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Wisconsin attract the needed capital investment for new generation, even if other markets are more attractive to investors?"

This leads directly to another question: "Do the prices developed by the study encourage the investment of the necessary capital to meet the need for additional generation capacity in the WUMS market?" Once again, the answer is no.

The prices contained in the Report will not support the development of the necessary capital to meet the need for additional generation capacity in the WUMS market. The prices are too low; hence the measure of market power potential attributes price increases to market power that are in reality a necessary part of an open market's reaction to increasing demand. And, more critically, given the need for additional capacity within the WUMS market, failure to base public policy on attracting the needed capital will cause electric system reliability to decrease dramatically. From a public policy perspective, the responsibility to keep the lights on far exceeds the responsibility to address a theoretical market power issue.

The Report forecasts capacity prices ranging from \$0.00 to \$1.45 per MWh in the years 2001 through 2007. This forecast of capacity price is unchanged in the Revised Report. It appears that the Report assumes a central spot pool similar to the market used in California without checking the values produced to see if the capacity prices are adequate to pay for new capacity. In the Revised Report, the \$300 cap from the original Report that is assumed to operate on the maximum hourly price is increased to \$1000. In a Revised Report footnote, the authors point out that "the cap prevents extreme values in a few hours from distorting the average prices used to define product markets."²

² One need only look to the troubles in California to see the failure of a market structured in this very manner. How can one separate out the problems of the specific market structure assumed from the potential market power inherent in the utilities' generation ownership?

This approach raises two very significant points. First, it is these high prices removed from the Report by the cap that are necessary if open competitive markets are to attract the necessary capital and investment in additional generation capacity. To ignore these market outcomes is to assume that the needed capacity will be made available without cost.

Second, the Revised Report produces no changes in the anticipated entry of additional generation capacity into the WUMS with the increase in the assumed market clearing price. This implicit assumption in both the original Report and the Revised Report raises significant questions as to the validity of the Report as a basis for policy decisions. It remains unexplained how the Report can assume that significant increases in the anticipated market prices will not create additional investments in generation within the WUMS market, that would in turn decrease the potential market power of an incumbent utility.

The Map Is Not the Territory

The ability of the Report to accurately anticipate market outcomes under open market conditions underlies the basis for any policy recommendations. Rather than modeling the behaviors of all energy providers, including new providers that would be allowed to enter the market, the Report simply assumes that the announced plans of existing energy providers will be completed. To adequately understand future outcomes the behavior of both existing and new generation must be anticipated.

Market conditions are an essential element in determining how many additional providers might enter the WUMS wholesale market. Correctly estimating the amount of new generation entering the market is critical to understanding how long, if ever,

potential market power will exist in WUMS. The most significant factor in the behavior of potential new suppliers, after open access is assured, is the anticipated price.

The Revised Report's estimates of electricity prices are well below the price necessary to attract additional generation to Wisconsin. Estimating the future prices correctly is critical to estimating the amount of new generation that can be expected to enter the WUMS market. The documentation available in the Appendices is not adequate to demonstrate the exact assumptions that cause the Report's estimate of market clearing price to be so low. However, several factors are possible.

First, as the Report shows on P. A-5, the assumed natural gas prices (as well as oil prices that would have a negligible impact) are significantly below present prices, and below the forward price curve at least through 2004 (see Appendix 1, attached). Use of the higher current prices would increase the market-clearing price of electricity significantly in the increasing number of hours where natural gas fired plants set the price curve.

While it can be argued that any market power held by the incumbent utilities would allow them to pass these higher costs through to the customer and still maintain their economic rents (and effectively make market power independent of market price), WP&L believes this argument is incorrect. Adopting present forward prices for natural gas is an important part of identifying when new, higher efficiency plants can effectively enter the market. Higher cost natural gas provides a significant cost advantage to new entrants compared to existing utilities that have older, less efficient plants. New simple cycle gas turbines are over 35% more efficient than a typical gas unit. With this advantage, new entrants are less likely to fear that existing utilities would cut prices to keep new entrants out of the market, thereby increasing the likelihood that new entrants

would emerge in the WUMS market. This new entry would, in turn, limit the ability of existing utilities to increase the market price as much as they would if the natural gas prices were lower. Even if there were no growth in demand, an accurate model would reflect that new generation owners could push out the old generation owners and therefore reduce market power.

The extent to which the inclusion of more accurate natural gas prices would decrease the market power of existing utilities can not be estimated from the Report. WP&L cannot demonstrate the effect but believes that it could be significant. An examination of the Report's breakdown of the specific markets where potential market power is alleged shows that this potential market power predominates in the on-peak hours, when new high efficiency natural gas plants would be competing with the older, less efficient utility plants. (See all of the Report's Appendix D. *Behavioral Analysis Results: PCMI by Scenario*.) This suggests that inclusion of the higher natural gas prices would significantly decrease the potential market power in any case, the example demonstrates that market conditions are an essential element in determining how additional providers might enter the WUMS wholesale market.

A second, and much more important, reason for the low energy price forecast is the failure of the study's model to require that capacity prices produced by the model be adequate when new capacity is required in the market. New capacity will not enter a new market until anticipated prices will cover the recovery of and a return on, the new investment. The Report and its Appendices offer little information on the derivation of capacity prices assumed. WP&L bases the comments that follow on the information in the Pool Capacity Balance Table found on A-10.

The Report assumes significant capacity available from the areas of MAIN outside of WUMS. WP&L's first observation is that the Table is based on MAIN, not WUMS. Based on the relevant market as defined in this study, and reflecting the number and capacity of plants located outside of Wisconsin that can move power into the WUMS market at competitive prices, this may appear appropriate. But the practice introduces a severe distortion with the inclusion of the New Entry category. The Table shows 6537 MW of new capacity introduced into the MAIN market in the four years starting with 2000. This represents an increase of more than 13% in capacity for MAIN as a whole.

This large level of new additions overstates the likely actual capacity additions. Experience nationwide suggests that the number and capacity of announced plants significantly outpace the actual level of construction. The experience to date suggests that roughly 25 percent of the plants that are announced will be constructed. Within the model, the assumption of excess capacity has the result of lowering the estimate of competitive market prices in the near term years because the model includes neither the recovery of, nor the return on, investment necessary to attract new investment in these new generating plants. As a consequence, the market modeled in the Report produces unrealistically low price estimates for competitive markets in the early years.

This significant increase in capacity, followed by four years of no capacity additions, raises serious questions about the market activity that serves as a backdrop for measuring competitive market prices. WP&L believes that the numbers shown in Table A-10 strongly suggest that the modeling is not realistic.

For example, consider Table A-10, and the restatement of these values in the Revised Table 2.3's list of capacity price for WUMS. First, the model assumes that prices of \$0.00/MWh in 2001 will attract additional capacity of 1484 MW, prices of

\$0.36/MWh in 2002 will attract 2682 MW, and \$0.02/MWh in 2003 will attract 752 MW, but that prices of \$1.11/mwH in 2004, \$1.45/mwH in 2005, \$0.84/MWh in 2006 and \$1.44/MWh in 2007 will not attract any additional capacity. These outcomes simply are inconsistent with common experience with the operation of open markets. High returns from higher prices attract more capital than low returns from lower prices. The distortions are well beyond any assumable market lag. Further, it seems reasonable to assume that if models such as those in the Report can predict market prices well into the future with any reliability and accuracy, then new entrants would anticipate these price swings in their modeling of future prices and the lag will be eliminated.³

Even at the high end of the range for capacity prices, a charge of \$1.45/MWh for each and every 730.5 hours of the average month would produce only \$1.059/ kW month. The present market for capacity ranges from five to nine times as high. By way of illustration, consider applying the cost of per kW of new peakers as estimated in the old Advance Plan process. This assumes a \$350/ kW cost and a useful life of 30 years. The capital recovery without any return, equates to $(\$350 / (12 * 30))$, or $\$350 / 360$ equals \$0.97/kw/month. Clearly, the resulting amount- under \$1/ kW month- does not reflect the current market and will not attract the necessary capital investment at current construction cost levels. The market conditions anticipated in the Report are clearly inconsistent with the fundamental relationships between prices and anticipated capital investment with regards to timing of investment and adequate capital recovery.

Correctly estimating the amount of new generation entering the market is critical to understanding how long, if ever, potential market power will exist in WUMS. In the

³ If the model can not be expected to produce these prices with any reliability, then serious questions must be addressed before the findings in the Report can serve as the basis for any policy decision that could dramatically effect the reliability of the Wisconsin utility system.

Report the measure of potential market power is the PCMI. The effect of the price distortions explained above on this critical measure can be explained as follows.

Figure 4.5 PCMI in the *WUMS Market: Base Case (No Mitigation) vs. Mitigation Options* found on P.45 is based on the estimated competitive market price. This price assumes that 6537 MW of capacity is dumped into the market over four years, but that it has no effect on the Wisconsin market until after transmission additions bring simultaneous transfer capability to 3000 MW of transmission capacity. Figure 4.5 suggests that the vast amount of potential for market power exists in the years where this massive amount of capacity has been built, but can not enter the Wisconsin market.

WP&L anticipates that many parties commenting on this Report will argue that without the transmission investment significant market power will continue. But what the Report has created is a worst case scenario where all of the non-utility owned capacity is built outside of the transmission congestion points of WUMS. This is counterintuitive. Generation will be built where there is access to the highest market prices. Similarly, in years 2004, 2005, 2006 and 2007, the Report anticipates no new capacity entering the market, yet the potential for market power declines drastically.

One must question the assumption that no new capacity will enter into the market when the model shows that three of the incumbent utilities are increasing output and prices and producing profits from 10% to nearly 40% above competitive market prices. If the Wisconsin market is assumed to be truly open and new entrants have an advantage of high efficiency plants, one anticipates that additional generation would be built in Wisconsin. Under this more plausible assumption of new generation located in Wisconsin, potential market power is at worst a temporary thing.

A roadmap is only valuable to the extent it accurately represents the road. The Report has offered a faulty roadmap of reasonable expectations for the behaviors of generation owners under open market conditions in Wisconsin. Electricity supply is too important to the future of Wisconsin's economic health for policy decisions to be based on an inaccurate model. Policy makers must rely on their knowledge of actual behaviors as shown in other markets that have correctly anticipated the need to attract additional generation into an open market.

Remedies

The above analysis suggests that there is little need for remedies for potential market power in Wisconsin. A competitive market that produces adequate investment in new transmission and generation should be sufficient. But there are real problems with the proposed divestiture solution in the Report. What Wisconsin needs is additional generation capacity. Both the "contracts" mitigation and the divestiture proposals cause capital to flow out of the electric generation industry.

