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Illinois Commerce Commission On its Own Motion -vs- Central Illinois Light Company, Central Illinois Public Service Company, Commonwealth Edison Company, Illinois Power Company, Interstate Power Company, MidAmerican Energy Company, Mt. Carmel Public Utility Company, South Beloit Water, Gas and Electric Company, and Union Electric Company. Investigation Concerning the Unbundling of Delivery Services Under Section 16-108 of the Public Utilities Act.	:	99-0013

ILLINOIS POWER COMPANY'S PHASE 2 BRIEF

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November 10, 1999

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I. INTRODUCTION AND STATEMENT OF ISSUES AND POSITION

A. Procedural Background

On April 12, 1999, the Commission entered the First Interim Order ("FIO") in this docket. The Commission concluded that "metering and billing should be unbundled." (FIO, p. 11 and Finding(4)) The Commission also found that it was unable to conclude that "customer handling" should be unbundled because there was no clear definition or delineation of the services that would comprise "customer handling", but that unbundling of "customer handling" could be considered in the next phase of this proceeding. (FIO, p. 11) The Commission ordered that this docket should be reactivated in September 1999 and scheduled to result in a Commission order by May 1, 2000, establishing how metering and billing should be unbundled. The reactivated proceedings were to include both evidentiary hearings and workshops, with the latter focused on allowing parties to attempt to develop solutions to the many technical and business process issues associated with unbundling. The Commission stated that implementation of the results of the May 1, 2000 order should occur so that by September 1, 2000, alternate providers will have an opportunity to provide metering and billing services. (FIO, p. 17)

This docket was reactivated in mid-August with a series of workshops. Contemplating the May 1 and September 1, 2000 dates in the FIO, the parties recognized that it would be useful for the Commission to issue a further interim order to provide guidance to the electric utilities ("DSPs") and other parties in filing specific implementation proposals, including tariffs, for unbundling delivery services. Accordingly, this phase of the docket was scheduled to provide for the filing of testimony, evidentiary hearings, briefs, and a further interim order by late December, 1999 or early January, 2000 on several overriding issues.

B. The Commission Should Adopt the Provisions of the Memorandum of Understanding Among Several DSPs and Meter Service Providers

Several parties, including Commonwealth Edison Company ("ComEd"), Illinois Power Company ("Illinois Power" or "IP"), the Ameren companies, Alliant Energy, PHASER Advanced Metering Services, ITRON, eMeter, and FIRSTPOINT Services, Inc., have entered into a "Memorandum of Understanding" ("MOU") which comprises these parties' agreement and recommendation to the Commission on numerous policy issues in this phase, including issues 1, 3, 4, 5 and 6 listed below.[1] While the MOU is not an agreement among all parties, it provides a reasonable resolution of these issues, and is supported by substantive evidence. Mr. Ward Camp of PHASER, a prospective meter service provider ("MSP"), testified that the agreements in the MOU provide a reasonable and practical manner in which to implement the conclusions in the FIO. (PHASER Ex. 1, p. 4) He identified the following benefits of adopting the MOU:

- Potential market participants would have the opportunity to enter the Illinois market on acceptable terms.
- DSPs would be able to develop new business processes and systems that could implement the FIO under the time frame contemplated.
- MSPs would be certified by the Commission, enabling the Commission to appropriately monitor MSPs, insure that they have appropriate resources, and oversee them with respect to health, safety and consumer issues.
- Modifications to the provision of unbundled metering and billing could be implemented by January 1, 2002 or when residential customers become eligible for delivery services, whichever occurs earlier, thereby providing for the possibility of additional unbundling which may be beneficial to customers. (Id., p. 4)

In addition, although Commission Staff is a not a party to the MOU, the recommendations of Staff witnesses Christel Templeton and Richard Zuraski on the issues covered in the MOU are generally

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[1]The MOU is Appendix A to the Direct Testimony of H. Ward Camp (PHASER Ex. 1).

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consistent with the MOU. (See Staff Exs. 3.0, 6.0, 7.0) For the reasons detailed in this brief, Illinois Power urges the Commission to adopt the provisions of the MOU.

C. Statement of Issues and Summary of Illinois Power's Positions

Illinois Power believes that the Commission should resolve the following issues in this phase of the docket, in the manner summarized after each issue:

General

1. What retail customers are eligible to take unbundled delivery services?

Customers that are taking delivery services under the DSP's delivery services tariff should be the only customers eligible to take unbundled delivery services.

