DOCKET NO. 14695
PUBLIC UTILITY COMMISSION OF TEXAS

Application of
Central Power & Light Company
for Authority to Change Rates
and to Reconcile Fuel Clause

DIRECT TESTIMONY OF

SCOTT HEMPLING

FOR

OFFICE OF PUBLIC UTILITY COUNSEL

Phase IV
Competitive Issues

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I. Introduction

The Proper Regulatory Role is to Promote Effective Competition, Not to Assist a Particular Competitor

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Scott Hempling, Attorney at Law, 417 St. Lawrence Dr., Silver Spring MD, 20901.

Q. PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL QUALIFICATIONS.

A. I received a B.A. cum laude in Economics and Political Science from Yale College. I received a J.D. magna cum laude from Georgetown University Law Center. I am a member of the Bars of the District of Columbia and Maryland.

I provide legal and policy advice and representation to clients in the electric industry, including state commissions, consumer advocates, municipal power systems, independent power producers and public interest organizations. I have been a frequent witness before Congressional committees and am a regular lecturer at professional conferences and training sessions, including sessions sponsored by the National Association of Regulatory Utility Commissioners.

More detail on my professional background appears in Exhibit SH-1.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I respond to CPL Witness William D. Steinmeier's stated justifications for CPL's positions on three subjects: (1) accelerated depreciation of book cost related to South Texas Project (STP); (2) "incentive" ratemaking for CPL; and (3) the preference for a wholesale generation pool over retail services competition. I also urge the Commission to protect

CPL's ratepayers from improper use of CPL resources in Central & South West's diversified activities.

Q. IS THERE A GENERAL THEME TO YOUR TESTIMONY?

A. Yes. In describing the present period in the electric industry, Mr. Steinmeier refers to "the phenomenon of growing competition." (p.8 l.18). During such a period, it is natural to expect industry participants to maneuver for competitive success. However, most customers of CPL still are served by a monopoly provider, as they have been for decades. As long as these customers still are served by a monopoly, the "phenomenon of growing competition" is an unreliable device for establishing appropriate rates, terms and conditions. A continuing regulatory role is necessary.

Q. WHAT IS THE APPROPRIATE REGULATORY ROLE DURING SUCH A "TRANSITION"?

A. That is the question with which my testimony is largely occupied. Regulators should focus not on the competitive interests of any one participant, but on the need for neutral standards which reward efficiency and innovation and penalize inefficiency and lack of creativity.

In particular, regulators should not use the "phenomenon of growing competition" as a rationale for creating or maintaining advantages for particular competitors. From the perspective of an incumbent, "getting ready for competition" means "preparing to defend market share." For a utility with a market share near 100%, "getting ready for competition" means trying to keep the market share near 100%. It means, for an

incumbent utility, exploiting its advantages while preventing competitors from exploiting their advantages. Regulators should not assist such efforts.

Q. WOULD CPL'S PROPOSALS ENABLE THE COMPANY TO EXPLOIT ITS ADVANTAGES WHILE PREVENTING COMPETITORS FROM EXPLOITING THEIR ADVANTAGES?

A. Yes. Most of the CPL proposals defended by Mr. Steinmeier fit within this description. CPL has at least 6 present advantages which its proposals are designed to maintain:

1. Government-erected barriers to competitors, in the form of limits on the number of competitors which can serve each territory. Mr. Steinmeier supports continuation of these limits. See p.102 l.15.

2. Continued ownership of a large percentage of the generation serving its retail customers. CPL's proposal for a wholesale-only pool (Steinmeier at p.100) allows CPL to maintain this ownership, as opposed to (a) letting customers shop in the pool directly, or (b) disposing of its generation to dispersed competitors.

3. High certainty of recovery of fixed costs due to monopoly relationship to most customers. Mr. Steinmeier proposes to increase the certainty by accelerating the recovery of the STP costs, and by recovering the remaining nuclear costs by tying them to purchases of a monopoly product such as transmission or distribution.

4. Ability to discount to some customer groups while denying discounts to others. "Incentive" ratemaking, as described by Mr. Steinmeier, would appear to maintain this ability.

5. Ability to increase the profits on monopoly services without undue risk, thereby increasing the internal funds available to invest in competitive businesses. "Incentive ratemaking," advocated by Mr. Steinmeier, can have this effect under certain circumstances.

6. Ability to use assets and employees financed by ratepayers of the monopoly business to enter competitive businesses at a below-market cost, whereas the competitors have to pay a market price for similar assets and employees. CPL's parent company, CSW, is aggressively entering many markets. To the extent it is using goods and services paid for by ratepayers, it may not be compensating the ratepayers at a market price.

Q. HOW SHOULD REGULATORS RESPOND TO THESE EFFORTS?

A. On this question, Mr. Steinmeier and I differ fundamentally. In the six ways listed above, CPL has certain advantages over its competitors that flow not from its skill, but from its historical status as provider of a service largely protected from effective competition. CPL now seeks the regulator's assistance in maintaining, and even increasing, these advantages. In contrast, I urge regulators to be objective: to reject proposals which grant advantages to a particular competitor, and instead to act affirmatively to eliminate any artificial advantages.

For example, Mr. Steinmeier states (p.24 l.17-20): "As traditional revenue streams diminish or become threatened, utilities must seek new revenue streams in related but unregulated businesses in order to preserve and grow shareowner value." Assuming utilities "must" seek new revenue streams, there is no reason why regulators "must" help.

The premise that utilities "must" seek new revenue streams is mistaken as well. If regulators or legislators determine that competition in some product markets is inherently a more efficient way to serve customers than the present bundled service, then regulators or legislators would be justified in authorizing competition in those markets. This competition may increase the risks (and the rewards) of investments in those markets. Those present utility shareholders who prefer less risk will sell their stock and make other investments. Those investors (including both present utility shareholders and new investors) who prefer the new types of risks will invest in them. There is no particular imperative that the existing utility, as an entity, "must" branch out into several businesses. In any event, the utility does not need, nor is it entitled to, any special regulatory assistance in making its decisions whether to branch out.

Moreover, assuming competition is efficient, the increase in risk is not a negative event warranting regulatory concern. Under the logic of competition, the greater risk can be a positive feature. It is the risk of failure, as well as the prospect of reward, which drives competitors to reduce their costs and increase their innovation.

Q. WHAT SUBJECTS DOES YOUR TESTIMONY COVER?

A. As noted above, CPL is seeking, or relying on, regulatory assistance in several ways. My testimony covers four such ways:

Part II: Accelerated Depreciation of South Texas Project Cost is Not Consistent With the Requirements of Consumer Protection

Part III: "Incentive Ratemaking," Improperly Designed, Can Harm Captive Customers

Part IV: Creation of a Wholesale Pool Does not Justify Protecting CPL From Retail Competition

Part V: Regulators Should Ensure that as CSW and Its Affiliates Position Themselves for Competitive Markets, They Pay CPL Competitive Market Value For Use of Ratepayer-Funded Resources

II. Accelerated Depreciation of South Texas Project Costs is Not Consistent With the Requirements of Consumer Protection or Effective Competition

Q. CPL HAS PROPOSED ACCELERATED RECOVERY OF THE BOOK COSTS ASSOCIATED WITH THE SOUTH TEXAS PROJECT (STP). WHAT IS YOUR POSITION?

A. I oppose this request. The request raises two distinct questions: (1) Is CPL Entitled to Recovery of all STP Costs? (2) Assuming CPL is Entitled to Recovery, Is Accelerated Recovery Appropriate? In response to the first question, Mr. Steinmeier states that CPL is entitled to full recovery for the simple reason that the costs are on CPL's books and historically reflected in rates. In response to the second question, Mr. Steinmeier argues that given CPL's entitlement to the costs, requiring today's ratepayers to pay for them sooner than normal is appropriate.

Both positions are incorrect. My answer is set forth in the next three subparts, as follows:

Part II.A explains that CPL is not necessarily entitled to full recovery of STP costs.

Part II.B explains that full recovery of past STP costs is not necessary for the achievement of economic efficiency, as Mr. Steinmeier argues.

Part II.C explains that even if CPL were entitled to recover all STP costs, recovery on an accelerated basis can cause inter-ratepayer inequity and a mismatch of risk and reward.

A. CPL is Not Necessarily Entitled to Full Recovery of STP Costs

Q. IS CPL NECESSARILY ENTITLED TO FULL RECOVERY OF STP BOOK COSTS?

A. No. For past costs to be recoverable by the utility, two conditions should be met:

1. The costs at issue must be costs for which the legal responsibility lies with customers rather than shareholders.
2. The utility must have taken every feasible action to maximize the value of the associated investment and to provide that value to ratepayers.

CPL has met neither condition. I will discuss each in turn.

