

PART III

Recommendations to Facilitate Effective Competition in the Commonwealth

Executive Summary

Part III of the Report consists of two sections. The first section includes a discussion of recommendations advanced by various stakeholders as means of facilitating effective competition in the Commonwealth as soon as practicable. The second section of Part III discusses the SCC's recommendation that a suspension of the Act is in the public interest because delaying implementation of the Act is a prerequisite to the preservation of Virginia's jurisdiction.

To assist development of a comprehensive list of recommendations to foster effective competition, the Staff sent a letter to over 70 interested stakeholders seeking their suggestions. In a letter dated April 16, 2003, Staff posed eight questions designed to stimulate respondents' thoughts on specific restructuring issues. Although the Staff's mailing list targeted stakeholders thought most affected by electric restructuring issues, responses were received from just twelve stakeholders. In a similar survey conducted in 2002, the SCC received sixteen responses. The twelve 2003 responses are included as Appendix III-A to this Report.

Generally, most of the comments received are similar to those expressed in last year's report and reiterated during the past year via various forums such as work group discussions. Respondents' recommendations, while discussed in detail in Part III, do not provide new ideas; the recommendations presented have already been considered by the SCC and the CEUR. Many of the twelve respondents continue to believe that the major

obstacles to effective competition in Virginia include:

- The existence of low, capped rates of the incumbent utilities,
- The existence and method of determining wires charges,
- The recovery of yet-to-be-quantified stranded costs,
- The lack of a functional RTO, and
- The lack of effective customer demand response programs.

The second section of Part III contains the recommendation that the General Assembly take action to suspend portions of the Act by re-bundling rates and continuing the moratorium on the transfer of control of Virginia's electric transmission systems to federally-regulated regional transmission entities.

Section 56-596 of the Act requires the SCC to report its recommendations to facilitate effective competition in the Commonwealth as soon as practicable, which shall include any recommendations of actions to be taken by the General Assembly, the SCC, electric utilities, suppliers, generators, distributors, and regional transmission entities it considers to be in the public interest. This year, the SCC has one recommendation, and it is not new.

The status of competition for electric service is not encouraging. There has been little change in market conditions around the country or in Virginia since we submitted the December 2002 Addendum. Though there are isolated instances in other jurisdictions of competitive activity among larger commercial and industrial customers, retail choice is not yet providing meaningful benefits or yielding sustained savings anywhere in the country. Even more distressing than the absence of sought-after competitive activity is the likelihood that the implications of the SMD NOPR will be detrimental to Virginia's electricity consumers.

For these reasons, we renew our recommendation that the General Assembly suspend the Act. Suspension of the Act would require rebundling the components of retail electricity rates and continuing a moratorium on transfers of control over transmission assets to RTOs. However, the General Assembly could allow other aspects of the Act to continue to evolve while these two elements of the Act are temporarily suspended.

Pausing in the implementation of the Act is the best course if we are to preserve Virginia's ability to protect its citizens from the problems that are likely to result from the ceding of regulatory authority to FERC and regional transmission entities. The potential costs of adhering to a perceived schedule for the sake of implementing change outweigh the risks of delay. It is possible that any future benefit of retail access could be affected by a delay of retail access. However, we currently have the basic rules, systems, and procedures in place to harmonize retail access. If Virginia delays full implementation now and retail access proves successful elsewhere, we will be in position to implement retail choice quickly and effectively. This ability to respond quickly should minimize any loss to Virginians with a delay at this time.

