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# **DEREGULATION AND COMPETITION IN ELECTRICITY MARKETS**

**A Report to the Coalition of Northeastern Governors  
Prepared by the CONEG Energy Working Group**

A report of the CONEG Policy Research Center, Inc.

November 1995

This report was prepared by the CONEG Policy Research Center, Inc., under the guidance of the CONEG Energy Working Group. The findings do not represent the views or opinions of the Coalition of Northeastern Governors (CONEG) nor its individual member Governors.

**Coalition of Northeastern Governors  
Energy Working Group**

Reginald Smith  
Chairman  
Department of Public Utility Control  
Connecticut

Laurie Lachance  
State Economist and Director  
Economics & Energy Division  
State Planning Office  
Maine

David O'Connor  
Commissioner  
Robert Sydney  
General Counsel  
Division of Energy Resources  
Massachusetts

Jonathan Osgood  
Director  
Governor's Office of Energy and  
Community Services  
New Hampshire

Michael Ambrosio  
Executive Director  
Board of Public Utilities  
Robert Chilton  
Director  
Division of Electric, Gas & Energy  
Board of Public Utilities  
New Jersey

Paul Powers  
Deputy Director  
Policy Coordination  
Energy & Water Division  
Department of Public Service  
New York

Maria Keating-Titelman  
Deputy Chief of Staff for Government  
Affairs/Cabinet Liaison  
Governor's Office  
Pennsylvania

Janice McClanaghan  
Manager of Energy Programs  
State Energy Office  
Rhode Island

Richard Sedano  
Commissioner  
Department of Public Service  
Vermont

November 1995

## PREFACE

In early 1995, the CONEG Governors agreed that the Coalition should look at how competition in electricity markets and restructuring of the electricity industry are likely to affect the Northeast states. Under the leadership of Governor Angus King of Maine, CONEG Lead Governor for Energy, the Coalition of Northeastern Governors' Energy Working Group focused its attention on two primary aspects of these dynamic and complex developments:

- what aspects of competition and deregulation are most likely to affect Governors and their key policy interests; and
- what aspects are multi-state in their implications?

The Working Group worked cooperatively to identify the major issues of deregulation and competition considered directly relevant to the Governors given their wide-ranging policy responsibilities. Under the auspices of Governor King, a Roundtable discussion solicited the views of diverse interested parties: utilities, industrial users, consumers, legislators, independent power producers, environmentalists and financiers. State officials, working with the Energy Working Group members, then refined a list of key questions which deregulation and competition raise for their respective states, drafted their responses to each question and collectively guided the drafting of this report.

This staff report, *Deregulation and Competition in Electricity Markets*, is the result of this collaborative effort. It provides summary background on fast-moving developments in this field, including the specific nature of these markets in the Northeast, the sources of competition, and the various ways in which states are responding. It identifies five key issues confronting state policy officials, and discusses the differing views about how each issue may play out in the restructuring process and the associated concerns and opportunities generated by these changes. The appendices provide summary information on the status of electric restructuring activities underway in each CONEG state, as well as the text of principles which have been developed by a number of CONEG states to guide their restructuring efforts.

While the paper captures the varying views on the pace of restructuring and the likely outcome of market competition, it also reflects several underlying findings: change is underway in electricity markets, with no one able to predict with certainty what markets will look like in the future; dealing with these changes will involve a wide range of state regulatory, executive and legislative officials; states can and do differ in how to address these changes; and that, in spite of these differences, the opportunity for cooperative action - among the states, with the federal government, and between the public and private sectors - does exist.

This report of the CONEG Policy Research Center, Inc. (Center) was developed by the CONEG Energy Working Group and reflects their findings. It does not reflect the views or opinions of the Coalition of Northeastern Governors. Both the Working Group and the Center were assisted throughout the process of research and drafting by Charles Guinn of Strategic Guidance Associates. Anne Stubbs and Mark Wolfe of the Center served as project staff.

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## EXECUTIVE SUMMARY

The movement towards competition in the electricity market is becoming an accelerating tidal wave of change which could crash upon the states, the electricity industry, and their customers in the near future. Although events are moving very fast, with continuing active steps to channel the wave, Governors can dramatically improve the economic vitality of their states and region while limiting any negative consequences and enhancing the opportunity of the inevitable change. States must maintain the lead, resolve disputes and push to reach decisions in a timely manner.

The Governors must build a strong public policy consensus around what is best for their state and this will continue to require strong leadership. Although events are moving at their own pace, the Governors can bring together the affected public and private sector parties. This wave of change is not confined to the state regulatory agencies or other executive agencies, and has already begun entering the legislatures. The Governors can also ensure that conflicts between states are limited and the federal government is not given the opportunity to usurp state power by intervening.

Some aspects of the approaching change are beyond all but very limited guidance by the states. These include:

- *Technology change* - more efficient generation at smaller sizes; smart interactive meters and controls; real-time computer based pricing; real-time computer controlled transmission and distribution controls; more efficient transmission.
- *Energy prices* - low cost natural gas is driving the fuel decision and potentially making high cost generation uneconomic; low oil prices depress all energy prices.
- *Federal action* - The Federal Energy Regulatory Commission (FERC) is opening the transmission grid to all wholesalers at comparable terms; progress toward full competition will improve resource allocation in the United States.
- *Private sector market action* - utilities are downsizing and merging; large customers are demanding choice of supplies; small businesses, residential consumers and local governing bodies are expressing dissatisfaction with high utility rates; brokers are entering the electricity industry to package electricity products for specific customers; Corporate America is seeking to cut any cost including electricity.

The opportunity to channel some aspects of the change still exist. They include:

- *Retail competition* - the degree of retail competition and how to achieve it is under the control of individual states unless the courts or the Congress significantly change FERC's jurisdiction.
- *Utility assets rendered uneconomic by competition* - the degree of recovering these "strandable costs" and the mechanism to recover them is under the control of individual states. Some recovery mechanisms would work in all forms of competition, others would work only under specific levels of competition.

- *Public policy and programs implemented through utilities* - policy and programs beneficial to society can be maintained or restructured by state action; the state has available mechanisms, such as a wires or meters charge, which would work under either wholesale-only or retail competition.
- *Utility industry structure* - while the final new utility corporate structure is a private sector choice based upon a reaction to FERC's new rules, the state regulators can influence these choices. The state legislature could greatly influence the choice.
- *Generation and transmission siting* - the siting of both generation and transmission is under state control; determination of need in a competitive market could be an emerging states issue if demand grows; and siting decisions could influence the electricity market in the future.