Consider first the contract mitigation proposal. In an open market, rising prices would allow the industry to collect the additional revenue required to fund additional investment. By limiting the collection of revenue by companies based on the historical cost of the plant, the Commission is requiring any entrant to generate the necessary capital from outside of the electric industry. This can only increase the total cost of the capital. Just as importantly, the contract mitigation remedy that is proposed sends the wrong price signals to customers, causing the customer to invest less in efficiency and demand control options.

This argument applies to the divestiture option as well. If stranded benefits exist at the level purported in the Report, and stranded benefits are returned to the customers,

then the capital value of existing plants would be liquidated and the proceeds beyond book value would be distributed to customers. The customers are very unlikely to invest the money in the infrastructure so desperately needed to provide adequate reliability in Wisconsin.

Generation owners are reluctant to build within the Wisconsin market for two reasons. First, they do not have access to assured markets on a date certain. Second, recent siting experiences raise fears of regulatory delays in permitting. The open markets in Illinois have created a large influx of new generation, while the uncertainty in Wisconsin has limited new investment. The research firm RDI estimates that as much as 75,000 MW of capacity will be built in the lower 48 United States during the period 2000-2001. This is more capacity than was built during all of the 1990s.

The challenge within Wisconsin is to attract new investment rather than to depend on development of adequate transmission capacity. In terms of the analysis captured in Figure 4.5, PCMI in the *WUMS Market: Base Case (No Mitigation) vs. Mitigation Options* found on P.45, the question is: if the market was open in Wisconsin, would sufficient generation be built to remove any potential for the existing utilities to withhold generation capacity profitability? The answer cannot be determined by the types of models used in the Report because the answer rests on the willingness for policy makers to create a market environment that is as attractive as the market created in Illinois and other open access states. Sufficient capacity built in Wisconsin would eliminate any potential market power within the planning time period of new plant construction.

III. Recommendations

WP&L believes that use of the Report should be limited to a demonstration that under some specific circumstances, open access could create market power for a period

of two to five years. The Report does little more than offer a specific example of what was generally realized prior to the study. To the extent that moving to retail access is discussed, it should proceed with a clear understanding that providing access to the market will attract the necessary additional generation to limit the use of potential market power. The Report should also be used to demonstrate that given a lead-time for retail access of no more than four years, adequate generation capacity could reasonably be expected to enter the market.

Given the present capacity shortfall anticipated in Wisconsin, and the PSCW's traditional use of marginal price analysis for ratemaking, any future market power studies should estimate the incremental price levels necessary to attract the required new generation.⁴ Such an approach would produce dramatically different estimates of competitive market prices and the ability of existing utilities to utilize potential market power.

Based on these understandings of likely market responses, restructuring discussions -which may or may not include a discussion of moving to retail access- should recommence focused on three fundamental issues. The first and most important is attracting new generation into Wisconsin to meet demand. The second fundamental issue is how to develop wholesale market structures that allocate available capacity at times of peak demand without causing the adverse price impacts of the pure market pool systems. The third fundamental issue is to create the systems and technologies needed to provide customers with tools that create meaningful alternatives to electricity use during times of high prices.

⁴ The Report does use short run incremental prices in establishing competitive market cost. The Report does not indicate how its capacity price is derived; the type of plant assumed, first cost, assignment of the capacity cost to the MWh charge, capital structure or risk premiums.

None of these fundamental issues require the invasive divestiture proposal contained in the Report. We believe serious questions have been raised about the market clearing prices and the arbitrary modeling of the location and activity of new generation investments in the Report. Since these questions directly impact the characterization of market power after January 1, 2004 as contained in the Report, divestiture based on this characterization cannot be justified.

In conclusion, WP&L finds that the study has serious flaws. It does not produce reasonable estimates of near term market prices. It assumes new generation availability without producing prices sufficient to reward the investment. The study has not defined the market dynamics in a manner that can anticipate potential behaviors of all potential participants. Consequently the recommendations that follow from the study are not justified.

We believe the surest way to mitigate potential market power is to provide greater certainty in the public policies related to new generation construction in Wisconsin. While discussions of potential market power and whether or not Wisconsin should move to retail access are important, they are not the critical path issues today. Electricity customers in Wisconsin will be much better served if we focus on building the necessary infrastructure to meet their energy needs, and provide them with the tools to receive and react to energy price signals.

NATURAL GAS FUTURES
 PRICES AS REPORTED IN
 THE WALL STREET
 JOURNAL FOR THURSDAY,
 NOVEMBER 23, 2000

Appendix 1

MONTH	PRICE	12 MONTH ROLLING AVERAGE	REPORT ASSUMED PRICE	PERCENT DIFFERENCE (H-K)/K
DECEMBER 2000	\$ 6.577			
JANUARY 2001	\$ 6.584			
FEBRUARY	\$ 6.244			
MARCH	\$ 5.600			
APRIL	\$ 4.880			
MAY	\$ 4.630			
JUNE	\$ 4.595			
JULY	\$ 4.575			
AUGUST	\$ 4.560			
SEPTEMBER	\$ 4.540			
OCTOBER	\$ 4.530			
NOVEMBER	\$ 4.615	\$ 5.161		
DECEMBER 2001	\$ 4.702	\$5.005	\$ 2.56	95.49%
JANUARY 2002	\$ 4.697	\$4.847		
FEBRUARY	\$ 4.462	\$4.699		
MARCH	\$ 4.272	\$4.588		
APRIL	\$ 4.032	\$4.518		
MAY	\$ 3.987	\$4.464		
JUNE	\$ 3.957	\$4.411		
JULY	\$ 3.952	\$4.359		
AUGUST	\$ 3.952	\$4.308		
SEPTEMBER	\$ 3.960	\$4.260		
OCTOBER	\$ 3.949	\$4.211		
NOVEMBER	\$ 4.064	\$4.166		
DECEMBER 2002	\$ 4.165	\$4.121	\$ 2.60	58.49%
JANUARY 2003	\$ 4.175	\$4.077		
FEBRUARY	\$ 4.005	\$4.039		
MARCH	\$ 3.835	\$4.003		
APRIL	\$ 3.673	\$3.973		
MAY	\$ 3.647	\$3.945		
JUNE	\$ 3.667	\$3.920		
JULY	\$ 3.682	\$3.898		
AUGUST	\$ 3.682	\$3.875		
SEPTEMBER	\$ 3.702	\$3.854		
OCTOBER	\$ 3.712	\$3.834		
NOVEMBER	\$ 3.837	\$3.815	\$ 2.64	44.51%

05-EI-120

FOLEY & LARDNER

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November 30, 2000

Ms. Lynda L. Dorr
Secretary to the Commission
Public Service Commission of Wisconsin
610 North Whitney Way
Madison, WI 53707

Re: WPSC Comment -- Docket No. 05-EI-120

Dear Ms. Dorr:

Enclosed please find the original and 15 copies of the comments of Wisconsin Public Service Corporation ("WPSC") to the Horizontal Market Power in Wisconsin Electricity Markets report submitted by Tabors Caramanis & Associates on November 2, 2000.

While the two attachments to the enclosed WPSC comment letter put this filing over the twenty-page limit established by the Commission in this docket, we received verbal confirmation yesterday from Mr. Randel Pilo that the entire filing would be accepted notwithstanding such limitation.

Please contact me at your earliest convenience if you have any questions or concerns regarding this filing.

Very truly yours,



David A. Meisinger

Enclosures

cc: Larry L. Weyers
William L. Bourbonnais

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CLIENT/MATTER NUMBER 05-EI-120-0550

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Wisconsin Public Service Corporation
(a subsidiary of WPS Resources Corporation)
700 North Adams Street
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Green Bay, WI 54307-9001

November 30, 2000

Ms. Lynda L. Dorr
Secretary to the Commission
Public Service Commission of Wisconsin
P.O. Box 7854
Madison, WI 53707-7854

RE: Market Power Study for Retail Competition

05-EI-120

Dear Ms. Dorr:

Wisconsin Public Service Corporation (the "Company") appreciates the opportunity to submit comments on the Market Power Study report developed by Tabor Caramanis and Associates ("TCA") for the Public Service Commission of Wisconsin (the "Commission") in this docket. The Company believes that this study report and more importantly the process it initiates is a good first step, which is needed to move toward the development of a competitive generation market in Wisconsin.

In general, while the TCA study provides a good starting point for the evaluation of market power in the Wisconsin and Upper Peninsula of Michigan System ("WUMS"), it is premature to use it as a basis for any conclusions on market power levels, market power mitigation methods or stranded costs and benefits levels. The Company is most concerned about the limited amount of information regarding the assumptions and models TCA relied on in developing this study, and the lack of time for a meaningful opportunity for peer and stakeholder review of the study prior to its submission to the Legislature. The Company recommends that the Commission submit to the Legislature the TCA study along with all stakeholder comments received as a preliminary study only, and holds a formal contested case proceeding on the issues addressed in the report and in stakeholder comments to provide all stakeholders a full and fair opportunity to review, understand and provide their input on those issues.

Because the Company has not had an adequate opportunity to review the TCA study and its underlying assumptions and models, the Company can only offer preliminary comments at this time. The Company includes, as part of its comments, the comments of Dr. Mark W. Frankena, Economists Incorporated, Washington D.C. in Attachment #1. In addition, the Company includes as part of its comments, in Attachment #2, a copy of its Application for Approval of Transfer of Certain Generation Plants (the "WPS GenCo Proposal") which was filed separately today with this Commission and which, particularly on pages 2 through 11, contains additional relevant comments. The Appendix to the WPS GenCo Proposal is not included in Attachment #2.

Market Power and Mitigation:

Contrary to the conclusion of the TCA Study report, no market participant exercises market power in the current WUMS retail market. That retail market, which is the subject of the TCA study, is fully regulated, both in Wisconsin and the Upper Peninsula of Michigan. Therefore, the generation capacity committed by regulation to native, retail load, is sold at its cost of operation and deployed under economic dispatch. The TCA Study conclusions regarding market power and stranded benefits are both premised on an assumption (which is not sufficiently emphasized) that the current Wisconsin regulatory regime based upon cost of service is materially changed, and generation output becomes priced at market. This would be a very substantial change. Without that policy change, or an assumption that that policy change will be initiated, there is no market power, and no stranded benefit above book value. Even with electric restructuring in Michigan scheduled for 1/1/2002, the retail market will continue to enjoy full MPSC regulation of utility generation used in the market. This retail regulation by state commissions is a substitute for competition and if done properly fully mitigates market power. In Wisconsin to date, there has been no movement toward generation open access for the retail market and there are no advocates of full deregulation of existing utility generation. If market power becomes an issue in the future it can be eliminated either by creation of competitive markets, by continued regulation of existing generation or other mitigation measures.

