

September 2003

IMPACT OF COMPETITION ON THE GENERATION, TRANSMISSION, AND DISTRIBUTION OF ELECTRIC ENERGY STUDY - BACKGROUND MEMORANDUM

The Electric Industry Competition Committee was created by House Bill No. 1237 (1997) to study the impact of competition on the generation, transmission, and distribution of electric energy within this state. The bill was codified as North Dakota Century Code (NDCC) Sections 54-35-18 through 54-35-18.3. Section 54-35-18 states that the Legislative Assembly finds that the economy of North Dakota depends on the availability of reliable, low-cost electric energy and that there is a national trend toward competition in the generation, transmission, and distribution of electric energy, and the Legislative Assembly acknowledges this competition has both potential benefits and adverse impacts on the state's electric suppliers as well as on their shareholders and customers and citizens of this state.

North Dakota Century Code Section 54-35-18.1 outlines the composition of the committee and directs the committee to study the impact of competition on the generation, transmission, and distribution of electric energy within this state and on this state's electric suppliers. Electric suppliers include public utilities, rural electric cooperatives, municipal electric utilities, and power marketers.

North Dakota Century Code Section 54-35-18.2 outlines the study areas that the committee is to address in carrying out its statutory responsibilities. This section provides that the committee is to study the state's electric industry competition and electric suppliers and financial issues, legal issues, social issues, and issues related to system planning, operation, and reliability and is to identify and review potential market structures.

Senate Bill No. 2015 (2003) extended the Electric Industry Competition Committee from August 1, 2003, to August 1, 2007. The bill also expanded membership of the committee from three or four members of the House of Representatives, no more than two of whom may be from the same political party and three or four members of the Senate, no more than two of whom may be from the same political party, to six members of the House of Representatives, four of whom must be from the majority political party and two of whom must be from the minority political party and six members of the Senate, four of whom must be from the majority political party and two of whom must be from the minority political party.

ELECTRIC INDUSTRY RESTRUCTURING Background

House Bill No. 1237 (1997) reflected the Legislative Assembly's concern that the electric industry is changing rapidly and if competition is to be introduced into North Dakota, it should be done in a fair and equitable manner. Nationally, builders of new technology

generating plants, the natural gas industry, and states with high electric rates or excess generating capacity are promoting electric industry restructuring. Arguments put forward for restructuring or implementing competition in the electric industry include greater customer choice, the possibility that open competition may lower costs, encourage generating efficiency, and allocate capital. However, risks and challenges of retail competition include maintaining reliability of supply, pricing outcomes in which some customers may benefit at the expense of others, and allocating stranded costs. The impetus for electric industry restructuring has also come from large industrial and commercial energy users that are opposed to subsidizing residential electricity users. For example, some industrial users are paying 150 percent of the actual cost of providing energy to those users, while residential customers are paying only 60 to 70 percent of the actual cost of providing energy to them.

Traditional Rationale for Regulation

Under the current industry structure, electricity is provided to retail customers by utilities that have geographic monopolies on the provision of electric service within their service territories. Customers within a utility's service territory must purchase all their electric services from that utility. These services include generation, transmission, distribution, customer service, meter reading, demand-side management, and aggregation and ancillary services.

Generally, three major types of electric utilities exist-- investor-owned utilities, municipal and other government-owned utilities, and rural electric cooperatives. States regulate investor-owned utilities regarding their profits, operating practices, and pricing to end-use retail customers, while the Federal Energy Regulatory Commission (FERC) governs the pricing of wholesale bulk power sales and transmission services. Although House Bill No. 1237 (1997) directed the committee to study the impact of competition on the generation, transmission, and distribution of electric energy, nationwide the restructuring debate is over whether and how to separate the generation of electricity from other electric services in order to allow retail customers to shop for the electricity supplier of their choice.

In North Dakota the Public Service Commission regulates electric utilities engaged in the generation and distribution of light, heat, or power. North Dakota Century Code Section 49-02-03 grants to the Public Service Commission the power to supervise and establish rates. This section provides:

The commission shall supervise the rates of all public utilities. It shall have the power, after notice and hearing, to originate, establish, modify, adjust,

promulgate, and enforce tariffs, rates, joint rates, and charges of all public utilities. Whenever the commission, after hearing, shall find any existing rates, tariffs, joint rates, or schedules unjust, unreasonable, insufficient, unjustly discriminatory, or otherwise in violation of any of the provisions of this title, the commission by order shall fix reasonable rates, joint rates, charges, or schedules to be followed in the future in lieu of those found to be unjust, unreasonable, insufficient, unjustly discriminatory, or otherwise in violation of any provision of law.

