

**GRIP, GRIPES, NODES AND TOADS
UPDATE ON PUBLIC UTILITY ISSUES**

**PRESENTATION TO
TEXAS CITY ATTORNEYS' ASSOCIATION**

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PUBLIC POLICY ON NATURAL GAS PRICING WASTES BILLIONS

1. **MID-1970s** Rising natural gas prices and almost total dependence upon natural gas as a fuel source for electricity are used to justify the most incredibly wasteful power projects ever built -- the Comanche Peak (about \$12 billion) and South Texas Nuclear Project.
 - a. Off gas provisions of the Fuel Use Act and RRC Order No. 500 become the legal backdrop for billions of dollars of imprudent and unnecessary rate base for electric utilities.

2. **MID-1980s** The Federal Energy Regulatory Commission determines that long-term gas supply contracts are imposing excess of market costs on interstate pipeline companies. Gas on the spot market becomes cheaper than the average embedded cost of gas that is heavily weighted by long-term contract portfolios. Lone Star shed its interstate connections, avoided FERC oversight and RRC scrutiny (by not appealing rate ordinances set by Cities) and managed to pocket around \$700 million in excess of market costs from Texas consumers.

3. **MID TO LATE 1990s** A period of historically aberrant low natural gas prices leads large electric consumers to believe Enron's promises of an ability to lower electricity prices if only legislators would restructure and deregulate the electric industry and permit competition.
 - a. As electric deregulation picks up pace nationally, virtually all new electric generation investment is in gas combustion turbines. The increased demand for gas creates a strain on supply, driving up the price of the commodity.
 - b. Virtually all energy companies become jealous of Enron and its ability to grow revenues through virtual assets, creative accounting and energy trading.
 - c. Believing that low natural gas fuel prices would cause the wasteful investment in nuclear power plants to become "stranded," the Legislature created multiple means for the owners of nuclear power plants to maximize recovery of potential stranded cost. Despite the fact that the South Texas Nuclear Project is probably economic in comparison to today's energy costs from gas powered electric generators, Houston area and South Texas residents are looking at the prospect of paying billions of dollars in surcharges over the next 15 years so that Reliant and AEP can avoid the economic risks presumed to apply when deregulation was approved in 1999.

4. **EARLY 2000S**

- a. Enron is mostly gone but the day traders now control the retail market. Electric prices are set daily based on gas futures prices, regardless of whether the electricity being sold was generated using gas or more cheaply, using nuclear, coal or lignite.

- b. Electric markets are deregulated but not competitive. Electric deregulation stimulated higher gas prices which in turn have caused higher prices for electricity. In the late 1990's, the electric industry appeared to be a declining cost industry. Prices should have fallen from 1999 levels, but the wisdom of those anxious to trust Kenneth Lay has brought us complex, chaotic, and irrational energy policy and high and extremely volatile energy prices.

RECENT GAS UTILITIES REGULATORY ACTIVITY

1. GUD No. 9400

This case involves TXU's efforts to consolidate its regional distribution systems (created from over 200 Lone Star distribution systems) under a uniform set of rates. With jurisdiction at the Railroad Commission extending over a year, the Final Order has been entered and Motions for Rehearing are pending. TXU originally sought an increase of \$69.5 million in annual revenues. Based on the evidence and argument of Cities, the Examiners recommended a rate reduction of \$19 million. The Commission has instead ordered a rate increase of \$11 million, but because of policy decisions made by the Commission more than 100% of the increase will fall on residential customers because commercial and industrial customers were given rate decreases. While residential customers will experience an average increase of 5.4%, commercial customers will receive an average decrease of 8.4% and industrial customers will receive an average decrease of 27.3%.