PART III

**RECOMMENDATIONS TO FACILITATE
EFFECTIVE COMPETITION
IN THE COMMONWEALTH**

CONTENTS

<u>Section 1 - Stakeholder Recommendations</u>	1
Issue 1: The existence of low capped rates of the incumbent utilities.	3
Issue 2: The existence and determination of wires charges.	6
Issue 3: The recovery of yet-to-be quantified stranded costs.	9
Issue 4: The lack of a fully functional RTO.	10
Issue 5: The lack of effective customer demand response programs.	13
Issue 6: The volatility of natural gas prices.	15
Issue 7: The robustness of the Retail Access Rules.	16
Issue 8: The continuation of consumer education outreach.	17
Issue 9: Update to proposals to consider from the 2002 Report.	18
<u>Section 1 - Summary</u>	19
<u>Section 2 - SCC Recommendation</u>	19

This part of the Report consists of two sections. The first section includes a discussion of recommendations advanced by various stakeholders as means of facilitating effective competition in the Commonwealth as soon as practicable. The second section of Part III discusses the SCC's recommendation that a suspension of the Act is in the public interest because delaying implementation of the Act is a prerequisite to the preservation of Virginia's jurisdiction.

Section 1 - Stakeholder Recommendations

This final section of the Commission's 2003 report on competition presents a discussion of issues affecting competitive activity within the Commonwealth's electricity market. To assist the Commission in developing this discussion, our Staff sent a letter on April 16, 2003, to over 70 interested stakeholders. In that letter the Staff asked for any thoughts and recommendations related to the specific topics listed in § 56-596 B of the Act. These topics include the supply and demand balance for generation services, new and existing generation capacity, transmission constraints and market power. In addition, Staff posed eight questions designed to elicit respondents' thoughts on specific restructuring related issues.

Staff received comments from twelve respondents. It then held a meeting on June 6, 2003, to discuss the comments and issues raised. Not counting Staff, only twelve people attended the meeting representing eight different organizations.

Provided in Appendix III-A, are the Staff's letter, a list of stakeholders the letter was sent to, and all of the comments that were received.¹ The following stakeholders provided comments and recommendations to the Staff:

¹ Comments are also posted to http://www.state.va.us/scc/division/eaf/comments_comp.htm .

Utilities:

Allegheny Power (“AP”)
American Electric Power (“AEP-VA”)
Dominion Virginia Power (“DVP”)
Virginia, Maryland & Delaware Association
of Electric Cooperatives (“Cooperatives”)

Competitive Service Providers/Aggregators:

New Era Energy (“NewEra”)
Pepco Energy Services (“PES”)
Strategic Energy, LLC (“SEL”)

Consumer Representatives:

Urchie B. Ellis, Esquire

Others:

Municipal Electric Power Association of Virginia (“MEPAV”)
National Energy Marketers Association (“NEM”)
Virginia Committee for Fair Utility Rates and Old Dominion
Committee for Fair Utility Rates (“VCFUR/ODCFUR”)
Virginia Energy Providers Association and
Virginia Independent Power Producers (“VEPA/VIPP”)

The remainder of this section discusses the issues identified through the aforementioned forums. These issues are not ranked in any order of preference or importance. Similar to last year's report, the major obstacles to effective competition identified by the respondents include:

- the existence of low, capped rates of the incumbent utilities,
- the existence and method of determining wires charges,
- the recovery of yet-to-be-quantified stranded costs,
- the lack of a functional RTO, and
- the lack of effective customer demand response programs.

Additional comments received by Staff addressed the volatility of natural gas prices, the FERC's SMD NOPR, the robustness of the Retail Access Rules, and consumer education efforts. This section will also update any progress regarding the proposals presented in last year's report. Finally, this section will identify any recommendations to be considered during the next twelve months.

Issue 1: The existence of low capped rates of the incumbent utilities.

Several respondents stated or implied that traditionally, Virginia has enjoyed relatively low electricity prices with the existing monopoly structure. This implies that *"generation, transmission and distribution assets are generally adequate to meet customer demand and that they are generally operated efficiently"* as stated by New Era Energy, Inc. ("New Era") in its letter of May 23, 2003. Currently, these low prices continue providing little margin for which alternative suppliers can compete.

