

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION
AND THE
ELECTRIC ENERGY MARKET COMPETITION TASK FORCE**

Competition in the Wholesale and }
Retail Markets for Electric Energy } **Docket No. AD05-17-000**

Comments of the National Rural Electric Cooperative Association

The National Rural Electric Cooperative Association (NRECA) appreciates this opportunity to respond to the Joint Task Force’s Draft Report to Congress on Competition in the Wholesale and Retail Markets for Electric Energy (Draft Report). NRECA appreciates the enormous task that the Joint Task Force was asked to undertake, as well as the limited direction provided by the Energy Policy Act of 2005. The Joint Task Force has done a remarkable job of collecting and compiling a vast amount of information on competition in the electric utility industry.¹

NRECA believes, however, that several aspects of the Draft Report can be significantly improved. As discussed in greater detail in these comments, the Draft Report has unduly focused on academic questions about theoretical economic efficiency rather than giving its attention to the impact that competition has had on retail consumers and our economy. In so doing, the Draft Report inaccurately suggests that Congress and State governments pursued restructuring in order to ensure the efficient allocation of resources, rather than lower costs and better service for retail consumers. The Draft

¹ Most of the studies compiled in the Draft Report are relatively recent. It would be useful for the Joint Task Force also to enumerate at least some of the dozens of studies that have analyzed restructuring efforts as they have unfolded. Many of those studies were disregarded at the time that they were issued because they contradicted the pro-market ethic of the times. It would be a shame if a lot of good work discussing the challenges faced by electric markets was lost simply for lack of institutional memory. A list of many such studies are attached at the end of these comments as Attachment A.

Report also repeats without analysis or question several of the myths about electric utility competition that have lead to significant consumer costs, including the myth that competition insulates retail consumers from bad investment decisions.

BACKGROUND

As discussed in its initial comments, NRECA is the not-for-profit national service organization representing the nearly 1,000 not-for-profit, member-owned rural electric systems that provide retail electric service to more than 39 million consumers in 47 states. As a major purchaser of wholesale power (in excess of 60,000 MW annually), NRECA and its member Load Serving Entities (LSEs) have and continue to support a transmission access-based version of generation competition.

DISCUSSION

I. The Draft Report Fails to Ask how Consumers Have Fared from Restructuring.

The Draft Report chooses to ask the question “Has competition in wholesale markets for electricity resulted in sufficient generation supply and transmission to provide wholesale customers with the kind of choice that is generally associated with competitive markets?” Draft Report at 2. While this is an interesting question, it has several key flaws.

First, the Draft Report’s chosen question assumes that the country has competition in wholesale and retail markets. In fact, the Joint Task Force received considerable evidence that effective wholesale competition still does not exist in many transmission-constrained areas in the country and that most retail customers in restructured states have

never seen true retail competition.² The first question the Draft Report should have asked is whether we have achieved competition, or whether we have merely achieved a regulatory restructuring of the industry.

Second, the Draft Report's chosen question is based on the erroneous assumption that "Federal and several state policymakers introduced competition to provide for an economically efficient allocation of resources." Draft Report at 35. Economists know that markets do not necessarily bring consumers lower prices and better service. Efficient allocation of resources necessarily leads to higher costs for some consumers and more volatile prices. Those consumers that cannot be served at a profit may not be served at all. But, that was not the expectation with which policymakers or consumers promoted competition. As demonstrated by Boxes 4-1 and 4-2, it is clear that policymakers believed that restructuring would bring the cost of power down for retail consumers and improve the quality and reliability of service. They acted on the basis of a number of well publicized studies by the Department of Energy and others touting the consumer benefits of competition.³ Efficiency may have been seen as a tool, but the goal was to make things better for retail consumers. The final report should make explicit that gap between policy makers' expectations concerning competition and the reality.

² The lack of effective competition is also evident in the decision of the Federal Energy Regulatory Commission (FERC) to update its open-access transmission regulations because the existing regulations do not sufficiently eliminate the opportunities for undue discrimination. FERC is likewise reevaluating its market-based rate authorizations. These and other significant rulemaking initiatives would not be pending if competition were already fully effective.

³ See, e.g., Michael T. Maloney et al., *Customer Choice, Consumer Value; An Analysis of Retail Competition in America's Electric Industry* (finding that retail competition would reduce residential consumer bills by as much as \$30 per month, or 43%); *NCPA Study: Electricity Deregulation Could Benefit Consumers*, PRNewswire (October 15, 1999) (quoting Vernon Smith, "If done correctly, competition could save the average household more than \$200 a year, in the first two years alone"); *Supporting Analysis for the Administration's Comprehensive Electricity Competition Act* (May 1999) (predicting that consumers would save \$20 billion/year from competition); Robert Crandall, Jerry Ellig, *Economic Deregulation and Customer Choice: Lessons for the Electric Industry* (finding that deregulation and customer choice lower prices and align service quality with consumer desires).

