjoy an estimated $1.2 billion in other taxpayer subsidies.

Facing Economic Realities?

To accumulate a $29 billion debt while enjoying monopolistic control over its service territory must rank among the most egregious examples of business mismanagement. While private utilities pay only 7 percent in finance costs, TVA pays 35 cents of every dollar it earns to service that enormous debt.

During the many years when the agency's debt skyrocketed, politically-motivated officials refused to raise revenue by increasing electric rates. In fact, they boasted that rates had not risen for a full decade. Yet in July 1997, TVA officials could no longer avoid reality -- they increased rates by 5.5 percent and announced an ambitious ten-year plan to cut the agency's debt in half (from $29 billion to $14 billion by 2007) and subsequently to reduce its prices by 16 percent (from 4 cents per kilowatt-hour to 3.5 cents by 2007).

The much-needed proposal demonstrates a new commitment to get TVA's financial house in order. Unfortunately, the plan provides little detail on important issues and includes numerous questionable assumptions. For instance, for TVA to argue that it will reduce its capital expenditures from $732 million in 1997 to $500 million in 2000 it must exclude the $1 to $3 billion it must spend to meet clean air requirements. TVA also fails to account for replacing or upgrading its aging coal, nuclear, and hydro units, and it assumes that it need not build any new generators to meet its own projected increased demand for electricity.

TVA, moreover, does not specify how it will achieve $2 billion in cost cuts. Although the electricity market throughout the country is becoming competitive and most utility restructuring bills before Congress eliminate electric monopolies, TVA assumes that it will retain monopoly control of its customers. Although TVA's total operating revenues since 1989 have declined more than 10 percent in real terms even while kilowatt-hour sales increased by about 35 percent, TVA unrealistically assumes that a rate increase in 1997 will result in increased revenues of $345 million in 1998, or more than 6 percent on average. And although TVA's operating expenses have increased in recent years, the agency projects that its operating expenses (less depreciation) will decline over the next four to five years and rise only by small amounts thereafter.

TVA's ten-year plan, in another questionable assumption, assumes it will save $1 billion by refinancing its $3.2-billion long-term debt held by the Federal Financing Bank without paying the required market value premium. However, Treasury officials, noting that TVA's proposal would cost taxpayers $1 billion, have rejected repeatedly the agency's previous refinancing appeals.

Moreover, TVA assumes that the energy market will not change, despite the billion-dollar-deals and aggressive competition engendered by new state restructuring programs. Consider just the potential competition from privately-owned generators fired by natural gas. Although pipelines have tended to avoid the Tennessee Valley, in part

because of TVA's dominance, three natural gas firms showed up recently to compete for new markets in Clairborn County, Tennessee. Since innovative natural-gas-fired turbines can generate electricity cheaper than can TVA, industria customers within the Valley may soon be able to generate their own less-expensive power. New microturbines are making this option available even for commercial firms like a McDonald's restaurant, and engineers envision refrigerator-sized turbines supplying individual homes with electricity and heat. As new pipelines offer natural gas throughout the Valley, independent power producers also will soon compete for markets with TVA, throwing the giant utility's growth projections into serious question.

TVA also doesn't address its more than $6 billion in "deferred" assets at three nuclear power plants (Bellefonte 1 and 2, and Watts Bar 2). If it was to employ the same accounting principles as used by private utilities, TVA would "write off" rather than "defer" these debts. In 1984, TVA bit the bullet, abandoned accounting gimmicks, and increased rates to pay for the $3.6 billion spent but not recovered at eight canceled nuclear units. After taking a charge of $800 million against its accumulated retained earnings, TVA amortized the remaining $2.8 billion over an 11-year period. Taking a similar course today would lead to a one-time charge of $1.3 billion and 12.3 percent higher rates over an 11-year period.

Despite these concerns about the plan's projections, TVA officials are to be commended for acknowledging their debt problem, developing a long-term strategy, and making that strategy public. While the General Accounting Office reviews the reasonableness of that plan, TVA needs to provide more specifics and a clear timetable, with year-to-year targets and implementation strategies for achieving the stated goals.