Possibly the most vigorously argued premise advanced by several respondents since the passage of the Restructuring Act is that competition cannot develop until customers are subjected to market-based prices for competitive energy supply. It is also believed by several respondents that price caps prevent appropriate price signals from reaching customers. Allegheny Power points out in its letter of May 23, 2003 that *"Rate caps serve to protect customers during the transition period, but the same rate caps also insulate retail customers from the reality of pricing variability that exists in the wholesale market. This obstacle will be removed when rate caps are removed, at which point the generation component of default service rates will be based on competitive market prices."* The National Energy Marketers Association ("NEM") submits that *"Price caps do not facilitate energy competition and do not permit consumers to modify their consumption levels in response to price."* in its comments of May 23, 2003.

As was the comments last year, not all respondents agree that the rate caps should be removed. AEP-VA, DVP, and the Cooperatives state that the rate caps and wires charges are included in the Restructuring Act as a result of negotiations intended to balance developing competition with a smooth transition process. Mr. Ellis states in his

letter of May 13, 2003 that "*we now have low rates, good service, and a fine prosperous major power company (Dominion). The only way this can be overcome is to increase the amount that Virginia residential users have to pay for electricity!*"

This issue of removing price caps so that the price for competitive energy supply is market-based has generated a tremendous amount of debate. One side believes that price caps are a fundamental flaw of the Restructuring Act and competition will not develop until they are removed. Once removed, it is argued that the market will develop quickly and serve to regulate prices and protect consumers.

The other argument is that the primary concern during the transition to a competitive market is the protection of the consumer. Such protection requires consumers not be exposed to market-based prices until effective competition has developed and can be depended upon to regulate prices. As a result, there is tension between letting the market set price levels where it will, and ensuring an *effectively* competitive market, a touchstone of the Restructuring Act, where *competition* sets market prices.

Similar to last year, rate caps are believed by many to be an essential consumer protection built into the Act. A concern expressed by several respondents going into restructuring was that Virginia had relatively low-cost energy and that there would be upward pressure on prices in a competitive market. Virginia's electric utilities assert that they agreed to cap their rates through mid-2007 with the expectation that they could continue to earn an adequate return plus recoup any stranded investment during that time frame, thus the rate caps provide a protection for utilities as well as consumers.

The Act changes the processes and obligations through which Virginians will obtain retail electric service. The General Assembly determined that non-fuel rates should be “capped” for incumbent utilities until July 1, 2007. However, this rate cap imposes costs and benefits on incumbents. It also imposes costs and benefits on ratepayers. That is, it is not clear that capping rates confers net benefits on customers. The “cap” has had the effect of a “freeze”. In the absence of the cap, it is not known with certainty if non-fuel rates would have been higher or lower than the capped rate level.

Many believe the underlying premise of the Restructuring Act is that a competitive market will result in lower retail electricity prices for Virginia consumers. It appears counterintuitive to believe that these prices must rise to induce competition. A stronger case could be made for market-based pricing during this transition period if Virginia was surrounded by effectively operating competitive electric markets, particularly if the low-cost states in the southeast had deregulated and injected their low-cost generation into the market. Unfortunately, retail competitive activity continues to develop slowly throughout the nation, not just in Virginia or in the Mid-Atlantic region. Consequently, a market has not yet fully developed that can be depended upon to regulate prices.

Issue 2: The existence and determination of wires charges.

Related to the aforementioned issue, respondents continue to claim that the wires charge mechanism may be as strong a detriment to the development of competition as rate caps. For instance, NEM submits, *"the wires charge is a significant barrier to entry in the Virginia market. The manner in which the wires charge is calculated and implemented makes it virtually impossible for competitive suppliers to compete with the utilities."* They further state that *"Imposing a wires charge on switching customers is unfair and unwise because it penalizes those customers who attempt to lower their energy costs and defeats the entire purpose of permitting price competition in the first instance."* NEM believes that any costs that are unavoidable to provide default service should be recovered through adjustments to the default service rates and any costs or lost revenues not related to the provision of default service should be added to distribution rates in a neutral fashion.

