

TESTIMONY OF THOMAS R. KUHN

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BEFORE THE COMMITTEE ON FINANCIAL SERVICES

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AND ECONOMIC GROWTH

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“ENCOURAGING CAPITAL FORMATION IN KEY SECTORS OF THE
ECONOMY”

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Testimony of Thomas R. Kuhn

Mr. Chairman and Members of the Subcommittee:

My name is Tom Kuhn. I am the President of the Edison Electric Institute (EEI), which is the association of U.S. shareholder-owned electric companies and industry affiliates and associates worldwide. I am pleased to have the opportunity to testify before the Subcommittee on encouraging capital formation in the energy industry.

The Growing Demand for New Capital Formation

Electricity drives America's economy. Modern technologies powered by electricity have been responsible for as much as half of the nation's economic growth since the 1930s. Electricity powers our homes, offices, industries, medical services, transportation, and computer and Internet activities.

The electric industry is one of the most capital-intensive industries in the nation. In the 1990s, electric generation, transmission and distribution assets together comprised nearly 9 percent of all U.S. business assets. In 1999, construction expenditures by regulated investor-owned electric utilities were \$22.8 billion; data for 2000, the latest available, show an increase to \$25.3 billion. With the growth of merchant generation and competitive wholesale markets, construction expenditures by unregulated power producers have also grown significantly, as have wholesale power trading revenues. Overall for the year 2000, total expenditures by investor-owned electric companies for generation, transmission, environmental and other purposes were approximately \$45 billion.

Electric companies have been through enormous change over the last ten years, beginning with the passage of the 1992 Energy Policy Act that started us down the road to wholesale competition. The electric industry is in the middle of a sometimes painful transition from an industry composed of highly regulated, integrated utilities with monopoly service territories and cost-based pricing, to an industry with competitive power generation markets, market-based pricing and a wide diversity of market participants. New institutions are emerging, such as regional transmission organizations (RTOs). It remains our firm belief that market-oriented restructuring of the electric industry remains the best opportunity we have to provide consumer benefits and to develop reliable new sources of supply.

This past year brought additional financial challenges for the electric industry. 2001 began with severe problems in the California electricity market and ended with the collapse of Enron. The combined events of September 11 and the resulting economic downturn led to sharp declines in stock performance for businesses across-the-board. Even under these conditions, however, the electric industry fared better than most others. For example, the EEI index of utility stocks fell 8.8 percent, compared to the S&P 500, which fell 13 percent. The industry's financial results show growth in assets and revenues, and earnings that are stable. Total assets increased by 1.5 percent compared to 2000, rising from \$860 billion to \$872 billion. This follows significant growth of 20 percent in 2000. Total revenues increased by \$128 billion, up 29 percent from 2000 and the fifth consecutive year of double-digit growth. Despite the impacts of the California electricity crisis, September 11, and the downturn in the economy, the industry's bottom-line, after all nonrecurring activity, was down a slight 1.3 percent.

The Uncertainty of Investor Confidence

Of course, the stunning collapse of Enron has brought much greater scrutiny to the energy industry. Enron is a major financial story, but it is not an energy story. Enron's failure is not an indictment of competitive markets or the fault of electricity competition. In fact, Enron's collapse has unfortunately, but clearly, illustrated the benefits of competitive markets. It has been widely acknowledged by the Secretary of Energy, the Chairman of the Federal Energy Regulatory Commission (FERC), and others that, even with the loss of such a major player, bulk power markets continue to function well. Electricity continued to flow. There were no shortages. There were no price spikes. There was no chaos in electricity or gas delivery. Markets are working the way they are supposed to.

Nevertheless, Enron dealt a blow to investor confidence that, at least in the short term, has affected the cost of capital for energy companies. Because Enron happened to be one of its leading participants, the unregulated power generation and trading sector has been especially hard hit by the fallout from the Enron bankruptcy. Analysts and investors have scrutinized these companies with extra care. Some companies have seen their ratings downgraded, and many have restructured their finances. All this has contributed to a rise in capital costs. A number of companies have cancelled generation projects.

EEl is leading a campaign to promote best financial practices in the industry, clear up many of the misconceptions surrounding the Enron situation, and distinguish Enron's practices from those engaged in by other energy companies, all in an effort to restore investor confidence in our industry.

FERC, under Chairman Pat Wood, is pursuing an aggressive agenda aimed at enhancing competition in wholesale electric markets and broadening the benefits and cost savings to wholesale and retail customers. Currently, the Commission is considering some rather far-reaching initiatives that are aimed at increasing certainty about market rules and cost recovery for greater investor confidence. But if these initiatives are implemented in a way that does not preserve a stable business climate, investors will perceive increased risk and uncertainty, which could affect the attractiveness of electric companies in the eyes of investors.