As competitive markets for electricity emerge, it will be up to the public sector to ensure that the overall interest of the customer and the broader public interest are not lost as decisions are made regarding specific restructuring proposals. The objective of restructuring must be to benefit the customer, not just the utility or the investor. Equally important, only the public sector can be expected to take the lead in determining how to address valued at-risk public benefits. The degree to which these benefits are lost or stranded will depend on the willingness of the Governors, legislators, and regulators to provide for their funding through wire charges or alternative means such as tax revenues, as restructuring decisions are made. In this task, the leadership of Governors remains essential.

The role of CONEG during the movement towards competition is a vital one if the Governors' influence is to continue to be exercised. The wave of change in electricity markets which is coming towards the states will not stop at the state line. Decisions in one state could affect the choices available to another state, as well as impact on the economic climate in the region. As an organization of nine Governors and their key policy-makers, CONEG can be a vehicle to assist the states during this period of rapid change. Working through CONEG, state policy officials can exchange ideas and information on how states can and are responding to change; assess the likely consequences of individual actions upon other states; facilitate coordinated action among the states; and coordinate a proactive role for the Northeast states in regional transmission matters. Regional transmission coordination, especially among the three major pools serving the nine states, is an area which will benefit from CONEG's leadership. CONEG can also mitigate any adverse environmental consequences of a restructured electricity industry.

This wave of change should be viewed as a great opportunity for the Region. Bold, decisive actions are necessary to seize its opportunities and reduce its risks. The process will be difficult and not without casualties; however, action is necessary for the transition to an electricity industry that provides lower costs and better consumer choice.

## BACKGROUND

### *The Problem*

Electricity prices in the Northeast are the highest and fastest growing of any region in the country. The Northeast spends over \$41 billion per year on electricity, and the regional average retail price for electricity is about 40 percent higher than the national average.\* The approximate differential of \$12 billion per year is a drain on the Northeast's economy. It reduces disposable income, exports wealth from the Region to pay for the generation and/or its fuel, and contributes to higher costs for the goods and service produced in the Region, thus making less competitive the Region's facilities and firms engaged in national and international markets.

A regional manufacturing facility of a multi-facility firm is at a disadvantage *within the firm* if its electricity costs are 10¢/Kwh while a competing unit in the Midwest can buy electricity at 5¢/Kwh. Similarly, a regional firm is at a disadvantage competing against other national or international firms with significantly lower electricity costs. The level of concern of the firm rises with the relative amount of electricity required to provide a unit of output.

While not as widely discussed as industrial electricity prices, the impact of high electricity prices on the Northeast's cost of living also has a negative affect on the ability of the Region to compete against other regions. "Your utility bill is what?!" is not an inducement to relocate to the Region.

Average electricity rates in the CONEG states are significantly higher than the national average for all customer classes, however, the degree of this differential varies significantly among the states as shown in Table 1. Often there is even a greater variation within individual states. For example, New York residential customer rates in 1993 varied from 2.5¢/Kwh to 16¢/Kwh). The Region's utility industrial rates in 1993 ranged from a low of 3.24¢/Kwh to a high of 12.44¢/Kwh. Obviously, under a fully competitive market, there is a great potential for intra-regional competition for customers. The level, variations, and trend in industrial rates shown in Table 2 are the reason for the pressure to reduce industrial rates. Until very recently, the Northeast's industrial electricity prices were rising at about twice the national rate. As shown in Table 2, this upward trend in industrial rates has been reversed in some states.

The reasons for the Northeast's higher electricity prices are numerous: the high wages and salaries typical of our Region; costs associated with being at the end of the pipeline and coal train; some higher costs for environmental protection due to higher population density; the relative amounts of nuclear unit capital in rate base; the relative amount and price of purchase power from independent power producers in a surplus capacity market; and the relative level of state and local taxes.

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\* Source: Table 28, Estimated Revenue for Retail Sales by U. S. Electric Utilities to Ultimate Consumers by Sector, Census Division, and State, 1993-94. Electric Power Annual 1994, The Energy Information Administration, 1995, Vol. 1, p. 44.

States	All Sectors	Industrial	Commercial	Residential	Other
<b>New England</b>					
Connecticut	10.2	8.1	10.0	11.5	14.0
Maine	9.7	7.3	10.2	12.3	14.8
Massachusetts	10.2	8.7	9.8	11.3	13.2
New Hampshire	11.3	9.0	11.4	13.1	14.9
Rhode Island	10.3	8.9	10.0	11.3	11.3
Vermont	9.0	7.5	9.4	9.7	13.3
<b>Mid-Atlantic</b>					
New Jersey	10.1	8.0	9.8	11.6	17.7
New York	10.8	5.5	11.8	13.5	8.8
Pennsylvania	7.8	5.9	8.2	9.5	11.5
<b>Examples of Other Industrial States</b>					
Illinois	7.4	5.2	7.7	9.9	6.6
Indiana	5.2	3.9	5.9	6.8	9.4
Michigan	7.1	5.3	8.0	8.3	5.0
Ohio	6.2	4.1	7.8	8.6	6.4
Texas	6.5	4.3	7.1	8.1	7.0
California	9.8	7.0	10.9	11.4	5.8
<b>Examples of Public Power States</b>					
Alabama	5.4	4.0	8.7	8.7	5.8
Tennessee	5.2	4.2	6.1	5.9	7.4
Washington	3.7	2.8	4.7	4.9	3.7
Oregon	4.4	3.4	4.9	5.3	5.0
<b>U.S. Average</b>	<b>6.9</b>	<b>4.7</b>	<b>7.8</b>	<b>8.4</b>	<b>13.4</b>

Source: Electric Power Annual 1994, Vol. 1., The Energy Information Administration, 1995.