Finally, because of their expectations going into restructuring, the Draft Report's chosen question is significantly less relevant to consumers and policy makers than the more fundamental questions: (1) are wholesale and retail customers better off with wholesale and/or retail competition – or more accurately, restructuring?; and (2) has wholesale or retail competition or restructuring driven down the cost of power or improved reliability and service? The final report should not force readers to guess who has benefited from “the kind of choice that is generally associated with competitive markets.” Draft Report at 2.

Having said this, we view with a great deal of irony the recent statements of participants in many centralized markets – PJM, MISO, NY-ISO and NE-ISO – related to upcoming blackouts and brownouts because no one is building new generation in those markets. We suggest that this information be included in the Task Force final report.

II. The Draft Report Perpetuates the Myth that Competition Insulates Consumers from Bad Investment Decisions.

In several places the Draft Report states that under traditional regulation, ratepayers (rather than investors) may bear the risk of potential investment mistakes. Draft Report at 4, 70. It suggests that, by contrast, ratepayers are insulated from the costs of bad investments in a restructured environment. It is true that there is no “direct pass-through” of costs from imprudent Independent Power Producer (IPP) investments to ratepayers. Nevertheless, unfortunately, all consumers are harmed by IPPs' bad resource decisions. There are a number of reasons why this is true.

First, the collapse of the merchant sector caused the cost of capital for new non-rate based generation to rise dramatically. The IPPs' credit woes dramatically increased their costs and the costs of most other generation-owning companies – and thus the price

at which they all sell power. Only a few generation-owning companies have avoided credit downgrades: predominantly vertically integrated utilities in non-restructured states without exposure to merchant affiliates. These include most cooperatives, municipal utilities,⁴ and a few larger investor-owned utilities like Southern Company. Perhaps the final report should include analysis of the differing cost of capital of the segments along with an explanation of the impact of the higher capital costs on consumer prices in this most capital-intensive industry.

Second, the merchant sector's vast overbuilding of gas generation to the exclusion of other fuels contributed to a significant increase in the price of gas. Where most vertically integrated utilities operating in regulated environments must consider the value of fuel diversity in their resource decisions, the merchant sector was drawn unvaryingly to natural gas by its low capital costs and relatively short construction times. The higher gas prices caused by the IPPs' over-reliance on gas have dramatically increased power costs for consumers (along with higher costs to heat their homes, and the resulting loss of jobs in industries that use natural gas for feedstock). And, the restructured wholesale market has magnified that cost because gas generation – frequently the marginal resource in many regions of the country – often sets the price received by all generators for their power. Consumers are directly suffering from the merchant sector's unwise resource decisions.

⁴ See, e.g., “Credit quality of cooperatives remains ‘strongly’ investment grade, S&P says,” Electric Utility Week (June 19, 2006) (explaining that the “cooperative sector demonstrates sound debt-service coverage and good liquidity” but noting that “Counterparty risk, even through a limited dependence on wholesale purchases, and uncertainty over the future of transmission capacity and availability, continue” to put pressure on cooperatives, *i.e.*, the poor credit quality of market players imposes costs even on load-serving entities with good credit).

Third, consumers in organized markets are being asked to bail out generators that own uneconomic units in load pockets or in other areas where the generators are required for reliability. FERC and the Regional Transmission Organizations (RTOs) have developed and implemented several different approaches for ensuring that such generators receive a regulated rate of return where market prices are not adequate to ensure their continued operation.

Finally, it should be obvious that consumers suffer directly when generators fail to invest in sufficient generation, or invest in the “wrong generation” in the “wrong places.” Consumers may pay too much in monopoly rents; in scarcity rents that could have been avoided through appropriate long-term planning by a utility with the obligation to serve; through regulated locational capacity charges that penalize consumers in order to encourage investment in constrained areas that would have been adequately served by a vertically integrated utility with the obligation to serve; or potentially, through blackouts.⁵ Recent initiatives in New England to implement a locational installed capacity (LICAP) concept, and in the PJM RTO region to develop the Reliability Pricing Model (RPM) are prime examples. Both of these market designs, as proposed, would increase power supply costs to consumers located in already high-cost, constrained regions of the grid. These market designs would also create additional incentives for capacity owners in these constrained areas to oppose any initiatives to build badly needed transmission expansions. The net effect would be to create “mini-markets” with the “illusion” of competition, and create barriers that would essentially guarantee that “real” competition would never be achieved for consumers in these regions. We suggest that

⁵ See, e.g., “Resource adequacy outlook may be grim,” *Restructuring Today* (June 20, 2006) (noting that PJM could see outages within 5 years due to inadequate generation capacity).

the final report analyze the impact of these costs on consumers, along with an analysis of how these “new” costs impact the “saving” to consumers from competition found in a number of recent studies.