2. How should the DSP determine the bill credit which will be given to the delivery services customer that elects to take an unbundled service from an alternate provider?

In order to allow the DSP to recover its costs of providing delivery services and to facilitate economically efficient competition, the bill credit should be based on the costs which the DSP avoids when a delivery services customer switches to an alternate provider of unbundled services, net of the costs which the DSP is incurring to implement and enable unbundling. The DSP must be allowed to continue to recover the costs it incurs as the provider of last resort of the unbundled services. Basing the bill credit on fully-allocated embedded costs, as some propose, would prevent the DSP from recovering its costs of providing delivery services and would subsidize inefficient providers.

Metering

3. What are the specific metering service functions that should be unbundled?

The 16 metering functions listed and defined in the MOU comprise the metering service functions which can be unbundled. The demarcation points between unbundled metering facilities and DSP facilities should be determined as provided in the MOU.

4. Should unbundled metering service, at least for an interim period, be limited to the provision of advanced metering services?

With some limited exceptions (as provided in the MOU), providers of unbundled metering service should be required to deploy advanced metering systems, i.e., meter systems that do not require on-site reading.

5. Should MSPs be certified by the Commission, either as alternative retail electric suppliers ("ARES") or in some other way that requires these providers to demonstrate financial, technical and managerial qualifications?

MSPs should be retail electric suppliers ("RES"), and non-electric utility MSPs should be certified as ARES based on compliance with technical, managerial and financial capability criteria appropriate to the service they provide.

6. Should customers be allowed to obtain unbundled metering service from more than one provider, and should DSPs be required to provide partially unbundled metering services to customers?

A customer should be allowed to obtain its unbundled metering service from more than one provider, so long as (i) a single RES is responsible for provision of all metering service to the customer and for interfacing with the DSP, (ii) the DSP is not required to continue to provide a portion of the meter service functions to that customer, and (iii) the DSP can provide a single bill credit directly to the customer.

<u>Billing</u>

7. Is there any need for further unbundling of billing beyond the unbundling resulting from implementation of the "single bill option" ("SBO") which has been incorporated in each DSP's delivery services tariffs that were approved by the Commission in its August 1999 orders in the delivery services tariff cases?

Some of the metering functions proposed for unbundling could also be considered billing functions. Beyond this, no further unbundling of billing beyond the SBO should be implemented at this time. In particular, the functions of calculating the DSP's bill and maintaining its customers' payment and account records should not be unbundled.

<u>Customer Handling</u>

8. Are there any "customer handling" functions which should be unbundled?

"Customer handling" still has not been adequately and consistently defined. The specific functions identified by certain parties, including

"customer enrollment", either are not delivery services, or are not capable of being unbundled because the DSP would still need to perform these functions for the customer.

II. ONLY CUSTOMERS TAKING DELIVERY SERVICES ARE ELIGIBLE FOR UNBUNDLED DELIVERY SERVICES

The MOU states: "Customers that are taking service under the utility's delivery services tariff are the only customers who are eligible to take unbundled delivery services." (PHASER Ex. 1, App. A, p. 1) Two witnesses – Kennan Walsh on behalf of Enron Energy Services, Inc. and New Energy Ventures Midwest, L.L.C. ("Enron/NE") and Larsh Johnson on behalf of eMeter -- testified that, at least under certain circumstances, retail customers taking service on a DSP's bundled service tariffs should be allowed to take metering service from an alternate provider.[2] (Enron/NE Ex. 2.0, p. 5; eMeter Ex. 1, p. 7; Tr. 273) These proposals must be rejected as contrary to the Public Utilities Act ("Act") and outside the scope of the Commission's authority. Section 16-108, under which this proceeding is being conducted, gives the Commission

> . . . the authority pursuant to Article IX to review, approve and modify the prices, terms and conditions of those components of delivery services not subject to the jurisdiction of the Federal Energy Regulatory Commission, including the authority to determine the extent to which such delivery services should be offered on an unbundled basis. (§16-108(a); emphasis supplied)

Section 16-109, "Unbundling of delivery services", which could also provide authority for this proceeding, states that "The Commission may also, in accordance with Section 16-108, upon complaint or upon its own initiative without complaint, upon reasonable notice, enter upon a hearing concerning the need and desirability of requiring additional or other unbundling of delivery services offered by electric utilities." (emphasis supplied)

[2]However, Mr. Johnson also testified that eMeter continues to support the provision of the MOU quoted above. (Tr. 784-85)

Both of these sections limit the Commission's authority to allowing the provision of unbundled delivery services. There is no section of the Act which gives the Commission authority to require that components of bundled service tariffs be offered on an unbundled basis. Indeed, §16-109A gives the Commission only "the authority to investigate the need for, and to require, the restructuring or unbundling of prices for tariffed services, other than delivery services, offered by an electric utility". (emphasis supplied) It is clear from the Act that the General Assembly considered whether and to what extent the Commission should have authority to require unbundling of delivery services and of bundled services, and gave explicit direction on these points in the Act. If the General Assembly had intended for the Commission to have authority to require unbundling of bundled tariffed services, it would have said so in the Act.

