PRINCIPLES APPLICABLE TO THE ELECTRIC INDUSTRY REFORM LEGISLATION

RECOMMENDED BY

THE GOVERNOR'S ADVISORY COMMITTEE FOR ELECTRIC UTILITY REGULATORY REFORM¹

PRESENTED

APRIL 28, 1997

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PRINCIPLES APPLICABLE TO THE ELECTRIC INDUSTRY REFORM LEGISLATION

PREFACE

The Governor's Advisory Committee for Electric Utility Regulatory Reform is charged in its Mission Statement with a responsibility to provide accurate information in a timely manner to the Governor and his staff. Consistent with that responsibility, the Advisory Committee has developed the following principles it believes should be incorporated in legislation seeking to restructure the Illinois electric industry and reform the State's system for regulating the industry. These principles fall into three categories:

- Market Structure
- Regulatory and Financial
- Preservation of Revenue Neutrality for the State

An executive summary of the principles is presented below. Following the summary commentaries on each principle are presented.
EXECUTIVE SUMMARY OF PRINCIPLES

MARKET STRUCTURE PRINCIPLES

• Restructuring Objectives

Decisions and actions to restructure the Illinois electric industry should be guided by the intent to create an unregulated generating industry disciplined by competitive forces and to permit each user of electricity to choose his electricity supplier. Furthermore, the new industry structure must provide reliability that is as good as or better than the current industry structure provides.

• Safety and Reliability

Safe and reliable electricity service is important. Decisions taken to restructure relationships among utilities, between utilities and their customers and between current customers of utilities and new, non-utility generating companies must consider the impact of such decisions on safety and reliability of service. Industry restructuring that creates an independent system operator (ISO) as proposed herein and a robust, efficient spot market with transparent spot market prices will allow the State to gain increased generation and transmission reliability and lower prices simultaneously.

• Initial Organizational Separation

In anticipation of fully separating generation from distribution and both from transmission, Illinois utilities should unbundle the prices of services to users as soon as practicable. Furthermore, each transmission-owning, investor-owned utility whose principal service area is in Illinois should be required to implement functional separation of distribution, transmission and generation as soon as practicable, and

• these divisions should be operated as if they were independent firms, and

• exchange relationships between these utility divisions should be formalized as if they were separate businesses.
• FERC Filings

Illinois's transmission owning, investor-owned utilities whose principal service areas are in Illinois should be encouraged to file a coordinated request, or consistent individual requests, with the Federal Energy Regulatory Commission (FERC) that will implement the industry structure and the market structure desired by the State.

• Municipals and Co-ops

The new market structure must permit municipal and cooperative utilities to buy and sell freely and, if those utilities, or regulators of those utilities, approve, users served by them should be free to buy and sell in this market.

• An Illinois Independent System Operator

One or more (preferably only one) independent system operators (ISOs) should be created in Illinois. All transmission-owning, investor-owned utilities whose principal service areas are in Illinois should be required to merge their control centers into the operation of the ISO. The Illinois ISO(s) should be merged into a regional ISO when one is created.

• Independent System Operator Independence

Credibility for independence of the ISO requires that the initial governance structure of the ISO be determined before the State loses its present powers to influence such decisions. Neither the ISO nor its employees should have significant financial interests in any market participant.

• Transmission Assets

All transmission assets in the ISO control area, other than radial lines, but including control centers, should be leased to the ISO immediately upon its creation. Current owners should receive the regulator-determined "just and reasonable" rates of returns on the value of these assets but exercise no control over their use.

• Transmission Ownership

In due course, (as soon as administratively feasible after the ISO comes into existence) all transmission assets, including control centers, relied upon by the ISO should be transferred to the ownership of the ISO, and the ISO should be fully responsibility for building and maintaining transmission capacity to satisfy efficient market demands thereafter.
• Creating the Independent System Operator

The State’s interests in achieving an efficient, competitive electricity market requires State action to ensure that the utilities’ restructuring proposal(s) to the FERC will lead directly and quickly to the creation of the desired ISO, the creation of the desired competitive markets, and the development of efficient pricing practices for transmission services.

• Creating a Spot Market

Each ISO, or a closely cooperating affiliate of the ISO, should create and administer a spot market for electricity in its control area.

• Bid-Based Pool

Each ISO, or a closely coordinating affiliate of the ISO, ought to administer a bid-based pool to ensure both a robust, efficient spot market and transparent spot market prices for all market participants and observers.

• Buying Options

The market system created by the ISO should allow users to take title to electricity at either their meter, the meter of their distribution company or at the generator’s meter so that each user can decide for himself the degree of direct involvement he will have for arranging the delivery of electricity to his meter.

• Clearing House

The ISO, or a closely coordinating affiliate of the ISO, ought to administer a clearing house for buyers and sellers who choose to trade through the bid-based pool.

• Generating Services Market

The ISO, in pursuit of its obligation to preserve reliability, ought to facilitate a competitive market for the generation services it must purchase for reliability needs.

• Regulating the Independent System Operator(s)

Each ISO must be a regulated utility. It ought to be charged by its tariffs with the responsibility to enforce operating standards on generators and users in its control area, empowered by its tariffs to impose penalties on generating companies and users in its control area who violate operating rules or who default on contractual obligations to the ISO, and charged to respect the rules imposed on it by independent interconnection operators (IIOs) and/or other network governing bodies.
• Roles of an Independent Interconnection Operator

If more than one ISO is created in Illinois, an Independent Interconnection Operator (IIO) is needed to coordinate the ISOs. The IIO must also be a utility regulated by the FERC. The IIO will not be a system operator, it will not have any direct control over the use of generators. Instead, it must have the responsibility to enforce operating standards on ISOs (and perhaps SOs interconnected with the Illinois ISO(s)) operating in its area of responsibility. The Illinois IIO should be merged into a regional IIO when the Illinois ISO(s) is (are) merged into a regional ISO.

• Market Power

The market power of generating companies ought to be eliminated. That market power which can not be eliminated must be mitigated. Generating companies, utility and non-utility, should be invited to sell to distribution companies and users in Illinois, and comparable access for Illinois utilities to the selling state’s electricity markets should not be a necessary condition for such access.

• Load Pockets

Protection of some users in “load pockets” will require that special conditions be placed on the use and/or ownership of generators inside the “load pocket.”

• Roles of Regulation

The legal mandates of regulators — the Illinois Commerce Commission, the Department of Natural Resources and Illinois courts — must be redefined so that their policies and decisions facilitate the objectives embodied in the legislation guiding restructuring.
PRINCIPLES APPLICABLE TO THE ELECTRIC INDUSTRY REFORM LEGISLATION

EXECUTIVE SUMMARY OF PRINCIPLES

REGULATORY AND FINANCIAL PRINCIPLES

• Rates

A primary goal of the restructuring legislation should be to minimize electricity rates. Rates should be brought to, or near, the regional average as soon as possible, consistent with maintaining the financial integrity of the utilities. Legislation should be specific about transition period rate decreases. In order to better prepare for the coming of a competitive electricity market, the fuel adjustment clause should be eliminated. Securitization of stranded costs may be a useful tool to achieve a portion of rate reductions.

• Distribution Regulation

The provision of transmission and distribution services will remain largely a monopoly function. Prices, entry and exit, and terms and conditions of service will remain regulated by the Illinois Commerce Commission (or, where jurisdictional, by the FERC). Accuracy of meters and meter reading is fundamental to a working electricity industry, and preserving this accuracy will remain a distribution utility responsibility. Regulation must vigilantly maintain high customer service standards. The denial or disconnection of monopoly distribution services ought not be used as leverage to obtain payment for competitive supply services.

• Phase-in Period

The legislation should incorporate a date certain for implementation of a fully competitive power supply market. Prior to that date certain, in order to help develop the system and capabilities necessary for full competition, customer choice may be phased-in in specified increments.

