

**OUTLINE OF MR. TOMPKINS REMARKS AT
THE CONSUMER'S ENERGY CONFERENCE
OF 1996**

On June 28, 1996 in the Workgroup titled:

**The Costs the Market won't Bear:
the Size Source & Nature of Utility Stranded Costs
and who should pay them.**

STRANDED COSTS

1) What are they and do they exist?

Definition of "STRANDED"

2) How do you calculate their size?

3) Source, How did we get here?

SUMMARY OF MR. TOMPKINS REMARKS AT THE CONSUMER'S ENERGY CONFERENCE OF 1996

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The Costs the Market won't Bear: the Size Source & Nature of Utility Stranded Costs and who should pay them.

- 1)** As a starting point, I believe we should try to **define** a Utility's Stranded Costs by looking first at the definition of the word **stranded**.

In the "American Heritage Dictionary" (*Second College Edition*), the definition of stranded, stranding or strands is ;

"to bring into or leave in a difficult or helpless position."

Given the high price of electricity and its large variance depending upon your geographic location and when your energy decisions were made, it is understandable why customers are frustrated trying to understand utility concepts like Stranded Costs.

Utility stranded costs with current regulated monopolies or with competitive deregulated utilities, appear when customers want to reduce their purchases of electricity that are higher than the market value, i.e. "The costs the market won't bear."

Current electric rates are higher than the marginal market value for a number of reasons. The major reason is simply Supply & Demand. Partially deregulating and bringing competition to the generation of electricity through PURPA and other State & Federal rulings stimulated an industry which was able to build generation at a lower cost than utility options and in many cases much lower than some existing utility generation. For example, several technologies are currently much lower in total cost than any recently completed nuclear units.

Some utilities try to claim the opposite by considering their investments in the high fixed costs of their generation "sunk costs" which allows them to only compare the variable cost of their nuclear units with the total cost of non-utility purchases.

This is further exacerbated by the fact that a utility's profit margin is a percentage of their rate base (which is some of their investments or sunk costs).

A further imbalance in Supply & Demand resulted from overestimated load and fuel cost forecasts and underestimated effects of customer use vs price.

Some utilities want to compete, others will only compete if their terms are accepted, which due to their high costs, usually involves recovery of their high sunk costs by calling them stranded. However, other utilities like Commonwealth Edison (the largest nuclear utility) have realized these costs are truly sunk (and uneconomic) and have decided to start writing them off by a direct charge to earnings. As with most non monopoly competitive companies this strategy may get them to the lowest cost position the quickest.

Given the monopoly situation where customers and in most jurisdictions Regulators⁽¹⁾ have had little control over utilities, and the fact that it was the utility not the customer or regulator who was responsible for forecasting, planning and investment decisions. The real question is ;

Who stranded Who?

One court has ruled there are no stranded costs only uneconomic costs.

FERC's recent order in its rulemaking for open access transmission tariffs has indicated there can be stranded costs in transmission transactions and utilities should be able to recover, in certain situations, 100% of their prudent and verifiable stranded costs using the "revenue lost" methodology.

¹ While Regulators approve or disapprove utility plans it is not their responsibility to originate plans.

2) Even more difficult than the definition of utility stranded costs, is their size or how to calculate them.

Utilities are quick to say they want to compete, but then they want to use the revenue lost method to determine Utility Stranded Costs or their costs that are uneconomic today.

The problem with this methodology, which is touted as the no-loss or no-pain transition to a competitive market place, is that,

- A) It produces stranded costs so large that any short term rate reductions are unlikely, and if 100% stranded costs were granted and applied uniformly there might actually be rate increases.

and

- B) Unfortunately, no loss or no pain competition is a myth. Competition produces winners, losers, mergers, consolidations and acquisitions.

100% revenue lost, as a Stranded Cost recovery, gives the utilities all the revenue they now receive or expected to receive whether they compete well or not, and more important to the utility management, insures that all their past decisions are viewed as 100% right whether they were good management decisions or not. This methodology also gives the greatest reward to the utility with the highest uneconomic costs.

3) Source, How did we get here?