Concerning electric utility franchises, NDCC Section 49-03-01 provides that an electric public utility must obtain a certificate of public convenience and necessity from the Public Service Commission before constructing, operating, or extending a plant or system. Similarly, the state's Territorial Integrity Act, Sections 49-03-01.1 through 49-03-01.5, requires an electric public utility to obtain a certificate of public convenience and necessity before constructing, operating, or extending a public utility plant or system beyond or outside the corporate limits of any municipality. However, Section 49-03-01.3 exempts electric public utilities from the requirement to obtain a certificate of public convenience and necessity for an extension of electric distribution lines within the corporate limits of a municipality in which it has lawfully commenced operations provided the extension does not interfere with existing services provided by rural electric cooperatives or another electric public utility within the municipality and that any duplication of services is not deemed unreasonable by the Public Service Commission.

Traditionally, an electricity customer must purchase all its electric services from the utility serving that customer's service territory, including the three primary services--generation, transmission, and distribution. Generation refers to the actual creation of electricity, which may be generated using a number of methods and fuel such as nuclear, coal, oil, natural gas, hydro, or wind. Transmission refers to the delivery of electricity over distances at high voltage from a generation facility through a transmission network usually to one or more distribution substations where the electricity is stepped down for distribution to residential, commercial, and industrial customers. For the retail customer the costs for these functions are bundled into retail rates, along with the cost of distribution. Distribution involves the retail sale of electricity directly to consumers.

Other functions traditionally provided by vertically integrated utilities include customer service, billing, meter reading, demand-side management, research and development, and aggregation and ancillary services. Aggregation is the development and management of both a power portfolio, combining power from a variety of sources in order to match the demand for power with adequate power supply, and a portfolio of customers with combined demands in order to economically serve those customers. Ancillary services are those services necessary to effect a transfer of electricity between a seller and a buyer and to coordinate generation, transmission, and distribution functions to maintain power quality and system stability.

Under the current industry structure, the utility serving a service territory provides all these services and functions selling them as a single bundle. Nationwide, the restructuring debate centers on whether or how the generation function should be separated from the bundle allowing retail customers to choose their electricity supplier. If generation is unbundled from transmission and distribution, these services may remain regulated functions.

The Regulatory Compact

The provision of electric service traditionally has been considered to exhibit the characteristics of a natural monopoly. According to economic theory, a natural monopoly exists in a market if one service provider in the market can serve customers more efficiently than many competing service providers. A common explanation for electricity provision as a natural monopoly is that allowing competitors to string duplicate transmission and distribution lines and construct excess generation capacity would waste resources and increase electric rates for customers. Generally, the characteristics of a natural monopoly include a high, upfront capital investment in technology; limited storability of a provided service or goods; limited transportability, requiring operations near the end users; and cost advantages of large and integrated systems as a result of better utilization of existing capacity or economies of scale and scope.

In markets exhibiting the characteristics of a natural monopoly, government intervention in the form of regulation over a single firm is considered necessary to provide the market discipline competition cannot provide. In exchange for this monopoly, each utility is required to serve all customers within its service territory and to provide quality service at just and reasonable rates. The utility is permitted to recover reasonable and prudent expenses associated with its provision of service plus a reasonable rate of return on its investment made to serve customers. This exchange is known as the Regulatory Compact.

Under the Regulatory Compact, the traditional method of rate determination has been rate of return regulation. This type of regulation is designed to ensure that utilities offer their services at prices that are based on the cost of the services rather than on the value customers place on those services. In traditional rate of return regulation, the regulating entity determines the revenue requirement (the reasonable and prudent cost of providing a utility service), allocates the requirement among customer classes, and translates the allocated revenue requirement into rates.

Traditional rate of return regulation has been criticized for allowing a utility and its shareholders to pass on all the utility's costs and risks to ratepayers and because the utility faces minimal risks, the utility has little or no incentive to increase its operating efficiency or to minimize its expenses. One critic has stated that rate of return regulation fails to penalize inefficient producers or reward efficient ones.

As an alternative to traditional rate of return regulation, some commentators have advocated and some states have implemented various forms of

incentive regulation, including flexible regulation, targeted incentive plans, external performance indexing, price and revenue caps, and performance-based regulation. However, these forms of incentive-based regulation also have their critics. Performance-based regulation opponents have argued that this type of regulation may result in the selection of inappropriate performance benchmarks; incorporation of too many, or contradictory, societal or regulatory goals into the performance-based regulation plan; unreasonable returns to shareholders; or exacerbation of the information asymmetry between utilities and regulators.