Similarly, New Era asserts *"the recovery of stranded cost is appropriate but it should only be for facilities investment and long term supply contracts that cannot be mitigated with reasonable efforts. It should not recover lost revenue."* New Era also states that *"even if the wires charge were to be reduced, its unpredictability creates an unnecessary high risk for competitors. Competitors cannot make price commitments to customers beyond the period of the existing wires charge rate. The inability to realistically predict the wires charge is a serious obstacle."*

Pepco Energy Services ("PES") contends that the most significant obstacle to an effective competitive retail market in Virginia is the *"artificially low price-to-compare ("PTC") set annually by the Commission on a customer class basis. Projected market*

prices for generation used by the Commission to set wires charges – which, in turn, affect the calculation of the PTC (the wires charge and the PTC have an inverse relationship) — should reflect a retail market price rather than a wholesale market price." It is worth noting that the PTC for our major low cost utilities is not the market price but rather the embedded cost of generation.

The incumbent utilities share a common view that the relationship between the wires charge and capped rates is a cornerstone of the Restructuring Act that was developed through intense negotiations. The wires charge, they say, is designed to assure utilities of revenue neutrality during the transition period.

It is hard to refute either side of the argument related to this proposal. The wires charge will cause it to be more difficult for competitive suppliers to offer savings to customers. On the other hand, the wires charge is a central component of the Restructuring Act.

The elimination of the wires charge may help, but certainly will not guarantee, competition. Although there is no wires charge within the service areas of Delmarva, AEP, or Allegheny Power, there still is no shopping.

The Commission has already made its interpretation of the Act and how it relates to the issue of a projected market price based on wholesale or retail market prices. It did so in its order in Case No. PUE-2001-00306, where the Commission concluded as follows:

We do not disagree that allowing for “headroom” by incorporating retail costs in market prices would fairly recognize the costs CSPs will incur to serve customers, and would likely promote competition. However, it would not be revenue neutral to the incumbent utility.

The Act, in our view, is designed to make the incumbent utility whole, with the wires charge priced to make the utility indifferent as to whether it

recovers stranded costs through capped rates or wires charges. Including retail costs in the calculation of market prices would not likely leave the utility in a revenue neutral position as the Act is designed to do. We cannot, therefore, find that the Act authorizes such action. If the General Assembly determines that this measure is appropriate to advance competition it, of course, may amend the Act to allow it.

Issue 3: The recovery of yet-to-be quantified stranded costs.

Another issue related to those above regard the recovery of stranded costs. Generally, the incumbent utilities believe the Restructuring Act simply requires any stranded costs that exist to be recovered through the utility's capped rates and wires charges without quantifying the amount of such stranded costs. Other respondents contend that one must quantify the total amount of stranded costs to determine an over or under recovery.

In fairness, comments to Staff's April 16, 2003 letter were submitted in May, prior to the release of our Stranded Cost Report on July 1, 2003 to the CEUR. Much discussion was entertained throughout the work group process as described in our Stranded Cost Report to the Commission on Electric Utility Restructuring issued on July 1, 2003. Additionally, we believe the issues raised in the May comments are sufficiently addressed in the Stranded Costs portion of Part II of this Report and need no further discussion at this time. The Commission awaits further direction from the CEUR.

Issue 4: The lack of a fully functional RTO.

