

**Report to the 79th
Texas Legislature**

***Scope of Competition
in Electric Markets
in Texas***

***Public Utility Commission of Texas
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ACKNOWLEDGEMENTS:

Public Utility Commission of Texas
Paul Hudson, Chairman
Julie Parsley, Commissioner
Barry T. Smitherman, Commissioner

W. Lane Lanford, Executive Director

Project Supervisor
Brian Lloyd

Project Team
Shawnee Claiborn-Pinto
Slade Cutter
Lauren Damen
Richard Greffe
Judith James
Nieves Lopez
Jeff Luna
Robert Manning
Matt Troxle
Sue Mainzer
Steve Hudson

In addition, special thanks to other PUC staff members who contributed to the preparation of this report:

Tammy Cooper
Martha Elvey
Tom Hunter
Mike Renfro
Keith Rogas
Jess Totten

2005 SCOPE OF COMPETITION IN ELECTRIC MARKETS IN TEXAS

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I. INTRODUCTION AND SUMMARY

During the last two years, the Public Utility Commission of Texas (Commission or PUC) has continued to implement the provisions of Senate Bill 7, which introduced retail competition in the electric market in Texas on January 1, 2002. Senate Bill 7 dramatically altered the provision of electricity from a monopoly regulated, cost based environment to one of competition among retail providers with market based pricing. The 2003 Scope of Competition in Electric Markets in Texas Report provided to the 78th Texas Legislature provides a more detailed discussion of the Senate Bill 7 market structure.

The Texas retail electric market has continued to develop and mature since the last Scope of Competition in Electric Markets in Texas Report. By most objective measures, Texas has the most robust, well-functioning retail market in the United States. The Center for the Advancement of Energy Markets' Retail Energy Deregulation Index ranks Texas as the number one competitive retail electric market in the North America, and number three in the world, based on twenty-two key attributes related to retail competition. New providers continue to enter the marketplace and develop new and innovative products for customers. Customers are becoming increasingly aware of their options in the marketplace, and are continuing to examine their options from various providers. As of September 2004, over one-million retail customers were taking service from a non-affiliated provider, and a total of 1.5 million switch requests had been processed by the Electric Reliability Council of Texas (ERCOT). While increasing natural gas and electricity prices have been a challenge to the development of the marketplace, market forces appear to be working well to provide competitive prices to customers.

The Commission continues to evaluate and monitor the operation of the competitive wholesale and retail market to ensure that the market continues to mature and develop with full and fair competition among providers and customers. This evaluation has led to the adoption of new rules to address issues not originally foreseen or to address deficiencies in the market design. The Commission has also modified previously adopted rules as needed to better conform those rules to a competitive marketplace, close loopholes, and better align economic incentives to produce economically efficient outcomes.

The Commission maintains regulation of the rates and service of investor-owned Transmission and Distribution Utilities (TDUs) and wholesale transmission rates, and the Commission is in the process of finalizing the stranded costs of the formerly bundled investor-owned utilities. The Commission also continues to regulate the price to beat rates of the affiliated retail electric providers (REPs) and approve fuel factor adjustments as warranted.

While retail competition is maturing in the areas of Texas in ERCOT, retail competition continues to be delayed in the non-ERCOT regions of Texas. While significant progress has been made in defining the market rules for the Entergy Gulf States, Inc. (Entergy) service territory, the Commission remains concerned about the pace of development of an independent transmission system operator(s) for the non-ERCOT regions of Texas, and has found that these regions are unlikely to be able to offer full and fair retail competition until those market institutions are further developed. The Commission continues to regulate the rates of utilities that have not opened to retail competition.

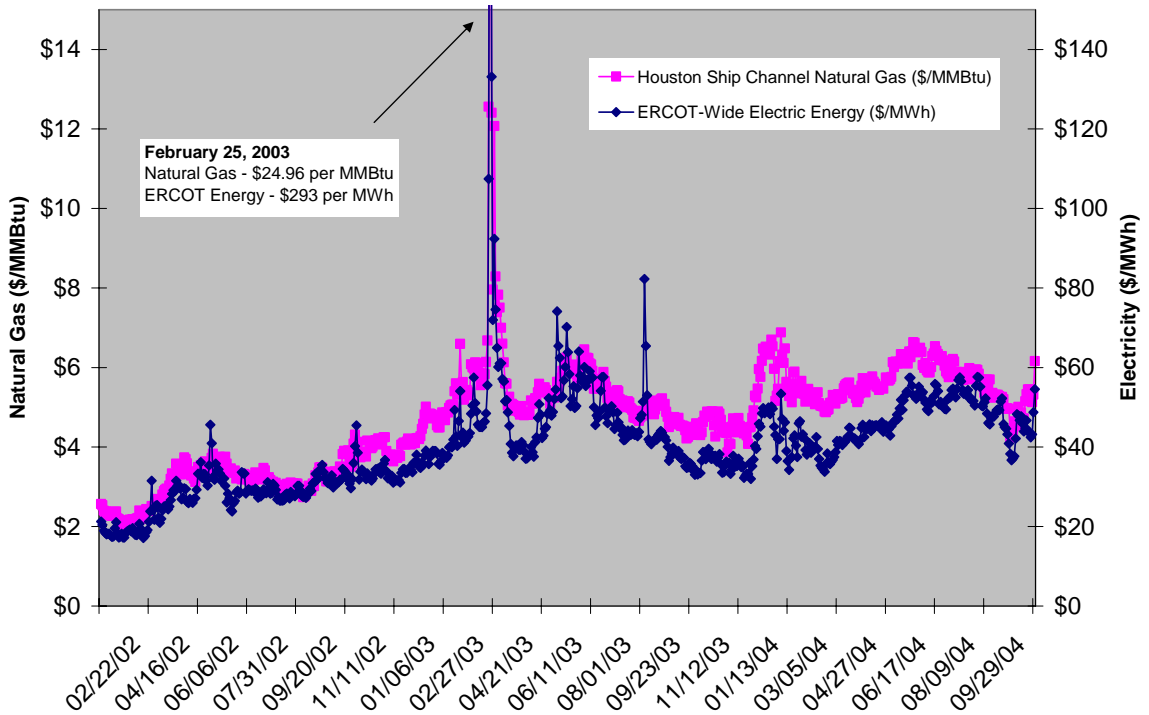
The Commission also increasingly focuses its efforts on the role of market monitoring and market oversight in both wholesale and retail markets in ERCOT. The Commission remains committed to aggressively enforcing the provisions of the Public Utility Regulatory Act (PURA) and Commission rules adopted to implement PURA.

Section II of this report provides a summary of these activities during the last two years, as well as customer education efforts and System Benefit Fund (SBF) administration.

Texas continues to see additional investment and entry into the electricity marketplace. Texas continues to see the addition of new generating plants, which have displaced older, less efficient units, while still contributing to projected reserve margins far in excess of the traditional standard of 15%. Furthermore, new REPs continue to enter the marketplace and compete for retail customers. In many cases, these providers are offering substantial discounts to the still-regulated “price to beat” that the incumbent providers are required to offer until January 1, 2007.

One of the primary challenges that the market has faced in the past two years is the dramatic increase in the price of natural gas and electricity, and the volatility that both of those markets have experienced. Both wholesale and retail electricity prices have increased from market opening due to the increased cost of natural gas.

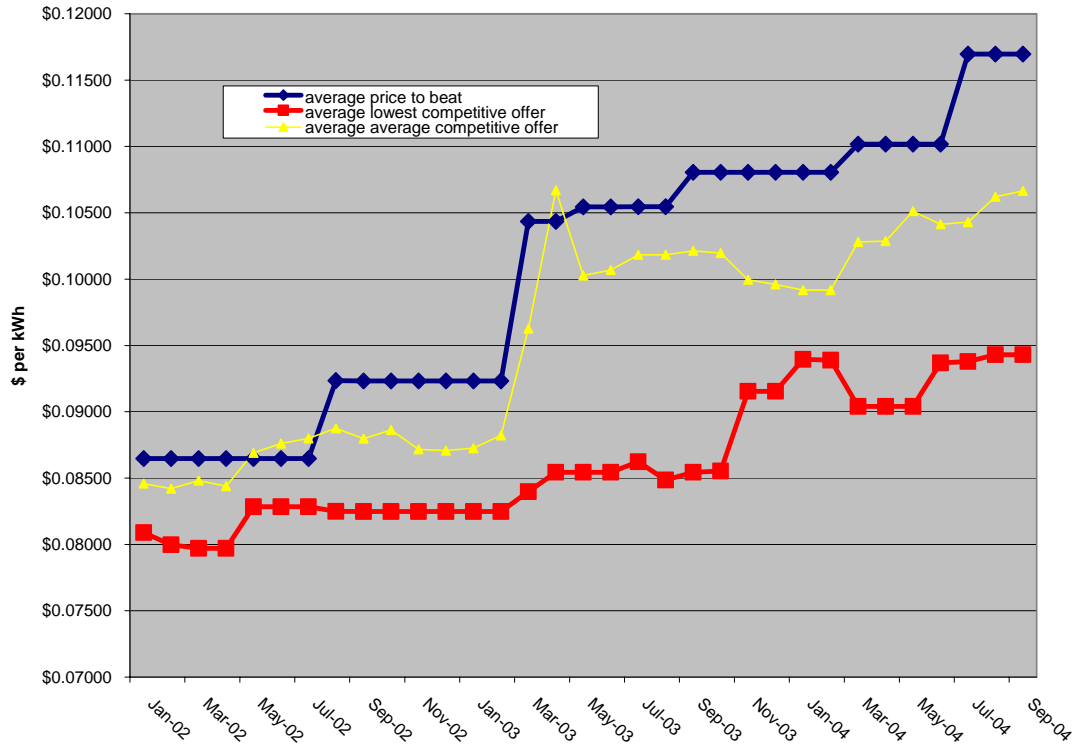
Figure 1: Daily Market Prices for Electricity and Natural Gas, 2002 - 2004



Source: Megawatt Daily

While these price increases and volatility have been challenging for both customers and market participants, new competitors continue to enter the market and are successfully winning customers away from the incumbent providers through lower prices. Notably, competitive prices have risen slower than the price to beat rates of the affiliated REPs, indicating that competitive pressures are resulting in the potential for increasing savings for customers compared to the price to beat. Also, rates for utilities that have not opened to competition also have increased due to natural gas price increases.

Figure 2: Average Residential Price to Beat vs. Average Competitive Offer vs. Average Lowest Competitive Offer, 2002 - 2004

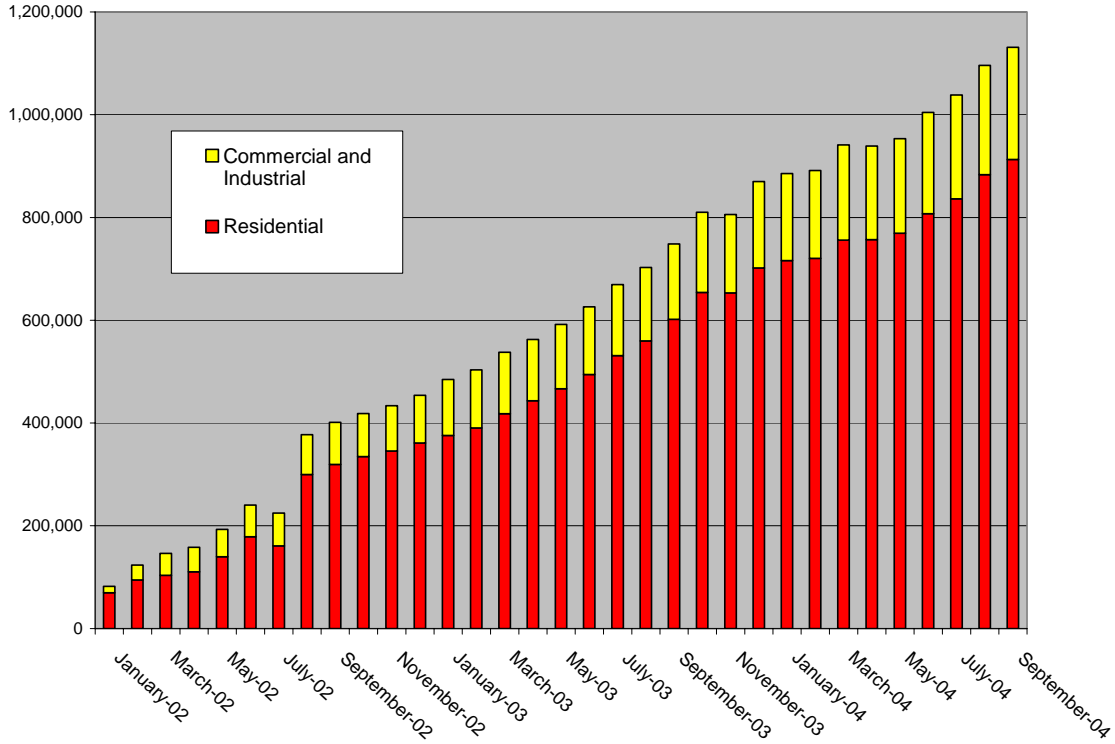


Source: Average Annual Rate Comparison for Residential Electric Service, Entergy Gulf States, Inc. Tariff Rates, PUC Electric Division

Section III of this report discusses the effects of competition on rates and the availability of electric services for customers in Texas.

As of September 2004, more than 1.1 million retail customers in Texas were taking service from REPs not affiliated with their local TDU, more than double the amount who had switched two years ago. More than 900,000 residential customers (18% of all residential customers) are currently served by non-affiliated REPs.

Figure 3: Number of Customers Served by a Competitive REP in ERCOT

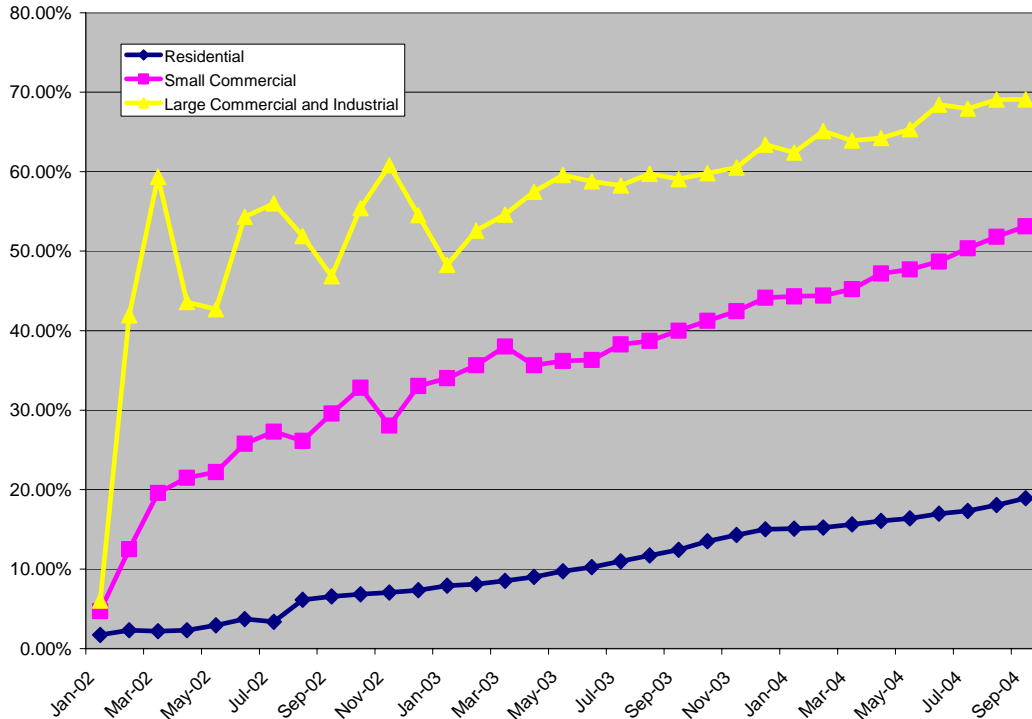


Source: Performance Measures Reports, Project No. 24462, PUC Electric Division

While commercial and industrial customers make up a smaller percentage of total customers who have switched, these customers have switched in much greater proportion within their class, and the larger customers in the classes have shown a greater propensity to switch. Over 50% of the megawatt-hours (MWh) sold to small commercial customers and nearly 70% of MWhs sold to large commercial and industrial customers in September 2004 were served by non-affiliated REPs.

It is also important to note that these statistics understate the level of competitive activity in the market, as some customers who had switched to a competitive provider have switched back to the affiliated REP. Additionally, non-residential customers may be receiving a competitive price from the affiliated REP (i.e. lower than the price to beat), and have thereby realized the benefits of retail competition.

Figure 4: Percentage of Load (Megawatt-hour sales) Served by Non-affiliated REPs, 2002-2004



Source: Performance Measures Reports, Project No. 24462, PUC Electric Division

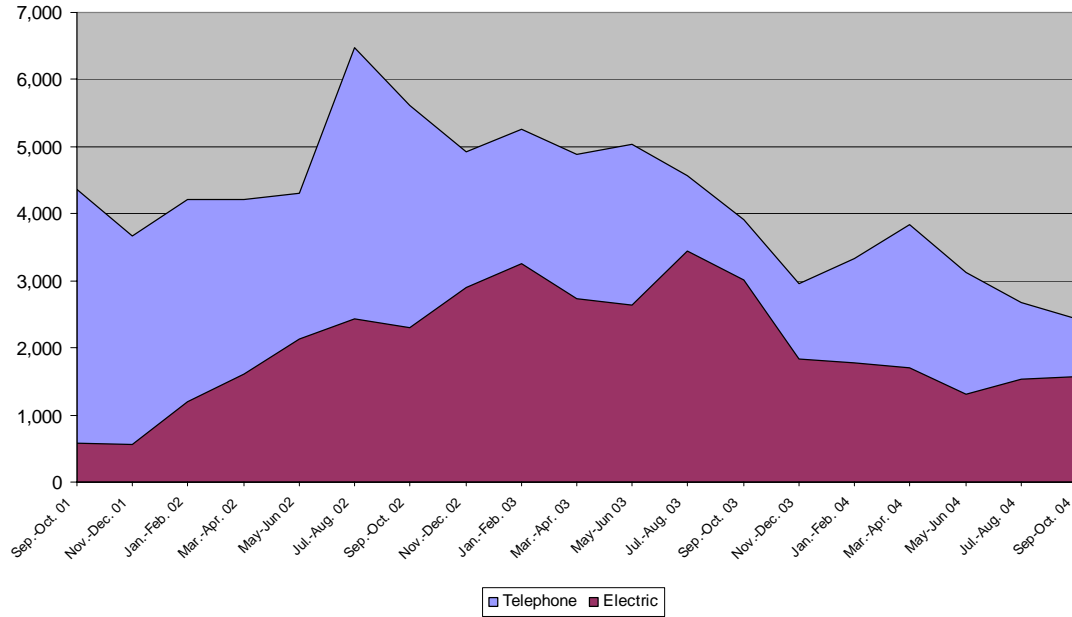
Section III of this report provides more detailed information on switching trends in the market.

Electric service related complaints have also begun to decline from the peak levels that occurred after the retail market opened to competition. These declines are attributed to:

- Electric service providers actively pursuing appropriate staffing and training strategies in their call centers to improve customer service and effectively handle their customers’ complaints.
- Success of the Commission’s ongoing education campaign, from which Texans are becoming more educated and knowledgeable on the subject of electric deregulation and their ability to choose an electric service provider.
- Continued collaboration between market participants and ERCOT to improve transaction processing.

Section IV of the report provides more detailed information on customer complaint issues, as well as other Senate Bill 7 goals, such as renewable energy and energy efficiency goals.

Figure 5: Total Complaints Received by the Commission, September 2001 - October 2004



Source: PUC Customer Protection Division

Section V of the report provides a discussion on the price to beat and potential options for the Legislature to discuss during the 79th Legislative Session. Section VI provides the Commission’s legislative recommendations. The Commission is recommending amendments to PURA that would:

- provide clear authority for the Commission to oversee the security of the electric grid in Texas and permit the Commission to suspend market rules in the event of an energy emergency declared by the Governor. The Commission also recommends amendments to the Open Meetings Act and Open Records Act with respect to the discussion and protection of security plans with respect to the electrical system in Texas;
- enhance the ability of the Commission to effectively enforce PURA and the Commission’s rules through amending the administrative penalty statute;
- permit the Commission to lower the discount that is required to be made available to low-income customers if sufficient funding does not exist to fund the current minimum discount of 10%;
- clarify the authority of the Commission to require refunds from market participants after a finding of market power abuses;

- clarify the authority of the Commission to ensure reasonable prices for ancillary services;
- clarify the authority of the Commission with respect to Qualified Scheduling Entities, Municipally Owned Utilities, and Electric Cooperatives;
- consider a revision to the current floor on electric utility deposits;
- clarify the appropriate uses of consumer credit information by REPs;
- clarify the authority of the Commission to declassify information after finding that the information is not competitively sensitive and in the public interest to release;
- clarify the authority of the Commission to ensure that nuclear decommissioning funds are protected and used appropriately;
- eliminate redundant and potentially conflicting language in the System Benefit Fund statute; and
- revise the provisions of the Utilities relating to interest rates that must be paid on utility customer deposits to reflect current financial conditions.

**II. SUMMARY OF COMMISSION ACTIVITIES FROM 2003 TO 2005 TO
REFLECT THE CHANGES IN THE SCOPE OF COMPETITION IN THE
ELECTRIC INDUSTRY**

The Commission continues to develop rules, policies, rates and procedures for the successful development of the competitive retail electric market in Texas. This development has occurred on the following tracks:

- the development and refinement of rules to implement Senate Bill 7, utilizing rulemaking procedures required by the Administrative Procedures Act (APA);¹
- the review and approval of price to beat fuel factor adjustments pursuant to PURA §39.202, and the review of whether or not 40% of small commercial load was being served by non-affiliated providers through contested cases at the State Office of Administrative Hearings (SOAH) and the Commission;
- the approval of the ERCOT Administrative Fee through contested proceedings at SOAH and the Commission;
- the finalization of the stranded costs of the formerly integrated utilities, including the reconciliation of the price to beat through contested cases at SOAH and the Commission;
- the review of rates for wholesale transmission service, the review of rates for electric retail delivery service, and the review of rates for regulated utilities that have not introduced customer choice through contested proceedings at SOAH;
- Market Oversight Activities, including enforcement activities and the assessment of administrative penalties for violations of PURA and the Commission's rules;
- continued efforts to explore the steps necessary to create adequate infrastructure to implement retail competition in the non-ERCOT areas of Texas;
- customer education activities;

¹ Administrative Procedures Act, TEX. GOV'T CODE ANN. §§2001.001-.902 (Vernon 200 & Supp. 2005)

- the certification of REPs and the registration of aggregators; and
- the administration of the SBF.

A. RULEMAKING ACTIVITIES

During 2003 and 2004, the Commission continued to implement new rules and refine existing rules in order to ensure that the necessary details for the successful operation of the competitive market are clearly defined. In some cases, the Commission has discovered a need for additional rules not originally developed prior to the opening of the retail market in 2002. In other cases, the Commission has found a need to revise previously adopted rules in order to provide additional clarity or to better conform the rules to the reality of the competitive market.

The APA prescribes a process for adopting new rules or amending existing rules that requires an agency to publish a proposed rule in the *Texas Register* for public comments, consider the comments it receives, and then adopt a rule with reasoned justification for its adoption, including a response to the public comments. In most of the rulemakings relating to retail and wholesale competition, the Commission has provided additional significant opportunities for interested persons to exchange views and suggestions through the solicitation of written comments and public workshops prior to the development of the proposed rule. While this process often takes a longer time than the standard APA process, the additional opportunities for interested persons to participate in the development of rules has resulted in more fully vetted proposed rules, and increased confidence in the rules by those who will have to comply with them.