The Company believes that the key to a transition policy from regulated to competitive markets is to focus on new generation, not the existing generation fleet. Existing generation is integrally linked to the support of the transmission and distribution systems and, therefore, should be the foundation on which the new competitive generation market is built. A competitive generation market for new generation can be created in WUMS if:

- 1) no new utility rate based generation is constructed,
- 2) an embedded cost of service contract between the owners of the existing utility generation sources and the Disco that serves retail customers is required,
- 3) any future generation facility expansion is non-utility, and
- 4) there are no energy transactions between utilities and their non-utility affiliates but for the contracts described in item 2 above.

As the WUMS transmission system is enhanced and new non-utility generation supplies are added to meet the growth of the system, consideration can be given to whether the contract governing existing generation is no longer necessary to protect consumers from market power. WPS has worked with stakeholders in the Wisconsin marketplace and has filed with the PSCW the mechanisms to achieve this new competitive generation marketplace using this concept.

The TCA Study is flawed because its analysis of market power and mitigation:

- 1) Uses a theory of market power based on a deregulated marketplace in which the output of existing generation plants is sold at market based prices, a model, which no stakeholder is advocating be created. The "Economic Capacity" Model assumption of no obligation-to-serve is not an alternative being pursued by anyone in the WUMS market.

- 2) Uses a divestiture theory for existing generation in the current supply deficient marketplace where the generation is fundamentally "must-run" to support the network. The change of ownership of must-run-units does not eliminate market power.
- 3) The TCA Study report recognizes that off-take contracts on existing generation units can simulate the existing regulatory management of market power. But then it illogically layers a divestiture concept on top of the contracts with no recognition that instead of adding value, divestiture causes damage to the economics and reliability of both utilities and customers.

In addition the Company hired Economist, Dr. Mark W. Frankena, to review the TCA Study report. His findings are included in Attachment #1. Dr. Frankena's finding also indicate that there is too little data, descriptions of methods and assumptions, alternative futures and alternative analysis to consider this Study complete enough to use for any constructive purpose without further study and input by all stakeholders.

Stranded Costs and Benefits:

The TCA Study report also alludes to a quantification of stranded benefits. As indicated in the review by Dr. Frankena (Attachment #1), there is insufficient information in the TCA Study report to evaluate whether the quantification of potential stranded cost or benefits is accurate. Of course, any value attributed to generation in excess of its book value must depend on an assumption that the generation output is sold at prices in excess of the operating costs (a shift to a market based pricing regime). Under existing rate base, cost of service, regulation generation is just worth the book value on which the utility returns are authorized. Generation plants have been sold at prices substantially above book value reflecting material stranded benefits only when they are sold out from under rate base, cost-of-service, regulation.

Because the TCA study is based on the evaluation of one, and only one, potential future, its conclusions regarding stranded benefits of existing generation is fundamentally flawed. In addition there is inadequate information on data, assumptions and methods used in the TCA Study to judge not only the probability of the future TCA postulated, but also the stranded benefits claimed. As Dr. Frankena also indicates, no sensitivities were run and/or reported on potential changes to even the results for the one future studied, such as the economic and operating effects of future environmental restrictions on existing generating units.

The Company believes that the stranded benefits in this report cannot be relied on or used for any purpose in WUMS since:

- 1) the TCA study appears to use a PX design which pays everyone at marginal cost, a design which is even under scrutiny in the California market where it was initiated for US markets,
- 2) there are alternative futures which have alternative technology, fuel cost, environmental regulation, load growth, and environments which have the potential to materially reduce the value of existing generation and
- 3) there are material probabilities that such alternative scenarios will occur to such an extent that stranded costs will occur.

The Commission and Legislature should recognize that the quantification of stranded costs and benefits in the TCA Study report is highly uncertain and is unusable in the WUMS market for anything but a start in arriving at this quantification.

The Company requests that the Commission's report to the Legislature, due on or before January 1, 2001 as required by Act 9, expressly recognize the preliminary nature of the TCA Study and include recommendations for completing the study of market power and stranded cost/benefits issues in WUMS, including a PSCW contested case.

Thanks again for the opportunity to comment.

Sincerely,

A handwritten signature in cursive script, reading "William L. Bourbonnais". The signature is enclosed in a thin, hand-drawn oval.

Mr. William L. Bourbonnais
Manager Rates and Economic Evaluation

cc: Dr. Mark Frankena, Economist Inc.
Mr. Brad Jackson, Foley & Lardner
Mr. Richard James, WPSR
Mr. Pat Schrickel, WPSC
Mr. Sandy Williams, Foley & Lardner

**Attachment #1
Wisconsin Public Service Corporation Comments on**

**The Public Service Commission of Wisconsin
Market Power Study for Retail Competition**

05-EI-120

Comments of Dr. Mark W. Frankena, Economists Incorporated, on the Tabors Caramanis Associates (TCA), *Horizontal Market Power in Wisconsin Electricity Markets*, Report to the Public Service Commission of Wisconsin, Nov. 2, 2000 (TCA Report), and correction, Nov. 14, 2000.

The TCA Report analyzes market shares, concentration, and market power over electric energy supplies in WUMS during 2001-07. TCA presents both (1) structural analyses that involve computation of market shares and concentration indexes and (2) behavioral analyses that involve simulations of market prices using computer models.

Structural Analyses: Computations of Market Shares and Concentration

TCA's structural analyses are based on two alternative assumptions regarding generation owners' future obligations to supply energy at prices set by regulation or contract. TCA's Economic Capacity calculations assume that WUMS generation owners are free to sell all their energy output at market-based prices. TCA's Available Economic Capacity calculations assume that WUMS generation owners have obligations to supply some energy at prices set by regulation or contract. The obligation of each generation owner is to supply energy to meet approximately 69% of the what the corresponding utility's native loads would be absent restructuring.

Notwithstanding potential shortcomings in the methodology used in TCA's structural analyses, reasonable methods of computing market shares and concentration for energy in WUMS are likely to produce results similar to those of the TCA structural analyses, given TCA's assumptions regarding load obligations. Concentration in WUMS and WEPCO's market shares are at least moderately high under these assumptions because WEPCO owns approximately half of the generating capacity in WUMS and transmission capacity into WUMS is both limited and heavily used during some periods.

Given uncertainty about what load obligations will be in Wisconsin, the TCA Report should have presented sensitivity analyses using additional assumptions about the level of these obligations. Also, the TCA Report should have tested the effect of assuming—realistically—that load obligations in some other states will be reduced below 100% during 2001-07.

Behavioral Analyses: Simulations of Market Prices

TCA uses two distinct computer simulation models, GE MAPS and COMPEL, to assess market power over energy in WUMS and to assess two potential remedies for market power.

- TCA used GE MAPS to simulate prices under perfect competition. GE MAPS is a proprietary model licensed by TCA. The prices that TCA simulated using GE MAPS were used as an input into the COMPEL model to assess market power. The prices simulated using GE MAPS were also used as an input into an asset valuation model to assess stranded costs/benefits relating to utility generating facilities.
- COMPEL was used to simulate the effects of anticompetitive bidding and withholding of generation capacity on profits and market prices. COMPEL is a model that was developed by TCA.

The TCA Report provides little information about either of these models or how they were used. The information that is provided in the TCA Report concerning these models, the specific assumptions made by TCA in using these models, the voluminous data inputs used in running these models, and the nature of the model results is insufficient to assess the reliability of the output from the models. As a result, one cannot reach a conclusion that TCA's behavioral analyses provide results that are reliable for any purpose. Specifically, one cannot conclude that GE MAPS or TCA's use of that model provides a reliable basis for estimating perfectly competitive baseline prices, or that COMPEL or TCA's implementation of that model provides a reliable basis for assessing the profitability and price effects of anticompetitive strategies or of mitigation proposals.

The GE MAPS Computer Model

GE MAPS is an extremely complicated computer model that is difficult to understand, evaluate and operate, according to reports from consultants and utility personnel that have attempted to use it to analyze market power and for other purposes. While GE MAPS has been used by some consulting firms in some regulatory proceedings, this model is widely regarded as a Black Box. In any event, TCA has not provided evidence regarding the model or its reliability, so GE MAPS is certainly a Black Box as far as most participants in Wisconsin electricity markets are concerned. For example, TCA has not explained the structure and operation of GE MAPS, and TCA has not explained how, if at all, GE MAPS has been benchmarked to demonstrate that it produces output that is relevant to the real world.

The TCA report states that the GE MAPS baseline scenario “is *assumed* to represent the system conditions and prices that would result under perfect competition.” (p. 10, emphasis added.) It appears that TCA submitted its Nov. 2, 2000, report without evaluating whether the GE MAPS prices were reasonable. I infer this from the fact that the GE MAPS price of power (energy and capacity) used by TCA in its analyses was lower in WUMS than in MAPP in 2003, 2004, and 2007 (Table 2.3), a relationship that was contrary to experience and to what one would expect. TCA corrected the GE MAPS prices on Nov. 14, 2000, but still did not provide support for their reasonableness.

In summary, it would be inappropriate at this stage to rely on the output of the GE MAPS model in assessing market power or stranded costs/benefits in Wisconsin. At a minimum, there would have to be a full review of the model and its use before the model output could be used.

TCA’s COMPEL Computer Model

The COMPEL model was constructed by TCA. We have no knowledge of this model other than the scant information in the TCA Report. The information provided in the report is insufficient to understand or assess the COMPEL model, its implementation by TCA in this particular instance, or its results. COMPEL is a second Black Box.

Because we have almost no information on COMPEL, it is impossible to point to more than a few specific weakness that this model or its implementation for WUMS appear to have:

- TCA states that its implementation of COMPEL assumes that there are no transmission constraints within WUMS. However, a number of transmission constraints affect transfers within WUMS under system conditions that occur during a significant share of hours. There is a constraint at the Wisconsin-Michigan border, in the middle of the Wisconsin Electric system. There are constraints on some other transfers within WUMS because loop flows go over the facilities that constrain WUMS imports. And there are load pockets and must-run generation within WUMS.
- It seems odd that TCA concludes in its structural analysis that price differences in WUMS are sufficient to justify treatment of individual control areas as separate destination markets, and yet that TCA treats all of WUMS as a single market in the COMPEL model (TCA Report, p. 11).

An additional difficulty is that without a much more thorough review of the COMPEL model and its results than the TCA Report provides, it is impossible to understand what is driving its results. For example, TCA does not attempt to explain *why* in the COMPEL model a utility is able to exercise market power by withholding capacity while it is not able to exercise that same market power by increasing its bid prices to a very high level for the output from that capacity.