Looking for a Bailout

Although TVA managers finally developed a long-term (if incomplete) plan to reduce their $29-billion debt, they are not beyond seeking some quick fixes. They and several members of the Tennessee congressional delegation quietly have worked on a proposal to refinance TVA's $3.2 billion debt to the Federal Financing Bank without paying the contractual prepayment penalties. As noted above, the Treasury Department, calculating that such a move would cost U.S. taxpayers almost $1 billion, hasn't been exactly wild about the proposal.

The Tennessee lawmakers, however, proposed a "bargain." In what must be among the high ranks of political chutzpah, they suggested that TVA pay for its own non-power programs in exchange for the refinancing. They failed to note, however, that this "deal" would mean TVA annually pays $70 million but receives some $200 million. Moreover, they failed to point out that Congress already had declared that TVA should pay for its own non-power programs.

When that plan wouldn't fly, TVA's supporters decided they would ask the federal Department of Energy to complete one of the utility's abandoned and budget-busting nuclear reactors. Since few taxpayers would see the wisdom of paying $2-4 billion to finish constructing the Bellefonte power plant in northern Alabama, TVA officials cloaked the proposal as a national security matter. They argued that a completed Bellefonte could be designed to produce both electricity and tritium, a gas used to help boost the explosive yield of nuclear bombs.

Although Vice President Gore quietly promoted the "deal," South Carolina's senators were advancing an alternate "linear accelerator" that would supply tritium and be built in their own state. But TVA's proposal suffered its most serious blow when India and Pakistan tested their nuclear weapons and sparked a fire-storm of international criticism. Suddenly it was awkward for any politician, on the one hand, to criticize India and Pakistan for using commercial reactors to build bomb materials, while, on the other hand, to advance a similar arrangement for TVA. The House of Representatives, therefore, voted in May 1998 to prohibit the production of tritium from commercial nuclear reactors, a move that would effectively bar TVA from finishing its Bellefonte nuclear plant. House-Senate negotiations set for September 1998 are expected to reject this particular TVA bailout.

Restructuring, Reform, and Privatization

A growing number of states have restructured their utility industry, replacing monopolies with competition. Federal lawmakers are advancing similar proposals, and TVA, just like every smaller utility throughout the nation, faces change

TVA bureaucrats may like the status quo, but the current monopoly structure -- complete with its arrogance, unaccountability, and mismanagement -- simply is too expensive for both the nation's taxpayers and the Valley's ratepayers. Senator Mitch McConnell (R-KY), a senior senator from within the Tennessee Valley, introduced legislatior in April 1998 to make TVA accountable to its customers. The Tennessee Valley Customer Protection Act, according to McConnell, "will require TVA to justify its rates." The Republican lawmaker noted, "Only through years of unaccountability and fiscal irresponsibility could a monopoly power provider have ever reached this level of debt. If a business was run in this manner it would have filed for bankruptcy years ago."

As any good politician, the Kentucky lawmaker is watching out for his constituents' interests -- which he concludes are not being served by the government-owned utility. According to McConnell:

- Valley ratepayers deserve to know how TVA, as a monopoly provider with full rate-setting authority, could rack up a staggering $29 billion debt.
- Ratepayers deserve to know why they are paying higher rates than ratepayers outside the Tennessee Valley.
- Valley ratepayers deserve the same authority to challenge unreasonable rates just like other power customers.

To allow the public to see how TVA justifies its rates and to have TVA play on the same field as private utilities, M[illegible]Connell proposes to have agency become a "public utility" subject to the authority of the Federal Energy Regulatory C[illegible]mission. He would force TVA to disclose publicly its tariffs and schedules, to abide by antitrust laws, and to restrain from competing against private-sector businesses for equipment leasing and engineering services.

McConnell's reforms move significantly toward accountability and fairness. Other possible steps include the removal of TVA's exemption from nuclear decommissioning rules, a requirement that TVA abide by all relevant environmental law: and regulations, and an equalization of labor laws and civil liability laws among all power suppliers.