III. The Draft Report Perpetuates the Myth that the Industry is no Longer a Natural Monopoly.

The Draft Report recites a fairly common history of the industry. It explains that where the industry was once (perceived as)⁶ a natural monopoly, periods of high interest rates and improvements in gas generation and transmission technology caused a fundamental shift in electric utility industry economics, making wholesale competition feasible. Draft Report at 13, 27. The Draft Report (and most others) however, have badly overstated the extent of the changes in the industry.

Most apparently, the changes described in the Draft Report were an artifact of low gas prices and high interest rates. Only those cost imbalances between small gas resources and larger base-load plants made the gas plants economically superior to larger coal generation. Today, we face the opposite conditions. Gas in the past 12 months hit record prices, nearly 10 times the price during the gas bubble in the mid-1990s. Interest rates, while rising slightly recently, are still near their historic lows.

Moreover, while the changes noted by the Draft Report suggest that anyone could enter the market, build gas plants, and compete effectively with the incumbent utilities, that assumption is not proving true. Competitive suppliers are finding that it is very difficult for them to compete with the vertically integrated utilities in their local markets, even when their gas plants are economic in the peaking and intermediate power markets. In addition, these competitive suppliers have found that access to broader markets is not

⁶ The Draft Report includes a gratuitous suggestion that the industry was never a natural monopoly.

really available to them, due to the lack of sufficient transmission capacity. As a result, we have seen a dramatic retrenchment in the past few years. Most of the new generation is being built by vertically-integrated utilities for rate base, and a large amount of formerly IPP generation is also being sold to incumbent utilities. In part, the IPPs are suffering from exercise of monopsony power and transmission market power by those incumbents. But there are also some other legitimate factors that make the incumbents more competitive than IPPs. These include the incumbents' efficiencies of vertical integration, lower cost of capital, higher credit ratings, and certain cash flow.

Another error that the Draft Report and most industry observers have made is that they have ascribed significant changes in one area of the electric utility industry to the entire industry. The technological improvements that the Draft Report described did have a dramatic effect on the market for peaking energy and perhaps also for intermediate energy in some regions of the country. Even today, gas generators can be built faster and cheaper for peaking and some intermediate resources than other traditional generators.

Those changes, however, did not change the fundamental economics of the industry as a whole. Just as in 1935, the high capital costs of the industry, high barriers to entry, and significant efficiencies of size and scope make it difficult if not impossible for centralized short-term commodity markets to meet consumers' need for reliable, low-cost power over the long-term.

Even with the dramatic improvements in technology, natural gas generators cannot effectively compete to meet base-load requirements. The effect of that was masked during the 1990s because most of the country was still working through a bubble of excess base-load capacity built during the late 1970s and 1980s. That bubble is now

gone and utilities throughout the country are looking to acquire additional base-load coal and nuclear generation. Most of that base-load generation will be built by incumbent utilities or by highly capitalized IPPs, such as Peabody Coal and AES, which have long-term contracts with load serving entities.⁷ Only LSEs have the capital, credit ratings, and assured consumer base required to finance such enormous investments: directly or by long-term contract with an IPP.

While there will continue to be wholesale competition, it will likely be limited to certain areas. There will likely be some open competition for peaking and perhaps for intermediate power, particularly if gas prices come back down. The development of centralized markets will also allow balancing markets to provide an easier and more efficient substitute for what used to be bilateral short-term economy trades. Most competition, however, will likely take place in the resource acquisition stage, when LSEs look into the future to find the resources they need to meet the long-term needs of their consumers. It will take place between IPPs, and between those IPPs and the generation arms of the LSEs. Those IPPs that can build and operate power plants more efficiently and capably than LSEs will continue to do so, but primarily under long-term contract with LSEs. Very few plants will be built on “spec.”

Finally, while improvements to transmission technology may allow generators hundreds of miles apart to compete with each other in theory (Draft Report at 27), the transmission system is so congested in fact that it is often very difficult for LSEs to acquire competitive energy supplies. In regions without RTOs, the ATC simply is not

⁷ See, e.g., Rebecca Smith, “NRG Plans Buildup to Increase Power Output, Reduce Emissions,” Wall Street Journal (June 21, 2006), page B2 (discussing NRG’s plans to invest in new base-load generation, but quoting one person as saying that “plants wouldn’t be built without contracts in place to purchase the output”).

available to move the energy, and the cost and time required to build the necessary transmission makes the competing supplies uncompetitive. In regions with RTOs, transmission service may be available to all within the region, but congestion costs incurred to move the competing energy supplies makes those competing supplies uneconomic. Congestion charges can be hedged to some degree – at a price – but not yet on a long-term basis. The final report should note that for competition of any form to work effectively, those transmission challenges will have to be addressed.

