EEI EDISON ELECTRIC INSTITUTE

NRDC
THE EARTH'S BEST DEFENSE

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Dear NARUC Commissioners

At your invitation, we conducted a lively debate at the 2002 Annual Meeting on utilities' future role in "electric resource portfolio management." Many of you encouraged us to return with joint recommendations on the formidable challenges associated with choosing and managing balanced portfolios of electricity and grid resources for customers unable or unwilling to do this themselves. Here we are again.

While details vary among states, EEI and NRDC agree that among most distribution companies' most crucial and challenging responsibilities is meeting their systems' long-term needs for grid enhancement, generation and demand-side resources. Distribution companies need not own the resources involved, and an active portfolio management role for distribution companies is entirely consistent with efforts to promote competitive wholesale generation markets. Indeed, as NARUC's members know well, many participants in such markets increasingly are calling for more long-term distribution company investments to help overcome a capital availability crisis that affects all elements of the power system, from grids to generators to end-use efficiencies.

We are deeply concerned, however, about an increasingly obvious mismatch between these important societal needs and the tools available to utilities, other market participants and regulators. We also believe we need clear workable frameworks for resource portfolio procurement, and we are committed to working together with NARUC's members to secure them.

THE CHALLENGES

Utility-based resource portfolio management faces a host of challenges, including but not limited to the following:

1. Misaligned incentives.
   a. Traditional regulation does not create any clear performance-based incentive to manage comprehensive electric resource portfolios effectively; at best, utilities can hope to recover the costs of long-term contracts with generation and demand-side service providers, with no opportunity to earn a reward for addressing risks in minimizing the long-term cost of reliable service.
   b. For energy efficiency and distributed generation options specifically, today's rate regulation typically penalizes any such utility investments - however cost-

effective - by linking much or all of utilities' fixed cost recovery to their retail electricity sales volumes.

c. Traditional rates of return from a cost-of-service framework do not reflect significant new risks (outlined in part below).

d. It is difficult to negotiate symmetrical incentives that reward long-term performance and will not be revisited or withdrawn when utilities do well.

2. Major new risks in honoring service obligations in restructured markets:
   a. Volume Risk: in states with retail competition loads are far more variable because of customer switching; and,
   b. Price Risk: wholesale prices are increasingly volatile, most customers don't like being exposed to such volatility, and many utilities have divested their own generation in response to market forces and/or direction from regulators and legislatures.

3. Illiquidity in wholesale markets: lack of long-term deals impedes temporal diversity, and lack of derivative products obstructs some kinds of risk hedging.

4. Uncertainty regarding the duration of the supply obligation: some states have reframed portfolio management as "Provider Of Last Resort" (POLR) service, which was originally intended to be part of a transitional strategy but now is being recast as a renewed and extended obligation.

5. Analytical challenges in developing sound portfolios: portfolio managers must find new tools and methods to evaluate regulated and unregulated resources with significantly different asset lives and non-price attributes; Commissions need to gain greater familiarity with new risk management concepts, methods and tools (e.g., Value-at-Risk, Cash Flow-at-Risk, measures of gas price volatility)

6. Expediting decisions: traditional trial-type adversarial planning proceedings take too long to identify and exploit opportunities.

7. Addressing the role of affiliates: no consensus yet exists on whether and how to accommodate affiliate participation in resource portfolios.

NEXT STEPS

This daunting list of concerns is not an invitation to despair or for paralysis; solutions must be found in the public interest. We offer these initial recommendations and remain committed to timely solutions:

1. Get the incentives right: performance-based incentives tied to objective benchmarks have been tested for both demand- and supply-side resources; it's time to put them to widespread use. Procurement plans filed by utilities with their regulators can be used to establish these benchmarks, which should address cost-effective short- and long-

term investments in generation, demand-side resources and grid enhancements. Also, to eliminate a powerful disincentive for energy efficiency and distributed-resource investment, we both support the use of modest, regular true-ups in rates to ensure that any fixed costs recovered in kilowatt-hour charges are not held hostage to sales volumes. EEI believes regulators should explore new rate designs for collection of the fixed costs of investments.

2. Provide reasonable assurance of cost recovery: uncertainty of cost recovery constrains adaptive rate design, and discourages investment in new infrastructure needed for security, reliability and environmentally sustainable service for all customers. Moreover, extended rate freezes make impossible any true-ups to remove energy efficiency disincentives (see item 1 above).

3. Provide opportunities for utilities to seek advanced regulatory approval for resource portfolios under standards and criteria defined upfront, with assurances that approved commitments will not be revisited and disapproved after-the-fact.

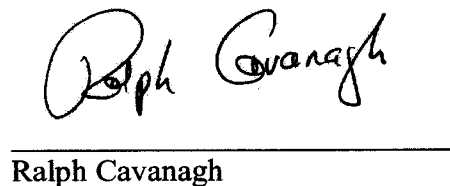
4. Add objective risk management goals to the traditional utility resource procurement mission of minimizing costs subject to reliability and other constraints.

5. Establish frequent communications with Commissioners and staff, to keep up with dynamic market changes and avoid surprising regulators.

6. Develop RFP processes that are unbiased and fair for all parties, including utility affiliates and independent suppliers. One illustration is the joint NRDC/PacificCorp/Calpine proposal *Defining Electricity-Resource Portfolio Management Responsibilities* submitted to NARUC in July 2003.

Through these recommendations, we hope to help NARUC members achieve the best possible long-term results for all of their constituents, in both economic and environmental terms.

Yours sincerely,



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