

PROJECT NO. 28971

PUC EVALUATION OF THE	§	PUBLIC UTILITY COMMISSION
READINESS OF THE EL PASO AREA	§	OF TEXAS
FOR RETAIL COMPETITION IN	§	
ELECTRICITY	§	

**ORDER ADOPTING NEW §25.421
AS APPROVED AT THE OCTOBER 13, 2004 OPEN MEETING**

The Public Utility Commission of Texas (commission) adopts new §25.421, relating to the Transition to Competition for a Certain Area Outside of the Electric Reliability Council of Texas (ERCOT) Region, with changes to the proposed text as published in the June 25, 2004, issue of the *Texas Register* (29 TexReg 6012). The rule addresses the readiness of El Paso Electric Company (EPE) to offer retail competition at the expiration of its rate freeze in August 2005 and defines the process and the sequence of events for the introduction of retail competition in the portions of Texas served by EPE. This new section is adopted under Project Number 28971.

The key provision of the new section is a commission determination that the power region in which EPE is located is unable at this time to offer fair competition and reliable service to all retail customer classes in the EPE area of Texas. Accordingly, the new section delays retail competition until a number of development activities are completed and the region is ready for competition. While the persons that commented on the proposed rule suggested modifications to the sequence of events in the development stages, they supported the basic concepts of delaying retail competition and conducting development activities in stages. The commission adopts the rule as proposed with respect to delaying retail competition and prescribing development stages as a prerequisite for full retail competition, but makes revisions concerning some of the details of the sequence of events.

The commission received comments on the proposed new section from El Paso Electric Company (EPE) and the Alliance for Retail Markets (ARM). In its comments ARM presented the views of Strategic Energy and Constellation NewEnergy, Incorporated.

Both commenters supported the proposed rule with modifications. ARM recommended that the proposed rule be amended so that a pilot project for retail competition would be allowed to begin before the establishment of a regional transmission organization (RTO) in the El Paso area. ARM's recommendation was based on a number of arguments. ARM argued that (1) under the Public Utility Regulatory Act (PURA), the existence of an independent system operator (ISO) or RTO in a region is not a prerequisite to beginning retail competition outside ERCOT; (2) experience with retail competition in ERCOT demonstrates the significant benefits of retail competition; (3) the ERCOT experience does not provide a basis for deciding which conditions would be sufficient for the successful introduction of retail competition elsewhere; (4) in another non-ERCOT area (the Southwestern Electric Power Company area) the commission allowed a retail pilot project to proceed, without RTO or ISO involvement; (5) and experience from other states demonstrates that customers can benefit from retail competition even when RTOs are not present. ARM described its members' experience in retail competition in other states where retail competition began before an RTO or ISO was in place. It argued that modifications of the utilities' open-access tariffs have been developed in other areas that have allowed the successful introduction of retail competition before an RTO was operating.

In reply comments EPE countered the arguments raised by ARM. It argued that an independent organization is essential under law, and that, in assessing how to introduce competition in the El Paso area, the commission must give primary consideration to its experience in attempting to introduce retail competition in non-ERCOT areas of Texas. EPE also challenged ARM's assertions that retail competition in other states without RTOs was successful. In particular, EPE noted that residential customer participation in retail competition has been minimal in the markets that ARM referred to. With respect to ARM's suggestions for modifying the open-access tariff, EPE argued that ARM is seeking special rules that would transfer to EPE and its customers costs and reliability risks that are properly borne by retail electric providers (REPs) and their customers. EPE argued an operating RTO is the proper forum to develop market-based mechanisms to address the reliability concerns associated with retail competition and provide appropriate price signals to users of the transmission system. EPE also noted the cost of operating a pilot project and argued that a pilot project should be implemented as a final evaluation of the ability of a power region and a utility to implement customer choice, not to gauge customer interest in retail competition.

Commission response

The preamble adopted by the commission to explain the proposed rule set out the bases for its view that fair competition and reliable service were not feasible in the El Paso area. As ARM pointed out in its comments, the bases for this conclusion included the commission's experience in introducing retail competition in the ERCOT region, its attempts to

introduce retail competition in other regions in Texas, and the characteristics of the El Paso region.