2. 9400 MAJOR POLICY ISSUES

- a. **Poly-Pipe.** In 1970 Lone Star and an affiliate NIPAK engaged in a marketing effort that led to the development of a type of poly-pipe that Lone Star installed in the Metroplex and other areas throughout Texas. The pipe was quickly recognized to be prone to failure and in 1971 NIPAK ceased its manufacture. While contemporaneous memos from the 70's and 80's reflect Lone Star's recognition of a need to replace all poly-pipe, significant portions were still serving customers when TXU acquired the system in the mid-1990s. Poly-pipe became more of an issue during the course of the hearing than it was during the discovery and testimony preparation phase when it was discovered that TXU concealed documents from discovery. On a 2-1 vote, the Commission supported the examiners' recommendation that cost recovery on poly-pipe testing and replacement be disallowed. This will require TXU to take a write-off on more than \$100 million in invested capital. That is, of course, insignificant in comparison to the almost \$5 billion in equity TXU wrote off for imprudent activity in Europe.
- b. **Rate of Return on Equity.** The Railroad Commission has typically used rate of return as an end-result ratemaking device to produce the desired overall number. That policy has generally led to grossly inflated return values. In this case the examiners recommended and the Commission adopted a 10% rate of return on equity. While higher than necessary to reasonably attract capital, this decision is the first time in several years that the Commission has seemed to appreciate the declining risks and declining costs that have been obvious to all capital market observers.

- c. **Cost Allocation and Rate Design.** There are two hypothetical constructs that large industrial customers and utilities use to persuade regulatory commissions to shift costs from competitive services to customers with no choices (residential and small commercial): maximum design day demand and minimum system. Cities won the MDDD debate and recent decisions that fixed costs should be spread between demand and energy based allocators were followed. However, the Commission made a substantial public policy turn against residential consumers by adopting TXU's hypothetical minimum system approach to cost allocation.

Hypothetical Constructs to Maximize Allocation to R&C

- Maximum Design Day Demand
 - Assumes pipeline system is designed to meet firm (non-industrial) current peak demand under historic extreme weather conditions
- Minimum System
 - Assumes distribution system is designed to serve nominal needs of R&C customers (43% of mains alleged by TXU to be necessary regardless of usage)

Additionally, in a causal manner with no policy discussion, the Commission set aside the public policy currently being pursued by Cities throughout the state regarding rate design. Over the last five years all TXU Gas Distribution regional rates set by city councils have imposed a flat rate for all consumption on the residential class. The Commission has now implemented a declining block rate that will, in addition to discriminating against low volume consumers, add to class demand at time of peak and that increase in class demand will likely lead to future allocation shifts of additional cost onto the residential class.

3. **GUD NO. 9364 -- EVALUATION OF ENTEX GAS PURCHASE AND ALLOCATION PRACTICES**

The Commission has voted to permit a complaint by the City of Tyler against Entex for imprudent gas acquisition and the filing of false and misleading tariffs. Unfortunately, for the City, the examiner scheduled to hear the case ruled that the City is not entitled to rate case expense reimbursement. The City seeks an appeal of that ruling prior to proceeding on the merits.

4. **ATMOS ENERGY CASES**

Atmos recently received rate increases for its entire territory. The Company made three separate filings from the same cost of service model and period. Separate filings were made in Amarillo and Lubbock and a third filing was made in all other (roughly 66) cities, including Midland and Odessa. The Cities of Amarillo and Lubbock settled for 55% of the Company's request. The remaining Cities were able to achieve greater concessions, including a lower revenue requirement, lower customer charges and a lower rate of return on equity.

5. **ENTEX -- HOUSTON AREA RATE CASES**

Entex has pursued a divide and conquer tactic with its Houston area Cities, filing a rate case with the City of Houston, reaching an agreement with Houston and then attempting to shove the settlement down all surrounding Cities and environs customers. The Cities of Conroe, Willis, Cut and Shoot, Shenandoah, Missouri City, and West University Place have resisted Entex and have won a concession that future filings will be made on a system-wide basis. The outstanding issues involve a prompt payment discount that is really a penalty for failure to immediately pay a bill upon receipt and a policy disagreement over rate design.

