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KURT ADAMS  
CHAIRMAN

STATE OF MAINE  
PUBLIC UTILITIES COMMISSION  
242 STATE STREET  
18 STATE HOUSE STATION  
AUGUSTA, MAINE  
04333-0018  
January 15, 2008

SHARON M. REISHUS  
VENDEAN V. VAFIADES  
COMMISSIONERS

Honorable Philip Bartlett III, Senate Chair  
Honorable Lawrence Bliss, House Chair  
Joint Standing Committee on Utilities and Energy  
115 State House Station  
Augusta, ME 04333

Re: Report on Transmission & Distribution Utilities Participation in the Energy Supply Business

Dear Senator Bartlett and Representative Bliss:

During its First Regular Session of the 123<sup>rd</sup>, the Legislature enacted Resolve 2007, ch. 54 directing the Commission to review issues involved with transmission and distribution utilities entering the energy supply business. The Resolve requires the Commission to submit a report with its findings and recommendations to the Joint Standing Committee on Utilities and Energy by January 15, 2008. The attached report is the Commission's response to that directive.

We look forward to working with you and your Committee on the issues addressed in the attached report during the upcoming session. If you have any questions or comments regarding this report, please contact us.

Sincerely,

  
Kurt Adams, Chairman  
Maine Public Utilities Commission

On behalf of

Sharon M. Reishus  
Vendean V. Vafiades

Commissioners  
Maine Public Utilities Commission

Attachment

cc: Utilities and Energy Committee Members  
Lucia Nixon, Legislative Analyst



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# **MAINE PUBLIC UTILITIES COMMISSION**

## **Report on Transmission & Distribution Utilities Participation in the Energy Supply Business**

**Presented to the Utilities & Energy  
Committee**

**January 15, 2008**

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## I. INTRODUCTION

During the 2007 session, the Legislature adopted Resolve, Regarding the Reentry of Electric Utilities into the Energy Supply Business (“Resolve”).<sup>1</sup> The Resolve directs the Commission to undertake a review of the issues involved with transmission and distribution (“T&D”) utilities entering the energy supply business. The Resolve specifies that for purposes of the review, “energy supply business” includes owning, operating or having an interest in electric generation facilities, load management activities or demand-side management activities. The Resolve contains nine items that the Legislature stated must be included in the Commission’s review. The Resolve requires that the Commission submit a report containing its findings and recommendations for further action and legislation to implement its recommendations to the Joint Standing Committee on Utilities and Energy no later than January 15, 2008.

As the vehicle for conducting the required review, the Commission initiated an Inquiry to explore the issues involved with Maine utilities’ participation in the energy supply business.<sup>2</sup> On July 25, 2007, the Commission issued a Notice of Inquiry (“NOI”) that contained the nine items included in the Resolve, other relevant issues, and a number of clarifying questions. To obtain information, viewpoints and recommendations from interested persons on the issues raised in the Resolve as presented in the NOI, the Commission requested written comment and, on September 6, 2007, convened a public meeting to discuss the issues in the Inquiry and allow an opportunity for responsive comments.<sup>3</sup> On December 10, 2007, the Commission released a Draft Report for comment by interested persons.<sup>4</sup>

The following interested persons participated in the Commission’s inquiry: Central Maine Power Company, Bangor Hydro-Electric Company, Maine Public Service Company, Houlton Water Company, Kennebunk Light and Power District, Eastern Maine Electric Cooperative, Public Advocate, Independent Energy Producers of Maine,<sup>5</sup>

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<sup>1</sup> Resolves 2007, ch. 54.

<sup>2</sup> *Inquiry Regarding the Reentry of Electric Utilities into the Energy Supply Business*, Docket No. 2007-317.

<sup>3</sup> The Resolve states that the Commission review must be conducted through a “public investigative proceeding.” The Inquiry conducted by the Commission is such a proceeding.

<sup>4</sup> All comments filed in this Inquiry as well as the transcript of the public meeting are posted on the Commission’s virtual case file on its webpage, [www.maine.gov/mpuc](http://www.maine.gov/mpuc), through reference to Docket No. 2007-317.

<sup>5</sup> In addition to filing its own comments, the IEPM also submitted a whitepaper by the Brattle Group entitled “An Assessment of Retail Rate Trends and Generation Costs in Maine.”

Constellation Energy Commodities Group and Constellation NewEnergy, Calpine Corporation, New England Power Generators, Retail Energy Supply Association, and Competitive Energy Services.