Federal Actions to Promote Competition

In 1978 Congress enacted the Public Utility Regulatory Policy Act. The goals of this Act were to make the United States self-sufficient in energy, increase energy efficiency, and encourage the use of renewable alternative fuels. The Act intended to achieve these goals by abandoning the use of natural gas to make electricity, mandating conservation of oil, and encouraging industry to cogenerate electricity using waste heat. The Act required utilities to purchase bulk power produced from cogeneration facilities to ensure that it was financially attractive. However, states were allowed to determine the avoided costs (the amount of money an electric utility would need to spend for the next increment of electric generation that it instead buys from a cogenerator) and quantity of such power. Some states capped the price at the utility's avoided costs and limited the obligation to purchase to the capacity of the utility. Other states allowed prices above the utility's avoided costs and ordered purchases of additional generation whether needed or not.

In 1992 Congress enacted the Energy Policy Act to encourage the development of a competitive, national, wholesale electricity market with open access to transmission facilities owned by utilities to both new wholesale buyers and new generators of power. In addition, the Act reduced the regulatory requirements for new nonutility generators and independent power producers. The Federal Energy Regulatory Commission initiated rulemaking to encourage competition for generation at the wholesale level by assuring that bulk power could be transmitted on existing lines at cost-based prices. Under this legislation and rulemaking, generators of electricity, whether utilities or private producers, could market power from underutilized facilities across state lines to other utilities.

Finally, the Federal Energy Regulatory Commission has taken a number of steps to encourage competition in the wholesale market. These actions include authorizing market-based rates, issuing Section 211 wheeling orders, ordering open-access transmission tariffs, and issuing the open-access transmission rule (FERC Order No. 888). Market-based rates are those set by willing buyers and sellers of power. This method may be used instead of the more traditional method of ratesetting by regulators pursuant to administrative hearings, with rates based on the cost of producing power. On April 24, 1996, the Federal Energy Regulatory Commission issued Order Nos. 888 and 889, which require all utilities

that own, control, or operate transmission lines to file nondiscriminatory open-access transmission tariffs that offer competitors transmission service comparable to the service that the utility provides. In addition, FERC Order No. 888 recognizes the right of utilities to recover legitimate, prudent, and verifiable costs stranded by opening the wholesale electricity market, i.e., stranded costs. Finally, FERC Order No. 888 requires public utilities to unbundle their power and services for wholesale power transactions by requiring the internal separation of transmission from generation marketing services.

ELECTRIC INDUSTRY RESTRUCTURING INITIATIVES IN OTHER STATES

Twenty-four states and the District of Columbia have either enacted enabling legislation or issued a regulatory order to implement retail access. The local distribution company continues to provide transmission and distribution (delivery of energy) services. Retail access allows customers to choose their own supplier of generation energy services, but each state's retail access schedule varies according to the legislative mandate or regulatory orders. Arizona, Connecticut, Delaware, District of Columbia, Illinois, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Oregon, Pennsylvania, Rhode Island, Texas, and Virginia have either enacted enabling legislation or issued a regulatory order to implement retail access. Retail access is either currently available to all or some customers or will soon be available. In Oregon no customers are currently participating in the state's retail access program, but that state's laws allow nonresidential customers access. Alabama, Alaska, Colorado, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Minnesota, Mississippi, Missouri, Nebraska, North Carolina, North Dakota, South Carolina, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin, and Wyoming are not actively pursuing restructuring. In West Virginia the legislature and Governor have not approved the Public Service Commission's restructuring plan authorized by state law. The legislature has not passed a resolution resolving the tax issues of the Public Service Commission's plan, and no activity has occurred since early in 2001. Arkansas, Montana, Nevada, New Mexico, and Oklahoma have delayed their restructuring process or implementation of retail access. California has suspended direct retail access. A summary of the *Status of State Electric Industry Restructuring Activity as of February 2003* prepared by the United States Department of Energy's Energy Information Administration is attached as Appendix A.

FEDERAL RESTRUCTURING INITIATIVES

Nine bills relating to electric industry restructuring were introduced during the 105th Congress. However, none became law. At least 14 bills relating to electric industry restructuring were introduced in the 106th Congress; however, some dealt with taxation and other issues and only related tangentially to electric industry restructuring. None became law. At least 48 bills relating directly or indirectly with the issue of

restructuring the United States electric power industry were introduced in the 107th Congress. To date, at least 34 bills relating directly or indirectly with the issue of restructuring the United States electric power industry have been introduced in the 108th Congress. A summary of federal restructuring legislation prepared by the United States Department of Energy's Energy Information Administration is attached as Appendix B.