Many utilities are quick to point accusing fingers in any direction except at themselves. Some utilities accuse their customers, their non-utility suppliers, the government officials and policies, and finally the Regulators who oversee or approve and disapprove some utility decisions.

However, there is some element of truth in utility statements, which we shall examine.

A) Utilities in exchange for monopoly status, and assured profits have historically had an obligation to serve a customer even though such investments would take long periods to amortize.

For Example, If you live 20 miles away from any electrical line, and you request service they must build the facilities to supply you with power and sell to you at the same tariff rate which they sell to their other customers.

(although in recent years, in some jurisdictions, utilities have required customers to pay interconnect costs and in past years, in some regions co-op's had to be started because utilities claimed service was too uneconomical).

In this simple example, we see some real possibility of Utility Stranded Costs. If a utility, 1) built equipment which was not useful for any other customers or any other utility need, and 2) prudently and cost effectively built only the facilities necessary to supply you, and 3) did not charge the you initially, and 4) you decided not to buy after the facilities were built (for reasons other than death, bankruptcy or relocation), then that utility was "brought into or left in a difficult or helpless position" by the obligation to serve and your request for electricity and could have a stranded cost. It is critical to determine however if those costs were not used and useful to serve other customers.

Now contrast this with the case of an industrial customer leaving, shutting down or co-generating - a normal growth/loss expectation not historically "stranded". Any increased costs shouldn't be blamed on the departing customer as they historically haven't been. It is just economic reality now. Price elasticity assumptions assumed switching or reduced purchases would occur, as prices went up the variable was supposed to reduce use. If use is higher, we don't automatically lower prices.

B) Your mere existence, as the utilities' customers caused them to plan for your future needs.

This implies that, its the customers fault that some utilities over estimated the amount of capacity they needed and grossly under estimated price/use elasticity (which is a fancy term for the fact that a customers' desire to purchase and use electricity would be dependent upon its price).

In exchange for monopoly status utilities were required to maintain reserves sufficient for reliable current operation and forecasted customer needs.

As evidenced by the differing situations of utilities throughout the various regions in the United States, some did a better job at this than others.

C) Elected Government officials enacted bad public policy which regulators have enforced to increase their costs.

There are 3 major areas where some utility's accusations have been directed.

- 1) *Social policies to increase efficiency, reduce wastes through conservation and DSM, and subsidies to provide for low income customers.*
- 2) *Environmental restrictions and regulations.*
- 3) *Some utilities favorite criticism is against PURPA. Where you and I are at fault for electing the Government officials who enacted State and Federal legislation (they claim bad public policy) which our regulator's enforced to make them buy overpriced power which they now don't need or they claim they can buy at lower rates.*

It is ironic that this last accusation has the smallest shred of truth, yet is distorted the most in order to be used by many utilities in their attempt to divert attention from their own past inadequacies by falsely accusing others.

PURPA and several legislative and rulemaking proceedings since then were aimed at increasing competition and reducing monopoly provisions at least on the wholesale supply side.

As stated in FERC's recent rulemaking and order for open access transmission tariffs, there was a time when economies of scale, innovations and technical developments favored vertically integrated monopoly utilities.

Circumstances have changed the basis which the utility industry was built on in the early 1900's is not valid today. Competitive diversified or unbundled utility supply now meets customers and societies needs best.

"The Real Story About Purchased Power in Maine" (March 1994), shows that today's statements by utilities are not only false they are contradicted by the same utilities previous statements.

State and Federal regulation did require utilities to buy non-utility generation.

However, PURPA and other regulations only required purchases at or below the total cost that the utilities would otherwise have to pay.

**IT IS, AND ALWAYS WAS, THE UTILITIES RESPONSIBILITY
TO DETERMINE HOW MUCH POWER THEY NEEDED
AND THEIR COSTS AVOIDED.**

All non-utility generation, to obtain contracts, had to agree to be less than the avoided costs that the utility claimed were valid, and agree to the terms required by the utilities in their contracts. Utilities controlled the contracts in a buyers market and could have structured them for dispatchability or variances in fuel prices.