1. Major Retail Market Rulemakings

a. Revision of Customer Protection Rules

The Commission focused significant efforts and resources during 2003 and 2004 toward revising Subchapter R of the Commission's Substantive Rules, which governs customer protections for customers in areas of Texas open to retail competition. This review was initiated after a year of operation of the competitive retail market in order to ensure that the Commission's rules provided necessary protections for consumers, while at the same time not being overly burdensome or expensive for REPs to implement.

The Commission adopted several new rules in June 2003² that addressed unforeseen issues that arose in the marketplace, such as premises with no REP of record, issues

² *Rulemaking to Revise Customer Protection Rules*, Project No. 27084, Order Adopting New §§25.487 - 25.490 (Jun. 18, 2003)

surrounding disconnection of premises when a customer moved out of the premise, and processes related to establishing new service for customers moving into the premises.

Additionally, the existing customer protection rules only permitted affiliated REPs to disconnect customers for non-payment, and limited the amount of deposits that REPs could require from customers as a condition of receiving service. Many REPs expressed concerns that these rules were leading to difficulties in operating in the market, did not adequately reflect the time required under Commission rules to cease providing service to non-paying customers, and were contributing to unsustainable levels of uncollectible revenue. The existing customer protection rules were also difficult to enforce in several respects and lacked sufficient detail on other items, such as time limits for reconnecting service to a customer.

The Commission also adopted several major changes to the existing customer protection rules in April 2004,³ including:

- adding more specificity and clarity to the processes required to authorize and verify a customer's choice of REP, including the documentation that must be provided by a REP if an enrollment is challenged;
- permitting greater flexibility for providers to market their products and services, provided that certain standardized information is made available to customers;
- permitting an increase in the amount of security deposit that REPs can require of customers as a condition of providing service in recognition of the length of time that REPs must provide service to customers before being able to disconnect or transfer a customer that does not pay the REP;
- requiring all REPs to offer deferred payment plans to customers who express an inability to pay, or in extreme weather conditions, with certain exceptions;
- permitting all REPs to disconnect customers for non-payment; and
- specifying the timelines in which REPs and TDUs must process reconnection requests once a customer remedies the reason for disconnection.

The Commission anticipates that it will continue to examine the customer protection rules as the market matures.

³ *Rulemaking to Revise Customer Protection Rules*, Project No. 27084, Order Adopting Amendments to Chapter 25, Subchapter A, §25.5 and Amendments, Repeal, and New Sections of Subchapter R, Customer Protection Rules For Retail Electric Service (Apr. 15, 2004).

b. Revision of Rules Relating to the System Benefit Fund and Low-income Discount Program

The Commission adopted changes to the processes used to enroll customers in the low-income rate reduction program required by PURA §39.903 in order to ensure that only eligible electric customers are enrolled in the program.⁴ The revised rules provide for the automatic enrollment of electric customers in the low-income discount program provided that the electric customer is currently receiving medical benefits or food stamps from the Texas Health and Human Services Commission (HHSC).⁵ The rules also permit customers whose household income is at or below 125% of the federal poverty level to “self-enroll” in the program at six month intervals through providing verification of their income level, if the customer is not otherwise automatically enrolled by virtue of the customer’s receipt of HHSC benefits.

These rule revisions were intended to address concerns that certain program participants were not eligible for the program because the initial process used to enroll customers in the program utilized the HHSC’s database of clients with the service address database maintained by the ERCOT registration database (used to track a customer’s selection of REP for purposes of wholesale settlement). The new process utilizes the customer lists of all the REPs serving residential customers, and matches those lists against the HHSC database. The rule revisions also shortened the self-enrollment period to six months from twelve months to better harmonize the self-enrollment process with the automatic enrollment process.⁶

The Commission believes that the rule revisions provide a more accurate matching process, and consequently, more accountability for the program.

c. Retail Market Performance Measures

In order for the Commission to monitor the competitiveness and technical systems of the retail electric market, the Commission requires data in the possession of ERCOT, TDUs and REPs. This rulemaking⁷ established a standard format for the reporting requirements for ERCOT, TDUs and REPs that focuses on the key indicators relating to the technical systems necessary to enable customers to enroll with alternative providers, receipt of timely electric service, and the competitiveness of the market.

⁴ *Modifications to Electric Low-Income Discount Rules*, Project No. 27711, Order Adopting Amendments to §25.451, §25.454, and §25.457 (Dec. 30, 2003).

⁵ Formerly the Texas Department of Human Services.

⁶ The majority of the HHSC programs used for automatic enrollment have a six-month enrollment period. The Commission is currently permitting self-enrolled customers to certify their continued eligibility at six months with a full re-enrollment at the end of twelve months on the program.

⁷ *Proceeding to Establish Performance Measures Relating to the Competitive Retail Electric Market*, Project No. 24462, Order Adopting New §25.88 (Apr. 2, 2003).

d. Price to Beat

PUC SUBST. R. 25.41, relating to Price to Beat, was amended to ensure that adjustments to the price to beat fuel factors reflect true and significant changes in market prices of natural gas, not temporary price spikes.⁸ The revised rule requires the use of a 20-day average of the forward 12 month average market clearing price of natural gas traded on the New York Mercantile Exchange (NYMEX) with a 5.0% materiality threshold instead of the ten-day average and 4.0% threshold contained in the original rule. The rule also provides that, following the stranded cost true-up proceedings, the Commission will adjust the fuel factors downward if natural gas prices have fallen below the level used to set the then-current fuel factors, as well as adjusting the price to beat to account for increases in non-bypassable charges resulting from the stranded cost true-up proceedings.

e. Evaluation of the Readiness of the El Paso Area for Retail Competition

The Commission adopted PUC SUBST. R. 25.421, relating to the Transition to Competition for a Certain Area Outside of the Electric Reliability Council of Texas (ERCOT) Region in recognition that the El Paso Electric (EPE) service area was approaching the September 2005 date for the introduction of retail choice established by PURA §39.102(c). The rule finds that EPE will be unable to offer full and fair competition at the expiration of its rate freeze in September 2005, delays the implementation of retail choice for EPE, and defines the process and the sequence of events for the introduction of retail competition in the portions of Texas served by EPE.

2. Major Wholesale Market Rulemakings

a. Bilateral Transaction Reports

More than 90% of the electricity in the Texas wholesale market is sold under bilateral contracts. The Commission adopted a rule that requires power generators, power marketers, and others who sell power at wholesale in Texas to file quarterly reports concerning their wholesale power transactions in the state.⁹ The information collected under this rule will deter anticompetitive behavior by increasing wholesale market transparency and improving the Commission's ability to investigate allegations of anticompetitive behavior, including market power abuse.

The rule adopted by the Commission was appealed by the cities of Garland, Denton, San Antonio and Austin. This appeal is pending at the Court of Appeals.

⁸ *Revisions to the Provisions of PUC Subst. R. 25.41, Relating to Price to Beat Fuel Factors*, Project No. 26556, Order Adopting Amendments to §25.41 (Mar. 5, 2003).

⁹ *Rulemaking Concerning Disclosure of Information Related to Electricity Transactions Originating or Terminating in Texas*, Project No. 26188, Order Adopting New §25.93 (Aug. 15, 2003).

b. Enforcement of Wholesale Market Rules

The Commission adopted new PUC SUBST. R. 25.503, *Oversight of Wholesale Market Participants*, in February 2004.¹⁰ The new rule establishes:

- the standards that the Commission will use in monitoring the activities of entities participating in the wholesale electric market in Texas and enforcing PURA, the Commission's rules, and the ERCOT Protocols;
- a description of the duties and prohibitions applicable to wholesale market participants, such as prohibitions on creating artificial congestion, withholding of generation from the market, "wash trades", and other types of market gaming activity;
- record keeping standards for market entities;
- a requirement for ERCOT to create a procedure for providing official interpretations and clarifications of ERCOT Protocols to requesting market participants;
- a requirement for ERCOT to develop and submit for Commission approval, a process to monitor material occurrences of non-compliance with the ERCOT Protocols; and
- the informal and formal investigation and enforcement procedures used by the Commission to enforce the rule.

The rule adopted by the Commission was appealed by several parties. This appeal is pending at the Court of Appeals.

c. Wholesale Market Design Issues

In July 2002, the Commission opened a project to evaluate the operation of the ERCOT wholesale market to determine if modifications were needed to the design and operation of the market. The project initially focused on developing a method to directly assign the costs of local transmission congestion to market participants that cause the congestion, thereby eliminating some of the incentives and behavior that lead to the unexpectedly high cost of resolving local congestion.

While considering several models to address the local congestion cost issue, additional market design issues were identified, including concerns about inadequate price signals to inform decisions regarding the locating of new generators, concerns about operational

¹⁰ *Rulemaking to Address Enforcement of Wholesale Market Rules*, Project No. 26201, Order Adopting New §25.503 (Feb. 9, 2004).

problems encountered by ERCOT operators that result from the lack of adequate information for specific generating units, and concerns about the lack of development of a liquid day-ahead market as an alternative to the predominantly bilateral market in ERCOT.

The Commission adopted PUC SUBST. R. 25.501, *Wholesale Market Design for the Electric Reliability Council of Texas*, in September 2003 to set forth the basic principles of a new market design for ERCOT.¹¹ Key elements of the rule include:

- requirements for ERCOT to permit market participants to self-schedule and bilaterally contract for energy and ancillary services;
- requirements that ERCOT require that bids for energy and other services procured by ERCOT in the day-ahead and real-time market be submitted on an individual generating unit basis;
- a requirement to directly assign the costs of resolving all transmission congestion, including local congestion, to the resources that caused the congestion; and
- a requirement for the use of nodal energy prices for resources and zonal energy prices for loads.

The rule also required ERCOT to develop the protocols and energy load zones to implement the market design elements using a stakeholder process, and to file the protocols and load zones, along with an independent cost-benefit analysis of the market design, with the Commission by November 1, 2004 for approval.

In October 2004, the Commission amended PUC SUBST. R. 25.501 in Project No. 30160.¹² The amendment modified the rule requirements by extending the deadline to file the market protocols and energy load zones to March 18, 2005, and requiring that the independent cost-benefit analysis, the draft protocols, and the draft energy load zones be filed with the Commission for informational purposes rather than formal approval.

d. Pricing Safeguards

In a well-functioning competitive electricity market, prices are disciplined by the normal forces of competition. However, there are circumstances in which competitive conditions may not prevail and safeguards are needed in order to protect customers from excessive prices, particularly because of the lack of cost-effective storage capacity and the inability of customers to respond to higher prices in the short run.

¹¹ *Wholesale Market Design for the Electric Reliability Council of Texas*, Project No. 26376, Order Adopting New §25.501 (Sep. 23, 2003).

¹² *PUC Rulemaking Proceeding concerning Implementation of a Nodal Market Design for the Electric Reliability Council of Texas*, Project No. 30160, Order Adopting Amendments to §25.501 as Approved at the October 28, 2004 Open Meeting (Oct. 29, 2004).

The Commission adopted a rule in December 2004 that requires ERCOT to develop protocols to mitigate the price effects of congestion on transmission lines in which competitive conditions do not exist, in conjunction with other wholesale market design changes. The rule also prohibits the submission of offers in ERCOT operated markets in excess of \$1,000 per megawatt-hour, and requires the disclosure of market participants who offer in excess of \$300 per megawatt-watt hour in those markets. The rule also requires that ERCOT be kept informed as to the identity of the entity controlling resources and specifies procedures for the designation of generation units as reliability-must-run (RMR) units.

e. Market Power Definition

The Commission has opened a rulemaking to develop an appropriate definition of the term “market power” to be applied to the wholesale electricity market in ERCOT.¹³ PURA §39.157 provides authority to the Commission to address market power associated with the generation, transmission, and sale of electricity in the state. In August 2004, Commission Staff distributed a strawman for the rulemaking to stimulate discussion and seek comments on key issues including the similarities and differences between market monitoring under PURA and antitrust law.

The Commission anticipates publishing a proposed rule in the first quarter of 2005.

3. Rulemakings Concerning Oversight of ERCOT

a. ERCOT Governance

In March 2003, the Commission adopted rules requiring ERCOT to adopt and comply with procedures for providing access to its meetings to market participants and the general public, including provisions on advance notice of the time, place, and topics to be discussed during open and closed portions of the meetings. The rule also required ERCOT to adopt and comply with procedures that allow persons to request and obtain access to records that ERCOT has, and requires ERCOT to provide information that is available for public disclosure within ten business days.

b. Allowable Fees and Rates of Independent Organizations

ERCOT is funded through a fee that is assessed to all entities scheduling power in ERCOT. This fee must be approved by the Commission, and ERCOT generally requests approval of its fee in the fall of each year. In October 2003, the Commission adopted several rules governing the process for approving the ERCOT fee, as well as specifying the manner in which ERCOT must maintain its accounts and records, the appropriate

¹³ *Rulemaking on Definition of Market Power*, Project No. 29042 (pending).

expense components to be included in ERCOT's fees and rates, and the method of calculating those rates.

Specifically, the Commission adopted PUC SUBST. R. 22.252, relating to Procedures for Approval of ERCOT Fees and Rates. Procedures for conducting a review of an ERCOT fee change had been developed by the Commission on an *ad hoc* basis in prior cases. Based upon its experience in those prior cases, the Commission decided to standardize the procedure it will use to review the reasonableness and sufficiency of ERCOT's fees.

Additionally, the Commission adopted amendments to PUC SUBST. R. 25.362, relating to Electric Reliability Council of Texas (ERCOT) Governance that requires ERCOT to provide quarterly reports to the Commission concerning the results of audits conducted by ERCOT, and a report on expenditures and annual long term operations plan.

The Commission also adopted PUC SUBST. R. 25.363, relating to ERCOT Fees and Other Rates. This rule requires ERCOT to maintain its books and records in accordance with Generally Accepted Accounting Principles, and to employ a standard chart of accounts on a consistent basis. Additionally, the rule provided additional guidance as to what expenses the Commission considers ineligible for inclusion in the ERCOT fee.

c. ERCOT Oversight

In November 2004, the Commission adopted two rules that will enhance the Commission's ability to execute its statutory duties in overseeing the operations of ERCOT. The amendment to PUC SUBST. R. 25.362 requires ERCOT to immediately report to the Commission any event or situation that could reasonably be anticipated to adversely affect the reliability of the regional electric network; the accounting procedures applicable to ERCOT or the ERCOT market; ERCOT's performance of activities related to the customer registration function; or the public's confidence in the ERCOT market or in ERCOT's performance of its duties.¹⁴ The amendment to PUC SUBST. R. 22.252 would remove a provision that allows a rate change to become effective on an interim basis if the Commission has not ruled on it in 120 days.¹⁵ Under the amended rule, a requested rate change will be deemed denied if the Commission fails to act before the date for final decision

¹⁴ *PUC Rulemaking Proceeding Concerning Oversight of the Electric Reliability Council of Texas (ERCOT)*, Project No. 29855, Order Adopting Amendment to §25.362 as Approved at the November 23, 2004 Open Meeting (Dec. 7, 2004).

¹⁵ *PUC Rulemaking Proceeding Concerning Oversight of the Electric Reliability Council of Texas (ERCOT)*, Project No. 29855, Order Adopting Amendment to §22.252 as Approved at the November 23, 2004 Open Meeting (Dec. 7, 2004).

4. Other Rulemakings

In addition to the major rulemakings discussed above, the Commission also conducted other minor rulemakings on the topics discussed below.

| Project No. | Topic | Date Adopted | Summary of Rule Provisions |
|-------------------------|---------------------------------------------|----------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 25516 | Load Profiling and Research | March 2003 | Clarifies responsibilities of TDUs and ERCOT with respect to load research and load profiling activities in order to ensure that the usage of retail customers is accurately assigned to their provider during the settlement process. |
| 26359/ 27244 | Competitive Metering | May 2003/ August 2003 | Permits commercial or industrial customers to chose and own their meter. Permits TDUs to continue to provide metering service to customers who do not prefer to own their own meter. |
| 27826 | Capacity Auction | July 2003 | Required sale of additional two-year strip of capacity by affiliated power generation companies. |
| 27903 | Energy Efficiency Implementation | August 2003 | Formalizes the work products developed through the energy efficiency implementation project, including energy efficiency program templates, deemed savings estimates and forms. |
| 26418 | Competitive Energy Services | September 2003 | Permits electric utilities to continue to offer certain competitive energy services, and to provide assistance to customers in case of emergencies. |
| 28715 | Energy Efficiency for Military Bases | December 2003 | Implements PURA §39.910, which provides incentives to military bases in areas not open to competition to reduce consumption by 5%. |
| 29159 | Electric No-Call List | August 2004 | Requires REPs that make non-exempt telemarketing calls to purchase the Electric No-Call List; and to provide information upon Commission request. |

| | | | |
|-------|-----------------------------------------------------------------------|---------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 29169 | Nuclear Generating Plant Decommissioning Fund | September 2004 | Prescribes the utility's responsibility for charging rates for the purpose of collecting funds for nuclear decommissioning trust funds after sale of a nuclear plant and provides for protection of the funds. |
| 29637 | Pro-forma Retail Delivery Tariff | Pending | Will consider amendments to standard Tariff for Retail Electric Delivery Service, which governs the relationship between TDUs and REPs. |
| 28884 | Transmission Planning, Licensing and Cost Recovery | Pending | Will consider amendments to the Commission's rules relating to transmission planning, licensing, and cost recovery in response to House Bill 2548 enacted by the 78 th Legislature. |

B. CONTESTED PROCEEDINGS

1. 40% Small Commercial Load Loss Threshold Cases

PURA §39.202(e) prohibits the affiliated REP from offering rates other than the price to beat to residential and small non-residential customers until the earlier of January 1, 2005, or when 40% or more of the electric power consumed by customers prior to competition is served by non-affiliated providers. During late 2003, five of the six affiliated REPs in Texas requested authority from the Commission to offer electricity to their small-commercial customers (1 MW of peak demand or less) at rates other than the price to beat. In early 2004, each of the requests was granted by the Commission, after confirmation of the affiliated REPs' claims.

2. ERCOT Fee Proceedings

In October 2003, ERCOT requested that the Commission grant it authority to increase the fee that it collects from market participants by thirteen cents per MWh. ERCOT's application with the Commission maintained that the increase was necessary to support its 2004 budget of \$173.9 million.¹⁶ This budget was approved by the ERCOT board and reflected a substantial increase over its 2003 budget of \$154.7 million.

¹⁶ The administrative fee provides the majority of ERCOT's funding. ERCOT also assesses other fees (i.e. membership fees) that provide revenue to ERCOT.

The Commission approved an eleven-cent increase in March 2004. The Commission did not approve the full increase because critical information was lacking from ERCOT's request. The increase that the Commission approved resulted in a new fee of \$0.44 per MWh, which is expected to generate \$129.4 million in annual revenue.

3. True-up Proceedings

The Commission is in the final stages of determining the stranded costs of the formerly bundled electric utilities in Texas. Stranded costs are the uneconomic portion of investments that utilities made in purchasing power and providing electric generation service when these functions were regulated. PURA §39.252 entitles an electric utility to recover all of its net, verifiable, nonmitigable stranded costs.

PURA provides for four methods that companies may use to establish the market value of generation assets. These methods generally involve either a sale of the assets, or a valuation through the issuance of stock in the generation companies of the former utilities. As reported in the 2003 Scope of Competition Report, Texas New-Mexico Power Company, CenterPoint, and AEP Texas Central Company (and their affiliated power generation companies) are the only companies required to finalize their stranded costs.¹⁷ Each utility is at a different point in the process of finalizing its stranded investment.

a. Texas New-Mexico Power Company (TNMP)

TNMP utilized the sales of asset method of valuing its generation assets through the sale of its sole generating unit to Sempra Energy Resources in October 2002 for \$120 million. This method requires that a bona-fide third party sale under a competitive offering be completed to establish the market value of the applicant's generation assets.

TNMP filed a claim of \$373 million in stranded investment in January 2004. In July the Commission issued its Order in which the valuation was reduced to approximately \$87 million, with additional adjustments to be calculated later relating to carrying charges and depreciation. The Commission found that TNMP failed to demonstrate that the generating unit had been sold in a bona-fide third-party transaction, and that TNMP engaged in certain actions that were not commercially reasonable.

b. CenterPoint Electric Delivery Company

CenterPoint chose the "partial stock valuation" method, which requires that the applicant's generation assets be transferred to a separate company in which at least 19% of the stock is spun off and sold to public investors and has traded for at least a year.

¹⁷ TXU entered into a settlement that was approved by the Commission that finalized TXU's stranded costs without the need to conduct a true-up proceeding (Docket No. 25230).

CenterPoint filed its application to finalize its stranded costs and other true-up items at \$4.4 billion in March 2004. In November 2004, the Commission issued an Order in which CenterPoint's stranded costs were determined to be approximately \$2.3 billion. The Commission found that CenterPoint failed to demonstrate that it had properly established the market value of its generating assets, and had engaged in certain actions that were not commercially reasonable.

c. AEP Texas Central Company

AEP Texas Central is tentatively scheduled to file its application to finalize stranded cost in early 2005, although meeting this goal depends upon negotiations it is conducting with potential buyers of its generating assets. AEP Texas Central completed the sale of 3,813 megawatts of generating assets, including eight natural gas plants, one coal-fired plant and one hydro plant, to a joint venture of Sempra Energy Partners and Carlyle/Riverstone Global Energy and Power Fund for approximately \$430 million in July 2004. Two other transactions, involving the sale of TCC's portions of the Oklaunion Power Station and the South Texas Project, are still pending.

4. Cap Rock Energy Corporation (Cap Rock)

SB 1280, passed by the 78th Legislature, amended PURA and made Cap Rock Energy an electric utility, subject to Commission oversight and rate regulation. SB 1280 also authorized the Commission to oversee the transition of Cap Rock to retail competition on an appropriate timeline.

In October 2003, the Commission Staff initiated a review into the rates of Cap Rock Energy in order to determine if Cap Rock's current rates were just and reasonable. This case is currently pending at SOAH, with a proposed decision expected during the first half of 2005.

5. Price to Beat Fuel Factor Revisions

The Commission processed sixteen requests by the five major affiliated REPs for adjustments to the price to beat fuel factors between January 2003 and September 2004 as permitted under PURA §39.202(1). The impact of these adjustments is shown in Section III.A.2.

6. Transmission and Distribution Utility Rate Proceedings

AEP Texas Central filed a request for an increase in the non-bypassable charges it assesses REPs and customers for access to the transmission and distribution system in November 2003. This case is currently pending at SOAH, with a decision expected in early 2005.

Additionally, the Commission has conducted nine wholesale transmission rate proceedings and three interim wholesale transmission cost recovery proceedings since January 2003. Three additional cases are currently pending.

C. MARKET OVERSIGHT ACTIVITIES

Market monitoring of both wholesale and retail electric markets has become an important function of the Commission in order to ensure that consumers receive the full benefits of competitive markets.

Market oversight, in its most general sense, involves the Commission and Commission Staff actively monitoring the operation of the competitive market on a day to day basis, through analyzing prices and behavior in the market. This monitoring allows the Commission to evaluate the actual operation of the market rules adopted by the Commission and ERCOT. This evaluation is critical to illuminating imperfections or loopholes in the rules that market participants can exploit to the detriment of other competitors and consumers. Many of the recent rulemaking proceedings discussed in Section II.A of this report were initiated for this reason.

Vigilant market oversight also permits the Commission to ensure that the requirements of Commission rules and orders, PURA, and the ERCOT Protocols are followed by all market participants. This monitoring is conducted through analyzing routine reports that the Commission requires market participants to file, independent analysis by the Commission Staff through formal and informal informational requests to specific market participants, and through monitoring of customer complaint trends.