TERRITORIAL INTEGRITY ACT

Background

In conducting past studies of the impact of competition on the generation, transmission, and distribution of electric energy within this state, the committee has reviewed the history and operation of the Territorial Integrity Act. The Territorial Integrity Act was enacted by the Legislative Assembly in 1965 and is codified as NDCC Sections 49-03-01 through 49-03-01.5.

Although the legislative history of the Territorial Integrity Act is extensive, the rationale for its enactment was summarized in *Capital Electric Cooperative Inc. v. Public Service Commission*, 534 N.W.2d 587 (N.D. 1995). In this case, it was noted that "the Act was adopted at the request of the North Dakota Association of Rural Electric Cooperatives to provide 'territorial protection' for rural electric cooperatives and to prevent public utilities from 'pirating' rural areas," and the "primary purpose of the Act was to minimize conflicts between suppliers of electricity and wasteful duplication of investment in capital-intensive utility facilities." In *Capital Electric*, the North Dakota Supreme Court established a requirement that a request by a new customer for electric service from a public utility must be made before the Public Service Commission may consider whether to issue a certificate of public convenience and necessity to the utility.

The Territorial Integrity Act basically allowed cooperatives to extend service in rural areas and public utilities to extend service in municipal areas without first obtaining a certificate of public convenience and necessity from the Public Service Commission, the theory being that the delineation of service areas would allow each type of enterprise to expand within its own sphere without conflict with each other. Problems arose, however, as the public utility companies believed that by being confined to municipal areas except as provided in the Act, they were being denied a fair share of the business arising in the rural "growth" areas. This objection to the effect of the Territorial Integrity Act resulted in *Montana-Dakota Utilities Co. v. Johanneson*, 153 N.W.2d 414 (N.D. 1967), which squarely attacked its constitutionality. In *Johanneson*, the public utility companies took the position the law was an unconstitutional classification for several reasons. They contended cooperatives were given a monopoly in rural areas and were allowed to operate without Public Service Commission regulation, while the public utilities were regulated in every respect by that agency. They claimed that cooperatives could infringe on the existing service areas of public utility companies in rural localities and that new customers could be gained in municipal areas only if there was no interference with cooperative services already provided

in the municipality. They also asserted cooperatives had a right to complain against public utilities' actions, but the utilities had no such right against actions of the cooperatives. Thus, they maintained, the Territorial Integrity Act was unfair, arbitrary, and unreasonable, and the Act discriminated against the public utility companies and the public generally.

The North Dakota Supreme Court in *Johanneson* upheld the constitutionality of the Act in all but one respect. It held that although the Act treated public utilities and cooperatives dissimilarly, the classification was not objectionable as it was based on legally justifiable distinctions. While public utilities were denied the right under the Act to complain of improper actions by cooperatives, the right remained to bring an action in the courts of the state for redress of any injury that might be suffered. Thus, the public utilities did have an adequate remedy and were not prejudiced.

However, the court found otherwise with regard to NDCC Section 49-03-01.2, which conditioned the issuance of certificates of public convenience and necessity on the written consent of the nearest cooperative, or upon a finding a cooperative could not provide the service. Here, the court found that it was "the cooperative, and not the public service commission . . . that determines whether a certificate of public convenience and necessity shall be granted to a public utility in the area outside the limits of the municipality" and that "[n]o guidelines are set out in the law to be followed by the cooperative in making such determination, and no safeguards are provided against arbitrary action . . ." Thus, the court held that when "the Act attempts to delegate, to either the Public Service Commission or the cooperative, powers and functions which determine such policy and which fix the principles which are to control, the Act is unconstitutional." Likewise, the court found that the portion of the Act that permitted supplying of service without certificates if a "consent" agreement was entered by the cooperative and public utility as to service areas also was unconstitutional, as again the cooperative was permitted to determine whether a certificate should be granted.

The impact of *Johanneson* immediately became evident. Because the provisions of the Territorial Integrity Act allowing for "consent" agreements in lieu of certificates of public convenience and necessity were declared unconstitutional, it was apparent the caseload of the commission and the issuance of certificates would increase substantially. In anticipation of this increase and to reduce the delay caused by the notices and hearings necessary for the issuance of certificates, the Public Service Commission requested an opinion of the Attorney General as to whether conditional certificates could be issued without the usual full-scale hearing and determination. The Attorney General, in an opinion dated October 30, 1967, said the issuing of conditional certificates without hearing was proper, provided the controversy was fully submitted to the commission by an interested party in such a manner so a decision could be made, and the parties waived the notice and hearing required in the issuance of a certificate of public convenience and necessity. Thus, the

issuing of temporary certificates under certain conditions was allowed.