Other Limitations on the TCA Analyses

There are other weaknesses in TCA's methodologies for the structural and behavioral analyses and in the TCA Report:

- Excluding its assessment of mitigation strategies, TCA evaluates market power under only one set of assumptions. TCA does not present sensitivity analyses to test or demonstrate that its results and policy conclusions hold up if one changes assumptions about the future within reasonable limits. For example, the TCA report provides no information on how its results depend on its particular assumptions about native load requirements, fuel prices, environmental

policies, reserve requirements and other conditions in Wisconsin and other states as much as seven years in the future.

- The TCA Report concludes that “Market power in the WUMS region is so significant that the creation of [a] workably competitive market for electricity in that region will not be possible under the current market structure.” This conclusion goes beyond the behavioral results presented in the TCA Report. TCA does not present behavioral model results for a test of the hypothesis that there would be a workably competitive market for electric power in WUMS, given the current ownership structure of existing generators, if generators were obligated to supply output equal to more than 70% of native loads at prices determined by regulation or contract. For example, TCA does not present results confirming there would be market power if generators were obligated to supply 80% or 90% of native loads at prices determined by regulation or contract.
- TCA states among its conclusions that “Entry of new commercial generation will help to reduce market power in WUMS but it is not sufficient to fully eliminate the market power threat.” (TCA Report, p. 36) However, TCA does not present an analysis of entry conditions. As far as one can determine from its report, TCA incorporated entry by new generators into its analyses only by adding (1) specific generators presently in various stages of development and construction that are expected to be in service by 2004 and (2) other new generators after 2004 to the extent that they would be profitable at competitive prices. However, TCA did not investigate the extent to which there would be an increase in entry in response to an attempt to exercise market power. Because TCA appears to have ignored the response of entry to higher prices, it seems likely that (other things equal) TCA’s results regarding the profitability of anticompetitive behavior and the magnitude of anticompetitive price increases for energy in WUMS are biased upward. This is particularly true in light of the fact that the TCA analyses cover a seven-year period. Seven years is much longer than the time required by independent power producers to build additional combined cycle units.
- TCA concludes that “By 2007, a combination of the assumed system expansion options and divestiture impact appears sufficient for mitigating market power. At that time, the need for fixed price contracts could be revisited and their level could be reduced.” (TCA Report, p. 37, emphasis added.) Yet, in discussing the behavioral model results, TCA states that “From 2004 onward, when all assumed system expansion options are in place, WEPCO divestiture appears

sufficient for maintaining PCMI under the 5% level almost all the time.” (TCA Report, p. 35, emphasis added.) TCA also states that “This study considers the 5% threshold in PCMI as an indicator of market power. Thus, *PCMI below the 5% level indicates the absence of market power.*” (TCA Report, p. 31, emphasis added.) In light of the two statements quoted here from pp. 31 and 35, it appears that the 2007 date in the statement quoted from p. 37 should read 2004.¹

- TCA considers only two very specific mitigation strategies—(1) split WEPCO into three equal sized units, (2) impose contract obligations equal to 69 percent of native loads—and a combination of the two. Since the TCA Report does not suggest that TCA considered any alternatives, it is difficult to understand how the TCA Report could be used to decide on the most appropriate form of mitigation.

Stranded Costs/Benefits

TCA states that it estimated the stranded costs/benefits for utility-owned generating facilities in WUMS based on (1) prices simulated using the GE MAPS computer model for years into the future and (2) an unspecified “asset valuation model.” The asset valuation model is not identified or provided, and many of the assumptions used in the asset valuation model are not stated. For example, the TCA Report does not disclose what discount rate was used in computing the present discounted value of a future stream of income, or what the justification for that discount rate is. Thus, the asset valuation model is a third Black Box.

Because the stranded cost/benefit estimates are derived from two Black Boxes—GE MAPS and the unspecified asset valuation model—these estimates should be given no weight.

¹ TCA Report (Nov. 2, 2000), pp. D-9 to D-12, indicate that the PCMI for the WUMS divestiture scenario with capacity withholding and strategic bidding averages 6.19% in 2001, 5.20% in 2002, 4.33% in 2003, 3.20% in 2004, 3.05% in 2005, 4.01% in 2006, and 3.22% in 2007; pp. D-13 to D-16 indicate that these percentages are reduced to the following by the addition of contracts: 2.85% in 2001, 2.61% in 2002, 2.44% in 2003, 2.05% in 2004, 1.92% in 2005, 1.50% in 2006, and 1.85% in 2007.

BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

**APPLICATION OF WISCONSIN PUBLIC SERVICE CORPORATION
FOR APPROVAL OF TRANSFER
OF CERTAIN ELECTRIC GENERATION PLANTS
TO A NONUTILITY AFFILIATE GENERATING COMPANY
AND COMMENTS UPON
HORIZONTAL MARKET POWER IN WISCONSIN ELECTRICITY MARKETS:
A REPORT TO THE PUBLIC SERVICE COMMISSION OF WISCONSIN
DATED NOVEMBER 2, 2000**

Wisconsin Public Service Corporation, a Wisconsin corporation headquartered in Green Bay, Wisconsin (referred to hereafter as "WPSC" and for certain purposes "WPSC DisCo"), by its attorneys Foley & Lardner, hereby seeks the approval from, and consent of, this Commission to transfer title to its wholly-owned, non-nuclear electric generating plants to another wholly-owned subsidiary of its parent WPS Resources Corporation ("WPSR"). For the purpose of this Application, the transferee affiliate shall be called "WPS GenCo." This transfer is requested to be conditioned upon, and subject to this Commission's approval of, a power purchase agreement with material terms and conditions consistent with the form of agreement attached to this Application as Appendix A (the "Power Purchase Agreement" or "PPA"), as well as the transfer to WPS GenCo of the real property on which the divested generation plants are situated. The electric generating plants to be transferred pursuant to this Application are described in Exhibit A of the PPA.

In addition, the proposed transfer is requested to be conditioned upon those requirements consistent with the transactions and course of action more completely described in this Application. These Commission approvals are sought pursuant to the pertinent statutes of the State of Wisconsin, including Wis. Stat. §§ 196.491(3m)(a) and (c), 196.52, 196.795(5)(k), (r) and (s), 196.80 and 196.807 as well as Chapter PSC 100 of the Wisconsin Administrative Code.

Related Policies

This Application seeks relief which is novel. It proposes adoption of a rational and deliberate regulatory transition plan to a competitive generation market. The proposal might require certain statutory amendments if the Commission concludes that innovative aspects of the proposal do not avoid constraints imposed by certain provisions of the state's utility holding company act, Wis. Stats. Chapter 196.795. But, Applicants respectfully request that this Commission fully evaluate this proposal, so that this proposal will be appropriately taken into account as the public policies associated with electric utility regulation in the State of Wisconsin unfold. Also, this proposal constitutes, in part, the comments of WPSR and WPSC on the November 2, 2000, Horizontal Market Power in Wisconsin

Electricity Markets report to this Commission submitted by Tabors Caramanis & Associates (the "TCA Report").

The instant proposal, as explained below, creates a smooth transition path to a competitive generation market, not constrained by undue market power. Also, the proposal substantially eliminates the negative consequences of market power which could be caused by the existing, regulated electric generation fleet if it were released into market-based pricing, pending the development of robust competition.

This proposed transition to a competitive generation market is also premised upon the adoption of parallel policies and procedures designed to promote the development of a robust, competitive generation market. These parallel policies include implementation of a request for proposal ("RFP") process whereby Wisconsin regulated electric distribution utilities would be required to purchase their increased electric power requirements from third parties or, as an alternative to new purchased capacity, be required to offer existing firm retail customers the opportunity to leave the utility's system and obtain service directly from (a) third party(ies). In addition, the proposal puts all of the transferred generating capacity and energy under the control of a regulated distribution utility or "DisCo" - and requires that all power sales by the distribution company be facilitated by a bulletin board in which the DisCo will post the prices at which it will sell power in the increments covered by the Power Purchase Agreement. All energy available to the DisCo and not used by the DisCo to serve its load would be made available for sale into the power market by the DisCo through a public process. As such, this proposal effectively precludes both WPS GenCo and WPS DisCo from engaging in "strategic bidding" and "capacity withholding," the two forms of behavior cited in the TCA Report as posing the greatest threat to a perfectly-functioning competitive market, during the term of the PPA.

Finally, only upon a determination by this Commission that the generation market has failed, and will fail, to provide reliable electric supply to a Wisconsin utility should that utility be allowed to construct a facility. This would in a more significant way than currently exists shift the burden of proof for a "needs" showing for a certificate of public convenience and necessity ("CPCN") to the utility seeking approval of a plant. With respect to such new electric facilities constructed by unregulated utility affiliates, sales to utility affiliates need to be prohibited to avoid thwarting the construction of new generation capacity by independent power producers ("IPPs").

For the reasons described herein, the proposed transfer, the Power Purchase Agreement and the related transactions described and proposed in this Application are consistent with the public interest. WPS requests that this Commission investigate and hold a public hearing to consider this Application, consider this proposal as a suggested form of market power mitigation in the Commission's evaluation of the Horizontal Market Power report to the legislature, and give its consent and approval to the transactions proposed herein in writing. In support of its Application, WPS states as follows:

I. SUMMARY

A. The Problem With Divestiture to Unaffiliated Entities

WPSC asserts that the development of a competitive market for electric generation is inevitable, regardless of when, whether or how energy industry restructuring occurs in Wisconsin. This shift to a competitive generation market will occur, if only to provide electricity on a wholesale basis to the ultimate retail providers. Numerous other states have highly developed, competitive generation markets. Numerous states have moved substantially down the road to having most generating assets owned by independent (non retail-utility) power producers or "IPPs." Wisconsin has a growing number of generating plants owned by IPPs - 2416 MWs of the 3137 MWs of generating capacity built or approved for construction in Wisconsin between 1995 and 2000 are owned by IPPs. The Federal Energy Regulatory Commission (the "FERC") has announced its preference for policies which promote competitive generation markets. In addition, Congress is apparently on the verge of considering legislation that would spawn competitive generation markets.

If (regardless of whether or when retail access occurs and independent of other industry restructuring issues) a competitive generation market is likely over the next decade, then what policy should Wisconsin adopt as the transition to that market?

Should Wisconsin utilities be allowed to build new, ratebased generating plants? Should affiliates of Wisconsin utilities build new facilities and sell the output back to their affiliate? Would that frustrate or defer the development of a competitive generation market?

Should Wisconsin utilities be allowed to hold onto their existing, ratebased power plants, or will that frustrate or defer the development of a competitive generation market?

Should Wisconsin utilities be required to divest their existing plants, by auctions, to IPPs? Would that put at risk continued access by customers at the cost of production to Wisconsin's low cost electric generating plant output? How should the proceeds of those plant auctions be handled? Will auctions disable Wisconsin-based energy companies in their efforts to stay in the energy business?

