POLICY PAPER

The Case for Competitive Procurement in States with Vertically-Integrated Utilities

Introduction

States with vertically-integrated utilities (those that both own power generation facilities and control the sole means of distribution to ratepayers) can and should protect consumers by requiring such utilities to obtain power supplies on a competitive basis, rather than granting them the exclusive right to build new power plants on a cost-plus basis at a time of rapidly rising costs.

States in all regions of the country, regardless of whether they have a vertically-integrated utility system, or are restructured to promote competition by separating power generation from transmission and distribution, will need substantial amounts of new electricity supply in the years ahead. This will be the case even with the most aggressive steps to conserve electricity, generate and use it more efficiently, and empower customers through "demand response"- measures EPSA strongly supports.

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How new electricity generation is procured will have consequences for decades to come. This next build out of electricity generation will be the most expensive in the nation's history with a large projected demand and rapidly rising underlying costs for new power plants. Further compounding how this critical infrastructure is built is the legacy these investments will leave, both environmentally and economically. The power plants built in the next few years will last for decades. The right decisions need to be made today.

Policymakers have choices about how their states can procure electricity, even in vertically-integrated states without retail choice. All states have access to wholesale power markets. This means that even where only the regulated monopoly utility can sell to retail customers, utility-owned generation is not the sole potential source of the electricity generated to provide that service.

What is Competitive Procurement?

Competitive procurement is a process in which all electricity suppliers (third party independent competitive suppliers as well as the utility and its affiliates) are permitted to bid on an equal basis to win the right to supply electricity and/or build new power generation facilities.

States with vertically-integrated utilities generally have two potential sources for the electricity supply needed to serve customers. One is the monopoly regulated utility and its affiliates who build and operate power generation facilities on a cost-plus basis, which places most of the risk on ratepayers. The other source is a range of suppliers and marketers independent of the monopoly utility that build and operate power plants and otherwise supply electricity largely at their own risk and compete with each other to meet consumer needs.

The utility and independent sources of electricity supply are not mutually exclusive. In other words, it is likely that future power needs will be met by a combination of both independent competitive suppliers and the utility's power plants. The problem arises when the decision of whether to"buy or build" rests with the utility without putting all options - the utility's self-build option and the option of buying from others - to a competitive test to determine who can best serve consumers. Competitive power procurement provides that test.

Unfortunately, there is an inherent conflict of interest as the monopoly utility will, for its own financial reasons, prefer its generation even if a third party supplier or marketer could offer the best deal for consumers. The utility makes more money by getting as much capital investment in its rate base on which it earns a rate of return. This prejudices the utility to select its own power plants over those of independent competitors or marketers. By contrast, the consumer is best served by the lowest priced and most environmentally friendly electricity that is available regardless of who owns the power plant or power supply source. A comprehensive, robust competitive procurement process is the only way to secure the best choice for consumers between buying and building.

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EPSA Procurement Guidelines

EPSA's guidebook to competitive procurement, "Getting the Best Deal for Electric Utility Customers" is designed to provide regulators the tools they need to ensure that independent solicitations are made and that they are fairly evaluated and implemented. Such solicitations are important not only because they produce the best competitive option for the utility's customers, but also because they produce a market test against which to assess any utility proposal to build its own resources.

Once a given state has decided to use a competitive procurement process, it is important that regulators keep the following guidelines in mind to maintain a level playing field:

- Utilities should submit sealed bids at the same time and under the same process as other market participants.
- If the utility is the winner, it must be bound to live with its bid in the same manner as other competitors would be expected to do. If the costs are less than the estimates on which it based its bid, it may be allowed a greater than average return. If the costs end up higher than the utility's winning bid, then the utility bears the risk for cost overruns.
- The utility should not subsidize its proposal by discounting certain costs (e.g., engineering, transmission upgrades, etc.) that are otherwise recoverable in its rates.
- The utility should not unfairly skew the solicitation by imposing requirements only it can satisfy.

While all of this may seem obvious, and it should be, it will not happen without strictly enforced rules to make it happen. Using an independent evaluator to monitor the process in concert with regulators is the most effective way to ensure that it functions properly.

Ultimately, if competitive power suppliers and other market participants perceive that the solicitation process is unfair or biased, participation by a wide range of competitors will be limited, resulting in costs and risks to consumers that will be much higher than otherwise necessary.

Electricity customers deserve nothing less than a fair competitive solicitation process with respect to their power supply options. Whether procuring power for hours, days, weeks, months or years, utilities and states that engage in fair and open competitive solicitations will ensure that customers get the lowest-priced available power with the least possible risk.