When violations or possible violations are discovered, the Commission and its staff utilize multiple methods to compel compliance. For minor violations of rules or reporting requirements, the Commission Staff generally attempts to obtain compliance through informal discussion with the providers, or through formalized requests for remedial actions. In many cases, these attempts are successful in achieving rule compliance, and are more efficient than utilizing the formal notice of violation/administrative penalty assessment procedure.

In cases of continued non-compliance or serious violations of Commission rules, the Commission Staff prepares a formal recommendation for administrative penalties (and requests for refunds or disgorgement of revenues when appropriate). In many cases, the staff is successful in reaching settlements with the market participants who have committed the alleged violation, and a joint settlement is submitted to the Commission for approval. In other cases where settlement is unable or unlikely to be achieved, the Executive Director issues a formal Notice of Violation (NOV) pursuant to PURA §15.024. Following issuance of the NOV, the alleged violator has the option of (1) paying the recommended penalty, (2) requesting a settlement conference, or (3) requesting a hearing at SOAH.

1. Retail Market Oversight

a. Oversight Activities

The Retail Market Oversight Section of the Electric Division and the Enforcement Section and Electric Section of the Legal and Enforcement Division coordinate activities regarding oversight of the retail electric market. Oversight of the retail electric market is performed in several ways:

- ongoing review of the operation of the market as measured through the number of providers in the market, retail prices in the market, switching rates, and other competitive market indicators;
- ongoing review of the appropriateness and completeness of Commission rules governing the operation of the retail market, including customer protections;
- detection and investigation of possible violations of Commission rules, PURA, or the ERCOT Protocols through planned compliance monitoring, ad hoc compliance monitoring, evaluation of reports of violations by other market participants, and the informal complaint process; and
- informal and formal attempts to compel compliance when potential violations are discovered.

b. Investigations and Enforcement Activities

In addition to the informal resolution of minor matters of non-compliance, eight notices of violation have been resolved since January 2003, resulting in the assessment of over \$1.5 million in administrative penalties. An additional three notices of violation recommending penalties of over \$166,000 and refunds to customers of over \$1 million are pending.

- Docket No. 28306**, *Notice of Violation (NOV) of Republic Power d/b/a Energy America for Violation of PUC SUBST. R. 25.474(c)(3)(F) and PUC SUBST. R. 25.475(c)(5)(B) and 25.475(f)(1) (relating to Selection of Changes of REP and Information Disclosures to Residential and Small Commercial Customers*

The NOV issued in Docket No. 28306 initially addressed processes used by Energy America to enroll customers that were not compliant with the Commission's rules. Ultimately, the Commission Staff and Energy America reached a settlement that was subsequently approved by the Commission, resolving all potential violations of Commission rules, including concerns about door-to-door marketing, up to August 31, 2003. As part of the settlement, Energy America agreed to pay an administrative penalty of \$750,000 and to take other remedial actions. In addition, Energy America agreed, for

a one-year period, to advance review of all marketing materials, call center scripts, etc. by Commission Staff prior to their use to ensure continued compliance.

- ii. Docket No. 28604**, *Notice of Violation by Andeler Corporation for Violation of PUC SUBST. R. 25.454(d) and PUC SUBST. R. 25.451(j)(Relating to Rate Reduction Program, and Reimbursement for the Rate Reduction Discount)*

The NOV issued in Docket No. 28604 alleged that Andeler Corporation (Andeler) failed to properly provide the low-income discount required by PURA §39.903 to eligible low-income customers and failed to file reports with the Commission demonstrating its compliance with Commission rules. Andeler and Commission Staff reached a settlement that was approved by the Commission in which Andeler agreed to pay an administrative penalty of \$16,000, and to provide retroactive discounts to the customers to whom Andeler had failed to initially provide discounts.

- iii. Docket No. 29661**, *Agreed Notice of Violation and Settlement Agreement Relating to TXU Energy Retail Company LP's Violation of PUC SUBST. R. 25.41 and PURA §39.202(e)*

The Settlement and Agreed NOV filed by Commission Staff and TXU Energy resolved potential violations by TXU Energy of the price to beat pricing restrictions contained in PURA §39.202 and PUC SUBST. R. 25.41. Commission Staff alleged that TXU Energy violated the prohibition on affiliated REPs of offering prices other than the price to beat until January 1, 2005 by enticing customers to switch back to TXU Energy in exchange for a gift certificate. As part of the settlement, TXU Energy agreed to pay an administrative penalty of \$220,000.

- iv. Docket No. 29645**, *Agreed Notice of Violation and Settlement Agreement Relating to Oncor Electric Delivery Company's Violation of PUC SUBST. R. 25.214* and **Docket No. 29647**, *Agreed Notice of Violation and Settlement Agreement Relating to TXU Energy Retail Company LP's Violation of PUC SUBST. R. 25.474*

The settlements achieved in these dockets resulted from the improper disconnection of a traffic signal light in the City of Irving caused by TXU Energy's unauthorized switching of the account. TXU Energy agreed to pay an administrative penalty of \$4,000 for the unauthorized switch of the account, and Oncor Electric Delivery Company (now TXU Electric Delivery Company) agreed to pay an administrative penalty of \$4,000 for the improper disconnection of the traffic light.

- v. Docket No. 29646**, *Agreed Notice of Violation and Settlement Agreement Relating to TXU Energy Retail Company LP's Violation of PUC SUBST. R. 25.474*

The settlement achieved in this proceeding resolved the improper enrollment of 48 customers through forged letters of authorization by two agents of TXU Energy. TXU Energy discovered the forgeries and halted or reversed suspect enrollments from its agents, and self-reported the violation to the Commission. As a result, the Commission

approved an administrative penalty substantially below the standard penalty of \$5,000 per violation. TXU Energy agreed to pay an administrative penalty of \$29,000 for the 58 violations.

vi. Docket No. 30198, *Agreed Notice of Violation and Settlement Agreement Regarding TXU Energy Retail Company LP's Alleged Violation of PURA §39.101(b)(6)*

The settlement achieved in this proceeding resolved allegations raised by the Commission Staff concerning deceptive marketing by TXU Energy due to factual inaccuracies discovered in a TXU Energy radio advertisement, as well as concerns about advertisements suggesting that TXU Energy could provide a greater level of reliability compared to other REPs. TXU Energy agreed to pay an administrative penalty of \$530,000 and agreed to certain restrictions on future advertisements to address the Staff's concern.

vii. Docket No. 30064, *Investigation into Mutual Energy SWEPCO's Implementation of its Proposed Fuel Factor in Docket No. 27873*

The settlement achieved in this docket resolves the imposition of a fuel factor change prior to approval of the change and the issuance of an order by the Commission approving the change. Mutual Energy SWEPCO agreed to pay an administrative penalty of \$26,000 in addition to agreeing to a disallowance in a future fuel reconciliation proceeding.

viii. Docket No. 30158, *Notice of Violation by Hino Electric Power Company for Violation of PUC SUBST. R. 25.454(f)(3)(A)*

The NOV issued in this docket resulted from Hino Electric's failure to comply with PUC SUBST. R. 25.454, relating to Rate Reduction Program, which requires REPs serving residential customers to submit their customer list to the Low-Income Discount Administrator (LIDA) in order to ensure that all eligible customers receive the low-income discount required by PURA §39.903. While a violation of this type would not normally result in a formal NOV, Hino had received previous warnings from the Commission Staff concerning this requirement, and Hino's continued non-compliance caused increased costs to the Commission and the LIDA, delayed the monthly process that results in REPs being informed of which of their customers should receive the discount, and may have prevented some customers from properly receiving the discount. The recommended administrative penalty for this violation is \$500. This case is currently pending at SOAH.

ix. Docket No. 30215, *Notice of Violation by Cap Rock Energy of PUC SUBST. R. 25.28(b), Relating to Bill Payments and Adjustments*

The NOV issued in this docket alleged that Cap Rock Energy continued to assess late fees on residential customer bills after September 1, 2003, when Cap Rock became subject to regulation by the Commission as an investor owned utility. Such late fees are prohibited by Commission rule. The NOV recommends that Cap Rock be ordered to

refund approximately \$318,000 related to the allegedly improper fees, and to pay an administrative penalty of \$34,000. This case is currently pending at SOAH.

- x. Docket No. 30216**, *Notice of Violation by Cap Rock Energy of PUC SUBST. R. 25.28(b), Relating to Equality of Service and Rates and PUC SUBST. R. 25.241(b), Relating to Form and Filing of Tariff*

The NOV issued in this docket alleged that Cap Rock Energy inappropriately billed customers a “Regulatory Surcharge” that was not enumerated in Cap Rock’s tariff after September 1, 2003, when Cap Rock became subject to regulation by the Commission as an investor-owned utility. The NOV recommends that Cap Rock be ordered to refund approximately \$885,000 related to the allegedly improper fees, and to pay an administrative penalty of \$132,000. This case is currently pending at SOAH.

- xi. Project No. 29795**, *PUC Staff Investigation into Compliance with Code of Conduct Requirements for TXU Affiliates*

This project was opened by Commission Staff in response to concerns that certain interactions between TXU Electric Delivery and its affiliated REP, TXU Energy, violated certain restrictions contained in the Commission’s rules and PURA with respect to interaction between TDUs and their competitive affiliates. This investigation is ongoing.

- xii. Project No. 30199**, *Notice of Probable Non-Compliance by Hino Electric Power Company with PUC SUBST. R. 25.483(b)(2)*

This project was initiated as a result of Commission Staff becoming aware through reports filed at the Commission that Hino Electric was requesting disconnection of customers for non-payment prior to having authorization to do so. Commission Staff issued a request for information to Hino, and is the process of reviewing Hino’s response to determine if violations of Commission rules occurred.

2. Wholesale Market Oversight

a. Oversight Activities

The Market Oversight Division and the Enforcement Section and Electric Section of the Legal and Enforcement Division coordinate activities regarding oversight of the wholesale electric market. Similar to retail market oversight, oversight of the wholesale electric market is performed in several ways:

- ongoing review of the operation of the market as measured through analyzing wholesale prices in the market, the sufficiency of bids into ERCOT operated markets, and other competitive market indicators;
- ongoing review of the appropriateness and completeness of Commission rules and the ERCOT Protocols governing the operation of the wholesale market; including identifying gaming opportunities;

- detection and investigation of possible violations of Commission rules, PURA, or the ERCOT Protocols through planned compliance monitoring, ad hoc compliance monitoring, and analyzing reports of violations by other market participants;
- detailed analysis and investigation of the operation of the ERCOT wholesale market using computerized models of indices, screens and reports that can be used to summarize and review large amounts of market data on a daily basis developed by a consultant retained by the Commission, Potomac Economics; and
- informal and formal attempts to compel compliance when potential violations are discovered.

b. Investigations and Enforcement

i. Extreme Weather Event

Extreme and unexpected cold weather conditions on February 24-26, 2003 left many electric generators in ERCOT scrambling to keep their units on line and meet greater than expected demand. Freezing temperatures and freezing precipitation hampered normal plant operations and led to curtailments of natural gas supplies. At noon on February 25, ERCOT declared an emergency condition and requested that all available generation be brought on line.

During the weather event, no load needed to be shed in order to preserve reliability, but for brief periods the prices in the ERCOT Balancing Energy Market¹⁸ rose to \$990/MWh and prices in other ERCOT operated ancillary services markets reached \$967/MW. Investigation of the event identified several serious market and reliability issues.¹⁹

One major issue was the impact of “hockey stick” bidding on market prices. Hockey stick bidding occurs when a market participant offers a small portion of its capacity or energy at an extremely high price. Under normal circumstances, these small amounts of energy and capacity are not needed, and therefore do not affect prices. However, during the extreme weather event, ERCOT needed all of the energy bid into the Balancing Energy Market, and the resulting price was set by a hockey stick bid. The Commission has estimated that the additional cost for acquiring the balancing energy was at least \$17 million as a result of this bid.

¹⁸ ERCOT obtains and deploys balancing energy to maintain the balance between load and generation and to resolve transmission congestion through a centralized auction process known as the Balancing Energy Market.

¹⁹ *PUC Investigation into Possible Manipulation of the ERCOT Market*, Project No. 25937, “Market and Reliability Issues Related to the Extreme Weather Event on February 24-26, 2003,” May 20, 2003.

In August 2003, the Commission adopted new rules to mitigate the impact of hockey stick bidding.²⁰ The mitigation plan becomes effective at times when there is no congestion, but for whatever reason, ERCOT is forced to utilize all the bids available. The rules set a variable limit on the price of balancing energy that will significantly reduce the impact of hockey stick bidding, while still providing adequate compensation to all other providers of energy.

Another major issue that was identified was the problem of inaccurate and outdated information submitted to ERCOT. Qualified Scheduling Entities (QSEs) submit plans to ERCOT each day that serve to inform ERCOT of the status and capability of generating units (and load that is available to be curtailed²¹) for the next day. QSEs are required to continually update their plans as needed to reflect changes from what was originally submitted. During February 24 and 25, some generating resources were not able to produce at the levels indicated in the original plans due to operating limitations and natural gas curtailments. The failure of certain QSE's to update their plans meant that ERCOT operators were often trying to respond to the unexpected conditions by attempting to deploy resources that were not really available.

In order to address this problem, ERCOT stakeholders developed a set of performance measures to measure the accuracy and consistency of resource plans. ERCOT compliance staff now monitors QSE performance on an ongoing basis, and poor performance is reported to the Commission.

ii. TCE Allegations of Market Manipulation

A major consequence of the high balancing energy prices during the extreme weather event in February 2003 was that Texas Commercial Energy (TCE), a certified REP, filed for Chapter 11 bankruptcy protection. TCE was relying entirely on the ERCOT Balancing Energy Market to serve its customers during the extreme weather event, and consequently incurred significantly higher than expected costs during February 2003. TCE filed a federal antitrust lawsuit alleging that TXU and other market participants manipulated the Balancing Energy Market in order to increase prices. The Commission Staff conducted an investigation into the allegations that could be analyzed using actual market data.

The investigation found no violations of Commission rules or the ERCOT protocols by TXU.²² However, the investigation identified the concern that TXU is routinely guaranteed to be selected in an ERCOT balancing energy auction regardless of offer price because of TXU's size and the amount of generation TXU bids into the balancing energy

²⁰ *Report of the Electric Reliability Council of Texas (ERCOT) to the PUCT Regarding Implementation of the ERCOT Protocols*, Docket No. 24770, Final Order (Aug. 22, 2003).

²¹ In lieu of relying on generating units to provide additional power when needed, certain customers agree to curtail their operations and reduce their demand on the system in exchange for a lower rate or for a payment that reflects the need to buy less power.

²² *PUC Investigation into Possible Manipulation of the ERCOT Market*, Project No. 25937, "Staff Inquiry Into Allegations Made by Texas Commercial Energy Regarding ERCOT Market Manipulation," Jan. 28, 2004.

market. This special position is of fundamental concern because it provides a supplier with the potential to harm the competitive market, either intentionally or unintentionally.

As discussed above, the Commission has adopted additional rules on pricing safeguards to address issues of market power in Project No. 27917, *Rulemaking on Pricing Safeguards for ERCOT-Operated Wholesale Markets*.

iii. Costs for Local Balancing Energy in June 2003

ERCOT uses balancing energy to manage local transmission congestion when at least three unaffiliated generators submit bids that would solve the congestion, but no one of the three is essential to solving it. At times, certain generators that are required to submit a certain level of bids (needed to be sure ERCOT has appropriate capacity to manage congestion) may have a preference to not be deployed by ERCOT due to operational or other issues. These generators can submit a very high bid to indicate that preference, and are usually not selected by ERCOT because of that high bid. If there are insufficient unaffiliated generators who submit bids, ERCOT solves the congestion using cost based payments to the resources that can solve the congestion. Costs related to solving this type of congestion unexpectedly reached nearly \$60 million in June 2003.

After the new 1,220 MW Kiamichi generating facility came on line in the spring of 2003, ERCOT began experiencing local congestion on the Farmersville-Royce (F-R) transmission line in northeast Texas.²³ With the addition of this new generating facility, the three unaffiliated generators test was met, triggering the use of the market based pricing mechanism. However, three of the four entities representing the unaffiliated generators continued to submit bid premiums up to \$1,000/MWh, and because those bids were selected, the costs for resolving the congestion increased dramatically.

The four generators associated with the congestion agreed to adjustments to the payments they received as a result of the market rules that presumed a competitive bidding environment where none in fact existed. Agreements were reached with all four market participants that resulted in a reduction of more than \$51 million in payments related to this congestion. The market rules were subsequently revised so that this type of event would not happen again.

iv. Wind Energy Scheduling Issues

Due to the rapid expansion of wind resources in the McCamey area of West Texas, the McCamey area transmission system did not have sufficient capacity to handle the maximum wind energy output. When needed in order to resolve congestion and prevent damage to transmission equipment, ERCOT ordered curtailments of wind resources and provided compensation to the curtailed resources. In 2002, the total amount of payments associated with these curtailments of wind was approximately \$9 million. Upon discovery of certain types of scheduling behavior that suggested that more energy was being scheduled from some of these facilities than could actually be produced, Commission Staff initiated several investigations to evaluate the possibility that certain

²³ The Kiamichi generating facility is located in Oklahoma, but it is connected to ERCOT by a dedicated transmission line.

market participants may have been intentionally over-scheduling their generation units in an attempt to secure improper payments.

While the Commission Staff was reviewing these issues, one QSE approached the Staff to discuss their scheduling activities for their McCamey wind resources. The QSE admitted that its schedules for some periods had been inaccurate, and because of these inaccuracies, the QSE received curtailment payments that it would not have received had its scheduling been more accurate. The QSE denied that it had intentionally mis-scheduled its resources, and noted the inherent difficulty in scheduling these types of resources. The Commission approved a settlement agreement with the QSE that resulted in the return of \$1.9 million of curtailment payments related to the McCamey area from 2002.

Subsequent to these events, ERCOT stakeholders modified the ERCOT Protocols to eliminate virtually all of these types of payments in the McCamey area. In addition, since the beginning of 2003, more than 110 circuit miles of transmission lines have been built or upgraded in the McCamey area, and an additional 50 circuit miles of line will be completed by June 2005.²⁴ The ERCOT Board has approved additional 345 kV transmission lines to be built when the sum of interconnection agreements in the McCamey area reaches 1,500 MW and 2,000 MW.

v. ERCOT State of the Market Report 2003

The Commission hired a consulting economics firm to assist in monitoring the wholesale electric market in Texas. The firm, Potomac Economics, has developed a computerized model of indices, screens, and reports that can be used to summarize and review large amounts of market data on a daily basis.

The consultant also analyzed wholesale market operations and produced a major report on the state of the ERCOT market in 2003.²⁵ The report summarizes market outcomes, assesses the efficiency and incentives provided by the current market rules and procedures, and evaluates the behavior of market participants. The report finds that the performance of the ERCOT market has generally been improving due to changes in the market rules and software and the experience gained by market participants. However, the report also finds that the ERCOT market suffers from several operational issues and inefficiencies that can be attributed to the current scheduling, bidding, and congestion management rules that do not require market participants to provide information on each individual generating unit. The report provides a number of recommendations for improvement and notes that many of the identified issues would be effectively addressed by a nodal market design.

²⁴ "Report on Existing and Potential Electric System Constraints and Needs within the ERCOT Region," Electric Reliability Council of Texas, Oct. 1, 2004, p. 32.

²⁵ "2003 State of the Market Report for the ERCOT Wholesale Electricity Markets" Economics, Ltd., August 2004. The full report is available at the following location: <http://www.puc.state.tx.us/electric/reports/index.cfm>

vi. Balancing Market Price Spikes

At the end of July 2004, frequent price spikes began to occur in the ERCOT Balancing Energy Market. These events occurred during periods when ERCOT used all (or nearly all) of the available balancing energy, but were concerning because many of these spikes occurred during off-peak periods rather than on-peak periods. An investigation determined that these price spikes were likely caused by three factors: (1) suppliers not offering their excess energy into the balancing energy market, (2) inadequate information provided to ERCOT concerning the “ramp rates” of generating units,²⁶ and (3) procedures utilized by ERCOT for resolving local transmission congestion.²⁷

The Commission has initiated several investigations in order to further explore these issues.

3. ERCOT Oversight

In May 2004 the Commission became aware of possible criminal activity, fiscal mismanagement, and security problems at ERCOT.

Acting pursuant to its oversight authority in PURA §39.151, the PUC required ERCOT to retain several independent auditors to assess managerial and financial controls and security adequacy. The initial audits were issued November 15, 2004 and included a managerial audit and risk assessment performed by Deloitte and Touche, LLP and a security assessment performed by Ernst & Young. Both sets of audits found room for improvement within ERCOT, especially with respect to a lack of formalized policies and procedures for key managerial and financial duties.

It is important to note that the Commission has no reason to believe that the alleged improprieties at ERCOT have in any way affected the reliability of the electric grid in ERCOT or market operations. The Commission continues to work with ERCOT to implement corrective action to ensure efficient and effective operations at ERCOT.

D. NON-ERCOT UTILITIES MARKET DEVELOPMENT ACTIVITIES

Full retail competition in all areas of Texas outside of ERCOT has been delayed either by legislative mandate or order of the Commission. SB 7 delayed competition for the El Paso Electric (EPE) service area until the end of the rate freeze period extending through August 2005 resulting from EPE’s bankruptcy proceeding in 1995. The Legislature

²⁶ “Ramp rate” refers the rate at which a generating unit can increase or decrease its output.

²⁷ *PUC Investigation into Possible Manipulation of the ERCOT Market*, Project No. 25937, “Analysis of Recent Balancing Energy Price Excursions,” Oct. 1, 2004.

delayed competition in the Southwestern Public Service Company service area until 2007, at the earliest.

The Commission delayed competition for the Entergy Gulf States, Inc. (Entergy) and Southwestern Electric Power Co. areas due to a lack of independence in the administration of transmission services, a lack of necessary market institutions and a lack of open and non-discriminatory access to the transmission grid.

Since 2003, the Commission has continued to focus efforts on evaluating the prospects for robust retail competition and developing market rules for the Entergy and EPE service areas.

1. Entergy Gulf States, Inc.

After the decision to delay competition in the Entergy area in 2001, the Commission initiated a project to transition the Entergy service territory to full retail competition. Entergy, interested REPs, end-use customers, and Commission Staff began the process of drafting market rules (Protocols) in early 2003 for the portion of Entergy in Texas. The Commission ultimately approved a set of Protocols for use in the territory assuming that at some point, an independent entity (such as a Regional Transmission Organization (RTO), or other independent system operator) would oversee the transmission system. Entergy filed the Protocols with the Federal Energy Regulatory Commission (FERC), which approved the Protocols on December 22, 2004.

Because Entergy is not currently in a RTO, there is no independent overseer of the transmission system. Since open and non-discriminatory access to the transmission grid is essential for a competitive market, independent oversight of transmission service is vital. Entergy proposed that the Entergy transmission company, with oversight by an independent third party, could effectively fill the role of an RTO, until a full, FERC approved RTO could become functional. The Commission ultimately concluded that Entergy could not fill this role in a truly independent manner, and the Commission ordered the further delay of retail competition until Entergy joins a FERC-approved RTO or another independent organization that meets the requirements of PURA §39.151(b).

2. El Paso Electric

PURA §39.102 provided a delay in the start of retail competition for a utility that was under a system-wide rate freeze that extended beyond 2001. As a result, retail competition was not scheduled for EPE until its current rate freeze expires in 2005.

After conducting workshops in El Paso and Austin and soliciting comments, the Commission adopted a rule, finding that the area in which EPE is located is unable to offer fair competition to all retail customer classes in Texas, and further delayed customer choice beyond 2005. The rule also provides that EPE's rates will be regulated under traditional cost-of-service regulation until the date on which the Commission authorizes EPE to implement full customer choice.