It is interesting to compare purchases of non-utility generation with the utilities similar purchases of utility sources such as Millstone #III and Seabrook 1&2 power.

One would think that a company would want to reduce its highest cost supply. However, due to the rigorous terms of joint ownership contracts between utilities, the contracting process of utility vs non-utility generation and the utility accounting procedures in a vertically integrated utility, they have every incentive to keep their "own" higher cost sources and eliminate lower cost sources.

The accusations and rhetoric are merely to avert attention from the real issue. Only by separating utilities into generation, transmission and distribution companies, where the distribution companies buy all their power on equal or the same terms, can this problem be rectified.

Interestingly, FERC currently believes Functional unbundling and requiring uniform Open Access Tariffs on all wholesale transactions will accomplish the same goal of non-discriminatory contracting which they found to currently exist.

07:04 ET DEC 22, 1995 DOW JONES INTERNATIONAL NEWS
12/21 ComEd/Analysts -2: Utility Wants Retail Wheeling By 2003

Commonwealth Edison's proposal recommends full implementation of retail wheeling by 2003. The plan includes a retail wheeling pilot program, to run in the meantime, which would give ComEd customers who expand load by 3 megawatts or more, the option of entering the market through direct access. 'We would expect to compete for expanding load of existing customers,' a ComEd spokesman said. In addition, the proposal outlines revisions of the Public Utilities Act, including repeal of least cost planning, which would mean that markets would dictate cost and supply instead of regulation. The utility's suggested revisions of existing law also would require ICC certification of non-utility electric power suppliers. Certification would be contingent on reciprocal access to transmission and distribution grid by suppliers. Commonwealth Edison's proposal backs full recovery of stranded costs, suggesting that ICC duties be redefined to include reliability of service and recovery of stranded costs. Stranded costs are investments or expenditures that become unrecoverable when customers are able to choose suppliers regardless of service territory. The big Illinois utility, however, is working to mitigate stranded costs that may develop with competition. ComEd has filed with the ICC to accelerate depreciation of its nuclear assets to \$430 million per year, up from \$400 million per year. ComEd also is continuing to cut costs through a restructuring program, which began in 1992 and included a reduction of 2,000 managers. In the months ahead, a voluntary buyout program is expected to result in a reduction of 2,500 to 3,000 positions represented by collective bargaining units, a ComEd spokesman said. Moody's Investors Service said the ratings outlook for Commonwealth Edison's debt is stable, noting that the utility is working to improve operations at its nuclear plants, including Dresden. ComEd also has reduced operating and maintenance costs, and it has been disciplined in paying down debt and keeping shareholder dividends in line, analysts said. (END) AP-DOW JONES NEWS 21-12-95 0150GMT DOW JONES INTERNATIONAL NEWS

12/21 Commonwealth Edison's Secret Weapon May Be Cost: Analysts

By REBECCA MELVIN NEW YORK (DJTES)--Commonwealth Edison, the utility operating the largest number of nuclear units in the U.S., is in fairly good shape as the countdown to competition and deregulation in the electricity industry continues, analysts say. 'The company could be a powerful cost-competitor,' said Samuel Brothwell, a utility analyst with Moody's Investors Service. The company, with 12 nuclear units at six plants in northern Illinois, has made a substantial investment in nuclear power, a key driver of costs in the electricity industry. However, 'spread over 12 units, ComEd's high fixed cost of an estimated \$10 billion is not that bad,' Brothwell said. The Moody's analyst said some utilities in Ohio, Texas and California have fixed costs for nuclear operating facilities that 'are much higher.' NatWest Securities analyst Ed Tirello said, 'Commonwealth Edison has got a lot of cheap power in an area enjoying good growth to offset capacity.' This month, Commonwealth Edison filed a proposal outlining its ideas for competition in the electric power industry with the Illinois Commerce Commission. More utilities are likely to submit such proposals to the ICC before December 1996, when a bill rewriting rules for public utilities will be drafted for introduction to the Illinois Legislature in January 1997. AP-DOW JONES NEWS 21-12-95 0148GMT FEDERAL FILINGS