III. CREDITS FOR UNBUNDLED DELIVERY SERVICES SHOULD BE DETERMINED BASED ON THE DSP'S AVOIDED COSTS, TAKING INTO ACCOUNT THE DSP'S PROVIDER-OF-LAST-RESORT OBLIGATIONS

The proper methodology for developing a pricing credit for unbundled delivery services should encourage the efficient utilization of resources and should not favor one competitor over another. (IP Ex. 8.1, pp. 4-5; Tr. 874-76) The only real issue is what costing methodology would ensure that result. The credit that is provided to customers who choose an alternative provider of delivery services must be based on the DSP's avoided decremental costs so that the DSP's lost revenues match its saved costs. Any other decision may result in the DSP failing to recover the full cost of providing delivery services, in violation of § 16-108 of the Act, or in a market that does not operate efficiently, contrary to the intent of § 16-101A(d) of the Act.

A. The Avoided Cost Approach is the Only Pricing Approach That Provides DSPs the Opportunity to Recover the Costs They Incur to Implement Unbundling and Interact with MSPs, as Required by Law

Section 16-108 of the Act states that electric utilities must be given the opportunity to recover the costs of providing delivery services. Use of an avoided cost credit will enable the DSP to recover its costs of providing delivery services including the costs it incurs as provider of last resort. Use of fully-allocated embedded costs for developing the credit would fail to comply with this statutory mandate because would it reduce the DSP's revenues by more than the cost the DSP avoids when it no longer provides the service to the customer.

Section 16-108(c) of the Act states in relevant part:

> Charges for delivery services shall be cost based, and shall allow the electric utility to recover the costs of providing delivery services through its charges to its delivery services customers that use the facilities and services associated with such costs.

This provision makes clear that the electric utility must be allowed to recover all costs associated with the provision of delivery services through its charges to delivery service customers.

The Commission has approved a revenue requirement for each DSP through the delivery service tariff proceedings that were recently concluded. The revenue requirement for each DSP includes only those costs necessary and appropriate to the provision of delivery services. (Tr. 388-92, 876-77) Since the credit for unbundled services is an offset to the rates based on the approved revenue requirement, the only costs at issue for developing the credit are costs the DSP appropriately, prudently and reasonably incurs in the provision of delivery service. The only appropriate offset to those costs are the costs which the DSP is able to avoid if the customer switches to another provider. Any credit methodology that fails to provide for the recovery of those remaining costs would prevent the DSP from recovering its costs of providing delivery services, in violation of §16-108(c) of the Act.

Determination of the unbundled services credit must take into account the DSPs' obligation to maintain the infrastructure to provide metering and billing services to customers as part of the DSP's provider of last resort obligations. The DSP is required to offer the service of standing ready to provide billing or metering service to a customer who has chosen to take those services from another provider. The customer will make that decision with the knowledge that it can always return to the DSP it if desires. That option provides a benefit to all delivery service customers. When a subset of customers departs IP's metering and billing service, some variable costs may be avoided but fixed or overhead costs (including joint and common costs) may continue to be incurred to maintain IP's billing and metering infrastructure and to stand ready to provide these services if the customer returns to Illinois Power's metering and billing services.[3] (IP Ex. 8.1, p. 10)

The issue with regard to provider of last resort costs is simple. The DSP would be denied cost recovery by a bill credit calculation methodology that gave the customer taking service from an alternate provider credit for the costs incurred by the DSP to fulfill its provider of last resort obligations. As Mr. Kingerski agreed, utilities are entitled to get paid for services they provide and