The Commission also established a sequence of market development activities that must be completed prior to the introduction of retail choice in the El Paso area. These activities include:

- development, approval, and operation of a RTO for the EPE region by the FERC;
- development of retail market protocols to facilitate retail competition;
- development of a balancing energy market, market for ancillary services, and market-based congestion management system for the wholesale market in the region;
- implementation of a seams agreement with adjacent power regions to reduce barriers to entry and facilitate competition;
- implementation of a business separation plan, unbundled transmission and distribution rates, and price to beat rates;
- approval of a qualified power region pursuant to PURA §39.152; and
- implementation and evaluation of a pilot program.

3. Southwest Power Pool Issues

The other utilities in Texas that have not yet opened to retail competition are located in a region known as the Southwest Power Pool (SPP). On October 1, 2004 the FERC granted the SPP's application for status as a RTO. One of the key issues that the SPP had to resolve to obtain FERC approval was implementing an independent board. Previously, the SPP has been managed by a board consisting of stakeholders and independent directors, but in response to an earlier FERC order, the SPP implemented a fully independent board. The SPP is conducting a cost-benefit analysis of the RTO, which the utilities in the region plan to use in proceedings at their respective state commissions to establish that it is in the public interest for them to join the SPP RTO. While Oklahoma and Kansas appear to favor having their utilities join the SPP, others, such as Arkansas, Louisiana, and Missouri, appear to have reservations about having their utilities join the SPP RTO. The electric utilities owned by American Electric Power (AEP) are major transmission-owning utilities in the SPP, and AEP-Southwestern Electric Power Company operates in Texas, Arkansas, and Louisiana.

E. CUSTOMER EDUCATION ACTIVITIES

PURA §39.902 requires the Commission to develop and implement an educational program to inform customers, including low-income and non-English-speaking

customers, about changes in the provision of electric service resulting from the opening of the retail electric market. In FY 2002 and 2003, the Legislature appropriated \$18 million for customer education. This funding was reduced to \$1.5 million for FY 2004 and FY 2005.

Since its inception in February of 2001, the “Texas Electric Choice” campaign has endeavored to educate Texans about the changes and choices in the retail electric market. The third year of the campaign (September 2003-August 2004) continued the previous year’s focus on educating Texans about Electric Choice and the choices in electric providers available in the marketplace.

The integrated education campaign uses a number of vehicles, in both English and Spanish, to reach and educate the public. A summary of each of these methods is included below.

1. Advertising and Public Service Announcements

The campaign responded to a significant budget reduction by migrating from paid advertising to greater reliance on grass-roots organizations and public service announcements:

- **Lone Star Radio Network.** This series of public service announcements on Electric Choice on a statewide network of radio stations reached an estimated audience of 4 million listeners.
- **Recruitment of Education Partners.** Efforts to recruit community-based organizations as “Power Partners” to help educate Texans about Electric Choice reached an estimated 1.5 million people.
- **Media Tours.** Regional visits by Commissioners and staff to local media outlets reached almost 2.6 million Texans in Abilene, Corpus Christi, Dallas/Fort Worth, Harlingen/McAllen, Houston, Laredo and San Angelo.
- **E-Mail Campaign.** Of 163,930 educational e-mails on Electric Choice sent statewide, nearly 17,000 were opened, and more than 14% of the audience who opened the e-mail clicked through to the TEC website. These figures are well above the range of success for direct e-mail marketing industry.

2. Websites

The Texas Electric Choice campaign website, www.powertochoose.org, and its Spanish-language counterpart, www.poderdeescoger.org, are a vital part of the customer education process.

- Unique Visitors: 149,814
- Page Views: 3,839,488

- Downloads: 143,971

3. Answer Center

The campaign provides a Texas-based toll-free, bilingual answer center, 1-866-PWR-4-TEX (1-866-797-4839), as a way to give customers another point of contact with the campaign. Customer service representatives are available six days a week, and an automated system serves customers seven days a week. Customers can ask questions, learn which REPs serve their area, and request educational materials.

- Total Calls: 199,355
- Total Rep-Assisted Calls: 155,578
- Total Spanish-language Calls: 15,715

4. Educational Literature

Brochures, fact sheets and other educational materials are distributed via e-mail, at campaign events, through a network of community-based organizations, and via the campaign’s websites and Answer Center. Fact sheets on a number of topics are routinely created and updated for distribution as part of the campaign’s outreach efforts.

| | <u>English</u> | <u>Spanish</u> | <u>Total</u> |
|-------------------------|----------------|----------------|--------------|
| • Power Guide: | 18,353 | 5,026 | 23,379 |
| • Electricity Facts: | 5,123 | 1,641 | 6,764 |
| • Low-income Brochures: | 6,317 | 2,754 | 9,071 |
| • Customer Protections: | 3,996 | 1,692 | 5,688 |
| • Power Tools Kits: | | | 1,330 |

5. Community-Based Outreach

In late 2003, the campaign formally launched an Education Partners Program to recruit community-based organizations to help reach consumers. Through August 2004, this program had recruited nearly 160 “Power Partners”, organizations, associations and volunteers statewide that make presentations on Electric Choice and distribute campaign literature. These organizations reach an estimated 1.5 million Texans. Statewide Power Partners include the Texas State Energy Conservation Office, TAMU Energy Systems Laboratory, Texas State Technical College System, Texas Association of Community Colleges, and Independent Bankers of Texas.

F. ADMINISTRATION OF THE SYSTEM BENEFIT FUND

The SBF created by SB 7 was initially designated to fund four programs:

- an electric rate discount (10%-20%) for low-income customers, also referred to as LITE-UP (Low-Income Telephone and Electric Utilities Program);
- a targeted low-income energy-efficiency program administered by the Texas Department of Housing and Community Affairs;
- appropriations to the Commission for customer education programs and to the Commission and Office of Public Utility Counsel (OPUC) for administrative costs; and
- compensation for school districts for losses in taxes due to the lower property values of the utilities' assets directly caused by the electric restructuring.

The SBF is funded through a non-bypassable delivery charge set by the Commission each year. The fee is currently set at the statutory cap of 65 cents per MWh. Total revenue into the SBF for FY 2003 and FY 2004 was approximately \$134 million, and is projected to rise to \$143 million in FY 2005.

The Commission initially set the low-income discount at 10%. In late 2002, the Commission had sufficient funds available to increase the low-income discount from 10% to 17%. The 78th Legislature approved appropriations sufficient to provide a 10% discount for low-income customers, funding for customer education programs and administrative costs for OPUC. No funds were appropriated for weatherization programs or the property tax replacement.

Table 1: System Benefit Fund Revenue and Expenses for FY 2002 - 2005

| | FY 2002 | FY 2003 | FY 2004 | FY 2005 (Projected) |
|---------------------------------------------------|----------------------|----------------------|----------------------|------------------------|
| PUC Order (8/23/2001) for Sept-Jan | \$55,934,826 | | | |
| SBF Fee (Monthly Receipts) | \$60,734,924 | \$135,165,159 | \$133,882,991 | \$142,448,627 |
| Total Receipts | \$116,669,750 | \$135,165,159 | \$133,882,991 | \$142,448,627 |
| Customer Education | \$9,173,024 | \$7,978,680 | \$642,937 | \$750,000 |
| PUC Administrative | \$875,843 | \$803,143 | \$1,347,614 | \$2,875,843 |
| OPUC Administrative | \$288,733 | \$238,733 | \$288,138 | \$288,733 |
| Property Tax Replacement | \$27,191,339 | \$7,259,546 | \$0 | \$0 |
| Weatherization | \$7,178,000 | \$10,767,000 | \$0 | \$0 |
| Low-Income Discount | \$28,793,112 | \$147,855,548 | \$90,020,351 | \$55,507,515 |
| LIDA Contract Administration/Customer Database | \$1,356,715 | \$960,823 | \$2,075,075 | \$900,000 |
| Total Disbursements | \$74,856,766 | \$175,863,473 | \$94,374,115 | \$60,322,091 |
| Source: PUC Fiscal Services | | | | |

Since 2003, the Commission has focused on refining the implementation of the low-income assistance program by integrating the administration of the telephone and electric discount programs. The Commission awarded a contract to a new third-party administrator to develop and operate a customer-based computer matching system to identify low-income customers for both the electric and telephone low-income discount programs. The new matching process allows eligible customers to enroll in both the electric and telephone discount programs simultaneously, and provides solutions to the problems of customer move-ins, move-outs and switches. The Low-income Discount Administrator continues to answer customers’ questions via the toll-free number, (866) 4-LITE-UP, work with customers and companies to resolve customer issues, process self-enrollment forms, streamline enrollment, and improve overall program quality.

Enrollment in the program declined during FY 2004 as a result of the refinement to the Commission’s rules governing automatic enrollment in the program.²⁸ These rule revisions were intended to address concerns identified by the Commission that certain program participants were not eligible for the program. The Commission believes that the new process provides a more accurate matching process, and consequently, more accountability for the program.

²⁸ Customers who are no longer automatically enrolled have the option to re-enroll through the self-enrollment process. Currently, approximately 20,000 customers of the approximately 390,000 total customers in the electric discount program have self-enrolled. At the inception of the program, the Commission estimated that the total number of customers eligible for the program could be as high as 650,000 (assuming all of those customers completed the enrollment process).

Table 2: Average Number of Customers Enrolled and Discounts Disbursed, FY 2002-2005

| Low-Income Customers and Discounts | | | | |
|----------------------------------------------------------------------------------------------------|----------------|----------------|----------------|--------------------------------|
| | FY 2002 | FY 2003 | FY 2004 | FY 2005 (Projected) |
| Average Number of Customers | 407,598 | 701,992 | 554,234 | 384,833 |
| Average Monthly Discount per Customer | \$12 | \$18 | \$11 | \$12 |
| Average Yearly Discount per Customer | \$96 | \$220 | \$135 | \$149 |
| Source: Monthly REP reports filed in accordance with PUC SUBST. R. 25.451 and PUC Fiscal Services. | | | | |

III. EFFECTS OF COMPETITION ON RATES AND SERVICE

The Texas retail electric market has continued to develop and mature since the last Scope of Competition in Electric Markets in Texas Report. By most objective measures, Texas has the most robust, well-functioning retail market in the United States. The Center for the Advancement of Energy Markets' Retail Energy Deregulation Index ranks Texas as the number one competitive retail electric market in North America, and number three in the world, based on twenty-two key attributes related to retail competition. New providers continue to enter the marketplace and develop new and innovative products for customers. Customers are becoming increasingly aware of their options in the marketplace, and are continuing to examine their options from various providers. As of September 2004, over one-million retail customers were taking service from a non-affiliated provider, and a total of 1.5 million switch requests had been processed by ERCOT. While increasing natural gas and electricity prices have been a challenge to the development of the marketplace, market forces appear to be working well to provide competitive prices to customers.

Wholesale and retail electricity prices have increased significantly since 2002, largely due to dramatic increases in the market price of natural gas. Because the majority of generation in ERCOT is fueled by natural gas, the market price of electricity in ERCOT is very highly correlated with natural gas prices. Natural gas prices have increased approximately 150% since the retail market opened to competition, and wholesale electricity prices have also more than doubled.

With the exception of the price spikes discussed in Section II.C.2, wholesale market prices have generally remained reasonable, given the higher cost of fuel. This in large part is due to the significant over-supply of generating capacity in the ERCOT market. Current projections are that ERCOT will continue to have a 25% reserve margin through 2009.

Retail prices have also increased, reflecting the higher market price of natural gas and electricity. Price to beat rates have increased approximately 30% since January 1, 2002. However, competitive offerings are available to customers that provide a substantial discount to customers who switch away from the affiliated REP. Competitive forces appear to be working, as competitive offers have generally risen more slowly than the price to beat.

It is also important to note that higher natural gas prices also have significant impacts on customers of utilities that have not opened to competition, because utilities are permitted to recover all of their prudent and necessary fuel expenses through increased fuel factors and surcharges for past under-collected expenses.

Customers continue to take advantage of their opportunities to switch providers and obtain a lower rate. As of September 2004, over 1.1 million customers were taking service from REPs not affiliated with their local TDU. Over 18% of residential customers and more than 25% of commercial and industrial customers are receiving service from non-affiliated REPs. These customers are typically the biggest and most energy intensive customers, as evidenced by the fact that these customers represent more than 43% of the energy used by all retail customers.

The significant increase in the price of natural gas in the fall of 2004 has impacted the ability of REPs to offer prices competitive with the price to beat. Additionally, many contracts that customers executed in 2002 and 2003 expired in late 2004, resulting in the customers facing much higher prices at the time of contract renewal. Volatility in the price of natural gas and electricity continues to be a challenge for market participants and customers. Those customers who executed longer-term, fixed price contracts prior to the recent increase in prices have been able to avoid much of the increase in costs, but either have, or will likely see a significant increase in their costs when it is time to renew those contracts. As a result, it appears that many customers are negotiating contracts with prices that are indexed to natural gas, with the intention of fixing the price at a later date when natural gas prices have declined.

A. EFFECT OF COMPETITION ON PRICES

1. Wholesale Market Prices

Wholesale market prices for capacity and energy in ERCOT were significantly higher in 2003 and 2004 than in 2002 due to substantial and sustained increases in the cost of natural gas. More than 70% of the installed generating capacity in ERCOT relies on natural gas as the primary fuel or the only fuel. As a result, natural gas fueled generation generally sets the market price for all types of generation.

a. Bilateral Market Prices

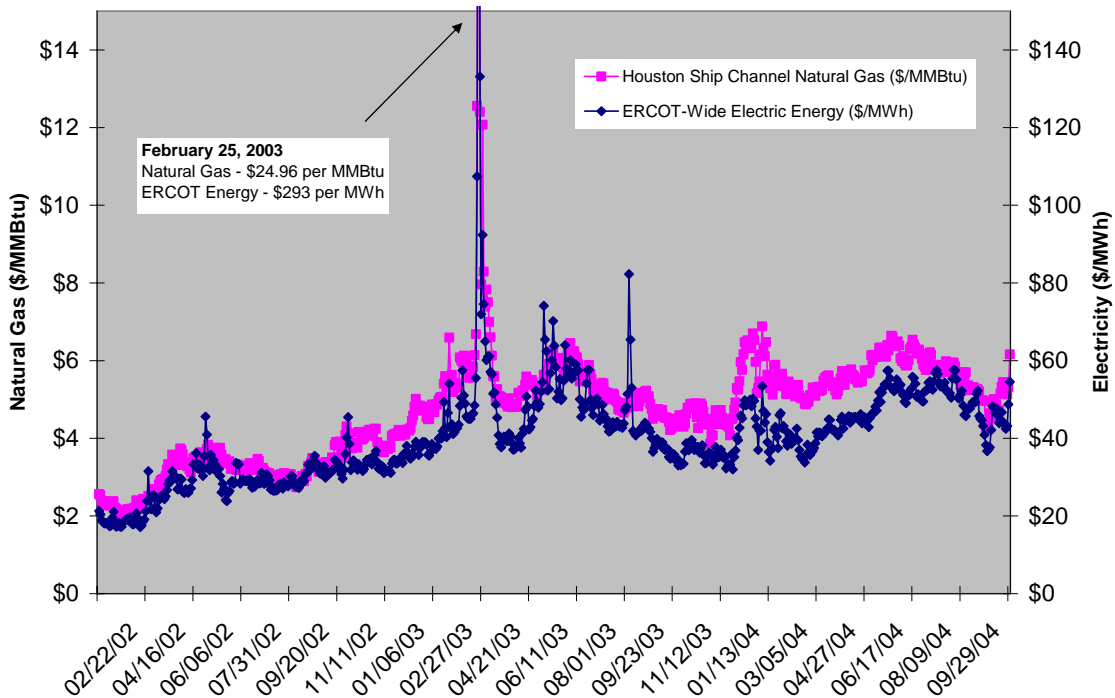
The ERCOT market relies primarily on bilateral contracts between buyers and sellers of electricity as the principle mechanism by which power is traded and sold. Bilateral contracts are privately negotiated between buyers and sellers, and encompass a variety of durations, terms, and pricing. As a result, the impact of changing natural gas prices affects buyers and sellers differently depending on whether or not the contract provides for a fixed price and the time at which the contract was executed. While bilateral agreements are negotiated in private, some daily market prices are reported to industry trade publications, and changes in these prices are generally indicative of how prices in the market as a whole are changing.

The following chart shows that the daily on-peak market price for electricity in ERCOT rose from approximately \$18.50/MWh in January 2002 to about \$44/MWh in October

2004. As discussed above, the price generally followed the upward trend in natural gas prices. In early 2003, daily market prices reached \$293/MWh during the extreme weather event of February 24 to 26.

Even with higher natural gas prices, wholesale prices have routinely remained below \$60 per MWh, even in summer months when demand is the highest. This is due to the significant amount of new generation that has been added to the market in recent years and the resulting high reserve margins. While these high reserve margins generally prevent suppliers from extracting premiums for their capacity in the wholesale market, unexpected conditions can cause temporary shortages in the market, as occurred in February 2003.

Figure 6: Daily Market Prices for Electricity and Natural Gas, 2002 - 2004



Source: Megawatt Daily

b. Balancing Energy Market Prices

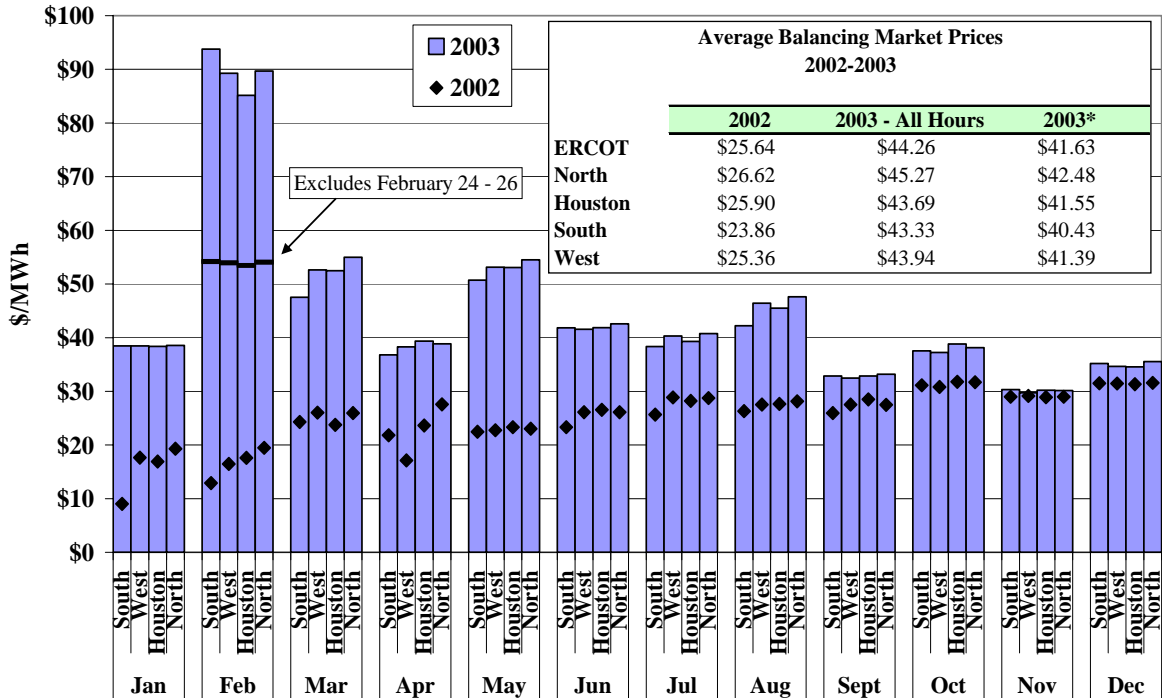
ERCOT obtains and deploys balancing energy to maintain the balance between load and generation and to resolve transmission congestion through a centralized auction process, referred to herein as the “Balancing Energy Market”. The Balancing Energy Market typically represents less than 5% of the total energy consumed in ERCOT, and was primarily designed to be used by ERCOT to balance supply and demand in real time.

Market participants also have the option, within limits to rely on the Balancing Energy Market to serve some or all of their power needs in lieu of bilateral contracts. ERCOT procures balancing energy in each of the major congestion zones. At times when there is no transmission congestion, prices in each of the zones are equal. When transmission congestion limits the transfer of power between zones, prices will typically be higher in those zones that are transmission constrained.

Balancing Energy Market price volatility generally results from a variety of unexpected short term factors such as unforeseen generation or transmission outages, unexpected changes in weather, and changes in transmission congestion.

The average price for balancing energy in ERCOT was \$25.64/MWh in 2002 and \$44.26/MWh in 2003, reflecting the increase in natural gas prices. As shown in Figure 7, there were relatively small differences among the zonal prices for balancing energy. During the extreme weather event in February 2003, 15-minute interval prices for balancing energy reached \$990/MWh and the daily weighted average price for UBES reached \$523.45/MWh. Without the three extreme weather days in February 2003, the average ERCOT price for balancing energy was \$41.63/MWh.

Figure 7: Average Balancing Energy Market Prices, 2002 - 2003



Source: PUC Market Oversight Division

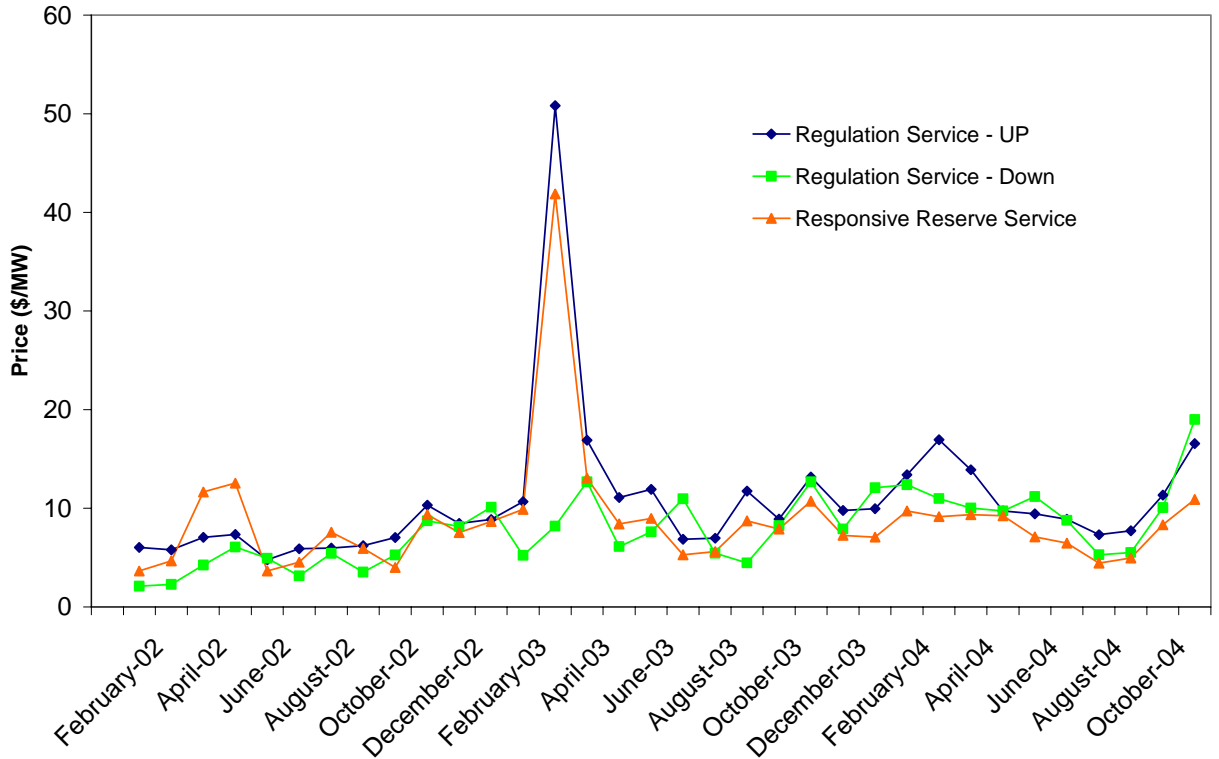
c. Ancillary Service Capacity Market Prices

As the system operator, ERCOT deploys ancillary service capacity and balancing energy in order to maintain system reliability and resolve transmission congestion. For ancillary service capacity, ERCOT assigns an obligation to each market participant based on its historical load. Market participants may “self-provide” the capacity or rely on ERCOT to acquire it for them through a centralized auction.