## **II. INDUSTRY STRUCTURE OVERVIEW**

Prior to 2000, Maine's electric utilities, like most utilities across the country, were "vertically integrated." They provided generation, transmission and distribution services on a monopoly basis within defined geographic service territories. The utilities owned or controlled (through long-term contracts) the generation assets that served retail customers within their territories and these customers could only purchase electricity from their local utilities. Utilities also provided energy efficiency and conservation services and products (generally referred to as demand-side management) as part of their obligation to provide electricity to their customers on a least cost basis.

This paradigm was fundamentally changed beginning in March 2000 with the restructuring of the electric industry in the State. In 1997, the Legislature enacted the Restructuring Act,<sup>6</sup> which deregulated the energy supply portion of electric utility service and allowed retail customers the option of purchasing supply from a competitive market.<sup>7</sup> Customers that do not purchase supply from the competitive market receive standard offer service from retail suppliers chosen by the Commission through a competitive solicitation.

Under the Restructuring Act, Maine's utilities were required to divest most of their generation assets<sup>8</sup> and to periodically auction the output of their pre-existing long-term qualifying facility ("QF") contracts. The utilities were prohibited from acquiring new generation assets<sup>9</sup> and from providing retail energy services to customers; the utilities essentially became "wires companies." In addition, the Legislature transferred energy

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<sup>6</sup> P.L. 1997, ch. 316 (codified at 35-A M.R.S.A. ch. 32).

<sup>7</sup> The transmission and distribution portions of utility service remained a regulated monopoly.

<sup>8</sup> The proceeds from the sale of these "regulated assets" went to the benefit of ratepayers through an offset to the utilities' revenue requirements.

<sup>9</sup> The Restructuring Act contains an exception that allows utilities to own or control generation assets to allow them to provide transmission and distribution service in an efficient manner. 35-A M.R.S.A. § 3204(6). This provision allows utilities to own or control generation assets for reliability purposes, such as for voltage support or as a less costly alternative to a new transmission line.

efficiency and conservation program responsibility away from the utilities, placing the responsibility first with the State Planning Office and then to the Commission.<sup>10</sup>

One of the primary motivations behind the Restructuring Act was to avoid the future creation of “stranded costs.” Under the traditional regulation paradigm, utilities were allowed to recover from ratepayers all costs of service (as long as they were prudently incurred). Thus, utility ratepayers were required to pay the capital costs and expenses associated with utility generation assets and the costs of long-term supply contracts even if those costs turned out to be above the market value of electricity. Conversely, utility ratepayers received the benefits of utility assets to the degree that the costs were below the market. During the 1990s, the market cost of electricity fell substantially below prior expectations and the result was that the utility costs of providing electricity supply became much higher than the cost of electricity available from the wholesale market. The difference between the utilities’ cost of providing generation service from their assets and contracts, and the market cost of electricity is what became referred to as “stranded costs.” Because these costs were prudently incurred before industry restructuring, the Restructuring Act allows utilities to recover the costs through their T&D rates.<sup>11</sup> The total amount of stranded costs from pre-restructuring utility obligations is in the range of \$3 billion.

By restructuring the industry so that utilities no longer have the obligation to provide generation supply, Maine ratepayers would no longer be at risk for future stranded costs. However, there are other risks that come with complete reliance on the market for generation supply (as occurred with industry restructuring). Generation supply is a commodity and, like most commodities, it is subject to substantial fluctuations in price. This is especially the case with generation supply in that the regional market price to customers is dependent to a great degree on world energy markets (primarily natural gas). As a result of the design of the restructured New England wholesale market, customers in the region generally pay prices based on the relatively high cost of natural gas generation, even though there is a significant amount of lower cost generation in the region mix (e.g. hydro and nuclear).<sup>12</sup>

If Maine utilities had retained ownership of generation assets (particularly the lower cost hydro units) after the restructuring of the wholesale market, ratepayers would have had what can be referred to as a “cost-of-service hedge” against complete

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<sup>10</sup> The Commission conducts its efficiency and conservation services through its Efficiency Maine program.

<sup>11</sup> 35-A M.R.S.A. § 3208.

<sup>12</sup> The New England wholesale market is structured so that generators are paid clearing prices based on the highest cost bid needed to serve load in every hour. Because the highest cost bid is often from a natural gas plant, all generators in the region tend to receive natural gas-based prices.

exposure to market prices. This is because ratepayers would have been obligated to pay only the actual costs of the assets for their energy and capacity value, rather than the prevailing market prices for the energy and capacity from the facilities.<sup>13</sup>

Although there is some opportunity for customers to hedge against market price volatility through fixed-priced contracts from competitive suppliers for a number of years (e.g. 1 to 5 years), the price of such contracts remain based on expectations for the future market price of electricity. Consequently, there is little or no opportunity for a cost-of-service hedge available to retail customers from the restructured competitive market.