Q. PLEASE SUMMARIZE YOUR REASONING ON WHERE THE LEGAL RESPONSIBILITY FOR PAST COSTS LIES.

A. Mr. Steinmeier appears to argue that if an investment was declared prudent and placed in rates, the shareholders are entitled to full recovery. This argument is incorrect for at least three reasons:

1. The argument that the U.S. Constitution mandates full recovery of prudent costs has been rejected expressly by the U.S. Supreme Court.
2. The oft-cited "regulatory compact" does not include any legal guarantee of the recovery of prudent costs.

3. A "prudence equals recovery" rule makes ratepayers the bearers of all business risks, a position inconsistent with the traditional goals of regulation.

The amount of past costs which should be absorbed by shareholders is not necessarily zero, as CPL argues; nor should it be the excess of book over market, as others argue. The disallowable amount, I explain below, should be the difference between (a) CPL's costs and (b) the cost CPL would have incurred had it chosen the least cost option selected by a utility having similar obligations in the same time frame.

Q. PLEASE EXPLAIN YOUR STATEMENT THAT THE U.S. SUPREME COURT EXPRESSLY REJECTED THE ARGUMENT THAT FULL RECOVERY OF PRUDENT COSTS IS MANDATED BY THE U.S. CONSTITUTION.

A. In Duquesne Light Company v. Barasch, 488 U.S. 299 (1989), the U. S. Supreme Court upheld a Pennsylvania statute prohibiting recovery of investments not used and useful, even if prudent. The Court held that so long as the "end result" of the ratemaking process is a rate of return that is not so low as to be confiscatory, the specific treatment of particular components of the rate did not violate the Constitution. The Court specifically rejected the notion that if an investment is prudent, its recovery is mandated by the Constitution (id. at 315-16):

> Finally we address the suggestion of the Pennsylvania Electric Association as amicus that the prudent investment rule should be adopted as the constitutional standard. We think that the adoption of any such rule would signal a retreat from 45 years of decisional law in this area which would be as unwarranted as it would be unsettling. Hope clearly held that "the Commission was not bound to the use of any single formula or combination of formulae in determining rates." [Federal Power Commission v. Hope Natural Gas Co.,] 320 U.S. [591] at 602 [1944] ....

> ... The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors. n10 The Constitution within broad limits leaves the States free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public.
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> n10 For example, rigid requirement of the prudent investment rule would foreclose hybrid systems such as the one Pennsylvania used before the effective date of Act 335 and now uses again. See n. 4, supra. It would also foreclose a return to some form of the fair value rule just as its practical problems may be diminishing. The emergent market for wholesale electric energy could provide a readily available objective basis for determining the value of utility assets.

Not only has the U.S. Supreme Court rejected the argument that prudence requires recovery; it has suggested that ratemaking which protects shareholders from economic forces can produce a windfall:

> Without analyzing rate cases in detail, it may safely be generalized that the due process clause never has been held by this Court to require a commission to fix rates on the present value of something no one would presently want to reproduce, or on the historical valuation of a property whose history and current financial statements showed the value no longer to exist, or on an investment after it has vanished, even if once prudently made, or to maintain the credit of a concern whose securities already are impaired. The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values that have been lost by the operation of economic forces.

Market Street Ry. Co. v. Railroad Comm'n of State of California, 324 U.S. 548, 567-68 (1945) (emphasis added). Where the reason for loss of financial integrity is "operation of

economic forces" rather than government regulation, therefore, there is no Constitutional basis for recovery.

In fact, Judge Kenneth Starr has written that where utility shareholders suffer market-induced losses, a government order forcing ratepayers to cover those losses may itself may violate the Constitution:

> Requiring an investment to be prudent when made is one safeguard imposed by regulatory authorities upon the regulated business for benefit of ratepayers. As I see it, the "used and useful" rule is but another such safeguard. The prudence rule looks to the time of investment, whereas the "used and useful" rule looks toward a later time. The two principles are designed to assure that the ratepayers, whose property might otherwise of course be "taken" by regulatory authorities, will not necessarily be saddled with the results of management's defalcations or mistakes, or as a matter of simple justice, be required to pay for that which provides the ratepayers with no discernible benefit. n1
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> The two principles thus provide assurances that ill-guided management or management that simply proves in hindsight to have been wrong will not automatically be bailed out from conditions which government did not force upon it. That is, government forced upon the utility an obligation to provide service, but that obligation, as we have seen, is the quid pro quo for a protected area of service (and eminent domain authority). What is fundamental is that government did not force upon the utility a specific course of action for achieving the mandated goal.
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> Indeed, it would be curious if the Constitution protected utility investors entirely from business dangers experienced daily in the free market, the danger that managers will prove to have been overly sanguine about business prospects or the danger that a particular capital investment will not prove successful. In the face of anticipated demand, an airline may acquire additional aircraft, only to face unhappy consequences when passenger traffic does not meet expectations, perhaps due to economic factors entirely beyond management's control. Utilities are not exempt from comparable forces. n2 As the cases have repeatedly held, the Fifth Amendment does not provide utility investors with a haven from the operation of market forces. See, e.g., FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 590, 86 L. Ed. 1037, 62 S. Ct. 736 (1942) ("Regulation does not insure that the business shall produce net revenues.").

Yet, the prudent investment rule, in full vigor, would accomplish virtually that state of insulation, all in the guise of preventing government from effecting a taking without just compensation.

For me, the prudent investment rule is, taken alone, too weighted for constitutional analysis in favor of the utility. It lacks balance. But so too, the "used and useful" rule, taken alone, is skewed heavily in favor of ratepayers. n3 It also lacks balance. In the modern setting, neither regime, mechanically applied with full rigor, will likely achieve justice among the competing interests of investor and ratepayers so as to avoid confiscation of the utility's property or a taking of the property of ratepayers through unjustifiably exorbitant rates. Each approach, however, provides important insights about the ultimate object of the regulatory process, which is to achieve a just result in rate regulation.

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n1 The obvious danger in not examining both ends of the continuum -- both the prudence of the investment and whether the end result of the investment was used and useful -- is to build in pressures for building excess generating capacity. The "used and useful" rule operates as a restraining principle, reminding utility managers that they must assume the risk of economic forces working against an investment which is prudent at the time it is made.

n2 The comparison is, of course, imperfect since the airline will enjoy the full fruits of financial success if its acquisition program succeeds. A utility's rate of return, in contrast, is limited by regulation. On the other hand, the airline is not provided with the protection of a regulatory body's interest in preserving the financial soundness of the enterprise.

n3 I recognize that venerable authority supports firm adherence to "used and useful" precepts. In Denver Union Stock Yard Co. v. United States, 304 U.S. 470, 82 L. Ed. 1469, 58 S. Ct. 990 (1938), for example, the Supreme Court (in an opinion joined by Justice Brandeis, the leading proponent of the prudent investment approach) embraced the "used and useful" rule in the following language:

> The rate base. As of right safeguarded by the due process clause of the Fifth Amendment, appellant is entitled to rates, not per se excessive and extortionate, sufficient to yield a reasonable rate of return upon the value of property used, at the time it is being used, to render the services....But it is not entitled to have included any property not used and useful for that purpose....

> Id. at 475 (citations omitted) (emphasis added). But it seems to me that this language was not meant to state an absolute and unchanging constitutional rule regardless of the nature of the investment and the impact of the rate order. The Court's subsequent teaching in Hope makes it clear that no specific methodology is either inherently infirm or sacrosanct.

Jersey Central Power & Light v. FERC, 810 F.2d 1168, 1190-91 (D.C. Cir. 1986) (Starr, J. concurring) (emphasis added).

The absence of a Constitutional rule mandating recovery of prudent cost does not authorize arbitrariness. As the Duquesne Court stated, 488 U.S. at 619 (emphasis added):

> The risks a utility faces are in large part defined by the rate methodology because utilities are virtually always public monopolies dealing in an essential service, and so relatively immune to the usual market risks. Consequently, a State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions. But the instant case does not present this question. At all relevant times, Pennsylvania's rate system has been predominantly but not entirely based on historical cost and it has not been shown that the rate orders as modified by Act 335 fail to give a reasonable rate of return on equity given the risks under such a regime.

Q. PLEASE EXPLAIN YOUR POSITION THAT THE OFT-CITED "REGULATORY COMPACT" DOES NOT INCLUDE A LEGAL GUARANTEE OF RECOVERY OF PRUDENT COSTS.

A. Mr. Steinmeier cites "the regulatory compact" in response to the question "What reasons do you believe exist as a matter of law for stranded cost recovery?" (pp. 66-67, emphasis added). None of the three cases cited by Mr. Steinmeier -- Hope, Bluefield or Barasch -- describes a "regulatory compact" resembling that which Mr. Steinmeier describes (if the investment is prudent, it is entitled to recovery). Barasch, as noted above, explicitly upheld a disallowance of prudent costs. Mr. Steinmeier's concept of "regulatory

compact" -- if prudent, then recoverable -- has no basis in constitutional law. In fact, nowhere does Mr. Steinmeier define the specific "regulatory bargain that was in place when STP was planned, built and placed in service" (p. 104 l.1-2).