WPSC asserts that allowing or requiring Wisconsin retail utilities to build more ratebased electric power plants today will frustrate the development of a robust, competitive generation market to serve Wisconsin tomorrow. Allowing more ratebased electric generation will diminish the likelihood that IPPs will build power plants. Without a substantial amount of IPP plant construction in the next several years, which construction would significantly diminish the current level of generation ownership concentration in this state, Wisconsin will be more likely to require the wholesale auction by utilities of their generating plants to "jump start" a competitive generation market. But is wholesale divestiture to independent third parties a good idea? Is there a better way to transition to a competitive generation market? Requiring new generation to be constructed under the current ratebased scheme will only

increase the need for large scale generation plant auctions to solve the even larger market power issues they create in a transition to a competitive generation market scenario.

Among the options available to further a competitive generation market, WPSC does not prefer wholesale electric generation plant auctions in Wisconsin. States like California, New York, Massachusetts, Pennsylvania and Illinois – the states which have had plant auctions – were all high-cost electricity states. There are several immediate problems associated with divestiture, including the fact that it: (1) accelerates taxes; (2) has the potential to raise wholesale prices; (3) creates immediate market power issues; (4) complicates the resolution of “must run” reliability issues; and (5) uncouples prices from the embedded costs of the utility plants.

Wisconsin was and is a low cost electricity state. In the current situation, Wisconsin remains relatively low-cost. An attempt to divest electric generation by Wisconsin utilities before the development of more robust electric production competition in the region, and more IPP-controlled generation capacity, risks increased upward pressure on the price for wholesale power. Wisconsin’s electricity costs will trend up with the construction of new, higher cost generation. But a robust, competitive IPP market will mitigate that upward cost pressure. Upward price pressure could be a greater risk in a regional market with relatively disparate energy pricing (Wisconsin and Illinois) and with a competitive market of untested robustness – particularly if essentially all generation is outside of rate base and not available to customers at the cost of production. The proposed transition plan will stay in place until at least 30% of retail customer energy use has been shifted to a competitive market – the customers will retain their ability to access existing generation at cost until that occurs, if it occurs.

B. The Problem With Not Divesting

If divestiture should not occur in Wisconsin, and if utilities should not build more ratebased electric generation going forward, then are the Wisconsin utilities simply sentenced to a “going out of the electric generation business, run it into the ground and turn off the key” strategy? Today, electric generating plant investment represents 42% of WPSC’s balance sheet. If WPSC should not divest its existing generation nor build new generation, then the existing generation will continue to depreciate and approach zero on its balance sheet. Utilities like WPSC will struggle to attract personnel for operation of their shrinking power plant fleet, and they will be forced to phase-out of the power supply and the power engineering businesses altogether. Holding companies like WPSR will be unable to deploy their massive existing utility generation investments in a manner that would support development of a going-forward business.

A typical enterprise, knowing it intends to, or must, get out of a particular core competence business, will attempt to redeploy that portion of its balance sheet and that competence for its long-term business success. It could do so by selling that part of the business (the auction scenario), or by using that core competence to develop a growing business opportunity (the GenCo Scenario proposed by this Application). Responsible

businesses struggle to avoid the negative social and economic impacts of a "go out of business" strategy. Responsible businesses build upon what they have and what they can do to create future business opportunities, services and jobs for their stakeholders. The State of Wisconsin should encourage the efforts of such a homegrown initiative. This is a powerful motivation for this proposal.

C. WPSC's Solution

WPSC proposes to transfer all of its wholly-owned, non-nuclear electric generating plants to its affiliate WPS GenCo, a wholly-owned subsidiary of WPSC's parent WPSR. After the time of that transfer WPSC would be a regulated electric distribution utility, referred to herein as "WPSC DisCo." The transfer would be conditioned upon the elimination from rate base for state regulatory purposes of the book value of those plants at the time of the transfer. The transfer would also be conditioned upon the execution of the PPA, in the form attached as Appendix A and as approved by this Commission. In addition, ownership of the real property on which the divested plants are situated would also be divested by WPSC. In effect through a ratebase adjustment WPSC DisCo will receive a premium above book value equivalent to the extent to which the market value of the fleet of plants transferred, at the time of the transfer, exceeds their book value as determined by this Commission (the "Purchase Premium"). The PPA includes a fixed payment stream from WPSC DisCo to WPS GenCo which amortizes the book value over the existing depreciation lives and the Purchase Premium over an estimated term of the PPA. The ratepayers of WPSC DisCo would at the time of the transfer receive adjustments to the ratebase and expenses of the utility which has the effect of reducing the total cost of service by the same amount as the fixed-charge payment. In the event that the contract terminates prior to the full amortization of the purchase premium, the unamortized portion of the DisCo ratebase adjustment will be eliminated and the future expense adjustment will cease for DisCo ratemaking.

D. No Loss of State Jurisdiction

This Commission has initial approval authority over all terms and conditions of this proposal. The FERC has parallel jurisdiction over certain aspects of this proposal, most notably certain rate and non-rate terms and conditions of the PPA. In recognition of the fact that this Commission's findings and approvals in this docket could later be modified by the FERC in its application of the public interest standard it is charged with enforcing, the Applicants request that each and every finding made and approval granted by this Commission be conditioned upon the Applicants obtaining all FERC approvals required by this proposal in a manner which does not materially alter the value of the transaction to WPSR, WPSC, WPSC DisCo and/or WPS GenCo.

WPSC also suggests that to the extent any changes to the proposed PPA permitted by its terms (viz., the fuel cost reopener) require the approval of the FERC in addition to this Commission's approval as contemplated herein, the PPA contemplates the lower cost requirement (for the customers of WPSC DisCo) will prevail. This is designed to remove the potential for any "federalization" of the generation process (by FERC Federal

Power Act jurisdiction) trumping this Commission's state jurisdiction. The PPA also states that the parties intend the Commission interpretation to apply, and designate the "public interest" standard of FERC to be the applicable standard - meaning that FERC would have to find the Commission's determination "against the public interest" in order to contradict such decision. Pending final approval of both agencies of any material change, WPSC DisCo and WPS GenCo will implement any changes approved by the first such agency subject to any true-up payment or similar after-the-fact transaction necessitated by the final approval of the second agency - thus allowing the parties to conduct business while precluding any party from benefiting, even temporarily, from contract terms which are not ultimately consistent with this Commission's decision.

E. WPSR's Commitment To Build To Meet State Needs

WPSR, through its unregulated affiliates, hereby commits and announces its ability to bid for and if it is the successful bidder to meet the capacity needs deemed to be required by any and all of the other Wisconsin retail utilities over the next ten years, in the mix of scale and technologies deemed optimal. WPSR understands this could constitute a two billion dollar capital cost over that period, and if this proposal is adopted WPSR stands ready to make capital investment commitments of that magnitude to assure the necessary IPP capacity to meet the state's utilities' needs. WPSC is confident the IPP market can and will meet its own needs.

II. REQUIRED COMMISSION FINDINGS AND APPROVALS

In order for WPSC's divestiture proposal to proceed, the Commission must make certain findings and grant certain approvals as required by Wisconsin law.

A. The Proposal Will Not Have a Substantial Anti-Competitive Effect

1. WPS GenCo Will Not Have Market Power

Under Wisconsin law, WPSC is a "public utility affiliate" pursuant to Wis. Stat. §196.795(1)(L), and WPS GenCo is a "nonutility affiliate" of WPSC pursuant to Wis. Stat. §196.795(1)(j). Both entities are in the same "holding company system" as that term is defined in Wis. Stat. §196.795(1)(i). As such, the divested generation plants will be "wholesale merchant plants" as defined in Wis. Stat. §196.491(1)(w) because the divested generation plants will be owned by WPS GenCo, and WPS GenCo will sell power only at wholesale.

In order for the Commission to approve the transfer proposed herein, the Commission must find that the following two conditions are satisfied:

1. The public utility has transferred control over its transmission facilities, as defined in s. 196.485(1)(h), to an independent system operator, as defined in s. 196.485(1)(d), that is approved by [FERC] or the public utility has divested its

interest in the transmission facilities to an independent transmission owner, as defined in s. 196.485(1)(dm).

2. The commission finds that the ownership, control or operation will not have a *substantial anticompetitive effect* on electricity markets for any classes of customers.

See Wis. Stat. §196.491(3m)(a) (emphasis added). WPSC has applied to transfer operational control of its transmission facilities to the Midwest ISO and intends to transfer ownership of its transmission facilities to a transmission company at the end of this year.

With respect to the second Commission approval required under this statute, WPSC believes that during the term of the proposed PPA discussed below (this Commission's approval of which is a requested condition of the Commission's approval of the proposed transfer) between WPSC DisCo and WPS GenCo and because of the rights to WPSC DisCo granted thereunder with respect to plant output, WPS GenCo will not hold any market power. Thus, the market power screen analysis contemplated and otherwise required by Wis. Admin. Code §PSC 100.15 is unnecessary for purposes of this Application because all output of the divested generation plants will be contractually tied to serving WPSC DisCo's native load. Only WPSC DisCo will control such capacity under the PPA by utilizing it to serve its native load and/or selling it at wholesale. As such, this proposal complies with the most important market power mitigation measure recommended by the TCA Report – that WPS GenCo “commit a significant portion of [its] capacity under fixed contracts . . . as the source of generation for retail customers on standard offer service.” *See* TCA Report at p. 4. As the TCA Report notes, “possessing market power is possessing both the incentive and ability to raise prices.” *Id.* at p. 8. Under this proposal, neither WPS GenCo nor WPSC DisCo will have the ability to artificially raise prices or otherwise manipulate the market.

WPS GenCo will be unable to exercise market power during the term of the PPA unless and until it constructs or acquires new generation plants, and then only to the extent of that increased capacity. Such new or modified facilities would be subject to a market screen prior to their approval for construction. As such, the market power screen analysis will remain unnecessary with respect to WPS GenCo unless and until any new generation capacity is constructed or otherwise obtained by WPS GenCo.

For purposes of the instant Application, therefore, WPSC relies upon the “declaratory ruling” procedure contemplated by Wis. Admin. Code §PSC 100.13(4).¹ Specifically, for the reasons stated herein and due to the interrelation of each of the transactions proposed in this Application, the proposed divestiture will not have a substantial anti-competitive effect on electricity markets for any classes of customers because the affiliate relationship between the relevant entities, along with the long-term nature of the PPA and its

¹ WPSC also relies upon Wis. Admin. Code §PSC 100.15(3)(c) in seeking a waiver of the market power screen analysis, and encourages interested parties to provide comments on this and all other aspects of this Application.

inherent protection of customers by preventing WPS GenCo from exercising any market power, will eliminate the potential for anti-competitive effects and preserve the status quo with respect to the amount of energy available for purchase from WPSC DisCo by third parties in all relevant markets.²

2. Additional Market Power Safeguards

a. WPSC DisCo "Power Exchange"

WPSC DisCo will establish a procedure whereby it will publicly announce, at regularly scheduled time intervals, the price at which it is then willing to sell incremental amounts of energy (up to the incremental amounts available from WPS GenCo under the PPA). Any capacity available to WPSC DisCo under the PPA but not required to satisfy its native load obligations will be offered for sale by WPSC DisCo in this power exchange.