• Pre Phase-in Period Pilots

During the period before customer choice is introduced, electric utilities should offer open access on a limited pilot basis to permit competitive suppliers to market electricity to small consumers in their service area, so as to help develop the market for competitive suppliers to small customers. Other than such limited market-development pilots, no customer should have greater or earlier rights to direct access than any other customer.
• **Obligation to Serve**

Distribution utilities will continue to have the responsibility to provide distribution services to all customers, regardless of the identity of their power supplier. During the transition period, distribution utilities must continue to have an obligation to provide all residential and other small customers (e.g., under 15,000 Kwh/yr) bundled electric supply and delivery services. However, the prices for distribution services should be unbundled as soon as practicable. Distribution prices should be consistent with the rate reduction and transition charge recovery principles in the restructuring legislation.

• **Affordable Service for All**

Electric industry reform legislation should include funding for a low income assistance program within a customer choice environment. All households should have affordable access to essential electricity services. To assist low-income customers to manage and afford their home energy costs, there should be established a Supplemental Low-Income Energy Assistance Fund in the State Treasury. This fund should be raised by a monthly Energy Assistance Charge on both gas and electricity bills.

• **Default Supplier**

Customers who have not entered into a retail supply agreement, customers whose retail supplier has not provided service, customers whose retail supply contract has been terminated, and customers who are unable to secure a retail supply contract on reasonable terms and conditions, should receive Basic Service from a designated default supplier. Basic Service should be provided by a supplier chosen by the distribution utility through a competitive bid process on the basis of price, as well as quality customer service and reliability. The Illinois Commerce Commission should oversee the services and prices delivered by the supplier of Basic Service.

• **Certification of Competitive Suppliers**

Retail electric suppliers should be required to obtain a certificate from the Illinois Commerce Commission, or another appropriate State Agency. The certification process should be public, and it should be expeditious. Certification requirements can be less stringent in the case of suppliers that limit their services to very large customers.

• **Financial Integrity**

Investors should be provided the opportunity to earn fair and equitable rates of returns on investments that have been deemed appropriate by the Illinois Commerce Commission under the current regulatory scheme, and on future investment in the distribution and transmission businesses. Investors should assume the risks associated with future investments in generation.
• Stranded Costs

Utilities should be provided a reasonable opportunity to recover stranded costs via a non-bypassable transition charge that ends at a date-certain, is consistent with the recommended rate reductions and with maintaining the utilities financial integrity. Savings from successful mitigation measures should be used to recover stranded costs.

• Alternative Regulation

The distribution utilities and the Illinois Commerce Commission should be encouraged to use, where practicable, "incentive" or "performance based" regulation models. Alternative regulation is not intended to shift costs from one customer class to another, and standards for customer service, safety and reliability and affordability should not be lowered because of alternative regulation.

• Energy Conservation and Environmental Programs

The legislation should encourage market-based mechanisms for energy conservation and environmental programs. Both existing and future Illinois generation sources should be subject to comparable environmental regulations.

• The Illinois Commerce Commission

Given the critically important role that the Illinois Commerce Commission should play in electric industry restructuring, it is imperative that the Commission procedures and decisions be credible. However, the Advisory Committee has determined that the present rules and regulations governing the Commission are inadequate and hinder the Commission's effectiveness and credibility. The Committee recommends, therefore, that an impartial expert (or panel of experts) in economic regulation, utility commission organization and utility commission decision making be assigned the task of evaluating the Commission's decision processes and making recommendations.
EXECUTIVE SUMMARY OF PRINCIPLES

PRESEVATION OF REVENUE NEUTRALITY FOR THE STATE

• State Revenue Neutrality

The revenues received by the State should not be significantly decreased or increased by the restructuring of the electric industry. Furthermore, the new tax(s):

♦ should be structured so that it (they) cannot be avoided by out-of-state purchases, leveling, thereby, the playing field between in-state and out-of-state suppliers, and

♦ should be one(s) that can be easily and fairly administered.

The Department of Revenue recommends that the tax be imposed on electricity consumed or used on a per kilowatt hour basis and be collected by the distribution company, which will remain a regulated utility, and that the tax also capture usage of electricity that is not distributed by a regulated utility.

• Efficient Competition Between Electricity and Natural Gas

Efficient competition among energy sources that are close substitutes for one another is furthered if the State's taxation policies do not encourage one energy source or one energy supplier rather than another. Currently, however, customers who buy natural gas directly from an out-of-state supplier can avoid the tax on natural gas which customers who buy from an in-State supplier must pay. Furthermore, an Illinois utility need not pay the tax when selling to a customer who previously bought tax free out of state.
PRINCIPLES APPLICABLE TO THE ELECTRIC INDUSTRY REFORM LEGISLATION

PRINCIPLES AND COMMENTARIES

MARKET STRUCTURE PRINCIPLES

• Restructuring Objectives

Decisions and actions to restructure the Illinois electric industry should be guided by the intent to create an unregulated generating industry disciplined by competitive forces and to permit each user of electricity to choose his electricity supplier. Furthermore, the new industry structure must provide reliability that is as good as or better than the current industry structure provides.

Commentary: An efficient, unregulated generating services market requires

♦ that existing vertically integrated utilities be de-integrated,

♦ the existence of unregulated electricity merchants and brokers disciplined by competitive forces.

♦ continued State regulation of the distribution industry,

♦ expanded federal regulation of the transmission industry and of system operators on which the system depends for its efficiency and reliability,

♦ improved institutional arrangements for determining and enforcing operating standards.

Improved efficiencies in the use of industry assets and personnel will be gained by:

♦ substituting competitive market pricing for regulated pricing of electricity in wholesale and retail markets, thereby, more efficient price signals to operators and builders of electricity generators and to users of electricity (and to users of substitutes for electricity, such as oil, coal and gas),

♦ shifting the locus of risk bearing for the use of existing generating assets and personnel from captive users (where much of it has rested in the current system of economic regulation) onto shareholders of unregulated generating companies,

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2 This and the next bullet are primarily federal responsibilities, but the Energy Policy Act of 1992 and current circumstances permit the State substantial discretion in proposing solutions to the FERC.
- shifting the locus of risk bearing for constructing new generating assets from captive users (where much of it has rested in the current system of economic regulation) onto shareholders of unregulated generating companies, and

- providing users, both large and small ones, with freedom of choice of electricity suppliers.  

- Safety and Reliability

Safe and reliable electricity service is important. Decisions taken to restructure relationships among utilities, between utilities and their customers and between current customers of utilities and new, non-utility generating companies must consider the impact of such decisions on safety and reliability of service. Industry restructuring that creates an independent system operator (ISO) as proposed herein and a robust, efficient spot market with transparent spot market prices will allow the State to gain increased generation and transmission reliability and lower prices simultaneously.

Commentary: Illinois currently enjoys very reliable electricity supplies. This safety and reliability depends in part on decisions made in Illinois and in part on decisions made by regional and international organizations. Illinois benefits enormously from regional and international organizations designed to aid interconnected utilities in maintaining reliability. As the industry evolves from one dominated by vertically-integrated utilities into one with competitive electricity markets and unregulated generators, the system of regional and international coordinating institutions that has worked acceptably well to restrain and guide self-interested decision makers of regulated firms must now be reconstructed to restrain and guide self-interested decision makers of unregulated generating companies, electricity merchants and direct purchase users.

Power failures occur for many reasons, but clarity is furthered if two sources are distinguished, distribution system failures and bulk power system failures. Failures of distribution systems are caused primarily by weather-related phenomena, such as ice storms, thunderstorms, hurricanes, and tornadoes that break distribution lines. Such power outages are usually localized, and planning and actions to minimize the frequency and duration of them are management problems for distribution utilities. Nothing currently being proposed will reduce the ability of distribution companies to fulfill their safety and reliability obligations.

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1 Freedom of choice is a valuable freedom and ought not be suppressed in the absence of some compelling public interest. The justification for suppressing that freedom for electricity users in the past was the desirability of efficiently exploiting economies of scale in building and using generators. Developments in the last few decades have removed that justification, providing, thereby, an opportunity to permit freedom of choice of electricity suppliers to users. Natural monopoly conditions in distribution and transmission continue to call for imposition of constraints on users' choice of suppliers of deliver services.