State	1980	1985	1990	1992	1994
<b>New England</b>					
Connecticut	\$16.60	\$21.93	\$22.15	\$24.09	\$23.74
Maine	13.15	15.15	17.46	20.23	21.40
Massachusetts	18.21	20.47	23.14	25.20	25.50
New Hampshire	15.82	19.32	21.95	23.92	26.38
Rhode Island	18.39	21.93	24.46	26.96	26.08
Vermont	11.37	18.40	19.31	21.37	21.98
<b>Mid-Atlantic</b>					
New Jersey	16.96	22.54	21.57	22.59	23.45
New York	12.11	15.34	16.94	19.05	16.12
Pennsylvania	12.87	17.07	17.51	18.21	17.29
<b>Examples of Other Industrial States</b>					
Illinois	11.82	15.35	15.83	16.04	15.24
Indiana	11.00	14.54	11.94	11.73	11.43
Michigan	13.18	16.75	17.14	17.29	15.53
Ohio	9.73	11.75	11.81	12.14	12.02
Texas	9.71	14.22	13.74	13.49	12.60
California	16.04	22.00	21.35	22.24	20.52
<b>Examples of Public Power States</b>					
Alabama	10.29	13.60	12.72	12.57	11.72
Tennessee	9.71	14.22	13.74	13.49	12.31
Washington	2.26	6.23	7.00	6.56	8.21
Oregon	4.65	10.32	9.27	9.42	9.96
<b>U.S. Average</b>	<b>\$10.81</b>	<b>\$14.67</b>	<b>\$13.92</b>	<b>\$14.18</b>	<b>\$13.77</b>

Source: Electric Power Annual 1994, Vol. 1, The Energy Information Administration.  
1992 State Energy Price and Expenditure Report, The Energy Information Administration, 1994.

The high electricity prices are particularly troubling to those industrial customers who have relatively high electricity consumption and compete in national and world markets. The highly competitive economic climate of today is forcing businesses everywhere to seek lower costs for all inputs. The large differential between the wholesale price of generated electricity and the retail price distributed to customers, especially large customers, is driving the search for alternative supplies and new electricity industry structures.

### ***The Competition***

The source of competition in wholesale electricity will come from both outside and inside the Northeast. Any electricity that can be generated and wheeled to an area at a lower cost than the area's current cost of generation at the margin will replace that generation for an hour, day, week, season, year or multi-years, depending on the contract terms.

A utility or independent power producer with excess capacity and available transmission should be selling electricity at its marginal cost to generate the electricity. For example, a New York utility with a surplus of generation might be able to sell both capacity and energy into the New England market at prices lower than the New England marginal cost of generation. Similarly, western Pennsylvania utilities might be able to sell electricity into eastern Pennsylvania, New Jersey, and New York.

Hydro Quebec, especially during periods of high rainfall, might be able to sell low cost energy into New England, New York, and perhaps New Jersey and Pennsylvania. Mid-western and southern coal-fired utilities might be able to sell surplus capacity and energy into the Northeast if adequate transmission were available. Brokers might be able to stimulate the wholesale market by buying capacity and energy and repackaging its purchases into the products desired by wholesale customers or retail customers.

The source of retail electricity competition will depend upon the degree of competition permitted. Under full retail competition, the role of brokers would increase greatly, while the role of the distribution utility as a seller would decrease. A supplier of electricity might offer to service all facilities of a specific corporation in one or more states that permit full retail competition. The source of the electricity would be from the broker's generation portfolio.

### ***The Utility Trends***

The regulated electricity utilities are downsizing to reduce their costs. Expensive-to-operate generation is being either retired or mothballed. Dramatic utility labor force reductions have a negative impact upon the Region's employment. Management is asking this question of all utility operations: "Would we be doing this in a fully competitive market?"

Mergers of utilities, driven by pressure to reduce costs and to open new market opportunities, are underway nationally and within the Region. Whether utility mergers reach the level of corporate restructuring that the airline industry experienced and the banking industry is experiencing is unknown. However, greater electricity industry competition probably will lead to fewer utilities. In turn, fewer cities and even states will be home to utility headquarters.

### ***The Concerns***

A number of concerns about the possible consequences of electricity utility deregulation and restructuring are valid. As publicly chartered corporations, electric utilities have been used to accomplish many social policies. If society desires a different outcome, corrective public policy measures at the federal and/or state level is required. Mergers could result in some states having no native utility. Loss of in-state generation and employment might be a trade-off for lower electricity bills. The utility stockholders and bondholders could bear all or most of the risk for their utility's uneconomic assets. In a competitive market, where the responsibility of existing utilities to carry out these programs has ended, decades of utility programs that benefit society may vanish. The reliability of the system may be reduced. Environmental standards may be difficult to achieve. However, all of these concerns can be addressed usually by state action.

### ***The Opportunity***

"Deregulate the industry and let the market sort it out" has been the theme of changing many regulated industries -- airlines, telephone and natural gas. There have been great variations in these deregulation efforts. However, the general consequences of deregulation -- leading to a restructured industry -- have been constant. Most parties agree that under deregulation the total costs were reduced, new services were offered, the large customers benefited more than the small customers, and the employees of the regulated industries were the greatest losers.

The potential economic benefit of greater competition in the electricity industry is impossible to determine. However, assuming total regional expenditures for electricity of about \$41 billion, a 10 percent reduction in average prices would result in savings of about \$4 billion per year for the Northeast, after any transition costs and assuming no new burdens on society.\* This savings could make the Region more competitive and demonstrate the willingness and ability of its leadership to tackle and resolve one of the Region's difficult problems.

Competition could also foster new electricity products and services for the Region's electricity customers, making them more competitive. Many utility companies are already behaving differently; for example, by reorienting themselves in anticipation of deregulation. A timely introduction of expanded competition in the industry could move the Northeast into the forefront of new markets in such products and services. Lower electricity prices should attract new economic activity and greater electricity use, thus spreading the fixed costs over a larger base and further reducing prices.

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\* Estimated annual revenue data is provided by The Energy Information Administration. See footnote on page 3.

### ***The Activities***

The restructuring of the electricity industry is underway, driven by technological advances creating market pressure, and encouraged by federal actions deregulating elements of the industry. The Public Utility Regulatory Policy Act of 1978 (PURPA) stimulated the growth of a non-utility generation industry. The Energy Policy Act of 1992 (EPACT) has further promoted competition by allowing open access to the transmission system for all wholesale generators. The Federal Energy Regulatory Commission (FERC) had followed up on EPACT by proposing to require the unbundling of utility transmission services to promote open access. FERC also appears eager to expand its jurisdiction and to encourage a competitive wholesale market in electricity generation.