With such a mechanism in place, WPSC DisCo will have a call on the capacity of the divested generation plants which will be utilized by WPSC DisCo to serve its native load and/or offered by WPSC DisCo for third party wholesale sales. This will allow IPPs (to the exclusion of WPS GenCo) to discipline wholesale market prices, which will benefit WPSC DisCo's native load customers, and will assure that the transferred capacity remains available to the market in the same manner it currently is – through the regulated distribution company and subject to WPSC DisCo's native load obligations.

This will preclude WPSC DisCo, as the entity in control of all plant output, from withholding capacity from the wholesale market or having the opportunity to distort the wholesale market by subsidization. WPSC DisCo's control over the generation units would also preclude WPS GenCo from engaging in "strategic bidding" because the sale price fixed by the PPA will prevent it from causing its more expensive energy units to set the market-clearing price – WPS GenCo will not participate in the wholesale market with this contract's capacity and energy. Further, WPSC DisCo would have no incentive to engage in bidding strategies on the wholesale level because any profit it makes by reselling the WPS GenCo energy would be offset by the need to replace this energy, in order to provide service to its retail customers, at the same market prices. To the extent that WPSC DisCo's native load obligations are so low as to free-up WPS GenCo energy which WPSC DisCo may sell without replacement, WPSC DisCo would pass the profit made on such sales to its customers – just as it does today.

² WPSC believes that the required Commission findings in Wis. Stat. §196.795(5)(s) that WPS GenCo's acquisition of the generation plants will not result in unjust discrimination against, or have an anti-competitive impact on, any competitor of WPS GenCo may be made based upon the same facts and circumstances which support the Commission's required finding under Wis. Stat. §196.491(3m)(a), and relate to the requested generic finding that generating plants tied to a DisCo in the manner established herein by the PPA do not create or constitute unreasonable market power for WPSC GenCo or any comparable GenCo entity created by the divestiture of other public utilities in Wisconsin.

b. RFPs and the Managed Release of Firm Retail Customers

As a method of reducing affiliate transactions and mitigating against future market power concerns, WPSC DisCo agrees that whenever it purchases long-term electric capacity, it will solicit bids both for firm wholesale sales of power to meet its demand and, in the alternative, bids from existing firm retail customers (or groups thereof) of sufficient size who are willing to terminate their access to firm service and instead make arrangements for service from a third party. This release of firm capacity would (to the extent that load is coincident with peak requirements) serve as an alternative to new capacity. This alternative could potentially obviate the need for new construction to serve WPSC DisCo's native load. Applicants urge that such an RFP process for new electric capacity requirements, and the managed-release-of-firm-load alternative to new capacity, be required of all Wisconsin investor-owned utilities.

B. The PPA

As concluded in the TCA Report, the PPA is the proper and best possible mechanism for mitigating any market power WPS GenCo would otherwise obtain as a result of this Application, ensuring reliable service for the public during the transition to a competitive market, and enabling WPSC to remain competitive in the changing regulatory and economic sphere of the energy industry.

1. In General

The PPA is designed to simulate continued ratebased treatment for rate-making purposes for the transferred generation plants during the term of the PPA. Customers will continue to get power at cost and will continue to pay the same cost of capital they currently bear on top of reasonable fixed and variable costs. The PPA is designed to simulate a rate base, cost-of-service like passthrough of reasonable costs of production based upon the costs deemed reasonable in the most recent rate case and escalated with cost indices and adjustments based upon costs exogenous to WPS GenCo and as approved by the Commission in this proceeding. The firmness of power provided by WPS GenCo would be the same as that historically provided by the transferred plants to the utility. In essence, fleet output will be purchased by WPSC DisCo at a price equal to WPS GenCo's fixed and variable costs for the term of the PPA so that the costs borne by WPSC DisCo's customers would equal those that would have been experienced had the divestiture not occurred.

WPS GenCo will bear the financial risk of outage rates higher than those historically experienced and predicted for the fleet transferred. WPS GenCo will also bear the risk of its reasonable costs escalating more rapidly than the allowed indices. WPSC DisCo will have a call on 100% of the capacity and 100% of the energy measured at the time of transfer and as projected to diminish as the result of, among other things, plant retirements (at the historic price-weighted availability of the transferred units). See Exhibit L to the PPA. The capacity, and the energy production such capacity represents, will continue to be dedicated to the native load of WPSC DisCo and be available for opportunity sales by WPSC

during the term of the PPA. Capacity from each site will continue to be available, as it has been historically, when needed to resolve system constraints. The energy will be sold under a formula which reflects electricity's cost of production and which depends upon when the electricity is utilized, and is premised upon unit availability consistent with the history and forecasts for the plants at the time of transfer.

2. The Term of the PPA

The proposed term of the PPA is designed to be long enough to provide a smooth transition to a competitive market or, in the absence of the development of real, effective competition, the term extends for the full useful life of each of the transferred plants. Therefore, unless the benefit of competition is realized, the ratepayers will have the benefit of the transferred plants at their current real costs for their projected lives. WPSC asks this Commission to consider the appropriate term for the PPA, taking into account its current prediction for the date upon which a "Robust Competitive Generation Market" is likely to exist. The Commission also needs to decide how long the ratepayers should bear the fixed carrying cost obligations of existing generation technologies (implicit in ratebased treatment of the existing plants) in order to have the right to obtain power at cost out of the units - rather than allowing these customers to benefit from the opportunities provided by a competitive market. This projected crossover point represents the crossover from ratebased access (bearing fixed costs and the return on utility plant at its historic cost in exchange for getting plant output at cost) having a positive value (compared to purchasing power in the open market) to ratebased access having a negative value in that same comparison.

The chosen term of the PPA is also relevant in the Commission's comparison of the price paid by WPS GenCo for the divested assets as compared to the restriction in value of such assets, at least in the near term, due to the financial constraints the PPA imposes upon WPS GenCo.³ Because the PPA provides a return limited to the reasonable return only on the book value of the transferred assets, and given the customers' access to power at its cost, for the life of the units, the plants' value if any above book value is being reserved for WPSC DisCo's customers. The Commission must evaluate this principle, and determine the appropriate definition of a Robust Competitive Generation Market. Under the PPA, when such a Robust Competitive Generation Market exists, both WPSC DisCo and WPS GenCo have the option to terminate the PPA. The proposed definition is when at least 30% of energy sales at retail in the Eastern Wisconsin Utility service area are not sold by the incumbent utility. This definition is intended to define the "crossover point" in time when the competitive generation market has proved to be at least as attractive as the power generated by

³ The term of the contract as proposed extends out to the projected life of the transferred units, but with an early termination available when 30% or more of the retail energy sales in the Eastern Wisconsin utility region are met by sales from other than the incumbent utilities. However, the Commission may prefer to set a finite term of years based upon its projection of when a "robust" competitive market will be achieved. The attached PPA has identified the first 15 years of fixed payments and if the Commission wishes to consider a contract term greater than 15 years, WPSC will provide the additional payment information.

the fleet of plants of incumbent utilities – eliminating the potential for material stranded value from the transferred fleet, and also creating the situation when the fixed payment by WPS DisCo for the transferred fleet under the PPA could be burdensome due to its reduced load caused by the market penetration of non-incumbent suppliers.

3. Long-Term PPA is the Best Policy

The power to be generated from the fleet will be on a when, as and if available basis – with pricing established to approximate continued ratebased treatment for the historic and predicted fleet availability, and with pricing adjusted to reflect the weighted market value of electricity when it is or is not provided by the WPS GenCo. The pricing formula provides a very powerful incentive for the WPS GenCo (and the shareholders of WPSR who guarantee the GenCo Obligations) to operate their fleet of plants to achieve reliability under the PPA which meets or beats the reliability the plants would experience if owned directly by the utility.

The pricing formula also avoids the pitfalls cautioned against in the TCA Report, which notes that “[i]t is important to note that in order to mitigate market power, contract prices should **not** be indexed or in any way tied to spot market prices, otherwise they would not be fixed price contracts and their ability to reduce incentive to behave strategically will be compromised.” See TCA Report at p. 34 (emphasis original). The PPA contract price is not tied to market prices, but rather reflects the fixed and variable costs incurred by WPS GenCo in providing the energy. The price paid by WPS DisCo (and passed on to its customers) will be the same as under the current ratebased pricing, regardless of developments in the wholesale market.

Wis. Stat. §196.491(3m)(c) forbids “firm” sales from a merchant plant owned by a nonutility affiliate of a public utility. This proposal could require a statutory amendment of that provision. However, as explained below,⁴ WPS believes there is a sound, innovative

⁴ The sale of power under the PPA from WPS GenCo to WPS DisCo can reasonably be interpreted not to constitute a “firm sale” as that term is defined in Wis. Stat. §196.491(3m)(c), and thus the term of the PPA would not be limited to three years solely because the power sales under the PPA will be between a public utility affiliate and a nonutility affiliate.

The type of “firm sale” limited to a three year term by this statute is “a sale of electricity that is generated at a wholesale merchant plant that is owned, operated or controlled by an affiliate interest” in which “electricity is intended to be available to a purchaser at all times during a specified period on an uninterruptible basis.” See Wis. Stat. §196.491(3m)(c)1.

The sales to WPS DisCo under the PPA will be “interruptible” to the extent that the fleet’s targeted availability will be less than 100% of total fleet capacity. More importantly, the sales under the PPA are not “firm sales” to the extent that WPS GenCo is authorized to “interrupt” its provision of energy from the fleet at anytime, subject to a potential financial disincentive.

“Firm” does have meaning in the wholesale power sales market. There are several traditional types of wholesale power sales contracts. There are “system sales,” in which the wholesale customer has a right at all times to a

(Continued)

way to structure this proposal which would support the Commission's approval without a statutory amendment. Similarly, as explained at footnote 4, WPSC has an innovative proposal to deal with the real estate transfer restrictions found at Wis. Stat. §196.795(5)(k). Even if the Commission decides it will not, or cannot, make the findings necessary to avoid the impact of the three year, firm, off-take limitation and the real property transfer restrictions, this Commission should proceed with this docket to examine the public's interest in the "unbundling" of electric generation and provide input to the legislative and administrative processes dealing with electric industry structuring issues and market power issues.