[3]MidAmerican Energy witness Ms. Czachura and Enron/NE/PHASER witness Mr. Kingerski claim that the DSP can simply outsource its supplier of last resort obligation to another supplier (MidAm. Ex. 6.0, p. 13; Tr. 404), thereby suggesting that costs would only be incurred to the extent a customer returns to the DSP's service. This suggestion ignores the fact that there will be a cost to the DSP for such outsourcing. As Mr. Kingerski agreed, "some entity is going to have to have the infrastructure and facilities and labor pool ready to provide that service, whether it's an outsource company or the utility, to be able to ensure that the utility can meet its obligation of being the supplier of last resort." (Tr. 406) While the DSP will likely weigh the costs of that option against the cost of maintaining the infrastructure to provide the service itself, the fact is there will be a cost which must be accounted for in the delivery service ratemaking process in order to ensure that the requirements of §16-108(c) are met. That cost must be recovered from delivery service customers.

should not be required to provide service at below their reasonably and prudently incurred costs. (Tr. 398-99) He further agreed that if it is determined that provider-of-last-resort service has value -- which the evidence establishes it does--then DSPs should be allowed to recover its costs. (Tr. 411) Under the fully-allocated embedded cost approach to the credit, DSPs will never be able to recover their costs of offering this service. Under the decremental avoided cost approach, they will.

The evidence described the impact on the credit calculation of the obligation to serve. For example, Illinois Power has developed and installed a Customer Information System ("CIS") which is used in the billing process. If a segment of its customers switch from bundled tariffed services to delivery services and elect to take the SBO from the customer's RES, IP must remain ready to provide billing services to these customers should they return to IP's tariffed services. IP must continue to own and maintain the CIS so that it is available should these customers return to bundled tariffed services with the Company, or switch to another RES that does not offer the SBO. Illinois Power would incur ongoing labor costs to maintain the CIS. On the other hand, while the delivery services customer is taking the SBO from a RES, IP will avoid certain printing and mailing costs and, depending on the number of customers taking the SBO, may also avoid some labor costs, which would appropriately be included in the credit. (IP Ex. 9.1, p. 4)

Similarly, with respect to metering service, even if a substantial segment of the utility's customers switched to delivery services and elected to obtain unbundled metering services from an MSP, the DSP would have to maintain an inventory of metering equipment to be able to provide the necessary metering services on short notice should customers return to taking metering services from the DSP, either under the delivery services tariff or by returning to bundled tariffed service. The DSP also has to continue to maintain and operate its meter shop and to employ a staff of meter installers, testers and repairmen to be ready to provide metering service should customers return to the DSP (as well as to serve the customers who remain with the DSP). (IP Ex. 9.1, p. 4) These costs would not be recovered if a fully-allocated embedded cost credit is used, and instead would fall on the utility's shareholders.

The fully-allocated embedded cost approach is essentially a long run approach, since it assumes that all costs can be avoided. (See Tr. 461-62) The choice between long-run and short-run costs is not a matter of time frame but rather will depend on whether the resources that underlie the costs can be avoided. In the "short run," only a few costs can be varied, i.e., avoided, while in the "long run" it is likely that more costs, including costs that are fixed in the short run, can be varied, and therefore avoided, as the DSP begins to reshape its metering and billing systems in response to the new competitive environment. (IP Ex. 8.3, p. 4) However, defining "long-run" versus "short-run" should not be the focus. Rather, the focus should be on determining the appropriate avoided cost and the unit values for purposes of the credit or charge based on an estimate of the number of delivery services customers that would take the service from an alternate provider. The estimate of the number of customers taking the service from an alternate provider, and therefore the charge or credit, may be revised from time to time based on experience as additional customers switch to alternate providers. (IP Ex. 9.1, p. 3) That way, the credit will reflect the actual costs avoided, and no more.

Staff and Enron/NE/PHASER suggest that if their credit proposal prevents DSPs from recovering their costs of providing delivery services -- which the evidence shows it will -- the DSPs should simply seek to recover any remaining costs through a rate increase. (See Tr. 444-45, 886-87) This proposal would not solve the problem. First, given the statutory bundled service rate freeze, the

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only rates through which these additional costs could be recovered is delivery service rates. (Tr. 446) However, the impact of a delivery services rate increase on the transition charge would result in a revenue offset that would reduce or eliminate entirely any additional cost recovery (Tr. 893), thereby leaving these costs to be borne by shareholders.