IV. The Draft Report Fails to Identify Significant Inherent Challenges to Retail Competition.

The Draft Report correctly notes that “[o]ne of the main impediments to retail competition” is the fact that there are few if any suppliers willing to compete for retail load. Draft Report at 5. The report then assigns primary responsibility for that phenomenon to the design of Provider of Last Resort (POLR) service. Unfortunately, the Draft Report fails to discuss the core issue: the lack of margins available in the supply of retail electric energy. There is little money to be made in supplying retail electricity, and thus little interest among competitive suppliers. As noted recently by Art Meyer, a DP&L vice president, “[i]t’s difficult for marketers to obtain power at rates lower than what the established utilities buy power for and provide it to customers and still make a profit.”⁸ This can be seen by looking at the few instances where retail competitors have done well.

- Value added services: Green power is a good example as many customers are willing to pay an above-market rate for renewable energy. Other

⁸ John Nolan, “Power deregulation isn’t going smoothly for Ohio, other states; Newcomers can’t offer prices lower than entrenched companies like DP&L and expect to make a profit,” Dayton Daily News (Jun 17, 2006).

competitive suppliers have offered fixed-rate contracts to commercial and industrial (C&I) customers that faced highly volatile market rate under POLR service. These suppliers charge a margin for providing the retail hedging service that used to be provided by regulated utilities.

- Access to below-market power: Some competitive suppliers were able to attract consumers for a period in Ohio during which the incumbent utility was required to sell a portion of its generation resources to those specific competitors at a below-market rate. The new suppliers could resell that power at retail with a margin and still beat the incumbent's retail rate. Consumers switched but the competition was artificial.
- Competing against above-market POLR rates: Competitive suppliers were extremely active in investor-owned utility territories during the early years of the Pennsylvania retail restructuring in part because the Pennsylvania Public Utilities Commission deliberately set POLR rates at an above market level in order to encourage switching. Most of those customers have now switched back to POLR service because those "above market" rates are now below market. Now, ninety-eight percent of all customers served by competitive suppliers are in Texas where POLR rates are significantly above market. Consumers served by cooperatives and municipal utilities that did not restructure generally pay lower rates in Texas than consumers with either POLR or competitive service.⁹

⁹ It is interesting to note that Texas is considering rules that would set POLR rates at 130% of the market-clearing price for power. See "Texas PUC eyes changes to POLR rules," *Electric Power Daily* (Wednesday June 21, 2006), at 3. In a similar effort to stimulate competition artificially, National Grid in

In fact, more sophisticated observers never expected retail competition to provide savings opportunities for the vast majority of retail consumers. Large industrials, for example, were quoted in the mid-90s as saying that, “big dogs eat first.”¹⁰ They expected to drive their costs down at the expense of residential consumers. Many consumer advocates also predicted that residential consumers would fare poorly in competition.¹¹ The rate freezes that are causing havoc today were the best that those advocates could negotiate in light of the political power that competition supporters had at the time they were adopted.

The Joint Task Force should recognize in the final report that vertically integrated utilities operating under the regulatory compact successfully provided American consumers with safe, reliable, and affordable power for over 60 years at consistently declining rates. There were, of course, some regulatory failures. But the cost of those failures paled in comparison with the costs to consumers caused by the melt-down of the

New York will provide customers a 7% discount for choosing an alternative supplier, and National Grid will purchase the receivables of the alternative suppliers.

¹⁰ See, e.g., John Anderson, ELCON Statements at NASUCA Conference (March 15-16, 1999), reported in *The Energy Report* (“Competition will not benefit everyone . . . we’re going to do some balancing.”); Electric Utility Shareholders Alliance (Electric USA) 1998 Comments to OMB re Administration Bill (“In a moment of candor, an employee of one large industrial conglomerate observed: ‘In the world of electric deregulation, the big dog eats first . . .’”).

¹¹ See, e.g., Consumers Federation of America and the Consumers Union, *The Residential Ratepayer Economics of Electric Utility Restructuring* (July, 1998) (reporting that the potential costs to residential consumers of competition could outweigh the potential benefits by more than 4 to 1; David Freshwater, *et al.*, *The Consequences of Changing Electricity Regulations for Rural Communities in Kentucky* (December 1997) (predicting that rural residents in Kentucky will be worse off under a restructured electric industry); John B. Chilton, *et al.*, *Electricity Deregulation in South Carolina: An Economic Analysis* (1997) (explaining that the economic development advantages of low cost states will not only shrink, but will disappear under retail electric competition); Electric USA 1998 Comments to OMB re Administration Bill (“Losers will likely include customers who consume relatively small amounts of electricity, typically families and small commercial interests. The overwhelming majority of Americans fit the ‘losers’ profile.”); Ronald J. Binz, *et al.*, *Navigating a Course to Competition: A Consumer Perspective On Electric Restructuring* (April 1997) (“The equity among consumer classes that is today enforced by regulators will give way to a competitive regime in which consumers’ bargaining power and specific load characteristics will determine the price paid for electricity. This could work to the advantage of the largest customers of the electric utilities and against small consumers.”).

California market and the enormous rate increases being experienced in a number of restructured states today as they begin to remove price caps.