This proposal is not specific to units, nor does it commit output from specific, existing generating units, other than the hydroelectric and wind facilities. Rather, this proposal transfers a fleet of generating plants and promises the future delivery of power from WPS GenCo which matches the capacity and reliability of power obtained from, and projected for, the plants at the time of their transfer. Under the proposal, the transferred plants can be modified or replaced by WPS GenCo without restriction (but for certain transmission and renewable resource credit considerations). The result could be substantially modified facilities. The contract does assure that power generated from the sites transferred will meet or exceed the generation profile of the sites transferred. When required for system support reasons, the contract will require WPS GenCo to provide that system support from the site (with its defined attributes as projected at the time of transfer) - or pay the consequences.

The contract does not create firm rights to the actual total output of each or all of such modified facilities. The proposal will not reduce reliability. WPS GenCo, under the proposed PPA, will have significant incentives to provide energy at or above the historic reliability levels of the transferred units. In addition, WPSR's shareholders will guarantee this obligation - in a manner which shifts fuel cost and purchased power risks to the shareholders in a very direct manner. WPS GenCo will therefore need to meet or exceed the reliability projected for the units as if they had remained within the utility; if it does not, it (and WPSR shareholders) will bear the financial consequence based upon the market cost of replacement power (or the price of service interruptions). This PPA will preserve at least that level of financial risk exposure for WPSR shareholders that they face in the current, ratebased treatment.

Further, WPS GenCo will have the incentive, and the financial strength, to expand generation capability. While the capacity of such new plants would not be expressly

certain contracted level of output from the seller's entire fleet of plants. Such sales are "firm." The proposed contract is not such a "system sale." There also are power purchase agreements that are generating unit specific. Such agreements might commit output from a generating unit whenever it is available. Such sales might be "firm" unit sales. This power purchase agreement is not unit specific in an actual, physical sense.

For these reasons, the PPA could be construed as being outside of the three-year limitation with respect to "firm sales."

bound by the PPA, such additional merchant plants would protect the reliability under this contract and would make the competitive generation market more robust.

4. PPA Allows WPSC DisCo to Meet its Renewable Resource Obligations

The PPA provides that all of WPSC's divested facilities, including all hydroelectric or wind generation facilities, must be operated by WPS GenCo in a manner which allows WPSC DisCo to maximize the value of all renewable resource credits, and any other benefits available to WPSC DisCo under Wis. Stat. § 196.378, such that WPSC DisCo shall be in the same position with respect to the statutory renewable resource requirements after divestiture as WPSC is prior to divestiture. In addition, because the energy from the hydroelectric and wind facilities shall be delivered to WPSC DisCo at a price based only on capital and fixed O&M costs, the price paid by and renewable resource credits available to WPSC DisCo's customers for energy from such renewable resources shall be consistent with what would have been the case for WPSC's customers without the divestiture. As such, both WPSC DisCo and its native load customers will stand in the shoes of their pre-divestiture predecessors with respect to this state's statutory renewable resource requirements.

C. **The Transfer from WPSC to WPS GenCo Will Be At Fair Market Value**

Wis. Stat. §196.795(5)(s) requires a finding by the Commission that WPS GenCo will compensate WPSC "at the fair market value of the property." WPSC submits that the proposed transfer price of the generation assets in effect realized by WPSC DisCo will be equal to the market value of the plants in the aggregate, which value is potentially comprised of two components: (1) the book value of the plants as utilized for rate-making purposes, and, if the Commission so determines, (2) an amount representing the net "stranded benefits" of the plants. Today, the generation plants to be divested by WPSC are relatively low-cost providers of power, and thus could have value in the marketplace greater than their book value, but only if they were free to sell power at a price in excess of the incremental cost of production. During the time when the transferred plants are encumbered by the PPA, and their return is restricted to the return on capital, the market value of the plants is effectively capped at close to that asset value. If the Commission determines the transferred fleet have a value in excess of their book value, at the time of transfer, the PPA can accommodate that decision. To the extent there is stranded value above book value, the additional asset value above book value will be transferred off the books of WPSC. This reduction in the ratebase of WPSC DisCo will offset its payments to WPS GenCo amortizing these ratebase reductions due to the suppressed value of the fleet during the duration of the PPA.

As noted above, however, in a robust market with newly-constructed plants operating at higher levels of economic efficiency, the market value of the generation plants divested by WPSC will likely decline over time and, at some "crossover point," be lower than book value. The PPA protects WPSC DisCo and its customers with respect to this crossover point in two very important ways.

First, because the price for energy and capacity paid by WPSC DisCo under the PPA, after consideration of the ratebase and expense reductions related to the purchase premium, simulates continued ratebased treatment providing a return only on the book value, WPSC's native load customers will capture the stranded benefit of these plants and thus will not be put at risk of paying high and unchecked market prices in the near term. Second, if and when WPSC DisCo or WPS GenCo do exercise their right to escape the PPA and purchase power from IPPs in the robust competitive market, the unamortized portion of the WPSC DisCo ratebase adjustment will be eliminated and the future expense adjustment will cease for WPSC DisCo ratemaking.

As such, the transfer from WPSC to WPS GenCo will be at fair market value at the time of divestiture. In addition, WPSC DisCo will not be artificially constrained from escaping its obligations under the PPA at that "crossover point" in time when this Commission agrees that doing so is in the best interest of its retail customers because the PPA is less valuable than access to the competitive power market.

D. The Transfer and the PPA Are Consistent With The Public Interest

Wis. Stat. §§ 196.80(1m)(e), (3) require the Commission to find that the proposed transfer is "consistent with the public interest" taking into account, among other things, the "reasonable value of the property value and assets." In addition, Wis. Stat. §196.52(3)(a) requires the Commission to determine that the PPA and the proposed transfer of property are "reasonable and consistent with the public interest."

Again, in light of the fact that WPSC must take this action to remain competitive in the changing electric industry, and in light of the duration of the PPA and the effect of such duration on the value of the fleet to WPS GenCo as well as the resulting reliability of service to the public, WPSC believes that the reasons stated throughout this Application support the Commission making these required findings.

E. The Proposed Transfer Properly Minimizes Affiliate Transfers

Wis. Stat. §196.795(5)(s) requires the Commission to find that its "potential burden in administering" this transaction and the PPA does not outweigh "the potential benefits to the public utility affiliate's customers" and further that WPSC has "minimized selling, leasing, transferring to or exchanging with nonutility affiliates in the holding company system" property such as that proposed to be transferred to WPS GenCo.

First, because the proposed divestiture is "consistent with the public interest," the amount of property proposed herein to be transferred to WPS GenCo is an appropriate minimization of such property transfers to WPSC's nonutility affiliates because a transfer at a "lower" level than that proposed would be insufficient to allow the transactions contemplated herein to result, as a whole, in a financially appropriate and economically viable transaction for WPSR, WPSC and WPS GenCo which provides the necessary level of service reliability and all other requirements necessary to fully satisfy the public interest.

In addition, subject to the statutory obligations of WPSC as discussed below, WPSC agrees to minimize any such property transfers in the (post-divestiture) future between WPSC and its nonutility affiliates, including without limitation the minimization of any "sharing" of employees.

Finally, this transaction will not result in any significant administrative burden for the Commission, and any expected burden will be substantially outweighed by the long term benefit received by WPSC's customers under the proposed transfer and PPA.

F. Transfer of Real Estate

According to Wis. Stat. §196.795(5)(k),

1. Except as provided under subd. 2, no public utility affiliate may *transfer, sell or lease* to any nonutility affiliate with which it is in a holding company system any *real property* which, on or after November 28, 1985, is held or used for provision of utility service *except by public sale or offering to the highest qualified bidder.*

(Emphasis added).

The instant proposal could require an amendment to this statutory restriction. However, this proposal includes two options which the Commission should consider as alternatives, each of which would avoid the need for a statutory amendment.⁵

⁵ 1. WPS GenCo is the Only "Qualified Bidder"

This proposal unlocks some of the value in generation ownership for the WPSR shareholders, but without WPSC's customers risking a change in (1) costs (2) reliability or (3) market power. WPS GenCo will be able to consolidate generation plant operations with other IPP facilities, and thereby create employment and business opportunities. The output transferred will be dedicated to Wisconsin native load uses, avoiding any even theoretical market power concerns during the term of the PPA. This transaction creates no acceleration of an added tax burden. The generating units will be held in a subsidiary of a Wisconsin public utility holding company - whose prime jewel is the highly regulated WPSC. The shareholders of WPSR will have the ultimate liability to assure the performance of WPS GenCo, and will provide a financial guarantee to back up its financial obligations under the PPA. These are situations, conditions and obligations no other bidder for these plants could duplicate - and as such the proposal by WPS GenCo as an affiliate of WPSC to take these plants from WPSC, subject to the terms of the PPA and with the guarantee of WPSR, qualifies WPS GenCo as the only bidder who could qualify because only WPS GenCo and WPSR can provide this unique affiliate guarantee which is "more" consistent with the public interest than other potential arrangements involving third party owners of the real property.

Therefore, WPSC believes that a "private" transfer of its ownership interest in such real property is consistent with the public interest, and not inconsistent with Wis. Stat. §196.795(5)(k).

2. Public Sale of "Real Property" as Part of Divestiture

(Continued)

to this Application, will not have a substantial anti-competitive effect on electricity markets for any classes of customers.

3. That capacity and energy of electric generation plants owned by generation companies and dedicated, pursuant to a power purchase agreement materially comparable to the PPA, to serving the native load of an affiliated electric distribution utility shall constitute a safe harbor and shall not be considered capacity or energy which constitutes unreasonable market power held by such generation company for the purpose of Wis. Stat. §196.491(3m)(a)2 during the term of such power purchase agreement.

4. As required by Wis. Stat. §196.795(5)(s), that the proposed transfer of property and PPA will not result in unjust discrimination against, or have an anti-competitive effect on, any competitor of WPS GenCo.

5. As required by Wis. Admin. Code §PSC 100.13(4), that WPS GenCo's ownership, control and operation of the fleet will not have a substantial anti-competitive effect on electricity markets for any class of customers that will not be effectively mitigated by the PPA and the other mitigation remedies inherent in the facts and circumstances underlying this Application.

6. As required by Wis. Admin. Code §PSC 100.13(4) and 100.15(3)(c), a market power screen analysis, as defined in Wis. Admin. Code §PSC 100.15, is unnecessary for purposes of the instant Application.

7. That the sales of power from WPS GenCo to WPSC under the PPA comply with Wis. Stat. §196.491(3m)(c).

8. As required by Wis. Stat. §196.795(5)(s), that WPSC will be compensated by WPS GenCo for the transfer at fair market value.