ARM argued that an RTO is not a prerequisite, as a legal matter, to initiating full retail competition in a region outside of ERCOT. While an RTO may not be required, some form of independent organization to provide transmission service, ensure reliability, and settle wholesale accounts is a legal prerequisite and is critical to the success of a retail market. The commission believes that establishing an RTO prior to retail competition is preferable to creating some other form of independent organization, in order to start the pilot project. Regional transmission organizations provide a high level of assurance that transmission service will be provided on a non-discriminatory basis. One of the risks a retail electric provider (REP) may confront in a market without an RTO (and where the utility has not unbundled) is the risk that a transmission service provider that also controls generation facilities or makes retail sales would discriminate against REPs in the provision of transmission service. This is an operating risk that the REP faces if it enters the market, but it is also a risk that it must assess in deciding whether to enter the market at all. Codes of conduct exist at both the wholesale and retail level, but these codes of conduct are not likely to be as effective in preventing discriminatory conduct by the transmission provider. Many RTOs also provide advanced market functions, such as operating markets for energy and ancillary services and managing congestion through market-based mechanisms. Without these market functions, REPs may face significantly higher costs and risks in committing to deliver power to retail customers. Finally, RTOs afford market participants a stakeholder process for proposing revisions to market rules, which would

not be available in a wholesale market in which the transmission service provider is operating under its own open-access tariff.

Retail competition has not been successfully introduced in other areas of Texas where there is no RTO. As the commission pointed out in the preamble to the proposed rule, the commission conducted pilot programs for retail competition in the service areas of Entergy Gulf States, Incorporated (Entergy) and Southwestern Electric Power Company (SWEPCO). In the SWEPCO areas, no REPs offered service during the three years that the pilot project has been open, and no customers switched their service from the utility to competitive REPs. A single REP served a small number of commercial customers under the Entergy pilot project for a short period, but it has discontinued its service to these customers. The lack of participation in the pilot projects in these areas is an important consideration for the commission, particularly because of the similarities between these areas and the El Paso area. The EPE service area and the Entergy and SWEPCO areas do not have an RTO, so that to operate in these areas REPs would have to obtain transmission service and ancillary services under the utility's open-access transmission tariff. Like the SWEPCO and Entergy markets, the El Paso market is a small retail market. The Entergy Texas area has about 360,000 customers, and the EPE and SWEPCO areas are even smaller. The ERCOT retail market, on the other hand, consists of roughly six million customers. Thus the success of competition in the ERCOT retail market is not indicative of the possibilities for success in the EPE service area. Other factors that are likely to make the successful introduction of retail competition more difficult in EPE's Texas service area are the fact that the El Paso area is isolated geographically from other large markets in the

western electric system, and that the local generation supply is dominated by a single company, EPE.

ARM has argued in favor of modifications to the EPE open-access tariff that would reduce certain operating risks for REPs competing in the El Paso region. It appears that the key modifications relate to simplified analysis of requests for transmission service to serve retail customers in El Paso and greater latitude to depart from balancing energy schedules. The commission and interested persons developed retail market rules to address issues like balancing energy, and these market rules were to be incorporated in Entergy's open-access tariff, to reduce the risks for REPs operating in the Entergy area. However, the effort to develop retail market rules was ultimately not successful in the Entergy area. The rules that were developed and ultimately approved by the Federal Energy Regulatory Commission did not achieve all of the objectives of some of the REPs, and the commission decided not to proceed with an invigorated pilot project under these rules.

In reply comments, EPE argues that providing REPs greater latitude in balancing energy simply shifts costs from the REP to EPE. While the commission does not reach a conclusion about whether this assertion is correct, it does conclude that a significant effort would be required to modify the open-access tariff to address the balancing energy issues to the satisfaction of both new retail providers and EPE. Other modifications in commission rules might also be needed to facilitate retail competition, such as modifications to the products that are required to be sold in the capacity auction, so that they could be used more effectively as a balancing energy or ancillary service resource.

The commission concludes that it is preferable to develop and implement wholesale market rules to accommodate a competitive retail market in the context of an RTO, where there will be a higher assurance of independence, rather than in the context of a bundled utility operating under a code of conduct.