B. Use of Avoided Costs for Developing the Credit Will Provide the Correct Price Signals and Will Promote Economically-Efficient Competition in the Unbundled Services Without Subsidizing New Entrants

Dr. Kenneth Gordon, a Senior Vice President of National Economic Research Associates, and formerly Chairman of the Maine Public Utilities Commission and of the Massachusetts Department of Public Utilities and President of the National Association of Regulatory Utility Commissioners, testified that electric restructuring should be implemented in ways that lead to efficient competition in electricity markets. Efficient competition is present when all competitors are free to succeed or fail in the marketplace on the basis of their relative efficiencies and advantages in serving consumers. Firms who can produce most efficiently, based on forward-looking costs, and bring the most value to consumers, should (and will) prevail. Efficient competition leads to production at the lowest achievable costs, which is socially desirable because it results in the efficient use of society's resources and provides consumers with the products they desire at the lowest possible prices. (IP Ex. 8.1, p. pp. 1-2, 4)

Dr. Gordon explained that the role of efficient retail competition is to create benefits for end-use customers. Efficient competition would allow retailers to enter and profit in the market if and only if they are able to deliver benefits in at least one of two forms. The retailer must either: (1) be more efficient than the utility in the provision of retail service, and thus offer a lower price to gain market share; or (2) innovate to introduce value-added products and services that inspire switching because customers demand these products and are willing to pay a premium to receive them. (IP Ex. 8.1, p. 6)

Dr. Gordon also explained that a policy that subsidizes new entrants or shelters them from the competitive process should be rejected by the Commission. Rather, competition should be introduced appropriately at the outset rather than artificially tilting the market to favor some competitors over others (IP Ex. 8.1, pp. 4-5), a concept with which Staff witness Mr. Lazare agreed. (T. 875-76) Given the opportunities that are open to new entrants, and the capital that these firms have invested, it is not likely, in any event, that they really need protection. Protection may discourage these firms from developing the efficient practices needed to make them viable, efficient competitors in the future. For competition to be competitively neutral, competitors must be free to succeed or fail in the marketplace on the basis of their relative efficiencies in serving the needs of consumers. In sum, policies that favor less efficient competitors or disfavor more efficient competitors would clearly be harmful to consumers and would contradict the basic purpose of substituting competition for regulation. (IP Ex. 8.1, pp. 4-5)

Dr. Gordon also testified that if competition is introduced in ways that encourage entry by inefficient competitors, this inefficient situation could persist indefinitely. Once inefficient entry occurs, it will be difficult for policymakers to go back and change the rules of the game to be more efficient. That is why regulators must focus on introducing efficient competition in both retail electricity markets and in metering and billing markets from the outset. (IP Ex. 8.1, pp. 5-6)

Dr. Gordon explained that prices should reflect the costs caused by consumption of a good or service. When consumption decisions are guided by cost-based prices, the highest-valued goods and services are produced and consumed using society's scarce resources. On the other hand, if buyers are induced to consume more of a service than they would if it were priced at its economic costs, resources are being wasted: society could be made better off by consuming less of that service. Competition should be favored where it ensures that customers are made better off. Any policy that encourages entry and survival of suppliers less efficient than incumbents will result in consumers paying higher prices or receiving poorer services. (IP Ex. 8.1, p. 8)

The bill credits and/or charges to customers for the costs associated with introducing competition should be based on these basic, well-accepted economic principles. Specifically, customers who take service from a competitive supplier of metering and billing services should receive a credit that reflects the actual decremental costs that the DSP avoids. The amount of the credit should reflect all of the costs that the DSP avoids as a result of those customers no longer taking metering and billing services from the DSP, including labor, capital, and material.[4] Thus, the credit would be based on the average utility-specific avoided costs for a decrement that reflects the expected number of customers choosing alternative suppliers. Calculation of the credit will require utility-specific cost evidence and a judgment about the number of customers that are likely to choose alternative suppliers. (IP Ex. 8.1, pp. 9-10)

There are additional factors that will impact the size of the credit. Combination gas and electric utilities such as Illinois Power have historically been able to combine metering and billing services in ways that allowed them to develop economies of scale and scope. Thus, they are able to

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[4]The credit must be based on the actual functions avoided by the DSP, not just on costs recorded in FERC accounts for distribution functions. FERC accounts were created for accounting and reporting convenience in the context of regulation of vertically-integrated electric utilities. Given the substantial changes relating to the introduction of competition and the unbundling of electric service, these accounts do not necessarily accurately capture or depict the costs associated with specific work functions, particularly the calculation of utility-specific avoided costs. (IP Ex. 8.1, p. 10) This issue is addressed below (§IV.E) with regard to Mr. Lazare's proposed filing requirements.