Private utilities surrounding TVA a few years back formed TVA Watch to advance reforms that would level the playing field. Don Meiners, the group's co-chair and president of Entergy Mississippi, recently spoke to TVA's distributors about his vision of TVA's future in a restructured market. According to the private utility executive, "If our markets are not separated by geographic franchised territories, then we will need to be governed similarly. (TVA Watch) sees no reason for TVA to be any different from investor-owned utilities if and when they move to either wholesale or retail competition. ... If we are to compete against TVA, then the rules and regulations should be the same. It can be the rules under which TVA currently operates or it can be under the rules which apply to IOUs or it can be a new set of rules, but the rules should be the same."

TVA tends to like its different sets of rules. In fact, its rather one-sided vision of the future would increase its monopolistic benefits at the expense of customers and competitors. The agency, for instance, wants the authority to sell power outside the "fence," to restrict others from selling inside the "fence," and to preserve all of its protections and subsidies.

Since virtually no one endorsed TVA's initial vision, agency officials have begun to admit that some changes are p[illegible]bly needed, but their proposed "reforms" are rather cute ... and suspect. Noting criticism that it alone in the utility industry doesn't face oversight by the Federal Energy Regulatory Commission, TVA recently offered to follow FERC rules voluntarily. But such a move differs substantially from submitting to the same rigors of regulation as the rest of

electricity industry. TVA's proposal, for instance, would exempt it from paying penalties for failing to comply with FERC regulation.

. ıg criticism that it alone avoids antitrust oversight, the government-owned monopoly also recently offered to allow courts to review its actions. But TVA cleverly notes that it would not subject itself to the same level of enforcement and penalties as others in the power industry. TVA may not want treble damages, but the threat of such penalties influences behavior and is needed as a check on all unfair competitors.

The most direct reform, of course, would be privatization -- getting the federal government out of the electricity busines: At least two dozen other countries over the past decade have launched electricity privatization programs, including highly developed countries such as Australia and Britain, as well as emerging economies such as Argentina and Taiwan, as well as former communist countries such as Hungary and Poland. This global move from government control to the free market is described well in Daniel Yergin's recent *The Commanding Heights*. Senator Frank Murkowski (R-AK), who knows first hand about the privatization of the Alaska Power Administration, stated the issue succinctly: "When the rest of the world is trying to get government out of business, so should we."

The privatization debate offers some fascinating rhetorical inconsistencies. Some conservative TVA beneficiaries argue vehemently that the government should get out of business and let the free enterprise system work its wonders. Although they wouldn't fathom having the Air Force compete with Delta Air Lines, some maintain that Washington should continue to own and control the nation's largest utility.

Is there some failure in the electricity market that requires government intervention? There was 70 years ago when only 15 percent of rural Americans enjoyed electricity. But strong private-sector electricity companies exist throughout this country. One could argue that there's far more justification for the Air Force to provide rural airplane service than there is for the federal government to generate electricity.

A ıong list of suitors -- power brokers, independent power producers, shareholder-owned utilities, and investment bankers -- have expressed an interest in TVA assets, assuming the agency reduces its enormous debt. Just as Britain reformed its debt-ridden government enterprises before privatization, TVA's ten-year plan -- if its assumptions are realistic and if it is monitored aggressively -- will (ironically for TVA's current managers) make the utility a likely candidate for privatization.

Selling TVA to the private sector is not a new concept. Neighboring investor-owned utilities never wanted the federal agency established in the first place, and they sometimes have found powerful political allies. Barry Goldwater called TVA a "federal white elephant" that produced enormous quantities of electricity but paid no taxes. The Arizona senator and presidential candidate suggested TVA's mammoth power plants be sold to either the states or private industry. According to Goldwater, moving management of dams for flood control and navigation to other agencies already doing such work elsewhere in the country, such as the Army Corps of Engineers, would "end the duplication by TVA of national programs."

Wall Street is intrigued with privatization. Peter Lynch, the famous former manager of the giant Fidelity Magellan mutual fund, stated, "There has never been a serious effort to privatize the TVA but if there was I would be the first in line to get a copy of the prospectus."