The Commonwealth of Virginia provides an interesting case study. At the time it divested its power plants, Delmarva agreed to a provision in its tariff that capped fuel factor increases to the level consumers would have experienced had Delmarva kept its generators. Under that formula, the Virginia State Corporation Commission (SCC) recently found that Delmarva was entitled to a 25% rate increase. As noted recently in the press, that is about half of the 49.5% rate increase that Delmarva sought following an “RFP for power to serve its Virginia customers where only one bidder – Delmarva affiliate Conectiv Energy Supply – competed.”¹²

Given that history, NRECA hopes that the Joint Task Force will conclude that the service provided by vertically integrated utilities operating under the regulatory compact should continue to be the yardstick by which competitive service is measured. If competitive suppliers can provide lower cost power or value added services, then they will do well and consumers will be well served. If they cannot, then at least consumers could continue to receive the service that they have relied on for decades. POLR policy should not spur artificial competition by raising rates or shifting consumers to highly volatile market-tracking retail rates in the hopes that the consumers would be driven into the arms of competitive suppliers

V. The Draft Report Overemphasized the Role of Demand Response, to the Exclusion of Supplier Competition.

¹² “Delmarva politics as usual can be painful, utility learns,” Restructuring Today, Wednesday June 21, 2006, at 3.

The Draft Report focuses extensively on consumer response to prices. Draft Report at 39-43. Consumers, the Draft Report emphasizes, must see and respond to wholesale price changes in order to improve efficiency. The Draft Report, however, spends very little time discussing what should be the more significant interaction in an industry characterized by low demand elasticity (Draft Report at 41) – competition among suppliers. Basic economic theory suggests that competitive suppliers should drive each others' prices down to marginal costs, keeping prices low for consumers and ensuring efficient production. Why is there so little discussion of that side of the equation in the Draft Report? Why is the onus placed on consumers to bear increased costs and risk and ultimately alter their behavior in order to make the market operate efficiently? NRECA believes that Congress and the States intended markets to serve the interests of consumers, not the other way around.

VI. Specific Comments.

- *In several areas the data shown are not the currently available data. This should be remedied prior to release of the Final Draft.*
- *Page 3: The Draft Report states that “This bilateral format . . . better accommodates bilateral contracts.”*

The issue is broader than the Draft Report states. In fact, the bilateral format better accommodates long-term planning with all of the value that long-term planning provides to consumers. This includes reliable service at stable rates that benefit from the lower risk that long-term planning and long-term contracting provide. This also includes the construction of adequate long-term capacity reserves. Both of these advantages have been difficult or impossible to achieve in centralized markets.

- *Page 3: The Draft Report states that transparency of prices in centralized markets “can increase the efficiency of the trading process.”*

The sentence ought to note that the transparency can increase the efficiency of the short-term trading process. The focus on the short term appears, in fact, to have undermined the quality of long-term resource decisions. Focus on the short-term, for example, led to the market’s dramatic overbuilding of gas-fired generation and the unwise location of generation. For example, planners focused on the long-term would have been unlikely to overbuild capacity in export-constrained Maine instead of building capacity in import-constrained Connecticut. Planners focused on the long-term would also have been unlikely to have so seriously overbuilt new gas capacity in export-constrained Louisiana.

- *Page 3: The Draft Report states that “price spikes can provide incentives for generators to invest in new capacity.”*

That statement is highly questionable. After the wave of bankruptcies in the merchant generation sector, short term price volatility is unlikely to provide many investors with the incentive to make enormous investments in long-term assets. Investors rely on long-term forecasts and long-term contracts rather than daily or hourly price signals. The costs of entry and exit are far too high for investors to be willing to make investment decisions based on fairly fleeting price spikes – even if they occur fairly often. This scenario is also supported by the evidence provided with the New England and PJM RTO capacity market proposals discussed earlier. To paraphrase numerous papers and presentations given supporting these proposals, “the current market designs (*i.e.*, volatile LMP-based energy markets) do not provide sufficient certainty of revenue

recovery to incent sufficient new generation investment to maintain reliability.” If investors cannot bear the risk to build even for reliability purposes in the volatile, short-term energy markets, then it is fairly certain that “competitive investments” will not happen without at least the same level of revenue recovery certainty.

- *Page 3: The Draft Report states that if wholesale markets have not, or cannot, hedge against price spikes, it can lead to “adverse customer reactions.”*

The Draft Report is apparently concerned that price spikes can cause consumers to advocate for price caps that are economically inefficient. The Draft Report should instead have expressed concern that price spikes can be extremely harmful to consumers and the economy. Extended price hikes and significant volatility can cause severe distress to residential consumers on fixed incomes and can force businesses (employers) to close or to move to other areas or countries with lower or just more stable energy costs. Such “pain” may lead to economically efficient behavior, but it is not socially or politically acceptable.