In one important respect, however, the EPE area is different from the SWEPCO and Entergy areas. The EPE area has significantly higher retail rates, and ARM argues that this factor weighs in favor of initiating a pilot project in the EPE area. The commission concludes that the higher retail prices in the El Paso area are likely to be conducive to retail competition, but that there are other important issues that need to be addressed before a pilot project should begin.

Another concern with respect to this matter is the lack of support for a pilot project among other retail providers that are active in the ERCOT market. There are numerous REPs currently actively participating in the ERCOT market, ranging in size from very small start-up companies to affiliates of major, multi-state utility companies. It is to be expected that these companies would be interested in expanding their efforts to include providing service in the EPE service area if they felt that the area could support retail competition now. However, despite the commission's request for comments on this issue, none of these REPs (other than the two represented by ARM) filed comments supporting the initiation of customer choice. If other REPs are not willing to file comments in this proceeding, it raises questions about whether any REPs would participate in a pilot project in El Paso. The commission is also concerned that if a pilot were opened early in the process of developing

the conditions for full retail competition, a few participating REPs could concentrate their efforts on industrial and large commercial customers, so that there would be few benefits for residential and small commercial customers and an inadequate test of the systems needed to serve mass-market customers.

Sections 39.103 and 39.104 of PURA direct the commission to delay competition if it concludes that a power region is not able to provide fair competition and reliable service to all customer classes and authorize it to use pilot projects to evaluate the ability of power regions and utilities to offer customers choice. These provisions and the commission's efforts to introduce customer choice in the Entergy area suggest that the commission should be cautious in introducing customer choice and that it should have a high level of confidence in the results before it does so. In particular, these provisions suggest that it would not be appropriate to initiate a pilot project when significant changes in the wholesale power market are needed to provide the conditions for the successful introduction of customer choice. A pilot project should be a final test for retail competition under rules that are the same as or very similar to the market rules that will be in effect for full retail competition. A pilot should not be used as a platform to develop the changes in market rules that are needed for the success of full retail competition.

Based upon the comments received from EPE and ARM, and the lack of support from other REPS active in ERCOT, the commission reaffirms its preliminary conclusion that the power region that includes the EPE service area will be unable to offer fair competition and reliable service to all retail customer classes in Texas upon the expiration of the

system-wide rate freeze in August 2005. This conclusion is also supported by the commission's experience in introducing retail competition in the ERCOT region, its attempts to introduce retail competition in other regions in Texas, and the characteristics of the El Paso region. Because the foundation to help ensure the successful introduction of retail competition is not present in EPE's service area, the commission finds that retail competition should be delayed until all of the necessary steps in the preparation for competition are accomplished. The commission also finds that this rule is necessary to specify the steps that are needed and the sequence of those steps so that retail competition can be introduced in an orderly and efficient manner. Accordingly, the commission adopts the new section with changes, as described in other portions of this order.

ARM noted that in implementing PURA Chapter 39, the Commission adopted numerous rules. It argued that the Commission should review those rules and conduct a single rulemaking proceeding to make any modifications, such as changes in dates or references to ERCOT or other changes needed to reflect differences between ERCOT and the EPE service area, so that the rules provide clear directives for introducing competition in EPE's service area.

Commission response

Carrying out this suggestion would provide significant clarity in the rules that will apply to the El Paso region as retail competition is adopted. No amendment to the rule is needed in order to adopt this suggestion. Rather, the commission intends to review the rules related

to retail competition at an appropriate point in the retail-market development process to ensure that their application to the El Paso region is clear.

EPE expressed the view that it should not be required to complete its business separation before the commission concludes that the region is ready for retail competition. Rather, the business separation should take place after the commission has evaluated whether the region is ready for retail competition and has ordered retail competition to begin. In reply comments, ARM said that it does not object to EPE's proposed sequence so long as business separation and full retail competition are not as a result unduly delayed. It expressed the view that this concern could be addressed if the commission imposed appropriate deadlines in its orders on business separation and unbundling and on full retail competition. It also noted that this change in the sequence would highlight the need for competition protections, such as an appropriate code of conduct and an open-access tariff that would allow the retail pilot project to succeed.