### **III. POLICY CONSIDERATIONS**

The primary policy question to be addressed in this review is whether utilities should be allowed to own or have a financial interest in generation assets to provide ratepayers a cost-of-service hedge against the uncertainties and volatility that result from complete reliance on the competitive electricity markets. Commenters in this Inquiry have not suggested a complete retreat from electric restructuring and a return to vertical integrated electric utility monopolies.<sup>14</sup> There is no proposal that retail choice for electricity consumers be eliminated or that utilities return to an obligation of providing generation supply to customers within their service territories<sup>15</sup> (including the provision of standard offers service). Rather, the investor-owned utilities propose that they be allowed to own or obtain an interest in generation assets on a “regulated” basis so that their customers, who would pay for these assets on a cost-of-service basis, would have some hedge against open market prices.

Under current law, unregulated corporate affiliates of Maine’s T&D utilities are allowed to own or have an interest in generation assets. The unregulated status means

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<sup>13</sup> Utilities in Vermont and New Hampshire retained ownership of some generation assets. As a result, ratepayers in those states have had less exposure to the impact of higher natural gas prices and the introduction of the regional capacity market than Maine’s ratepayers. It should be emphasized, however, that Maine’s utilities cannot regain this benefit by simply re-purchasing the divested generation assets. These assets would be valued currently according to future expectations of natural gas-based market prices, rather than their costs of service. Moreover, Maine’s ratepayers did receive a substantial benefit from the sale of generation assets through the reduction of stranded costs.

<sup>14</sup> Commenters did, however, express opinions on whether electric restructuring is “working.” Proponents on both sides of the issues were able to point to studies and data that supported their positions.

<sup>15</sup> Bangor Hydro-Electric Company did suggest that if it were allowed to reenter the generation business, it should be the provider of standard offer service for the small commercial and residential customer class.



that shareholders, rather than ratepayers, would have both the risk and benefits of generation investment. Under the prevailing interpretation of the Restructuring Act, such utilities affiliates would be able to own generation assets within Maine.<sup>16</sup> Similarly, unregulated affiliates of utilities are permitted to participate in the competitive retail supply market.<sup>17</sup> Thus, commenters in the Inquiry agreed that the focus of the review should be on utility participation in the generation supply business on a regulated basis in which assets would be included in rate base and all prudent costs of supply business activities would be included in rates.

As mentioned above, utilities are no longer obligated to engage in demand response or energy efficiency activities. However, current law does not prohibit utilities from engaging in such activities on a regulated basis to the degree that the Commission permits cost recovery in rates. Utilities have stated that they are in unique position to engage in demand response and energy efficiency activities, noting their access to electricity customers and the possible use of automated metering infrastructure (AMI). The Commission is engaged in demand response initiatives and will seek utility cooperation when needed. The Commission is also actively considering the potential benefits of AMI<sup>18</sup> and is open to any utility proposal that would take advantage of their position for demand response or energy efficiency purposes.

Because utilities are not legally prohibited from demand response and efficiency activities and such efforts can currently be authorized by the Commission, utility demand-side activities do not represent a major policy consideration of this review and were not the subject of extensive comment. Accordingly, this Report focuses on the issues involved with utility ownership of generation assets on a regulated basis.

#### **IV. INQUIRY COMMENTS**

The investor-owned utilities take the position that the restructuring law should be changed to allow them to own or have a financial interest in generation assets on a regulated basis. The generators, retail suppliers and the consumer-owned utilities (“COUs”) commented in strong opposition to the re-entry of Maine’s utilities into the generation business. The Public Advocate urges caution in considering whether utilities should be allowed back into the generation business, stating that the restructured market has protected customers from the financial risks associated with generation ownership.

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<sup>16</sup> None of Maine’s utilities have an affiliate that owns generation within the State.

<sup>17</sup> None of Maine’s utilities currently have an affiliated retail electricity supplier that is engaged in business in the State.

<sup>18</sup> *Central Maine Power Company, Revenue Requirement and Rate Design, and Request for Alternative Rate Plan*, Docket No. 2007-215; *Bangor Hydro-Electric Company, Investigation into the Rate Design for Demand Classes*, Docket No. 2005-554.

### Investor-Owned Utilities

The investor-owned utilities state that the ownership of generation assets on a regulated basis has the primary benefit of providing ratepayers with a cost-of-service hedge against natural gas-based energy market prices and against the costs of the regional forward capacity market. The utilities assert that the restructured market has not been structured to attract the kind of institutional participants needed to ensure long-term adequate supply or long-term reasonableness of fuel mix and, thus, without utility participation, future development is likely to continue to more gas-fired plants. The utilities state that they have a unique, longer term perspective and have an interest in developing different types of generation facilities for the benefit of customers.