Privatization advocates have even come from within the agency. William Malec, who retired in 1995 as TVA's executive vice president and chief financial officer, argued that selling the "New Deal dinosaur" could reduce the federal deficit and add $600 million a year in taxes to the federal till. Privatization, said Malec, "would move one of the largest electric c' anies in America out from under the burden of federal bureaucracy into the private sector, where I believe it could co..pete effectively, without excuses or alibis." Noting that a sale would generate big savings for the U.S. taxpayer, Malec called TVA's hydropower and coal-fired plants "dramatically undervalued" and added: "If TVA's physical

generating capacity were valued at only half of what it would cost to replace it, TVA's net asset value would be $50 billion, rather than its current book value of $32 billion."

[illegible] from the nuclear reactors, which supply TVA's most expensive electricity, the 29 hydroelectric dams and the coal-fired plants would sell easily. But perhaps the agency's most valuable asset are its 17,000 miles of transmission wires, which "could ultimately turn out to be a major thoroughfare for power transfer in the region," according to a 1995 study TVA commissioned on its competitive future.

Options for selling TVA's assets are numerous and varied, according to *Should the Federal Government Sell Electricity*, a November 1997 study by the Congressional Budget Office (CBO). The British privatized their electric utilities and other industries, selling common stock in the enterprises to the general public. The U.S. government already has sold numerous assets, including the Alaska Power Administration, Conrail, the U.S. Enrichment Corporation, the naval petroleum reserve at Elk Hills, and radio spectrum rights. According to CBO, "There are strong similarities between the sale of spectrum licenses and power facilities: many different combinations of asset types and locations may be offered, each having a different value for different buyers."

Among the existing privatization proposals: The Heritage Foundation has encouraged that TVA be divided into "three to six geographical units that could be sold to separate buyers to ensure that one company is not left holding the TVA's massive regional monopoly; buyers would be required to take a little bad with the good when they purchase a newly privatized unit of TVA assets." The Progress and Freedom Foundation has advocated that the ultimate customers of federal utilities be given stock in the entities, basically buying consumer support for privatization. An option proposed by the Tennessee Valley Energy Reform Coalition, a coalition of environmental and consumer advocates, would have TVA's reactors and coal-fired plants sold to a regional power pool while a new multi-purpose watershed management agency would control the hydroelectric dams. Reps. Marty Meehan (D-MA), Bob Franks (R-NJ), Mark Foley (R-FL), and Scott Klug (R-WI) have proposed outright auctions to sell TVA's utility assets.

Federal restructuring legislation must address TVA, if for no other reason than TVA is the nation's largest utility. The government simply must get its own house (or businesses) to participate fairly in a competitive electricity market as it orders others to do the same. Any such legislation must recognize that in this era when hundreds of private-sector firms want to generate and sell electricity, the federal government should no longer do so. It's time for politicians to declare victoriously that TVA served its purpose. Yet since situations have changed in the past 65 years, it's also time for politicians to restructure and privatize this outmoded government agency that has become too expensive for both taxpayers and ratepayers.

23 June 1999
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TRANSFER OF FUNCTIONS

"Secretary of Energy" and "Secretary" substituted in text for "Federal Power Commission" and "Commission", respectively, pursuant to Pub. L. 95-91, § 301(b), which is classified to section 7151(b) of Title 42, The Public Health and Welfare.

Federal Power Commission terminated and its functions, personnel, property, funds, etc., transferred to Secretary of Energy (except for certain functions transferred to Federal Energy Regulatory Commission) by sections 7151(b), 7171(a), 7172(a), 7291, and 7293 of Title 42.

§ 828c. Applicability of this subchapter

Except as herein provided, the provisions of this subchapter shall not be construed as repealing or affecting any of the provisions of this chapter.

