STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 6140

Investigation into the Reform of)
Vermont's Electric Power Supply)

DEPARTMENT OF PUBLIC SERVICE POSITION PAPER

The Department of Public Service ("Department," "DPS") respectfully submits this paper as its initial comments on the issues identified by the Public Service Board ("Board," "PSB") in its Order opening this proceeding. These comments are necessarily brief, given the time allotted. The Department has discussed possible mechanisms for power cost mitigation in many venues, including Docket 5854, the Board's recent Forum, Legislative testimony and in rate cases. While more could always be said, the DPS offers these comments as a vehicle to collect certain ideas for reducing Vermont's power costs, and to offer observations regarding both opportunities and barriers for implementing those ideas. We look forward to participating in the development of further understanding of the opportunities for power cost mitigation as this proceeding develops.

Opportunities for cost reduction by regulatory action

Utilities with exposure to above market costs that were incurred through imprudent actions are at risk for regulatory action to prevent these costs from being passed to consumers. Indeed, to the extent that such power supply commitments are above market at all, traditional rate making subjects them to risk of non-recovery. See, for example, the Board's Order in Docket 5983. These risks leave utilities in the position of incurring potentially large costs with the possibility that there will not be offsetting revenues from rates to pay the suppliers. This potentiality is being addressed in Docket 6107, and may emerge elsewhere.

The fundamental problem is the question of whether power supply agreements which are so far out of line with currently available alternatives — alternatives which are likely to be available for the foreseeable future— are economically sustainable. The existence of such alternatives is amply evidenced, for example, by the existing applications to the New England ISO for interconnection studies; dozens of natural gas fired generator proposals have applied.

By law, electric utilities are responsible for minimizing costs consistent with providing safe and reliable service, including seeking reductions in their power costs. Some Vermont utilities have had success in recent years in reducing the price of power from Hydro-Quebec. Regulators must appreciate, however, that their decisions influence the motivations and priorities of the utilities and the power suppliers to reduce the price of power in these contracts. We can only expect parties to act rationally based on the conditions they see.

Today, the regulatory scene is in flux. Board actions in rate cases in the next four to eight months should strive to promote reexamination of power sale contracts by utilities and power suppliers.

As to how that might be done, it is instructive to examine the case of Hydro-Quebec ("HQ"). HQ has stated publicly that it wants to see Vermont adopt retail competition before it will entertain contract adjustments. We perceive two reasons for this. First, HQ apparently believes that some legislative directive mandating less than full stranded cost recovery is possible and feels that this may require an adjustment to the contract -- HQ does not wish to go through this twice. Second, HQ states that retail competition makes sense and may be an acceptable reason to adjust contracts and regulatory assets to more market-oriented values as power suppliers must be more competitive. Regardless of the merits of these positions, it is possible that regulatory action could create new reasons for power suppliers to consider reducing their prices, including the possibility that a power supplier may need to manage its risks through a potential or actual utility insolvency.

On the Qualifying Facility ("QF") front, we are aware that VEPPI, the present purchasing agent, is pursuing developments that might lead to a plan to reduce the price of Vermont's obligation to QFs under PURPA. We are glad to see that VEPPI has begun to pursue mitigation efforts. At this time as part of this docket, it seems best to allow VEPPI to present its ideas and explain the prospects for mitigation, as well as the conditions under which mitigation might be obtained. The Department would expect to comment more fully thereafter.

Many observers are concerned that a regulatory or legislative decision which denies recovery of any substantial amount of power costs could precipitate a bankruptcy. Further, there is concern that possible defaults resulting from a bankruptcy may affect nearly all the utilities in

the state due to so called contract "step-up" provisions. These matters are very complex, and DPS proposes that when these matters are addressed, they receive focused attention not available now or here.

Cost reduction by securitization

Securitization is a complex financial device. However, the following essential points should be kept in mind when considering securitization as an option for power cost mitigation. Securitization is fundamentally a way of obtaining credit using future accounts receivable as collateral. In the context of power cost mitigation, the future receivable is a stream of future payments from ratepayers. The public policy justification for securitization depends on the assumption that those future payments are a *portion* of recoverable costs and, hence, a *portion* of the rates that ratepayers would otherwise have been obliged to pay if securitization had not been established. In any program to collateralize receivables, the proceeds from a known or highly likely payment from consumers is transferred to another party, in exchange for an up front cash settlement. This is essentially debt financing using receivables as collateral. Because electricity consumers in the aggregate are highly reliable in paying their electric bills, this source of cash is very low risk to the financier.

Thus, securitization, if authorized, may be used to "collect" a stream of above market power costs which the consumer will pay. These revenues are then packaged into a low risk financial instrument. The consumer can save in two ways. Typically, the financing raised by securitization is applied to reduce a cost that ratepayers would have borne in the future. For instance, if the cost to be borne in the future is the payment of principal and carrying costs on an obligation, securitization may result in the carrying cost being reduced. Alternatively, the money raised by the securitization notes can be used to buy out or buy down high priced power contracts provided the power supplier sees economic value in either transaction.