Mr. Steinmeier (p.71) also cites the Federal Energy Regulatory Commission's (FERC) finding that wholesale stranded costs should be recovered. However, this finding is confined to costs incurred to provide service to wholesale customers. It also focuses on the FERC's interpretation of the Federal Power Act rather than constitutional law.

Q. PLEASE EXPLAIN YOUR POSITION THAT MAKING RATEPAYERS THE GUARANTORS AGAINST BUSINESS RISK IS INCONSISTENT WITH TRADITIONAL GOALS OF REGULATION.

A. A rule of "if prudent then recoverable" makes ratepayers the guarantors of business success. That is, if Utility A and Utility B make prudent but different investments at the same time under similar conditions, but Utility A's investment turns out to cost 20% more than Utility B's investment, then Utility A's ratepayers must bear the 20% difference under Mr. Steinmeier's approach.

This treatment incorrectly separates decisional responsibility from decisional risk. Management makes the decision but ratepayers bear the risk. By insulating management from risk, this treatment leads to inefficiency. In traditional regulation, state regulatory commissions leave the running of the business to the company. The regulator does not prescribe the choice. But if the regulator allows the utility to make the choice, it cannot force customers to bear the consequences of that choice. To repeat Judge Starr's words:

> The two principles [i.e., the prudent investment rule and the used and useful rule] thus provide assurances that ill-guided management or management that simply proves in hindsight to have been wrong

> will not automatically be bailed out from conditions which government did not force upon it. That is, government forced upon the utility an obligation to provide service, but that obligation, as we have seen, is the quid pro quo for a protected area of service (and eminent domain authority). What is fundamental is that government did not force upon the utility a specific course of action for achieving the mandated goal.
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> Indeed, it would be curious if the Constitution protected utility investors entirely from business dangers experienced daily in the free market, the danger that managers will prove to have been overly sanguine about business prospects or the danger that a particular capital investment will not prove successful.

Jersey Central Power & Light, 810 F.2d at 1190-91 (Starr, J. concurring).

Q. PLEASE EXPLAIN YOUR POSITION ON THE PROPER STANDARD FOR DETERMINING THE RECOVERABLE AMOUNT OF PAST COSTS.

A. The proper standard for assigning the utility responsibility for prudent but uneconomic investments involves two distinct questions:

a. Why is it appropriate for shareholders to bear the risk that a prudent decision will be uneconomic?

b. Where the shareholders bear the risk that a prudent decision will be uneconomic, what is the appropriate measurement of the disallowable amount?

I address each in turn.

Q. WHY MIGHT IT BE APPROPRIATE FOR SHAREHOLDERS TO BEAR THE RISK THAT A PRUDENT DECISION WILL BE UNECONOMIC?

A. Whether shareholders should bear the risk that a prudent decision will turn out to be uneconomic depends in turn on two other questions: (a) What was the utility's obligation? (b) What discretion did the utility have to meet that obligation?

What was the utility's obligation? The utility's obligation was to meet its load, not to build a particular plant. Only rarely does law or regulation direct a utility to take a specified action. (An example would be where state regulators directed the utility to enter into particular terms pursuant to a contract under the Public Utility Regulatory Policies Act.)

What discretion did the utility have? Since the utility was not obligated to build a particular plant, the utility had discretion to select the manner in which it could meet load. That discretion can be limited by factors like federal prohibitions on certain fuel types, or state and local zoning restrictions. But within these boundaries the utility has a set of options. In most cases, the choice is the utility's to make.

In the exercise of this discretion, the utility takes a risk. As with any business decision, there can be more than one prudent choice; but some choices will turn out better than others. The question then is: Who should bear the difference between the prudent cost and the option which turned out to be the lowest cost?

In competition, the difference is borne by the higher cost competitor, not by the customer. To remain competitive, the competitor must drop its price to the level charged by the competitor whose decision produced a lower cost result. The purpose of regulation is to place pressures on utilities similar to what they would face in a competitive market. See, e.g., PURA sec. 1.002 (regulation of public utilities "shall operate as a substitute for competition"). Regulation, therefore, should require the utility to absorb the difference between its cost (even if prudent) and the cost of the more successful alternative. In this manner, regulation truly "operates as a substitute for competition."

Assigning management the risk of decisions which are prudent, but which turn out to be uneconomic relative to alternatives available to the utility at the time of its decision, is supported by common sense. The implication of Mr. Steinmeier's position is that because the utility was protected from competition, it should be protected from the risk of uneconomic results. There is no basis for this assumption. The purpose of protecting the utility from competition is to prevent excess costs associated with uneconomic redundancy; not to protect management from risk. The purpose of regulation is to elicit a result from management comparable to what would happen if management were subject to competition. In competitive markets even prudent decisions do not always turn out well. That risk induces care.

The common sense justification for assigning to shareholders the risk that prudent investments will not turn out well makes for a strong argument that shareholders already have been compensated for this risk. If the purpose of regulation is to emulate the results of competition, one reasonably could assume that regulators would have assigned this risk to the shareholders, and compensated them appropriately. If this assignment and compensation did occur, then to protect shareholders from this risk after the fact would be a windfall of the "heads I win, tails you lose" variety.

Whether Texas regulators did in fact assign CPL this risk and authorize compensation for it requires an analysis of Texas Public Utility Commission decisions. I am aware that there is a debate on this factual question in Texas and do not take a position on it.

Q. WHERE THE SHAREHOLDERS BEAR THE RISK THAT A PRUDENT DECISION WILL BE UNECONOMIC, WHAT IS THE APPROPRIATE MEASUREMENT OF THE DISALLOWABLE AMOUNT?

A. A disallowance must be based on a comparison between the cost incurred by the utility at issue, and some other measure. Where the rule requires disallowance of amounts which are "prudent but uneconomic," the relevant comparison must be to those utilities who had similar obligations, and similar opportunities, in the same time frame that the utility at issue made its investment. CPL made an investment in STP. If CPL had alternatives to STP, and other utilities with similar obligations, making decisions in the same time frame, chose those alternatives and came out with lower costs, CPL should bear the difference.

The disallowable amount, therefore, should be the excess of (a) CPL's book costs over (b) the cost CPL would have incurred had it chosen the least cost option selected by a utility having similar obligations in the same time frame. To be accurate, the analysis cannot look at cost differences at a snapshot in time. For example, it may be that in 1996, a utility which chose a coal plant over a nuclear plant nuclear in the late 1970s might now have plant costs 30% lower than a utility which chose nuclear. But that difference could increase or decrease by the end of the plants' lives, depending on such factors as environmental regulation and decommissioning costs. Therefore the analysis cannot be complete until the plant life is over. A similar challenge exists for those who define stranded investment as the excess of book over market; there is a need to wait until the end of the plant's life to determine its final market value, or, alternatively, to estimate the future value today or track the value each year, truing up that value; relative to previous estimates.

Some analysts argue that the disallowable amount should instead be the excess of (a) the utility's book costs over (b) the lowest-priced power source available on the market today. This is the figure which many call "strandable investment": the portion of book costs whose prospective recovery is rendered uncertain by competition. However, this figure is not an appropriate measure of what the utility should absorb, because the second element -- the benchmark against which the utility is to be judged -- could be a price level established by an entity which did not have the first utility's historic obligation to meet load.

Consequently, utilities' frequent defense against disallowance -- "we didn't see competition coming" -- is not a defense against my approach. Mr. Steinmeier, for example, argues (p.41 l.1) that

> [n]ew supply options made available by reason of the statutory and regulatory changes outlined above expose utilities to risks with respect to recovery of these investments and regulatory assets that were never envisioned by regulators or utilities when these costs were incurred.

I reiterate that the risk which likely was undertaken by shareholders is different from the one Mr. Steinmeier argues was not assigned to shareholders. This risk I am referring to is not the risk of CPL ratepayers substituting "new supply options" for STP. I am referring instead to the risk that other utilities having similar obligations and making supply decisions in the same time as CPL chose options that turned out to be lower cost than STP, and that regulators would hold CPL responsible for the excess. In the words of Market St. Railway, supra, this risk is not a risk of "governmental destruction of existing economic values."

Similarly, Mr. Steinmeier cites the authors Tye and Kolbe for the proposition that regulators could not have compensated utility investors for the risk of stranded investment. See p.61 l.16 (citing L. Kolbe and W. Tye, "The Cost of Capital Does not Compensate for Stranded-Cost Risk," Public Utilities Fortnightly (May 15, 1995)). My understanding is that these authors address the risk of underrecovery due to retail customers leaving the utility's investment behind and buying from a new seller; that is, the risk of not recovering the difference between book cost and the present market price, which could reflect the costs of sellers that did not have to incur costs historically to fulfill an obligation to serve all load. The risk I have referred to is different.