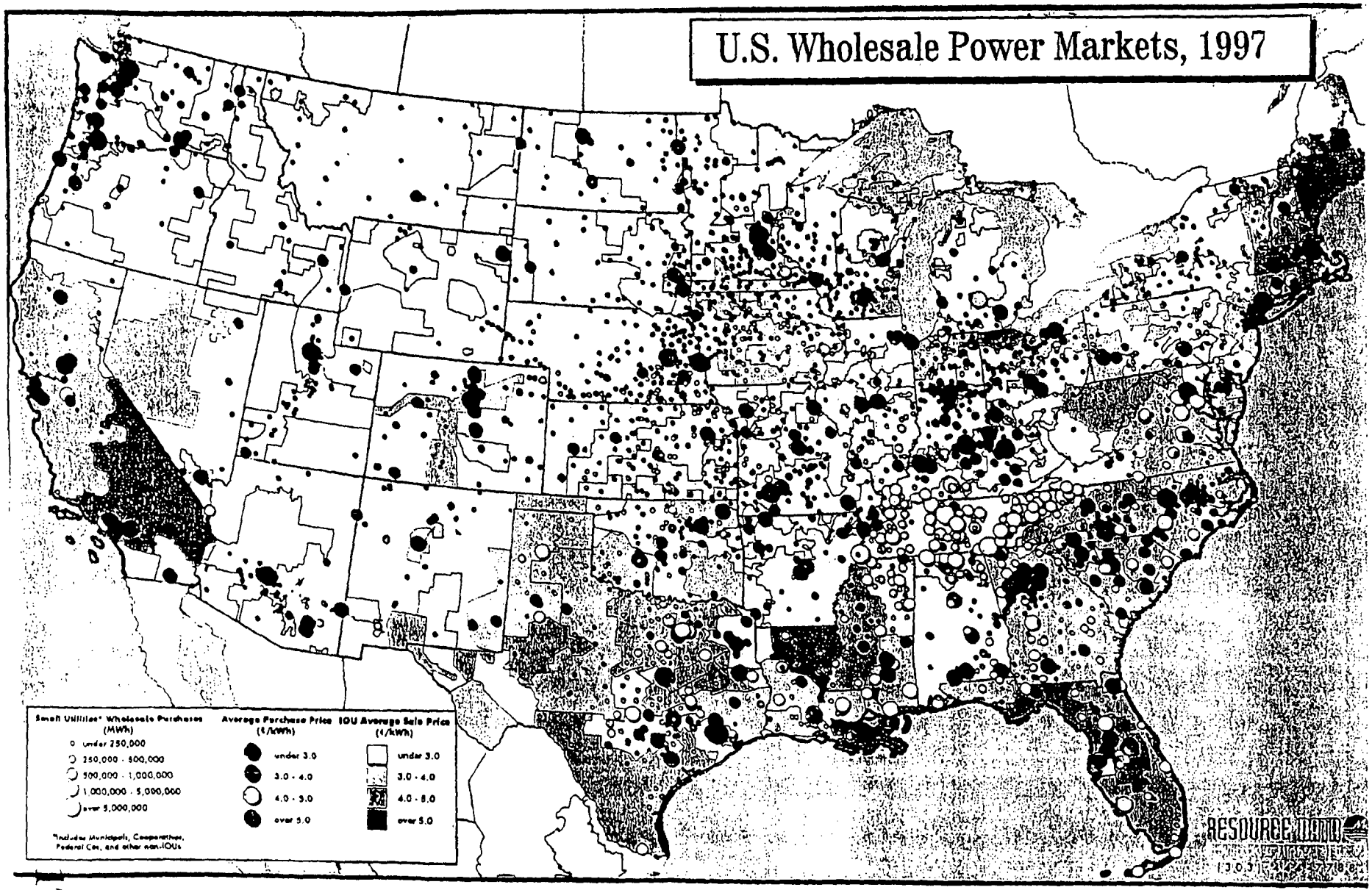
(Aug. 15, 1953, ch. 503, 64, 67 Stat. 587.)

CODIFICATION

Section was not enacted as part of the Federal Power Act which generally comprises this chapter.