2 A bulk power system is defined as a set of generators and the transmission lines that interconnect them and, in turn, connect them to users and distribution companies.
Bulk power system failures usually affect many distribution companies, and perhaps many states simultaneously. Consequently, the reliability of each distribution utility's services depends critically on the reliability of the bulk power system from which the distribution company receives its power. Failures in bulk power systems can arise for many reasons in a complex transmission network connecting many generators, distribution companies and users. It is customary to divide policies and actions directed towards maintaining the chosen levels of reliability into those directed towards preserving network security and those directed towards maintaining adequate capacity. Rules designed to provide network security impose operating standards and constraints on interconnected and interdependent system operators. Existing rulemaking bodies and their enforcement powers will change in response to changes in the industry. The rules may change also. Illinois can be a constructive force in making those changes, although it cannot stop them. Creating an Illinois ISO (discussed below) and an Illinois independent interconnection operator (IIIO) (discussed below) will be constructive steps.

Rules for defining and maintaining adequate generation and transmission capacity are also created by regional and international bodies, although they are implemented in the current industry by utilities. Almost certainly the definition of adequate reserves, especially generating reserves, will change as the generating services market becomes competitive, but there is no reason to expect reliability to diminish as a consequence. If generators are coordinated more efficiently and, consequently, used more efficiently in a market system than in the old regulated system, generating reserves may decrease while reliability increases and prices fall. ISOs and IIIOs are important ingredients in achieving these desirable results.

- Initial Organizational Separation

In anticipation of fully separating generation from distribution and both from transmission, Illinois utilities should unbundle the prices of services to users as soon as practicable. Furthermore, each transmission-owning, investor-owned utility whose principal service area is in Illinois should be required to implement functional separation of distribution, transmission and generation as soon as practicable, and

5 See, "Blackout a Caution Sign on Road to Deregulation." New York Times, August 19, 1996, p. A.7 for a description of the August 10, 1996, failure that caused a loss of power in nine states in the Western System Coordinating Council area. See also "Did Competition Spark Power Failures?" Wall Street Journal, August 19, 1996, p. B.1 which notes, "During a 105-minute period Aug. 10, five trees came into contact with five lines in the Portland Area. There was also a mechanical failure at a power substation. The last straw came when a 600-megawatt hydroelectric plant that could have prevented the outage was kept partly off-line to allow salmon to migrate downstream on the Columbia River." This article notes that 4 million customers were affected. It also notes that the July 2, 1996, failure, in an overlapping area, affected 2 million customers. In the Secretary of Energy's letter to the President of August 2, 1996, reporting on the July 2, 1996, outages in the Western System Coordinating Council region, it was noted that these 2 million customers were spread over 14 states. One part of that letter states, "The outage was initiated when a transmission line sagged too close to a tree, creating a short circuit and causing the line to disconnect automatically. A protective device on a parallel line misinterpreted the short circuit and disconnected its line. Loss of the two lines activated an automatic procedure to shut down two large generating units at a nearby power plant served by the two lines because the generators' output otherwise would overload remaining transmission lines."
- these divisions should be operated as if they were independent firms, and
- exchange relationships between these utility divisions should be formalized as if they were separate businesses.

Commentary: Creation of a transmission division is necessary in preparation for transferring transmission and control center assets and personnel to a regional transmission company and/or to an independent system operator. Creation of a distribution division is needed because distribution division officers and employees should be impressed quickly with their utility obligations to act in the interests of users in their service area. The current, vertically-integrated utility structure tends to make officers and employees of a utility, including officers and employees who work in the distribution division, concentrate primarily on the needs of the generation division. The distribution division is a “small dollar” division with strong monopoly powers, so the risk of significant losses there are small. In contrast, the generating division is the “big dollar” division. The risk of large losses in that division are large, so, not surprising, the corporate culture of a vertically-integrated utility tends to focus attention of all employees on the tasks of avoiding generation division losses. The corporate culture of distribution divisions needs to be changed so as to induce distribution division officers and employees to identify the firm’s interests with the interests of users for whom they buy and/or deliver electricity.

- FERC Filings

Illinois’s transmission owning, investor-owned utilities whose principal service areas are in Illinois should be encouraged to file a coordinated request, or consistent individual requests, with the Federal Energy Regulatory Commission (FERC) that will implement the industry structure and the market structure desired by the State.

Commentary: The interstate transmission network is an essential facility in the operation of a competitive power market in electricity. and the FERC has jurisdiction over transmitting utilities in so far as they are providing unbundled transmission services. A competitive electricity market will be a market in which electricity and transmission services will be unbundled. Proposals for creating terms under which the transmission system will be used to support a competitive market will, consequently, be subject to FERC approval. The only vehicle currently available for ensuring that FERC decisions in this matter serve the interests of the State is to use the State’s control over the current industry to create a common proposal for all the transmission-owning investor-owned utilities or to insist on common elements in individual utility proposals.
• Municipals and Co-Ops

The new market structure should permit municipal and cooperative utilities to buy and sell freely, and, if those utilities, or regulators of those utilities, approve, users served by them should be free to buy and sell in this market.

Commentary: Increasing the number of generating companies and the number of buyers will, other things being equal, increase the intensity of competition and mitigate the monopoly problem. Furthermore, competition among generating companies will provide constructive incentives to all generating companies, however owned. Expanding the geographical area subject to the control of the ISO will, by the law of large numbers, increase system reliability. Denial of access to such utilities would deny the right of choice to users served by them. Those utilities, and/or their regulator, may choose to do that, but there is no significant reason for the State to do so.

• An Illinois Independent System Operator

One or more (preferably only one) independent system operators (ISOs) should be created in Illinois. All transmission-owning, investor-owned utilities whose principal service areas are in Illinois should be required to merge their control centers into the operation of the ISO. The Illinois ISO(s) should be merged into a regional ISO when one is created.

Commentary: The establishment of an Illinois ISO is a necessary step in the creation of a competitive electricity market in which new players can compete efficiently with old ones and small players can compete efficiently with large ones. Circumstances may later justify merging the Illinois ISO(s) into a larger, regional one, but that likelihood does not justify delay in the creation of an Illinois ISO.

The fundamental building blocks of the existing North American electric industry are control areas. They, and the agencies that coordinate their plans and operations, are critical agencies in maintaining system reliability. Although responsibilities of control area operators (system operators (SOs) for short) will change in fundamental ways in the new industry, control areas will remain fundamental building blocks. In the current industry the SO is an employee of the utility, or group of utilities, whose plants are being dispatched, or of a pool organization created by the set of cooperating utilities whose plants are being dispatched. In order to create non-discriminatory access to transmission services, the current system must be replaced with one in which SOs have no special loyalties to any subset of generators or users. Such new

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6 Since the ISO will be engaged in interstate commerce, the FERC will, of necessity, reserve the right to reject any proposal made by Illinois utilities. The FERC is, however, on record supporting the creation of ISOs.

7 A control area is a set of generators connected via transmission lines to a single control center and coordinated in use by that single control center. Each generator belongs to one and only one control area. The system operator (SO), sometimes called a “controller” or “dispatcher,” is the agent of coordination.

8 It is logical to expect that the professional staff of the Illinois ISO will include many, perhaps most, of those persons who currently are staff members of existing control centers.
system operators are commonly called “independent” system operators (ISOs). Their loyalties must be to the preservation of reliability and the implementing the preferences of buyers and sellers in so far as those preference are consistent with accepted reliability standards. The ISO will take control and ownership of existing control centers and existing transmission lines in their control area.

- Independent System Operator Independence

Credibility for independence of the ISO requires that the initial governance structure of the ISO be determined before the State loses its present powers to influence such decisions. Neither the ISO nor its employees should have significant financial interests in any market participant.

Commentary: Independence is not an easy criterion to satisfy. Credibility for the assertion that an Illinois ISO is truly independent of undue influence by direct market participants may be even more difficult to satisfy because of the market powers of existing vertically integrated utilities, especially market power in the generation market. If such utilities continue to control transmission assets and remain vertically integrated with the distribution division, the market power problem in generation is compounded.