Q. WHAT ABOUT THE ARGUMENTS THAT CPL HAD NO CHOICE BUT TO BUILD STP?

A. I have seen no evidence supporting that argument in this case. Among his arguments for accelerated recovery of STP costs, Mr. Steinmeier states that "federal discouragement of building new gas or coal-fired power plants and federal promotion of nuclear power plants led utilities and Commissions to conclude that nuclear capacity was the best available option." P.43 l.12-16. As an argument for insulating CPL against risk, this statement has several problems.

First, the statement is too general to be used in CPL's defense. In determining the appropriateness of accelerated, guaranteed recovery of STP, the question is not what "utilities and Commissions" were led to do, but what options CPL had and how successful CPL was in selecting among them.

Second, the reference to "federal promotion of nuclear plants" is too vague to explain CPL's voluntary decision to build with STP. The federal government promotes many things, but not every such promotion "led" CPL to take action. The federal government promoted conservation and renewable energy, but that promotion never "led" CPL to invest in those areas on the scale of its investment in STP.

Third, the "federal promotion" argument is inconsistent with the facts surrounding STP. I am informed by counsel that most of STP costs were incurred after the 1979 accident at Three Mile Island. No one would describe the federal policy on nuclear power after Three Mile Island as "promotion."

Fourth, Mr. Steinmeier fails to specify the "discouragement" of gas and coal and how this "discouragement" applied to CPL specifically. Environmental laws did make coal-fired power more expensive, but utilities still built coal plants instead of nuclear plants.

In summary, to say that this "encouragement" and "discouragement" "led" CPL to build STP leaves too much unexplained. No one ordered CPL to build STP. Whatever the "encouragements" and "discouragements" were, they applied to all utilities; yet not all utilities have an STP to show for it. The relevant question is not whether CPL faced constraints, but how well CPL responded to those constraints relative to other utilities with similar obligations. These constraints define the boundaries within which CPL could exercise its managerial discretion; they do not insulate CPL from the risk of exercising that discretion.

Q. PLEASE EXPLAIN WHY RECOVERY OF PAST COSTS SHOULD BE CONTINGENT ON THE UTILITY DEMONSTRATING THAT IT TOOK EVERY FEASIBLE ACTION TO MAXIMIZE THE VALUE OF THE ASSOCIATED INVESTMENT FOR RATEPAYERS.

A. For recovery of stranded costs to be justified, the utility must show that the costs are truly unrecoverable. This showing requires a subsidiary showing that the utility has taken every lawful action possible to exploit the value of the associated investment. This obligation is the proper meaning of the obligation to "mitigate stranded investment."

In the context of an identified plant like STP, a showing of "mitigation" should include at least the following two steps:

1. Attempts to sell capacity and energy on the market at the highest lawful price.
2. Attempts to sell the plant, or the right to operate the plant, to the entity willing to pay the most for it.

This second point deserves more attention. The ability to manage and market the output of a plant takes skill. The entity with the greatest skill will be willing to pay the most for the chance to operate or own the plant. The utility's obligation to maximize the value of the asset, therefore, must include a search for the entity willing to pay the most for the chance to operate or own the plant.

An argument for this approach appears in R. Sant and R. Naill, "Let's Make Electricity Generation Competitive," The Electricity Journal 49-50 (Oct. 1994). The authors argue that savings from "lowering the cost of capital, fuel costs, increasing plant

availability or lowering non-fuel O&M costs" are available if a competition for the right to own and operate could take place.

CPL has made neither of these showings. Therefore its bid to recover STP costs on an accelerated basis should be denied.

In closing on this topic of mitigation, I would note that there has arisen a distinct usage of the term "mitigation" which departs its proper definition. Specifically, Mr. Steinmeier uses the phrase "mitigation of costs" to refer to proposals to make ratepayers bear the costs. Thus he describes "accelerated depreciation" as a form of "mitigation." See p. 41 l.13-14. To use the phrase "mitigate" this way is to void the term of its normal meaning. To mitigate must mean to reduce the cost impact as a whole, not shift the cost to someone else. Under Mr. Steinmeier's usage of "mitigation," one would claim credit for mitigating the nation's waste problem each time the garbage truck hauled one's trash away.

B. Guaranteed Recovery, Before Competition Begins, is Not Necessary for Economic Efficiency

Q. DOES ECONOMIC EFFICIENCY REQUIRE THAT PAST COSTS BE RECOVERED BEFORE COMPETITION BEGINS?

A. No. Economic efficiency, in the static sense, requires only that the utility be permitted to lower its price to marginal cost to prevent uneconomic bypass. Assuming a properly constructed rule allowing the utility to discount rates to prevent uneconomic bypass, a transaction which results in stranded investment is a transaction which creates net benefits (because, assuming both sellers were free to reduce their price to marginal cost, the customer would be switching suppliers because the new supplier had a lower marginal

cost). If the alternative seller's marginal cost is lower than the utility's marginal cost, the transaction should be encouraged, not discouraged on grounds of "stranded investment."

This error is capsulized in Mr. Steinmeier's statement (p.54 l.16-20) that state commissions "can mitigate the problem of potential stranded costs by postponing the availability of retail direct access until the problem of potential stranded costs has been satisfactorily resolved." This view is incorrect. Stranded investment is a problem that must be resolved. But it should not be interposed as a reason not to allow economic bypass, since economic bypass produces a net economic gain.

Insistence on holding back competition until past costs are recovered can produce real stranding: the stranding of prospective cost savings, where the alternative supplier's price is lower than the utility's marginal cost. If it is proven that retail competition can reduce total costs, CPL's insistence on making past cost recovery a pre-condition to retail competition would elevate the interest of one utility over the interest of all consumers (as well as those competitors whose marginal cost is lower than the utility's). Delaying efficiencies thus does not "mitigate the problem"; it creates a new problem: permanent loss of economies.

Mr. Steinmeier further argues (p.58 l.9-14) for delaying retail competition on the grounds that

> some customers will leave the utility's system and leave costs that had been incurred to meet the utility's obligation to serve them. Those costs will have to be reallocated among the utility's remaining customers in order to be recovered through the utility's rates.

This argument begs the question whether a non-bypassable charge is possible. If a non-bypassable charge is possible, then this argument fails. Nowhere does Mr. Steinmeier suggest that a nonbypassable charge is not feasible. In fact, the Baumol-Joskow-Kahn study cited by Mr. Steinmeier (see the next paragraph) describes several types of non-bypassable charges at p.44.

It is significant that the paper by Professors Baumol, Joskow and Kahn, cited by Mr. Steinmeier at p.63 l.16, nowhere argues for a delay of efficient competition until past costs are recovered. They argue that competition should be based on marginal cost rather than on a comparison of new competitors' marginal cost with incumbent utilities' regulated prices. They also argue for full recovery of the costs, through some method other than competitively-set prices. But they do not argue that competition should be delayed until the costs are recovered. [1]

C. Recovery on an Accelerated Basis Can Cause Inter-Ratepayer Inequity and a Mismatch of Risk and Reward

Q. DO YOU HAVE ANY OTHER CONCERNS WITH RESPECT TO ACCELERATED RECOVERY OF STP COSTS?

A. Yes. Even if full recovery were appropriate, acceleration of that recovery creates two unnecessary problems: inter-ratepayer inequity, and mismatch of risk and return.

[1] The authors do say, in their final sentence, that "[o]nce we agree on the proper treatment of the utility companies' potentially stranded costs we are likely to be in a much better position to have an open and constructive dialogue on these issues [i.e., market structure concerns, reform of wholesale market institutions, regulatory reform for monopoly service and alternative mechanisms for dealing with social goals] and to resolve them in ways that best serve the public interest." Id. at 51. They also state (at p.3) that the issue -- of "how best to deal with utility costs associated with past investments, purchased power commitments and deferred regulatory assets" -- "should be resolved at the outset in order to facilitate the institutional changes that will be required for comprehensive competitive reforms."

I do not view these statements as arguments for delaying competition, where competition can reduce prospective costs, until there is recovery of past costs.

Inter-ratepayer Inequity: Assume STP had 20 years left, and accelerated recovery ensures full recovery in 8 years. A customer who left Texas in the 11th year would have paid for much more of STP than he would have paid under a more typical depreciation schedule. This ratepayer would have paid for capacity but been deprived of the energy benefits, if any, associated with that capacity payment. (I use the phrase "if any" because it is possible that STP's "going forward" production costs exceed, or will exceed, the marginal cost of alternatives in the market.)