9. As required by Wis. Stat. §§ 196.52(3)(a), 196.80(1m)(e) and 196.80(3), that the proposed transfer is reasonable and consistent with the public interest.

10. As required by Wis. Stat. §196.795(5)(s), that the Commission's potential burden in administering the transactions contemplated herein will not be greater than the potential benefits to WPSC's customers.

11. As required by Wis. Stat. §196.795(5)(s), that this Application sufficiently minimizes WPSC's selling, leasing, transferring to or exchanging with nonutility affiliates in its holding company system the property to be transferred pursuant to this Application.

12. As required by Wis. Stat. §196.795(5)(k)1, that WPS GenCo is the only "qualified bidder" for purchase of the real estate on which the transferred plants are situated, and thus WPSC may privately transfer its ownership interest in such real estate to WPS GenCo.

13. In the alternative to requested finding number 12, above, that the public sale of the real estate on which the transferred plants are situated to the highest qualified bidder, subject to Commission approval of all other terms and conditions of this Application and additionally subject to, among other things, a lease in the form described in this Application, is consistent with the requirements of Wis. Stat. §196.795(5)(k)1.

14. That the Commission is satisfied that WPSC will comply with the requirements of Wis. Stat. §§ 196.795(5)(r) and 196.807.

15. That sales or purchase of electricity to or from their regulated utility affiliate by unregulated affiliates beyond this contract will potentially thwart the development of a competitive generation market, and is not in the public interest.


16. That in order to issue a CPCN to a regulated utility for a ratebased electric generating plant, the "need" standard of §196.491 requires a determination that the electric generation market will fail to provide adequate electric supply to that utility.

17. That each and every finding made and approval granted by this Commission shall be conditioned upon the Applicants' receipt of all necessary approvals from the FERC, which FERC approvals may not require material substantive changes to the transaction and PPA contemplated and proposed by the Applicants herein as approved by this Commission.

18. That to the extent any changes to the proposed PPA permitted by its terms require the approval of the FERC in addition to this Commission's approval, the PPA contemplates that the lower cost requirement (for the WPSC DisCo) will prevail.

Dated this 30th day of November 2000.

FOLEY & LARDNER



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November 30, 2000

Via Hand-Delivery

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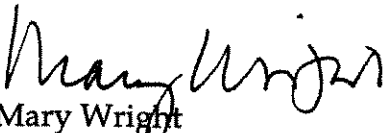
Re: Market Power Study for Retail Competition
Docket No. 05-EI-120

Dear Ms. Dorr:

Enclosed for filing is an original and 15 copies of the Comments of the Customers First! Coalition on the Study of Tabors Caramanis and Associates on Horizontal Market Power in Wisconsin Electricity Markets in the above-referenced docket.

Sincerely,

CULLEN WESTON PINES & BACH LLP


Mary Wright

MW/rs
Enclosures

05-EI-120

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**BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN**

Market Power Study For)
Retail Competition)

Docket 05-EI-120

**Comments of the Customers First! Coalition
on the Study of Tabors Caramanis and Associates on
Horizontal Market Power in Wisconsin Electricity Markets**

The Public Service Commission of Wisconsin (PSC or Commission) has opened this docket to receive and consider comments on the horizontal market power study conducted pursuant to 1999 Wisconsin Act 9 by Tabors Caramanis and Associates. The Customers First! Coalition files the following comments on the study.

I. THE STUDY SHOWS THAT WISCONSIN FACES SEVERE MARKET POWER PROBLEMS THAT WILL MAKE A SUCCESSFUL TRANSITION TO RETAIL COMPETITION VERY DIFFICULT.

A. The Tabors Caramanis and Associates (Tabors) study shows that there is a very significant market power problem in Wisconsin that will make it very difficult to make the transition to a competitive retail market. The study conclusions should surprise no one familiar with the Wisconsin electric situation in the WUMS area. The WUMS area is highly constrained and concentration of ownership and control of generation is very significant.

B. The study's conclusions are confirmed by the study of horizontal market power in Wisconsin conducted by economists James Bushnell, Frank Wolak and Christopher Knittel on behalf of Customers First! (the Bushnell study). The Bushnell study is attached. In fact, the Bushnell study shows that the market power obstacles are

even greater than those identified by Tabors, and that the prospects for robust competition in Wisconsin are considerably worse than were California's prospects prior to the opening of its electricity markets to retail competition in 1998. The Bushnell study found that the costs of mitigating market power problems in Wisconsin may well exceed the benefits of retail competition. The reasons for the differences between the two studies' conclusions are discussed below.

C. The bottom line is that concentration and the opportunity for strategic behavior -- that is, manipulation of the market -- are dramatically greater in Wisconsin than in California this summer, where the largest owner of generation owns less than 10 percent of the generation, and transmission import capability is close to 30 percent of the load. The end state proposed in the Tabors analysis would leave the largest generator in Wisconsin owning close to 20 percent of the generation and import capability closer to 20 percent of the load.

D. The primary issue at this point for the PSC is what to say to the Legislature in forwarding the Tabors study. The Commission should state that the study indicates that Wisconsin faces very major market power obstacles if the state wishes to replace regulation with competition. In addition, the proposed remedies for these problems are likely to be very controversial. The study also shows that there are large stranded benefits, as opposed to stranded costs, associated with our existing generation. A decision as to who -- shareholders, ratepayers or a combination -- will reap these stranded benefits will also be very controversial.

No cost benefit analysis has yet been performed by the PSC of the proposed remedies. Nor has any substantial work been done by the Commission to determine

whether customers in Wisconsin are likely to realize a net benefit from deregulation, given projected costs of new generation.

These issues should continue to be analyzed carefully by the Commission and stakeholders, with the help of experts and by learning from the experience of other states. Any argument that California had a significant first mover advantage from deregulation is laughable at this point. The Tabors and Bushnell studies are only a starting point, confirming that the state should continue to steer a deliberate and careful course in determining what changes in regulation will be beneficial, and how and where to introduce the benefits of competition into this unique and monopolistic industry. Given the impediments to achieving effective competition at retail in a highly constrained and concentrated market, the focus of action at this point should clearly be on wholesale competition and getting new resources built to avoid a debilitating shortage of power.

E. Customers First! is very concerned that the state not get bogged down in 2001 in a difficult debate over moving to a deregulated environment and, in the meantime, neglect to take necessary steps to get new infrastructure built as soon as possible within the context of existing law. The deregulation debate would be a quagmire. After the California debacle, legislators are likely to be very reluctant to make major changes in industry structure, which could have dramatically different results from the results projected by some economists. For this reason, we believe that the prudent course is for the state to pause the deregulation debate and concentrate on getting new infrastructure built pursuant to existing regulatory procedures. If that infrastructure is built, it will certainly be easier and less risky to move to competition.

The study does not address the current state of the wholesale market. Recent requests for proposals by municipal utilities for wholesale energy purchases have yielded poor results. In one case, no responses at all were received. In another, requests were sent to about 30 utilities. Only a third of those responded, and the responses generally had very high prices and were made contingent on future construction or uncertain transfer across constrained interfaces.

The lack of competition in the wholesale market means that municipal utilities and other purchasers in that market will be facing significant price increases, assuming supplies will be available at all. Some of Wisconsin's large investor-owned utilities, a traditional source of supply for the wholesale market, appear to have adopted a policy of declining to serve municipal customers as their contracts expire. Customers First! urges the PSC to make its first priority now to do what it can to ensure that needed electric infrastructure is built over the next 3 to 5 years. New infrastructure is essential for reliability and reasonable electric costs for customers in either a regulated or deregulated environment. Clearly, the state does not want to deregulate into scarcity -- a seller's market. That is a recipe for disaster for customers. If more high voltage transmission and generation are constructed, the market will be more competitive and customers will have more access to a wide variety of supply sources. Balanced against this benefit will be the environmental costs of new transmission and generation, and the inevitable landowner and environmental controversy that will engulf construction applications. It is very important that this policy choice be confronted honestly and directly in the debate.

F. The Tabors study is a snapshot based upon a number of assumptions. Customers First! believes that the Tabors study demonstrates the serious problems

Wisconsin faces. We also believe that before taking any actions based on such a study, it is essential to undertake sensitivity analyses of key assumptions in order to understand the range of possible risks presented by concentration and strategic behavior opportunities, and the efficacy of possible remedies.

G. The study has some shortcomings. The Tabors study understates the market power problem for Wisconsin. The weakest part of the study is the analysis that leads to the conclusion that electric prices in real dollars will be less in 2007 than in 2001. The efficacy of the remedies proposed is also doubtful. In addition, the study does not define the risks to Wisconsin customers of a failure of the remedies. The study points out that no judgment is made as to the political feasibility of the proposed remedies. What is the risk to consumers if deregulation proceeds with watered-down remedies? Nor does the study provide any analysis of the sustainability of effective competition once the initial remedies have been completed.

H. Customers First! recommends that the study be forwarded to the Legislature with a description of the serious obstacles that have been identified and a pledge that the Commission will continue to review these problems, analyze in more detail possible remedies, including doing cost-benefit and sensitivity analyses, and continue to reform regulation and introduce competition where benefits are very likely to be achieved for all classes of customers. One lesson California has taught is that if restructuring is to occur, the restructuring must be very carefully put together. Half measures are likely to result in disaster.

In particular, as the experience in California has shown, the Commission should be wary of proposals that would eliminate the state's jurisdiction over Wisconsin's

generation assets prior to implementation of adequate measures to eliminate the exercise of market power. Both the Tabors study and the Bushnell study make it clear that divestiture of Wisconsin Electric into three firms is one remedy (among others) that must be implemented to mitigate market power, and it is likely that WPS and Alliant may also need to divest some generation to address locational market power and lessen the risk of strategic behavior. Wisconsin must not lose the ability to implement that remedy in a manner that benefits customers by giving up its jurisdiction to act.

Therefore, the Commission should recommend that the Legislature take no action at this time as a result of the study.

In the meantime, the Commission should turn its attention to rapidly processing, in a fair manner, any applications for the construction of new transmission. It should ask the American Transmission Company LLC to submit a comprehensive transmission plan to meet ATCLLC's statutory obligation to ensure that Wisconsin's transmission system remains highly reliable and to allow Wisconsin utilities to take full advantage of the Midwest wholesale market.

The Commission also should address, on an expedited basis, the potential generation shortage that Wisconsin faces. Customers First! recommends, consistent with its Generation Action Plan, that the PSC immediately implement reasonable incentives for both utility and independent power producer-built generation. Perhaps the most troubling issue facing Wisconsin's energy future, regardless of whether that future is regulated or deregulated, is our increasing dependence on natural gas. Significant increases in natural gas prices appear inevitable, and the fact that IPP gas plants function on interruptible gas, as California has learned within the last month, is very troubling.