NORTH DAKOTA LEGISLATIVE MANAGEMENT

Minutes of the

ELECTRIC UTILITIES COMMITTEE

Thursday, October 9, 1997
Roughrider Room, State Capitol
Bismarck, North Dakota

Representative Al Carlson, Chairman, called the meeting to order at 9:00 a.m.

Members present: Representatives Al Carlson, Robert Huether, Matthew M. Klein; Senators Randel Christmann, Pete Naaden, Larry J. Robinson

Others present: See Appendix A

It was moved by Senator Robinson, seconded by Representative Huether, and carried that the minutes of the Tuesday, July 29, 1997, meeting be approved as mailed.

Committee counsel distributed copies of the legislative history for the Territorial Integrity Act, a letter from each of the state's investor-owned utilities containing property and income tax information, copies of federal statutes governing the electric utility industry, and copies of the bills relating to electric utility restructuring under consideration by Congress. Copies of these materials are on file in the Legislative Council office. Committee counsel also said that copies of Federal Energy Regulatory Commission Order Nos. 888 and 889 are also on file in the Legislative Council office.

At the request of Chairman Carlson, Mr. Kevin Kelly, Deputy Director, Electric Power Regulation, Federal Energy Regulatory Commission, addressed the committee. A copy of the overheads used in his presentation is attached as Appendix B. He said competition is growing because of an awareness that generation, unlike transmission, does not have to be a monopoly business; a belief that market forces can produce lower electricity prices than can the oversight of regulators; enactment of the Public Utilities Regulatory Policy Act which showed that nonutility generators can often compete successfully with utilities; and enactment of the Energy Policy Act of 1992, which allowed independent power producers to enter the power market without onerous regulation. Also, he said, competition is growing because of changes in technology and fuel prices that make power for many new generating plants cheaper than power from existing plants and adoption of the Federal Energy Regulatory Commission's open access rules in 1996. He said the open access rules have created a vigorous competitive market for wholesale electricity, and this has stimulated demand for retail competition. He said that as competition grows, there is economic pressure to "unbundle" services, i.e., to offer and price these services separately. Until recently, he said, a typical utility provided "bundled" service for generation, transmission, distribution, and other services to its retail and many of its wholesale customers and charged a single price for all of these services. Because competition is growing in the electric power business, he said, federal law and the Federal Energy Regulatory Commission have evolved to facilitate competition in wholesale power markets. Also, he said, many state laws and regulations are also changing to facilitate competition in retail power markets.

Concerning Federal Energy Regulatory Commission Order Nos. 888 and 889 or the open access rules, Mr. Kelly said, their goals are to promote wholesale power competition, remedy undue discrimination in transmission service, and establish standards for recovery of stranded costs. He said the basic elements of the Federal Energy Regulatory Commission's open access rules, Federal Energy Regulatory Commission Order Nos. 888 and 889, are that public utilities that own, operate, or control interstate transmission facilities must have on file at the Federal Energy Regulatory Commission an open access tariff that offers wholesale transmission services, comparable to those that the utility provides to itself in serving its own power customers. Another element, he said, is that the open access rules provide a pro forma tariff to achieve this comparability. He said a utility's tariff must offer transmission services to any eligible entity, including foreign utilities, and eligible unbundled retail customers. Finally, he said, a utility may seek recovery of certain prudently incurred stranded costs that result from unbundled transmission services. He said the Federal Energy Regulatory Commission requires that regulated utilities must act or behave as if their transmission and power sales businesses are unaffiliated. He said this is known as functional unbundling. He said functional unbundling requires four elements. These, he said, are that a public utility separate prices for wholesale generation and transmission, take transmission service for wholesale power sales and purchases under its own tariff at the same price as its competitors and under the same terms and conditions of service, provide same-time access to transmission information to all customers through an open access same-time information system, and follow standards of conduct for its employees.

Concerning independent system operators, Mr. Kelly said, they are not required by the Federal Energy Regulatory Commission. However, he said, their establishment is encouraged. He said an independent system operator is a public utility subject to Federal Energy Regulatory Commission regulation.