Commission response

The commission agrees that it is preferable to require EPE to unbundle only after the commission has ordered full retail competition to begin, and it has modified the rule accordingly. The developmental activities for retail competition in the El Paso service area include developing protocols for retail competition. In the Entergy context, these protocols addressed the kinds of issues that ARM has raised in this rulemaking proceeding. The commission agrees that such issues will also need to be resolved for the EPE service area in a future proceeding, but they need not be addressed in this rulemaking project.

EPE also commented that the date for the energy efficiency and renewable obligations to be applied to it were not clear. It proposed modifications to make the effective date clear.

Commission response

The commission agrees that this modification is appropriate.

All comments, including any not specifically referenced herein, were fully considered by the commission. In adopting this section, the commission makes other minor modifications for the purpose of clarifying its intent.

This section is adopted under the Public Utility Regulatory Act, Texas Utilities Code Annotated §14.002; and specifically, PURA §39.051, which requires an electric utility to separate its business functions prior to the introduction of retail competition; PURA §39.102, which specifies that at the expiration of EPE's system-wide rate freeze, the utility shall be subject to PURA Chapter 39, relating to restructuring of the electric utility industry; PURA §39.103, which grants the commission authority to delay competition if a power region cannot offer fair competition and reliable service to all retail customer classes; PURA §39.104, which addresses the retail competition pilot projects; PURA §39.151, which requires the establishment of independent organizations to perform certain competition-related functions in each power region; PURA §39.152 and §39.154, which grant the commission authority to certify a power region and to evaluate market power; PURA §39.201, which addresses unbundled cost-of-

service rates; PURA §39.202, which establishes the price-to-beat obligation for affiliated retail electric providers; and PURA §39.904 and §39.905, which address the state goals for renewable energy development and energy efficiency.

Cross Reference to Statutes: Public Utility Regulatory Act §§14.002, 39.051, 39.102, 39.103, 39.104, 39.151, 39.152, 39.153, 39.154, 39.201, 39.202, 39.904 and 39.905.

§25.421. Transition to Competition for a Certain Area Outside the Electric Reliability Council of Texas Region.

- (a) **Purpose.** The purpose of this section is to address the process and the sequence of events for the introduction of retail competition in the portions of Texas served by El Paso Electric Company (EPE).
- (b) **Application.** This section shall apply to an electric utility that is subject to Public Utility Regulatory Act (PURA) §39.102(c), namely EPE.
- (c) **Readiness for retail competition.** The commission determines that the power region in which EPE is located will be unable to offer fair competition and reliable service to all retail customer classes in Texas upon the expiration of its system-wide rate freeze period in August 2005. Therefore, pursuant to PURA §39.103, the introduction of retail competition for the portions of the power region in Texas is delayed until this region can offer fair competition and reliable service to all retail customer classes.
- (d) **Cost-of-service regulation.** Until the date on which EPE is authorized by the commission to implement retail competition pursuant to this section, its rates are subject to regulation under Chapter 36 of PURA.
- (e) **Transition to competition.** The sequence of events set forth in paragraphs (1) through (5) of this subsection shall be followed to introduce retail competition in EPE's service territory. All the listed items in each stage must be completed before the next stage is initiated. Unless stated otherwise in the rule, each of the activities will be conducted by

the commission in conjunction with EPE and other interested parties. Full retail competition will not begin in EPE's service territory until completion of the fifth stage.

- (1) The first stage consists of the following activities:
 - (A) Develop and obtain approval of a regional transmission organization for the EPE region by the Federal Energy Regulatory Commission and commence independent operation of the transmission network under the approved regional transmission organization.
 - (B) Develop retail market protocols to facilitate retail competition.
 - (C) Complete an expedited proceeding to develop non-bypassable delivery rates for the customer choice pilot project to be implemented under paragraph (2)(A) of this subsection.
- (2) The second stage consists of the following activities:
 - (A) Initiate the customer choice pilot project pursuant to PURA §39.104 and §25.431 of this title (relating to Retail Competition Pilot Projects).
 - (B) Develop a balancing energy market, market for ancillary services, and market-based congestion management system for the wholesale market in the region in which the regional transmission organization operates.
 - (C) Implement a seams agreement with adjacent power regions to reduce barriers to entry and facilitate competition.