An ISO might be a non-profit organization (the New England ISO model) or a public agency (which would make it difficult to merge with other ISOs to create larger primary trading area) or an investor-owned, profit-seeking utility (which may or may not own transmission assets), but in all cases it will need a governing structure. Two models now dominate thinking. In one, the New England model, the board of directors of the ISO will be self-perpetuating, as are many boards of private universities. Its initial members were carefully selected with public input so as to ensure no significant affiliation with any market participant, and the ISO’s charter of incorporation imposes on the board a responsibility to select replacement members to perpetuate that condition. In the second model (the California model) the ISO board of directors will be composed of representatives of all major stakeholder groups. Obviously, if the ISO is a for-profit utility, the board will be selected by its shareholders, and the FERC will be charged with the responsibility to ensure that significant affiliations with market participants are avoided.

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Airline traffic controllers are often cited as examples of desired standards for independent system operators, since their responsibility is to implement the preferences of pilots to the extent doing so does not infringe on accepted safety standards.

The FERC’s “Principles” enunciated in its Order No. 888 suggest that this model may not be acceptable. One of the eleven principles enunciated says that an ISO and its employees should have no financial interest in the financial performance of any power market participant. Obviously, the proposers of the California and Texas ISOs believe that FERC principles are consistent with an ISO board of directors composed of stakeholders if no one or two sets of stakeholders’ representatives cannot either constitute a majority or exercises veto power.
• Transmission Assets

All transmission assets in the ISO control area, other than radial lines, but including control centers, should be leased to the ISO immediately upon its creation. Current owners should receive the regulator-determined “just and reasonable” rates of returns on the value of these assets but exercise no control over their use.

Commentary: The essential facility in an electricity market is the transmission network. The ability to control that network is the ability to discriminate. Regulators’ abilities to control discrimination when the network is controlled by a firm that owns generators or which buys power in the market is limited. Comparable access to transmission access for all generators and all users requires that all transmission assets in the ISO’s control area come under the full control of the ISO.

• Transmission Ownership

In due course, (as soon as administratively feasible after the ISO comes into existence) all transmission assets, including control centers, relied upon by the ISO should be transferred to the ownership of the ISO, and the ISO should be fully responsibility for building and maintaining transmission capacity to satisfy efficient market demands thereafter.

Commentary: Most existing transmission interconnections with adjoining utilities were created by utilities primarily to share reserves, coordinate maintenance schedules and to satisfy other reliability standards. The existing system, therefore, has significant limits on its ability to move power in and out of many existing control areas. Gaining efficient markets and removing market power of generating companies may require expansion of transmission lines at critical places. It is not to be expected that transmission-owning utilities who are also generating companies will work vigorously to overcome the many obstacles in gaining regulatory approval and building new transmission lines, or upgrading old ones, if the profits of the affiliated generating company will be lowered by the expansion. Consequently, responsibility for expanding the transmission network and adjusting control centers to meet the ever changing need of a competitive generating market should fall on the ISO.

• Creating the Independent System Operator

The State’s interests in achieving an efficient, competitive electricity market requires State action to ensure that the utilities’ restructuring proposal(s) to the FERC will lead directly and quickly to the creation of the desired ISO, the creation of the desired competitive markets, and the development of efficient pricing practices for transmission services.

Commentary: The FERC’s jurisdiction includes activities of “utilities” engaged in “interstate commerce” as those terms are defined in the Federal Power Act and by the courts. The State
of Illinois and the Illinois Commerce Commission may be parties before the FERC when the agency is considering the utilities’ proposal(s), and the arguments of the State’s representative(s) will be given great weight, but the reality is that the FERC will not have either the time nor the talent, and perhaps not the authority, to rewrite each restructuring proposal to meet its desires. If the agency finds a utility’s proposal “reasonable” and in conformity with its rules, its may approve it despite the Commissioners’ preference for an alternative. Consequently, it is vital that the State use its existing powers to ensure that the proposal submitted by Illinois utilities satisfy the interests of the State.

Once industry restructuring has progressed to the stage where distribution companies, generating companies and transmission companies are deemed separate business and the FERC has deemed the wholesale market prices to be just and reasonable, the State will have no more voice in the price that generating companies charge for unbundled electricity than they do over the price that oil refineries charge for gasoline. Generating companies with generators located in other states will have access to Illinois markets on terms comparable to generating companies located in Illinois. Furthermore, the State will have no more voice in the price that distribution companies pay for electricity than it does for the price they pay for other supplies.\footnote{11} If on the other hand, the State, as a part of a coherent program to aid vertically-integrated utilities recover transition costs, insists on a set of contracts between the distribution division and the generation division of Illinois’ vertically-integrated utilities, the State can protect existing distribution division users and mitigate the exercise of whatever monopoly powers the vertically integrated utilities’ generating divisions retain after restructuring.

The critical time for State action is while the large Illinois investor-owned utilities are still vertically integrated and the State retains substantial influence over their financial welfare.

- Creating a Spot Market

Each ISO, or a closely cooperating affiliate of the ISO, should create and administer a spot market for electricity in its control area.

Commentary: A robust, efficient spot market for electricity is an essential component of an efficient commodity market. It also is an essential element in facilitating competition among generating companies. Sellers in general and generating companies in particular, will not, for many reasons, always deliver what their bilateral contracts specify they are to deliver, and buyers will not, for many reasons, always take what their bilateral contracts specify they are to take.\footnote{12} This problem is especially important in the electric industry where all contracting

\footnote{11} The State will continue to have the power to regulate the price at which distribution companies sell electricity to users located in Illinois.

\footnote{12} It is assumed herein that the “law of large numbers” will permit rules that allow both generators and users some deviation from perfect performance. In a control area in which there are many sellers and many buyers, the many minor deviations from promised performances will tend to “cancel out.” If, however, incentives to game the system are not to be provided, these tolerance limits must be kept relatively small. “Relatively small” means that even diligent parties seeking to honor all rules will exceed the tolerance limits occasionally. The topic herein deals with delivery or take failures that exceed the tolerance limits.
parties are continuously interacting in an interconnected network, and in principle, each one’s actions (takes or deliveries) affect all others.

A spot market allows (1) individual generating companies to (a) substitute purchases from the spot market for delivery to users to compensate for its generation deficiencies, and (b) sell short-term power from its otherwise unused capacity, (2) individual users to (a) acquire deliveries in addition to those specified in their direct bilateral contract and/or (b) resell power purchased under direct bilateral contracts, but not needed. A spot market in the electricity industry will be composed of short-term forward markets of different horizons. Market participants should be able to trade in one-hour blocks (or perhaps, one-half hour blocks) and any multiple thereof.

Furthermore, it is difficult to imagine a robust, efficient electricity market without generator owners being able to dispatch their plants in response to spot market prices, and it is difficult to imagine a competitive business of dispatching plants in a single control area. Therefore, it is difficult to imagine anyone other than a system operator (SO) providing such dispatching services.

- **Bid-Based Pool**

Each ISO, or a closely coordinating affiliate of the ISO, ought to administer a bid-based pool to ensure both a robust, efficient spot market and transparent spot market prices for all market participants and observers.

**Commentary:** An efficient market communicates offers to buy and offers to sell in as timely a manner as technically feasible. Since the physics of moving electricity over complex networks requires a system operator, and that operator must be in close communications with generators and users (or those who buy for users), that operator is in a position, which no other organization can duplicate, to assemble buy and sell bids and discover market clearing prices. Furthermore, the ISO’s responsibilities to maintain reliability and to restore order in emergencies requires detailed knowledge about the willingness of generating companies to provide generating services and the willingness of large users to be interrupted. The communication system needed to facilitate that service complements the communication system needed to facilitate a spot market.

