



Don D. Jordan
Chairman
and
Chief Executive Officer

May 8, 1997

The Honorable John D. Dingell
United States House of Representatives
2125 Rayburn House Office Building
Washington, DC 20515-6115

Dear Congressman Dingell:

As the debate on the future structure of the electric utility industry continues—both in Washington and here in our own state capitol—I appreciate your request to share our company's views on the complex policy issues with you and the House Commerce Committee.

Houston Industries Incorporated and other electric utilities around the nation are working to promote a responsible and well-reasoned transition from a fully regulated industry to one of increased competition that benefits all energy consumers. In 1995, the Texas Legislature rewrote our utility regulatory law in a way that began the process of introducing market forces, where appropriate, while continuing to maintain consumer safeguards. Currently, the 75th Texas Legislature is working on passage of a restructuring plan, which calls for retail electric customer choice in Texas after September 1, 2001 and in return, provides utilities with full stranded cost recovery.

Our opinion is that this bill, as written, contains the necessary safeguards for both consumers and the electric industry to ensure fair and efficient retail competition. After debate on the plan is completed later this month, I will provide a final assessment of its contents to you and your staff. This input may be helpful as Congress considers deregulation of the electric utility industry.

Regarding the important questions you raised in your letter of April 10, you will find enclosed a detailed response to those questions.

In closing, let me applaud your willingness to explore all points of view toward restructuring an industry so vital to America's safety and economic well-being. I look forward to continuing to work with you and your staff on this and other matters of importance to the nation's power supply.

Sincerely,

A handwritten signature in black ink, appearing to read 'Don D. Jordan', written in a cursive style.

Attachment

**The Honorable John D. Dingell, Ranking Member
Commerce Committee Democratic Office
U. S. House of Representatives**

**Response of Houston Lighting & Power Company (HL&P) to Questions on Electric
Industry Restructuring**

- 1. From your company's point of view, is it necessary for Congress to enact legislation bearing on retail competition, and why? If you favor legislation, please outline which issues should be addressed and how you think they should be resolved.**

The issues concerning retail competition have vast economic, social, and political ramifications. We believe that those issues should be addressed in legislation and regulatory policy to ensure fair and effective retail competition. Specifically, as will be discussed further in our response to No. 2, HL&P believes there are four primary issues associated with any discussion of industry restructuring.

First, obligations previously deemed prudent should be honored. Anything short of full recovery of the utility industry's prudently incurred costs not only creates an undue financial burden on the industry, it is also unjust to the many shareholders who have placed their confidence in the industry.

Second, reliability must be maintained or improved. Few would argue that reliability is the consumer's uppermost concern when it comes to delivery of electric service. If restructuring of the electric industry results in diminished reliability; legislators, regulators, and the electric industry itself will have failed our fellow citizens and customers.

Third, all classes of customers must have an opportunity to benefit from the new industry structure. Retail access could hurt smaller electricity consumers by allowing large, more sophisticated consumers, who have more negotiating power and a better understanding of the marketplace, to garner better deals--this must be prevented.

Finally, all market participants must have an equal opportunity to compete. No competitive advantage should be allowed because of discriminatory regulatory rules or tax code provisions. The advantages currently enjoyed by public power entities must be eliminated.

- 2. If the state(s) you serve has adopted or is considering adopting retail competition, what are your biggest concerns? Please be specific. Indicate how you are dealing with them and any recommendations you may have.**

For the purposes of this discussion we will deal with four primary issues. These include: 1) stranded

cost recovery; 2) service reliability; 3) ensuring that all classes of customers have an opportunity to benefit; and 4) insuring that all market participants have an equal opportunity to compete.

Stranded Costs

Utilities should be allowed the opportunity to recover fully all prudently incurred costs and obligations. The utility's prudently incurred costs include investments in power plants, as well as long-term contracts for fuel and/or purchased power. They also include costs to fulfill public priorities established by legislators and regulators. These programs include energy conservation, low-income energy assistance and alternative fuel use, all of which may be placed at risk in a competitive environment. Utilities must be afforded a reasonable opportunity to recover fully all costs which have been determined to be reasonable and prudently incurred regardless of whether those costs are termed transition costs, stranded investment or excess costs over market. Anything short of full recovery of the utility industry's prudently incurred costs not only creates an undue financial burden on the industry, but also harms the many shareholders who have placed their confidence in the industry.