When NDCC Section 49-03-01.2 was declared unconstitutional, the legislative directions to the Public Service Commission were eliminated, and no criteria upon which the commission could make its decisions remained. However, this deficiency was remedied by the court in *Application of Otter Tail Power Co.*, 169 N.W.2d 415, 418 (N.D. 1969), in which the court established that in addition to customer preference, factors to be considered in determining whether an application for a certificate of public convenience and necessity should be granted include "the location of the lines of the supplier; the reliability of the service which will be rendered by them; which of the proposed suppliers will be able to serve the area more economically and still earn an adequate return on its investment; and which supplier is best qualified to furnish electric service to the site designated in the application and which also can best develop electric service in the area in which such site is located without wasteful duplication of investment service." Thus, customer preference is not a controlling factor but only one of a number of factors that must be considered for a certificate of public convenience and necessity to be granted.

Previous Studies

1967-68 Study

In 1967 the Legislative Assembly approved House Concurrent Resolution No. "B-2" which requested a two-year study be made of the laws relating to certificates of public convenience and necessity for extensions of service by electric suppliers and the extensions of electric transmission and distribution lines of electric utilities. The resolution directed that a committee composed of three members of the House of Representatives and two members of the Senate meet during the succeeding biennium with two persons representing electric public utilities and two persons representing rural electric cooperatives to study what method, if any, should be provided to resolve territorial disputes between electrical suppliers, whether more lucrative market areas were essential to the efficiency of rural electric cooperatives, and if rural electric cooperatives should be regulated in the same manner as rural telephone cooperatives.

This committee received testimony from the Public Service Commission, rural electric cooperatives, and public utility companies. The public service commissioners were basically of the opinion that the Territorial Integrity Act was beneficial, and they pointed out some areas where improvements could be made. The position of the rural electric cooperatives was that the Territorial Integrity Act was working and that fair and adequate guidelines were being developed by the Public Service Commission in following the interpretation placed on the law by the North Dakota Supreme Court in *Johannesson*. The cooperatives maintained any change in the law would result in considerable expense to cooperatives and public utility companies alike, as interpretive measures would have to begin anew. The position of the public utility companies was that the Territorial Integrity Act stifled growth and created confusion and uncertainty

as the utilities are not allowed to expand with the population move from city and rural areas into the fringe locations around cities. The public utilities maintained that in order to serve their customers economically and to provide a return to their stockholders, they must also continue to grow, and the only area in which growth was possible was in the metropolitan fringe areas. The committee made no recommendation as a result of this study.

1997-98 Study

In conducting its study of the impact of competition on the generation, transmission, and distribution of electric energy within this state, the 1997-98 interim Electric Utilities Committee reviewed the history and operation of the Territorial Integrity Act. The committee received testimony from representatives of the state's investor-owned utilities and the state's rural electric cooperatives.

Representatives of Montana-Dakota Utilities Company testified that the Territorial Integrity Act is unfair in fostering effective electric competition in North Dakota. They argued that it is a barrier to giving customers throughout the state the ability to make economic energy choices and as such should be repealed and fairplay rules substituted in its place for all competitors. They testified if rural electric cooperatives wish to pursue loads in urban areas, in competition with public utilities, then rural electric cooperatives engaging in such activity should no longer qualify for favorable financing arrangements with the federal government, exemption from state and federal income taxes, preferential access to low-priced federal power, and potential for debt forgiveness by the Rural Utilities Service, and should be subject to the same regulatory overview as public utilities.

The committee received testimony from a representative of Otter Tail Power Company that the Territorial Integrity Act is not accomplishing what its stated objectives are--to efficiently allocate scarce resources and to minimize disputes between electric suppliers--because the Act leads to a wasteful duplication of electrical facilities and increases, rather than minimizes, the likelihood of disputes between electric suppliers.

Representatives of the state's rural electric cooperatives responded that the Territorial Integrity Act is working well and is serving the purposes for which it was enacted. The committee received testimony that the state's investor-owned utilities have exclusive territories within the state's municipalities the rural electric cooperatives cannot penetrate and that the Act avoids the costly duplication of utility infrastructure. They noted there is substantial undeveloped land within the service territories of the investor-owned utilities while there is an outmigration of population in the rural areas and a corresponding decline in electrical usage. They testified that if it were not for some larger industrial and commercial loads, and some growth around cities in areas that were previously rural, rural electric cooperatives would have experienced a substantial decline in their sales, and it makes no sense to expand investor-owned utility territorial growth at the expense of the rural electric cooperatives that have invested in rural North Dakota. Representatives of the rural electric cooperatives

responded to the charge investor-owned utilities are competitively disadvantaged by the Territorial Integrity Act by testifying that since enactment of the Territorial Integrity Act, investor-owned utilities have continued to grow in customers and revenue and have not lost market share to rural electric cooperatives.