Perhaps the most common issue raised among the comments submitted in response to Staff's letter regards the lack of a fully functional RTO as the major obstacle to an inactive competitive market in Virginia. AEP-VA states "*a critical element of successful implementation of the Act, entry in of Virginia's major utilities into an independent regional transmission entity, has been substantially delayed until well into the period ending July 1, 2007.*"

Allegheny Power contends that "*another obstacle to the development of competition is the need for a wholesale power exchange, including real-time energy markets. Real-time energy markets provide an alternative to the purchase of load following products when supplying a retail load-shape.*" NEM "*urges the Commission to require the utilities to transfer control of their transmission systems to an RTO as soon as possible...*"

The Virginia Energy Providers Association ("VEPA") observes that "*the most significant obstacle to the development of robust competition in Virginia is the delay of Virginia's incumbent electric utilities in gaining state approval to join an approved Regional Transmission Organization to serve wholesale markets, ultimately to the benefit of retail customers. Without the participation of Virginia's incumbent utilities in a fully functioning, truly independent, unbiased regional transmission organization, effective wholesale competition can not develop. And without effective wholesale competition, retail competition is impossible.*"

Members of the Municipal Electric Power Association of Virginia (“MEPAV”) have *"supported the development of independent RTOs of sufficient size and scope to provide benefits to consumers and have been supportive of the concept of Standard Market Design for wholesale electric markets."* The MEPAV also supports the 2003 amendments to Sections 56-579 A 2 d and 56-579 F of the Act for the SCC to ensure that consumers’ needs for economic and reliable transmission are met and that any transfer of transmission facilities maximize the benefits to all consumers.

DVP states that *"Development of an open-access, non-discriminatory wholesale power market covering a broad region is an essential foundation for successful retail choice. Even most critics of the Standard Market Design initiative launched by the Federal Energy Regulatory Commission concede the benefits of an open interstate wholesale market."*

Strategic Energy submits that *"because Virginia does not belong to a Regional Transmission Organization, and therefore lacks an active bilateral market and a balancing energy market, there is little or no opportunity to offer value-added services."* They further state that *"Larger control areas not only create more robust markets, but improve reliability by better coordinating the use of transmission facilities."*

The Virginia Committee for Fair Utility Rates and the Old Dominion Committee for Fair Utility Rates believes that *"membership in an RTO should enhance reliability by easing access to generation sources across an entire region."* They also contend that the SCC Order in Case PUE-2000-00550, dated March 7, 2003, *"represents a good start in fulfilling the Commission's revised responsibilities under the new legislation."*

Many of the respondents also urge the Commission to proactively and cooperatively continue working with the FERC and neighboring states to develop a satisfactory SMD or Wholesale Market Platform. They claim that such resolution will ease the entry of incumbent utilities into RTOs.

The Addendum to 2002 Status Report on Competition that we issued in January discusses our concerns regarding an RTO and FERC's proposed SMD. This supplemental report identifies our concerns regarding FERC's proposed SMD and implications upon an RTO serving the Commonwealth. Since that report, FERC issued its White Paper regarding changes to its originally proposed SMD and the Department of Energy released its cost-benefit analysis of the original SMD proposal.

We further articulated our concerns regarding the proposed SMD and the results of the DOE Study in a letter to U.S. Congressman Bob Goodlatte on June 19, 2003. This letter was also sent to members of the Commission on Electric Utility Restructuring. Summarily, FERC's White Paper amplified our concerns relative to the potential impact of FERC's initiative. The DOE Study reinforces these concerns because, even with optimistic assumptions and virtually no risk analyses, the results do not make a case for going forward. In short, the SMD, overlaid onto Virginia's Restructuring Act, could have significant negative results for Virginia consumers.

As previously discussed in the RTE Development portion of Part II of this Report, the Staff is currently evaluating the transfer of transmission facilities of the incumbent investor-owned utilities to PJM prior to January 1, 2005 and approval of such transfers are pending before this Commission.

Issue 5: The lack of effective customer demand response programs.

Similar to last year, a few respondents submitted comments indicating the need for more effective customer demand response programs. New Era states their belief “that in the long-run, competition will benefit the consumer by creating significant technological advances, new products, alternative rate options, and a far more efficient overall industry” and “that the LTTF, supported by the SCC, needs to create a vision of what new structures and options are desired in the electricity industry and to determine if legislation, regulation or incentives are appropriate to encourage the transition.”