6. **GRIP RULEMAKING**

The Railroad Commission ("RRC" or "Commission") is expected to approve publication of proposed rules for implementation of the Gas Reliability Infrastructure Program ("GRIP") at its next meeting on June 22nd. New rules could be adopted as soon as September. In theory, the Commission rules don't affect what can be charged inside city limits. However with the increasing trend by gas utilities requesting region-wide rates (TXU, Atmos, Entex and West Texas Gas), cities cannot be sure that GRIP charges within city limits will be controlled by the cities.

The Commission's proposed rules drastically limit the amount of time for review of a utility's GRIP filing. Whereas the Commission normally has at least 150 days to review a utility's request for a rate increase, the proposed rule will limit staff to only 60 days to review GRIP filings. Commission Staff was drastically reduced after the last legislative session and will be hard-pressed to keep up with these filings, much less thoroughly review a system-wide filing in only 60 days. In addition, the rules do not provide for any participation by cities or affected customers during the Commission's review. The proposed rules only give a utility the right to a hearing and that is only if the Staff *denies* the utility's application.

The current trend with several utilities is away from filing first with cities and toward filing consolidated actions with the Commission at the same time that city filings are made. With the shortened review period at the Commission, its decision on GRIP filings will likely be made before the cities have made decisions on whether the proposed increases are justified. As the utilities can appeal all city decisions to the Commission,

utilities will be able to use the Commission's hasty review and decision as a precedential hammer against the cities.

Texas Gas Services has already filed for a GRIP adjustment in El Paso. Atmos insisted on GRIP findings in its most recent city ordinances approving rate increases. TXU has made it clear that it will be making GRIP filings based on the recent final order in GUD 9400. Cities must be alert to the dangers posed by these filings when made at the city level and should also not stand idly by while the Railroad Commission makes its very limited review of GRIP filings. If utilities can use the new rules to get quick and favorable results from the Commission, the cities' ability to maintain control over increased rates to customers may be seriously damaged.

GAS RELIABILITY INFRASTRUCTURE PROGRAM (“GRIP”)

1. WHAT IS GRIP?

- a. Automatic rate adjustment to allow gas utilities to include costs related to new plant investment in rates *without filing a full rate case*.
- b. Costs included are return (profit) on investment, depreciation expense, and certain taxes.

2. HOW DOES THE UTILITY GET A GRIP?

- a. Must have baseline rate case within last two years before requesting adjustment.
- b. Utility must file tariff or rate schedule with city 60 days before implementation date.
- c. Utility must give notice to all affected customers by direct mail or bill insert.

3. WHAT CAN A CITY DO?

- a. Can suspend implementation of GRIP.
- b. Until new charge has been approved as part of a full rate case, city can disallow adjustments and order a refund.
- c. Can open an inquiry (TEX. UTIL. CODE §104.151) and set new rates if rates are found to be excessive.

4. WHAT HAPPENS AFTER GRIP HAS BEEN IMPLEMENTED?

- a. Required annual reports by utility describing all new investment and retired plant.
- b. Required statement of cost, need, and customers benefited by new investment.
- c. Required annual earnings monitoring report showing earnings in past year.
- d. If earnings are high (more than .75% above currently approved rate of return), utility must state why earnings are not unreasonable.
- e. Utility must file a full rate case no later than 5½ years after implementation.

POTENTIAL ACTION ITEMS FOR CITIES REGARDING GAS ISSUES

1. Join Coalition of City efforts to investigate municipalization of gas distribution services and to develop regulatory and franchising protocols. *See*, attached memo and resolution.
2. Plan now for the GRIP filings that will be made within the next year.

ELECTRIC ISSUES BEING PURSUED BY CAPP AND STAP CITIES

1. Investigate separation of administrative functions provided by a Retail Electric Provider (“REP”) from power procurement functions. To address the fact that all REPs’ price electric power based on gas futures and that price differentials from quotes of various REPs given on a given day are insignificant, CAPP and STAP are evaluating the possibility of sending one RFP to REPs for administrative services and another RFP to generators to provide power to the REPs for service to CAPP and STAP load.
2. Seeking longer term solutions to the tremendous volatility in energy prices, CAPP and STAP are investigating taking ownership interest in one or more power projects.
3. Legislative changes necessary to make the marketplace functionally competitive include:
 - a. Creation of an independent ERCOT Board of Directors.
 - b. Limiting market power in the generation market.
 - c. Stop the transition to “nodal” pricing or constrain implementation of nodal so that congestion charges are spread throughout the State or precluded from being surcharged to specific regions until the transmission system is upgraded and equalized.