The early academic debate on restructuring the industry has been replaced by a series of regulatory proceedings at FERC and before many state public utility commissions. California has led the nation in airing (though not necessarily acting on) the issue with a long and contentious proceeding which has produced a massive record before the California Public Utilities Commission (CPUC). The result from California was a split decision on whether to go quickly to retail competition (the CPUC majority decided not to). The decision headed to the legislature; and concern about the regional impacts was raised by neighboring states (i.e., why should our prices go up so California prices can come down).

As shown in Appendix A, restructuring is actively underway in the CONEG states. Nearly every state has a public utility commission proceeding in progress. The restructuring issue is outgrowing the individual public utility commissions and has begun entering state legislatures. Proposed legislation has been offered in most states to address some aspect of restructuring. Some states have comprehensive legislative studies underway. Six states have principles governing restructuring, either adopted or under development. Fundamental state policies are being reexamined. The regional consequences of individual state actions are also being raised. The emerging electricity industry appears likely to outgrow its current boundaries, in both a physical and a regulatory sense.

### ***The State Decisions***

Individual states currently face decisions on the direction, pace, and sequence of events on restructuring. Should the movement be toward full retail competition or something less? Should these changes be encouraged to move quickly or should the state wait? Should wholesale competition be established and then work on retail competition, or should the state seek to move directly to retail competition? The treatment of potentially strandable costs and social benefits is a significant decision that will impact each citizen.

The maintenance and operation of the transmission grid is a major systems implementation concern. It must be successfully resolved in a manner that balances reliability and promotes open access to all.

The following material addresses the critical decisions.

## **WHOLESALE COMPETITION WILL CHANGE THE INDUSTRY**

### *Debate Over Future Structures*

The development of a fully competitive market in electricity generation will have a significant impact upon the electricity industry structure. The vertically integrated electric utility of today will likely be replaced by the unbundling of functions into generation, transmission, dispatch, and distribution at least. Whether this will be accomplished by divestiture spinoffs or by a virtual separation of current utility function is a major decision. The competition among utilities will grow as each tries to expand its customer base, find and develop profitable markets, and lower its costs.

The technical debates among various parties concerning the optimal future structure of the electricity industry are intensive and the views are diverse. However, a consistent theme among the parties is that the status quo is both undesirable and unfeasible. The debate is over the direction, pace, and sequence of actions to guide the restructuring of the industry.

### *FERC Is Opening Transmission*

FERC is leading the administrative deregulation of the electricity industry through its authority to set the terms and conditions of wholesale trade in electricity. FERC is in the process of establishing new rules for transmission access and the terms and conditions of wholesale transactions using the transmission grid. A notice of proposed rulemaking regarding promoting wholesale competition through open access transmission (MEGA NOPR) has been issued and the comment period is concluded.

The essence of the proposed FERC action is to turn the transmission grid into a common carrier which provides known uniform terms and conditions for similar use. Current owners and operators of the transmission grid would be required to apply the comparable terms and conditions to their own transactions as they would to those of another party (i.e., the Golden Rule). Thus, ownership of transmission would not provide any advantage to a utility engaged in selling electricity.

FERC's apparent intent to turn the electric grid into a common carrier parallels its actions which turned the interstate natural gas pipelines into common carriers. As a result, bilateral deals between production agents and gas distributors, or deals among agents, brokers, and final customers replaced the pipeline's previous "merchant" function of buying and selling gas. Many believe the electricity industry is on a similar path. Major gas brokers are beginning to become active in electricity trading.

### ***Degree of Unbundling***

The debate over the level of wholesale competition is intense over the issue of unbundling the industry into separate generation, transmission, distribution, and systems operations functions. Many utilities believe a virtual separation of their existing functions into separate units within the utility will accomplish the spirit of deregulation. These utilities do not believe an actual unbundling or divestiture of their industry into separate firms for generation, transmission, distribution, and system operation is desirable. Other parties, especially independent generators, electricity brokers, and some large customers, believe a virtual unbundling will not accomplish the fundamental restructuring of the industry necessary for a fully competitive wholesale market to develop.

The degree of unbundling has been at the core of various proceedings. The following, from the Massachusetts Interdependent Principles,<sup>\*</sup> is illustrative of concerns and policy direction:

*The existing vertically integrated structure of the industry should change. Generation should be subject to full and fair competition and must be at least functionally separated from transmission and distribution so as to avoid the potential to favor affiliates when offering and pricing their services. Companies providing transmission should file comparable service transmission tariffs at FERC that provide open access for all competitors. Restructuring plans should be designed to avoid anti-competitive behavior. Companies providing both transmission and distribution should be reviewed in order to determine whether other mechanisms are necessary to avoid the potential to favor affiliates when offering and pricing their services.*

New York's Principles to Guide the Transition to Competition for Electric Service raise a similar concern:

*The current industry structure, in which most power plants are vertically integrated with natural monopoly transmission and distribution, must be thoroughly examined to ensure that it does not impede or obstruct development of effective wholesale or retail competition.*

### ***Municipal Electric Interest***

The movement to a competitive market in wholesale electricity has created a great interest among many current retail customers to benefit directly from the wholesale market. Cities, counties, towns and villages could form municipal electric systems ("munis"), leave their current utility, and acquire the necessary distribution system assets. The degree of difficulty associated with forming a municipal electric company varies by state. The desirability of creating munis is driven by the difference between wholesale and retail electricity prices and the perception that creating and operating a municipal electric system is not that difficult.

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<sup>\*</sup> A number of states have various processes underway to develop principles governing state electricity industry restructuring. Copies of these principles are included in Appendix B. For many of the states, these principles have not been formally adopted and are under consideration by the relevant state's legislature or public utility commission.

Other variations of public access to the emerging wholesale electricity market are being advanced. "Muni-lite" is a proposed municipal electric system structure created by takeover of the retail customers' meters and not the distribution system. The utility would operate the distribution system; the muni would buy and sell electricity to the retail customers in their community. Another variation would be for special accounts such as school districts to form buying cooperatives.

FERC, apparently concerned over bypass of stranded utility costs, has proposed an exit fee on wholesale customers leaving their utility for another supplier. This FERC proposal, especially if adopted and subsequently sustained by the courts, could have a chilling effect on the current municipalization efforts by many communities. An exit fee could reduce significantly the economies of creating a municipal system; hence the great concern raised over the proposed fee by many parties.