New Era also submits that demand response programs already exist but generally are not promoted. Further, they contend that small customers do not understand demand and that there are actions to take to reduce their peak demand, affect their costs, and that there are products available to assist with demand response. Such customers may well respond to price signals if they understood the implications and such signals were made available. Additionally, New Era contends that reliable demand response should be equal in value to supply in meeting reserve requirements.

Allegheny Power submits that an obstacle to a competitive market in Virginia is the absence of demand response to price. AP contends that "*Demand response to price is a key fundamental which is missing in the retail electricity markets. The introduction of demand elasticity based on price, such as real-time pricing, will result in lower market clearing prices, as load will diminish as prices rise.*"

Last year the Consumer Advisory Board recommended to the LTTF that an Energy Management Working Group be established to evaluate demand side

management options under the leadership of the SCC. The LTTF elected to table the recommendation because of the heavy work load in 2003.

The SCC has recognized the potential of such developments and has charged the Competitive Metering Work Group to continue to study expanded or voluntary Time-Of-Use programs and expand such study to include new meter technology. Such investigation could include examination of the types of meters used by the utilities and seek to ensure that the current technologies do not inhibit the use of price signals or the development of a competitive metering market. We have directed the Staff to file a report by May 1, 2004, providing the results of its investigation.

Issue 6: The volatility of natural gas prices.

Natural gas prices over the past year or so have experienced high volatile fluctuations compared to prior periods. This uncertainty can have a significant impact on any study or forecast. We have recently experienced natural gas prices above \$5.00 per MBTU, compared to around \$3.00 last year. Current expectations are for prices to remain higher than traditionally experienced and not return to the low prices we enjoyed earlier.

Environmental concerns have been a primary driver causing natural gas to be the fuel of choice for new generating facilities. As such, one may expect electricity prices to converge with natural gas prices. Allegheny Power summed this issue by stating, *"Traditionally, natural gas-fired peaking facilities set the marginal cost of electricity only during summer peaking conditions. However, with the establishment of NOx regulations, over-firing of coal boilers and the construction of intermediate natural gas generation facilities (combined cycle) have resulted in natural gas setting the marginal cost of electricity more hours of the year, both on-peak and off-peak. Further, with the volatility of summer prices, outages on base-load generation are taken in non-peak periods (spring and fall shoulder peak months), which causes natural gas facilities to supplant this capacity during periods of unseasonal weather in the spring and fall, again increasing the number of hours per year that natural gas sets the marginal cost of electricity."*

NEM submits that *"Promoting a competitive energy market in Virginia will help to mitigate the potential impact of higher fuel prices by permitting customers to see and select the lowest cost alternative supplies including properly priced demand reduction, load shifting and energy efficiency products and services."*

Issue 7: The robustness of the Retail Access Rules.

Similar to last year, most respondents generally agreed that the current Retail Access Rules are adequate and consistent with most of the rules in neighboring jurisdictions. The Rules generally strike a balance among all stakeholders by providing consumer protections while ensuring equal treatment of all market participants. Several respondents indicated that although the Rules appear conducive to promoting effective competition in the Commonwealth, the continued lack of competitive activity has not yet fully tested the Retail Access Rules. There is not yet enough information to know from the CSP's perspective how adequate these Rules may be and the burden to explain any reluctance to enter the Virginia marketplace based on the Retail Access Rules falls upon the potential CSPs.

Issue 8: The continuation of consumer education outreach.

Most of the respondents support the current suspension of consumer education regarding energy choice until such time as there are several CSPs actively soliciting customers to enroll. Broad scale efforts should be less visible until the market more fully develops and offers competitive choices. To achieve more effective results, reactivation of the program should be scheduled closer to the expected onset of widespread customer choice.

Issue 9: Update to proposals to consider from the 2002 Report.