The following chart shows that the monthly weighted average prices for these capacity services (Regulation Up, Regulation Down, and Responsive Reserve) increased during the period from January 2002 to October 2004. The Regulation Up price exceeded the \$10/MW level in thirteen months, while the Regulation Down and Responsive Reserve prices exceeded that level in nine and six months, respectively. Ancillary service prices were also affected by the extreme weather event in February 2003. In its State of the ERCOT Market Report, Potomac Economics determined that ERCOT ancillary service prices may be higher than other markets due to ERCOT’s limited interconnection with other areas and to certain market design features.²⁹ One of the report’s recommendations, joint optimization of energy and ancillary service markets, is currently being considered in the wholesale market design project.

²⁹ “2003 State of the Market Report for the ERCOT Wholesale Electricity Markets,” Potomac Economics, August 2004, pp. 25-38.

Figure 8: Monthly Average Ancillary Service Prices, 2002 - 2004



Source: PUC Market Oversight Division

d. Reserve Margin

Notwithstanding the limited price spikes seen in wholesale markets in early 2003, the relatively low prices in the wholesale market have lead several generators to mothball or retire generation units that are not economically viable in the current market. These announcements included:

- AEP announced in the fall of 2002 that it intended to mothball approximately 3,866 MW of generation. About half of this total was initially designated by ERCOT as RMR units, and remained on-line. ERCOT has developed RMR exit strategies to eliminate the need for these units.
- Texas Genco extended the mothball status of two generating units in April 2003 totaling 926 MW of capacity through November 2003. Texas Genco subsequently announced in September 2003 that it was placing an additional of 2,064 MW of capacity in mothball status through April 2004.
- American National Power announced the mothballing of a relatively new 1,100 MW generating plant in January 2004 for an indefinite period of time due to low wholesale market prices in ERCOT.

- TXU announced in March 2004, the retirement of 653 MW of gas-fired capacity, and the mothballing of an additional 443 MW. TXU subsequently announced in November 2004 that it was mothballing an additional 2,516 MW of gas fired generation.

Although some of these generating units have been permanently retired, most of them can be brought back on-line if future market conditions enable the units to run profitably.

Even with these units being placed in mothball status, Texas continues to enjoy a significant reserve margin of installed electric generating capacity. More than 31,000 MW of new capacity have been installed since 1995. In 2004, ERCOT generating capacity was approximately 75,000 MW, while the actual peak demand was 58,351 MW.³⁰ ERCOT’s five-year forecast projects planning reserve margins that exceed the traditional 15% standard through 2009. As shown in following table, ERCOT projects a reserve margin of 32.5% in 2005, which declines gradually to 20.5% in 2009.³¹

Table 3: ERCOT Reserve Margin Forecast

| | 2005 | 2006 | 2007 | 2008 | 2009 |
|---------------------------------------------------|--------|--------|--------|--------|--------|
| Firm Load (MW) | 61,425 | 62,935 | 64,481 | 66,064 | 67,685 |
| Capacity Resources (MW) | 81,395 | 81,996 | 82,014 | 81,623 | 81,558 |
| Projected Reserve Margin | 32.5% | 30.3% | 27.2% | 23.6% | 20.5% |
| Projected Reserve Margin Without Mothballed Units | 18.3% | 16.4% | 13.6% | 10.3% | 7.6% |

Source: PUC Market Oversight Division

The ERCOT forecast assumes load growth of about 2.4% per year, and it incorporates known information about new plant construction, mothballed capacity, and plant retirements as of August 2004. For purposes of the forecast, ERCOT included only new capacity that has a signed interconnection agreement. This is a conservative assumption that does not consider new capacity that may be still in the planning and development stage. Conversely, the forecast includes capacity that is currently mothballed under the assumption that this capacity will return to service if it is needed in future years. It is likely that some, but not all of the mothballed capacity will be available in the future. Table 3 also shows the projected reserve margins without any of the mothballed capacity included.

³⁰ The all-time peak demand in ERCOT was 60,995 MW in August 2003.

³¹ “Capacity, Demand and Reserves Report,” ERCOT, August 2004.

Prior to retail competition, the Commission had the authority to require electric utilities to maintain a 15% reserve margin of generation capacity beyond that needed to serve their firm load. In the competitive market, no specific reserve margin is currently mandated, and issues associated with mandating a specific reserve margin and allocating the cost responsibility for maintaining that reserve have proven to be very complex and controversial. The Commission is continuing to explore this issue and analyze the effectiveness of mechanisms adopted by other jurisdictions to determine their suitability for Texas.

2. Retail Market Development and Prices

a. Available Choices for Customers

One key measure of the success of retail market development is the number of providers in the market place that are available for customers, even if customers elect to continue to take service from their incumbent provider.

As of October 2004, there are 85 REPs certificated by the Commission, with 55 of those REP actively serving customers. There are 19 REPs that are serving at least 500 residential customers, and residential customers in all service areas of the state have numerous offers available to them. As of October 2004, residential customers have between seven and twelve choices of REPs in their service areas, including the affiliated REP. Because some REPs are offering more than one product, customers have between nine and fourteen different products to choose from, including renewable energy options in all areas.

Importantly, the number of REPs and products in each service territory has grown since 2002. This suggests that the residential retail market continues to be competitive, and there is sufficient incentive and opportunity for new providers to enter the market. The following table summarizes the number of REPs serving residential customers and the number of offers available to residential customers in each TDU area as of October 2004 compared to December 2002.

Table 4: Number of REPs and Product Offerings Available to Residential Customers, 2002 - 2004

| TDU | # of REPs (December 2002) | # of REPs (October 2004) | # of Products (December 2002) | # of Products (October 2004) |
|-----------------------------------|------------------------------------------|-----------------------------------------|----------------------------------------------|---------------------------------------------|
| TXU Electric Delivery | 10 | 12 | 11 | 14 |
| CenterPoint | 10 | 11 | 11 | 12 |
| Texas New Mexico Power | 5 | 8 | 6 | 11 |
| AEP Central | 7 | 10 | 8 | 13 |
| AEP North | 3 | 7 | 3 | 9 |

Source: Average Annual Rate Comparison for Residential Electric Service, PUC Electric Division

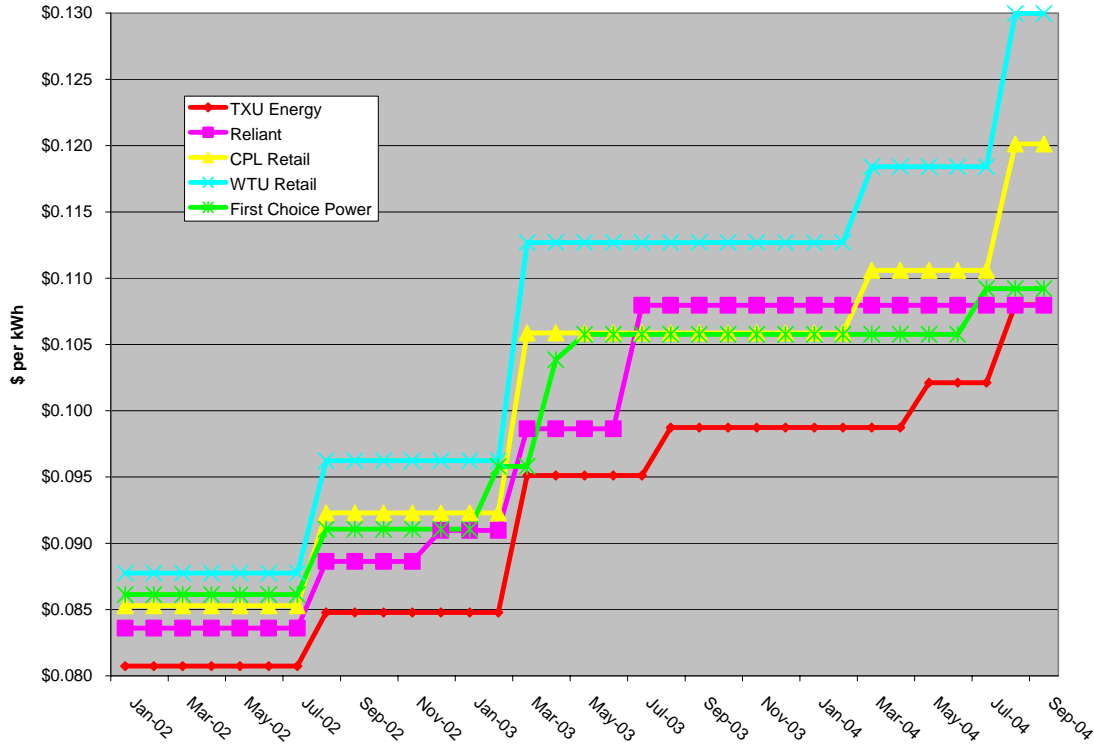
Commercial and industrial customers also continue to have the option of service from a variety of REPs.

b. Residential Rates

The affiliated REP in each service area is required to offer all residential customers service at the price to beat, which is generally 6% less than the rates charged by the former bundled utility in the service area, adjusted for fuel costs. Each affiliated REP is permitted to request an adjustment in the fuel factor portion of the rate up to twice per year if the market price of natural gas and purchased energy changes significantly.

Since January 2003, affiliated REPs have requested numerous adjustments to the price to beat fuel factors due to escalating natural gas prices, although not all affiliated REPs have used both adjustments permitted under PURA. These increases have led to increases in the prices to beat of the affiliated REP of between 20%-35% from January 2003 through September 2004. The following chart illustrates these price increases.

Figure 9: Increases in the Prices to Beat, January 2002 - September 2004

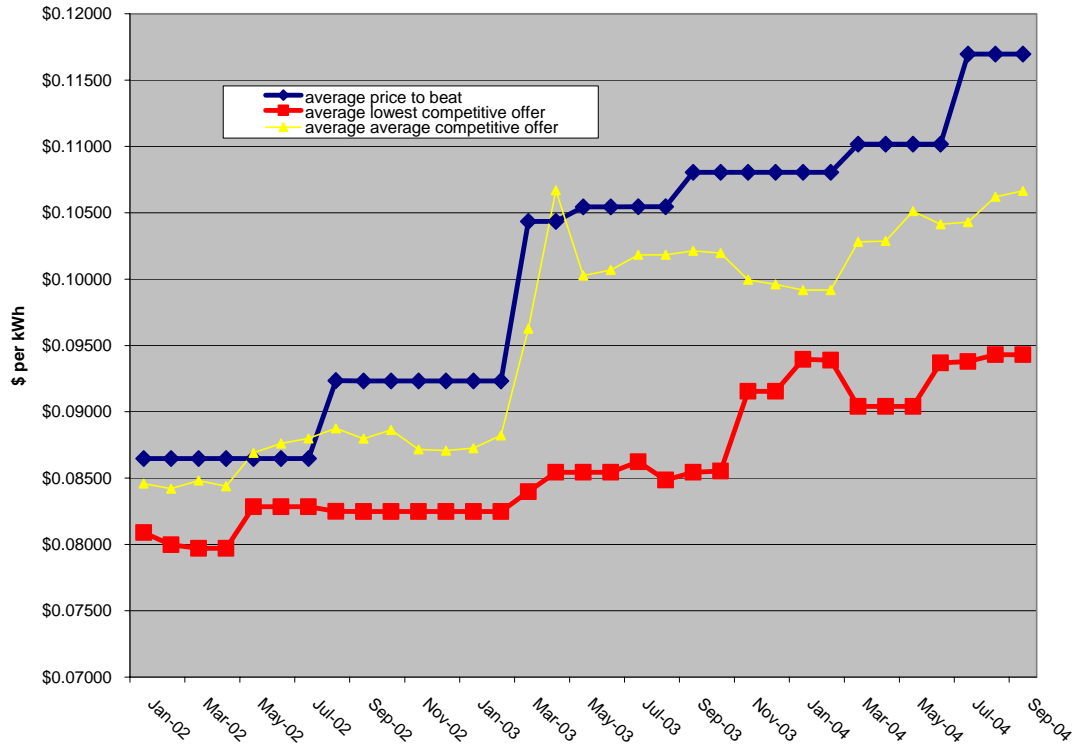


Source: Average Annual Rate Comparison for Residential Electric Service, PUC Electric Division

These price increases, while resulting in higher prices to residential customers who do not switch, have played an important role in enabling new entrants to continue to effectively compete in the marketplace. Without the fuel factor adjustments requested by the affiliated REPs, it is likely that new competitors would be unable to offer savings to customers due to increases in the price of natural gas and electricity. Although the market prices charged by competitive providers have also increased, on average, these prices have not risen as much as the price to beat.

The following graph shows the average of the residential price to beat for each service area, the average competitive offer across all service areas, and the average of the lowest residential competitive offer available in each service area from January 2002 to October 2004. As can be seen by the graph, the difference between competitive prices and the price to beat has risen over time as competitive prices have risen more slowly than the price to beat.

Figure 10: Average Residential Price to Beat vs. Average Competitive Offer vs. Average Lowest Competitive Offer, 2002 - 2004

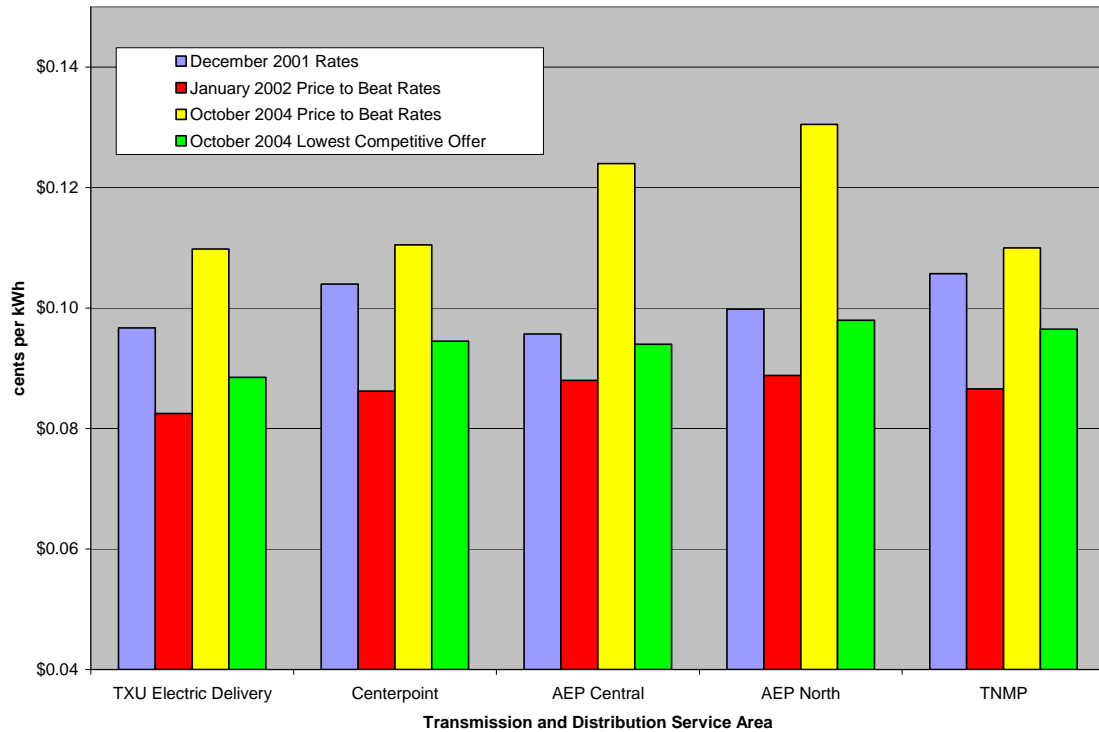


Source: Average Annual Rate Comparison for Residential Electric Service, PUC Electric Division

This increasing spread has led to the potential for customers to realize significant savings by switching from the price to beat to competitive rates. Figure 11 illustrates the pre-competition rates, original price to beat rates, the price to beat rates as of September 2004, and the lowest competitive offer available in October 2004. This figure demonstrates that customers can avoid much of the increase in price to beat rates through switching to a competitive supplier, resulting in substantial savings to customers. For example, a residential customer in the WTU Retail service area using 1,000 kWhs per month could save, on average, over \$32 per month, or more than \$380 per year by switching to the cheapest option in that service area.

Notably, Figure 11 also demonstrates that the lowest competitive offer remains lower than the regulated rates that were in effect in December 2001 in all service areas. While the rates in December 2001 included fuel surcharges for past under-recovered fuel expenses, this further suggests that competitive forces can be more effective than regulation in establishing competitive prices.

Figure 11: Price to Beat vs. Lowest Competitive Offer by Service Territory



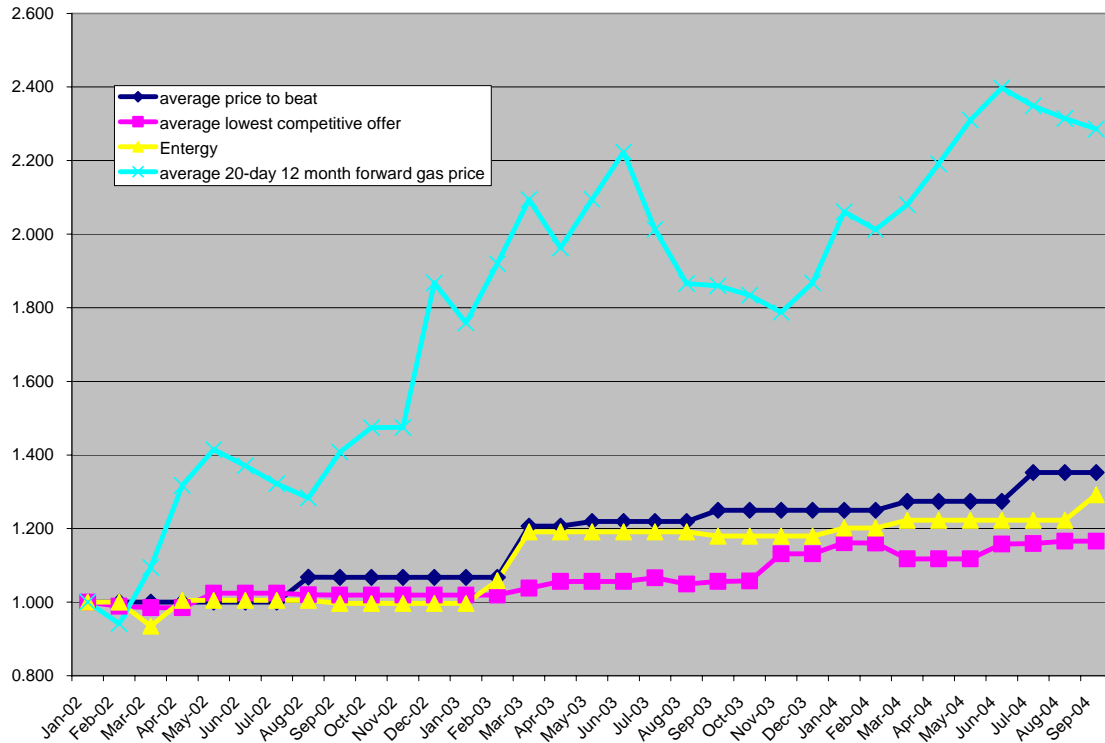
Source: Average Annual Rate Comparison for Residential Electric Service, PUC Electric Division

A complete list of residential offers and prices offered in an area can be found at www.powertochoose.org by entering a Texas zip code. Customers can also have a list of offers mailed to them by calling 1-866-PWR-4-TEX.

It is also important to note that while natural gas price increases have led to increases in both the price to beat and competitive offers, natural gas price increases have also led to increases in the rates of utilities that have not gone to competition. Under regulation, utilities are entitled to recover all of their prudently incurred fuel costs, either through fuel factor increases, or fuel surcharges for past under-recovered amounts, if the fuel factor was too low to fully cover costs. This surcharge mechanism is not available to affiliated REPs subject to the price to beat.

Figure 12 shows the increase in the average price to beat in areas open to competition, the average lowest competitive offer available in areas open to competition, natural gas prices, and the regulated rates of Entergy since 2002 (all prices were normalized to January 1, 2002). As can be seen from Figure 12, price to beat rates have risen more rapidly than the regulated rates of Entergy, but competitive rates have generally risen more slowly than regulated rates. Again, this strongly suggests that competitive forces have been very effective forcing non-affiliated REPs to efficiently manage their costs in order to be able to effectively compete for customers.

Figure 12: Average Residential Price to Beat, Average Lowest Competitive Offer, Natural Gas Prices, Average Entergy Gulf States Residential Rate, 2002 - 2004 (normalized - January 1, 2002=1.00)

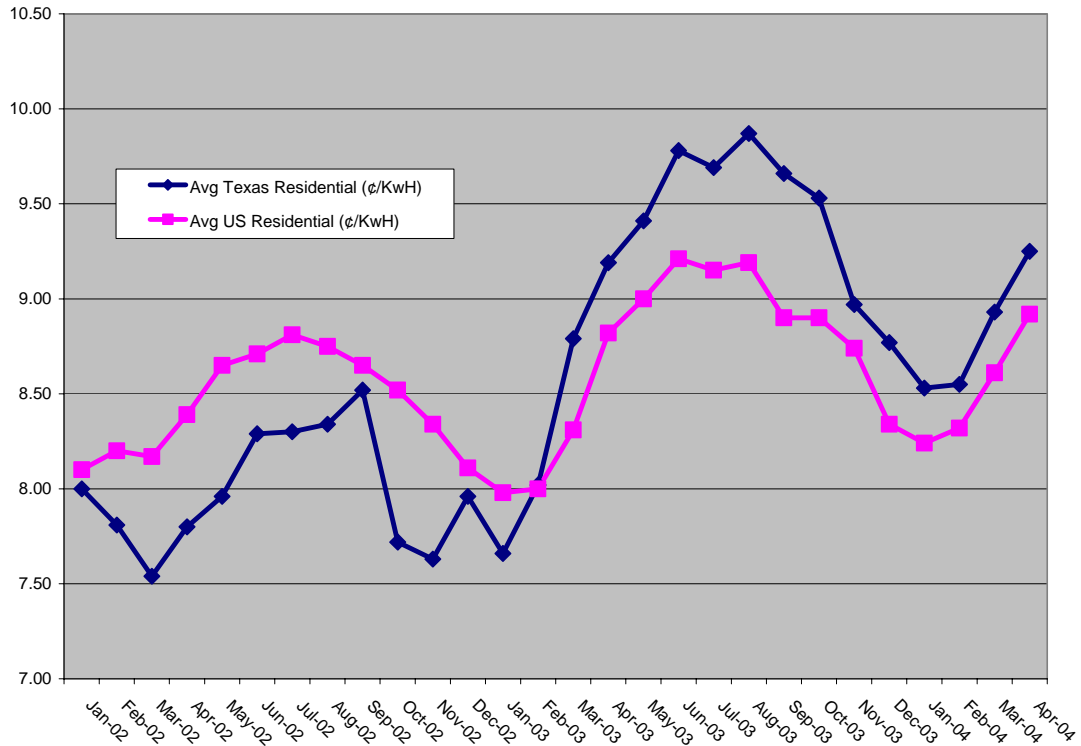


Source: Average Annual Rate Comparison for Residential Electric Service, Entergy Gulf States, Inc. Tariff Rates, PUC Electric Division

Overall, Texas electricity rates have risen at a faster pace than the United States as a whole from 2002 to early 2004. Figure 13 shows average monthly residential prices in Texas compared to average monthly residential prices in the United States.³² This relatively greater increase in Texas rates likely reflects the fact that natural gas fired generation comprises a greater mix of the electricity capacity in Texas, and that prices are therefore more subject to fluctuations in the price of natural gas.