- *Page 32: The Draft Report states that natural gas prices have been increasing in recent years, due in part to historically high petroleum prices.*

It is important that the Draft Report also note that the historically high natural gas prices are due in part to the enormous increase in natural gas demand for electric generation. Electric market prices are often “adjusted for fuel prices” to argue that the markets have not caused wholesale prices to rise. Those analyses fail to take into account the impact that wholesale electric competition has itself had on fuel prices. The Draft Report should also note that the price effect of the rise in natural gas prices has been magnified in

centralized markets because all market and bilateral contract prices are pegged to the price of gas-fired generation.

- *Page 33: The Draft Report discusses IOU divestiture of generation resources.*

The Draft Report explains that many IOUs divested their generation: some voluntarily, some pursuant to state requirement, and some under state encouragement. The paragraph should be recast to show that divestiture requirements reflected states' thinking a decade ago when they enacted their restructuring plans. Many states would no longer hold the same views today. For example, the Draft Report states that state public utility commissions (PUCs) may encourage divestiture to arrive at a quantifiable level of stranded costs. That is true as a historical statement in the past tense, but is not accurate in the present tense.

Few if any PUCs today are likely to believe that any utility generating assets constitute stranded costs. In fact, there is substantial question today whether former stranded cost recovery by utilities was appropriate. Those assets sold at a "loss" have proven extremely valuable in today's market. For example, BGE divested many of its assets "at a loss" to its affiliate Constellation. BGE recovered significant stranded costs from its ratepayers in compensation for that loss. Today, BGE has contracted with Constellation for 70% of its power needs at so high a price that it has asked for a 72% rate increase. If BGE had never divested, BGE's retail customers would be getting extremely low-cost power from fully depreciated assets for which they had paid only once. Instead, BGE's consumers are paying for those assets three times: first through their regulated rates; second in their stranded cost payments; and, now a third time

through rate increases required by the BGE contract with BGE's sister company Constellation.

- *Pages 37-38: The Draft Report is overly critical of regulation.*

The Draft Report is extremely critical of investment decisions by regulated utilities. The Draft Report fails to note, however, that retail rates for consumers generally declined steadily under regulation; service was good; and the system was reliable. Although consumers bore the cost of excessive construction during a period of overbuilding in the 70s and 80s, due in no small part to the off-gas provisions of the Fuel Use Act of 1978, they benefited from those depreciated investments for two decades before any new base-load construction was required.

- *Page 55: The Draft Report's discussion of generation investment in PJM is potentially misleading.*

To make certain the final report does not give the wrong impression, the final report should cite the recent dire predictions of lack of sufficient generation in parts of PJM because of inadequate capacity additions.

- *Pages 58 and 59: The Draft Report inappropriately minimizes LSEs' or Wall Street's concerns about the availability of long-term contracts.*

In two places, the Draft Report describes LSEs' concern about the lack of available long-term contracts as "perceived." The problem is real. The Draft Report should not downplay or deny the reality of a problem experienced by real operating companies.

- *Page 64: NRECA strongly disagrees that calls for LICAP, RPM, etc. were driven solely by market power mitigation price caps.*

- *Page 67: The Draft Report claims bid-based dispatch will increase efficiency.*

It would be more accurate to state that dispatch efficiency would be accomplished by cost-based bids, not bid-based stacking. Where bids are unrelated to cost, the bid-based stacking does not increase efficiency.

- *Page 152: Recent data suggests that coops, munis and even small regulated IOUs outside ERCOT have retail rates about half the best retail prices within ERCOT*
- *Some have suggested that rural electric cooperatives receive excessive subsidies. As shown in Appendix B, this simply is not the case.*

We appreciate the opportunity to provide these comments to the Task Force.

Respectfully submitted,

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Appendix A

Additional Reports and Studies on Restructuring

Electric Utility Deregulation: Rural Effects, Briefing to Senior USDA Policy Officials, Office of Energy Policy and New Uses, Office of Chief Economist, January 1999 (finding that savings to retail customers will be concentrated in some states while substantial costs will be borne in other states and that economic growth will slow down under competitive pricing in states where rates are expected to increase).

Richard A. Rosen and Feyer Sverrisson, *Comparison of Studies By U.S. DOE and Stone & Webster On the Effect of Electric Restructuring in Colorado* (Tellus Institute 1999) (finding that the DOE's methodology used in its "Supporting Analysis for the Administration's Comprehensive Electricity Competition Act" is seriously flawed because the study is national and uses modeling techniques designed to deliver regional results, and inappropriately concludes that Colorado is likely better off if electricity restructuring occurs, while the results from a study by Stone & Webster Management Consultants, which treated Colorado exclusively, prepared for the Colorado Electric Advisory Panel in May 1999 concluding that consumers should expect substantially higher prices, is far more credible).

The Impact of Industry Restructuring on Electricity Prices, prepared by Science Applications International Corporation, prepared for American Gas Association, The Policy Analysis Group, July 1999.

Charles A. Campbell, *The Impacts of Electricity Restructuring with Emphasis on Rural Electric Cooperatives in Mississippi* (1999) (asserting that Mississippi rural electric rates are not likely to be reduced as a result of retail access and customers are likely to bear many of the transition costs associated with retail access without incurring significant improvements).