Last year's report identified two proposals for consideration by the CEUR that: 1) there should be a staged transition to the competitive markets by rate class, and 2) shopping customers who return to the incumbent utility should have a market-based price as an option of avoiding minimum stay requirements. Having merit, both proposals were drafted and introduced as bills for consideration as amendments to the Act. Both of them were tabled with the request for future consideration of the CEUR.

As a result of continued discussions, the proposed amendments were later withdrawn as DVP announced plans to request approval for three pilot programs to explore the concepts implied by these proposals. The proposed pilot programs are currently pending before the Commission as previously discussed in Part II of this Report.

Other proposals presented last year did not receive any further direction from the CEUR or General Assembly. However, the Commission has addressed several of those proposals in some way with activities previously described in Part II of this Report. Such items regard default service, competitive metering rules, supplier consolidated billing rules, and distributed generation.

Section 1 - Summary

The Commission appreciates the input it received from those respondents that responded by letter and/or participated in the various discussion groups hosted by our Staff. Although we would have preferred a larger number of participants, we did receive the thoughts of a reasonable cross-section of stakeholders: utilities, competitive service providers, aggregators, consumer representatives, and business associations.

In terms of the existence of retail competition, little, if anything, has changed since last year. There still appears to be universal agreement that before a viable competitive retail market develops in the Commonwealth there must be a robust wholesale market and an operational and independent regional transmission organization. While much work has been done or is in the process of being done, it will take more time before that foundation becomes a reality. The stakeholder recommendations included in this section are not new; they are similar to those expressed in last year's report. The SCC does not believe that the adoption of any of these recommendations will facilitate effective competition in the Commonwealth in the present environment.

Section 2 - SCC Recommendation

It has been over four years since the Virginia General Assembly passed the Virginia Electric Utility Restructuring Act; less than four years remain until the mid-2007 end of the transition period set forth in the Act. Section 56-596 of the Act requires the SCC to report to the CEUR and the Governor by September 1 of each year on the status of competition in the Commonwealth, the status of the development of regional competitive markets and the SCC's recommendations to facilitate effective competition in the Commonwealth as soon as practicable. This section of the statute also requires the

SCC to report any recommendations of actions to be taken by the General Assembly, electric utilities, suppliers, generators, distributors, and regional transmission entities that the SCC considers to be in the public interest.

On December 30, 2002, the SCC submitted an Addendum to its status report issued September 1, 2002, that addressed the FERC's NOPR on SMD. That Addendum, entitled "Review of FERC's Proposed Standard Market Design and Potential Risks to Electric Service in Virginia" raised several concerns we had regarding electric industry restructuring and its likely impact on Virginians. In the December 2002 Addendum, the SCC stated:

Only if the Commonwealth reverses the Act's requirement to unbundle rates and defers the Act's requirement that Virginia's utilities join an RTE can Virginia preserve state jurisdiction. If rates remain unbundled or control of the transmission system is transferred to an RTE, then Virginia's choice will likely have been made. It will be difficult -- if not impossible -- to reverse that choice.

In the months since the SCC issued its December 2002 Addendum to the September 1, 2002, status report, industry events have not lessened our concerns nor cause us to alter our recommendation that the General Assembly take action to preserve Virginia's authority to ensure reliable electric service at just and reasonable rates. Industry, federal regulatory, and legislative uncertainty continue and Virginia's ability to ensure control over its restructured electric utility industry cannot be assured. Consequently, the SCC believes that it is in the public interest to suspend portions of the Act by re-bundling rates and continuing the moratorium on the transfer of control of Virginia's electric transmission systems to federally-regulated regional transmission entities. We note that such a suspension will leave in place rules, procedures and systems

that enable retail access. The SCC recommends suspension only as a means to best preserve Virginia's jurisdiction and only as long as necessary to provide Virginia policy makers a reasonably clear view of the likely nature of the transformed industry.

