

Seattle City Light



Gary Zarker, Superintendent
Norman B. Rice, Mayor

May 9, 1997

Congressman John D. Dingell
Ranking Member
House Commerce Committee
US House of Representatives
Washington, DC 20515

Dear Congressman Dingell:

I'd like to express my gratitude for your many years of leadership on electric utility policy and regulation. I hope that the responses that we've provided to your questions are helpful as you and other members of the House Commerce Committee consider restructuring options.

By way of background, I would like to emphasize a few characteristics of Seattle's municipally-owned electric system. We've been in existence for more than 100 years and serve approximately 300,000 customers - both inside city limits and in formerly unincorporated communities of greater King County. We own about 1,800 megawatts of generation, nearly all hydroelectric from facilities that set a high environmental standard, with several on rivers with robust salmon runs. We are continuing strong advocates for environmental protection, energy efficiency, and low income programs, spend about 7-8 percent of total retail revenues on the latter two, and want to continue that effort many years into the future.

Our generation meets about 80% of our needs in an average water year, and we rely for the remainder on spot market purchases and a long term relationship with the Bonneville Power Administration. Because we have little hydro storage in the Northwest and the resource fluctuates by season and by year, we sell a significant amount of surplus power annually in the west coast market. Our retail electric rates average 3.7 cents/kWh, significantly below the Washington state average, which has the second lowest retail rates in the nation.

We have a handful of customers who are interested in market-based rates and new delivery choices, and we are taking steps to meet their needs. We have a pilot underway with customers that have the metering, communications technology, and wherewithal to experiment with rates pegged to the California/Oregon border spot market price, which changes hourly, plus **transmission and local distribution**. We are also paying close attention

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City of Seattle — City Light Department, 700 Fifth Avenue, Suite 3100, Seattle, Washington 98104-5031

Telephone: (206) 625-3000 TDD: (206) 684-3225 FAX: (206) 625-3709

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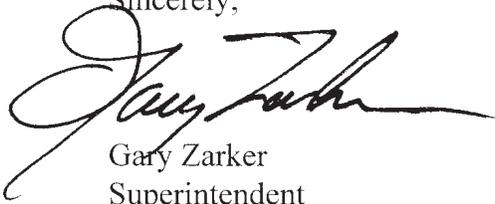
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to many electricity restructuring experiments - in the UK, Australia, New Zealand, Norway, Argentina, California, Illinois, Wisconsin, and most of New England - so that we can learn what's worked and what hasn't in these efforts.

But the overwhelming majority of our customers are pleased with the high quality, high reliability, and low cost product they receive. They share in the management of the utility and shape the choices that we offer all our customers.

Please feel free to call me (206-684-3200) or our Director of External Affairs, Jim Harding (206-386-4504), if you have further questions. Our responses to your specific questions are attached.

Sincerely,

A handwritten signature in black ink, appearing to read "Gary Zarker". The signature is fluid and cursive, with a large initial "G" and "Z".

Gary Zarker
Superintendent

Attachment

Seattle City Light's Response

1(A). What concerns does your company have in connection with increased competition in wholesale markets?

We have five principal areas of concern with increased wholesale market competition. The first involves the need to adapt the Bonneville Power Administration, and the resources it controls, to this new reality in a way that is fair and equitable to the market, the US Treasury, and the many values of the Columbia and Snake river systems. The other four issues - taxes, environmental issues, bulk power system reliability, and market power - are more or less regional.

Reforming BPA is an extraordinary challenge, and the Northwest Governors began with a four state process that culminated last December in the issuance of a final report. The Governors also have a Transition Team that is working on implementation of the recommendations at the state and federal level. I participated as a member of the Regional Review and continue to work closely with the Transition Team. But, as you know, the challenges are many.

The market position of Bonneville is an issue we struggled with. The agency owns and operates 85% of the region's high voltage transmission; it markets power from all federally owned dams on the Columbia and Snake rivers - about two-thirds of the hydropower in the region, half the total generation, and clearly the lowest marginal cost generation. In addition, many of the other dams in the Columbia and Snake river are hydrologically coupled to BPA operation; they have very little storage and must generate essentially in parallel with the federal system. In 1980, with your help, Congress passed the Northwest Power Act, which greatly strengthened Bonneville's already dominant position in the region.

