

WHITE PAPER

Deregulation: Bright Idea or Dim Bulb?

Prepared by

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an association of local governments within Dominion Virginia Power's service territory

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I. Introduction and Executive Summary

This White Paper has been prepared by the Virginia Energy Purchasing Governmental Association (VEPGA) to help educate VEPGA members about the implications of moving from cost-of-service pricing for electricity procurement to market pricing for electricity procurement.

VEPGA's basic assessment is that rate shock is the likely outcome of implementing market pricing for electricity service to Virginia customers.

Electricity rates for VEPGA members, like all local governments, state agencies, and other political subdivisions in Virginia, are set by contract. Traditionally the contract rates for VEPGA members have been based upon cost of service. Electricity rates for other Virginia consumers are based on cost-of-service rates initially established by the Virginia State Corporation Commission ("SCC") and subsequently modified by the Electric Utility Restructuring Act ("Restructuring Act"). Starting in January 1, 2011, the Restructuring Act currently requires non-governmental customers to pay electricity rates established by the market rather than by cost-of-service. It is VEPGA's assessment that once cost-of-service rates are eliminated for non-governmental customers, the end result will be the elimination of cost-of-service rates for governmental customers, as well.

Cost of service pricing has served Virginians well for about 100 years, and replacing cost-of-service pricing with market pricing will likely increase electricity rates significantly.

This White Paper was written to inform local governments that

- (1) absent legislative action, steep market price increases for electricity will be implemented throughout Virginia, and
- (2) there is still time for the General Assembly to prevent rate shock by not implementing market pricing for Virginia customers.

The General Assembly has delayed, but not eliminated, market pricing by extending capped rates to 2010. Thereafter, power supply will be priced at the market, instead of the traditional cost of service standard. Market prices greatly exceed cost of service pricing.

Deregulation of electric service has not produced the anticipated cost savings for customers. Instead, the rate increases in deregulated states when they are forced to market prices are truly staggering, far exceeding the rate increases in states that have not embraced deregulation. Rate increases in neighboring deregulated states of Delaware and Maryland are triggering rate shock.

The implications of market pricing are frightening. If electricity in Virginia were priced at current market prices, there would be rate shock to residential customers. Rate shock

would also impair Virginia's business competitiveness. If rates are based on such market prices, businesses are likely to migrate to non-deregulated states, such as North Carolina and West Virginia, where sharply lower cost-of-service rates will be available. Market pricing could:

- (1) discourage business from moving to Virginia;
- (2) encourage existing Virginia businesses to relocate to other states;
- (3) reduce state and local government tax revenue;
- (4) blunt job creation; and
- (5) lead to job losses.

Deregulation and market pricing of retail electricity sales are contrary to the public interest because:

Rate Increases: Unregulated market prices easily exceed the cost of service rates. If market pricing is implemented, rate increases to residential, commercial, and industrial customers and to state and local governments will dramatically increase. The rate shock could impair the Commonwealth's economy by discouraging business from moving to Virginia, encouraging existing Virginia businesses to leave Virginia, reducing state and local government tax revenue, blunting job creation and increasing job losses.

Free Market Ideology and Customer Choice: Free market ideology has been applied to electric utility service. Deregulation and market pricing were promoted, not with factual studies, but rather with economic theory using catch words such as competition, free markets, light handed regulation and customer choice. This theory, when applied to electric utility service, has not benefited customers because market prices drastically exceed cost-of-service prices.

Impact on Local Governments and the Commonwealth: The consequences of higher market pricing for local governments could require noticeable increases in property taxes. Services that local governments are expected to provide would likely be curtailed, if market pricing is implemented. To make matters worse, tax revenues would decline if businesses seek reasonable rates in other states that have not embraced market pricing.

Deregulation in other States: Deregulation of electric service has not produced the anticipated cost savings for customers. The rate increases attributable to market pricing far exceed the rate increases in comparable states that have not embraced deregulation.

The General Assembly should look to the neighboring deregulated states of Delaware and Maryland and contrast them with North Carolina and West Virginia, which have not deregulated. Delaware is experiencing rate increases of 59% to 117%. Maryland is experiencing rate increases of up to 72%. By contrast, North Carolina recently approved a 4.5% decrease in base rates, and

West Virginia is considering a rate case settlement that would result in a 4.2% rate increase.

Excess Profits: Virginia Power's Annual Information Filings with the SCC have disclosed rates of return under capped rates that exceed reasonable rates of return for the vast majority of years under deregulation. Virginia Power has waived wires charges for 2005 and 2006, thereby admitting that its capped rates are below market prices. When years of over-earning under capped rates are coupled with the ability to charge even higher rates if market pricing is implemented for local governments and for jurisdictional customers, Virginia Power will earn far more excess profits.