The utilities cite to their ability to take advantage of lower cost financing as a benefit for customers and that their participation in the market could help meet the State's fuel diversity goals. They state utility generation has co-existed with unregulated generation since the 1970s and thus their participation will not negatively affect the competitive generation market. Finally, the utilities note that California, Connecticut, Delaware, Virginia, and Montana have begun to allow or require utilities to acquire generation assets because those states have concluded that deregulation has not worked well for their customers.

### Other Commenters

Generators, retail suppliers and the COUs all oppose a change in State policy that would allow for the re-entry of Maine's utilities into the generation business on a regulated basis. These commenters state that utility participation in the generation business would result in an unfair competitive advantage that would damage or destroy the competitive generation market. Commenters are concerned that utilities could unfairly favor their own generation assets in a variety of ways (e.g. interconnection process, maintenance scheduling, settlements) These commenters also state that utility participation in the generation business would create substantial ratepayer risk and would not solve the problems of electric industry restructuring—real or perceived.

Utility ownership of generation assets on a regulated basis provides a guarantee of cost recovery from the State's ratepayers and no other market participant has assured recovery of all prudently incurred costs. This cost recovery guarantee lowers utility costs and provides an unfair competitive advantage that will discourage merchant investment in generation. These commenters suggest that, if desirable, a hedge against market prices and fluctuation can be provided through long-term contracts with unregulated generators, rather than through utility ownership of generation assets.

These commenters also state that utility-owned generation would create substantial ratepayers risks of above-market or stranded costs, and that this risk offsets any benefit of lower financing costs. Ratepayers would also be exposed to both cost overruns during construction, and sub-optimal operation and maintenance of generation facilities. These commenters note that the utilities no longer have in-house generation

expertise and there is no reason to expect that utilities can do a better job owning and operating generation facilities than experience market participants. To benefit customers, these commenters state that there must be an assumption that utilities can consistently make better choices about investments and will do a better job of operating and maintaining generation facilities than those entities that are in the business of owning and operating generation assets. Such an assumption, according to these commenters, is not warranted.

## **V. DISCUSSION**

As discussed above, the restructuring of the electric industry in Maine has left the State's ratepayers exposed to the overall level and volatility of the natural gas price driven regional market. Maine's electricity ratepayers are also exposed to the costs of the regional capacity requirements. Thus, it is appropriate for the Legislature to consider whether there are effective mechanisms to protect ratepayers from complete reliance on the market cost of energy and capacity.

The Legislature has already taken one step away from the market reliance objectives of industry restructuring. In 2006, legislation was enacted that authorizes the Commission to direct Central Maine Power Company ("CMP") and Bangor Hydro-Electric Company ("BHE") (the legislation did not include Maine Public Service Company ("MPS")) to enter into long-term contracts for capacity and associated energy.<sup>19</sup> This legislation also directs the Commission to develop a long-term resource adequacy plan. The Commission will submit the resource plan to the Utilities and Energy Committee during the 2008 session and subsequently conduct a competitive solicitation for long-term capacity and energy contracts.

Long-term contracts with unregulated market participants can serve to provide a ratepayer hedge against market fluctuations, but come with similar stranded costs risks as utility generation ownership.<sup>20</sup> Such contracts would generally be priced based on expectation of future market prices which in turn would reflect future projections of natural gas prices. However, in its long-term contract solicitation, the Commission anticipates seeking (among other types pricing arrangements) cost-of-service arrangements with market participants that would provide similar hedging benefits as would utility-owned generation.

Utility ownership of generation assets on a regulated basis would provide a cost-of-service hedge. However, utility generation ownership should not be the only means

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<sup>19</sup> P.L. 2005, ch. 677. The Commission has adopted implementing rules (Chapter 316).

<sup>20</sup> Long-term contracts and utility generation ownership would also have similar impacts on a utilities cost of capital. Because both endeavors would tend to increase the utility's risks, both would tend to increase the utility's cost of capital.

to achieve this benefit. A similar cost-of-service hedge may be available from the market without the need to allow utilities back into the generation business. By offering market participants ratepayer cost recovery, through long-term contractual arrangements, these participants would have the same cost of capital advantage as utilities and, due to their experience, may be able to provide the hedge at an overall lower cost to ratepayers. The Commission's long-term contracting rule (as well as the authorizing statute) limits contract terms to ten years "unless the Commission finds that a contract for a longer term to be in the ratepayers interest."<sup>21</sup> To obtain the benefits of a cost-of-service hedge similar to that which would occur with utility ownership, contracts may need to be significantly greater than ten years (e.g. 20 to 30 years) so that ratepayers obtain the value as capital costs are depreciated over time.