- (3) The third stage consists of the following activities:
- (A) EPE shall:
- (i) Prepare and file with the commission an application for business separation pursuant to PURA §39.051 and §25.342 of this title (relating to Electric Business Separation);
 - (ii) Prepare and file with the commission an application for unbundled transmission and distribution rates pursuant to PURA §39.201 and §25.344 of this title (relating to Cost Separation Proceedings);
 - (iii) Prepare and file with the commission an application for certification of a qualified power region pursuant to PURA §39.152; and
 - (iv) Prepare and file with the commission an application for price-to-beat rates pursuant to PURA §39.202 and §25.41 of this title (relating to Price to Beat).
- (B) The activities to be completed by the commission in the third stage are to:
- (i) Approve a business separation plan;
 - (ii) Set unbundled transmission and distribution rates;
 - (iii) Certify a qualified power region, which includes conducting a formal evaluation of wholesale market power in the region, pursuant to PURA §39.152;
 - (iv) Set price-to-beat rates for EPE; and

- (v) Determine which competitive energy services must be separated from regulated utility activities pursuant to PURA §39.051 and §25.343 of this title (relating to Competitive Energy Services).
 - (C) The activity to be completed by the regional transmission organization, the statewide registration agent and market participants in the third stage is testing of retail and wholesale systems, including those systems necessary for switching customers to the retail electric provider of their choice and for settlement of wholesale market transactions.
- (4) The fourth stage consists of the following activities:
 - (A) The commission shall evaluate the results of the pilot project pursuant to §25.431 of this title.
 - (B) EPE shall initiate capacity auctions pursuant to PURA §39.153 and §25.381 of this title (relating to Capacity Auctions) at a time to be determined by the commission.
 - (C) EPE shall separate competitive energy services from its regulated utility activities, in accordance with the commission order approving the separation of competitive energy services.
- (5) The fifth stage consists of the commission evaluating whether the power region can offer fair competition and reliable service to all retail customer classes. If the commission concludes that the power region can offer fair competition and reliable service to all retail customer classes, it shall issue an order initiating retail competition and directing EPE to complete the business separation and unbundling.

- (f) **Applicability of energy efficiency and renewable energy requirements.** Beginning January 1, 2006, EPE shall be subject to the energy efficiency requirements under PURA §39.905 and §25.181 of this title (relating to Energy Efficiency Goal) and the renewable energy credit requirements under PURA §39.904 and §25.173 of this title (relating to Goal for Renewable Energy).
- (1) EPE shall begin administering the energy efficiency programs prescribed in §25.181 of this title by January 1, 2006. EPE shall meet, at a minimum, 5.0% of its growth in demand through energy efficiency savings resulting from these programs by January 1, 2007 and 10% of its growth in demand by January 1, 2008, and each year thereafter.
- (2) EPE shall obtain, at a minimum, renewable energy credits in an amount sufficient to meet the requirements for the compliance period beginning January 1, 2006, and for each compliance period thereafter.
- (g) **Applicability of other rules.** This section governs the implementation of PURA Chapter 39 requirements as applied to EPE. If there is an inconsistency or conflict between this section and other rules in this Chapter (relating to Substantive Rules Applicable to Electric Service Providers), the provisions of this section shall control.
- (h) **Good cause.** Upon a finding of good cause, as determined by the commission, the sequence for retail competition set forth in subsection (e) of this section may be modified by commission order.

This agency hereby certifies that the adoption has been reviewed by legal counsel and found to be a valid exercise of the agency's legal authority. It is therefore ordered by the Public Utility Commission of Texas that §25.421, relating to the Transition to Competition for a Certain Area Outside the Electric Reliability Council of Texas (ERCOT) Region, is adopted with changes to the text as proposed.

ISSUED IN AUSTIN, TEXAS ON THE 18TH DAY OF OCTOBER 2004.

PUBLIC UTILITY COMMISSION OF TEXAS

PAUL HUDSON, CHAIRMAN

JULIE PARSLEY, COMMISSIONER

BARRY T. SMITHERMAN, COMMISSIONER