³² Figure 13 incorporates data gathered by the Department of Energy’s Energy Information Administration. This data is gathered from a sampling of utilities and retail electricity suppliers, including municipally owned utilities and electric cooperatives in Texas. The Commission does not have access to the underlying data, and therefore, cannot assess the reliability of the data or whether or not the sample is indicative of the Texas market. The data in Figure 13 are also not annualized as is the data in the other charts in this section.

Figure 13: Average Monthly Residential Prices, Texas vs. United States, 2002 - 2004



Source: Department of Energy, Energy Information Administration, US Electric Utility Average Retail Price, http://www.eia.doe.gov/cneaf/electricity/page/at_a_glance/sales_tabs.html

c. Commercial and Industrial Rates

Competitive rates for commercial and industrial customers are more difficult to estimate than residential customers because of the fact that these customers typically negotiate individual contracts and the prices are not publicly disclosed.

Small commercial customers who have continued to receive service under the price to beat from affiliated REPs have seen price increases similar to those discussed above for residential customers. Generally speaking, it appears that non-affiliated REPs have been able to offer savings to customers at a level sufficient to entice customers away from the affiliated REP, as evidenced by the increased switching rates illustrated in Section III.B of this report.

The Commission has been able to derive some price information from data that REPs are required to report to the Department of Energy’s Energy Information Administration (EIA). Although this information is aggregated by REP, and therefore cannot be used to derive the price any particular customer has paid, the data suggests that, although prices in general were higher in 2004 than 2003 due to increased natural gas prices, non-affiliated REPs are able to offer significant savings to commercial and industrial customers. Table 5 shows the average price reported to the EIA by non-affiliated REPs

for commercial and industrial customers for 2003 and 2004 compared to the average rate reported by affiliated REPs for those years.

Rates at these levels represent a similar level of savings as the residential rates shown above suggest, but the actual savings for customers will depend largely on when they entered into their contract. Current prices for new contracts will likely be at or above the upper range of these estimates, due to the recent increase in the price of natural gas and purchased power.

Table 5: Average Commercial and Industrial Rates, 2003-2004

| | 2003 | | 2004 (through September) | |
|-------------------|----------------|---------------------|--------------------------|---------------------|
| | Affiliated REP | Non-affiliated REPs | Affiliated REPs | Non-affiliated REPs |
| Commercial | 9.50 | 6.38 | 10.58 | 6.98 |
| Industrial | 5.75 | 4.69 | 6.52 | 4.85 |

Source: Department of Energy, Energy Information Administration Form EIA 826, PUC Electric Division

The significant increase in the price of natural gas in the fall of 2004 has impacted the ability of REPs to offer prices competitive with the price to beat. Additionally, many contracts that customers executed in 2002 and 2003 expired in late 2004, resulting in the customers facing much higher prices at the time of contract renewal. Volatility in the price of natural gas and electricity continues to be a challenge for market participants and customers. Those customers who executed longer-term, fixed price contracts prior to the recent increase in prices have been able to avoid much of the increase in costs, but either have, or will likely see a significant increase in their costs when it is time to renew those contracts. As a result, it appears that many customers are negotiating contracts with prices that are indexed to natural gas, with the intention of fixing the price at a later date, when natural gas prices have declined.

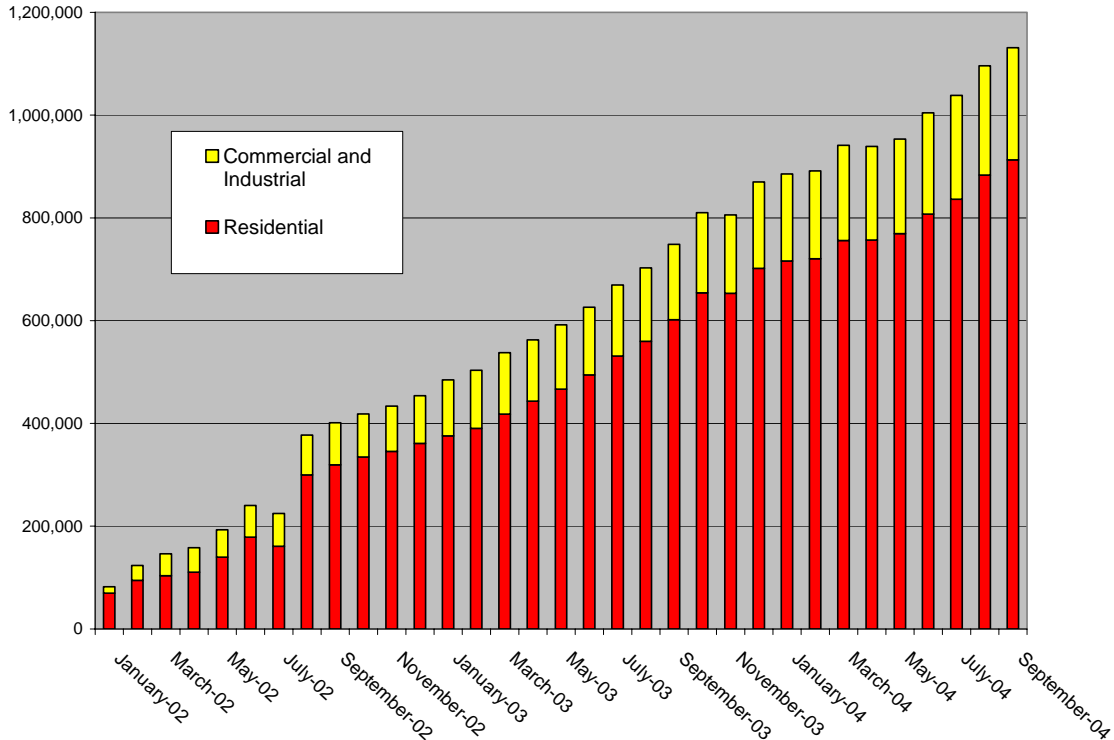
B. SWITCHING ACTIVITY

As of September 2004, over 1.1 million individual customer premises were taking service from REPs not affiliated with their local TDU.³³ This number has doubled since January

³³ Data in this section of the report is compiled by the TDUs and is required to be reported to the Commission. All of the data reflects a “snapshot” in time with respect to the numbers and percentages of customers served by non-affiliated providers. As such, the data in this section understates the level of competitive activity in the market, as customers who have switched providers, but subsequently switch

2003 and represents approximately 17% of all customers in areas open to customer choice.

Figure 14: Number of Customers Served by a Competitive REP in ERCOT



Source: Performance Measures Reports, Project No. 24462, PUC Electric Division

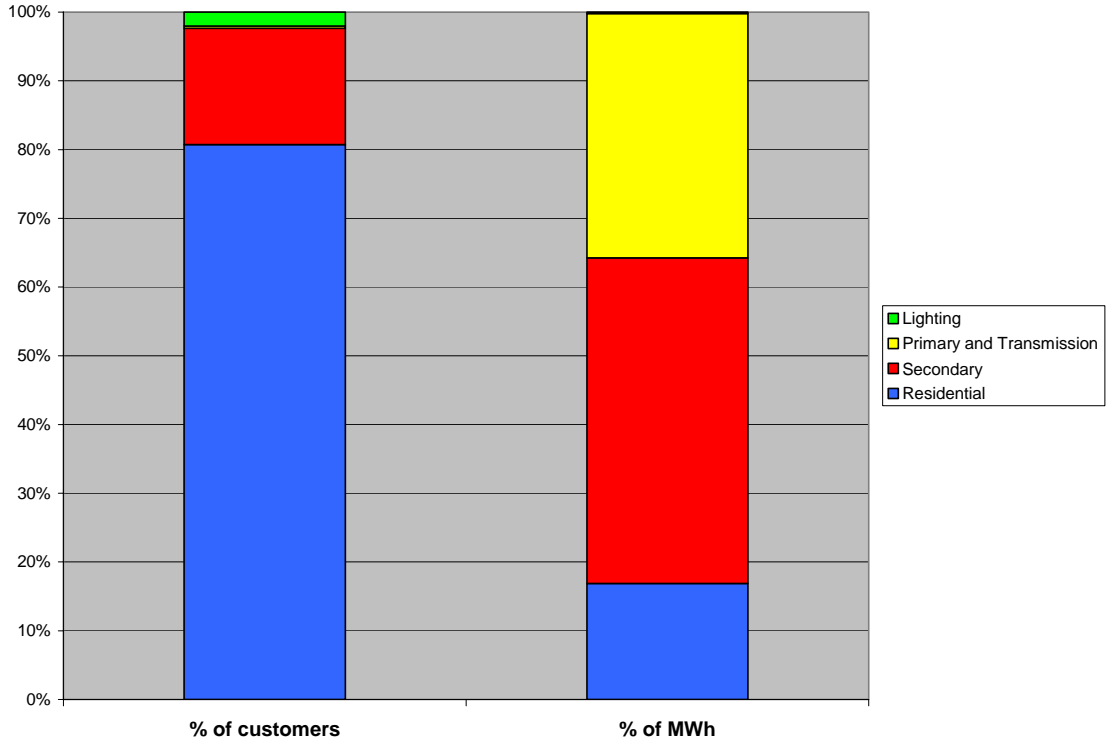
Of these premises, 913,000 (80%) are residential customers. Approximately 17% (191,000 customers) of the customers are commercial and/or industrial customers that take service at the secondary voltage level (predominately smaller commercial customers eligible for the price to beat). There are 3,400 (less than 1%) larger commercial and industrial customers taking service at the primary and transmission voltage level. The remaining premises are lighting accounts.

A total of 8,600,000 megawatt hours (MWhs) were served by non-affiliated REPs in September 2004. This represents approximately 42% of the total MWhs sold in September 2004. This number is higher than the percentage of customers who have switched because the larger commercial and industrial customers comprise a significant

back to their affiliated REP are not included in the information presented here. Additionally, customers who switch multiple times among competitive providers are only counted once for purposes of this presentation.

portion of the energy consumption in the state. While commercial and industrial customers only account for 18% of the customers who have switched, these customers comprise over 85% of the megawatt hours (MWh) served by non-affiliated REPs in areas open to competition.

Figure 15: Class Composition of Customers and Megawatt-hours served by a Competitive REP as of September 2004



Source: Performance Measures Reports, Project No. 24462, PUC Electric Division

1. Residential Market Switching

As of September 2004, approximately 18% of all residential customers were taking service from a non-affiliated REP, more than double the percentage of customers who were taking service from a non-affiliated REP in January 2003.³⁴

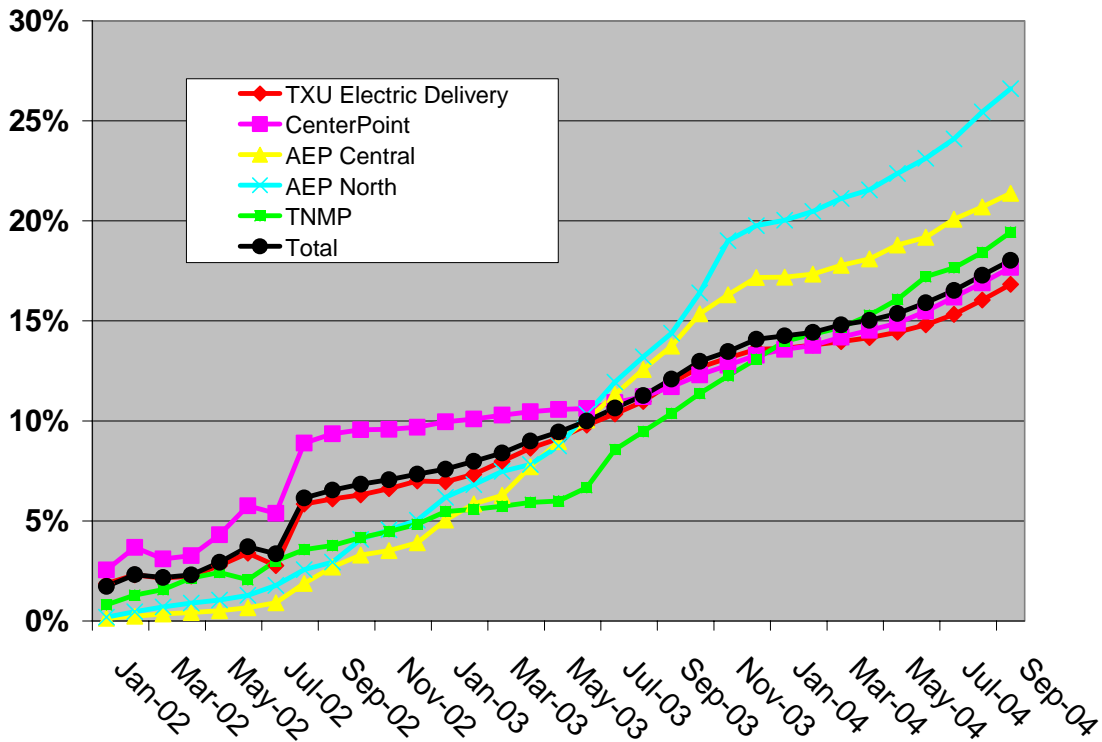
REPs serving the residential market face several challenges to acquiring retail customers, including:

³⁴ These percentages understate the level of competitive activity in the market, as some customers who switched to competitive suppliers have returned to the affiliated REP for various reasons. Additionally, some customers have switched multiple times among competitive suppliers. The analysis contained in this section of the report does not reflect this type of “churn” in the marketplace.

- increased customer protections for residential customers (*i.e.*, implementation of the low-income discount and requirements related to issuing terms of service documents and Your Rights as a Customer documents) that make it more costly to serve these customers;
- substantial customer acquisition costs (*i.e.*, advertising, direct-mail solicitations, incentives to entice customers to switch); and
- increased costs relating to investments in billing systems, call centers, and customer complaint resolution resulting from the need to serve a large volume of customers.

While REPs serving the residential market continue to focus much of their efforts in the large urban markets of Houston and the Dallas-Ft. Worth Metroplex, REPs have been most successful in winning customers in the AEP North (formerly West Texas Utilities) (more than 23% of customers served by non-affiliated REPs) and the AEP Central (approximately 19% of customers served by non-affiliated REPs) service territories. This is likely due to the relatively high price to beat in those markets, which has enabled competitors to offer substantial discounts to the price to beat.

Figure 16: Percentage of Residential Customers Served by a Competitive REP

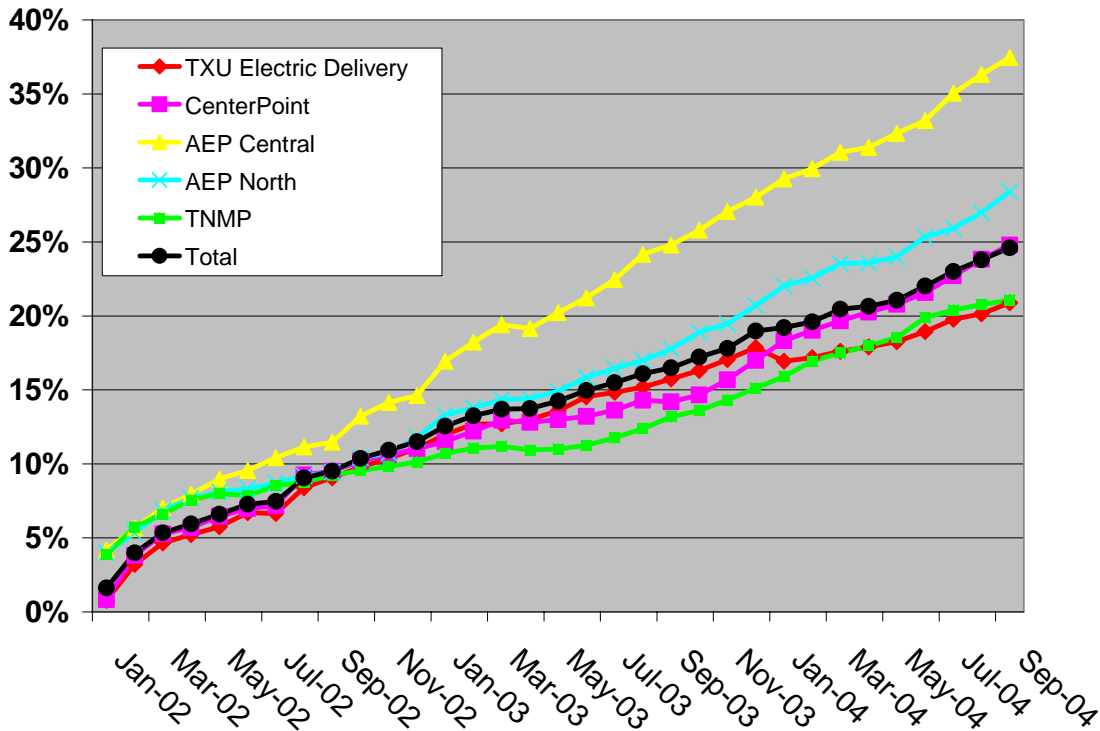


Source: Performance Measures Reports, Project No. 24462, PUC Electric Division

2. Secondary Voltage Level Commercial and Industrial Market Switching

Commercial and industrial customers taking service at the secondary voltage level (primarily small commercial customers, most of which are eligible for the price to beat) have shown a greater propensity to switch to a non-affiliated REP, in part due to the fact that the energy consumption of these customers is much higher than residential customers. As of the end of September 2004, nearly 25% of these customers were being served by non-affiliated providers, with the greatest response in the AEP Central service territory, where more than 37% of the customers have switched. These switching rates have also increased substantially since January 2003.

Figure 17: Percentage of Secondary Voltage Level Commercial and Industrial Customers Served by a Competitive REP

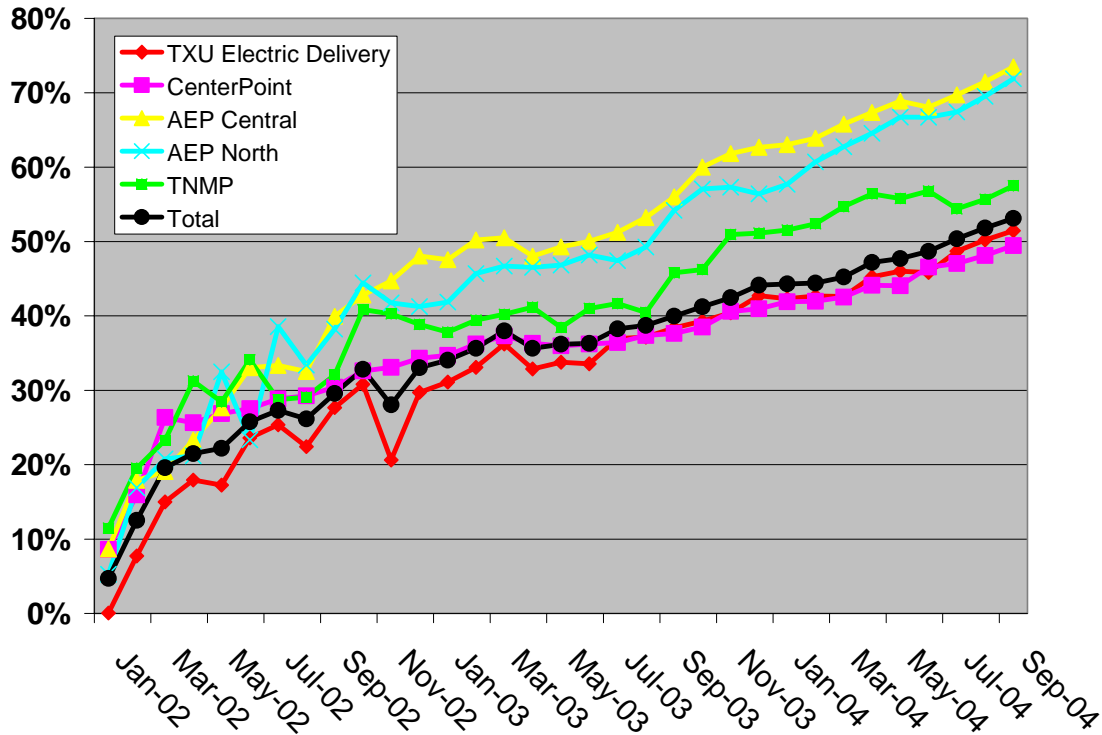


Source: Performance Measures Reports, Project No. 24462, PUC Electric Division

The customers who have switched in this customer class are predominately the larger-sized, more energy intensive customers, as demonstrated by that fact that the 25% of customers who have switched comprise nearly 53% of the energy consumption used by this set of customers. The AEP Central and AEP North service areas again show the greatest propensity to switch, with over 70% of the energy consumed by these customers served by non-affiliated REPs in September 2004.

It is also important to note that all affiliated REPs have been able to offer prices other than the price to beat since January 2004. As such, even customers who have remained with the affiliated REP may be paying rates below the price to beat, as the incumbent providers in some cases have made other offers to these customers.

Figure 18: Percentage of Secondary Voltage MWh Served by a Competitive REP



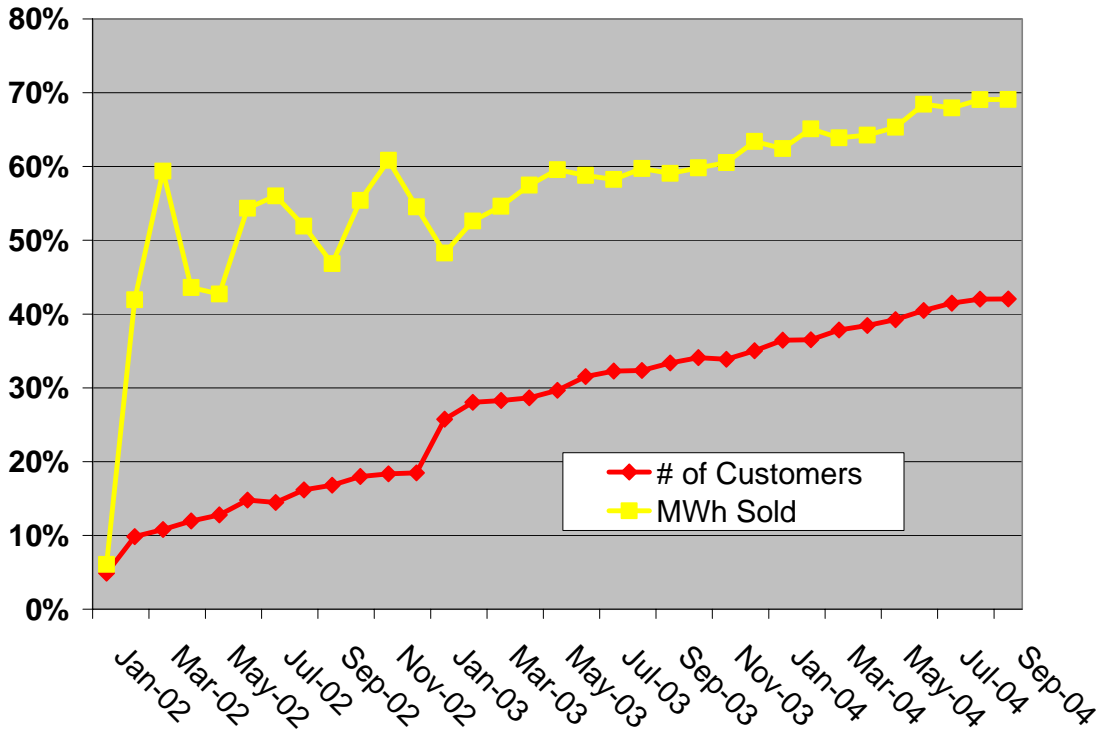
Source: Performance Measures Reports, Project No. 24462, PUC Electric Division

3. Primary and Transmission Voltage Level Commercial and Industrial Market Switching

Commercial and industrial customers taking service at the primary or transmission voltage level shows a similar switching trend. These customers are generally large commercial and industrial customers, many of whom are not eligible for the price to beat. More than 40% of these customers, comprising nearly 70% of the energy consumed by this customer class were taking service from a non-affiliated REP in June 2004.