### ***FERC Authority Expansion***

FERC appears to be aggressive in extending its jurisdiction into areas currently covered by the states. The Federal Power Act gives FERC jurisdiction over transmission rates for wholesale transactions. In its MEGA NOPR, FERC has attempted to expand its jurisdiction in several ways:

- While FERC acknowledges that states have jurisdiction over local distribution, its delineation of the boundary between transmission and local distribution could leave only the end user's meter under local control.
- FERC is attempting to regulate retail rates for the recovery of investments made to serve end-use customers in asserting jurisdiction over municipalizations and imposing stranded costs on the municipalized load.
- FERC proposed to establish and allow recovery of stranded assets where states do not exert jurisdiction.

### ***Proactive Governors***

The Governors could become proactive in the resolution of issues necessary to move thoughtfully to a functioning competitive wholesale electricity market. A settlement approach would be far superior to a series of litigated settlements following a protracted set of regulatory proceedings. The alternative to lengthy court action is legislation. Maintaining a regional perspective and awareness during state regulatory and/or legislative proceedings could be a major contribution of the Governors.

Expanded FERC jurisdiction could undermine states' ability to adopt their own models for a new industry that ensures reliability and safety. Many states are opposing FERC's attempt to control areas traditionally controlled by the state, but are attempting to negotiate in the spirit of "cooperative federalism," rather than pursuing litigation. In reality, FERC does not have the resources to regulate all the transactions that it is proposing to regulate.

## **RETAIL COMPETITION WOULD CHANGE THE ELECTRIC INDUSTRY MUCH MORE**

### *Degree of Customer Choice*

A critical decision in electricity industry deregulation and the resulting restructuring is whether, and if so to what degree, to allow retail customers to choose among electricity providers. The three basic options are: competitive wholesale market only; evolution from a competitive wholesale market to a competitive retail market; and a competitive retail market as soon as possible. Since none of these options have been implemented, the actual costs, benefits and relative merits of each are currently a matter of speculation.

The view of many customers is that full retail competition can only be accomplished by full customer choice: "Unless I can choose my vendors, I don't have a competitive market." Some utilities have countered with a proposed pooling arrangement where customers can buy from vendors buying from the central pool.

The "customer choice" viewpoint is illustrated by the Massachusetts Interdependent Principles:

*Retail customer choice can provide benefits beyond those provided by a competitive wholesale market and is therefore an immediate priority. Individual customers (or groups of customers) differ in the quality of electric service they require and in the risks they are willing to take. By purchasing themselves, they can commit to an electricity supply based on short- or long-term projections of their own needs, rather than on the necessarily long-term projections of the utility and its regulators for the system as a whole. Small customers' access to competitive supply options is expected to be accomplished, among other ways, through aggregators, which may include private firms, municipalities, cooperatives and other similar entities. Load management activities such as reducing usage during expensive peak periods can be of direct benefit. Access to the utilities' wires for the purpose of purchasing electricity from alternate suppliers should be made available to all customers as soon as practicable, subject to the resolution of engineering and regulatory prerequisites, including the establishment of charges for recovery of stranded costs and potentially strandable benefits. In the interim, some forms of efficient direct access may provide a useful means of introducing customer choice at the retail level. Distribution utilities should continue to have their current obligation to connect all customers in their franchise area to the distribution system.*

As illustrated by the accompanying Interdependent Principles negotiated in both Massachusetts and Rhode Island, those recommending a competitive retail market as soon as possible generally call for a comprehensive restructuring process that also includes additional policies to protect reliability, low-income and smaller customers, energy efficiency, and the environment.

In contrast, some states, such as California, that have proposed a structure for a competitive industry have backed away from an immediate transition to retail competition for several reasons. While retail access may allow greater price reductions, some states argue that transition to wholesale competition will be more predictable, and suggest that retail access may create reliability and operational problems.

Some decision-makers believe that a competitive wholesale market, which would allow utilities to shop the generation market for the lowest priced power, would capture most of the benefits of competition without sacrificing reliability and those benefits of the existing system which might otherwise be "stranded" in a competitive retail market: fuel diversity, demand-side management programs, low-income subsidies or research and development funding.

In addition, states with utilities carrying uneconomic generation facilities or overpriced purchase power contracts (i.e., strandable costs) may find it difficult to adopt retail competition without causing large shifts in costs from high load (industrial and large commercial) customers to low load (residential and small commercial) customers.

Despite these factors, the prospect of reduced electricity prices and greatly expanded consumer choice makes retail access a most attractive option to many interested parties. If a particular state were to move to retail competition by allowing utility customers to contract for power directly with a generator, a competing state might find itself compelled to follow suit in order to discourage the movement of industrial customers to direct access states, or to provide their industries with the same access to in-state low cost power enjoyed by the industries located in retail competition states.

### ***Visions of Retail Competition Differ***

There are differing visions of the desirable end state of full retail competition. In one, retail sales are handled through a pool with generation sold into the pool, and retail sales arranged by brokers working with the customers. This so-called "Poolco" approach requires resolution of a strongly debated issue: how bi-lateral retail contracts that are either long or short term are handled by this structure and the degree to which such contracts would change the structure.

In a second vision of the end state, utilities as we know them would not exist. They would be replaced by unregulated generation companies ("gencos"), regulated transmission companies ("transcos"), regulated distribution service companies ("discos") and unregulated retail companies ("retailcos"). The retailcos would be market aggregators that might work on a local, statewide, regional or national basis. The retailcos would work closely with the customer but the customer would be free to shop around between retailcos.

As FERC has stated, the choice of retail competition is up to the individual states. Yet, in a region such as the CONEG Region, with its set of very interactive state economies, close cooperation among the individual states could enhance the final individual decisions.

## **STRANDED ASSETS/COSTS ARE A MAJOR CONCERN, ESPECIALLY TO THE UTILITIES**

### *Disproportionate Northeast Problem*

The central question for many Northeastern utilities is how to survive the transition to a competitive market. An August 1995 report by Moody's Investor's Service, Inc. estimated \$29.5 billion of stranded costs for 17 New England and New York utilities. According to Moody's, the stranded costs of 12 of these utilities exceed their equity. Resource Data International Inc., in a late 1994 analysis, identified the Northeast as the region of the nation most impacted by stranded investment, with nearly 1/3 of the national total.