Any attempt to procure a cost-of-service hedge, either through utility ownership or long-term contracting, comes with a price (primarily the risk of new stranded costs). The extent of both the hedge benefit and hedge risk would depend on the amount of the generation assets that utilities are allowed to own.

Because of the inherent risk to ratepayers and the potential for the disruption of the competitive generation market, any decision to allow utility ownership of generation should be carefully considered. Although attempts can be made to minimize risk, there can be no guarantee that ratepayer risk can be managed under all circumstances.<sup>22</sup>

The most direct means to limit ratepayer exposure is to place a cap on the amount of generation capacity utilities are allowed to own. For example, a capacity cap of a specified percentage of the demand within the utility's service territory can be imposed. In addition, utilities should be required to demonstrate the reasonableness of any generation ownership proposal and obtain a certificate of public convenience and necessity in an adjudicatory process before the Commission prior to any commitment to invest in a generation project. In such a proceeding, the Commission, as well as interested parties, can carefully scrutinize the proposed project and the utility's plans for construction and operation of the facility. For example, a lack of current in-house expertise may be of little consequence if the proposal is simply for a utility to invest in project that is being developed and will be operated by other entities. Moreover, the Commission could consider imposing ratemaking incentives such as capping capital cost recovery based on proposed budgets and tying expense recovery to industry standards.

In the event that the law is changed to allow utilities to own generation, a requirement to test all utility proposals through a competitive solicitation process is of

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<sup>21</sup> Chapter 316, § 6(C).

<sup>22</sup> Under accepted ratemaking principles, ratepayers are protected from the cost consequences of "imprudent" utility decisions and actions. However, imprudent action is often very difficult to detect and ratepayers may not be shielded from the consequences of all mistakes that may be made in the ordinary course of business.

utmost importance to minimize ratepayer costs and risks. To illustrate, utility proposals for generation projects should be put out to bid so that the competitive generation market is provided an opportunity at some point in the process to submit competing proposals that might entail less costs or risk. As mentioned above, it should be possible to seek a cost-of-service hedge from the competitive market by offering a ratepayer guarantee of prudent cost recovery in return for energy and capacity at the cost-of-service. In concept, there is no reason that such an arrangement should be limited to utilities.

Regardless of the type of the long-term arrangement, the resulting energy and capacity should periodically be sold into wholesale market (rather than being used to directly serve load) as currently occurs with the utilities' QF entitlements. Commenters generally agreed that, in this manner, the hedge can be provided without disrupting the Maine's retail market.

The Commission does not view the promotion of resource diversity or a lack of interest by market participants in different types of generation projects (other than natural gas facilities) that have significantly higher up-front capital costs as a sufficient rationale for allowing utilities back into the generation business. Resource diversity can be promoted through other means, such as long-term contracts or a renewable portfolio requirement.<sup>23</sup> Moreover, there has been interest by non-utility entities in developing resources that rely on technologies that have significantly higher up-front capital cost than natural gas-fired generation (e.g. wind and coal gasification facilities). Thus, in the Commission's view, the provision of a cost-of-service hedge remains the primary rationale for utility ownership of generation assets.

## **VI. RESOLVE ITEMS FOR CONSIDERATION**

The Resolve contains nine items that the Legislature stated must be included in the Commission's review and discussed in this Report. The Commission lists and discusses these items below.

*1. The laws and rules that would need to be changed to allow electric utilities to participate in the energy supply business.*

Section 3204(5) of Title 35-A is the provision of the Restructuring Act that prohibits Maine utilities from owning, controlling or having a financial interest in generation assets. This provision would need to be repealed. A new provision would need to be added to govern the certificate of public convenience and necessity requirements and process that would authorize a utility's involvement in a generation project. Depending on the precise nature and extent to which utilities are allowed to

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<sup>23</sup> During the 2007 session, the Legislature enacted an enhanced portfolio requirement that requires certain percentages of Maine's load to be served by "new" renewable resources. P.L. 2007, ch. 403.

own or control generation assets, other statutory changes may be necessary. These include amendments to the standards of conduct provisions, 35-A M.R.S.A. § 3205(3), to avoid discriminatory preferences with respect to utility assets, and modification of the stranded cost provisions, 35-A M.R.S.A. § 3208, to specify the circumstances under which utilities may recover new stranded costs.<sup>24</sup>

The Commission's current rules would not have to be substantively revised if utilities were allowed to own generation assets. However, some conforming changes to a number of rules may be required. The adoption of a Commission rule implementing the new certificate of public convenience and necessity statute for utility generation is likely to be necessary.

As discussed above, there is currently no prohibition against utilities engaging in demand response or energy efficiency activities. Thus, no corresponding statutory or rule changes would be necessary in this area.