As discussed above, even customers who have remained with the affiliated REP may be paying rates below the price to beat. Additionally, customers who are not eligible for the price to beat may have also negotiated a competitive price with the affiliated REP if they are still receiving service from the affiliated REP.

Figure 19: Percentage of All Primary and Transmission Voltage Level Customers & MWh Served by a Competitive REP



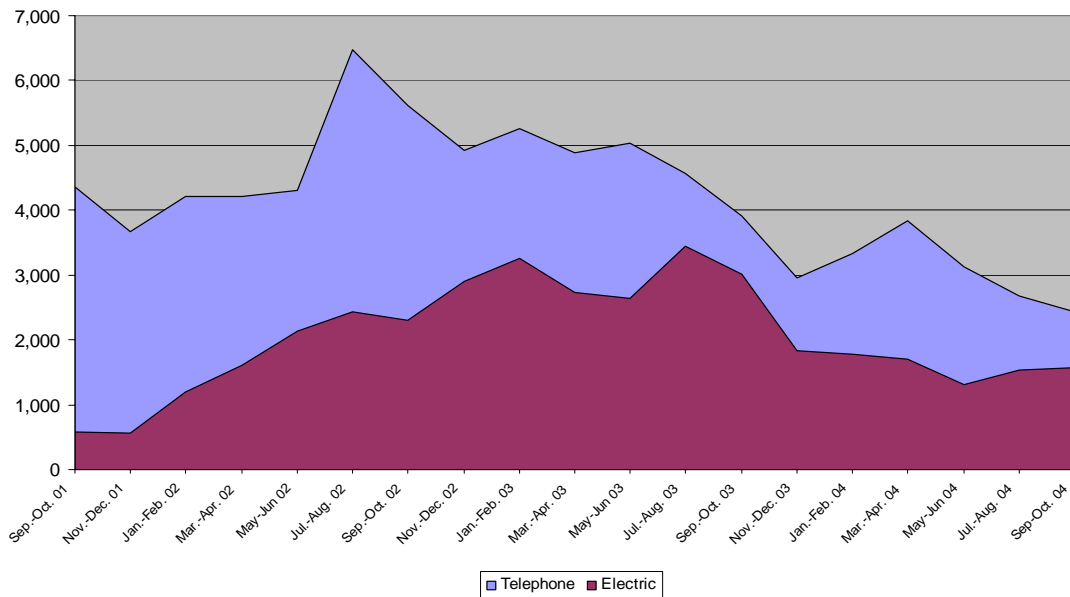
Source: Performance Measures Reports, Project No. 24462, PUC Electric Division

IV. ASSESSMENT OF OTHER SENATE BILL 7 GOALS AND BENEFITS

A. CUSTOMER PROTECTION/COMPLAINT ISSUES

The electric service related complaints³⁵ received and handled by the Commission’s Customer Protection Division steadily climbed from the beginning of competition in 2002 and peaked during July and August 2003. For Fiscal Year 2003 more than 31,000 total complaints were concluded. This is an average of 7,783 complaints per quarter. Complaints declined during Fiscal Year 2004 to approximately 20,631 total complaints. This represents an average of 5,157 complaints per quarter.

Figure 20: Total Complaints Received, September 2001 - October 2004



Source: PUC Customer Protection Division

³⁵ Complaint statistics are compiled from the database by using query commands. The commands can be created to include any of the specific data fields such as company name and complaint codes---rates and charges, cramming or slamming. A query command can also specify date ranges or complaint volumes which are used to create monthly and quarterly management reports. Similarly, ad hoc reports can be readily generated to accommodate administrative or legislative requests. In this regard, mining the data for complaint trends in either electric or telecom serves as a barometer for gauging company behavior and its effect on their customers or their industry. As a management tool, mining data to reveal trends serves as an impetus to meet with companies and discuss the trend information. It is also used to alert Commission Staff of the need for possible enforcement actions.

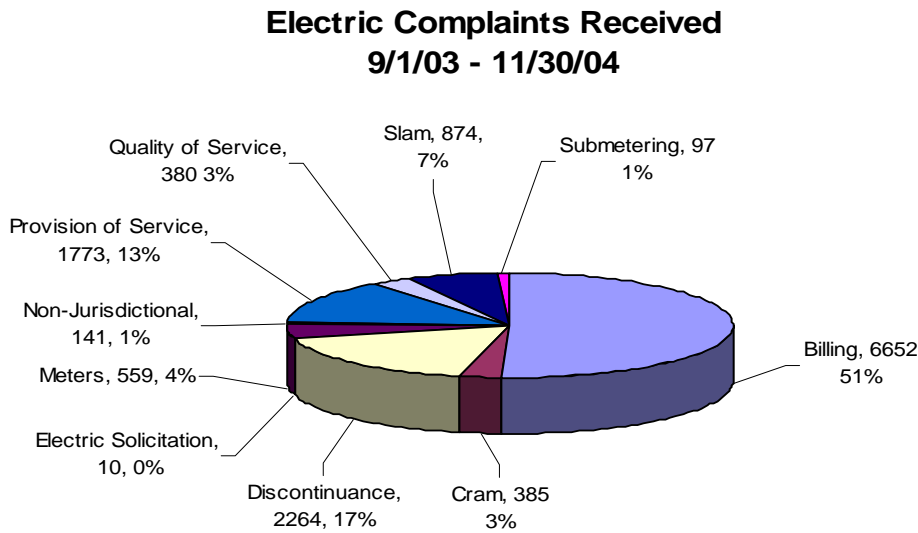
Since complaints are initiated by utility customers, the number of complaints is hard to predict. However, Commission Staff noted the following observations that may be contributing to the decline in customer complaints.

- Electric service providers have actively pursued appropriate staffing and training strategies in their call centers to improve customer service and effectively handle their customers’ complaints.
- Due to the success of the Commission’s ongoing education campaign, Texans are becoming more educated and knowledgeable on the subject of electric deregulation and their ability to choose an electric service provider.
- Continued collaboration between market participants and ERCOT to improve transaction processing.

Mild climate conditions including cool summer temperatures have kept energy bills from soaring, thus reducing complaints involving discontinuance of service and requests for payment arrangements.

The majority of electric-related complaints were billing-related and represented 51% of the total. Following, were discontinuance of service complaints at 18% and provision of service complaints at 12%. Decreases occurred in all three complaint categories from the previous fiscal year (FY 2003) when billing complaints represented 52% of the complaints, discontinuance of service was 19%, and provision of service was 14%.

Figure 21: Composition of Electric Complaints, September 2003 - November 2004



Source: PUC Customer Protection Division

B. RENEWABLE ENERGY MANDATE

The Commission continues to monitor progress toward the goal for renewable energy established in PURA §39.904. The construction of renewable energy facilities has proceeded significantly quicker than the timelines outlined in PURA, which contained a goal of 850 MW of new renewable capacity to be installed by January 1, 2005, and a total of 2,000 MW of new capacity by January 1, 2009.

As of November 2004, a total of 1,187 MW of new capacity was on-line, with another 194 MW of capacity announced to begin operation in 2005. The vast majority of installed renewable capacity is wind generation. Uncertainty surrounding the expiration/extension of the federal production tax credit has led to a slower growth in the installation of new capacity as compared to 2001 and 2002.

Additionally, the need for additional transmission to move wind power from West Texas to the more heavily populated areas of North and South Texas has also contributed to the slower growth in renewable capacity. The Commission and ERCOT continue to address these issues through the transmission planning process.

C. ENERGY EFFICIENCY

The Commission administers an energy efficiency program under PURA §39.905 and has, in the past, administered an energy-efficiency grant program under the Health and Safety Code. The PURA program is operated by the utilities and funded through transmission and distribution rates. In 2003, utilities spent roughly \$70 million on this program. The grant program was funded through appropriations in fiscal years 2002 and 2003, but was not funded in the current biennium. The goals of the PURA energy-efficiency program are to:

- achieve energy savings through incentive programs conducted by electric utilities in a market-neutral, nondiscriminatory manner;
- give all customers access to energy efficiency alternatives that allow them to reduce energy consumption and reduce energy costs; and
- acquire cost-effective energy efficiency equivalent to at least 10 percent of each electric utility's annual growth in demand.

The Commission adopted rules to implement the energy-efficiency program in 2000 and amended them in 2004.³⁶

Overall program performance appears to have been successful. In the aggregate, the utilities exceeded the goal of a 10% reduction in growth in demand. Some individual

³⁶ P.U.C. SUBST. R. 25.181, 25.183, and 25.184.

utilities, however, fell short of meeting their goal. The programs also served customer classes equitably, with programs offered and savings achieved among residential, commercial and industrial customers. In addition, the majority of the savings occurred in non-attainment areas, thereby contributing to air emission reductions. Specifically:

- The demand reduction goal for 2003 was 135 megawatts. The utilities exceeded this goal by 11% with an actual reduction of 151 megawatts.
- The programs resulted in 370,000 megawatt-hours of savings for customers.
- The Hard-to-Reach and Residential/Small Commercial Standard Offer Programs performed very well, with demand savings exceeding savings that the utilities had projected in 2002.
- Small project set-asides were used to stimulate program participation by smaller energy-efficiency providers, with apparent success, resulting in a numerous service providers in the program and a wide variety of measures being installed. For example, one utility has over a 100 contractors participating in the programs.
- Program participation was relatively weak in the commercial and industrial sectors, but changes to the program templates appear to be working and many of the programs were fully subscribed by July for the 2004 program.
- Only one utility operates a direct load control program. This program is fully subscribed at current incentive levels.
- Most program activity is in areas of the state that experience air quality problems: 86% of demand savings and 78% of energy savings were achieved in the non-attainment and near-non-attainment counties.
- Overall administrative costs were 8%, well below the ceiling of 10% of total program costs that the Commission included in the rules.

The Commission is in the process of retaining an independent entity to verify the energy and peak demand savings achieved by the programs.

The energy-efficiency grant program under the Health and Safety Code is intended to reduce air emissions in areas that do not meet air-quality standards under the Federal Clean Air Act or that are on the verge of falling into non-attainment status. The Health and Safety Code also calls on the Commission to calculate the air emission benefits of both the grant program and the PURA energy-efficiency program. The 2003 expenditures for the grant program were \$2.6 million, with savings of 18,000 megawatt-hours. The estimated first year reduction in nitrogen oxides for the two programs was 600 tons.

V. EMERGING ISSUES

EXPIRATION OF PRICE TO BEAT

As discussed previously in this report, the Commission has found that the 40% load loss threshold for small commercial customers has been reached for the majority of the service areas in the state. As such, the affiliated REPs are permitted to offer prices other than the price to beat, although they must continue to make the price to beat available until January 1, 2007.

After January 1, 2005, the affiliated REPs will also be permitted to offer rates other than the price to beat to residential customers, irrespective of the amount of residential load that has switched to non-affiliated REPs. After January 1, 2007, the affiliated REPs are not required to continue to offer the price to beat, and at that point, under the current statute, will become entirely unregulated with respect to the rates that they charge.

The Commission anticipates that some stakeholders will believe it appropriate for the Legislature to consider amendments to PURA to address the price to beat. The Commission offers the following observations on several options available to the Legislature to address this topic.

- i. **No changes.** It is likely that some parties will argue that the price to beat statute will have operated as intended by 2007, and no further action will be required by the Legislature. As discussed elsewhere in this report, there are a large number of REPs in the marketplace offering competitive prices to customers, and a significant number of customers have responded to these offers and switched to lower cost providers. The price to beat, although it has typically been an above market rate, has the potential to seriously distort the marketplace, and the Legislature may decide that the five year transition period will be sufficient for the market to develop.

If the Legislature determines that no changes to PURA are required, the Legislature may want to consider whether or not it is appropriate to increase the Commission's appropriation for customer education activities. As is discussed elsewhere in this report, significant savings are currently available to customers by switching to a non-affiliated REP. However, customers may be unaware of their options in the market or be unnecessarily concerned about issues such as the reliability of their service if they switch. Additional customer education funds and outreach by the Commission may be successful in addressing these issues.

- ii. **Extend the price to beat.** Although many of the measures used to analyze the market discussed in this report indicate a well-functioning retail market,

the fact remains that a significant number of customers have not switched to competitive prices, even though there are substantial savings available to customers. This “customer inertia” suggests that a large number of customers will continue to pay above-market price to beat rates through 2007, and some parties will likely be concerned that the affiliated REPs may dramatically increase prices for some or all customers once the price to beat expires.

One remedy to this concern is for the Legislature to amend PURA to require the affiliated REPs to continue to offer the price to beat beyond January 1, 2007. The Legislature could consider a short extension through June 2007 in order to permit the 80th Legislature time to evaluate the status of the market, or could consider a longer extension. To the extent that this concern is primarily with respect to residential customers, the Legislature could consider an extension for only the residential class, and permit the price to beat to expire as scheduled for small commercial customers.

- iii. **Consider “opt-out” aggregation.** Much of the concern about the expiration of the price to beat relates to residential customers, who generally take longer to respond to pricing offers and the potential for savings than larger customers. This is generally because the size of savings that are available may be insufficient to entice customers to incur the transactions costs associated with switching (i.e. researching competitive offers).

Aggregation of customers can potentially address the concern that many customers are paying above market price to beat rates by permitting an aggregator to pool customers and negotiate a better rate on their behalf. PURA currently permits the aggregation of residential customers either by private companies or local governments, but customers must affirmatively opt-in to the aggregation pool. Aggregators appear to have had limited success in enrolling residential customers in aggregation pools.

Other states that have implemented retail competition have permitted local governments to implement “opt-out” aggregation. These programs generally permit a local government to automatically aggregate all of the citizens in their jurisdiction, unless the customers affirmatively opt-out of the program, once an ordinance or other statute is approved by voters permitting such action. The local governments then negotiate on behalf of their citizens to obtain the best rate from competitive suppliers.

These programs have generally been successful in obtaining savings for customers compared to the incumbent utility’s “default offer”. Some observers, however, have criticized these programs as artificial customer choice, because customers are not making their own decision on their electric supplier, and note that local governments do not provide this type of service for any other industry. Some of the programs also restrict the ability of customers to switch to other suppliers until the term of the contract that is negotiated expires.

The Legislature could consider such a program in lieu of a price to beat extension if it wanted to provide local governments the opportunity to negotiate lower rates for those of their citizens that have not switched on their own.

- iv. **Consider other “default service” options.** Other states that have implemented retail competition, particularly in the northeast, have also implemented various other options to establish default service prices for those customers who have not switched. Most of the programs generally involve a procurement process/auction administered by the state utility commission that solicits bids to provide the generation and/or retail portion of utility service. The price resulting from the lowest bid is then passed automatically through to the customers who have not switched.

This type of default service has been somewhat successful in flowing through the benefits of wholesale competition to retail customers without the customers having to make an affirmative choice to switch. However, as discussed with respect to opt-out aggregation programs, this type of program is arguably not really retail choice, but instead is an alternate method for a state utility commission to regulate retail prices. This type of auction procedure also arguably suggests a perpetual role of the state in retail pricing, which is very different from the Senate Bill 7 model. While some of the states do permit customers to subsequently switch to other retail providers, practically speaking, unless wholesale prices subsequently drop dramatically, other providers generally cannot offer sufficient savings off of the procurement price to entice customers to switch.

There are also many variations or combinations of these options that are available to the Legislature, should the Legislature determine that it is appropriate to address this matter. The Commission is available as needed to assist with the Legislature’s analysis of this issue.

VI. LEGISLATIVE RECOMMENDATIONS

A. LEGISLATIVE RECOMMENDATIONS

1. Electric System Security

Current provisions of law give the Commission authority with respect to establishing reliability standards, but they do not directly address the grid security issues related to terrorism or other possible attacks on the system. It would be appropriate to amend PURA to address the security of the electric system to:

- authorize the Commission to prescribe and enforce grid security and emergency management rules with respect to all market participants; and
- suspend market rules in an energy emergency declared by the Governor.

Current law directs the Commission to implement service quality and reliability standards for the delivery of energy by investor-owned utilities, and requires municipal utilities, cooperatives, REPs, power marketers, and power generation companies to follow the reliability rules established by an independent organization. The Commission also has oversight authority over an independent organization. The existing statutory authority should be modified to explicitly give the Commission direct authority to prescribe and enforce grid security and emergency management rules with respect to all market participants.

There is nothing in current law that expressly allows the suspension of market rules in an emergency. Such authority could prevent significant economic harm to customers and market participants in an emergency situation. The existing statutory authority should be modified to explicitly give the Commission authority to suspend market rules in the event of a catastrophic event that disrupts electricity markets, as declared by the Governor. Legislation should also authorize the Commission to adopt streamlined procedures to carry out this responsibility. Because of the likelihood that the Commission would have to act quickly to assess the extent of an emergency and suspend market rules, the Commission should have the authority to make such a decision outside of the context of a contested case or rulemaking proceeding.

The following amendments to PURA would accomplish this objective:

§ 38.001. GENERAL STANDARD

An electric utility, municipally owned utility, power generation company, independent organization, and an electric cooperative shall furnish service, instrumentalities, and facilities that are safe, adequate, efficient, and reasonable.

§ 38.005. ELECTRIC SERVICE RELIABILITY, MEASURES SECURITY, AND EMERGENCY RESPONSE.

(a) The commission shall adopt and enforce rules as necessary or appropriate to ensure service quality and reliability ~~implement service quality and reliability standards~~ relating to the delivery of electricity to ~~retail~~ customers by electric utilities and transmission distribution utilities. The commission by rule shall develop reliability standards, including:

- (1) the system-average interruption frequency index (SAIFI);
- (2) the system-average interruption duration index (SAIDI);
- (3) achievement of average response time for customer service requests or inquiries; or
- (4) other standards that the commission finds reasonable and appropriate.

(b) The commission shall take appropriate enforcement action under this section, including but not limited to action against a utility if any feeder with 10 or more customers appears on the utility's list of worst 10 percent performing feeders for any two consecutive years or has had a SAIDI or SAIFI average that is more than 300 percent greater than the system average of all feeders during any two-year period, beginning in the year 2000.

(c) The standards implemented under Subsection (a) shall require each electric utility and transmission and distribution utility subject to this section to maintain adequately trained and experienced personnel throughout the utility's service area so that the utility is able to fully and adequately comply with the appropriate service quality and reliability standards.

(d) The standards shall ensure that electric utilities do not neglect any local neighborhood or geographic area, including rural areas, communities of less than 1,000 persons, and low-income areas, with regard to system reliability.

(e) The commission may require each electric utility and transmission and distribution utility to supply data to assist the commission in developing the reliability standards.

(f) Each electric utility, transmission and distribution utility, electric cooperative, municipally owned utility, and generation provider shall be obligated to comply with any operational criteria duly established by the independent organization as defined by Section 39.151 or adopted by the commission.

(g) A retail electric provider, municipally owned utility, electric cooperative, power marketer, transmission and distribution utility, independent organization, or power generation company and any person scheduling power or operating electrical facilities on their behalf shall observe all reliability, security, and emergency management rules and orders established by the commission. The commission may take the following actions for failure to comply with this subsection: suspend, revoke, or amend a retail electric provider's certificate; suspend or revoke a power marketer's or power generation company's registration; and, for any entity subject to this subsection, obtain enforcement and penalties pursuant to Chapter 15, Subchapter B. This section does not authorize the commission to establish or enforce quality standards for local distribution service provided by a municipally owned utility or an electric cooperative or require reporting of local distribution service quality by a municipally owned utility or an electric cooperative.

§ 39.103. COMMISSION AUTHORITY TO DELAY OR SUSPEND COMPETITION AND SET NEW RATES.

(a) If the commission determines under Section 39.104 that a power region is unable to offer fair competition and reliable service to all retail customer classes on January 1, 2002, the commission shall delay customer choice for the power region and may on or after January 1, 2002, establish new rates for all electric utilities in the power region as provided by Chapter 36.

(b) In the event of a catastrophic event that results in an energy emergency that disrupts electricity markets, as declared by the Governor, the commission may suspend competitive wholesale and retail market rules and set rates. The commission shall adopt rules that provide for a streamlined procedure to exercise its authority under this subsection, including provisions for providing notice to affected entities, but is not required to conduct a contested case to exercise its authority. If the commission determines in a contested case that an entity violated a commission order issued pursuant to this subsection, the commission may order the entity to refund any compensation obtained as a result of the violation and may impose administrative penalties and suspend, revoke, or amend the entity's commission-issued license pursuant to subsection 38.005(g).

Additionally, current law (Chapter 551 of the Government Code) does not provide an exception to the requirement that the Commission meet in open meeting to discuss the security of the electrical network that provides service to customers in the state. While not all deliberations by the Commission related to grid security would necessarily need to be discussed in closed meeting, certain deliberations relating to plans to protect the electric network, prevent, disrupt, or minimize the impact of an attack on the electric network, investigation of threats to the electric network, assessments of the vulnerability of the electric network, and plans for restoring service if electric facilities are damaged, should be considered in closed meeting. Therefore, the Commission requests that the Legislature adopt an exception to the Open Meetings Act that would provide an exception that would allow the Commission to meet in closed meeting to deliberate matters relating to the security of the electrical network if needed.

Additionally, the Legislature should also consider providing an exception to the Public Information Act (Chapter 552 of the Government Code) that would allow the Commission to except from public disclosure documents that relate to plans to protect the electric network, prevent, disrupt, or minimize the impact of an attack on the electric network, investigation of threats to the electric network, assessments of the vulnerability of the electric network, and plans for restoring service if electric facilities are damaged.

2. Administrative Penalties

PURA §15.023 provides authority to the Commission to enforce Commission rules and PURA, and to assess administrative penalties for violations of PURA or Commission rules. As discussed in the 2003 Scope of Competition Report, the Commission is concerned that certain provisions in this section may unintentionally impede the ability of the Commission to perform that role.

These include the following:

- The statute currently has a cap on administrative penalties of \$5,000 per violation. The Commission is concerned that this cap may not be enough of a deterrent to prevent the exercise of market power or the manipulation of market rules that could potentially enrich a company by millions of dollars. The Sunset Advisory Commission has also identified this concern.
- The statute currently appears to mandate referral of enforcement proceedings to SOAH. While the Commission relies on, and will continue to rely on, the

expertise of SOAH in most enforcement proceedings, the Commission is concerned that some cases may warrant more expedited action by the Commission than referral to SOAH can provide.