Mismatch of Prospective Risk and Return: Even assuming all prudent costs were recoverable by law (an assumption I disputed above), the Constitution, even under Mr. Steinmeier's interpretation, does not guarantee recovery; it guarantees only an opportunity to recover. Recovery is always at risk due to factors mentioned by Mr. Steinmeier (at p.46 l.13-22), such as regulatory lag, weather patterns, and determinations that the investment is "not used and useful."

Accelerated depreciation decreases the risk that these factors will prevent full recovery. The shorter the recovery period, the greater the certainty of recovery. But unless CPL has proposed a change in its authorized return on equity reflecting this lower risk, there will be a mismatch of risk and return.

Related to the problem of mismatched risk and return is the question of who has the right to the output of STP plant if CPL accelerates amortization of its costs. If CPL were proposing accelerated recovery of stranded investment, as defined by Mr. Steinmeier, the amount CPL would recover from its ratepayers would be STP's book costs, reduced by the expected market value of the plant over the remainder of its life. Mr. Steinmeier proposes

to accelerate recovery of the book costs without reducing those book costs by the market value of the plant. His proposal carries the risk, therefore, that once the plant's costs are fully recovered, CPL could sell STP output on the market and keep the proceeds. The ratepayers would have incurred the costs, and the shareholders would have kept the benefits. That mismatch is not consistent with traditional regulation. Absent a clear statement of how the value of STP, if any, will be shared with ratepayers, the concept of accelerated amortization must be rejected for this reason alone.

III. "Incentive Ratemaking," Improperly Designed, Can Harm Captive Customers

Q. DO YOU HAVE ANY VIEWS ON THE QUESTION OF "INCENTIVE RATEMAKING"?

A. Yes. Mr. Steinmeier states (p.30 l.12-15) that one effect of increased competition is "heightened interest, by utilities and regulators alike, in incentive regulation as a means of providing an effective bridge to a more competitive marketplace."

Regulators should take care that "incentive" ratemaking does not become a device for earning supra-competitive profits or precluding efficient competition. In this section I address 5 possible defects in "incentive" ratemaking, or in the reasons often advanced for "incentive" ratemaking. Those possible defects are:

A. Unclear Causal Connection Between "Incentives" and Improved Performance

B. Departure from Cost Without a Clear Standard

C. Potential to Downplay the Downside Risk in Incentive Ratemaking

D. Possible Exaggeration of Benefits from Less Frequent Rate Cases

E. Possible Exaggeration of the Benefits from the Elimination of "Contentiousness"

Based on these 5 defects, I conclude that those who argue for "incentive" ratemaking as an alternative to traditional embedded cost ratemaking sometimes misdiagnose the problem in the status quo. The status quo has two significant defects: the absence of a clear standard and the absence of readily available benchmarks. Neither is necessarily solved by "incentive" ratemaking.

Q. PLEASE DISCUSS YOUR CONCERN ABOUT THE CAUSAL CONNECTION BETWEEN "INCENTIVES" AND IMPROVED PERFORMANCE.

A. Mr. Steinmeier's generalized argument for "incentives" to improve company performance, pp. 104-108, has several troubling aspects.

First, the insistence that "incentives" are necessary for improved performance logically means that the "regulatory compact" requires a level of performance that leaves room for improvement. Implicit in Mr. Steinmeier's support for "incentives" is the view that a utility, while benefiting from government-imposed limits on competition, is authorized to "hold back," and not perform at its best, unless additional "incentives" are forthcoming.

Also implicit in Mr. Steinmeier's position is the notion that CPL's leadership tolerates less than top performance from managers and employees because the "incentive" to shareholders is not high enough.

Moreover, Mr. Steinmeier offers no empirical data indicating a causal connection between a departure from traditional cost-based regulation and increased performance in

the electric industry. Performance comes from humans: managers and employees. "Incentive" ratemaking rewards shareholders. Given this separation, between those who perform and those who receive the incentives, the necessary premise is that shareholders are not already exhorting management to do their best, and would more likely do so if the shareholders received more "incentives." Mr. Steinmeier offers no data to support this premise.

It may well be that "incentives" for employees can improve performance. If so, employee incentives, like bonuses and salary increases, should be treated as operating costs and subjected to normal regulatory scrutiny: that is, included in rates if they are the least cost means of obtaining the associated benefits. For example, the revenue requirement includes a line item for the CEO's salary. It usually is a very high figure. The traditional justification for the high figure is the need to attract talented and dedicated individuals and to give them an "incentive" to stay on the job. Mr. Steinmeier does not suggest that ratepayers are paying too little for CPL's CEO, and he is not saying that the CEO is dedicated to something less than top performance. It is not clear, therefore, how the "incentives" will lead to better performance.

Mr. Steinmeier does say that traditional regulation leads to overemphasis on capital additions because it rewards increases to rate base and that "incentive" ratemaking can solve this problem. Certainly reducing the link between capital additions and profit makes sense, if capital additions are not consistent with economic efficiency. But that is the task of prudence disallowances. It is also the task of management, which should be focusing on minimizing cost to ratepayers, regardless of the effect on profit. Implicit in

Mr. Steinmeier's statement is that CPL's leadership would put its profit interest before the consumer interest. If he disputes this implication, then his argument for "incentives" weakens.

There also is a contradiction in Mr. Steinmeier's view of CPL's past investments. When arguing for stranded cost recovery, Mr. Steinmeier says that the capital additions were necessary management decisions. When arguing for "incentives," Mr. Steinmeier says that present regulation induces unnecessary capital additions. CPL cannot have it both ways.

Q. PLEASE DISCUSS YOUR CONCERN THAT "INCENTIVE" RATEMAKING DEPARTS FROM COST WITHOUT A CLEAR STANDARD.

A. It appears that under Mr. Steinmeier's approach to "incentives," prices might not be limited to cost (including a reasonable return). But the rates still must be disciplined by some standard. If not cost, then what?

Under competition, rates are detached from cost "officially," to the extent that there is no regulator setting the rate based on cost. But competition, if effective, drives the rates toward cost, thereby protecting the consumer. The incentive ratemaking described by Mr. Steinmeier detaches rates from cost, but does not attach rates to a disciplined process like competition. What then, is the standard he would use to determine if rates are correct? Average performance? Excellence or mediocrity?

In a market with stiff competition, such as the market for new neurosurgeons, the standard is likely to be brilliance. The merely talented, the merely above-average, the merely hardworking, need not apply. Nor need anyone demand an "incentive" as a

"bridge to competition." What standard should apply to utility managers. Mr. Steinmeier does not say.

Absent a standard, there is no accountability; no basis exists for judging the result. Under competition, accountability comes from market forces. Those who perform at too high a cost lose. Under traditional regulation, accountability comes from auditors. Rates are based on cost, and the auditors determine the prudent, reasonable, and necessary cost. Under Mr. Steinmeier's concept of "incentive" rates, there is no clear source of accountability.

Q. PLEASE DISCUSS YOUR CONCERN THAT "INCENTIVE" RATEMAKING MAY CONTAIN INSUFFICIENT DOWNSIDE RISK.

A. In a competitive market, failure can mean loss of customers to other suppliers. To avoid that risk, the seller has to perform so well that the customers prefer that seller to all feasible alternatives.

Under Mr. Steinmeier's approach to "incentive" ratemaking, loss of customers is not a likely option. Mr. Steinmeier opposes retail competition, and wants government to continue to assist in limiting it. If there is little possibility of retail competition, then loss of customers is not much of a threat. Consequently, a major incentive for cost reduction and innovation is missing.

Other than a loss of customers, which is not likely given a legal limit on alternative sellers, the only remaining penalty for subpar performance would be financial penalty. But CPL is likely to insist on limits to this penalty also. In the area of stranded cost, Mr. Steinmeier (p.33 l.17) argues that failure to authorize full recovery could lead to financial

weakening and adverse effects on reliability. CPL likely would make the same argument when asked to bear risks associated with "incentive" ratemaking.

Thus Mr. Steinmeier's proposal for incentive ratemaking could end up being asymmetrical: extra profits if performance is above the standard (assuming some standard is defined), but no loss of customers, and no significant financial penalty if performance falls below that standard.

Q. PLEASE DISCUSS THE POSSIBLE EXAGGERATION OF BENEFITS FROM LESS FREQUENT RATE CASES.

A. Mr. Steinmeier (at p.105 l.3-11) criticizes traditional ratemaking because shareholders have to give up the gains from cost reductions at the next rate case. The implication is that management will have more incentive to create savings if shareholders can retain those savings longer.

Mr. Steinmeier argues (p.107 l.6-7) that "incentive regulation can more closely simulate competitive market incentives." A longer time between adjustments to the revenue requirement does not necessarily make regulation more like competition. In a competitive market, the seller's gains from cost reductions should last only until competitors can mimic those reductions. The original seller then will have to respond by reducing his prices. If the seller wants a new gain the seller will have to find a new cost reduction.