CAPP AND STAP REPRESENTATIVES WILL APPEAR BEFORE THE SUNSET COMMISSION TO PROVIDE PUBLIC TESTIMONY ON ELECTRIC ISSUES ON JULY 13-14, 2004.

UPDATE ON STRANDED COST TRUE-UP PROCEEDINGS

Pursuant to SB7, the legislation enacted in 1999 that deregulated the Texas electric retail market for much of Texas, several utilities filed (or will file) requests to finalize the stranded costs to be paid by ratepayers and recovered over the next decade. These cases involve reconciling (or “true-up”) the difference between the estimate of the utilities’ stranded costs, conducted in 2001, and a final market-based valuation of the utilities’ stranded costs. This true-up process allows utilities to use one of several market-based methods to establish the value of its stranded investments. In addition to settling stranded cost amounts, the Commission must make four basic determinations during the 2004 true-up proceeding:

1. **FINAL FUEL RECONCILIATION:** Calculate the actual market cost of fuel incurred by the utility during the final period of traditional regulation ending December 31, 2001 to reconcile the actual market cost with the prior estimates that had been used to set the fuel factor component of regulated rates.
2. **CAPACITY AUCTION TRUE-UP:** Calculate the actual market price of wholesale power to reconcile the actual market price with earlier cost projections for the same period that were used in the 2001 ECOM estimate of stranded costs. The market price is reflected in “capacity auctions” in which the utility or its unbundled power generation affiliate sold entitlements to generation capacity in order to reduce its market share as required by PURA.
3. **PRUDENCE REVIEW OF REGULATORY ASSETS:** Conduct a prudence review to determine whether previously unreviewed regulatory assets being recovered by the utility constitute reasonable and necessary costs. This review covers assets being recovered through securitization and is meant to prevent a utility from recovering imprudently incurred costs.
4. **CALCULATE THE RETAIL CLAWBACK:** Determine the actual retail market price of electricity for the first two years of competition in order to reconcile the retail market price with the Price to Beat rate during the same period. If the retail market price of electricity is found to be less than the Price to Beat rate, the affiliated REP must remit credits to the wires company.

Any final stranded cost amounts determined by the Commission will be charged to the retail electric providers as a nonbypassable charge. The retail electric providers will pass on the stranded costs to all residential, commercial, and industrial customers. Price to beat (“PTB”) rate customers will also be impacted by any stranded cost determination because the Commission intends to raise the PTB rate to reflect stranded costs.

TNMP STRANDED COST TRUE-UP CASE (Docket No. 29206)

On January 22, 2004, TNMP filed a request with the PUC to set its final valuation of stranded costs at \$373 million. If TNMP's request was approved in its entirety, the typical residential customer's bill was expected to increase by about \$10 every month for the next ten years.

However, the Commission disallowed a substantial portion of TNMP's stranded cost request before the hearing on the merits. Approximately \$106 million of TNMP's request was to purportedly recover costs associated with the capacity auction process. Because TNMP had successfully lobbied for legislation that exempted the utility from participation in the capacity auction process, the Commission ruled that the Company was not entitled to recover any costs associated with the capacity auction.