- **Buying Options**

The market system created by the ISO should allow users to take title to electricity at either their meter, the meter of their distribution company or at the generator’s meter so

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13 It is not unusual for one or more small utilities to “dispatch” their plants within the control area of a large utility, but in the current system such small utilities do not act as competitors to one another or to the large utility. Such small utilities operate in close cooperation with the SO of the larger utility, the primary SO, and assume only some of the responsibilities of a control area, namely, they match their generation and load and they schedule trades between one another with the principal control area SO.
that each user can decide for himself the degree of direct involvement he will have for arranging the delivery of electricity to his meter.

Commentary: It is to be expected that some buyers will be much more sophisticated that others. A residential user may want to delegate all responsibilities for buying and delivering electricity to his meter to a professional merchant, but a large industrial user with a professional staff who buys electricity in large quantities may want to contract separately with one or more generating companies, the ISO for transmission services and with one or more distribution companies for distribution services. Each user should be permitted rights to engage in the contractual arrangements of his/her choice.

• Clearing House

The ISO, or a closely coordinating affiliate of the ISO, ought to administer a clearing house for buyers and sellers who choose to trade through the bid-based pool.

Commentary: As a consequence of operating a bid-based pool, the ISO, or it affiliate, will create detailed information about (1) physical takes of buyers and physical outputs of generators and (2) prices at which transactions occurred. It, or a closely cooperating affiliate, consequently, is in an excellent position to provide a valuable service to buyers and sellers. In so doing it can keep the transactions costs of buying and selling relatively low, and that is a desirable characteristic of any market.

• Generating Services Market

The ISO, in pursuit of its obligation to preserve reliability, ought to facilitate a competitive market for the generation services it must purchase for reliability needs.

Commentary: Since it is not likely that the ISOs will own generation, it will be necessary for the ISO to contract for generation services needed to satisfy operating standards and preserve reliability. The ISO should be required to acquire these services competitively, and to do that it must create a local market for such services. In that market, prices should be transparent.

• Regulating the Independent System Operator(s)

Each ISO must be a regulated utility. It ought to be charged by its tariffs with the responsibility to enforce operating standards on generators and users in its control area, empowered by its tariffs to impose penalties on generating companies and users in its control area who violate operating rules or who default on contractual obligations to the ISO, and charged to respect the rules imposed on it by independent interconnection operators (IIOs) and/or other network governing bodies.

Commentary: Enforcement of operating standards in the new industry will require the ability to impose penalties on generators and users who fail to observe operating rules and/or default
on contractual obligations to the ISO. Such penalty powers must be derived from government. Furthermore, such powers must change as market conditions and economic conditions change. The FERC is the only government regulator with a continuing responsibility to revise rules for utilities engaged in interstate activities as circumstances change and to ensure that all interested parties have a forum suitable for addressing such matters, so it is necessary that ISOs be regulated by that agency and that ISOs derive their powers to impose fines and penalties from that agency.

- Roles of an Independent Interconnection Operator

If more than one ISO is created in Illinois, an Independent Interconnection Operator (IIO) is needed to coordinate the ISOs. The IIO must also be a utility regulated by the FERC. The IIO will not be a system operator, it will not have any direct control over the use of generators. Instead, it must have the responsibility to enforce operating standards on ISOs (and perhaps SOs interconnected with the Illinois ISO(s)) operating in its area of responsibility.¹⁴ The Illinois IIO should be merged into a regional IIO when the Illinois ISO(s) is (are) merged into a regional ISO.

Commentary: If more than one ISO is created, or if some individual utility SOs remain in operation, there must be coordination between them, and the rules under which all are to perform must be enforced by penalties. The power of the IIO to impose such penalties must derive from the FERC. The IIO, as a regulated entity, can be the coordinating agency of ISOs (and perhaps of ISOs and SOs) and it can also be the enforcement agency charged by the FERC to propose and defend such standards and rules as are necessary and to enforce them once approved.

- Market Power

The market power of generating companies ought to be eliminated. That market power which can not be eliminated must be mitigated. Generating companies, utility and non-utility, should be invited to sell to distribution companies and users in Illinois, and comparable access for Illinois utilities to the selling state’s electricity markets should not be a necessary condition for such access.

Commentary: The objective of industry restructuring is to obtain competitive electricity markets, not to create unregulated firms with monopoly power. Monopoly power is, among other thing, the ability to raise price above the competitive level by a significant amount and sustain that increase for a significant period.

The case against monopoly power is analogous to the business person’s case against “leaving money on the table” when negotiating an agreement. For business persons “money remaining

¹⁴ Compare, The NERC Team, Options, “Team Position: A single real-time authority in the form of an Independent Interconnection Operator (IIO) should be established to provide oversight, coordination, and direction as necessary to maintain the health and security of the full network.” P. 25.
on the table" signifies an opportunity to make both parties to the contract better off. Full satisfaction is not achieved until there is no possibility of increasing the benefits of one party without reducing the benefits to the other. Exercised monopoly power leaves "social welfare" on society's table. It signifies an opportunity to make at least some members of society better off without making anyone else worse off.

The creation of competitive electricity markets will require that existing large utilities either divest some of their generating plants and/or accept bidding requirement and/or accept running constraints on some of their generators until the market matures. The creation of competitive electricity markets also means that the "Illinois electricity market" should be open to all surrounding generating companies so as to reduce market power in that market. Welcoming generating companies from surrounding States to sell in the Illinois market will tend to reduce monopoly power of generating companies in Illinois and to cause market prices to be lower than they otherwise would be. Such a policy may cause estimates of stranded costs to be higher than they would have been with access to the Illinois market blocked. However, one cannot simultaneously argue for full recovery of stranded costs and for a need for utility-owned generating companies to retain substantial monopoly powers in order to recover such costs. As part of any deal to provide utilities with an opportunity to recover stranded costs, they should be requested to give up market power in the Illinois electricity market.

The Herfindahl-Hirschman Index, (HHI) is one measure of the degree of competitiveness of a market. It can also measure the change in competitiveness of a market if two or more firms serving the market merge and measure the change in competitiveness if a single firm is separated into two or more firms. HHI indices suggest the difficulty of creating competitive electricity markets in Illinois.\footnote{The HHI is defined as \( HHI = \sum (100x_i)^2, i = 1, ..., n. \)}

The Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, April 2, 1992, offers some suggestions about the relative intensities of monopoly power. First, the Guidelines note the obvious, namely, “Market concentration is a function of the number of firms in a market and their respective market shares.” P. 28. Then, the Guidelines divide the spectrum of market concentration as measured by the HHI into three regions that can be broadly characterized as:

- unconcentrated, i.e., HHI below 1000,
- moderately concentrated, i.e., HHI between 1000 and 1800, and
- highly concentrated, i.e., HHI above 1800.

For a pure monopoly, such as a utility, \( HHI = (100\times 1)^2 = 100^2 = 10,000. \)

For a duopoly in which each firm's sales are equal.
\[HHI = [100(.5)]^2 + [100(.5)]^2 = (50)^2 + (50)^2 = 5000.\]

One generalization of relevance is that a moderately concentrated market can be obtained only if six or more firms of approximately equal size are in the market. To gain an unconcentrated market, that is, an HHI of below 1000, the number of firms must be 10 or more of approximately the same size.\(^{16}\)

Clearly, if Illinois is to enjoy the efficiency benefits of a unconcentrated market for electricity -- and that is the only defensible objective -- it must increase the number of generating companies in Illinois dramatically (perhaps by divestiture of generators by the existing utilities) or it must design the Illinois market so that many of the generating companies in surrounding states can easily sell in Illinois. In all cases it should invite independent power producers and cogenerators into Illinois and deny to existing utilities the option of building another utility generator.

- **Load Pockets**

Protection of some users in “load pockets” will require that special conditions be placed on the use/ and/or ownership of generators inside the “load pocket.”