David Glycer & Cesar Herrera, Laurits R. Christensen Associates, *The Effects of Retail Access on Rural Electric Customers: A Study of Distribution Co-op Customers in Wisconsin* (not dated) (concluding that, because retail access is not *per se* the primary source of potential monopoly power in the industry, it may not raise rates to REC customers in Wisconsin, that changes in productivity will have substantial if not overriding impacts on customer welfare, and institutional constraints can saddle co-ops and their customers with increased costs).

David Freshwater, Stephan Goetz et al., *The Consequences of Changing Electricity Regulations For Rural Communities in Kentucky* (Any movement to a national market-based pricing structure will increase the price paid by most Kentuckians because electricity is inexpensive in Kentucky by national standards)

The Docking Institute of Public Affairs, Fort Hays State University, *Economic Impact of Retail Wheeling on Areas Served by Kansas Rural Electric Cooperatives* (1997) (finding

that retail wheeling that includes a dismantling of the RUS system of electricity will have adverse impact on areas served by RECs in Kansas).

Comment of the Staff of the Bureau of Economics of the Federal Trade Commission in Docket No. 26427, Before the Alabama Pub. Serv. Comm'n (January 8, 1999) (opining that the effects of regulatory reform may be overstated because Alabama has lower electricity prices than most other states).

Eugene P. Coyle, *Price Discrimination, Electronic Redlining, and Price Fixing In Deregulated Electric Power* (American Public Power Association 2000) (rigorous economic analysis reveals that, rather than driving prices down, deregulation will lead to price discrimination, redlining of customers, and ultimately, producer cooperation and/or collusion to frustrate competition).

Mark N. Cooper, Consumer Federation of America, *Electricity Deregulation and Consumers: Lessons From A Hot Spring and A Cool Summer* (2001) (Concluding that pervasive problems in restructured electricity markets exist, and asserting that creating competitive wholesale markets requires much less concentration of generation assets and much more oversight, adequate and open highways of commerce highways of commerce should be created).

Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform: Focus on Retail Competition, Report by the Federal Trade Commission Staff, September 2001 (reporting that: (1) “[t]he states that have moved toward competition in electricity generation and retail marketing are in a *transition* period, during which retail price regulation will continue as some elements of competition are introduced ...” and that “[n]o state has completed the transition period”; (2) “[m]ost policy choices that confront states during this transition period involve tradeoffs, with each presenting potential costs and benefits” and suggesting “use of additional pilot programs to test various tradeoffs” to make these policy judgments; (3) many of the expected benefits from competition have not yet been realized given that the states are in a transition period; and (4) “[n]othing that has happened so far – once the transition period is completed – will not produce additional benefits to electricity customers.” *Id.* (Executive Summary)).

Consumers Union and Consumer Federal of America, *The Residential Ratepayer Economics of Electric Utility Restructuring: Balancing All the Costs and Benefits* (July 1997) (finding that increases in transaction costs, price discrimination, abuse of market power and recovery of uneconomic costs undermine potential price benefits, and that if residential ratepayers are to benefit from restructuring, policy makers must devise safeguards to protect consumers).

Consumer Federation of America and Consumers Union *Electricity Restructuring and the Price Spikes of 1998: A Need for More Vigorous Efforts to Protect Consumers* (June 21, 1999) (concluding that market problems of 1998 indicated that more vigorous market protection is necessary if the restructured electricity market is to benefit all consumers).

Jaison R. Abel, The National Regulatory Research Institute, The Ohio State University, *An Economic Analysis of Marketing Affiliates in a Deregulated Electric Power Industry* (February 1998) (finding that “cross-subsidization from a upstream regulated market to a downstream unregulated competitive market is consistent with parent company profit-maximization and is not necessarily motivated by predatory pricing”).

Navigating a Course to Competition: A Consumer Perspective on Electric Restructuring, A policy paper of the Competition Policy Institute, April 1997 (Concluding that restructuring will improve efficiency and policy makers should distrust flawed economic studies of the benefits of electric restructuring).

David S. Habr & Joseph W. Murphy, Office of Consumer Advocate *The Impact of an Open Access Environment on Electric Prices Paid by Iowa Ratepayers, A 1998 Update* (1998) (concluding that under a restructured electric industry, Iowa ratepayers will be worse off than they are under regulation).

U.S. Gov’t General Accounting Office, GAO-03-271, *Lessons Learned From Electric Restructuring: Transition to Competitive Markets Underway, but Full Benefits Will Take Time and Effort to Achieve* (Dec. 2002) (identifying lessons that need to be addressed for the full benefits of restructuring to be realized).

Jon Hockenyos, Brian O’Connor & Julius A. Wright, Small Business Survival Committee *Potential Economic Impacts of Restructuring the Electric Utility Industry* (1997) (concluding that public policy concerning electricity restructuring should be unique to each state and policy should be developed that minimizes transition cost-shifting among customer classes in each state).