An estimate of stranded assets/costs is a function of the difference between a utility's cost of generation and power purchases and the market clearing price of electricity to meet expected demand in the region. Currently, the market clearing price is low due to an excess of capacity and continued low gas prices. A reduction in capacity, an increase in gas prices or an increase in demand would raise the market clearing price and lower the estimate of stranded costs. Also a specific utility's stranded assets may be offset by its under-valued assets. The net stranded assets/costs is a key factor that must be addressed for the transition to competitive markets. The stranded assets problem is not a permanent issue: it will be resolved over time and shrunk through negotiation.

The Northeast's fixed cost of generation is the highest in the nation and a major source of the stranded costs, followed by the utility purchase power contracts. Uneconomic utility generation has about 1.5 times the effect of uneconomic purchase power contracts on a regional basis, with a wide variation among the utilities and the states.\*

In the emerging competitive market, utilities with low capital costs remaining to be recovered and/or generation units able to generate electricity below the regional average cost have an advantage. Similarly, utilities with higher capital costs to be recovered and/or generation units producing above the regional total generation costs are at a disadvantage. The Northeast has some utilities in this category as well as utilities with uneconomic cost exposure.\*\*

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\* An overview of the economics of Northeast electricity generation might be summarized by: average total cost of generation by the Region's utilities of about 5.64/Kwh as compared to a national average total generation cost of 4.14/Kwh; an average variable generation cost of about 1.84/Kwh; an average fixed cost of generation of about 3.84/Kwh; and an estimated cost of new gas-fired generation from a combined-cycle unit in the Region of about 4.5 to 5.04/Kwh.

\*\* A general example of the economics of a theoretical, relatively new nuclear unit may be useful to understand the changing economics of a competitive wholesale generation market. This nuclear unit might have a variable cost of less than 14/Kwh and a fixed cost of nearly 104/Kwh. Under current regulation, both the 14/Kwh and most of the 104/Kwh is recovered from customers in their retail prices. The less than 14/Kwh variable cost means the nuclear unit will be run whenever it can operate and cause units with higher variable costs and lower total costs not to be operated. If all regional generation units received the regional average total generation cost (5.64/Kwh) instead of the current cost plus recovery, the owners of the theoretical newer nuclear unit would have a problem. Also, utilities purchasing power at 6.54/Kwh or nearly 14/Kwh above the regional total generation average and 4.74/Kwh above the regional variable generation cost, would have a problem.

### ***Transition Problem***

The stranded assets/costs problem does have a time dimension. The longer the time period for a specific utility to recover its high capital costs in its ratebase, the smaller the utility's stranded assets problem. Rising regional demand should increase the market clearing price, thus reducing the difference between the utility's stranded generation cost and the market clearing price.

### ***State Issue***

FERC has stated that the treatment of stranded costs is a state issue. Whether or not a given state decides to promote competition within its borders, utilities with uneconomic assets are already taking actions to lower the price of electricity. They are lowering operating and capital costs by securing the cheapest power available on the wholesale market. In fact, the impact of competition has already been felt by many utility investors in the reduced price of utility stocks and the higher cost of utility debt.

Any further movement toward deregulation will necessarily penalize non-competitive utilities, unless utilities are provided some means to recover a portion of their strandable assets. Various proposals have been put forward to address this issue. These range from complete recovery of verifiable, prudently-incurred costs (on the theory that the utility investors committed capital under the old regulatory compact), to the denial of any recovery at all (on the theory that most utility investors have been made aware of the competitive pressures facing the industry). Numerous methods for recovery have also been proposed, including exit fees for customers who leave the system or contract for non-utility power and access fees or charges placed on the distribution system.

Since utilities with franchise territories in multiple states may be subject to different regulatory treatment in regard to such costs, a regional approach to the problem may prove beneficial in some areas. There is a tradeoff between utility recovery of stranded costs and lower electricity prices to customers through a restructured industry. Yet this is not necessarily a "zero sum game" between utility investors and customers. Lower customer prices are possible through productivity gain and marketing driven by a new customer focus. Utilities can lower cost through out sourcing and joint operating agreements as well as mergers and boundary changes.

### ***More Than a Tradeoff Issue***

Those involved in a settlement process believe most utilities can lower their electricity prices or rates while recovering much of their investment in uneconomic assets -- if state policy makers and utilities get beyond the "zero sum game" by using negotiation to switch quickly from cost-of-service regulation to competition in generation and the retail merchant function and "incentive regulation" of the monopoly functions of transmission and distribution. This will require an across-the-board shift of strandable costs from generation to a non-bypassable charge, and an incentive ratemaking system that covers stranded costs and is performance-based. The negotiation process will provide a forum for balancing recovery of stranded costs with the achievement of important policy goals, including rate reduction. Quick action will initiate the dynamics of competition which will over time increase the "size of the pie."

The Rhode Island Interdependent Principles are illustrative of a concern over recovering stranded costs:

*Utilities should recover legitimate and verifiable costs incurred pursuant to the regulatory compact. Utilities have an obligation to take all reasonable measures to mitigate the cost of their existing commitments. During the next phase of the negotiations, the parties should work to identify and quantify such transition costs for recovery in a non-bypassable, non-discriminatory, appropriately structured charge. The amount of above-market costs should be determined on a net basis that takes into account both the above-market costs and below-market resources that are currently in rates. Charges to recover stranded costs should apply to customers within a utility's retail franchise territory only. The charges should not apply to wheeling-through transactions.*

### ***Markets and Contracts***

Treatment of above-market contracts for independent power generation in a competitive generation market is a major item in the stranded costs debate. Utilities have tended to argue, without great success, for government to intervene and break existing contracts. Others have argued that the rights and obligations embodied in contractual arrangements are and will be an indispensable element of the competitive power markets. To ensure that a competitive market develops, the contractual arrangements for the purchase and sale of power are and shall be enforceable by their terms. Unilateral changes to a contract which supports a power plant project that is permanently financed and constructed are neither reasonable nor appropriate. However, if a contract from a supplier is causing its customer to be uncompetitive, one should expect both parties to be willing to negotiate or both will lose.

### ***Governors' Leadership***

While treatment of stranded costs will be determined by each state, there should be value gained by a frequent exchange of ideas and information among the states of the Region. The Governors taking an active role in these issues will facilitate such an exchange.