Solution: Unlike other states, the deregulation legislation passed by the Virginia General Assembly did not allow Virginia Power, without SCC approval, to sell its generating units to unregulated affiliates. Virginia Power's generating facilities remain under the jurisdiction of the SCC and can be returned to traditional cost of service pricing if the deregulation law is amended. Because Virginia Power's generating assets remain with the state-regulated utility, it is still possible for the General Assembly to prevent rate shock without facing the thorny problem that other states have of trying to mitigate the effects of utilities having sold generating facilities and then being forced to supply their customers at market-based rates.

II. General Assembly's Opportunity to Prevent Rate Shock and Customer Choice

Unlike the situation in many other deregulated states, Virginia has the power to allow the SCC to retain jurisdiction over Virginia Power's generating units. Rate shock attributable to unforeseen staggering market prices can be avoided by pricing power supply on a cost of service basis, which includes a reasonable rate of return.

Virginia's Electric Utility Restructuring Act, by forbidding, without SCC approval, the sale of generating facilities to unregulated affiliates, gives Virginia the opportunity to return to lower cost of service pricing, without the difficulty other states will have putting the "toothpaste back in the tube."

Although Virginia law currently extends rate caps to 2010, rate shock will not be eliminated, only delayed. If the law remains unchanged and market pricing is implemented on January 1, 2011, grave consequences are likely to follow.

III. Theoretical Basis for Market Pricing has been Proven Wrong

Many believed that electric deregulation would lower electric rates through competition. The thought was that utilities and non-utility power generators would compete against

each other and thus drive prices lower. Instead, market prices in neighboring states are sharply higher than they would otherwise be under traditional cost of service regulation.

Why did states choose to deregulate electric prices? What was the evidence that deregulated market prices would lower rates? The evidence was theoretical, a blind belief in ideology. The popularity of words such as competition, free markets, light handed regulation and customer choice were the basis for deregulation, not factual studies demonstrating reduced rates.

The belief that competitive prices would lead to lower rates was accepted without any factual basis. Free market principles popular in the 1990's were applied to electric utility services based on economic theory alone. The rush to deregulate was not based on a demonstration of savings, but rather a blind belief in ideology and economic theory.

A free market ideology is inappropriate for electric utility service.

In essence, Virginia customers have exercised customer choice and chosen lower cost of service prices instead of higher market prices. There are three pilot programs available for Virginia Power customers. Those pilots are the Commercial and Industrial Pilot, the Competitive Bid Supply Service and the Municipal Aggregation pilot. Not a single commercial customer, industrial customer or local government in such pilots has chosen a supplier other than Virginia Power.

Sharply higher electric bills attributable to deregulation are a threat to the existing standard of living for all Virginians. Is it in the public interest to have higher rates with market pricing rather than lower rates with traditional cost of service pricing? The answer is clearly no.

IV. Comparing Increases of States that Have Deregulated and States that Have Retained Cost of Service Pricing

To understand the implications of deregulation, consider the neighboring states of Delaware and Maryland that are implementing market pricing. Increases are between 59% to 117% in Delaware and up to 72% in Maryland. By contrast, the neighboring state of North Carolina and West Virginia, which did not deregulate, have recent increases no larger than 4.2 %.

V. The Sale of Generating Facilities to Unregulated Affiliates

Virginia's restructuring legislation did not allow Virginia Power, without SCC approval, to sell its generating facilities, but other states did. Within two years of enactment of deregulation legislation, Delmarva Light & Power sold all its generating assets, enabling the new owners to charge market prices instead of cost of service prices. Delaware is experiencing increases of 59% for residential customers and 117% for large customers.

The Delaware Public Service Commission had no choice but to approve the increases because the Delaware Electric Utility Restructuring Act required the Commission to use regional market pricing for retail customers. Since that Commission was unable to find that the market prices were not representative of regional market prices, the Commission had to allow rates that “will make electric bills more painful for many, and real hardships for some.”

In Maryland, Baltimore Gas and Electric sold its generating facilities to an unregulated entity controlled by its corporate parent, Constellation Energy. The Wall Street Journal has reported that the unregulated entity had a 46% increase in quarterly profits.

VI. Competitive Markets do not Exist

Deregulation has not worked as competitive markets have failed to materialize. The Staff of the SCC reported to the Governor and General Assembly on September 1, 2005, that:

- (1) deregulation was not working;
- (2) that market prices *exceed* cost of service prices;
- (3) that future savings are unlikely to materialize and
- (4) prices are likely to rise “precipitously,” beyond what is fair and reasonable.

The problem is that beneficial competition has not developed in Virginia, nor is it likely to do so in the near future. A competitive market that can offer savings has not developed, and consequently customers should not be exposed to market prices.