CHAPTER 12A—TENNESSEE VALLEY AUTHORITY

DOE003-0387


U.S. Wholesale Power Markets, 1997
Small Utilities' Wholesale Purchases (MWh)
under 250,000
250,000 - 500,000
500,000 - 1,000,000
1,000,000 - 5,000,000
over 5,000,000
*Includes Municipals, Cooperatives, Federal Gov, and other non-IOUs
Average Purchase Price (¢/kWh)
under 3.0
3.0 - 4.0
4.0 - 5.0
over 5.0
IOU Average Sale Price (¢/kWh)
under 3.0
3.0 - 4.0
4.0 - 5.0
over 5.0
RESOURCE DATA

DOE003-0388

TITLE VI—FEDERAL ELECTRIC UTILITIES
Subtitle A—Tennessee Valley Authority

SEC. 601. DEFINITIONS.

For purposes of this subtitle:

(1) The term "Commission" means the Federal Energy Regulatory Commission.

(2) The term "distributor" means a cooperative organization, municipal or other publicly owned electric power system which on December 31, 1997, purchased substantially all of its wholesale power requirements from the Tennessee Valley Authority pursuant to a long-term power sales agreement.

(3) The term "distributor service area" means the geographic area within which a distributor is authorized by State law to sell electric power to retail electric consumers on the date of enactment of this Act.

(4) The term "electric utility" has the same meaning as provided by section 3(22) of the Federal Power Act (16 U.S.C. 796(22)).

(5) The term "excess electric power" means that portion of the electric power and capacity that is available to the Tennessee Valley Authority and which exceeds the Tennessee Valley Authority's firm power supply obligations to (i) distributors and to (ii) those Tennessee Valley Authority retail electric consumers (or predecessor in interest) that had

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a contract for the purchase of electric power from the Tennessee Valley Authority on the date of enactment of this Act.

(6) The term "public utility" has the same meaning as provided by section 201(e) of the Federal Power Act (16 U.S.C. 824(e)(1)).

(7) The term "retail electric consumer" has the same meaning as provided by section 3 of the Federal Power Act (16 U.S.C. 796).

(8) The term "Tennessee Valley Region" means the geographic area in which the Tennessee Valley Authority or its distributors were the primary source of electric power on December 31, 1997.

SEC. 602. WHOLESALE COMPETITION IN THE TENNESSEE VALLEY REGION.

(a) AMENDMENTS TO THE FEDERAL POWER ACT—

(1) Section 212(f) of the Federal Power Act (16 U.S.C. 824k(f)), relating to interconnection or wheeling orders that result in the sale or delivery of electric power outside the Tennessee Valley Region, is repealed.

(2) Section 212(j) of the Federal Power Act (16 U.S.C. 824k(j)), relating to transmission within the Tennessee Valley Region, is repealed.

(b) AMENDMENTS TO THE TENNESSEE VALLEY AUTHORITY ACT.—

(1) The third sentence of the first paragraph of section 15d(a) of the Tennessee Valley Authority Act of 1933 (16 U.S.C. 831n–4(a)), limiting the sale or delivery of electric power outside the area for which the Tennessee

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Valley Authority or its distributors were the primary source of electric power on July 1, 1957, is repealed.

(2) The second and third paragraphs of section 15d(a) of the Tennessee Valley Authority Act of 1933 (16 U.S.C. 831n–4(a)) are repealed.

SEC. 603. TENNESSEE VALLEY AUTHORITY POWER SALES.

(a) LIMIT ON RETAIL SALES BY TENNESSEE VALLEY AUTHORITY.—Notwithstanding sections 10, 11, and 12 of the Tennessee Valley Authority Act (16 U.S.C. 831i), the Tennessee Valley Authority shall not sell electric power at retail, except it may sell electric power to—

(1) a retail electric consumer (or predecessor in interest) that had a contract for the purchase of electric power from the Tennessee Valley Authority on the date of enactment of this Act; or

(2) a retail electric consumer who consumes that electric power within a distributor service area, if the distributor agrees that the Tennessee Valley Authority can sell electric power to such retail electric consumer.

(b) REGIONAL PREFERENCE FOR WHOLESALE POWER SALES.—

(1) REGIONAL PREFERENCE.—Nothing in this title shall be construed to modify or alter the existing obligations of the Tennessee Valley Authority under the Tennessee Valley Authority Act (16 U.S.C. 831 et seq.) to give preference in the sale of power to states, counties, municipalities, and cooperative organizations of citizens or farmers within the Tennessee Valley Region.