Mr. Kelly said the recovery of stranded costs is also an important part of the open access rules. Under the open access rules, he said, a public utility may recover all prudently incurred and verifiable costs stranded by wholesale customers choosing another supplier due to open access. He said this applies to costs incurred prior to July 11, 1994, the date of the original Federal Energy Regulatory Commission proposed rule on stranded costs, but after that date, recovery is according to contract. In order to recover stranded costs, he said, a public utility must demonstrate that it had a reasonable expectation of continuing to serve the customer for a certain length of time. He said stranded costs are directly assigned to the departing customer, who can choose either a lump sum exit fee or surcharge on transmission rates. He said under the open access rules, stranded costs are calculated using a "revenue loss" method, the market value of the power subtracted from the revenues the utility would have collected. He said a customer may resell power to determine its market value. Finally, he said, the Federal Energy Regulatory Commission will not act on recovery of retail stranded costs unless a state public service commission lacks authority to permit recovery.

Mr. Kelly said the open access rules permit a public utility to sell wholesale power from a new power plant at market-based rates without having to demonstrate that the utility lacks market power in generation. He said the rule continues to require that a public utility demonstrate that it lacks market power in generation for wholesale sales from existing power plants to get approval for market-based rates. In either case, he said, to qualify for market-based rates, a utility must show that it and its affiliates have no transmission market power, are not engaged in affiliate abuse or self-dealing, and cannot keep competitors from entering the market.

Although the open access rules went into effect in 1996, Mr. Kelly said, much remains for the Federal Energy Regulatory Commission to do. He said the Federal Energy Regulatory Commission is implementing Order Nos. 888 and 889; redesigning the tariff; reforming transmission pricing; developing policies for new institutions such as independent system operators, power exchanges, reform pools, security coordinators, reliability groups, and state retail programs; implementing merger policy; and evolving policy for market-based rates for power.

Concerning restructuring legislation, Mr. Kelly said, initiatives to restructure the electric utility industry are in various stages in many states. He emphasized that restructuring is a state rather than a federal issue. He said nine bills have been introduced in Congress and the Clinton administration is developing a bill concerning electric industry restructuring. At the state level, he said, eight states have authorized retail access, 10 states have bills pending that require retail access, 18 states are studying the issue, eight states have not passed proposed retail access legislation, and six states have not proposed legislation addressing the issue.

Concerning federal electric industry restructuring initiatives, Mr. Kelly said, Representative Dan Schafer, Colorado, and chairman of the House Energy and Power Subcommittee, has introduced the Electric Consumers Power to Choose Act of 1997. He said this bill would mandate nationwide retail choice by December 15, 2000. He said the bill provides that states must consider whether to provide for recovery of stranded costs. He said a bill sponsored by the House Majority Whip, Representative Tom DeLay, entitled the Consumers Electric Power Act of 1997, would mandate nationwide retail choice by January 1, 1999. He said a bill introduced by Representative Ed Markey, Massachusetts, entitled the Electric Power Competition and Consumer Choice Act of 1997, would require each state to consider whether to have retail choice and leave the recovery of stranded costs to the states. He said key issues that must be addressed in the federal legislation are linking repeal of the Public Utility Holding Company Act, the Public Utilities Regulatory Policy Act, and retail choice in federal legislation; the conflict between states' rights and promoting interstate commerce; the issue of public power; the issue of stranded costs; the issue of how social benefits such as low-income programs, conservation programs, and renewable requirements are integrated into restructuring initiatives; competition issues such as mergers and antitrust; and reliability concerns.

In response to a question from Representative Klein, Mr. Kelly said the Federal Energy Regulatory Commission does not have jurisdiction over municipally owned utilities. However, he said, the Federal Energy Regulatory Commission has reciprocity provisions in its rules which require that if a utility that is not regulated by the Federal Energy Regulatory Commission wants to use the transmission facilities of a utility regulated by the Federal Energy Regulatory Commission, it must allow the regulated utility to use its transmission facilities. He said this has resulted in nonregulated utilities, including Canadian utilities, adopting open access tariffs similar to regulated utilities.

In response to a question from Representative Carlson, Mr. Kelly summarized the status of current electricity regulation law. He said the Federal Energy Regulatory Commission sets rates for sales to utilities but is moving toward deregulation in this area. He said the other areas the Federal Energy Regulatory Commission regulates is the price of transmission services and the price for unbundled transmission. Other than these areas, he said, states have plenary authority over public utilities. This plenary power includes determining if and where power plants are built, what types of power plants are built, siting of transmission lines, setting retail franchise service territories, and ordering social or public benefit programs such as renewables, conservation, and aid to low-income consumers, he said. However, he said, the Federal Energy Regulatory Commission does not require states or public service or public utility commissions to take any specific action.