Electric utilities have been regulated through a "regulatory compact." Under this compact, utilities are granted service territories in which they have the right to serve retail consumers. In exchange for this franchise, utilities have an "obligation to serve" all consumers in that territory on demand; they must ensure that there is sufficient generation, transmission and distribution facilities to serve all their present and future customers.

Electric utilities have spent billions of dollars annually in order to fulfill their regulatory obligation to meet the current and future needs of their electric consumers. These costs are legitimate expenses incurred by utilities under a regulatory compact that makes utilities different from most businesses. For utilities, only reasonably incurred costs approved by regulators can be recovered through electric rates. (In fact, many investor-owned utilities, including HL&P, have experienced protracted prudence reviews and subsequent disallowances associated with various large generation projects.) In addition, regulators have consistently required utilities to delay recovery of their costs over long periods of time - up to 30 years, while limiting the profits that utilities can earn.

Stranded costs will be paid by someone - departing customers for whom the costs were incurred, the utility's remaining customers, or utility shareholders. There is no such thing as a free lunch. A fair and workable mechanism to recover these stranded costs is critical to assuring the development of a competitive environment that benefits all consumers and that maintain investor confidence in federal, state, and local government to honor its commitments.

Residential consumers and small business customers - who may be less attractive to some alternative power suppliers - should not have to pay higher prices so that only large customers can benefit. Nor

should utility shareholders be penalized. Millions of Americans own utility shares-either directly, or indirectly through mutual funds, pension funds, employer 401(k) programs and life insurance policies. The typical utility shareholder is of retirement age, and depends on dividends to contribute to their retirement income. These shareholders have upheld their part of the bargain by providing the money to build the electric systems that serve most Americans. Just because public policy may have changed, neither the shareholder's property interest in the utilities' generation, transmission, and other assets, nor their long-term investment savings should be devalued or lost because of revised public policy. All electricity customers, as well as utility shareholders, must be protected during this period of transition to greater competition.

Finally, contrary to the contention of some, shareholders have not been compensated for the risk of stranded cost because the risk premiums allowed in utility returns on equity never contemplated the risk that once investments were found prudent they could subsequently be disallowed via a change in the rules.

Service Reliability Must be Maintained or Improved

Under today's regulatory framework, utilities are required by law to provide continuous, reliable service to anyone who requests it. This involves two components of reliability— energy supply (generation) and energy delivery (transmission and distribution). In an open retail market, the utility obligation to supply and deliver electric power would become only an obligation to connect and deliver.

Regardless of industry structure, maintaining the reliability of power delivery will remain an important electric industry goal. In a deregulated world, the utility no longer ensures that adequate generation is available to meet the demands of its customers. In an open retail market, adequate supplies of electricity would be subject to the laws of supply and demand.

The reliability of the electric delivery system must be maintained or improved.

All Customers Must Have a Legitimate Opportunity to Benefit

Any restructuring of the electric industry will create a multitude of new marketers and sellers offering goods and services. Many of these new entrants do not have experience that can be readily evaluated by consumers. Retail wheeling in particular, could hurt smaller consumers by allowing larger, more sophisticated electricity consumers who have more negotiating power and a better understanding of the marketplace to garner better deals.

Other issues that must be addressed include clearly identifying who, if anyone, will bear the responsibility for ensuring that facilities are adequate to provide service to all and who, if anyone,

will be the provider of last resort. Customers need to understand that with choice comes risk. Therefore, any industry structure must provide consumers sufficient, accurate, and timely information so that they can make rational decisions about electricity services, providers and cost.

Granting residential customers the first choice does not mean that all will have equal retail access as long as suppliers can be selective in providing service. Cherry-picking of large, sophisticated customers as well as redlining of economically disadvantaged areas must be prevented to avoid undue discriminatory behavior.

All Market Participants Must Have an Equal Opportunity to Compete

No supplier should have an advantage over another except by virtue of corporate enterprise. No advantage should be given by mandating utilities' use of certain technologies (e.g., renewables), while requiring no restrictions to new entrants. Additionally, institutional advantages should not be conferred on any party to the detriment of another (e.g., public power entities getting tax subsidies not provided to other participants). (See discussion on Public Power in question No. 6.)