*Commentary*: In some large cities the demand for electricity is often significantly greater than the capacity of the transmission lines to move electricity into the area, especially during peak demand periods. Utilities currently satisfy such demands by a combination of imports plus the operation of a those generators located inside the transmission congestion points. After restructuring, the owner(s) of such city generators may have significant monopoly powers, since he (they) can, at times, reduce output of generators knowing that the deficiency cannot be “made up” by imports. When it cannot, the owner(s) of the load pocket generators may often be able to increase his (their) profits by reducing his (their) market offerings. Solutions to this problem are few, but (1) some or all of these generators could be left in the ownership of the distribution company and operated according to rules imposed by the distribution company’s regulators.\(^{17}\) or (2) they could be required to run at specified rates of output in critical periods, or (3) long term contracts between generators in the load pocket and the distribution company could be imposed as a part of the restructuring, or (4) transmission capacity into load pockets could be expanded.

- **Roles of Regulation**

The legal mandates of regulators — the Illinois Commerce Commission, the Department of Energy and Natural Resources, and Illinois courts — must be redefined so that their

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\(^{16}\) It is worthy of note that if one firm serves one-half of the market, the HHI will not be below 2500 even if there are thousand other firms.

\(^{17}\) The fact that many distribution companies will own some generators will not change the dominance of market-determined prices, as the fact that some gas distribution companies own some gas and oil properties does not change the fact of market dominance in gas markets upstream of city gates.
policies and decisions facilitate the objectives embodied in the legislation guiding restructuring.

*Commentary:* The transition to competitive generation services markets will require the collection and weighing of many complex facts. These tasks can best be left to regulators subject to the reviews of courts. The task which only the legislature can do is provide objectives of restructuring, provide regulators and courts criteria for just and reasonable outcomes and, perhaps, review progress in about two years, and/or create an oversight committee to exercise more frequent reviews.
PRINCIPLES APPLICABLE TO THE ELECTRIC INDUSTRY REFORM LEGISLATION

PRINCIPLES AND COMMENTARIES

REGULATORY AND FINANCIAL PRINCIPLES

• Rates

A primary goal of the restructuring legislation should be to minimize electricity rates. Rates should be brought to, or near, the regional average as soon as possible, consistent with maintaining the financial integrity of the utilities. Legislation should be specific about transition period rate decreases. In order to better prepare for the coming of a competitive electricity market, the fuel adjustment clause should be eliminated. Securitization of stranded costs may be a useful tool to achieve a portion of rate reductions.

Commentary: Rates should be lower than they would have been under the current regulatory system. In those areas where rates are already relatively moderate, that benefit should be maintained throughout the transition period. Where rates are above the regional average, staged rate reductions should be provided. Mechanisms should be provided for adjusting rates for changes in accounting policies, upgrades and maintenance of distribution and transmission facilities and services, and changes in nuclear decommissioning funding requirements. The fuel clause should be eliminated so as to introduce discipline into the purchase of fuel. Securitization of stranded costs may be used to achieve a portion of rate reductions; however, utilities should not be required to use securitization.

• Distribution Regulation

The provision of transmission and distribution services will remain largely a monopoly function. Prices, entry and exit, and terms and conditions of service will remain regulated by the Illinois Commerce Commission (or, where jurisdictional, by the FERC). Accuracy of meters and meter reading is fundamental to a working electricity industry, and preserving this accuracy will remain a distribution utility responsibility. Regulation must vigilantly maintain high customer service standards. The denial or disconnection of monopoly distribution services ought not be used as leverage to obtain payment for competitive supply services.

Commentary: High quality customer service is an important value of the electricity industry. Customer service includes availability and dissemination of accurate, timely and accurate information, as well as availability and responsiveness of knowledgeable company representatives. Customer service also includes convenient locations for bill payment and
inquiries. Distribution companies should have an obligation to educate distribution company users about opportunities in the new industry structure.\textsuperscript{18} The FERC, by demanding that control centers create electronic bulletin boards, has taken an important first step in this direction.\textsuperscript{19}

Each user who has gained the right to choose his supplier should have a right, constrained perhaps by his voluntary contracts, to change suppliers at his option. In contrast, a user who fails to pay the distribution company for its service could, under rules and procedures approved by the ICC, be disconnected.

- **Phase-in Period**

The legislation should incorporate a date certain for implementation of a fully competitive power supply market. Prior to that date certain, in order to help develop the system and capabilities necessary for full competition, customer choice may be phased-in in specified increments.

**Commentary:** At the end of the phase-in period, 100 percent of each distribution utility's customers must be allowed to choose their electricity supplier. During the phase-in period, all customers classes must be treated equally in terms of eligibility for direct access. Utilities should closely track technological developments and implement pilot programs designed to "smooth" the transition as increasing numbers of customer are allowed to choose their electricity suppliers. Safety and reliability must not be compromised.

- **Pre Phase-in Period Pilots**

During the period before customer choice is introduced, electric utilities should offer open access on a limited pilot basis to permit competitive suppliers to market electricity to small consumers in their service area, so as to help develop the market for competitive suppliers to small customers. Other than such limited market-development pilots, no customer should have greater or earlier rights to direct access than any other customer.

**Commentary:** An electricity market capable of supplying small consumers with competitive electricity will take time to develop, and will require solution to problems that do not arise in the case of large customers presently demand-metered. Pilot program to help marketers, aggregators, distributors and small consumers try out the concepts and technologies of competitive electricity supply should be started as soon as possible, so that when competition

\textsuperscript{18} Information is the essential element in managing the risks of becoming a player in the electricity market. The principal players subject to State influence after some critical point in restructuring will be the distribution companies. These regulated firms will have information valuable to all buyers, sellers and electric merchants. They should be required to anticipate the needs of such parties and publish price and planning information as a utility service.

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is phased-in, the market participants will have the experience needed to begin buying and selling in the new competitive arena.

- **Obligation to Serve**

Distribution utilities will continue to have the responsibility to provide distribution services to all customers, regardless of the identity of their power supplier. During the transition period distribution utilities must continue to have an obligation to provide all residential and other small customers (e.g., under 15,000Kwh/yr) bundled electric supply and delivery services. However, the prices for distribution services should be unbundled as soon as practicable. Distribution prices should be consistent with the rate reduction and transition charge recovery principles in the restructuring legislation.

*Commentary:* All distribution utilities, by definition of a distribution utility, should have a permanent obligation to provide distribution services to all users in its franchised territory. After a finding by the Illinois Commerce Commission that electricity markets in which a distribution utility customers would likely buy electricity are sufficiently mature to provide useful price signals, the price of electricity in the distribution company’s bundled service ought to be the market price. All distribution utilities should have an obligation to sell electricity at Illinois Commerce Commission approved rates to residential users and to other small users until the Illinois Commerce Commission has made such a decision, perhaps longer if the Commission determines that the degree of competition is not yet adequate to protect small users. A distribution utility that receives an ICC order relieving it of its obligation to sell electricity to its customers should not, thereafter, be permitted to offer a bundled service that includes electricity. If it sells electricity at all, it must do so through an affiliate that is treated by the distribution utility as it treats non-affiliated electricity merchants.

After a reasonable period after all users are free to buy electricity from a supplier of their choice, the Commission should consider relieving distribution utilities of their obligation to supply electricity. If the Commission finds that the markets in which the customers of one or more distribution utilities would logically buy electricity are fully competitive and robust, the distribution utilities should be ordered to cease offering a bundled service that includes electricity and relieve the distribution utilities of their obligation to sell electricity as a utility service.

- **Affordable Service for All**

Electric industry reform legislation should include funding for a low income assistance program within a customer choice environment. All households should have affordable access to essential electricity services. To assist low-income customers to manage and afford their home energy costs, there should be established a Supplemental Low-Income Energy Assistance Fund in the State Treasury. This fund should be raised by a monthly Energy Assistance Charge on both gas and electricity bills.
Commentary: The Supplemental Low-Income Energy Assistance Fund should be administered and assistance should be provided to eligible low income customer in such a way as to minimize the burden of their electricity and gas bills. Bill assistance should be designed to equalize and minimize the percentage of income that eligible households must pay for electricity.

Such an effort should be supported with sufficient funds to achieve the goal of affordable service for low-income Illinoisans. A part of this fund should be used to provide energy conservation and efficiency assistance to eligible households. The inclusion of energy efficiency services is important because they are a crucial element of a long-term solution to the problem of unaffordable bills. Reducing usage efficiently is a valuable tool to avoid the need for ongoing bill assistance.