At the request of Chairman Carlson, Mr. Michael J. Hinman, General Counsel, Basin Electric Power Cooperative, addressed the committee. A copy of the overheads used in his presentation is attached as Appendix C. Mr. Hinman said utilities are being told that they must do things in a new way, that the old ways of producing energy do not work anymore, that the United States has high-priced energy, and as a result the electric utility industry must restructure. He said public utilities are being told that the old paradigms are no longer accurate and that utilities must operate under new paradigms.

The first paradigm that needs to be examined, Mr. Hinman said, is the "need to restructure" paradigm. Under this paradigm, he said, American industry is being told it must now compete in a global economy and that access to lower electric rates is an important part of helping American industry compete. However, he noted, two of America's chief industrial competitors have higher industrial electricity prices than does the United States. He said these are Japan and Germany. He said if the United States is not competitive in the world economy, it is not because of the price of electricity for American industry. He noted that Federal Energy Regulatory Commission mega notice of proposed rulemaking stated that the cost of utility-generated electricity differs widely across the major regions of the United States. Average utility rates range from three to five cents in the Northwest to nine to 11 cents in California. He said Northwest rates are low due to massive, low-cost hydro resources and California's high rate problem is caused at least as much by social and environmental choices made by the California Legislature and Public Utilities Commission as by "utility mismanagement."

The next paradigm, Mr. Hinman said, may be termed the "new resource" paradigm. He said the Federal Energy Regulatory Commission notice of proposed rulemaking stated that smaller, more efficient gas-fired combined-cycle generation facilities can produce power on the grid at a cost ranging from five cents per kilowatt hour to less than three cents per kilowatt hour. He said this is significantly less than the costs for large plants constructed and installed by utilities over the past decade, which were typically in the range of four to seven cents per kilowatt hour for coal plants and nine to 15 cents for nuclear plants. Thus, he said, under the new resource paradigm the future of the electric industry is new, small gas-fired electric turbines and unlimited supplies of low-cost natural gas. However, he noted, problems with advanced combined-cycle turbines have become a major concern among owners, investors, and insurers and that new, smaller, more efficient gas-fired generation is lower cost only if experimental design is unimportant, reliability is unimportant, availability is unimportant, safety is unimportant, adequate insurance is unimportant, and manufacturers' warranties are unimportant. Thus, he said, the machine paradigm is improved design plus improved maintenance plus improved operator training plus increased insurance premiums plus better warranties equals higher cost generation.

Mr. Hinman said another new paradigm may be termed the new fuel paradigm. Under this new paradigm, he said, unlimited supplies of natural gas at a low price per million cubic feet is available. He said this has replaced the old paradigm that there is insufficient natural gas which resulted in the National Energy Plan of 1977 which sought to shift industrial and utility consumption of oil and natural gas to coal and other abundant resources. Another paradigm, he said, is the competition paradigm. He said this paradigm states that competition will result in lower rates.

Mr. Hinman noted that the motivations for investor-owned utilities and electric cooperatives are not the same. He said the entrepreneurial motivations for competition are to obtain the largest possible return with the least possible capital investment in the shortest possible time with the least possible risk with a minimum amount of continuing cost to generate return under the least amount of governmental "interference." He said the measure of success for investor-owned utilities or undercompetition is the highest possible profit. However, he said, the motivations for cooperatives are universal service to all members at the lowest possible cost. Thus, he said, the measure of success for a cooperative is the lowest possible rate to its members. He said an entrepreneur maximizes its return by increasing sales, reducing investment of cost, or increasing its competitor's investments and costs. He said the costs of electric cooperatives may be increased by eliminating Rural Utilities Service lending, eliminating access to federal hydropower, bringing the cooperatives under rate regulation, eliminating "preferential" tax treatment, or repealing territorial laws. He said that restructuring will not repeal the laws of economics in that it will still be more costly to deliver electricity to areas with low consumer density and that universal service is still an important social and economic policy and affordable electric service is an important social and economic policy. In summary, he said, the new paradigms driving utility restructuring need to be examined skeptically and proven correct before they are used to justify dramatic alteration of a system that has proven itself to be the most reliable in the world and one of the most reasonably priced in the world.

Concerning the model solution, Mr. Hinman said, the common elements are unbundling of investor-owned utility services resulting in a single horizontally integrated distribution entity, the state regulator playing a significant role in several steps in the process, with the solution being limited to individual states. He said the difference regarding cooperatives is that cooperatives have already unbundled their corporate structure but not the distribution function. He said in many states generation and distribution are not state-regulated, with the cooperative board of directors performing this function. He said the cooperatives do not have shareholders and have low generation and transmission equity levels that are unable to absorb

unrecoverable generation costs. He said cooperatives generally have limited cash resources and most cooperatives are tax-exempt.

