



**UNREGULATED UTILITY AFFILIATES:
IT'S NOT TIME FOR A CHANGE**



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REGULATED UTILITIES AND UNREGULATED ~~LOSSES~~ OPERATIONS

- It is easy to point to spectacular failures in the industry – situations in which utilities have been dragged down by the disastrous performance of unregulated affiliates.
- There was far less concern when unregulated businesses were enhancing shareholder value and increasing bond ratings through diversification and high profits.




REGULATED UTILITIES AND REREGULATED OPERATIONS continued

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- If the economic downturn had occurred in a regulated environment, utilities would have been stuck with excess generating capacity and ratepayers would have suffered anyway.
 - It is important to not be too hasty. Well-planned diversification into unregulated business can be a win-win situation for ratepayers and shareholders.





UTILITY AFFILIATE EXPANSION INTO UNREGULATED ELECTRIC ACTIVITIES CAN BE BENEFICIAL TO CONSUMERS


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- Competition – at least at the wholesale level – is critical to economically efficient utility operations.
 - Utilities cross-selling into each others' service territories provide only limited benefits.
 - Incentives are limited because profits are returned to ratepayers.
 - Utilities “compete” only with unneeded energy.





UTILITY AFFILIATE EXPANSION INTO UNREGULATED ELECTRIC ACTIVITIES CAN BE BENEFICIAL TO CONSUMERS



continued

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- Entirely independent companies are not making significant inroads in generation or transmission.
 - Utility affiliates are the natural choice to enhance competition.







COMPETITION AND DEREGULATION MUST BE “MANAGED” TO PREVENT ABUSE

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- Returning to a fully cost-based regime is impossible and unnecessary.
 - Non-utility generation accounts for a significant portion of the nation’s total capacity.
 - BUT – the electric industry will never be fully deregulated.
 - Large generation owners can exercise market power in some instances.
 - Transmission monopolies may remain in some regions for a substantial period.
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INTER-AFFILIATE RELATIONSHIPS ARE HEAVILY REGULATED

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- Affiliate transactions are regulated by many states and (for registered holding companies) the SEC.
 - FERC's Code of Conduct requires separation of utility and non-utility operations.
 - The utility and its affiliate must operate separately.
 - The utility and its affiliates must exchange market information only pursuant to EBB-type postings.
 - The utility sales of non-power goods and services to an affiliate must be at the higher of cost or market.
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INTER-AFFILIATE RELATIONSHIPS ARE HEAVILY REGULATED continued

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- The affiliate sales of non-power goods and services to the utility must be priced no higher than market.
 - Affiliate power sales transactions are closely regulated.
 - If an affiliate brokers utility energy (or vice versa) the utility's power must be offered first.
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- Many state utility commissions impose similar restrictions on affiliate relationships.




REGULATION OF UTILITY/AFFILIATE OPERATIONS CAN BE TOO RESTRICTIVE

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- FERC has refused to explain the Code of Conduct or evaluate procedures designed to implement it.
 - FERC's procedures can adversely affect utility/affiliate risk management practices, increasing financial risk.
 - Exchanges of market information can be unreasonably restricted.
 - Coordinated credit risk and market risk activities can be impaired.







REGULATION OF UTILITY/AFFILIATE OPERATIONS CAN BE TOO RESTRICTIVE continued

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- FERC rules on affiliate transactions have conflicted with SEC rules for years.
 - SEC requires affiliate transactions to be priced at cost.
 - In combination with FERC rules, affiliate transactions are at the lower of cost or market.
 - State have imposed rules on affiliate wholesale power sales that exceed their jurisdiction.




FERC's PROPOSAL TO REGULATE UTILITY CASH MANAGEMENT PRACTICES IS UNNECESSARY

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- FERC proposed to prohibit utility participation in cash management arrangements unless:
 - the utility has a minimum proprietary capital balance of 30%;
 - the utility and its parent have investment-grade credit ratings.
 - FERC's proposed rules conflict with (or at least replicate) the rules applicable to registered public utility holding companies.
 - The proposal also conflicts with or replicates many state utility commission requirements.
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FERC's PROPOSAL TO REGULATE UTILITY CASH MANAGEMENT PRACTICES IS UNNECESSARY continued

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- FERC hasn't established a persuasive legal or factual basis for its proposal.
 - EEI recommended exemptions for utilities whose LMPs are regulated by the SEC or state commissions.
 - EEI recommended liberalization of the capitalization requirement and the investment grade requirement.




HOW CAN UTILITIES BE PROTECTED FROM AFFILIATE OPERATIONS?

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- There is no substitute for good utility management. Good management can be a result of a competitive, unregulated business.
 - Commissions can provide oversight, but they cannot micro-manage utilities or their parent companies and affiliates.
 - Capped rates or rate freezes frequently have been the quid pro quo for restructuring and managed competition.
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HOW CAN UTILITIES BE PROTECTED FROM AFFILIATE OPERATIONS? continued

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- FERC or State Commissions may want to establish guidelines on utilities lending money to affiliates and establish a rebuttable presumption that compliance with the guidelines is prudent.
 - Traditional “imprudence” disallowances can protect ratepayers from bad management decisions.
 - Commissions can adjust ROE allowances to offset increased costs related to depressed credit ratings.
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