Section 56-596 of the Act requires the SCC to report its recommendations to facilitate effective competition in the Commonwealth as soon as practicable, which shall include any recommendations of actions to be taken by the General Assembly, the SCC, electric utilities, suppliers, generators, distributors, and regional transmission entities it considers to be in the public interest. This year, the SCC has one recommendation, and it is not new.

Our concerns with the bedrock issues of electric service adequacy and electric service prices likely to be available to Virginians prompted the SCC to issue its December 2002 Addendum. In the December 2002 Addendum, we described the many serious problems likely to result from implementation of the FERC's proposed rules on Standard Market Design. These problems include the elimination of native load preferences, the questionable ability of FERC to oversee market monitoring efforts, the potential exercise of market power by wholesale suppliers, increased costs resulting from the use of locational market pricing in transmission-constrained areas, and regional resource adequacy requirements.

In response to criticism levied by Virginia and other jurisdictions, on April 28, 2003, the FERC issued a "White Paper" entitled "Wholesale Market Platform." The FERC White Paper has been carefully studied by the SCC. In our opinion, the FERC White Paper neither clarifies nor alleviates our concerns with the SMD NOPR.

Next, on April 30, 2003, the U.S. Department of Energy (“DOE”), at the request of Congress, issued a report “...to assess various potential impacts of the proposed [SMD] rulemaking by the Federal Energy Regulatory Commission....” The DOE study of the SMD is based on optimistic assumptions and does not address many significant risks of the FERC SMD proposal. Even this optimistic study, however, shows that benefits of the SMD will be small, less than a 1% decrease in average retail electric rates, nationwide. Moreover, the DOE study shows that a majority of the areas of the country will have either no benefit or have retail rates actually increase as a result of SMD. Virginia customers, as a result of moving to retail competition under Virginia law and the pricing and other requirements of SMD, will likely see significant rate increases when the current rate freeze ends in 2007.

As outlined in this Report, the problems that are impeding the development of retail competition in Virginia and other regional markets continue unabated. Events in 2003 deepen our concern that problems are becoming increasingly complex and their implications irreversible. We face the likelihood that staying on the current path may cause such distress that the development of an effective competitive market at a future date will be foreclosed.

The continued lack of current and expected market activity leads directly to our recommendation that the Act be suspended in order to preserve Virginia’s authority. It is in the public interest to avoid ceding jurisdiction over transmission, generation, reliability and, ultimately, the cost of power, to federal regulators and regional entities. The likelihood that increased prices may be required to foster competition and uncertainty

regarding Federal direction with regard to RTOs poses additional uncertainty as to what will occur when capped rates end on July 1, 2007.

For these reasons, we renew our recommendation that the General Assembly suspend the Act. Suspension of the Act would require rebundling the components of retail electricity rates and continuing a moratorium on transfers of control over transmission assets to RTOs. However, the General Assembly could allow other aspects of the Act to continue to evolve while these two elements of the Act are temporarily suspended.

Pausing in the implementation of the Act is the best course if we are to preserve Virginia's ability to protect its citizens from the problems that are likely to result from the ceding of regulatory authority to FERC and regional transmission entities. The potential costs of adhering to a perceived schedule for the sake of implementing change outweigh the risks of delay. It is possible that any future benefit of retail access could be affected by a delay of retail access. However, we currently have the basic rules, systems, and procedures in place to harmonize retail access. If Virginia delays full implementation now and retail access proves successful elsewhere, we will be in position to implement retail choice quickly and effectively. This ability to respond quickly should minimize any loss to Virginians with a delay at this time.

In summary, the status of competition is not encouraging. There has been little change in market conditions around the country or in Virginia since we submitted the December 2002 Addendum. Though there are isolated instances in other jurisdictions of competitive activity among larger commercial and industrial customers, retail choice is not yet providing meaningful benefits or yielding sustained savings anywhere in the

country. Even more distressing than the absence of sought-after competitive activity is the likelihood that the implications of the SMD NOPR will be detrimental to Virginia's electricity consumers.