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add customers at a low incremental cost. Depending on how quickly customers depart for other providers, these economies of scale and scope will, over time, be lost, but the incremental effect of departing customers will initially be small. The cost that the DSP avoids, therefore, could be small. Further, many of IP's electric customers also take gas service and thus will need to have their gas meters read, and to receive bills for gas service, even if they decide to take electric metering and billing services from other suppliers. Thus, for combination gas and electric customers, the meter reading and billing costs that IP could actually avoid as a result of electric customers taking service from a competitor could be very small.[5] (IP Ex. 8.1, p. 11)

The additional costs that the DSP incurs as a service is unbundled must also be considered in developing the credit. These costs are incurred by the DSP because of the disaggregation of a vertically-integrated service into services provided by two or more entities that must coordinate and transact with each other. Dr. Gordon explained that standard economic principles require that these costs should be recovered from the cost causers -- new entrants into the metering and billing market -- by either direct charges to those entrants or offsets to the bill credit. Including these costs through appropriately-designed and specified charges to the cost causer, or through inclusion in the calculation of the metering and billing credit, will lead entrants and incumbents alike toward more efficient behavior. In other words, charging entrants for the costs they are imposing will give them an incentive to economize on unbundling (transactional) costs. (IP Ex. 8.1, p. 12)

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[5]Although Enron/NE/PHASER witness Kingerski supported an embedded cost based credit, he agreed that if there are joint economies resulting from the provision of two services together, which economies do not exist if each is offered separately, the credit for each such service should be set at no higher than one half of the embedded cost of providing the services jointly. He stated that in the case of such economies, the embedded credits should never exceed the total embedded costs, and if the individual embedded cost credit would sum to greater than that total, it should be adjusted down. (Tr. 452)

Dr. Gordon explained that the metering and billing credit should permit market mechanisms to work by giving new entrants efficient consumption and production signals. Consumers and society as a whole could be harmed if unbundling of metering and billing occurs in an inefficient manner. Consumers would be harmed if prices are higher (or services worse) than they otherwise would be. Society would be harmed if the price signals provided by an artificially-high metering and/or billing credit leads to a higher market share for less-efficient providers than would otherwise be the case. (IP Ex. 8.1, p. 13)

Use of incremental costs in emerging competitive markets is not novel. For example, the Commission has approved the use of incremental cost principles in the telecommunications industry. In the Second Interim Order in Docket No. 99-0486/98-0569 (Feb. 17, 1998), page 1, the Commission recognized that forward-looking incremental cost studies should be used to establish rates for Ameritech's provision of interconnection, unbundled network elements, and transport and termination of local traffic pursuant to interconnection agreements. Forward-looking costs are equally applicable for use in the development of a competitive electric industry.

C. Basing the Bill Credit for Unbundled Services on Fully-Allocated Embedded Costs Would Be Economically Inefficient, Arbitrary and Difficult to Administer

Dr. Gordon testified that fully-allocated cost methods attempt to assign costs that are not directly incurred to provide the service, a process that fails to promote efficient use of resources. Use of fully-allocated costs for determining the pricing of the metering and billing credit would not comport with the requirements of economic efficiency. Efficiency can be achieved by ensuring that the metering and billing credit reflects any costs that the DSP avoids because it no longer provides these services to some subset of its delivery service customers. Fully-allocated cost pricing has significant problems from the standpoint of resource allocation because it necessarily overstates the economic cost of the resource or service that is being considered. Moreover, it allocates common costs to different products and services in an arbitrary way. (IP Ex. 8.1, pp. 15-16)

Dr. Gordon cautioned that if fully-allocated costs are used to set the metering and billing credit, entry into the metering and billing market will be distorted, which is likely to lead to increased overall costs. Credits that are not based on appropriately-specified decremental costs would have the effect of providing a subsidy to new entrants. Specifically, the amount above the DSP's avoided decremental costs would be a subsidy to alternate providers. This would perhaps benefit customers that switch but it would not benefit customers that take bundled utility service. Moreover, in the aggregate, customers and society would not benefit if this subsidy results in inefficient competition. (IP Ex. 8.1, p. 16)

While fully-allocated embedded costs are used to calculate the DSP's revenue requirement, embedded cost pricing is not an acceptable substitute for avoided cost pricing when economic efficiency is an issue. The task of efficient competition is to see to it that the aspiring competitor is able to prevail to the extent -- but only to the extent -- that its incremental costs involved in supplying the service in question are lower than those of the incumbent, considering the sum total of the incremental costs. Embedded cost pricing, on the other hand, is useful in order to provide a DSP with a reasonable opportunity to recover its costs, including the cost of capital for obligation-to-serve services of which it is the only provider. Use of embedded costs to design prices for services that can also be provided by competitive suppliers would lead to inefficient resource allocation and distorted price signals and is therefore not an acceptable substitute to pricing based on avoided cost. (IP Ex. 8.1, pp. 17-18; IP Ex. 8.3, p. 12)