Representatives of the rural electric cooperatives also argued that the Territorial Integrity Act is not responsible for rural electric cooperative expansion into urban areas; that rural electric cooperatives can continue to serve their traditional service areas even when these areas become urbanized; and that the growth of the local rural electric cooperative around Fargo is overstated. The committee made no recommendation as a result of this study.

1999-2000 Study

The 56th Legislative Assembly enacted legislation that required the Electric Industry Competition Committee to study statutes relating to the extension of electric lines and facilities and the provision of electric service by public utilities and rural electric cooperatives within and outside the corporate limits of a municipality and to specifically address the criteria used by the Public Service Commission under NDCC Chapter 49-03 in determining whether to grant a public utility a certificate of public convenience and necessity to extend its electric lines and facilities to serve customers outside the corporate limits of a municipality and the circumstances under which a rural electric cooperative may provide electric facilities and service to new customers and existing customers within municipalities being served by a public utility.

The committee received testimony from the Public Service Commission that the 10 issues or factors that the commission considers in Territorial Integrity Act disputes are:

1. From whom does the customer prefer electric service?
2. What electric suppliers are operating in the general area?
3. What electric supply lines exist within a two-mile radius of the location to be served, and when were they constructed?
4. What customers are served by electric suppliers within at least a two-mile radius of the location to be served?
5. What are the differences, if any, between the electric suppliers available to serve the area with respect to reliability of service?
6. Which of the available electric suppliers will be able to serve the location in question more economically and still earn an adequate return on its investment?
7. Which suppliers extended electric service would best serve orderly and economic development of electric service in the general area?
8. Would approval of the application result in wasteful duplication of investment or service?
9. Is it probable that the location in question will be included within the corporate limits of a municipality within the foreseeable future?

10. Will service by either of the electric suppliers in the area unreasonably interfere with the service or system of the other?

Items 1, 9, and 10 were developed by the Public Service Commission while Items 2, 3, 4, 5, 6, 7, and 8 are taken from Supreme Court decisions concerning the Territorial Integrity Act. The Public Service Commission reported that it received 483 Territorial Integrity Act applications between 1988 and 2000. Of these, 458 applications were granted, 11 applications were denied, 12 applications were withdrawn, and two were pending. The commission reported that rural electric cooperatives filed 33 objections of which 15 applications were granted, 11 applications were denied, and seven applications were withdrawn. There were four applications appealed during this time period and one complaint appealed.

The committee received testimony from representatives of the state's investor-owned utilities that the Territorial Integrity Act and subsequent court interpretations have provided the distribution cooperatives with an opportunity to infringe upon the cities that are served by investor-owned utilities. They testified that over the years this situation has cut off their opportunity to share in the growth of the communities they serve and thus it is not a question of whether a change in the law is necessary but what changes need to take place to ensure the future, long-term viability of all the electric service providers in the state. Representatives of the state's investor-owned utilities testified that rural electric cooperatives currently enjoy virtually all of the growth opportunities in the state.

Representatives of the state's rural electric cooperatives testified that the Territorial Integrity Act is working well and avoids costly duplication of service. They testified that rural electric cooperatives should be able to participate in the state's growth areas as well as rural areas and that Congress never intended to limit cooperatives to serving only remote farmsteads and pasture wells, but federal and state law encouraged cooperatives to grow with their service areas. They testified that as some cities have expanded into the countryside where only the cooperatives were first willing to serve, the investor-owned utilities want to take away these growth areas at great cost to the consumers who built and own their own cooperative business. Representatives of the Association of Rural Electric Cooperatives argued that investor-owned utilities have had a fourfold increase in electric sales, a rate of growth comparable to the rural electric cooperatives, and the recent slowdown in the investor-owned utilities' growth rate is not because of state law, but because the state has not experienced the economic growth occurring in other states. They also said rural electric cooperatives have suffered more from this lack of growth than have the investor-owned utilities.

The committee received testimony from representatives of Fargo, Bismarck, and Minot concerning the franchising of electricity providers. The committee learned the City of Fargo has entered franchise agreements with two electricity providers--an investor-owned utility and a rural electric cooperative. These franchise agreements are nonexclusive, in that either provider can provide electric service anywhere within the city of Fargo. The

committee learned the usual practice is for franchise agreements to be amended to allow the provider to provide service in areas annexed by the city, and if there is a conflict, it is referred to the Public Service Commission for resolution.