Securitization gets mixed reviews. While the above market cost reductions would arguably benefit ratepayers and the increased certainty would help utilities and power suppliers, opposing

commentators are concerned that consumers will be found today to be obligated to pay for costs out into the future, and then those costs will not actually materialize as planned. This could happen, for example, if market prices turn out to be higher than forecast. This would be a very adverse event for consumers, since they would have paid for something they didn't have to pay for, or just paid too much. Some proponents suggest securitizing only 50-75% of eligible above market costs to hedge against the risk of market prices going up. On the other hand, it may be very difficult to determine whether the benefits from a particular securitization proposal are acceptable and justify obligating ratepayers to forego any additional savings. This is particularly difficult to decide if the securitization proposal requires ratepayers to forego claims that the costs were, in fact, not recoverable.

While specific legislative authority for securitization would increase the certainty afforded to financiers and, so, probably reduce the cost (or increase the potential benefits) of this approach, some say there are plausible arguments that existing law provides utilities with the latitude they need to use this tool. The Board should explore the issue in this docket.

In any case, the DPS believes that securitization can benefit consumers if done with great care. Naturally, any securitization proposal and instrument would have to be approved by the PSB. The PSB would also have to assure that only legitimate, verifiable, otherwise recoverable and prudently incurred costs are eligible for securitization. In addition, the PSB should take a conservative view on the market price forecast used as the basis of long term above market cost estimates. Other mechanisms, such as "true ups" might help to ensure meeting the appropriate goals for securitization.

It is worth noting that because of the technical characteristics of Vermont's above market power sources, securitization is especially apropos in Vermont's situation. The above market cost commitments of Vermont utilities are by and large long term contracts where the electricity prices are known with significant accuracy. (One exception is Vermont Yankee, to the extent that it may have above market costs.)

Auctions or All-Requirements Arrangements

A number of utilities in Vermont are rethinking their future. There have been announcements by some of their intent to exit the generation business altogether. Some such proposals involve auctioning off all current power supplies. Others, envision selecting a third party who would take on the management all of those supplies and receive the right to sell whatever power is required (hence, "all requirements") to meet the load of the divesting utility at some price or under some formula determined in advance. Utilities in other New England states are making or considering similar decisions, although most of those moving in that direction are major generation owners and do not depend so heavily on purchased power under fixed contracts. Utilities should actively consider these ideas and act on them in accordance with sound utility management principles, seeking to develop proposals that deliver significant net benefits for ratepayers.

These concepts are *potentially* relevant regardless of whether Vermont adopts retail competition. The implications in a retail competition transition are relatively clear and have been well illustrated in other states. Absent retail competition, these proposals presumably mean that those utilities would purchase the power needed to meet their obligation to serve retail customers in some manner that is "at the market" and cease building or owning generation and possibly divest some or all of the generation they now own. (At times, these pronouncements have seemed to imply that those utilities would divest their existing purchased power contracts, although it is less clear how purchasing "at the market" thereafter would differ fundamentally from the status quo.) Again, absent retail restructuring, the franchised utilities have and should expect to retain the obligation to serve in the least cost manner. A key question for an all requirements proposal would be the fate of the "right to sell" in the event of a transition to retail competition. In this case, the open issues described above under Securitization may need to be considered as well.

Renewable Portfolio Standard

In considering retail electric competition, many stakeholders, notably the DPS, have advocated that retail suppliers should be required to include a minimum percentage of renewable

power supplies. This device recognizes the public policy merits of a sustainable power supply, one that will not create a burden for future generations, as well as the benefits of a diverse power supply, one where incremental new capacity is not entirely one fuel, such as natural gas, which is the fuel for virtually *all* proposed new generation capacity in New England.

Observers have noted that, interestingly, a renewable portfolio standard could also have the effect of reducing stranded costs. To see how this would happen, note that creating a mandatory market segment for renewable power, would improve the economics for existing renewable supplies. Furthermore, we believe it likely that the cost structure of the emerging regional wholesale market will be dominated by large amounts of new gas combined cycle generation. That would likely result in a relatively flat supply curve so that the above market cost of existing non-renewable sources would not be very sensitive to moderate changes in the demand for generic or non-renewable generation that a renewable portfolio standard would cause. If renewable power commands a premium over the broader market clearing price, and if the above market cost of existing non-renewable sources remains relatively unchanged, then the *net* portfolio above market costs of existing resources are reduced. To the extent that Vermont utilities have a large proportion of their power supplies in renewables, the market value of their portfolios would be differentially increased, reducing their above market costs, while the above market cost of the remainder would be relatively unchanged. A concern raised about a renewable portfolio standard is that it could increase the *overall* cost of power, but through the competitiveness among those developing resources that would qualify within this market segment, the clearing price for this segment is reduced, just as it is in the broader and increasingly competitive wholesale power market.