- The statute also prohibits the Commission from assessing administrative penalties if a company remedies the violation within 30 days of receiving the notice of intent to assess administrative penalties (except for violations of Chapters 17, 55, or 64 of PURA).³⁷ The Commission is concerned that this provision may provide the unintended incentive for companies to violate Commission rules or PURA, knowing that if those violations are discovered by the Commission, they can remedy the violation without penalty. As a result, the statute may deter non-compliance as originally intended. The Commission believes that violations of Chapter 39 of PURA should also be exempted from this requirement.³⁸

The Commission recommends the following changes in PURA to address these concerns:

§ 15.023 ADMINISTRATIVE PENALTY

- (a) No change
- (b) The penalty for violation may be in an amount not to exceed ~~\$5000~~ **\$25,000**. Each day a violation continues or occurs is a separate violation for purposes of imposing a penalty.
- (c) No change

§ 15.024 ADMINISTRATIVE PENALTY ASSESSMENT PROCEDURE

- (a)-(b) no change
- (c) A penalty may not be assessed under this section if the person against whom the penalty may be assessed remedies the violation before the 31st day after the date the person receives the notice under Subsection (b). A person who claims to have remedied an alleged violation has the burden of proof to the commission that the alleged violation was remedied and was accidental or inadvertent. This subsection does not apply to a violation of Chapter 17, ~~39~~, ~~or~~ 55 or 64.
- (d)-(e) no change
- (f) If a person requests a hearing or fails to timely respond to the notice, the executive director shall set a hearing and give notice of the hearing to the person. The hearing shall be held ~~in accordance with Subchapter B of Chapter 14 of this title, by an administrative law judge of the State Office of Administrative Hearings. The~~ **For hearings conducted by the State Office of Administrative Hearings, the** administrative law judge shall make findings of fact and conclusions of law and promptly issue to the commission a proposal for a decision about the occurrence of the violation and the amount of a proposed penalty. Based on the findings of fact, conclusions of law, and proposal for a decision, the commission by order may find that a violation has occurred and impose a penalty or may find that no violation occurred.
- (g) No change

³⁷ PURA Chapters 17 and 64 relate to customer protections. Chapter 55 relates to certain regulations of telecommunications services. PURA §39.157(a) also provides that the cure provision does not apply with respect to market power abuses.

³⁸ PURA Chapter 39 relates to the restructuring of the electric industry.

3. Low Income Discount

PURA §39.903(e) requires that the PUC establish rules to provide for at least a 10% discount to eligible low-income customers and up to a 20% discount if sufficient funds are available. The discount is funded by the SBF, which is financed by a non-bypassable fee set by the commission in an amount not to exceed 65 cents per MWh. The fee is currently set at the statutory maximum.

In the 77th Legislature, the Commission was appropriated the entirety of the SBF, and for a period of time, raised the discount level to 17% because sufficient funds existed to do so. In the 78th Legislature, the Commission was only appropriated funds sufficient to fund a 10% discount. The Commission's Legislative Appropriate Request for the 79th Legislature also requests an appropriation that is projected to be sufficient to only fund a 10% discount. The Commission also requested a contingency rider providing for an additional appropriation if needed to provide the 10% discount, should enrollment in the program substantially exceed current projections. Absent such a rider, the possibility exists that the Commission could be faced with a need to suspend the program in mid-year if the appropriation level is reached. Such a suspension would be extremely disruptive to low-income customers, the REPs who are required to reflect the discount on the bills they send to customers, and the Commission's administration of the program.

Should the Legislature determine that the contingency rider is inappropriate, the Commission believes an amendment to PURA §39.903 would be appropriate to permit the Commission to provide for a discount of less than 10%. Such a provision would enable the Commission to avoid suspension of the program should increased enrollment in the program indicate that the appropriation of funds is insufficient to fund the 10% discount.

The following amendment to PURA would accomplish this result:

§ 39.903. SYSTEM BENEFIT FUND. (As amended by HB 3318)

(a)-(g) no change

(h) The commission shall adopt rules for a retail electric provider to determine a reduced rate for eligible customers to be discounted off the standard retail service package as approved by the commission under Section 39.106, or the price to beat established by Section 39.202, whichever is lower. Municipally owned utilities and electric cooperatives shall establish a reduced rate for eligible customers to be discounted off the standard retail service package established under Section 40.053 or 41.053, as appropriate. The reduced rate for a retail electric provider shall result in a total charge that is at least 10 percent and, if sufficient money in the system benefit fund is available, up to 20 percent, lower than the amount the customer would otherwise be charged. To the extent the system benefit fund is insufficient to fund the initial 10 percent rate reduction, the commission may increase the fee to an amount not more than 65 cents per megawatt hour, as provided by Subsection (b). **If the fee is set at 65 cents per megawatt hour or if the commission determines that funding is insufficient to fund a 10% rate reduction, the commission may reduce the rate reduction to less than 10 percent.** For a municipally owned utility or electric cooperative, the reduced rate shall be equal to an amount that can be fully funded by that portion of the nonbypassable fee proceeds paid by the municipally owned utility or electric cooperative that is allocated to the utility or cooperative by the commission under Subsection (e) for programs for low-income customers of the utility or cooperative. The reduced rate for municipally owned utilities and electric

cooperatives under this section is in addition to any rate reduction that may result from local programs for low-income customers of the municipally owned utilities or electric cooperatives.

(i)-(l) no change

4. Commission Authority to Address Market Power

PURA §39.157(a) vests the Commission with authority to monitor market power associated with the generation, transmission, distribution, and sale of electricity in Texas. PURA §39.157(a) further provides that on a finding that market power abuses are occurring, the Commission shall require reasonable mitigation of the market power abuse. Although PURA §39.157(a) lists a number of remedies for market power abuse, the list does not include refunds or disgorgement of revenues obtained through the abuse of market power.

The abuse of market power can potentially dramatically increase the costs to other market participants and customers. The Legislature should provide clear authority to permit the Commission to, in addition to ordering the other mitigation and remedies currently in statute, require market participants who abuse market power to disgorge the improper revenues received in order to adequately protect other market participants and customers.

The following amendment to PURA would address this concern:

§ 39.157. COMMISSION AUTHORITY TO ADDRESS MARKET POWER.

(a) The commission shall monitor market power associated with the generation, transmission, distribution, and sale of electricity in this state. On a finding that market power abuses or other violations of this section are occurring, the commission shall require reasonable mitigation of the market power by ordering the construction of additional transmission or distribution facilities, by seeking an injunction or civil penalties as necessary to eliminate or to remedy the market power abuse or violation as authorized by Chapter 15, requiring refunds or disgorgement of revenues received as a result of market power abuses, by imposing an administrative penalty as authorized by Chapter 15, or by suspending, revoking, or amending a certificate or registration as authorized by Section 39.356. Section 15.024(c) does not apply to an administrative penalty imposed under this section. For purposes of this subchapter, market power abuses are practices by persons possessing market power that are unreasonably discriminatory or tend to unreasonably restrict, impair, or reduce the level of competition, including practices that tie unregulated products or services to regulated products or services or unreasonably discriminate in the provision of regulated services. For purposes of this section, "market power abuses" include predatory pricing, withholding of production, precluding entry, and collusion. A violation of the code of conduct provided by Subsection (d) that materially impairs the ability of a person to compete in a competitive market shall be deemed to be an abuse of market power. The possession of a high market share in a market open to competition may not, of itself, be deemed to be an abuse of market power; however, this sentence shall not affect the application of state and federal antitrust laws.

(b)-(i) no change

5. Ancillary Services

PURA §35.004(e) requires the Commission to ensure that ancillary services are available at reasonable prices, terms, and conditions. This section also provides that after the

introduction of customer choice in the ERCOT power region, that acquisition of ancillary services by the ERCOT system operator is deemed to meet this requirement.

As has been discussed elsewhere in this report, certain types of behavior by entities participating in ERCOT operated ancillary services markets can result in prices that far exceed the price that would result in a fully competitive market. The Commission has had success in negotiating resolutions to the effects of unexpectedly high prices caused by unforeseen events or bidding behavior. However, some market participants have argued, mistakenly the Commission believes, that the Commission's authority to ensure reasonable prices for ancillary services under PURA §35.004(e) self-extinguished when customer choice began. This interpretation fails to recognize that the last sentence in PURA §35.004(e) applies only to actions of the ERCOT independent organization as the purchaser of ancillary services, not to market participants as sellers.

The following amendment to PURA would remove any ambiguity regarding the Commission's continuing authority under PURA §35.004(e) in this respect. It would also remove any ambiguity concerning the Commission's authority to ensure that the ERCOT independent system operator's acquisition of ancillary services is reasonable.

§ 35.004. PROVISION OF TRANSMISSION SERVICE.

(a)-(d) no change

(e) The commission shall ensure that ancillary services necessary to facilitate the transmission of electric energy are made available by suppliers and acquired by the independent organization at reasonable prices with terms and conditions that are not unreasonably preferential, prejudicial, discriminatory, predatory, or anticompetitive. In this subsection, "ancillary services" means services necessary to facilitate the transmission of electric energy including load following, standby power, backup power, reactive power, and any other services as the commission may determine by rule. ~~On the introduction of customer choice in the ERCOT power region, acquisition of generation-related ancillary services on a nondiscriminatory basis by the independent organization in ERCOT on behalf of entities selling electricity at retail shall be deemed to meet the requirements of this subsection.~~

6. Authority of the Commission with Respect to Qualified Scheduling Entities, Municipally Owned Utilities and Electric Cooperatives

PURA §39.151(j) requires REPs, municipally owned utilities, electric cooperatives, power marketers, TDUs, and power generation companies to observe all policies, rules, guidelines, and procedures established by ERCOT, and provides for revocation, suspension, or amendments of certain certificates or registrations or the imposition of administrative penalties for violations of that requirement.

The Commission does not certificate or register municipally owned utilities or electric cooperatives, and therefore, believes that it necessarily has authority to assess administrative penalties on these entities for a failure to comply with ERCOT rules. However, Chapter 15 of PURA permits the Commission to impose administrative penalties on "persons" who violate PURA, but the definition of "person" in PURA §11.003(14) does not include a municipally owned utility or an electric cooperative, which could potentially lead these entities to argue that the Commission cannot assess

administrative penalties for violations of ERCOT rules. Clarification of PURA to make it clear that the Commission can assess penalties on all market participants, including municipally owned utilities and electric cooperatives, would remove this potential ambiguity.

The Commission also believes that it necessarily has implied authority to order refunds or disgorgement of improper revenues obtained through a failure to follow ERCOT rules. However, it would be preferable to eliminate any ambiguity by stating this authority explicitly in PURA §39.151.

Additionally, the ERCOT primary rules (ERCOT Protocols), as initially approved by the Commission, established “Qualified Scheduling Entities (QSEs)” as the primary entity that interfaces with ERCOT with respect to the scheduling of power and participating in ERCOT operated markets. The Commission believes that, because it has authority over the ERCOT Protocols, it necessarily has authority over QSEs, but clarification of this would prevent claims that the Commission does not.

Lastly, although PURA §39.151(j) requires municipally owned utilities and electric cooperatives to comply with ERCOT rules, PURA §39.002, which outlines the applicability of Chapter 39, does not include PURA §39.151(j) in the list of provisions that are applicable to municipally owned utilities and electric cooperatives. Additionally, PURA §39.002 does not include PURA §39.157(a), which provides the Commission with authority to remedy market power abuses. Corresponding references are also not included in PURA §40.001 and PURA §41.001. The Commission believes that all market participants, including municipally owned utilities and electric cooperatives, should be prohibited from abusing market power, and that the Commission should have appropriate tools available to enforce that prohibition.

The Commission recommends the following amendments to PURA to address these issues:

§ 15.020. DEFINITIONS

In this subchapter, the term “person” includes a municipally owned utility and an electric cooperative with respect to violations of Sections 39.151(j) and 39.157(a).

§ 39.002. APPLICABILITY.

This chapter, other than Sections **39.151(j)**, 39.155, **39.157(a)**, 39.157(e), 39.203, 39.903, and 39.904, does not apply to a municipally owned utility or an electric cooperative. Sections 39.157(e), 39.203, and 39.904, however, apply only to a municipally owned utility or an electric cooperative that is offering customer choice. If there is a conflict between the specific provisions of this chapter and any other provisions of this title, except for Chapters 40 and 41, the provisions of this chapter control.

§ 39.151. ESSENTIAL ORGANIZATIONS.

(a)-(i) no change

(j) A retail electric provider, municipally owned utility, electric cooperative, power marketer, transmission and distribution utility, ~~or~~ power generation company, **or any other entity scheduling power on their behalf or any entity who participates in markets operated by the independent system operator in ERCOT**, shall observe all scheduling, operating, planning, reliability, and settlement policies,

rules, guidelines, and procedures established by the independent system operator in ERCOT. Failure to comply with this subsection may result in the revocation, suspension, or amendment of a certificate as provided by Section 39.356 or in the imposition of an administrative penalty ~~as provided by Section 39.357~~ **on any entity subject to this subsection. The commission may also require refunds or disgorgement of revenues that result from a failure to comply with this subsection.**

(k)-(m) no change

§ 40.001. APPLICABLE LAW.

(a) Notwithstanding any other provision of law, except Sections **15.020, 39.151(j), 39.155, 39.157(a), 39.157(e), 39.203, 39.903, and 39.904**, this chapter governs the transition to and the establishment of a fully competitive electric power industry for municipally owned utilities. With respect to the regulation of municipally owned utilities, this chapter controls over any other provision of this title, except for sections in which the term "municipally owned utility" is specifically used.

(b)-(d) no change

§ 41.001. APPLICABLE LAW.

Notwithstanding any other provision of law, except Sections **15.020, 39.151(j), 39.155, 39.157(a), 39.157(e), 39.203, 39.903, and 39.904**, this chapter governs the transition to and the establishment of a fully competitive electric power industry for electric cooperatives. Regarding the regulation of electric cooperatives, this chapter shall control over any other provision of this title, except for sections in which the term "electric cooperative" is specifically used.

7. Interest Rate for Utility Deposits

The Texas Utilities Code requires this Commission to set an interest rate for utility-customer deposits once per year, but also requires that the rate be at least six percent.³⁹ A six-percent floor no doubt seemed reasonable in 1997, but today, six percent is far above what financial institutions are willing to pay on deposits. Because of that disparity, concerns have been raised that, especially for very large customers, deposits at those rates may actually be attractive investment opportunities; and anecdotal evidence exists that some customers may be overpaying deposits for this very reason.

The Commission believes that it is appropriate for the Legislature to consider the removal of subsection (c) from Texas Utilities Code Section 183.003, thereby eliminating the six-percent floor. Additionally, the Commission believes that subsection (b)(1) should be amended. This subsection currently refers to "the average rate paid over the previous 12-month period on United States treasury bills with a 12-month maturity date."⁴⁰ There is no longer any such thing as a United States treasury bill with a 12-month maturity date.⁴¹ The current yield on a twenty-six-week (six-month) treasury bill is 2.46 percent.⁴² This rate approximates the 2.435 percent return on a treasury note bought today that matures

³⁹ TEX. UTIL. CODE §183.003(c) (Vernon 1998).

⁴⁰ TEX. UTIL. CODE §183.003(b)(1) (Vernon 1998).

⁴¹ See http://www.treasurydirect.gov/indiv/research/indepth/tbills/res_tbill_faq.htm#maturity (describing the maturity range of United States Treasury Bills as four weeks, thirteen weeks, and twenty-six weeks).

⁴² See <http://www.bloomberg.com/markets/rates/index.html>.

in December 2005, and therefore approximates the Legislature's intended benchmark. If the six-percent floor is removed from subsection (c), then the Commission believes that the subsection (b)(1) rate cap should be 100% of the twenty-six-week treasury-bill yield rather than 85%.

B. CLARIFICATIONS

1. Credit Scoring

In August of 2004, TXU Energy announced a plan to adjust the prices paid by TXU Energy customers located outside TXU Energy's incumbent service territory in part on the basis of the customers' credit history with electric utility, telecommunications, and cable providers. OPUC filed a complaint against TXU Energy, alleging that the intended pricing plan violated the provisions of PURA §17.004(a)(4), which entitles retail customers to protection from discrimination on the basis of race, color, sex, nationality, religion, marital status, income level, source of income, or geographic location. The complaint was subsequently dismissed when TXU Energy voluntarily withdrew the pricing plan.

The use of payment history and other credit information has long been used by utilities to determine whether or not to require customers to pay a deposit prior to initiating service, but has not traditionally been used to differentiate electric rates for customers. While it may or may not be the case that customers' credit scores are highly correlated with race or income level, PURA §17.004 does not state a clear position regarding the use of credit scores by REPs to determine whether or not to serve customers, or the price at which to serve customers. If the Legislature believes that some uses of payment history or credit scoring are either appropriate or inappropriate for REPs to utilize, an amendment to PURA §17.004 clarifying the Legislature's intent would be appropriate.

2. Commission's Determination of Competitively Sensitive Information

In PUC SUBST. R. 25.93 (Quarterly Wholesale Electricity Transaction Reports), the Commission asserted authority to decide whether information submitted to it by wholesale sellers of electricity must be treated as confidential by the Commission and its staff. Subsection 25.93(g) of the rule provides that if the Commission Staff seeks to release protected information, and there has been no request for the information under the Texas Public Information Act, the Commission may determine the validity of the asserted claim of confidentiality through a contested-case process. The rule was adopted by Commission order published in the *Texas Register* on September 5, 2003.

On September 19, 2003, several cities sued the Commission in the Third Court of Appeals claiming, among other things, that the Commission exceeded its authority in promulgating Subsection 25.93(g). See *City of Garland et al. v. Public Util. Comm'n of Texas*, No. 03-03-00550-CV, (Tex.App-Austin) (direct appeal of a competition rule). The cities claim that PURA does not authorize the Commission to determine, as a matter of fact, whether information is "competitively sensitive" as that term is used in PURA.

The case was submitted on oral argument on April 28, 2004. No decision has been issued.

The following amendment to PURA would make it clear that the Commission has the authority to conduct contested cases to evaluate an asserted claim of confidentiality:

§ 39.155. COMMISSION ASSESSMENT OF MARKET POWER.

(a) Each person, municipally owned utility, electric cooperative, and river authority that owns generation facilities and offers electricity for sale in this state shall report to the commission its installed generation capacity, the total amount of capacity available for sale to others, the total amount of capacity under contract to others, the total amount of capacity dedicated to its own use, its annual wholesale power sales in the state, its annual retail power sales in the state, and any other information necessary for the commission to assess market power or the development of a competitive retail market in the state. The commission shall by rule prescribe the nature and detail of the reporting requirements and shall administer those reporting requirements in a manner that ensures the confidentiality of competitively sensitive information. The commission may, after conducting a contested case, declassify and release to the public any information in its possession if the commission finds that the information is not competitively sensitive or confidential by law and declassification is found to be in the public interest.

3. Nuclear Decommissioning Fund

PURA §39.205 provides that after the introduction of retail competition, any remaining costs associated with nuclear decommissioning obligations will continue to be subject to cost of service rate regulation and be included as a non-bypassable charge to retail customers.

In September 2004, the Commission adopted a new rule to provide for protection of the funds with respect to the prudent management and expenditure of those funds by the power generation company that owns the nuclear generating plant.

While the Commission believes it has the authority to ensure that decommissioning funds are protected, used appropriately, and that excess funds are returned to ratepayers, clarification of PURA would provide greater protection from a power generation company challenging this authority at some point in the future.

The following amendment would accomplish this goal:

§ 39.205. REGULATION OF COSTS FOLLOWING FREEZE PERIOD.

At the conclusion of the freeze period, any remaining costs associated with nuclear decommissioning obligations continue to be subject to cost of service rate regulation and shall be included as a nonbypassable charge to retail customers. The commission may adopt rules to ensure that decommissioning funds are prudently collected, managed, and expended for their intended purpose, and that unused decommissioning funds are returned to retail customers after decommissioning is completed.

4. System Benefit Fund Clean-up

During the 77th Legislature and 78th Legislature, changes were made to PURA §39.903, relating to System Benefit Fund. HB 3088, HB 1902, and HB 2156, passed in the 77th Legislature created two subsections (a), each with a separate purpose, and two

subsections (e), each with a separate list of funding priorities. HB 3318 and HB 3378, passed in the 78th Legislature, amended subsection (a) to make it clear that the fund is a fund in the general revenue account, but did not provide a clarification with respect to subsection (e). The Commission believes it is appropriate to clarify PURA §39.903(e) in order to eliminate any confusion about the priorities for expenditures from the fund.

HB 3088 and HB 2156 provided that the fund be used solely to support certain regulatory purposes. HB 1902 contained similar provisions, but additionally provided for a prioritization of the various purposes. The Commission believes that the program allocations of the SBF are appropriately set according to the priorities listed in Subsection (e) of HB 1902. The Commission believes that HB 1902 appropriately established the fund priorities and recommends repealing PURA §39.903(e) as enacted by HB 3088 and HB 2156.

The following amendments to PURA would accomplish these clarifications:

§ 39.903. SYSTEM BENEFIT FUND. ~~(As amended by HB 1902)~~

(a) The system benefit fund is an account in the general revenue fund. Money in the account may be appropriated only for the purposes provided by this section or other law. Interest earned on the system benefit fund shall be credited to the fund. ~~Section 403.095, Government Code, does not apply to the system benefit fund.~~

~~(b) — On the effective date of this Act, the system benefit fund is re-created as an account in the general revenue fund, and the account and the revenue deposited to the credit of the account are exempt from Section 2 of this Act.~~

~~(As amended by HB 3378):~~

~~(a) The system benefit fund is an account in the general revenue fund. Interest earned on the system benefit fund shall be credited to the fund.~~

~~(As amended by HB 3088):~~

~~(a) — The system benefit fund is created as a trust fund with the comptroller in the state treasury.~~

(b) The system benefit fund is financed by a nonbypassable fee set by the commission in an amount not to exceed 65 cents per megawatt hour. The system benefit fund fee is allocated to customers based on the amount of kilowatt hours used.

(c) The nonbypassable fee may not be imposed on the retail electric customers of a municipally owned utility or electric cooperative before the sixth month preceding the date on which the utility or cooperative implements customer choice. Money distributed from the system benefit fund to a municipally owned utility or an electric cooperative shall be proportional to the nonbypassable fee paid by the municipally owned utility or the electric cooperative, subject to the reimbursement provided by Subsection (i). On request by a municipally owned utility or electric cooperative, the commission shall reduce the nonbypassable fee imposed on retail electric customers served by the municipally owned utility or electric cooperative by an amount equal to the amount provided by the municipally owned utility or electric cooperative or its ratepayers for local low-income programs and local programs that educate customers about the retail electric market in a neutral and nonpromotional manner.

(d) The commission shall annually review and approve system benefit fund accounts, projected revenue requirements, and proposed nonbypassable fees. The commission shall report to the electric utility restructuring legislative oversight committee if the system benefit fund fee is insufficient to fund the purposes set forth in Subsection (e) to the extent required by this section.

(e) The system benefit fund shall provide funding solely for the following regulatory purposes and in the following order of priority:

- (1) programs to assist low-income electric customers by providing the 10 percent reduced rate prescribed by Subsection (h);
- (2) customer education programs, administrative expenses incurred by the commission in implementing and administering this chapter, and expenses incurred by the office under this chapter;
- (3) programs to assist low-income electric customers by providing the targeted energy efficiency programs described by Subsection (f)(2);
- (4) the school funding loss mechanism provided by Section 39.901; and
- (5) programs to assist low-income electric customers by providing the 20 percent reduced rate prescribed by Subsection (h).

~~(As amended by HB 2156 and 3088):-~~

~~(e) Money in the system benefit fund may be appropriated to provide funding solely for the following regulatory purposes:~~

- ~~(1) programs to assist low-income electric customers provided by Subsections (f)-(1);~~
- ~~(2) customer education programs;~~
- ~~(3) the school funding loss mechanism provided by Section 39.901; and~~
- ~~(4) reimbursement to the commission and the Texas Department of Human Services for expenses incurred in the implementation and administration of an integrated eligibility process created under Section 17.007 for customer service discounts relating to retail electric service, including outreach expenses the commission determines are reasonable and necessary.~~

(f)-(1) no change.