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**SOME CURRENT PUBLIC POLICIES MAY BE  
LOST AS A CONSEQUENCE  
OF ELECTRIC INDUSTRY DEREGULATION  
AND RESTRUCTURING  
UNLESS GOVERNMENT ACTS**

***Stranded Benefits Too***

The regulated electricity industry, as a publicly chartered franchise, has been an instrument of public policy implementation, and its ratepayers a source of funding, for many public programs. These policies include fuel diversity requirements; demand-side management programs; low-income programs; research and development requirements and funding; universal service requirements; reliability standards; the preservation of visually significant resources through undergrounding; environmental protection; and, in many states, a high level of general support for government programs through taxes and other actions.

These public policies and programs, currently either implemented or funded by utilities and their ratepayers, are viewed as likely "stranded social benefits" by their supporters. These supporters pair the continuation of these policies and programs with utility recovery of "stranded assets" in many public forums. The state principles in Appendix B are examples of such pairings.

All these policies and programs are likely to increase the initial cost of a kilowatt hour provided by the utility. While these programs are diverse in nature, many believe that society benefits from their existence. However, the cost of maintaining these programs affects the price of electricity. In an era of cost-plus regulation, utilities were relatively comfortable with their role as public good providers; in a deregulated era or with a market-regulated capped price, utilities are likely to be very uncomfortable with the public good provider role. Their discomfort level will rise with the degree that others can serve the utility customers without the burdens of being a public good provider.

***Public Sector Action Required to Retain Benefits***

Unless state authority is eroded by FERC, states will still have the power to require utility facility users to fund public programs through charges placed on the distribution system. This will be the case whether a state chooses wholesale or retail competition. Thus, a debate over wholesale-only or retail competition should not include whether the public good programs are maintained or not. This decision is the state's to make. The means are available, and Governors must take a proactive role in this decision.

The debate is underway on the degree to which the competitive market will meet the public good objectives of the current utility-based policies and programs. Nearly everyone agrees that low-income programs will not survive without government intervention of some type, either linked to the provision of electricity or through a separate mechanism. Currently, utility investments in demand-side management, research and development, and fuel diversity resource procurement are in rapid decline under the prospect of greater competition.

Under any new industry structure, a customer could bypass a wires charge by deciding to self-generate electricity. Many parties believe the "wires charge" would not be a significant factor in whether a customer chooses to self-generate or not.

### ***Continued Efficiency Needs Help***

It is not certain that distribution companies will promote energy efficiency in a competitive market. Because distribution companies are expecting to have rate/price caps set by regulation, they may strive to sell kilowatt hours, not save them. An exception would be when a sale requires a wholesale purchase greater than the utility's return from the sale. This could occur during some peak demand periods.

The remaining utility demand-side management programs (DSM), post-restructuring, will be customer service based and driven by the interest and knowledge of the customers. Energy efficiency programs funded by a "wires charge" might be aimed at statewide market transformation of buildings and equipment; assistance to industries to assess energy efficiency, greater process efficiency and emission reduction; and community-side efficiency assessment tied to private capital procurement.

Development of energy efficiency entrepreneurs has been underway, guided by state and utility-based programs. Given their current level of development, some of these entrepreneurs may need help to survive as the utilities eliminate and/or greatly alter their DSM programs. Some parties believe the energy efficiency entrepreneurs would eventually prosper under a full retail competition form of the industry if they survive the transition.

Many believe that unless precautions are taken now, even before the transition to competition really begins, state energy efficiency goals could be frustrated by utility cost cutting. The Massachusetts Interdependent Principles spoke directly to this point: "Restructuring should be designed to reduce market barriers to energy efficiency and not to reduce cost-effective customer conservation" and, "The costs associated with these DSM programs should be included in a non-bypassable, non-discriminatory, appropriately structured wire charge." Even in a competitive market, the Northeast -- with its relatively high cost of electricity and the reliance upon imported electricity or imported fuel to generate electricity -- should carefully consider the importance of preserving the developing energy efficiency industry.

### ***Fuel Diversity Could Be Lost***

Fuel diversity, especially the procurement of in-state renewable resources, could be significantly reduced under either a wholesale-only or retail competition structure. Buying generation above the market clearing price would be unlikely unless a government mandate required such a purchase and/or a "wires charge" fund paid the premium over the current market. Some utilities have proposed "green pricing" which would use a voluntary customer surcharge to fund renewable procurement above market prices as a means to sustain some level of renewable source procurement. Interestingly, many renewable source producers are beginning to favor full retail competition because they believe under "green marketing" at the retail level they have the best

opportunity to develop a significant market niche. "Green marketing" by brokers would link renewable energy producers with customers desiring some level of renewable electricity.

The current fuel of choice in the CONEG Region is natural gas, and the technology of choice is a combined-cycle powerplant. The capital costs, ease of siting, modular nature, and current low overall costs have driven this fuel/technology to the fore. Whether the Region is betting its electricity future on the current price of gas is under debate. Future fuel diversity is a concern raised by some parties.

### ***Public Benefits Matter***

The Vermont Statement of Principles\* provides some detail and insight into the issue of stranded public benefits:

*A restructured industry must preserve key public benefits of the current system, including cost-effective end-use efficiency, research and development, and the development commercialization and use of renewable resources.*

*The impact of direct access and associated pricing arrangements on markets for energy efficiency is uncertain. At least during any transition period, utility energy efficiency investments will continue to play a valuable role in reducing market barriers in certain market segments, reducing customer costs, and mitigating power system environmental impacts. Programs that are determined to be cost-effective and approved by regulators should be available to all customers using the distribution system. The costs associated with these programs should be included in a non-bypassable, non-discriminatory, appropriately structured charge.*

*Clean and renewable energy sources can play a valuable role in providing fuel diversity, managing risks and reducing environmental impacts. At least during any transition period, recovery of investments in the development, commercialization and use of renewable and low emissions technologies, which are determined to be cost-effective and approved by regulators, shall be included in a non-bypassable, non-discriminatory, appropriately structured charge.*

The federal government is reducing, if not eliminating, the Low-Income Home Energy Assistance Program. This program has been used to pay utilities and fuel dealers for maintaining service to low-income customers unable to pay their bills. Also, under cost-plus regulation, unpaid bills eventually were recovered, in part, from other ratepayers. The probability of either of these options being available in the future is low. A "wires charge"-funded universal service program may be an alternative.