Tying bill and usage reduction assistance to the burden electricity rates put on the low-income household is an efficient way to identify customers who truly need assistance, provide targeted and effective assistance, improve customer payment patterns (and associated credit and collection costs), and achieve the goal of affordable service.

- Default Supplier

Customers who have not entered into a retail supply agreement, customers whose retail supplier has not provided service, customers whose retail supply contract has been terminated, and customers who are unable to secure a retail supply contract on reasonable terms and conditions, should receive Basic Service from a designated default supplier. Basic Service should be provided by a supplier chosen by the distribution utility through a competitive bid process on the basis of price, as well as quality customer service and reliability. The Illinois Commerce Commission should oversee the services and prices delivered by the supplier of Basic Service.

Commentary: There are many reasons why a customer may find himself without a current contract for service from a viable supplier for a short time, and some customers will have chronic difficulty finding competitive suppliers willing to serve them, although they would be entitled to service under today's regulations. For example, a customer may have a miscommunication with a supplier and be left thinking there is a contract when the supplier has no record of signing up that customer, leaving a potential gap in supply. A customer's contract with a supplier may be terminated by the supplier, and the customer may be having difficulty lining up another supplier before the contract termination date. Also, despite vigorous enforcement of anti-discrimination statutes, there may be communities and neighborhoods where suppliers are reluctant to extend credit.

To provide supply during these gaps in service, a default supplier should be identified. Rather than disconnect the customer from the grid, the customer should be switched to the default supplier, at least until the customer can make arrangements for supply in the competitive market.
Customers who do not pay their obligations to the default supplier should be vulnerable to disconnection from the grid under the same terms and conditions that protect customers of regulated utilities today.

Default service is in addition to, and different from, the settlements process at the wholesale level. That is a process of supplier settling up between themselves (probably under industry-wide and/or FERC-approved rules) for the imbalances between their designated bids to the ISO and the actual usage of their customers.

- Certification of Competitive Suppliers

Retail electric suppliers should be required to obtain a certificate from the Illinois Commerce Commission, or another appropriate State Agency. The certification process should be public, and it should be expeditious. Certification requirements can be less stringent in the case of suppliers that limit their services to very large customers.

Commentary: Applicants for a license to sell electricity in Illinois at retail should file sufficient information with the ICC, or alternative agency, to enable the evaluation of the applicant’s ability to provide service and it willingness and ability to comply with applicable rules and regulations, including anti-discrimination protections for small consumers, system reliability requirement, and consumer protection rules. Suppliers should make available information to the Illinois Commerce Commission that will help customers decide intelligently and fairly among suppliers.

Slamming of customers should be prevented, without unnecessarily restricting the freedom of users to change suppliers. Customers should have notice in plain language of the prices, and terms and conditions of service. Suppliers should be required to abide by the consumer protection regulations that now protect purchasers of electricity. The States Attorney should have the power to enforce the consumer protections by an action under the unfair trade practices statute. Consumers should have a private right of action for violations of certification provisions and consumer protection provisions under the same statute.

The Illinois Commerce Commission, if it is assigned the responsibility of certificating retail electric suppliers, should have authority and responsibility to require periodic and special reports from electricity suppliers. The content of periodic reports should be determined in a rulemaking. The Illinois Commerce Commission should hear complaints about the performance of electricity suppliers, and the agency should have authority to order compliance within the terms of the certification, and to impose fines, and modify or revoke or suspend certificates.

- Financial Integrity
Investors should be provided the opportunity to earn fair and equitable rates of returns on investments that have been deemed appropriate by the Illinois Commerce Commission under the current regulatory scheme, and on future investment in the distribution and transmission businesses. Investors should assume the risks associated with future investments in generation.

Commentary: Restructuring legislation should seek to establish and support an environment for financially healthy Illinois-based electric utility industry. Accordingly, utility companies should be provided with:

1. adequate financial incentives to invest further in the regulated distribution and transmission businesses, and
2. a reasonable opportunity to recover generation-related stranded costs and agreed upon transition costs.

Utility company investors should be provided the opportunity to earn fair and equitable rates of returns on:

1. existing distribution, transmission, and generation-related investments, and
2. future investments in regulated distribution and transmission businesses.

The utility companies and their investors should assume the risks associated with the recovery of future generation-related capital investments.

- Stranded Costs

Utilities should be provided a reasonable opportunity to recover stranded costs via a non-bypassable transition charge that ends at a date-certain, is consistent with the recommended rate reductions and with maintaining the utilities' financial integrity. Savings from successful mitigation measures should be used to recover stranded costs.

Commentary: Stranded costs are defined as the currently recoverable generation-related assets and costs which would be unrecoverable under a unregulated market structure for generation services. Stranded assets and costs include the above market price portion of:

A. Book value of generating plant investment
B. Generation related regulatory assets
C. Purchase power contracts
D. Nuclear plant decommissioning costs.

Stranded costs may also include certain agreed-upon costs caused by the transition to a competitive market. (e.g., employee retraining and other employee related restructuring charges).
The legislation should provide Illinois investor-owned utilities a reasonable opportunity to recover stranded costs. Stranded costs may be recovered via:

1. Non-bypassable transition charges
2. Company implemented mitigation measures
3. Securitization of stranded investment.

The period for collecting non-bypassable charges should be as short as possible given the constraint that rates to users must fall, and it ought not be more than ten years. During that period, company implemented mitigation measures should include, but not be limited to: accelerated depreciation, operating costs reductions, and generating plant closures and sales. Also, during that period, regulatory mechanisms should be in place that prevent companies from either realizing excessive earnings or experiencing financial distress. Securitization of stranded costs may be used but should not be required.

The "solution" to the transition costs problem of investor-owned utilities should also have the following characteristics: it

A. permits each class of users to benefit immediately from the restructuring, and does not cause a rate increase for any user.
B. facilitates efficient use of existing assets and efficient use of electricity,
C. provides constructive incentives for utilities to use their assets efficiently, and
D. denies to existing utilities an unfair and inefficient competitive advantage as they move their generators into the competitive market.

Transition costs that are to be recovered should be recovered in ways that minimize efficiency losses.

* Alternative Regulation

The distribution utilities and the Illinois Commerce Commission should be encouraged to use, where practicable, "incentive" or "performance based" regulation models. Alternative regulation is not intended to shift costs from one customer class to another, and standards for customer service, safety and reliability, and affordability should not be lowered because of alternative regulation. Any alternative regulation model should promote affordable service.

*Commentary:* The deficiencies of the rate-of-return-on-original-cost rate-base model of regulation are well known, and those deficiencies are aggravated by the intensification of decision-by-adjudication that has become common in the last two decades. It was the capital intensity of the electric industry that encouraged commissions and consumers to focus their attentions so compelling on the utilities rate of return: Capital costs were a very large proportion of total costs. With the generation industry unregulated, the focus of the Commission will now be on the distribution industry. Although this industry is also capital
intensive compared to much of American industry, it is far less capital intense than is electric
generation. Some alternative models of regulation promise more constructive incentives for
utility decision makers than does the rate-of-return-on-rate-base models. Increased
experimentation should prove to be productive.

- Energy Conservation and Environmental Programs

The legislation should encourage market-based mechanisms for energy conservation and
environmental programs. Both existing and future Illinois generation sources should be
subject to comparable environmental regulations.

Commentary: Energy conservation and environmental protection efforts should continue. The
utilities have critically important expertise in these areas, and their efforts in the past have
been helpful, especially to small users. Distribution utilities should continue their programs
designed to help users in their franchise areas make efficient use of electricity. Furthermore,
their responsibilities should, as now, be both educational and programmatic. Their position in
the industry makes them the logical channels through which knowledge of new technologies
for using energy more efficiently will flow to users, especially small one. It is likely that
distribution utilities will become the source of funds for much of the collective research for the
industry. They should ensure that the benefits of that research flow to their customers.
Generating companies have always been major sources of air pollution, and, as a consequence,
have always been subject to extensive environmental regulations, much of it imposed by the
federal government. Industry restructuring, in itself, should not cause any change in either
federal or state attention to the environmental problems created by generating electricity.
Requiring all generators, utility and non-utility, to abide by the same rules will tend to
accomplish that result.