The act gave BPA the *statutory responsibility* to serve all regional public and private utility demands placed upon it. I believe the agency is unique in the nation in having this wholesale obligation to serve. BPA was directed to acquire energy efficiency resources, hydro-firming resources, renewable resources, and last in preference, fossil and nuclear resources to meet growing regional loads. Bonneville's direct service companies - generally aluminum smelters - received a guarantee of service beyond their expiring contracts. Oversight of BPA's power business and fish and wildlife restoration was provided by the Northwest Power Planning Council, whose members are appointed by the region's four Governors.

This approach ably met the region's needs for more than a decade, but, for better or worse, it does not match the market realities, policies, and regulations of the 1990s. Rising BPA rates, falling surplus power prices throughout the west, and new FERC regulations on transmission have forever undercut the basic features and cost-allocation mechanisms of the Regional Power Act. Electric utilities want choices, as do many of their customers, and Bonneville needs some degree of relief from the obligation to meet any and all loads placed upon it.

I served on the Regional Review, and strongly support the recommendations directed to Bonneville. In the current marketplace, Bonneville's long term firm power product is not competitive with West coast spot market prices. We all hope and trust that the agency can

reduce its costs and retire some of its long standing obligations. As that occurs, we proposed that existing customers of BPA be able to buy power through a long-term subscription process. We believe that this transfers the near-term risk of over-market power to the buyers, strengthening the security of BPA's Treasury debt, in exchange for the longer term benefit of lower cost, if Bonneville falls below market. We felt this approach allocated power along much the same lines contemplated in the Regional Power Act, facilitating the usual wholesale and retail market competition between and among existing public and private utilities. It does not easily fit with vertical divestiture or full scale retail choice, but it does meet a number of other high priority financial and environmental national needs.

We strongly opposed the notion that a federal entity - not subject to state, local, or federal taxation, state or local siting laws, antitrust law, and any number of other special rules - should be free to compete against existing utilities for new retail customers. We recommended that Bonneville confine its marketing activities to *wholesale transactions*. We also recommended that Bonneville at least administratively separate its power and transmission business lines, with enhanced FERC supervision, if necessary, to ensure fair cost allocations, resolution of conflicts, and minimization of regional market power.

We believe these recommendations remain vital to the region, to the future of BPA, and to taxpayers' investments in the region's grid. I firmly believe that *the role of the federal assets must be clearly defined before the region can statutorily extend competition to retail loads*. Every public and private utility in the Northwest is tied hydrologically, economically, and statutorily to Bonneville, and every decision that agency makes has the potential for cost shifts and controversy that don't square well with the competitive market model.

We are also concerned about a number of other wholesale market issues, including tax issues, bulk power system reliability, environmental policy, and regulation of market power.

Briefly, Northwest public utilities have little in the way of stranded assets in a more competitive wholesale market. But the larger generating and transmitting publics do face a specific challenge in trying to comply with open transmission access requirements without exceeding the private use limitations on transmission lines financed with tax exempt bonds.

It is appropriate to ask whether it is good or bad public policy to "grandfather" the tax exempt status of public utility transmission under the federal tax code. If the assets are *not grandfathered*, there will be less transmission capacity available in most regional power grids, and the uncertainties may frustrate development of regional independent system operators. If the assets *are grandfathered*, they can be made available for use by a regional ISO. Is this unfair in any way to existing transmission owners? Not in our view. As we've seen with the IndeGo (our regional ISO) proposal, individual utility revenue requirements for transmission are protected in early implementation. The emerging advantage of an ISO is not price, but broad market access. Other transmission owners, whether public or private, high cost or low cost, should not be negatively affected by grandfathering.

Nor will grandfathering set a precedent. State legislation, Congressional legislation, FERC regulation, or marketplace pressure make it risky, if not impossible, for any utility - public or private - to bond finance *new generation or transmission*. Even if they wanted to, many utilities cannot credibly pledge their existing assets, vertical integration, and “core customers” as security for these investments. Instead, we - public utilities and most privates - hope to rely on merchant projects financed with venture capital. We have some concerns about long-term system reliability in this marketplace.