Concerning franchise agreements in Bismarck, the committee learned in 1973 Montana-Dakota Utilities Company and Capital Electric Cooperative entered an area services agreement effectively demarcating the area of service by each provider. When Capital Electric Cooperative was granted a franchise by the City of Bismarck to operate within the city, the area service agreement was incorporated into Capital Electric Cooperative's franchise agreement. The committee received testimony from representatives of the City of Bismarck that this system has worked relatively well with only one serious dispute, which was resolved by the Bismarck City Commission without the Public Service Commission becoming involved.

Concerning franchise agreements in Minot, the committee learned the franchise automatically follows into areas annexed by the city, and there has never been a disagreement between Xcel Energy, Inc., and Verendrye Electric Cooperative, the local rural electric cooperative, that has reached the city commission.

2001-02 Study

In conducting its study of the impact of competition on the generation, transmission, and distribution of electric energy within this state, the 2001-02 Interim Electric Industry Competition Committee again reviewed the history and operation of the Territorial Integrity Act. The committee received testimony from representatives of the state's investor-owned utilities, the state's rural electric cooperatives, and representatives of the cities of Fargo, Bismarck, and Minot.

A representative of the state's investor-owned utilities testified that the urgency for the state's investor-owned utilities to find a reasonable alternative to the Territorial Integrity Act is becoming critical. Representatives of the state's investor-owned utilities testified that under the Territorial Integrity Act, if a customer located outside a city's limits wants service from an investor-owned utility, the investor-owned utility must file an application for a certificate of public convenience and necessity to extend service to that customer. However, inside city limits, the process is different. Rural electric cooperatives have no limitations placed on them in extending service to new customers, but investor-owned utilities, even inside the city limits of a community they presently serve, cannot extend service to a new customer if it interferes with an existing rural electric cooperative's service or duplicates the cooperative's facilities. Representatives of the state's investor-owned utilities testified that no such limitation applies to rural electric cooperatives.

A representative of Montana-Dakota Utilities Company said the current Territorial Integrity Act is stifling the opportunity for investor-owned electric utilities to add new customers. The representative testified that while it is true that Montana-Dakota Utilities Company will show growth in electric revenues of 4 percent for 2001, that growth is primarily due to off-system sales into the wholesale market, which although fairly robust for a few

years have largely evaporated today--absent off-system sales and the operating efficiencies that Montana-Dakota Utilities Company has implemented, growth of its entire North Dakota electric system has been very minimal, probably in the 1 percent range. Representatives of the state's investor-owned utilities testified that in Fargo and Bismarck, the number of new customers they are adding annually is declining, and soon the areas remaining for the investor-owned utilities in those cities to serve will be fully developed and the number of new customers they will be able to add will be zero. Representatives of the state's investor-owned utilities testified that the Territorial Integrity Act continues to be of urgency to the investor-owned electric providers, and it is an issue that needs to be resolved.

Representatives of the North Dakota Association of Rural Electric Cooperatives pointed out that the committee had not received any testimony from a consumer, a city official, or a representative of the Public Service Commission complaining or finding fault with the Territorial Integrity Act or how it has operated. They testified the Territorial Integrity Act works well for both the state's investor-owned utilities and the state's electric cooperatives. They testified the Act places service decisions where they belong, with local city governing bodies. They testified the Territorial Integrity Act creates a level playing field with a balanced approach and avoids duplication of expensive electric infrastructure and and thus there is no need to change the Territorial Integrity Act.

Representatives of the North Dakota Association of Rural Electric Cooperatives advocated that the rural electric cooperative enabling law, NDCC Chapter 10-13, be amended to allow electric cooperatives an unlimited right to serve in urban areas and to make urban customers cooperative members, provided that the cooperative purchases or otherwise acquires electric facilities from another utility on a willing buyer-willing seller basis. Under this proposal, sales by investor-owned utilities to cooperatives would be subject to approval by the Public Service Commission and the local franchising authority just as sales of cooperative property to investor-owned utilities are regulated. Proponents of this proposal said that providing more options for local electric service, rather than fewer, supports the idea that territorial integrity issues should be resolved through negotiation rather than legislation.