- 3. Whether or not you favor federal legislation, please indicate your position on the following specific issues (to the extent not addressed in your prior responses):**
 - a. *A Federal Mandate requiring states to adopt retail competition by a date certain. If retail competition is under consideration in the state(s) you serve, do you believe Congress should provide additional direction or authority?***

The introduction of comparability rules for transmission and the ongoing debate over retail access poses several jurisdictional questions. For instance, at what level should policy be set--state or federal? What level of governmental authority should determine the regulatory responsibilities for retail access and reliability issues associated with generation, transmission and distribution? As the new structure of the industry unfolds and the magnitude of these questions is revealed, new legislative and regulatory roles must preserve the current and future infrastructure. More specifically, legislation should respect and "grandfather" any mandatory dates set under a reasonable state-determined transition plan.

Federal legislators and regulators can provide invaluable direction to the restructuring discussion by lending their guidance in how to make paramount the best interests of the nation as a whole. Federal and state authorities should work hand-in-hand to build a model framework for fair and effective competition in electricity, without one side dictating to the other.

- b. ***Recovery of stranded investment.*** If the state(s) you serve already has adopted retail competition, how was this issue addressed and are you satisfied with the outcome? If your state(s) is considering adopting retail competition, how would you recommend that this issue be treated? Do you think Congress should enact legislation relating to stranded cost issues, and if so what would you recommend? Is securitization a useful mechanism for dealing with stranded costs, and whom does it benefit?

The 75th Texas Legislature is currently deliberating the deregulation issue. As discussed previously, stranded cost recovery is central to the overall debate; how that issue is resolved will have a far-reaching impact on the industry and the reliability of the supply and delivery system. We continue to stress that utilities should have an opportunity to mitigate stranded cost prior to retail access in order to create an orderly transition to retail competition. A freeze on the current rates of a utility, coupled with several mitigation options can significantly increase the write-down of generation and/or regulatory plant assets, thus reducing stranded costs prior to retail access. These mitigation measures can include transfers of depreciation, accelerated depreciation and the use of securitization. Any legislation should support mitigation and recovery of utility stranded cost.

Securitization has been used successfully in other industries and has recently been suggested as a mechanism to help address the stranded cost issue in the electric industry. Securitization, approved by a few states and currently being explored in a number of other states, entails the financing of stranded costs, up to a defined limit, by issuing debt (asset-backed securities), and paying the interest and principal associated with the debt through a non-bypassable charge levied on the utility's customers.

The ability to securitize is typically established through enabling legislation. Because of the statutory ability conferred on the utility to collect these funds, including true-up mechanisms, the securities are highly rated by bond agencies, typically at triple A. This high rating carries with it reduced interest costs as compared to the utilities' cost of capital, including debt typically rated at single A or even triple B. This reduced interest cost will provide a lower cost of service compared to the traditional utility cost of capital built into current utility rates.

The use of these mitigation measures over an extended period during the transition to retail access can significantly reduce the amount of stranded cost exposure for a utility. If structured properly, stranded cost recovery prior to the introduction of retail access can be achieved without impairing competition or efficient operation.

- c. ***Reciprocity.* Can states condition access to their retail markets on the adoption of retail competition by other states? Should Congress enact such a requirement? Could such a requirement create an incentive for states with low electric rates not to adopt retail competition, in order to keep cheap power at home?**

States may condition retail access on reciprocity; however, because of wholesale competition, this is not an assurance that cheap power will be kept within the State that implements reciprocity. The competitive realities are that markets will change and prices will be set by the market.

4. **If Congress enacts comprehensive restructuring legislation, should it mandate “unbundling” of local distribution company services? What effects would this have, and would they differ for various customer classes? Would this entail substantial expense, and who would incur any such costs?**

The concept of unbundling local distribution company services presents unique economic and physical challenges. The scope of what entails unbundling can also vary. It can range from a separation of rates into their component parts to physical separation of a company’s functional areas. The impact of unbundling on municipals, cooperatives, and public power should also be included in the analyzing the issue. At this time, it is not clear if unbundling distribution company services is the appropriate way to proceed.

5. **Recently Chair Moler of the Federal Energy Regulatory Commission recommended that, as part of comprehensive legislation, Congress authorize the Commission to enforce compliance with North American Electric Reliability Council standards to help maintain reliability of service. Do you believe this is necessary, and why or why not?**

The North American Electric Reliability Council (NERC) was formed in 1968 by the electric utility industry to promote the reliability and adequacy of bulk power supply in the electric utility systems of North America. NERC is comprised of eleven regions of which the Electric Reliability Council of Texas (ERCOT) is a member. ERCOT has always utilized the NERC standards as a basis for comparison and currently not only complies but in many cases exceed these standards. The NERC initiative is a viable solution for addressing reliability standards.