Environmental policy is also affected by changes in the wholesale electric market. With its heavy reliance on hydroelectricity, the Northwest does not have the air quality issues raised by market changes in the rest of the nation. We do have a category of on-going environmental responsibilities that are difficult to estimate with precision, like a classic utility investment in an over-market asset. These responsibilities include on-going fish and wildlife restoration efforts associated with hydroelectric dams and nuclear decommissioning. These future obligations correctly belong to the resources built to serve current customers, and we believe Congress needs to consider how these future obligations will be addressed. It cannot become national policy to avoid these responsibilities in bankruptcy court.

As suggested by our comments on BPA, we believe that there are many wholesale market issues that Congress should pay attention to. If generation is completely deregulated, we need to pay close attention to regional and sub-regional market power. If the British experiment proves one thing, it is that an unregulated duopoly isn't any better than a regulated monopoly. Where viable competitive markets do not exist, we believe strong regulation of price and terms and conditions of service is entirely appropriate.

1(B). If states you serve have adopted, or are considering adopting retail competition, what issues have been most important to you and what, if any, concerns do you have with respect to state action?

2. What challenges would your company face if Congress mandated retail competition by a date certain? How would this affect your rights and responsibilities? What issues would have to be addressed, including but not limited to modifications to the tax laws, for you to successfully make the transition? What consequences would result if such issues are not specifically addressed, what interests would be affected, and how?

We have taken the two retail competition questions together. From our point of view, we believe that decisions on retail competition should be made at the state and local level and not pre-empted by the federal government. We believe that the terms and conditions of retail electric service are the province of state and local government, and that the appropriate interests of the federal government lie with policies and regulations for the wholesale market. We also believe FERC has already and unwisely crossed this line.

We did review and testify on several retail competition bills that came before the Washington legislature this year. Our principal issues with the state bill involved: 1) the risk to Bonneville and the US Treasury if public utilities did not have the customer load to meet their contractual

net billing obligations for WPPSS debt; 2) the impact on existing system bonds that are secured by all the assets of our current system, and would be impaired by the proposed legislation; 3) the opinion of our bond counsel that future borrowing would be significantly more costly; 4) the inequitable responsibilities left with existing utility companies; 5) funding of public purposes, including affordable, universal service, low income assistance, and energy efficiency; and 6) cost, technical feasibility, and benefits, if any.

Ultimately, the proposed state legislation did not pass, but we anticipate a continuing debate and other bills next session. We would support state legislation that meets our needs and our customers needs, and we will continue to provide new rate options and delivery choices to customers without deadlines or statutes.

But we are also aware that well-meaning legislation can have negative and unintended consequences, particularly for a state and region that enjoys high reliability and rates that are about half the national average. Our counsel to the state legislature and Governor has been to watch and learn from existing experiments in the UK, California, New England, and some of the midwestern states. We do not believe this strategy is a disadvantage to our citizens or citizens in high cost states with aggressive restructuring efforts.

As we know from recent changes in the phone industry, the longstanding goal of “universal service” is, increasingly, not being met. This is a problem we must avoid in electricity. For a number of reasons, affordable and reliable universal service is at risk in a more competitive market environment.

The historical commitment to universal service stems from in a vertically integrated utility structure with statutory obligations to serve all foreseeable franchise area loads. That structure is changing, though the outcome isn’t absolutely clear. However, most models of utility restructuring assume a completely deregulated generation market, with no enduring state or federal price regulation, a FERC-regulated regional transmission monopoly, and state and locally-regulated distribution system utilities. If we in fact head in this direction, the transition may take a decade to accomplish, given the complexity of the existing industry, market power of incumbent providers, divided responsibilities between state and the federal government, and the huge range of potential winners and losers in every part of the nation.

One piece that we do not want to lose is the reliability of the system, including the ability to build new generation when needed, the ability to add transmission when needed, the ability to expand and maintain local distribution systems, and the contractual and regulatory underpinnings to ensure that a divided system works as well as an integrated one.