*2. Potential impacts of electric utility participation in the energy supply business on unregulated generators of electricity and on competitive electricity providers.*

#### Unregulated Generators

In the event that utilities are allowed to reenter the generation supply business as dominant participants in the market, there could be a serious impact on unregulated electricity generators. The regulatory guarantee that utilities could recover all prudently incurred (even those that turn out to be above-market) could create an unfair competitive market. Unregulated generators, who do not have cost-recovery assurances, would have higher risks that translate into higher costs. The result may be some level of reluctance for investment in unregulated merchant generation.

However, there should be little or no adverse impact on unregulated generators under a limited approach in which utilities participate in the energy supply business only to provide a cost-of-serve ratepayer hedge when a similar product is not otherwise available from the market or can be provided by utilities at a price or terms that are significantly more attractive.

In the event that Maine's utilities re-enter the business of owning or operating generating assets, there could be some adverse impact on other generators to the extent utilities are able to unfairly favor their own generation assets through the generator grid interconnection process or through the load settlements process. Although there would always be some potential for utilities to act in this manner, such actions would be unlawful and there are currently substantial safeguards in place. The ISO-NE controls generator interconnections and the settlements process and the NMISA serves a similar function in northern Maine. Moreover, there is a broad-based

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<sup>24</sup> Current law generally prohibits the recovery of stranded costs related to obligations incurred after April 1, 1995. 35-A M.R.S.A. § 3208(3).

open access transmission tariff and FERC rules impose standards of conduct on utilities that separate the utilities generation activities from that of transmission provision. These comprehensive safeguards were put into place specifically to prevent the region's utilities from exploiting their positions and unfairly favoring their own assets or activities at the expense of those of competitors.

### Competitive Electricity Providers

To the extent that utilities continue to be prohibited from providing retail marketing services (except through an unregulated marketing affiliate) and have no load servicing obligations, there should be no adverse impact on the State's competitive electricity providers. The retail market could be disrupted to some extent if the utilities were allowed to serve load (e.g. standard offer load) with the output of their generation assets. This impact could be avoided if utilities were required to dispose of energy and capacity from their generation assets to the wholesale market through periodic competitive auctions, as currently occurs with the output of their remaining QF contracts and other generation assets.

*3. Potential impacts of electric utility participation in the energy supply business on consumers of electricity.*

### Potential Adverse Impacts

The primary adverse impact on electricity consumers that could result from utility participation in the energy supply business is the creation of new stranded costs. As discussed in section V above, the risk of new stranded costs can be reduced by limiting utility participation to a narrow set of circumstances. However, the risk can not be eliminated and the more the risk is reduced through limited participation, the less potential benefit there will be for consumers.

There is also a potential that unregulated generators will perceive a change in law that allows utility participation in the generation business as a retreat from the competitive principles embodied in the Restructuring Act, resulting in reluctance for merchant investment in the State. However, this potential can be minimized by a clear articulation in statute of the limited circumstance under which utilities may own or operate generation assets.

### Potential Positive Impacts

Utility participation in the energy supply business could potentially benefit consumers in several ways: 1) rights to energy and capacity at cost-of-service that turns out to be lower than prevailing market prices; 2) financing costs could be lower due to the regulated status of the assets compared to merchant assets resulting in lower costs to consumers; 3) greater governmental control over diversifying generation resources (e.g. increased ability to meet the State's renewable goals); and 4) a cost-of-service

hedge against sole reliance on market costs that are primarily driven by natural gas prices. Each of these potential positive impacts is discussed below.

1) The potential benefit of utility generation asset costs being lower than prevailing market prices is essentially offset by the risk of the creation of new stranded costs. There is no possibility that utilities, regulators or any other entity can predict future electricity prices with any degree of certainty. Thus, utility investment in generation can be viewed as at least equally likely to result in consumer benefit through lower prices or consumer harm through the creation of new stranded costs.

2) A regulatory guarantee of the recovery of prudently incurred costs should result in lower financing costs that would result in a lower cost-of-service for utility-owned assets. However, this consumer benefit comes with a consumer cost. The consumer "cost" is the possible responsibility for above-market or stranded costs. Thus, the financing cost benefit can view as offset by the stranded cost risk.

3) A change in law to allow utilities to own or operate generation assets should allow greater State control over diversifying generation resources and increasing renewable generation capacity. However, this goal can be accomplished through other means, primarily renewable portfolio requirements and long-term contracts. Maine and most of the other New England states have similar portfolio requirements. These portfolio requirements, together with federal production tax credits, have resulted in substantial efforts of private development of renewable resources in Maine and New England. The current interest in private development of renewable resources throughout the region diminishes the need for utility participation in the market for resource diversity purposes.