A majority of the remaining \$267 million in stranded costs was related to the difference between the net book value of TNMP's only generation asset, TNP One, and the market value that the Company received when it sold TNP One to Sempra in 2003. At hearing, parties focused on TNMP's failure to use commercially reasonable means when it sold TNP One. At the conclusion of the hearing, the administrative law judges determined that the Company failed to act as a reasonable market participant would have acted when selling a generation asset like TNP One. The judges' decision was based upon numerous considerations, including TNMP's failure to conduct any analyses or review long-range natural gas forecasts that would have impacted the expected sales price of TNP One, its failure to account for market conditions when all potential bidders, save Sempra, pulled out of the bidding process and Sempra lowered its initial bid, and the Company's imprudent management of its lignite supply contract renegotiation. The judges attributed TNMP's unreasonable conduct at least in part to the fact that the Company's financial advisor, Dr. William Catacosinos, was not experienced in the sale of assets like TNP One. To account for TNMP's failure to use commercially reasonable means, the judges recommended reducing TNMP's stranded costs by \$84 million.

All of the adjustments recommended by the administrative law judges resulted in a final stranded cost amount for TNMP of \$75 million. Residential and small commercial customers' share of TNMP's final stranded costs will be further reduced by \$15 million to reflect a partial refund for overpriced Price to Beat power charges. The PUC will consider the Proposal for Decision at its Final Order meeting on June 18th. Cities believe that the evidence at hearing supports greater reductions to TNMP's stranded costs and will recommend that the Commission issue a Final Order setting TNMP's stranded cost amount at \$0.

CENTERPOINT STRANDED COST TRUE-UP CASE (Docket No. 29526)

Texas Genco, LP, Reliant Energy and CenterPoint Energy Houston Electric, LLC (collectively, "CenterPoint") filed its stranded cost true-up request on March 31, 2004, seeking to recover \$4,323,550,823 in stranded costs from customers.

CenterPoint elected to use the "partial stock valuation methodology" to value its stranded costs assets. First, the Company transferred all of its generation assets into one company, Texas

Genco, which issued stock. Less than twenty percent of Texas Genco stock was available for trading. CenterPoint used the Texas Genco stock price, \$36.26, averaged over the 60 trading days preceding the filing of its true-up application to set a final value of its generation assets.

On June 1, intervenors filed their direct testimony. Issues raised by parties challenging CenterPoint's stranded cost request include environmental cleanup costs, Genco's capital structure, the encumbrances placed upon Genco's stock and the impact upon the share prices realized, and federal income tax implications associated with stranded cost recovery. Many parties filing testimony conclude that CenterPoint is entitled to substantially less than \$1 billion.

Since CenterPoint filed its stranded cost request, Texas Genco's share price has increased substantially. On June 7, 2004, Texas Genco closed at nearly \$42. If CenterPoint's stranded cost filing had been based upon the higher share price, their request would have been \$500 million less.

At the same time that CenterPoint is litigating its true-up case at the Commission, it is trying to sell Texas Genco for a price above its current share price. This situation sets up an interesting problem for parties and the Commission. According to the statute, CenterPoint is entitled to value its stranded cost using the hypothetical partial stock valuation. At the very same time, CenterPoint will be receiving an actual market price for its generation assets that is substantially greater than the value it is asking the Commission to approve.

CenterPoint's stranded cost hearing is scheduled to begin July 6th. The Commission has set aside three weeks to hear the case. A decision is expected by the end of the summer. If CenterPoint receives the entirety of its request, residential customers can expect to see their electric bills increase by approximately \$6 - \$12 each month for the next decade.

AEP - TEXAS CENTRAL STRANDED COST CASE (To Be Filed)

AEP-Texas Central (formerly known as CPL) will file its stranded cost case no earlier than September 2, 2004. AEP-Texas Central is in the process of selling its generation assets and will use the sales price to establish its stranded cost request. The Company has predicted that its request will be in the range of \$1.4 - \$1.8 billion. If the Company's entire request is approved, residential ratepayers' bills are expected to increase by approximately \$8 - \$10 per month for the next decade.

**POTENTIAL ACTION ITEMS FOR CITIES
REGARDING ELECTRIC ISSUES**

1. Share your negative experiences with deregulation with the Sunset Commission on July 13-14, 2004.
2. Consider joining CAPP. *See* attachments.
3. Take a stand against nodal market redesign.
4. Work cooperatively with other Cities to create model complaint tracking forms.

ATTACHMENTS