Mark N. Cooper, Consumers Union, *Reconsidering Electricity Restructuring: Do Market Problems Indicate a Short Circuit or a Total Blackout?* (2000) (arguing that the problems of the restructured electricity market arise from systemic market conditions and flawed market structures, not accidents, impatience or partial deregulation).

Comparisons of Federal Assistance to Electric Utilities

All electric utilities in the United States receive federal assistance, or subsidies. This was the conclusion of Nobel Laureate economics professor Lawrence R. Klein of the University of Pennsylvania and has been further substantiated by numerous studies by federal agencies and others.

Congressional Research Service Studies. Reports by CRS specialists confirm federal assistance to investor-owned and municipal utilities. One dated Nov. 30, 1999 states the following:

“Other utilities also receive various subsidies. Municipalities are able to issue tax-exempt bonds to finance generation of transmission facilities. Investor-owned utilities (IOUs) have benefited in the past from investment tax credits and accelerated depreciation.”¹

Investor-Owned Electric Utilities (IOUs), which on average serve 35 customers per mile of line, charge electric rates that also include amounts for presumed federal tax liabilities. Prior to 1987, IOUs collected taxes based on the 46 percent corporate tax rate. But due to available tax breaks — such as investment tax credits and accelerated depreciation — IOUs were permitted to retain much of the funds they collected for federal taxes.

The amount of these retained tax dollars is substantial: over \$56 billion according to the U.S. Department of Energy based on official reports filed by investor-owned utilities. Federal studies have referred to this amount as an "interest-free loan." The annual value of this major federal assistance to investor-owned utilities is estimated at nearly \$3 billion for 2004, making the subsidy to IOUs \$30 per customer. (See Table 1)

Rural Electric Cooperatives (RECs), which on average serve 7 customers per mile of line, receive reduced-interest loans from the Rural Utilities Service (RUS.) The federal assistance is the interest subsidy (federal borrowing rate minus the RUS rate) on outstanding RUS loans. The federal subsidy to 659 rural electric cooperatives amounted to \$57 million or \$5 per customer in 2004. Another 240 co-ops have repaid their RUS loans in full and thus now receive no federal assistance.

Conclusion — All electric utilities receive federal subsidies in one form or another, as confirmed by the Congressional Research Service. Calculations based on federal government financial reports show that rural electric cooperatives receive the *least* amount of subsidy per customer: \$5 compared to \$30 for IOUs. The difference in federal subsidies for each type of utility becomes even sharper after considering that because rural electric cooperatives serve sparsely populated areas across the vast countryside, they have only 7 customers per mile compared to 35 for IOUs. In addition, the appropriation to finance RUS electric loans has declined 93 percent since 1993. Although the RUS subsidy is down substantially, the assistance to the investor-owned and city-owned utilities continues at high levels.

Table 1: **Federal Assistance to Electric Utilities**

Investor-Owned Electric Utilities²

1. Number of systems	168
2. Investment Tax Credits	\$3,602,354,000
3. Accelerated Depreciation	\$52,463,007,000
4. Total retained taxes	\$56,065,361,000
5. Annual cost to gov't (5.04%)	\$2,825,694,000
6. Total customers	95,330,000
7. Assistance per customer	\$30

Rural Electric Cooperatives³

1. Number of systems	659
2. Total RUS loans outstanding	\$9,131,012,000
3. Gov't cost of money less avg. int. rate on RUS loans (5.04% - 4.41%)	0.63%
4. Annual cost to gov't	\$57,525,000
5. Total customers	11,622,000
6. Assistance per customer	\$5

Sources of information and data for Federal Assistance to Electric Utilities:

¹Cong. Research Service, "Sale of propane by rural electric cooperatives", Nov. 30, 1999.

²U.S. Dept. of Energy (DOE/EIA) 2004 data.

³U.S. Dept. of Agriculture (USDA), *2004 Statistical Report, Rural Electric Borrowers*, IP 201-1. December 2005.

Congressional Research Service (CRS), The Library of Congress, *Investor-Owned Electric Utilities versus Rural Electric Cooperatives: A Comparison of Tax and Financial Subsidies*. November 1982.

U.S. General Accounting Office (GAO), *Public Utilities: Disposition of Excess Deferred Taxes*. September 1991.

Notes:

- 1) Calculations are intended to illustrate only Federal subsidies that affect the utilities' cost of capital and the cost to the federal government of providing those subsidies.
- 2) IOU data provided by DOE reflect changes from the implementation of FASB no. 109. The analysis includes "Accumulated Deferred Investment Tax Credits", "Accumulated Deferred Income Taxes", and appropriate data included in "Other Regulatory Liabilities."

February 2006

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service compiled by the Secretary in this proceeding.

Dated at Washington, D.C., this 26th day of June, 2006.

By: /s/ Phyllis G. Kimmel

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