Finally, fully allocated embedded costs should not be used for the credit due to the adverse affect on transition cost recovery. The Act uses a "lost revenues" approach to transition cost recovery, in which delivery services revenues, the market value of power and energy, and a statutorily-specified mitigation factor are deducted from base rate revenues in determining the transition charge that a delivery services customer will pay the DSP. The Commission has determined that if the delivery services customer purchases metering or billing services from a third party provider, the delivery services revenue deduction in the customer's transition charge calculation is nevertheless to be based on the full delivery services revenues that the DSP would receive if the customer continued to obtain metering and billing services from the DSP. Therefore, if the metering and billing credit is based on avoided (decremental) costs, then the revenue loss which the DSP will experience through the transition charge calculation will match the DSP's actual avoided cost. If the metering and billing credit is based on fully-allocated (embedded) costs, then the DSP's revenue loss through the transition charge calculation will exceed its saved costs, which would create unrecovered costs for the DSP. The DSP will be harmed twice because: (1) its delivery services revenues will be reduced by more than its avoided costs (and, thus, it will not recover its cost of service), and (2) its transition charge revenues will be reduced by more than its avoided cost. (IP Ex. 8.1, p. 17) Only use of a decremental avoided cost credit will prevent this result.

D. The Proposals of Staff, Certain RESs and MidAmerican Are Flawed and Must Be Rejected

1. Flaws in Mr. Lazare's Proposal and Analysis

Staff witness Lazare argued that the credit for customers purchasing unbundled services from an alternate provider should be calculated on an embedded cost basis. He asserted that this is

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appropriate since embedded costs are used for other ratemaking tasks and because the credit for components of delivery services should recover the revenue requirement for those components of service. (Staff Ex. 4.0, pp. 2-9) As discussed above, embedded cost credits would result in a subsidy to new entrants and create inefficient competition. Specific problems with Mr. Lazare's approach are discussed below.

Mr. Lazare stated several criticisms of the use of an avoided cost credit. Upon close scrutiny, none of his criticisms are valid. For example, Mr. Lazare claimed that embedded costs are preferable to marginal costs sir :e embedded costs are historical data while marginal costs are forecasted data. However, he later agreed that the fact that the data is forecasted, as opposed to historical, does not render the data unusable for ratemaking purposes. Indeed, the Commission has previously determined that it could use forecasted data to develop a revenue requirement. (Tr. 885-86)

Mr. Lazare's proposal is flawed in that it relies only upon historic costs, and in particular, costs approved in the DSPs' last rate cases. The problem is that those rate cases were based on historic test years (1997 for Illinois Power) and many of the start-up and one time costs associated with implementing unbundling were not included in those test year revenue requirements. (Tr. 899) As discussed above, the credit cannot be properly determined without taking into consideration all relevant costs associated with implementing unbundling.[6]

Mr. Lazare also rejected an avoided cost based credit on the basis that marginal costs are subject to manipulation. He apparently believes there is greater certainty associated with embedded costs. However, Mr. Lazare admitted that embedded costs may also be manipulated. Indeed, he

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[6]The Commission recognized this in its delivery services tariff order for IP, in its specification of how the SBO credit should be calculated. (Order in Dockets 99-0120 & 99-0134 (Cons.), Aug. 25, 1999, p. 130)

justified his proposed filing requirements on the basis that in the absence of such requirements utilities could manipulate the embedded cost data and not provide all the data that he believes would be necessary for the development of the credit. (Tr. 877-80) His manipulation of data argument is a straw man. Moreover, as IP witness Kevin Shipp pointed out, given the difficulties associated with using historic information recorded by FERC accounts to determine metering and billing costs, as well as the considerable controversy in the DSPs' delivery services cases over the proper allocation methods to apply to historical cost data, Mr. Lazare's faith in the simplicity of embedded costs is seriously misplaced. (IP Ex. 9.1, p. 13)