The committee received testimony from representatives of the state's investor-owned utilities opposing the willing buyer-willing seller proposal submitted by the North Dakota Association of Rural Electric Cooperatives. They testified this would allow electric cooperatives to purchase much larger investor-owned or municipally owned utility electric systems than allowed under current law. They testified the proposal would encourage electric cooperatives to entice municipalities to acquire by purchase or eminent domain existing electric utilities from investor-owned utilities and an electric cooperative could subsequently repurchase the facilities from the municipality and thereby effectively remove the investor-owned utility from the community in a manner that could not otherwise be accomplished under current law. They testified electric cooperatives would also have a

substantial advantage in competing with investor-owned utilities for the purchase of other investor-owned or municipal-owned electric utilities because investor-owned utility rates are set based upon the net book value of their investment rate base, and the Public Service Commission generally will not allow an acquisition premium in an investor-owned utility's rate base. Representatives of the state's investor-owned utilities testified that if an investor-owned utility attempted to purchase utility assets, it could not bid more than the book value of those assets because it could not recover any excess in its rates, while a rural electric cooperative could bid two or three times the book value of the assets.

The committee received testimony from representatives of the cities of Fargo, Bismarck, and Minot that the franchise agreements they have with the electricity providers in those cities are working well.

2003 PROPOSED LEGISLATION

The 58th Legislative Assembly considered several bills relating to the electric energy industry. House Bill No. 1454 related to the establishment of electric service areas and would have provided that electric service providers serving within any portion of a city of 10,000 or greater population located within a metropolitan statistical area shall negotiate and file an electric service area agreement with the Public Service Commission within 45 days after the effective date of the Act, or within 45 days of the date the city is included in a metropolitan statistical area, for the provision of electric service to areas outside the corporate limits of the city. The electric service area agreement would have established electric service areas for each electric service provider extending outward from the established corporate limits of the city to the outer boundaries of the city's extraterritorial zoning limits established by the city to provide each electric supplier a reasonably equal opportunity to grow as the city expanded outward from its corporate limits. The Public Service Commission would have been required to review and approve the agreement within 45 days after filing upon finding that the agreement was in the public interest and complied with state law. Upon approval of the agreement, the Public Service Commission would have been required to issue its order and a certificate of public convenience and necessity to the public utility electric service provider authorizing it to provide electric service to the electric service locations and to extend its plant and system within its approved electric service areas.

The bill would have provided that if the electric service providers were unable to negotiate an electric service area agreement, they would notify the commission in writing, and the commission would designate electric service areas for each electric service provider within 90 days thereafter. The commission would have been required to designate electric service areas extending outward from the established corporate limits of the city to the outer boundaries of the city's extraterritorial zoning limits established by the city. Each electric service area, as nearly as reasonably practical for each electric service provider, would have comprised territories with equal potential for electric service load growth.

Electric service providers would have been able to continue to provide electric service to existing electric service locations being served by them in any electric service area on the date the electric service was approved or designated by the Public Service Commission. House Bill No. 1454 failed to pass the House.

Senate Bill No. 2369 would have placed rural electric cooperatives that have 2,500 or more members served under the general jurisdiction of the Public Service Commission. Senate Bill No. 2369 failed to pass the Senate.

House Bill No. 1339 provides that the Legislative Assembly finds and declares that it is an essential governmental function and public purpose to assist with the removal of electrical transmission export constraints and to assist with the upgrading and expansion of the region's electrical transmission grid in order to facilitate the development of the state's abundant natural resources for export to the region's consumers. The Industrial Commission is to give priority to those projects, processes, or activities that assist with the resolution of electricity transmission export constraints in this state. House Bill No. 1339 was signed by the Governor on March 12, 2003.

COMMITTEE ACTIVITIES

Although the committee has not made any recommendations concerning its studies of the impact of competition on the generation, transmission, and distribution of electric energy within this state, the Territorial Integrity Act, or wind energy, committee discussion has led to legislation sponsored by other entities being enacted.

House Bill No. 1445 (1999) established the differentiation between electricity transmission lines and electricity distribution lines. This bill provided that except for purposes of transmission facility siting under NDCC Chapter 49-22 and regulatory accounting, including the determination of the demarcation between federal and state jurisdiction over transmission in interstate commerce and local distribution, for purposes of Title 49 and Chapters 57-33 and 57-33.1, lines designed to operate at a voltage of 41.6 kilovolts or more are transmission lines, and lines designed to operate at a voltage less than 41.6 kilovolts are distribution lines. Legislation relating to taxation of the electric industry is covered in a separate background memorandum.

POSSIBLE STUDY APPROACH

In carrying out its statutory responsibilities, the committee may wish to monitor federal electric industry restructuring initiatives, review electric industry restructuring in other states, and follow electric industry restructuring developments in other states. In conducting this study, the committee could solicit testimony from a number of sources. These include the Public Service Commission and its staff, representatives of the state's investor-owned utilities, representatives of the state's generation and transmission cooperatives, representatives of the state's distribution cooperatives, the North Dakota Association of Rural Electric Cooperatives, the

state's municipal electric utilities, power marketers, and large commercial and industrial power users.

ATTACH:2