The Rhode Island Independent Principles illustrates the case for universal service:

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\* The second and third paragraphs from the Vermont Principles were not endorsed by all Workgroup participants (See Appendix B).

*Electricity is an essential product which must be available to all customers. Existing special rates, payment programs and projections regarding customer service and shut-offs for low income customers should be included in any restructuring proposal and funded through a non-bypassable, non-discriminatory, appropriately structured charge. Further development of such rates, programs and projections to address the goals of universal service should continue under restructuring.*

### ***Environmental Standards At Risk***

Another consequence of electricity restructuring could be putting at risk achievement of widely held public policy goals, such as the attainment of Clean Air Act standards in the CONEG states. A robust market in generation could challenge the ability and authority of environmental regulators to design the mitigation measures necessary to reach environmental standards compliance. Utilities may be less able to respond to general public policy calls by government, since their assessment of cost recovery for these actions would be severely reduced.

A fully competitive market should lower the customer's electricity cost and increase electric demand. Any relative decline in energy efficiency will increase the electric demand, as will utility programs to increase sales. Also, the demand for low cost/high environmental emissions generation should grow relative to the demand for high cost/low environmental emissions generation.

Some environmental emissions are capped on a tonnage-per-year or seasonal basis. Hence, greater electricity demand would increase the cost of compliance, not put compliance at risk. Others are capped on a rate basis (i.e., tons per MBtu's); hence, greater use of such facilities will emit more tons, creating stress for compliance.

Air emissions do not respect state boundaries or compliance regions. Air emissions of one state impact the air quality of downwind states. The Ozone Transport Commission (OTC) is dealing with NO<sub>x</sub> emissions, particularly during the summer, within the thirteen- state Ozone Transport Region (OTR). There is a significant potential for more lower cost generation to be imported into the CONEG Region from upwind states, along with any resulting air emissions, thereby putting compliance at risk. There appear to be limited means for the states or the OTC to address this potential problem. A role for CONEG could be to seek a national solution to this problem. CONEG could work on, or with, the OTC to expand the OTR, include the issue in the FERC MEGA NOPR, or pursue possible litigation.

## **THE REGIONAL TRANSMISSION SYSTEM IS CRITICAL**

### ***Reliability and Safety Are Paramount***

Transmission, the link between generation and distribution of electricity, is perhaps the most important element in a competitive electricity market. For a fully competitive market in wholesale electricity to function, generators and distributors of electricity must have open access to the transmission grid on comparable terms and conditions. The federal government, through EPACT and the recent FERC proposals, is well on the way to opening the transmission grid to access by all. The question of how to operate the open access transmission grid in a manner that maintains a high level of system reliability and safety, while also ensuring unbiased access and treatment of electricity transmission in an efficient manner, is central to the success of a restructured electricity industry. A failure of the transmission system due to its operation would be a major blow to the concept and to all parties involved in the concept. New York's Principles speak directly to this point: "the integrity, safety, reliability, and quality of the bulk electric system should not be jeopardized."

Currently, three power pools (New England, New York and Pennsylvania/New Jersey/Maryland) serve the Northeast. These pools were created by the Region's utilities to manage their use of the transmission system, to dispatch the generation units of the pool members on an economic basis, and to ensure the integrity of the electric system. Their performance has been excellent; indeed, they are a model for the entire world.

### ***Regional Transmission Groups***

FERC is encouraging the development of regional transmission groups (RTGs) to oversee the operation of the regional transmission system. Discussions are underway in all three power pools to determine how to utilize a regional transmission group of both utility and non-utility companies. These discussions are preliminary and appear to be awaiting the resolution of the FERC proceeding on transmission open access. The objective of the RTG must be to provide for open, uniform, non-discriminatory, and cost-effective access to the transmission system for power transactions, while also ensuring the reliability of the transmission grid. While creation of RTGs appears to be most advanced among the Western states where the state governments have taken a very active role in their development, the strong powerpools of this region in many ways exceed all expectations for RTGs. State government officials are members of the Western RTGs steering board.

The future ownership of the transmission grid is being debated. The need for an independent system operation of the transmission system is not. In every restructuring model applicable to the Northeast, there is a need for an independent entity, not affiliated with ownership of the transmission, distribution or generating systems, to operate the system. The independent system operator (ISO) would coordinate transactions and assure reliability acting under a set of rules set by itself, a regulator, and/or an RTG. An ISO will be necessary whether or not a spot market or markets are established separately, or if wholesale or retail bilateral contracts are allowed. While the ISO would be under the ultimate purview of the FERC; the CONEG states should be working together to ensure that the ISO rules maintain a reliable system, while enabling greater

competition. Reliability must be maintained, and any system which appears to compromise it must be rejected. The states must be assured that a competent party is charged with the responsibility to set standards and ensure safe and reliable transmission service.

If early movement of the Region to a fully competitive wholesale generation market via open access to the transmission grid is highly desirable for economic competitiveness, then the states should encourage the private sector parties to create RTGs, establish the necessary operational rules, and choose the independent system operator. A very proactive role in these areas by the states may be necessary to capture the economic opportunity in a timely manner.

The Massachusetts Interdependent Principles address the RTG issue directly: "NEPOOL should be reformed and a regional transmission group created to enhance competition and to complement and support industry restructuring on a regional basis." Many other parties in the other states have expressed similar views.

### ***Transmission Issues Must be Resolved***

The Region is likely to be served by multiple RTGs. Hence, the more consistency across the region in transmission systems, the better. The North American Free Trade Agreement does not permit discrimination in trade, including electricity. The Region, with its long boundary with Canada, must be in the forefront of ensuring a consistency in trade between the RTGs and the Canadian provincial systems.

Early, successful resolution of the transmission issues will be necessary for the full benefits of competition to be achieved. Resolution of the transmission issue must be addressed along with such other issues as resolving stranded costs and benefits. The transmission issues are regional in scope and appear to need some proactive public sector prodding. The Governors working together could improve and accelerate resolving the transmission issues.

### ***Siting Could Change***

The siting of generation and transmission is a state responsibility. The determination of need in a competitive electricity market could be an emerging state and regional issue. The Connecticut PUC Principles illustrated this concern:

*Any change in the structure of the electric industry must provide for direct siting review or explicit incentives for optimal siting decisions.*