4) As discuss above, utility involvement in the generation supply business would provide a cost-of-service hedge against sole reliance on prevailing market prices. As is true with any hedge (which is essentially an insurance policy), there is a cost in terms of the possibility of above-market costs. As mentioned, it is possible that a similar cost-of-service hedge can be obtained from the competitive market through a properly structured long-term contract.

*4. The relative advantages and disadvantages of various methods and options for allowing utility participation in the energy supply business.*

As discussed in section III above, utilities are already allowed to participate in the energy supply business on an unregulated basis through a corporate affiliate. The other primary option is for utilities to participate in the supply business on a regulated basis. If utilities continue to be restricted to participation through an unregulated affiliate, there will be no risk of creating new stranded costs. However, there would also be no potential benefit that could result from utility generation cost-of-service that is lower than prevailing market costs. A change in the law to allow utilities back into the generation business on a regulated basis would have the opposite advantages and disadvantage; the creation of a ratepayer cost-of-service hedge and the risk of new stranded costs.



*5. Options for regulatory oversight and approval of electric utility participation in the energy supply business.*

There are two basic approaches to regulatory oversight and approval of T&D utility participation in the energy supply business: 1) pre-approval proceedings and 2) after-the-fact prudence review. After-the-fact prudence reviews are very controversial and resource intensive proceedings. Utility imprudence is often very hard to detect and significant prudence disallowances can result in serious financial distress to utilities that could negatively impact ratepayers (e.g. more expensive access to capital markets). Thus, the preferable approach is for the Commission to pre-approve utility participation in a generation supply project through the certificate of public convenience and necessity process. In this manner, the Commission, through an adjudicatory proceeding, can assure that a proposed project is consistent with legislative policies and any statutory limitations placed on the utility's re-entry into the generation market. A pre-approval process would also lower the risk to the utility and thus lower project financing costs.

Any cost overruns in construction or excess operating costs would remain subject to after-the-fact prudence reviews. The Commission should have the discretion to establish limits on cost recovery based on proposed construction budgets and the option to establish ratemaking incentives based plant operations expenses (that would allow for the disallowance of costs if the plant is not operated in an efficient or prudent manner).

Before utility participation in a generation project is authorized, there should be a requirement for some type of competitive solicitation. Such a solicitation is necessary to test a utility proposal and determine whether the desired ratepayer benefit can be obtained at lower cost or risk from the competitive market.

*6. Options for restricting electric utility participation in the energy supply business in terms of the size or type of generation facility, total production, as measured in megawatts, and fuel source, including limiting production to renewable resources.*

There are several options for restricting utility participation in the generation supply business. These would have the effect of limiting the potential for stranded costs, but would also limit the potential for ratepayer benefit. As mentioned in the response to Item 3, there appears to be no reason to allow utilities to re-enter the generation supply business for the primary purpose of promoting the development of renewable resources. Thus, a limitation on utility participation should be in terms of a capacity or energy cap expressed in terms of a percentage of demand or energy usage within the service territory of the respective utilities.

*7. Specific issues presented by the participation of consumer-owned electric utilities in the energy supply business.*

The Restructuring Act currently allows COUs to participate in the energy supply business to a significant extent.<sup>25</sup> COUs may own generation assets, sell power within their respective service territories, purchase power at wholesale, and make incidental wholesale sales to reduce the cost of providing retail service.<sup>26</sup> A private and special law enacted in 2005 removed the “incidental” wholesale restriction for Fox Islands Electric Cooperative to allow for a potential wind development.<sup>27</sup>

The extent to which COUs are currently permitted to engage in the energy supply business appears sufficient given their status as non-profit entities that are owned or controlled by their customers. COUs exist for the sole benefit of their customers and thus there is no reason to expand their authority to operate in retail markets outside their territories or to be significant participants in the wholesale markets. However, the Legislature should consider making the Fox Islands exception available to other COUs who would similarly like to explore wind power developments that could violate the “incidental” wholesale restriction.

COUs are small systems and currently own only very minimal amounts of generating capacity. Accordingly, COU actions are unlikely to have a significant effect on the electric generation market. COUs do have access to tax-exempt financing that could in concept provide for a competitive advantage. However, large private generation developers are likely to have greater access to capital than small COUs and they have various tax advantages that are not available to COUs.

*8. Options for obtaining additional benefits for electricity consumers as a result of the State's participation in regional arrangements and the State's role in siting new electricity generation facilities to serve the regional market.*

Utility ownership of generation assets would provide some ratepayer protection against regional market rules that increase prices for the benefit of generators (such as the capacity requirements). However, this benefit is a subset of a cost-of-service hedge discussed extensively above and could also be provided through long-term contracts with unregulated market participants.