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(2) SALES OF EXCESS ELECTRIC POWER.—Notwithstanding sections 10, 11, and 12, or any other provision of the Tennessee Valley Authority Act of 1933 (16 U.S.C. 831 and following), the sale of electric power at wholesale by the Tennessee Valley Authority for use outside the Tennessee Valley Region shall be limited to excess electric power. The Tennessee Valley Authority shall not offer firm excess electric power under an agreement with a term of three years or longer to a new wholesale customer at rates, terms, and conditions more favorable than those offered to any distributor for comparable electric power, taking into account such factors as the amount of electric power sold, the firmness of such power, and the length of the contract term, unless the distributor or distributors that are purchasing electric power under equivalent firm power contracts agree to the sale to the new customer.

Nothing in this subsection shall prevent the Tennessee Valley Authority from making exchange power arrangements with other electric utilities when economically feasible.

(c) APPLICATION OF TENNESSEE VALLEY AUTHORITY ACT TO SALES OUTSIDE TENNESSEE VALLEY REGION.—The third proviso of section 10 of the Tennessee Valley Authority Act of 1933 (16 U.S.C. 831i) and the second and third provisos of section 12 of the Tennessee Valley Authority Act of 1933 (16 U.S.C. 831k) shall not apply to any sale of excess electric power by the Tennessee Valley Authority for use outside the Tennessee Valley Region.

SEC. 604. TENNESSEE VALLEY AUTHORITY ELECTRIC GENERATION FACILITIES.

Section 15d(a) of the Tennessee Valley Authority Act of 1933 (16 U.S.C. 831n–4(a)) is amended by striking the period at the end of the second sentence and inserting the following:", if the Corporation determines that the construction, acquisition, enlargement, improvement, or replacement of any plant or facility used or to be used for the generation of electric power is necessary to supply the demands of distributors (as defined in section 601 of the Electricity Competition and Reliability Act) and, to the extent permitted by section 603(a) of such Act, retail electric consumers of the Corporation. The Corporation shall not acquire any new generating source that it reasonably expects will necessitate the use of the authority granted in Section 608 of such Act to recover otherwise unrecoverable costs.".

SEC. 605. RENEGOTIATION OF POWER CONTRACTS.

(a) RENEGOTIATION.—Within one year following the date of enactment of this Act, the Tennessee Valley Authority and the distributors shall make good faith efforts to renegotiate their existing power contracts with respect to—

(1) the remaining term;

(2) the length of the termination notice;

(3) the amount of electric power a distributor may purchase from an electric utility other than the Tennessee Valley Authority, and access to the Tennessee Valley Authority transmission system for that electric power; and

(4) stranded cost recovery.

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(b) DISTRIBUTOR CONTRACT TERMINATION OR REDUCTION RIGHT – The Tennessee Valley Authority shall allow any distributor that had a contract to purchase wholesale electric energy from the Tennessee Valley Authority in effect on the date of enactment of this title to terminate its contract or reduce the quantity of its wholesale power requirements thereunder by, or to, either a specific amount of power, or a percentage of its requirements, upon two years notice which notice may be given at any time or from time to time beginning from one year after date of enactment.

(c) RENEGOTIATION OF CERTAIN WHOLESALE POWER CONTRACTS – If a distributor elects to reduce the quantity of its purchases from the Tennessee Valley Authority pursuant to subsection (b) of this Section, but not to terminate its contract, such distributor and the Tennessee Valley Authority shall, within one year following the date of such election, renegotiate the remaining terms of their existing contract under which the Tennessee Valley Authority will continue to provide wholesale power to the distributor, provided that such contract shall preserve the distributor's right under subsection (b) to elect further reduction(s). If the distributor and the Tennessee Valley Authority are not able to reach agreement on such remaining terms of their contract within the one-year period, either the distributor or the Tennessee Valley Authority may submit the matter to the Commission which shall have jurisdiction to and shall establish such terms.