In summary, Mr. Hinman said, issues raised by state legislation include the fact that state legislation does not address the all-requirements Rural Utilities Service contracts, the legislation typically assumes the same investor-owned utility generation/distribution relationships with fallback suppliers; the generic nature of the definition of stranded costs; the fact that the definition of stranded costs may vary from state to state; the fact that a state statute may be silent on the allocation of stranded costs because the statute assumes a single horizontally integrated distribution entity or leaves the issue to distribution cooperative boards; the fact that recovery mechanisms for stranded costs may vary from state to state; the fact that recovery periods for stranded costs vary from state to state; the fact that the disposition of revenues received from stranded cost recovery is not specified in most statutes and is open to question; the question of how to deal with varying state mitigation of stranded cost requirements; and securitization, tax, accounting, and wholesale power contract issues.

In response to a question from Representative Klein, Mr. Hinman said the two states that have addressed cooperatives in their restructuring legislation are Pennsylvania and Montana. In response to a further question from Representative Klein, he said, Montana's legislation contains an opt in or opt out provision under which a cooperative may elect to participate in a competitive environment or opt out.

In response to a question from Representative Carlson, Mr. Hinman said that since cooperatives are consumer-owned, if restructuring results in lower consumer electric costs then electric restructuring would be beneficial for cooperatives. However, he said, for the reasons outlined in his presentation, he has a great skepticism that restructuring will result in lower electric costs for consumers. He said North Dakota has not benefited from deregulation of the airline industry and it is unlikely that large energy marketers will wish to serve rural North Dakotans.

At the request of Chairman Carlson, Mr. LeRoy Neubauer, Director, Public Works, Valley City, addressed the committee. A copy of his presentation is attached as Appendix D.

In response to a question from Representative Klein, Mr. Neubauer said the city of Valley City receives 80 percent of its power as preference power from the Western Area Power Administration and 20 percent from the Missouri Basin Municipal Power Agency, a joint action agency located in Sioux Falls, South Dakota. He said the Western Area Power Administration preference power costs the city of Valley City one cent per kilowatt hour and the power received from the Missouri Basin Municipal Power Agency costs four cents per kilowatt hour. He said the average cost is 3.5 cents per kilowatt hour in Valley City, which is the lowest in North Dakota.

In response to a question from Senator Robinson, Mr. Neubauer said approximately 12 to 13 cities have municipally owned utilities, including the cities of Valley City, Lakota, Hope, Grafton, Sharon, Riverdale, Maddock, and Stanton.

In response to a question from Representative Carlson, Mr. Neubauer said the Valley City municipal electric utility pays 20 percent of its gross sales as a payment in lieu of taxes into the general fund of the city. He said the Valley City municipal electric utility pays more in payments in lieu of taxes than are collected from general property taxes in the city. He said the payments in lieu of taxes amount to approximately $600,000 per year.

At the request of Chairman Carlson, Ms. Marcy Dickerson, Utility Tax Appraiser, State Tax Department, addressed the committee concerning property taxes, in lieu taxes, and sales taxes paid by electric utilities. A copy of her presentation is attached as Appendix E.

At the request of Chairman Carlson, Mr. Kim Christianson, Energy Program Manager, Office of Intergovernmental Assistance, addressed the committee concerning the effects of restructuring on energy efficiency, renewable energy, and other societal programs. A copy of his presentation is attached as Appendix F.

In response to a question from Representative Carlson, Mr. Christianson said the energy assistance program does not receive money from utilities, but utilities participate jointly in the program. He said money to fund societal programs comes from state and federal sources.

At the request of Chairman Carlson, committee counsel presented a memorandum discussing the history and operation of the state's Territorial Integrity Act.

STAFF DIRECTIVES

Senator Robinson requested that the Legislative Council staff obtain information on the amount of electric utility in lieu of tax payments made by the state's municipal utilities.

Representative Carlson requested that the Legislative Council staff provide copies of the state statutes relating to utility taxation and a copy of the Oklahoma electric restructuring statute to the committee.

Chairman Carlson announced that the next meeting would be a joint meeting with the interim Taxation Committee and the meeting would be devoted to studying the tax implications of electric industry restructuring on the state and its political subdivisions.

No further business appearing, Chairman Carlson adjourned the meeting at 2:00 p.m.

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Jeffrey N. Nelson
Counsel

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