The PSB could consider adding to its implementation of Integrated Resource Planning under existing statutes a renewable portfolio standard for existing Vermont utilities. In this way, the size of the stranded cost "problem" could be recalculated. The issue of whether the PSB can or should attempt to render a definition of what is renewable and what would qualify for such a standard is complex, and the DPS wishes only to raise this issue here. A second issue is the effect such a plan would have. Skeptics would observe that imposing a renewable portfolio standard in a state which has already seen substantial development of renewable resources by its existing

utilities would be of no practical consequence. However, it is important to consider the operational future of existing renewables on incremental decisions made from time to time. For instance the recent announcement of interest in developing wind power on Mount Equinox, the on-going work on wood gasification, along with the infant net metering law, indicate a market which may be receptive to regulatory direction in this regard.

McNeil

The McNeil Station has become a magnet for development of renewable energy ideas. An advanced gasification system, an innovative district heating proposal, a far-thinking EcoPark concept are all attractive due to McNeil's existence and the commitment of BED and its other owners and the City of Burlington to renewable energy. On the other hand, McNeil as a stand alone power generator is often not dispatched due to its running costs. This is despite conscientious efforts by plant managers to control costs. DPS believes McNeil is an important asset to Vermont. These other opportunities must be developed aggressively and swiftly to assure that McNeil is not caught in a narrow attempt to cut current costs and closed precipitously.

Merger Opportunities

Presently, there are 22 electric utilities providing generation, transmission and distribution services in Vermont. Clearly, there are redundancies in the provision of these services to Vermonters. In addition, several franchise territories are not contiguous adding to redundant operating expense within a company itself.

Merger, or consolidation of the industry, among existing Vermont utilities should be explored as a means of reducing the cost of Vermont's power supply. Mergers in other states have resulted in rate reductions. The benefits of affiliation with a larger company with more leverage and purchasing options provides for these reductions. Benefits to consumers also extend beyond power supply costs to include reductions in Operations and Maintenance and capital investments. Careful analysis of merger/ acquisition activity is required under existing industry

structure and may need to encompass a broader view to ensure that today's mergers do not create market power issues in Vermont's future.

Sale of Vermont Yankee

We are, of course, aware that the owners of Vermont Yankee are considering selling the asset. It is important for the owners to consider this possibility. Another entity, which may specialize in operating many nuclear power stations, may be able to operate Vermont Yankee with less costs while maintaining or even improving quality. But we should be clear that such a transfer is unlikely to happen swiftly. No sale of this kind (outside a merger) has ever happened, though the first of its kind (regarding Three Mile Island 1) has just been proposed. The regulatory course at the U.S. NRC is uncharted. Finally, while it may be awkward to say so, provisions in S.62 from the 1997-8 biennium, which passed the Senate with provisions that could appear to seek the closure of Vermont Yankee, may discourage potential buyers.

Closure of Vermont Yankee

It is at this time uncertain whether early closure of Vermont Yankee would benefit consumers. The DPS is doing an economic viability study of Vermont Yankee where this and other issues will be examined. DPS expects to publish its results by the end of 1998. Vermont Yankee owners also engage in their own economic viability assessments in advance of each refueling outage. Observers should be prepared for the possibility that the DPS study may find that the economics of a potential early closure remain uncertain. In other words, we may find that in some futures, closure may be economically desirable, while in others, closure would be costly to ratepayers.

Concluding Remarks

The downside to resolving our above market contracts is that in doing so, we will only be

able to strike a compromise between our existing obligations and current market prices. Vermont stakeholders will wonder if we (meant in the broadest sense) did the best we could. Since the present offers significant uncertainty about the future, second guessing will be even easier than usual. Decision makers of courage will need to size up the opportunities with clear eyes and make decisions which will be criticized. Since we can see that going in, the PSB should urge those decision makers to bring forth not just the ideas needed, but the courage and clear thinking needed to bring these matters to resolution, and enable Vermont's electric industry to resume its focus on good, reliable, and safe service to customers.

While we aggressively support further investigation into the above mentioned ideas with regard to Vermont's power supply, we would be remiss in ignoring the benefits of comprehensive restructuring of Vermont's electric industry. The mitigation efforts under consideration have the potential to provide significant and, perhaps, immediate benefits to ratepayers. These efforts do not, however, correct the flaws inherent in the existing regulatory system and they do not address the long-term threats to Vermont's industrial, commercial and residential sectors from the competitive markets growing around us. We respect the Board's focus in this docket and have not elaborated on the opportunities presented by a move to retail competition in a restructured industry.

It is possible that the regulatory process will put heavy strains on our state's electric utilities. This could happen as a result of imprudence findings, or other events. In such an event, a bankruptcy of one or many Vermont utilities is a possibility. In such a situation, parties will have strong incentives to mind their own interests to the exclusion of others. If reorganization under bankruptcy law is inevitable, the PSB, DPS and other stakeholders will need to look for opportunities to use that reorganization to make the resolution of these high priced power contracts most efficient.