The time lag associated with this process may be long or short. It depends. If the innovator obtains a patent, the time lag can be 17 years. In the computer business, price

reductions seem to occur much more frequently; sometimes several times a year and certainly more frequently than the typical rate case cycle.

In summary, a competitive market offers no guaranteed time lags between pricing changes. "Incentive" regulation does not need to either.

Q. PLEASE DISCUSS THE POSSIBLE EXAGGERATION OF THE BENEFITS FROM THE ELIMINATION OF "CONTENTIOUSNESS".

A. Mr. Steinmeier asserts a desire to reduce contentiousness and argues that incentive ratemaking can meet this objective. P.116 l.10-11. I believe this passage again incorrectly misdiagnoses the problem and therefore offers the wrong solution.

Mr. Steinmeier identifies contentiousness as a problem and offers a solution designed to eliminate it: reduction in the magnitude and frequency of scrutiny. I suggest that contentiousness is not the problem; it is part of the solution.

Electric service has major impacts on many values: income distribution, environment, today's consumers, tomorrow's consumers, shareholders, bondholders, employees. There is no way to determine the price and quality of service to the varying electricity needs of the vast population of Texas without contentiousness. The question is: what is the most productive way to channel this inherent contentiousness?

Under regulation, the contentiousness is between shareholders, customers and regulators. The contentiousness usually takes the form of post hoc arguments over expensive sunk decisions.

The goal should be not to eliminate contentiousness, but to channel it productively. Under regulation, the contentiousness is among shareholders, customers and government

regulators arguing over past actions. Under competition, the contentiousness is among sellers vying for future sales.

Under competition, the contentiousness itself has a value because it drives cost reductions and product innovation. Competitive contentiousness increases accountability. Mr. Steinmeier, in contrast, aims at "reducing contentiousness" by reducing accountability. He is heading in the wrong direction.

Q. PLEASE DISCUSS YOUR CONCLUSION THAT SUPPORTERS OF "INCENTIVE" RATEMAKING MAY BE MISDIAGNOSING THE PROBLEM.

A. Mr. Steinmeier offers the incentive rates as a solution to the problem presented by conventional ratemaking. I believe Mr. Steinmeier misdiagnoses the problem.

The problem with conventional ratemaking is not that rates are based on costs, or that a company that achieves savings must pass them on to ratepayers. Both these features exist in competitive markets. There are at least three other problems: (a) absence of a clear benchmark, (b) absence of dynamic pressures, and © asymmetry of information. The absence of clear benchmark and of dynamic pressures were discussed above.

A third problem in traditional ratemaking is the asymmetrical access to information. This fact allows the utility to defend its case more readily than opponents can critique it. Again, Mr. Steinmeier's proposal for "incentive" ratemaking does not address this problem.

Unless "incentive" ratemaking addresses these three problems in present ratemaking, it is likely to fail in its stated objective of making consumers better off.

It is possible to design incentive ratemaking with some accountability. But the more accountability, the more it resembles either conventional cost-based ratemaking or a real market. Consider these two examples:

1. Under the typical "incentive" ratemaking proposal, one begins with the utility's historic costs. Then annual adjustments are made: upward based on expectations of future inflation; and downward based on expectations of future productivity. The proposal might provide that certain costs will be flowed through automatically (e.g., fuel costs). After a few years the numbers and formulae are revisited and possibly updated.

   This design is not necessarily very different from a typical cost-based revenue requirement, except that there is a longer time between rate cases and certain costs are targeted for special treatment.

2. A second type of incentive ratemaking would set a price cap based on some index of external factors, such as prices of other utilities, with similar annual adjustments, upward for inflation and downward for productivity.

The problem with both approaches is the loss of dynamic pressure. True competition is interactive and dynamic. A move by Competitor X stimulates a move by Competitor Y, which causes a move by Competitor Z, which in turn may cause a new move by Competitor X. There is constant pressure to lower costs and increase innovation. Under forms of monopoly ratemaking, including incentive ratemaking, this dynamism does not exist. The utility is playing against itself; or, at most, against an external standard that

does not move, except in the predictable directions established at the outset. There is no "competitive threat," no "fear of losing market share"; there is only a target to beat.

In short, rates are either based on administratively determined levels, or they are based on market prices. Either way, there is a need for a standard, for dynamic pressures, and for symmetry of information. Mr. Steinmeier provides for none of these.

IV. Creation of a Wholesale Pool Does not Justify Protecting CPL From Retail Competition

Q. DO YOU BELIEVE THAT A WHOLESALE POOL IS AN ADEQUATE SUBSTITUTE FOR RETAIL COMPETITION?

A. Not necessarily. If retail competition is efficient (a proposition which still must be proven for various services), its efficiencies are not duplicated by efficiencies which can be gained from wholesale generation competition. Therefore it is incorrect to oppose retail competition on the grounds that a wholesale pool is a substitute.

Q. PLEASE EXPLAIN.

A. Mr. Steinmeier opposes retail competition for CPL. Among other reasons, he argues (p.103 l.2-9) that

> CPL's market structure [wholesale non-nuclear generation competition through a pool] would capture the benefits of supply competition for all while mitigating [sic] the risk of stranded costs. Retail wheeling is not necessary for the realization of those generating market efficiencies....

The "wholesale instead of retail" argument is incorrect because the products available at wholesale are not the same as the products potentially available at retail. When one refers to the "wholesale market," one normally means generation products: bulk power, such as

blocks of capacity; the commodity electrons; and various combinations of capacity and energy known as "coordination services."

Retail services are very different. Under retail competition, residential customers theoretically might shop for such features as rate design, financial arrangements (e.g., a fixed rate for 5 years vs. a rate which varies with an index), various mixes of DSM and generation, choices of fuel mix, packaging of electricity products with telecommunications products, the packaging of electric service with services such as appliance purchases and repair, warranties, and possibly even home purchases where the home and appliances and certain guarantees of rate stability were offered in one package. [2]

[2] For example, in describing the market stimulated by New Hampshire's retail competition pilot program, Electric Utility Week reported:

> Public Service of New Hampshire, which is participating as a seller through a new affiliate, PSNH Energy, is offering customers a $ 25 sign-up bonus check. Customers are told to cash the check and send in a card to sign up for power for 3.3 cents/kWh.
>
> Northeast Utilities Wholesale Power, like PSNH an affiliate of Northeast Utilities, is offering customers a deal in which they pay a $ 10.75/month base fee and receive the first 600 kWh of energy for 1 cent/kWh. Supplies above that are 2.9 cents/kWh.
>
> A third NU spin-off, Northfield Mountain Energy, is offering customers who sign up a package of light bulbs, door mats and energy-efficient shower heads that it says will allow savings of up to $ 400 over several years.
>
> Green Mountain Energy Partners, a collaboration of Green Mountain Power and Hydro-Quebec, is offering customers up to $ 20 in ''Ecocredits'' off future bills and is promising further credits for those who carry out conservation measures. GMEP also will use a large hot air balloon to advertise its message across the state.
>
> Central Vermont Public Service, which has a small franchise territory in New Hampshire, has relied on speed and flexible price offerings to sign up customers statewide. CVPS' tactic included getting offers to customers within 24 hours of the official release of customer lists on May 1.
>
> ...
>
> Freedom Energy, a New Hampshire-based marketer, has teamed up with

The "wholesale" market does not supply these products or packages. No one does, except the local utility monopoly, which offers generally the same product, with little variation, to all residential customers. It is a reasonable possibility that given the diversity of needs and tastes of Texas' residential consumers, provision of services by many companies is more likely to stimulate and satisfy those tastes than the monopoly provision of those services.

Xenergy, an energy services provider based in Burlington, Mass., to offer customers both energy and conservation services. Xenergy's parent, New York State Electric & Gas, will provide low-cost power for sale in the pilot."

"In New Hampshire, Marketers Rushing to Sign Wheeling Pilot Participants" Electric Utility Week (May 13, 1996).

Wholesale generation competition, therefore, is not a substitute for retail services competition. A wholesale generation pool would supply customer's demand for generation. But that demand for generation should be the result of efficient retail customer decisions. Retail customer decisions are unlikely to be efficient if they have only one product to choose from: the product offered by the local utility. If a retail customer can choose among an efficiently provided array of retail services options, he is more likely to select that mix of generation and nongeneration services which minimizes total cost. The "wholesale instead of retail" argument misses this point.

Of course, it is possible that retail competition is inefficient because the provision of the traditional bundle of electric services is a natural monopoly. This issue still needs to be explored.

V. Regulators Should Ensure that as CSW and Its Affiliates Position Themselves for Competitive Markets, They Pay CPL Competitive Market Value For Use of Ratepayer-Funded Resources

Q. IS CSW ENGAGED IN ACTIVITIES IN ADDITION TO PROVIDING RETAIL ELECTRIC SERVICE TO ITS OPERATING COMPANIES' HISTORIC RATEPAYERS?