As we look ahead, capital formation will only become more important to our industry. The demand for power and the infrastructure needed to deliver it to consumers safely and reliably will increase as the economy continues its recovery. This will require massive infusions of new capital.

In addition, because of the critical nature of energy infrastructure, and the fact that electricity cannot be stored, more redundancy must be built into the system to enhance its ability to withstand potential terrorist attacks. This, too, will require significant capital investment.

I will now focus in more detail on some specific issues that affect the ability of companies to attract capital for investment in two key components of the nation's electric system: generation and transmission.

The Need for New Generation

Demand for electricity is growing rapidly as the U.S. becomes increasingly electrified. Between 1995 and 2000, U.S. electric demand increased by 13.8 percent, while total electric generation additions rose only 5.4 percent. This has resulted in a

decline in utility reserve margins. The Energy Information Administration (EIA) projects that 355 gigawatts of new electric generating capacity will be needed by 2020 to meet growing demand and to offset retirements of existing plants. Even with additional energy-efficiency improvements, EIA projects that electricity consumption will increase 43 percent by 2020.

The dramatic increase in electricity prices seen in California last year is proof of what happens when capacity does not keep up with demand. Responsible public officials must support the siting and construction of generating facilities to ensure reliable and adequate electricity supplies. Otherwise, it will be very difficult to attract investment in generation, and consumers will pay a very high price for electricity.

- **Federal Tax Code Impediments**

The ability to recoup investment costs, including the depreciation and amortization of generation assets, is of critical importance to the electric power industry's viability and the nation's access to reliable power. As I mentioned before, the electric industry is rapidly changing to one in which generation is becoming fully competitive at a time when there is growing need for new energy supply. However, the capital recovery rules that have applied in the past under the traditional regulatory framework are now inadequate.

To efficiently meet our nation's energy needs through adequate and reliable power, the electric supply industry requires the same ability that other industries have to more rapidly depreciate assets for federal income tax purposes. In stark contrast to the 15 or 20 year depreciation lives for electric generation assets, facilities for other capital intensive manufacturing processes, such as pulp and paper mills, steel mills, lumber

mills, foundries, automobile plants, shipbuilding, and even cigarette manufacturing plants are depreciable for federal income tax purposes over 7 years. Chemical plants and facilities for the manufacture of electronic components and semiconductors can be depreciated over 5 years.

There is no sound justification for these types of distinctions in today's competitive environment. For example, according to federal tax law, investment in pollution control equipment at other types of manufacturing facilities have shorter depreciable lives than at electric generation facilities. As the electricity industry evolves and becomes competitive, it is important for it to have the same types of tax incentives to encourage modernization and increase productivity as those available to other industries. We recommend that the federal income tax laws be changed to allow electric generation facilities to be fully depreciated over 7 years.

- **Constraints in Federal Law and Regulation**

Congress can facilitate the availability of adequate generation by removing federal roadblocks that hinder development of sufficient and affordable generation capacity. One of the most significant barriers is the Public Utility Holding Company Act (PUHCA). PUHCA is an outmoded 1935 statute that acts as a barrier to competition in power markets. By imposing a number of restrictions and regulatory burdens on the purchase and sale of securities and assets as well as other normal business activities, PUHCA restricts the flow of capital into energy markets and slows development of generation capacity. The Securities and Exchange Commission, which is responsible for administering PUHCA, has supported its repeal for over twenty years.

Because of multiple, uncoordinated, and overlapping existing and proposed air emission control requirements from federal and state agencies, and even neighboring countries, the electric power industry faces enormous uncertainty as it tries to develop appropriate plans to develop new generation capacity, upgrade plants and add pollution controls. In lieu of the current regime, EEI has long supported a reasonable, sound, and integrated multi-emissions strategy that would streamline the regulatory process through flexibility and certainty, accomplishing meaningful air quality benefits at a much lower cost, while protecting electric reliability and fuel diversity.

Regulatory certainty and stability are essential to attracting capital for air pollution control. Providing business certainty by establishing specific and reasonable emissions reduction requirements that remain unchanged for a definite period of time will facilitate capital acquisition at a price that allows for lower overall compliance costs. EEI seeks safe harbor provisions in clean air legislation that assure certainty through reasonable timeframes and the elimination of multiple regulatory requirements for SO₂, NO_x, and mercury.