- The Illinois Commerce Commission

Given the critically important role that the Illinois Commerce Commission should play in
electric industry restructuring, it is imperative that the Commission procedures and
decisions be credible. However, the Advisory Committee has determined that the present
rules and regulations governing the Commission are inadequate and hinder the
Commission's effectiveness and credibility. The Committee recommends, therefore, that
an impartial expert (or panel of experts) in economic regulation, utility commission
organization and utility commission decision making be assigned the task of evaluating
the Commission's decision processes and making recommendations.

Commentary: The Advisory Committee has encountered serious and extraordinary criticisms
of the Commission from nearly all parties involved in Illinois electric industry restructuring,
including ICC Commissioners and ICC staff members. The criticisms were wide-ranging, and
in many cases merited, primarily centering around:
1. the seemingly unnecessarily long time periods required for the Commission to issue rulings.
2. inadequate explanations for Commission decisions,
3. the Commission's inability to implement settlements over the opposition of a single party,
4. the Commission's inability to construct rate orders that can stand up to judicial scrutiny,
5. the Commission's lack of leadership in changing circumstances.

The Advisory Committee has concluded that the problem is not in the quality of Commissioners. The quality of Commissioners today is a high as it has been in the last several decades. The source of the problem is the present rules and regulations governing the Commission. Over the last 15 years, many piecemeal "reforms" of commission decision procedures have been imposed.

1. The Open Meeting Act limited the ability of Commissioners to deliberate efficiently.
2. Restrictive separation of functions rules limit the ability of the Commissioners to gain information from their staff members efficiently, and
3. Restrictive ex parte rules in rulemaking proceedings limit the ability of Commissioners and staff members to gain information from "outsiders."

The consequence of these reforms has been to substantially increase the time that it takes Commissioners and staff members to gather, analyze and synthesize information into meaningful options and then to deliberate to a majority decision. The direct and indirect results of the procedural reforms has been to convert an agency that was a quasi legislative one that often used adjudicatory procedures as a method of collecting information into a quasi judicial one that, of necessity, relies almost entirely on adjudication for decision making. Instead of five commissioners with expertise developing a consistent set of operational objectives, the pressure of process requirements tends to create five Commissioners acting with great individuality in deciding issues one at a time as they are brought to them.
PRINCIPLES APPLICABLE TO THE ELECTRIC INDUSTRY REFORM LEGISLATION

PRINCIPLES AND COMMENTARIES

PRESERVATION OF REVENUE NEUTRALITY FOR THE STATE

- State Revenue Neutrality

The revenues received by the State should not be significantly decreased or increased by the restructuring of the electric industry. Furthermore, the new tax(s):

- should be structured so that it (they) cannot be avoided by out-of-state purchases, leveling, thereby, the playing field between in-state and out-of-state suppliers, and

- should be one(s) that can be easily and fairly administered.

The Department of Revenue recommends that the tax be imposed on electricity consumed or used on a per kilowatt hour basis and be collected by the distribution company, which will remain a regulated utility, and that the tax also capture usage of electricity that is not distributed by a regulated utility.

Commentary: The Revenue Department notes: “State electric utility tax collections in fiscal year 1996 were $325 million. The current rate structure is the lessor of 5% of gross revenue receipts or .32 cents per Kilowatt hour of use. The “lessor of” language serves as a cap to prevent the state from benefiting from any increase in public utility rates. There is no floor. The decrease in utility rates anticipated after deregulation would result in a reduction in collections.

“To protect the state’s tax base, it is proposed that the current tax structure be replaced with a flat tax per kilowatt hour (kwh) of electricity used in Illinois. The new per kwh tax could also be sufficient to replace the revenue currently collected by the Illinois Commerce Commission’s 1/10th % tax on gross receipts. In fiscal year 1996 this amount was $15.4 million.”

The Department further notes, “This scenario allows no electricity to escape taxation, because it all has to be distributed by a regulated Illinois-based utility. In so doing, it puts in-state and out-of-state utilities and non-utility suppliers on a level basis. And the per kilowatt hour tax protects the state against revenue loss as rates fall, but eliminates revenue growth as rates increase.
"A tiered rate structure that imposed a lower per kilowatt tax on larger users could ease the problem that large users have with their bills going up, but the classes would have to be carefully drawn to avoid a legal challenge."

The impact of deregulation on the invested capital portion of the Person Property Tax Replacement is not addressed. The Department of Revenue proposed no change at this time to this tax.20

- Efficient Competition Between Electricity and Natural Gas

Efficient competition among energy sources that are close substitutes for one another is furthered if the State's taxation policies do not encourage one energy source or one energy supplier rather than another. Currently, however, customers who buy natural gas directly from an out-of-state supplier can avoid the tax on natural gas which customers who buy from an in-State supplier must pay. Furthermore, an Illinois utility need not pay the tax when selling to a customer who previously bought tax free out of state.

Commentary: The Department of Revenue reports that under current law, natural gas is taxed at the lesser of 5 percent or 2.4 cents per therm, generating $132 million in fiscal year 1996. The Department of revenue calls attention to three principles in regard to the taxation of natural gas:

"The current system that lets a customer avoid tax by buying out-of-state is fundamentally flawed."

Although incorporating natural gas taxation reforms in the electric industry restructuring legislation would complicate matters, electric industry restructuring does provides an opportunity to "bring gas and electric statutes into line."21

"The $35 million in tax being avoided [by users of gas] could be used for schools or other programs or to allow revenue neutrality with lower electric tax rates.

20 The Department or Revenue has not taken a position on how municipalities should be allowed to tax, other than to say the municipal tax administration should remain in local hands.
21 The Department notes that large users who currently buy out-of-state should be expected to protest such an action.
Parents Application to the Electric Industry Reform Legislation

Members of the Governor's Advisory Committee for Electric Utility Regulatory Reform are: Nancy Brockway, Randle L. Smith and Charles G. Stalon:

Nancy Brockway is an attorney and utility analyst with the National Consumer Law Center, where she specializes in the rights of consumers in the energy and utility field. She is a graduate of Yale Law School, and has over 20 years experience, including eight years on the staff of two utility regulatory commissions. She served as General Counsel of the Massachusetts Department of Public Utilities, and has frequently testified before utility commissions in several states. Ms. Brockway is the author of The Low Income Advocates Guide to Retail Wheeling and Electric Industry Restructuring, and principal author of Stranded Benefits in Electric Industry Restructuring, a publication of the National Council on Competition in the Electric Industry. She is a member of the Massachusetts Energy Facility Siting Board, and the California PUC Low income Governing Board. She has spoken and published widely on consumer and low-income issues in electric utility restructuring.

Randle L. Smith is Managing Director of Phoenix Duff & Phelps Investment Management Company in Chicago. His experience includes 15 years in the area of utility investment analysis, and his current duties include serving as a global utility analyst in support of the $2.2 billion Duff & Phelps Utility Income Fund. Previously he worked in the research arm of Duff & Phelps providing both equity and fixed income analysis. He received BS degree in Electrical Engineering Technology from Purdue University in 1978 and an MS degree in Finance from the Krannert School at Purdue University in 1981.

Charles G. Stalon is a Consultant on Energy Regulation. Prior to his retirement, he was Professor of Economics and Director of the Institute of Public Utilities at Michigan State University. He served for five years as Commissioner of the Federal Energy Regulatory Commission and for seven years as Commissioner of the Illinois Commerce Commission. Still earlier he served as Professor of Economics at Southern Illinois University at Carbondale. He received a Ph.D. in economics from Purdue University in 1966. He has been professionally recognized in Who's Who in the East, Who's Who in the Midwest, Who's Who in Society, Who's Who in American Education, Who's Who in American Politics, and Who's Who in America.