A. Yes. While seeking a competitive advantage for itself through accelerated depreciation of the South Texas Nuclear Project, and while enlisting the regulator in efforts to keep competitors out of its retail market, CPL is seeking entry into other markets. See Steinmeier Testimony at p.24 l.18 ("utilities must seek new revenue streams in related unregulated businesses in order to preserve and grow shareowner value").

This interest in other markets is not an idle one. As of December 31, 1992, for example, CSW was ranked third among diversified electric utilities in terms of non-utility revenues, with $499 million in such revenues. [3] In April 1996, Central & South West sought approval for raising the limits on the amount of its investments in FUCOs and EWGs from 50% to 100% of its consolidated retained earnings. CSW's application noted that it contemplates additional investments in FUCOs and EWGs totaling approximately $1.215 billion. [4] Additional examples of CSW's numerous investments in other markets are summarized in Exhibit SH-2.

Q. ARE THERE RISKS TO RATEPAYERS ASSOCIATED WITH THESE ACTIVITIES?

A. Yes. In these efforts, it is possible that CSW or CPL will make use of utility resources whose cost has been recovered from ratepayers who were legally bound to pay for them due to the government-imposed limits on competition. It would be inconsistent with effective competition, and unfair to those ratepayers, to allow CPL to exploit those resources without fully compensating ratepayers for this use. Failure to require full compensation can create a mismatch of risk and reward, and can distort competition in the unregulated market. Full compensation, as discussed below, means the market price for the resource.

Q. WHY SHOULD AN AFFILIATE COMPENSATE THE UTILITY FOR USE OF RATEPAYER-FUNDED RESOURCES AT A MARKET PRICE?

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[3] "Squeezed Utilities Shop Here and Abroad for Core-Related Business," Electrical World, Nov. 1994, p. 58.

[4] SEC Release No. 35-26503, April 12, 1996.

A. The requirement of market price is founded on the utility's obligation to minimize ratepayer cost. The converse of cost minimization is revenue maximization. A utility with surplus capacity has a duty to obtain maximum value for it. I discussed this concept previously, in the context of the duty to "mitigate stranded costs."

No one disputes that the affiliate should not get free use of utility goods and services. The question is: "At what price?" The rate treatment of the utility should be to assess the highest price consistent with fair treatment to the nonutility affiliate and consistent with commercial reality. The commercial reality is that but for the utility, the nonutility affiliate would have to buy the goods and services at fair market value. Pricing the interaffiliate transaction at fair market value leaves the nonutility affiliate no worse off, and it minimizes required charges to utility ratepayers by maximizing utility revenues.

It appears that CSW already is violating this pricing principle. In September 1995, the SEC approved CSW's formation of EnerShop, Inc. EnerShop will provide energy and demand-side management services to commercial and industrial customers. EnerShop is involved in consulting and energy analysis, project management, design and construction, energy efficient equipment installation and maintenance, equipment financing and leasing, facilities management services, environmental services and compliance and fuel procurement. In approving the formation of EnerShop, the SEC stated:

> In addition, EnerShop may request CSW Services, Inc. and the electric utility company subsidiaries of CSW to provide personnel and other resources to consult and assist in accounting, procurement, marketing, engineering and other required functions in connection with EnerShop's business activities. CSW states that all transactions between EnerShop and any other CSW system company will be <u>at cost</u>, in compliance with section 13 of the Act and the related rules. In addition to being reimbursed

> for their costs of providing services to EnerShop, the operating subsidiaries of CSW that provide successful referrals of customers to EnerShop may be paid a commission of up to 1% of the EnerShop revenues from those customers.

SEC File No. 70-8645, September 1, 1995 (emphasis added). It appears that the 1% commission is optional with the seller and therefore not a reliable substitute for a payment reflecting market value.

While "at cost" is the present practice under Section 13(b) the Public Utility Holding Company Act, an "at cost" rule is not required by statute. Section 13(b) expressly authorizes the SEC to exempt a transaction from the "at cost" rule if the transaction "involve[s] special or unusual circumstances." The "at cost" rule was intended to prevent non-regulated affiliates from milking utility subsidiaries by overcharging them when providing services to them. It would be ironic for the "at-cost" rule to be cited as grounds for allowing the non-regulated affiliate to milk the utility subsidiaries when purchasing services from them. To the extent EnerShop is using resources whose costs have been recovered from utility ratepayers, CSW should be seeking SEC approval to pay a market price.

Given the extent of CSW's investments, EnerShop may not be the only example of an at-cost transaction which makes use of resources funded by CPL ratepayers. The Commission should require CPL to produce all examples, and then take corrective action. For any use of resources whose costs have been included in CPL's retail rates, the Commission should set rates as if the nonutility business were compensating CPL at market, where market exceeds cost. (As noted above, where market is less than cost, the

nonutility affiliate would not make use of the ratepayer-funded resource because it would minimize its own costs by buying the product or service on the market.).

Q. WHY IS ALLOCATION OF BOOK COSTS BETWEEN THE REGULATED AND UNREGULATED USES NOT THE PROPER SOLUTION?

A. Fair treatment of CPL's consumers occurs when the relationship between utility and nonutility affiliate is arm's-length. Cost allocation is not consistent with an arm's-length result. Consider the situation where the nonutility affiliate's allocated share of costs for a particular asset or employee is a figure lower than the fair market value of the asset or employee. In this situation, the nonutility affiliate pays less than a nonaffiliate would. The utility, conversely, by "charging" the affiliate a sum (allocated cost share) lower than it would charge a nonaffiliate (fair market value), has obtained less for its ratepayers than it could had it dealt with a nonaffiliate. By definition, this is not an arm's-length relationship.

Some argue that the cost allocation approach is common in unregulated industries. This argument confuses the differing roles of cost allocation in the regulated and unregulated contexts. In unregulated industries, businesses use cost allocation to assess the productivity of cost centers or profit centers. This assessment is impossible unless there is a home for every cost. Cost allocation determines the location of those homes. Cost allocation does not set prices; the market sets prices.

In regulated industries, cost allocation serves a very different purpose: it sets prices for the regulated service. Regulators allocate costs to different products or customers to establish the prices for those products or customers.

Conclusion

Q. WHAT ARE YOUR RECOMMENDATIONS TO THE COMMISSION WITH RESPECT TO THE SUBJECTS YOU HAVE ADDRESSED?

A. The Commission should reject CPL's proposal to accelerate the recovery of STP costs. Moreover, in determining the resolution of the "Embedded Cost Over Market" issue, the Commission should hold the utility responsible for book costs to the extent they exceed the cost levels incurred by other utilities faced with obligations similar to CPL's.

Concerning "incentive" ratemaking, the Commission should reject forms of ratemaking that make the utility less accountable than it is today. The Commission should establish a standard of excellence and apply it consistently.

Concerning wholesale pools, the Commission should pursue vigorously its investigation of new forms of competition, to determine which products and services are likely to be provided more efficiently through competition rather than by monopolies. In doing so, the Commission should remember that the products available through "wholesale generation competition" are different from those potentially available through retail services competition.

Finally, the Commission should take immediate action to ensure that where a nonutility affiliate is making use of resources funded by ratepayers, the affiliate is compensating the ratepayers at a market price where market exceeds the book cost attributable to the resources.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

EXHIBIT SH-2
CSW INVESTMENTS OUTSIDE ITS
TRADITIONAL TEXAS UTILITY BUSINESSES

This Exhibit provides a partial summary of CSW activities outside its traditional utility business. The summary is divided into two principal categories:

1. Investments in Foreign Countries
2. Investments Within the United States

The first category consists primarily of investments in power generation and energy infrastructure investments. The second category is further divided into two categories: (a) investments in communications and energy services, and (b) power generation projects outside of the service territories of CSW's utility subsidiaries.

I. INVESTMENTS IN FOREIGN COUNTRIES

CSW created "CSW International" in November 1994 to focus on "forming, acquiring, financing and owning the securities of exempt wholesale generators and foreign utility companies."[5] In part through CSW International, the holding company runs operations from Taiwan to the United Kingdom and from Mexico to Brazil. The company is pursuing additional projects in these countries and in other countries. [6]

United Kingdom -- In November 1995, CSW (CSW Enterprises) made a successful $2.52 billion bid for Seeboard, one of the United Kingdom's 12 regional electricity companies. Seeboard serves a population of about 4.6 million customers over 6,000 square miles. Seeboard is diversifying its own operations; prior to CSW's acquisition, Seeboard executed a contract with Amoco Corporation to enter into the U.K.'s natural gas distribution market. [7]

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[5] "CSW Looks Abroad for Growth Opportunities," The Energy Daily, Nov. 15, 1994.

[6] See "CS&W Says Purchasing U.K.'s Seeboard will Boost Competitive Skills in U.S." Electric Utility Week, Nov. 13, 1995, p. 1.