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<sup>25</sup> The Utilities and Energy Committee recently voted to allow COUs to restrict retail access within their territories to allow for aggregation of their customers' load for purposes of acquiring power supply. The vote occurred during the Committee's consideration of LD 1248 during a work session on November 1, 2007.

<sup>26</sup> 35-A M.R.S.A. §§ 3204, 3207.

<sup>27</sup> P. & S.L. 2005, ch. 21.

To the extent that utility ownership of generation assets increases the amount of generation capacity within Maine, transmission constraints in the State may be enhanced. Such enhanced transmission constraints could result in Maine customers receiving the benefit of lower locational marginal prices relative to other New England rate zones. Due to the inherent stranded cost risk and the uncertainty surrounding the persistence of transmission constraints, any positive impact of enhanced transmission constraints should be considered incidental and not a rationale for authorizing utility-owned generation.

*9. Potential stranded costs and the recovery of any stranded costs that may be associated with electric utility participation in the energy supply business.*

Any type of authorization for utilities to re-enter the generation business on a regulated basis creates the risks of stranded costs. The level of stranded cost exposure is a function of the degree to which utilities own generation assets. As discussed in the response to Item 6, the exposure to stranded costs can be restricted through generation ownership limits (based on a percentage of customer demand or energy usage within the respective service territories). However, no absolute cap can be placed on the amount of stranded costs because these costs are a function of future energy and capacity market prices, which can never be known in advance with any degree of certainty.

As required by the Restructuring Act,<sup>28</sup> utilities recover their past stranded costs through a charge included in transmission and distribution rates. To the extent that new recoverable stranded costs are created, they should be recovered through the same ratemaking mechanism that is currently used.

## **VII. COMMISSION RECOMMENDATION**

The Commission recommends against any immediate legislative changes that would allow the State's utilities to re-enter the business of owning or controlling generation assets.<sup>29</sup> As discussed in section V above, the Legislature has already taken a step away from the fundamental principles of electric industry restructuring by authorizing the Commission to direct CMP and BHE to enter into long-term contracts for capacity and associated energy. The Commission has not yet conducted a solicitation

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<sup>28</sup> 35-A M.R.S.A. § 3208.

<sup>29</sup> This recommendation is premised on Maine's utilities remaining a part of the ISO-NE market. The Commission has released a report that examines alternatives to Maine's continued participation in the ISO-NE. To the extent Maine pursues such alternatives, the issues involved with utility ownership and control of generation assets could change dramatically.

under this authority, but anticipates doing so during the first part of 2008.<sup>30</sup> Among other contract pricing approaches, the Commission plans on seeking proposals from market participants that would provide ratepayers a cost-of-service hedge similar to that which would occur if a utility owned a generation asset on a regulated basis.

In the Commission's view, it is premature to amend the Restructuring Act to reverse one of its basic tenets and allow utilities to own generation before there has been a sufficient opportunity to test the potential to achieve similar benefits through the long-term contracting mechanism. The utilities have been out of the generation business for over seven years and, consequently, they no longer have in-house generation expertise. Although utilities may be able to access the expertise of affiliates, there is no reason to expect that utilities are in a better position to develop and operate generation facilities than those market participants that are in the generation business.

As mentioned above, the Commission's authority to direct utilities to enter into long-term contracts does not include MPS. In the event that the Legislature agrees that the long-term contracting mechanism should be pursued before allowing utilities to own generation, the Commission recommends that the Legislature amend the current long-term contracting authority to include MPS.

In the event the Legislature decides to allow Maine's utilities to re-enter the generation business, the Commission recommends that it do so on the cautious and limited manner described in this report. This limited approach should, at a minimum, include:

- A policy statement that utility ownership of generation assets should occur to provide a limited ratepayer hedge against complete reliance on market prices;
- A cap on the amount of generation capacity that utilities are allowed to own (as a specified percentage of demand within the service territory) to limit ratepayer exposure to stranded costs;
- A requirement for Commission pre-approval through the issuance of a certificate of public convenience and necessity;
- A requirement that any utility proposal be tested through a competitive solicitation process;

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<sup>30</sup> During recent standard offer solicitations, the Commission has unsuccessfully sought longer-term bids of up to nine years. However, those bids were for "all-requirements" retail standard offer service, in which the provider would have significant risk of customer migration. The long-term contract solicitation is anticipated to be significantly more flexible in terms of pricing and the timing of service so that the prospects of desirable proposals should be enhanced.

- Commission authority to establish ratemaking incentives and disincentives with respect to generation cost recovery;
- A requirement that energy and capacity from utility generation assets be periodically sold into the wholesale market to avoid disrupting Maine's retail market; and
- Consideration of detailed standards of conduct to protect against utilities inappropriately favoring their own generation assets.