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SEC. 606. REGULATION OF TENNESSEE VALLEY AUTHORITY TRANSMISSION SYSTEM.

(a) Notwithstanding sections 201(b)(1) and 201(f) of the Federal Power Act, sections 202(h), 205, 206, 208, and 210 through 213 and sections 301 through 304, 306, 307 (except the last sentence of subsection (c)), 308, 309, 313, and 317 of the Federal Power Act apply to the transmission and local distribution of electric power by the Tennessee Valley Authority to the same extent and in the same manner as such provisions apply to the transmission of electric power in interstate commerce by a public utility otherwise subject to the jurisdiction of the Commission under part II of such Act, provided that the preference granted in Section 10 of the Tennessee Valley Authority Act (16 U.S.C. 831i) to States, counties, municipalities, and cooperative organizations of citizens or farmers within the Tennessee Valley shall include access to transmission capacity on the Tennessee Valley Authority transmission system.

(b) No person shall duplicate the facilities of a distributor for the purpose of serving a retail electric consumer within the distributor service area.

SEC. 607. REGULATION OF TENNESSEE VALLEY AUTHORITY DISTRIBUTORS.

(a) ELECTION TO REPEAL TENNESSEE VALLEY AUTHORITY REGULATION OF DISTRIBUTORS.—Upon the election of a distributor, the third proviso of section 10 of the Tennessee Valley Authority Act of 1933 (16 U.S.C. 831i) and the second and third provisos of section 12 of the

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Tennessee Valley Authority Act of 1933 (16 U.S.C. 831k) shall not apply to wholesale sales of electric power by the Tennessee Valley Authority in the Tennessee Valley Region after the date of enactment of this Act, and the Tennessee Valley Authority shall not be authorized to regulate, by means of rules, contract provisions, resale rate schedules, contract termination rights, or any other method, any rates, terms, or conditions imposed on the resale of such electric power by such distributor, or any rates, terms, or conditions for the use of local distribution facilities.

(b) AUTHORITY OF GOVERNING BODIES OF DISTRIBUTORS.—Any regulatory authority exercised by the Tennessee Valley Authority over any distributor making an election authorized in subsection (a) shall be exercised by the governing body of such distributor, in accordance with the laws of the State in which it is organized. In the event a distributor does not make the election authorized in subsection (a), the provisions of the Tennessee Valley Authority Act specified in that subsection shall continue to apply for the duration of any wholesale power contract between the Tennessee Valley Authority and the distributor, according to its terms.

(c) USE OF FUNDS.—In any contract between the Tennessee Valley Authority and a distributor for the purchase of at least 70 percent of the distributor's requirements for the sale of electric power, the Tennessee Valley Authority shall include such terms and conditions as may be reasonably necessary to assure that the financial benefits of a distributor's electric system operations are allocated to the distributor's retail electric consumers.

(d) REMOVAL OF PURPA RATEMAKING AUTHORITY.—Section 3(17) of the Public Utility Regulatory Policies Act of 1978 (16 U.S.C. 2602(17)) is amended by striking ", and in the case of an electric utility with respect to which the Tennessee Valley Authority has ratemaking authority, such term means the Tennessee Valley Authority.".

SEC. 608. STRANDED COST RECOVERY.

(a) The Tennessee Valley Authority may recover any wholesale stranded costs that may arise from the exercise of rights by a distributor pursuant to Section 605 of this title to the extent authorized by the Commission based on application of the rules and principles the Commission applies to wholesale stranded cost recovery by other electric utilities within its jurisdiction, provided that Tennessee Valley Authority shall not be authorized to recover from any distributor any wholesale stranded costs related to loss of sales revenues by Tennessee Valley Authority, or its expectation of continuing to sell electric energy, for any period after September 30, 2007.

(b) DEBT.—Stranded costs recovered by the Tennessee Valley Authority under subsection (a) shall be used to pay down the Tennessee Valley Authority's debt to the extent determined by the Tennessee Valley Authority to be consistent with proper financial management. The Tennessee Valley Authority may not use amounts recovered to pay for additions to the Tennessee Valley Authority's generation capacity.