Why True Competitive Procurement is Necessary

Despite the benefits of a fairly and openly administered competitive procurement process where many parties have an opportunity to bid, most states with vertically-integrated utilities do not have competitive power procurement rules in place. Even in the minority of such states with rules on the books, there are a number of recent instances where either the utility has manipulated the process to exclude competitors or simply sought to toss the competitive procurement rules aside entirely.

- In Colorado, the Public Service Company of Colorado refused to accept bids for new coal-fired resources after two rounds of competitive bids by changing the required in-service date in mid-process. The utility then submitted its own self-build proposal outside of the procurement process. Public Utilities Commission staff has recently proposed a number of competitive procurement reforms in light of the utility's violation of the state's least cost planning process. The commission is currently reviewing the staff report.
- In Oklahoma, the Public Service Company of Oklahoma manipulated a technical accounting issue known as"debt imputation' to eliminate bids from others in a recent competitive procurement process. The utility then submitted a proposal outside of the competitive procurement process to rate-base a new plant. The state commission is currently reviewing the issue.
- In Georgia, Georgia Power (a subsidiary of Southern Company) recently requested a permanent exemption for all future baseload power needs from the state's mandatory competitive procurement rules. After opposition by every other party to the integrated resource plan, the utility withdrew its request and will conduct a competitive solicitation.
- In Virginia, Dominion attempted to pass legislation this year that included the elimination of the long-standing requirement for competitive procurement for all future resource needs. While that provision of the legislation was removed, there are indications that the utility will attempt to bypass the competitive process in the next legislative session.
- In North Carolina, Duke Energy proposed to build two 800-MW coal units at $2 billion without a competitive market test. Less then nine months later, after the state commission approved construction of only one of the units, the utility now says that the construction of a single 800-MW coal facility will cost $2.4 billion.

These and other attempts by vertically-integrated utilities to monopolize power supplies put consumers at risk by taking away the many benefits that the marketplace offers in terms of innovation, efficiency, affordability and environmental improvement. State and Federal policymakers must stand firm and ensure that ratepayers get the best deal possible through a fairly administered, independent market process.

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Competitive Procurement is Normal Business

The use of the marketplace to supply goods and services is used in every industry and at every level of commerce. In fact, vertically-integrated utilities often tout their use of competitive bidding as a way to hold down costs and minimize risks when contracting with engineering and construction firms for new plant projects. Utilities use competition to protect themselves, why shouldn't the same be done for electricity consumers?

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Competitive procurement is mandated by every state for purchases using taxpayer dollars over a nominal amount. For example, any government agency in the state of Virginia must use a competitive solicitation for goods over $50,000. If $50,000 worth of pencils must be purchased competitively, why shouldn't a $1 billion-$2 billion power plant have to meet the same simple and straightforward standard?

When government fails to use competitive procurement there is understandable public outrage and front page headlines that taxpayer money is not being spent wisely (e.g., "Costs Skyrocket as DHS Runs Up No-Bid Contracts;' *The Washington Post,* June 28, 2007). Predictably, there will be similar public outcry if new power plants are allowed to be built only by utilities with guaranteed cost recovery without fair competitive bidding just as those costs are surging (see, "Costs Surge for Building Power Plants,' The *New York Times,* July 10, 2007).

The case for competitive procurement is compelling - allow the marketplace we use for the purchase of all other necessary commodities to work for electricity consumers. If the process is conducted in a fair, open manner and a utility or regulated affiliate is subject to the same contract terms as any other bidder, the consumer will get the best possible deal.

The Time to Act is Now!

Time is of the essence. Vertically-integrated utilities in many states are rushing to secure commitments from regulators and legislators for guaranteed recovery of open-ended costs for multi-billion dollar power projects, some using unproven techologies, without fully evaluating all available supply options. Once these commitments are made, and competitive suppliers are excluded, it will be difficult to protect consumers as project costs and risks continue to increase.

EPSA strongly urges all state commissions to adopt fair and open competitive procurement rules for utility resource needs and to enforce those rules should a utility attempt to manipulate or bypass the process. The on-going federal-state dialogue on competitive procurement should, at a minimum, assist states with best practices on how best to do so.

For more information on necessary elements for a fair and open process, please contact EPSA for a hardcopy of the guidebook to competitive procurement, "Getting the Best Deal for Electric Utility Customers" or go to: www.epsa.org/documents/industry/MerchantPower/Policy_Guide.pdf

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