Some efforts are proceeding rapidly, especially in states with high retail electric costs, and we should take the opportunity to learn how restructuring affects universal service. On the generation end, state and federal regulators will probably spend some number of years trying to make sure that a deregulated generation market has the necessary elements for full and fair competition - multiple providers, none with market power; transparent prices for buyers and sellers; protection against excessive volatility; and prices that are high enough and stable

enough to encourage and sustain new generation. In the meantime, utilities are likely to reduce generation and transmission spending to a minimum.

At the distribution level, some competition is emerging with or without statutory change. Utilities are looking much more critically at distribution system investments that could become stranded in more competitive conditions. If customers want the right to choose their providers, then it is inevitable that providers will want the right to treat their customers differently. This may very well lead to significant changes in utility pricing and service. For example, residential, commercial, and industrial rates are typically set for the entire class of customers. In most circumstances, urban residential customers subsidize rural residential customers; old customers subsidize new customers; fully “built-out” areas subsidize areas with new growth; customers who pay their bills on time subsidize those who don’t. There will be strong pressure to eliminate these longstanding pricing and service policies.

Utilities faced with competitive threats and the chance of physical bypass will be forced to re-examine high cost segments of existing distribution systems and either charge full price or consider withdrawing from that market segment. The ultimate resolution may involve a universal service fund similar to the one used in the phone industry.

There are some other issues associated with system reliability. We are paying very close attention to pilots throughout the United States, the California retail experiment, and restructuring in England and Wales. One of the most challenging problems involves the communication, metering, and system software needed for real-time electricity pricing, billing, and scheduling of transactions. It is quite clear in the Northwest that BPA’s system software, which manages loads and resources for many public utilities, will not be able to manage a significant increase in wholesale transactions. This is not unusual - California expects to spend approximately \$250 million in hardware and first-of-a-kind software to develop a working power exchange.

The UK has considerable experience with software and billing for open access, but when the market expanded in 1994, systems were unable to cope, and customers were getting estimated bills or no bills at all for many months. Most analysts think that the full retail access planned for next year will prove nightmarish. They also question whether it is advisable or possible to extend real-time metering and billing to the household level, which would require some \$1.6 billion in new metering technology and another large investment needed in data processing for billing. An alternative scheme, imported from Norway and under consideration in California, would estimate demand profiles by customer class, though this option is no more than a best guess and faces legal and regulatory hurdles.

In our judgment, the technical and administrative mechanics of open transmission access and retail wheeling can create heavy burdens on existing providers. It is not at all clear how the costs of these activities are to be paid for, and by whom. We are getting somewhat better at estimating the scope and magnitude of the issue, thanks to existing experiments, especially in the UK and in California, but we should be very careful about 1) imposing high costs unless there are compensating benefits, and 2) allocating costs and benefits fairly among customers and suppliers.

3. Several states have either adopted or are considering securitization plans to address stranded cost recovery as part of a state retail competition plan. Whose interests are served by such an approach, and what if any risks are posed and for whom?

While Seattle City Light owns and operates resources, including hydro resources that cost 7 cents/kWh, our overall portfolio is currently at or below expected spot market electricity rates. As divestiture, plant retirements, and growth occur in the west, particularly in California, we expect spot prices to become much more volatile and generally higher. This is certainly what the California planners currently forecast. Our stranded cost issue, if we had one now, is likely to become smaller in the future.

Only one utility in our state -- Puget Sound Energy -- has sought any securitization of assets through the legislative process, and this was involved the issuance of 100% debt financing for prudently incurred conservation investments. This action did not expose the state to any financial risk and clearly reduced the carrying cost of conservation investments to Puget and its ratepayers.

4. Some states have argued that Congress should enact reciprocity requirements barring sellers in states which have not adopted retail competition from access to markets in states which have done so. Do you believe such legislation is warranted, and why? What consequences would ensue if Congress does not enact reciprocity provisions?

States that open themselves to retail competition are doing so, in very large part, to gain access to cheaper power outside their borders. They have made a calculated decision that represents a good balance for ratepayers and stockholders of existing utilities. If we respect that decision, there is no particular need to require reciprocity. Moreover, it would seem difficult to enforce without full FERC regulation of the terms and conditions of retail electric service. This we clearly oppose.