2. Flaws in Mr. Kingerski's Proposal and Analysis

Enron/NE/PHASER witness Mr. Kingerski argued that what he referred to as the "back-out credit" should be based on a fully allocated embedded cost methodology. He contended the credit should be equal to the utility's price for the service, which would equal the embedded costs of the service plus an allocation of administrative and general expense. (Enron/NE/PHASER Ex. 1.0, pp. 3-4, 8)

Mr. Kingerski agreed that if the credit is higher than the DSP's avoided costs and the DSP has taken all steps to avoid all costs that are avoidable, then the DSP will not recover its delivery service revenue requirement if a credit based on fully-allocated embedded costs is used. (Tr. 440-41) He further agreed that, with respect to the DSP's fixed costs, if the unrecovered sunk cost is greater than the salvage value or value redeployed, there would be no way the DSP would recover the cost if it is not included in delivery service rates. (Tr. 442-43) Mr. Kingerski acknowledged that an embedded cost credit prevents a DSP from recovering its costs of providing delivery services:

Q. Assume that the utility is unable to change its cost structure. Okay? It has the same costs. We're at one point in time. Its revenue requirement for delivery services was set assuming that cost structure, but what happens is at that point in time the utility loses a customer for metering service to an alternative provider and is required to credit that customer at a level higher than the cost it avoids. Wouldn't you agree, all else being equal, that the utility will not be able to recover its costs of providing delivery services?

A. (By Mr. Kingerski) Under those assumptions, and I mean I have to qualify my answer by saying those are very constraining assumptions, that there is no other answer than yes. (Tr. 397)

The reason Mr. Kingerski disagreed with the assumptions in the foregoing question is his belief that the remaining revenue requirement which is not recovered as a result of using an embedded cost based credit is not a reasonable cost of providing delivery service. Mr. Kingerski (as well as Staff witness Lazare) argued that the DSP should be able to shed those costs as well as the costs that are truly avoidable. Under their theory, if the DSP cannot do so, then the unavoidable costs could represent non-used and useful costs which the DSP is not entitled under §16-108 to recover. (See Tr. 888) This argument must be rejected for two reasons. First, a cost that was found to be reasonably and prudently incurred in the DSP's delivery service rate case cannot become non-used and useful if the only intervening event is the Commission's decision to unbundle metering or billing, if the cost cannot be avoided by the DSP. To hold the unavoidable cost to be not used and useful under these circumstances would be confiscation, and unlawful.

Second, and most significantly, Mr. Kingerski's and Mr. Lazare's position regarding costs that can or should be avoided ignores the DSP's legal obligation to be the provider of last resort.[7] This

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[7]Enron/NE/PHASER may argue what Mr. Kingerski stated in cross examination, i.e., that the utilities can terminate the supplier of last resort obligation. Mr. Kingerski contended that the supplier of last resort obligation terminates once a service is declared "competitive", and whether to declare a service "competitive" is up to the utility. (See Tr. 399-401) While it is true that only a utility can file a petition to have a service declared "competitive", the Commission can only declare the service

obligation means that a delivery services customer that elects to take unbundled metering service from an MSP, or the SBO from its RES, may return to bundled tariffed service from Illinois Power on little or no notice. Further, this delivery services customer may elect to return to taking metering service from IP even though remaining a customer of the RES for generation supply service. Until metering and billing services are declared "competitive", IP must accept the return of delivery services customers to its tariffed services. Therefore, IP must continue to incur costs to stand ready to provide metering and billing services to the customer. (IP Ex. 9.1, p. 3)

As support for his position, Mr. Kingerski claimed that the utilities' incumbent position gives them a tremendous advantage over potential competitors. (Enron/NE/PHASER Ex. 2.0, p. 5) However, he acknowledged that new entrants also have various advantages, such as technology, innovation and ideas. (Tr. 430-34) Others may be niche players. (Tr. 434) In addition, he conceded that the clients on whose behalf he was testifying are far from being small, start-up companies. Enron, for example, has been "a leading, worldwide provider of energy products and services . . . in many countries across the world . . . for years." (Tr. 433)

3. Flaws in Ms. Czachura's Proposal and Analysis

MidAmerican witness Ms. Czachura argued that DSPs should establish separate stand-alone rates (i) for delivery services excluding the services that are unbundled, and (ii) for the unbundled services. She stated that these rates should be based on embedded costs. (MidAm. Ex. 3.0, pp. 12-13) Her proposal is one of form over substance. What is important is that the proper cost basis is employed, regardless of whether it is a credit against the delivery services customer's bill or a stand-alone rate for metering service.

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competitive if it finds that the statutory criteria in §16-113 are met.