The reliability concerns associated with deregulation and the recent power outages in the western U.S. will require that NERC play a stronger role, similar to that of the Institute of Nuclear Power Operations (INPO), an industry-based group established to address common operational issues at the nation’s nuclear plants. All U.S. utilities operating nuclear plants are members of INPO. INPO routinely inspects operating reactors, reviews significant operating events and maintains data bases on nuclear power plant operation. The industry’s investment has paid off, as both safety and

performance have significantly improved.

NERC, in assuming this expanded role, could make use of self-enforcement tactics used by the National Association of Securities Dealers (NASD). NASD Regulation, Inc. an independent subsidiary, is charged with regulating the securities industry and the Nasdaq Stock Market. Created in 1938 by the Maloney Act amendments to the Securities Exchange Act of 1934, the organization has been the securities industry's primary self-regulator for over 57 years. The industry is essentially self-regulated and exposes itself to voluntary enforcement of prescribed standards.

6. What concerns does your company have with respect to the role of public power and federal power marketing agencies in an increasingly competitive wholesale electric market? In markets in which retail competition has been adopted? Are there concerns you would like to have addressed if Congress enacts comprehensive restructuring legislation? Should Congress consider changes to federal law as it applies to regulation of public or federal power's transmission obligations?

The direction of recent federal policy is toward greater competition in electricity markets, with the goal of lowering electricity prices for all consumers and stimulating economic growth. These policies are threatened by continued federal power subsidies that distort market forces. Electricity markets cannot be deregulated without addressing the respective futures of all the players including the investor-owned utilities, electric cooperatives, municipals and the numerous federal power marketing administrations.

Wholesale Competition

Unfair competition currently exists because of the types of subsidies available to government-owned electric utilities, rural electric cooperatives and municipal electric systems. Municipal utilities benefit from:

- exemption from federal and state income taxes;
- exemption from other taxes, such as property and excise taxes; and
- issuance of tax-exempt securities to finance investments.

Rural electric cooperatives generally find available such primary subsidies as:

- exemption from federal taxes, except social security;
- exemption from other taxes, such as property and excise taxes;
- direct loans from the federal government at below-market rates of interest; and
- loan guarantees that allow them to borrow at favorably low interest.

A significant federal subsidy available to both government-owned electric utilities and rural electric cooperatives is preferential access to low-price federal power. This is where the federal Power Marketing Administrations (PMAs) most forcefully make felt their impact on the industry.

These federal subsidies directly favor government-owned electric utilities and rural electric cooperatives at a cost to the U.S. Treasury of more than \$8 billion annually in revenue foregone, while benefiting fewer than 25 percent of American consumers.

Retail Competition

As referenced above, public power, municipalities, and cooperatives enjoy a myriad of tax exemptions not available to investor-owned utilities or any other private/publicly-owned enterprises. The responsibility to fund federal, state, and local governments, as well as our public schools, should be shared by all market participants.

Congressional Role

The tax inequities and subsidies for public power and cooperatives must be eliminated when they sell electricity outside their service territory. (This includes no exemptions from state/local taxation.) In addition, public power and cooperatives should adhere to the same transmission “comparability” standards imposed on investor-owned utilities by the states and FERC.

7. If Congress enacts comprehensive restructuring legislation, should changes be made to federal, state or local tax codes, and if so why? Please be specific.

Market share is likely to shift from regulated utilities, who pay more in taxes, to less heavily taxed electric providers. This will cause a decrease in the value of property belonging to currently regulated providers, who often made expensive capital investments required by regulators. Property taxes paid by utilities help to fund infrastructure, hospital districts, fire protection districts, public education and other societal needs of the communities they serve. Federal, state and local government will inevitably suffer losses in funding due to these decreased and depressed property values.

Attachment (A) cites major tax changes that are necessary to maintain societal benefits and preserve a level playing field for all market participants.

8. What, if any, concerns do you have about the reliability of the electric system? If the industry moved to retail competition, will adequate reserves be available? Is the transmission system capable of handling full retail competition?

The reliability of the bulk power system is intrinsically jeopardized by competition. For this reason, NERC standards should be uniformly applied to all market participants, including public power and cooperatives.

In response to the alarmingly high incidence of major blackouts in 1996, the NERC is coordinating a comprehensive effort to revise planning standards and guides, as well as enforcement mechanisms to alleviate reliability concerns. This is a very complex area, and ultimate success is far from secured. Certainly, more stringent planning standards will cause transmission costs to increase and aggravate many landowners and others who oppose additional transmission lines. In recent years, transmission line certification has often been highly contentious, with landowners afforded multiple opportunities in regulatory and civil proceedings to block construction of proposed transmission lines. With the advent of retail competition, and an increase in power transactions, reliability concerns will only increase.