VII. Excess Profits

Should market pricing be implemented, customers will pay noticeably higher high rates, leading to excessive profits for Virginia utilities. Market prices are set at the marginal cost of the last generating unit dispatched, typically expensive natural gas units. That marginal price is, however, paid to all of the generators whether they are natural gas or lower cost coal or nuclear generation.

According to The Wall Street Journal, awarding all generation the same price, whether gas fired or not, “has provided a special boost for owners of nuclear and coal-burning power plants, who benefit from sharply higher electricity prices, but whose fuel costs typically are low compared with natural-gas-fired plants.”

Dominion Resources, Inc. (“Dominion”), the parent company of Virginia Power, is likely enjoying excessive profits because much of its generation is coal and nuclear fired. For example, Dominion owns two nuclear facilities in Connecticut. Connecticut Attorney General Blumenthal believes that nuclear plants are reaping returns of 44% to 100%, compared with a regulated cost of service return of 10%. Dominion’s response has been that profit levels at the nuclear units are proprietary and that it opposes a windfall profits

tax. Moreover, Virginia Power has waived the recovery of stranded costs in 2005 and 2006 in Virginia. These facts suggest that Dominion and Virginia Power are earning excessive profits.

VIII. Stranded Costs and Market Pricing

Electric deregulation has not been beneficial to customers, but has been generous to utilities.

Virginia's restructuring legislation provides for recovery of "stranded costs" because it was thought that the investment of Virginia Power in generating facilities and contract commitments to purchase power might not be recoverable in retail rates that reflected market prices. The mechanisms for recovering these stranded costs were the so-called "capped rates," which were paid by customers who purchased their power from Virginia Power, and "wires charges," which were to be paid Virginia Power customers who purchased from competitive suppliers. The "wires charge" equaled the excess of Virginia Power's retail rates over market prices determined by the SCC. It has been estimated that Virginia Power has collected approximately \$1.57 billion available for recovery of stranded costs.

However, there has been virtually no competitive shopping by Virginia Power's customers, so Virginia Power has incurred no "stranded costs." In fact, there are currently no wires charges because Virginia Power's retail prices are below current market prices. Instead of incurring losses as a result of restructuring, Virginia Power has had the opportunity to profit handsomely by cutting its costs without having to pass the resulting savings along to its customers in the form of reduced rates. Virginia Power's base rates are essentially frozen, which means any savings from reductions in costs used in the calculated base rates (and base revenue increases) are not reflected in rate reductions.

Virginia Power should not enjoy excessive profits by either keeping its rates the same when its costs are reduced (the current situation) or by selling its power at market rates (the situation when "capped rates" expire).

IX. Large and Small Customers

The SCC Staff received comments from stakeholders prior to the SCC's September 1, 2005 Annual Report to the General Assembly and the Governor. The Staff reported that neither large nor small customers believed that restructuring is working in Virginia. The large customer group cautioned "that electric restructuring has not yet worked in Virginia and that current expectations are not promising for the future." Similarly, a small customer representative "contended that deregulation is not working, will not work in the future, and urged a reversal of direction back to a regulated environment."

X. A Foreseeable Competitive Environment Does Not Exist

A workable competitive market that could benefit Virginia consumers is not expected to develop in the foreseeable future. There are no base load generating plants under construction. There are non-base load projects, some with certificates, that have not begun construction and other plants that were cancelled prior to and after receiving certificates.

Virginia Power's absence from the PJM Power Pool was thought to a barrier to the development of a competitive market. In 2005 Virginia Power joined the PJM Power Pool, but the elimination of that impediment has not lead to consumer benefits from retail competition.

XI. Proposed Solutions

There are two solutions to address rate shock for local governments and jurisdictional customers. They are as follows:

- (1) Reject deferrals or phase-ins and
- (2) Impose re-regulation.

Deferrals or Phase-Ins: Some states have attempted to ease the pain of going to market rates by deferring costs or phasing-in rate increases. These solutions are illusory because the ultimate impact on the customer is the same: paying much higher rates than would be paid if rates were based on cost of service plus a reasonable profit for the utility. Deferring costs to a future period in the hope that market prices will decline in the future is a band aid approach and a risky solution. It is a band aid solution because customers would eventually have to pay for prior period market pricing. If market prices do not decline, customers would have to pay current market prices and prior period market prices at the same time.

Re-regulation: As discussed, Virginia is fortunate that the Electric Restructuring Act did not allow Virginia Power or AEP, without SCC approval, to sell their generating assets to affiliates. Unlike deregulation statues in other states, Virginia's law retains jurisdiction over Virginia Power's and over AEP's generating facilities. Since the generation is still owned by these utilities, it is still possible to prevent market pricing for their customers by revising Virginia law and returning to regulated cost of service pricing for electricity service.

XII. Additional Information

For more information about this White Paper, please direct inquiries to VEPGA@yahoo.com. Copies of this White Paper are available from VEPGA's website, www.vepga.org.