[7] "U.S. Utilities Continue Overseas Spending Splurge," The Energy Daily, Nov. 7, 1995. CSW's acquisition of Seeboard came about six weeks after a failed bid for Norweb plc, another of the UK's RECs. In the fall of 1995, CSW International, with Houston Industries, offered $2.7 billion to buy Norweb plc, one of the 12 regional electric companies in the United Kingdom. CSW lost the bid to a United Kingdom company that offered $2.89 billion. Electrical World, January 1996.

Brazil -- CSW International is one of several U.S. companies pursuing power projects in Brazil as the country moves to privatize its power infrastructure.[8] In May 1996, CSW International won a contract from the Brazilian government to perform a feasibility study for a 1,100-MW hydro plant. The contract was awarded to a consortium in which CSW is a member.[9]

Mexico -- CSW has offices in Mexico City. CSW International formed a partnership in late 1995 with a Mexican company, Alfa Corporation, to build a 100-MW cogeneration project in Altamira, Tamaulipas.[10] The plant, in which CSW has a 50% equity stake, is expected to be in operation by late 1997.[11] The company is pursuing similar projects elsewhere in Mexico.[12] In the past, CSW also has submitted bids to build power plants in the Yucatan and in Cuidad Juarez.[13] CSW has submitted other bids for projects as well.[14]

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[8] "Wary Developers See Large Brazil Market But Focus On Small Plants," Independent Power Report, Nov. 3, 1995, p. 11.

[9] "CSW International is Part of Consortium Awarded Contract to Perform Feasibility Study in Brazil," PR Newswire, May 13, 1996.

[10] "Hostile Bid for U.K.'s Norweb Fuels Speculation of U.S. 'White Knights,'" Electric Utility Week, Sept. 18. 1995, p. 18.

[11] PR Newswire, Dec. 21, 1995.

[12] "CSW Forms Venture with Mexican Industrial for 100-MW Project," Electric Utility Week, Jan. 8, 1996.

[13] "CSW Energy Forms Consortium to Bid on Mexico's 440-MW Merida Project," Independent Power Report, Dec. 30, 1994, p. 15.

[14] "CSW Developing 2,500 MW In U.S. While Pursuing Market in Mexico," Independent Power Report, April 23, 1993.

Taiwan -- CSW International leads a consortium of companies that proposes to build a 2,964 MW gas fired project in Ta Tan, Taiwan. Under Taiwan rules, foreign developers are limited to a 50% interest. [15]

Peru -- CSW Energy prequalified, but did not bid, for privatized assets. [16]

II. INVESTMENTS WITHIN THE UNITED STATES

A. Communications and "Energy Services"

Two wholly owned CSW subsidiaries market communications and non-power energy services inside and outside the service territories of the CSW utility subsidiaries -- EnerShop, Inc. and CSW Communications.

EnerShop, Inc. -- In September 1995, the SEC approved CSW's formation of EnerShop, Inc. In its application, CSW states that EnerShop will provide energy and demand-side management services to commercial and industrial customers. EnerShop is involved in consulting and energy analysis, project management, design and construction, energy efficient equipment installation and maintenance, equipment financing and leasing, facilities management services, environmental services and compliance and fuel procurement. [17]

[15] "CSW Subsidiary, Partners Propose 2,964-MW Gas Project in Taiwan," Electric Utility Week, April 10, 1995, p. 13.

[16] "Hostile Bid for U.K.'s Norweb Fuels Speculation of U.S. 'White Knights,'" Electric Utility Week, Sept. 18. 1995, p. 18.

[17] SEC File No. 70-8645, September 1, 1995.

CSW Communications -- CSW was the first registered holding company to file an application with the SEC under the Telecommunications Act of 1996 to form an exempt telecommunications company (ETC), CSW Communications, Inc. [18] Prior to SEC approval of ETC status, CSW already had begun to develop and market its Customer Choice & Control technology in Texas. [19] The communications subsidiary has already made inroads into the telecommunications market. Its Customer Choice & Control technology has been selected as the vendor of choice for the Georgetown, TX municipal utility. [20] More significantly, the City of Austin has selected CSW Communications to build and install its advanced communications and energy services system. According to press reports, the Austin project makes CSW "the first electric utility subsidiary to tackle a network communications project of this size." [21]

CSW's ETC application states that in the process of developing communications and other services for its utilities, CSW has developed significant excess fiber capacity which can be leased to third parties to provide other telecom services. [22]

Miscellaneous -- In late December 1995, CSW utility subsidiary Public Service Company of Oklahoma obtained SEC approval to make equity and debt investments totaling $3.5 million in four Oklahoma companies engaged in the development and commercialization of computer automation technology for the electric power industry. [23]

In March 1995, CSW and its four utility subsidiaries received SEC approval to engage in meter reading, billing, and collecting services for water and gas utilities provided by cities and

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[18] "Electric Utilities Rush into Telecom with New Law's Deregulation," Energy Report, Feb. 26, 1996.

[19] Id.

[20] "CSW Communication First to File at FCC for 'Exempt Telecom Company' Status," Energy Services & Telecom, February 15, 1996.

[21] "City Selects CSW to Provide Info Network," Electric Light and Power, May 1996.

[22] "CSW Communications First to File at FCC for 'Exempt Telecom Company' Status," Energy Services & Telecom, Feb. 15, 1996.

[23] SEC Release No. 35-26445, Dec. 29, 1995.

counties located within or near their franchise territories. [24] The first arrangement involved a proposal to read water meters for the City of Tulsa. [25]

B. Power Generation Projects Outside of Subsidiary Service Territories

[24] SEC Release No. 35-26250, March 14, 1995.

[25] "CSW Seeks SEC Okay to Read Meters, Bill for Cities and Other Utilities," Electric Utility Week, March 28, 1994, p. 6.

CSW formed its subsidiary CSW Energy, Inc. in 1990 to pursue power generation projects outside its service territory. [26] In 1993, trade press reports cited CSW officials as stating they had more than 2,500 MW of cogeneration projects under active development in the United States. [27] By Nov. 1994, it was reported that CSW Energy held equity in independent power projects in California, Colorado, Florida and Washington state. [28] More recently, the company has formed CSW Power Marketing, Inc. to buy and sell power on the wholesale market. [29]

Florida -- CSW Energy has two cogeneration projects totaling 229 MW; both plants serve customers of Florida Power and Tampa Electric. [30]

Texas -- CSW Energy has formed an alliance with Phillips Petroleum for construction of 300-MW cogeneration facility in Sweeny, Texas. The plant will generate power for a Phillips refinery and chemical plant and excess capacity will be sold to ERCOT. The plant is now served by Texas-New Mexico Power. [31]

Washington -- CSW has joined with Kansas City Power & Light and a Washington state independent power producer to develop and market power as well as other products and services in the Northwest. The partnership will initially focus on completing three plants: a 240-MW gas-fired power plant, a 838-MW combined cycle gas-fired plant and 240-MW peaking combustion turbine.[32]

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[26] "KCP&L, CSW Target Pacific Northwest Power Business," The Energy Daily, Oct. 31, 1995.

[27] "CSW Developing 2,500 MW In U.S. While Pursuing Market in Mexico," Independent Power Report, April 23, 1993.

[28] "New CSW Unit Pursuing International Power Projects in Mexico and Taiwan," Electric Utility Week, Nov. 21, 1994 p.16.

[29] "CSW Open-Access Tariffs," Electric Utility Week, April 22, 1996, p.2.

[30] "KCP&L, CSW Target Pacific Northwest Power Business," The Energy Daily, Oct. 31, 1995, p.1.

[31] "CSW Complete Pacts with Phillips for 300-MW Project in Sweeny, Tex.," Independent Power Report, Nov. 3, 1995, p.18.

[32] "KCP&L, CSW Target Pacific Northwest Power Business," The Energy Daily, Oct. 31, 1995.

Colorado -- With Thermo Industries, CSW runs a 272-MW plant that sells power to Public Service of Colorado. In 1994, CSW's second Colorado plant, Brush II, a 68-MW cogeneration project, began operation. [33]

Maine -- In 1992, CSW Energy reached an agreement with Caithness King, Inc. of New York to acquire a 50% interest in an 80-MW cogeneration project in Maine, which had signed a long-term power contract with Central Maine Power.[34] Less than a year later, however, CMP filed suit in U.S. District Court against CSW-Energy and its corporate parent as co-developers of the coal-fired plant, alleging the developers had failed to post a letter of credit on time. CMP sued to cancel the power purchase agreement. [35]

[33] Id.

[34] CSW Energy to Buy 50% of 90-MW Project in Maine From Caithness," Independent Power Report, May 8, 1992. p.8.

[35] "CMP Sues Caithness, CSW Energy, Central & South West Over NUG," Northeast Power Report, April 30, 1993.