If open access is embraced and a vibrant competitive market is encouraged, the logical outcome is for generation patterns to be increasingly based upon economics at a macro-system level, resulting in increased instances of generation-load mismatch. Large blocks of power will be transferred from one localized area to another, pushing the system capacities to their limit and ultimately requiring more transmission capacity.

Besides the inherent problems associated with large power transfers, disintegration of generation from transmission for the sake of competition raises its own reliability and economic issues. Integrated generating unit controls and protection have historically been a primary means of ensuring bulk system reliability. When disintegration occurs, these reliability-related functions will be provided by some other means at an additional expense.

Given the above concerns, it is impossible to estimate whether adequate transmission reserves exist to support a fully competitive market. To be sure, further study is needed to determine the impact of any unexpected generation shifts, peak demand requirements, and catastrophic disasters to the power grid.

ATTACHMENT (A)
FEDERAL, STATE AND LOCAL TAX MODIFICATIONS

Federal

- * Nuclear Decommissioning Costs - Currently, Title 26 of the U.S. Code Service, i.e., the Internal Revenue Code (“Code”) allows a current tax deduction for nuclear decommission costs. The deduction is limited to the lesser of the amount included in a utility’s cost of service or the ruling amount approved by the Internal Revenue Service. Congress needs to amend the Internal Revenue Code to allow electric utilities continued tax deductions for contributions to a qualified nuclear decommissioning trust even though they will no longer be subject to traditional cost of service rate making.

- * Tax-exempt Bond Financing - Currently, publicly-owned utilities, i.e., municipal and state-owned utilities, most rural cooperatives and federal power marketing agencies can make use of tax-exempt financing for the acquisition of new facilities to serve or sell to customers outside existing territories. This gives these entities a clear competitive advantage and significantly impacts taxes paid. Congress should remove the availability of tax-exempt bond financing for the publicly-owned utilities.

- * Tax Depreciation Lives on Plant Assets - Currently, the Code provides that utilities can depreciate most of their regulated electric utility plant assets over a period of twenty years. Congress needs to amend the Code so that the class lives of all electric utility assets, whether regulated or not is consistent with comparable manufacturing assets.

- * Federal Income Taxes - Investor-owned electric utility companies, independent power producers and some rural electric cooperatives are subject to the federal income tax at a 35% rate. Municipal and state-owned utilities, most rural cooperatives and the federal power marketing agencies are not subject to the federal income tax. Congress needs to amend the Code to remove the tax-exempt status from the municipal and state-owned utilities, rural cooperatives and the federal power marketing agencies.

- * Interest Expense Allocation - Some investor-owned electric utilities are investing in foreign power projects. Interest expense allocation rules limit the ability of many of these utilities to use the tax paid to the foreign country as a full credit against the U.S. tax liability. In order that domestic utilities can be competitive with foreign investors, Congress needs to amend the Code to allow such a credit

State and Local

* Public Utility State Gross Receipts Tax - This tax is imposed on investor-owned utilities located in an incorporated city or town having a population of more than 1,000, according to the last federal census. A tax rate of approximately two percent is imposed on all gross receipts from business conducted in an incorporated city or town. Changes should be made to mandate all electricity providers to pay this tax.

*State PUC Assessment Tax & City Gross Receipts (Franchise) Taxes - These taxes are imposed on investor-owned utilities by the State of Texas and the various municipalities in which an IOU sells electricity, and are similar in nature to the Public Utility Gross Receipts Tax, above. Changes should be made to mandate all electricity providers to pay this tax.

* Property Taxes - A major portion of the tax assessment on investor-owned utilities is the property tax. However, the methodology used to calculate property taxes is significantly different than that of other business entities. The result is that the value of the property for utilities has substantially increased compared to other businesses. Changes should be made to provide for consistency in the assessment methodology for all business assets

*Tax-Exempt Entities - Municipal-owned utilities, state-owned utilities, some rural cooperatives and federal power marketing agencies benefit from exemptions from some or all state and local taxes (e.g., Texas Franchise Tax, local Property Taxes, Sales/Use Tax and the various Gross Receipts Taxes). Changes should be made to mandate that all electricity providers pay their equitable share of all taxes.