New Transmission Must be Built

Having established the need for more investment in generation, I would suggest there is an even greater need for investment in the power delivery system. Without an adequate transmission system to deliver power to consumers, electricity will not get to where it is needed, no matter how abundant supply may be. Adequate transmission is absolutely necessary to make wholesale electric markets work, bringing lower energy prices to consumers.

Most of today's transmission systems were not designed to deliver large amounts of power over long distances. The grid—built originally to interconnect neighboring utilities—now is being used as a “superhighway” for electric companies.

The number of transactions on the grid has increased significantly because of competition. As a result, the transmission system is facing dramatic increases in congestion. Increased congestion on transmission lines threatens system reliability and increases costs to consumers. In fact, according to FERC, transmission bottlenecks cost consumers more than \$1 billion over the past two summers alone.

Competitive wholesale and retail electricity markets place more demands on a transmission grid that was not designed for such purposes, making it imperative to increase the transmission capacity in the U.S. The grid is nearing the limits of its capacity because of the growing demand for power and the use of the grid to serve competition.

While the demand for electricity is increasing rapidly, transmission investments in 1999 were less than half of what they had been in 1979. In fact, transmission grid expansions are expected to be slow. According to the North American Electric Reliability Council (NERC), about 10,500 miles of transmission facility additions (230 kilovolt and above) are planned throughout North America over the next ten years—only a 5.2 percent increase in total circuit miles. As NERC testified before Congress last year, “The nation is at, or fast approaching, a crisis stage with respect to reliability of transmission grids.” Most of this investment connects new generation to the grid, and does not upgrade the capacity of the basic infrastructure.

Maintaining transmission adequacy at its year-2000 level would require a quadrupling of transmission investments during the present decade. At a time when the transmission system is nearing the limits of its capacity, however, investments in transmission have actually been declining. We must turn this around.

As the electric industry makes the transition from one dominated by vertically integrated companies to one featuring more diverse players, stand-alone transmission companies are being formed. However, these companies can only survive and prosper if they can provide returns adequate to attract the significant amounts of capital investment needed to maintain and expand transmission systems.

Current rates of return on transmission infrastructure are too low to attract the significant amount of capital needed to finance and build new transmission facilities. According to one recent analysis, maintaining transmission adequacy at its current level might require an investment of about \$56 billion during the present decade. However, it is estimated that only \$35 billion will likely be invested.

The most severe choke points on our nation's transmission system are also by nature the locations at which an intentional physical attack on the system would cause the most widespread outages, an additional vulnerability that must be considered in the wake of September 11.

- **Current Law and Regulation Must be Changed**

The nation obviously needs to build new transmission facilities and upgrade existing facilities. Unfortunately, regulatory uncertainty and transmission ratemaking policies can create roadblocks that hinder investment in expansion of needed transmission facilities.

Policymakers can take several steps to help ensure that the transmission system will be able to meet the needs of consumers in increasingly competitive electricity markets.

FERC should be given authority to help site new transmission lines, similar to its long-standing authority to site natural gas pipelines, with appropriate state participation.

Financial incentives, including higher rates of return and other appropriate innovative pricing mechanisms, are needed to attract capital to fund investments in transmission expansion.

PUHCA should be repealed because it acts as a barrier to the formation of interstate independent transmission companies. Regional transmission organizations (RTOs) are expected to play a critical role in planning new transmission infrastructure in the future. RTOs are also a cornerstone of FERC's policy for the development of competitive wholesale electricity markets. However, PUHCA is an impediment to these efforts. An RTO could be required to become a registered holding company and subject to PUHCA restrictions and additional regulation. As investor-owned utilities attempt to raise financing for these newly formed RTOs, they are discovering that PUHCA's restrictions are a significant concern to Wall Street firms and a barrier to investment.

As mentioned before, FERC is pursuing an aggressive regulatory agenda that will shape wholesale electricity markets, including ownership and operation of the transmission grid, for years to come. Congress should seek to ensure that FERC's regulatory policies do not impede or discourage private investment in transmission infrastructure or operations. Encouraging FERC to implement performance based rates

and other innovative approaches are essential to enhancing the grid and creating a viable business climate for the formation of independent transmission companies.

- **Tax Law Considerations**

Current tax law is also a major impediment to the formation of independent transmission companies. In order to avoid tax liability while complying with FERC policy, transmission-owning utilities are forming corporate structures that have only passive ownership of transmission assets, with control of the lines being transferred to the RTO. However, attracting new investment capital to upgrade and expand the transmission system is extremely difficult for the utility (which owns but does not control the transmission lines) and for the RTO (which controls but does not own the system). Selling or spinning off the transmission assets to a separate stand-alone transmission company may be a better option for transmission-owning utilities. Yet they are discouraged from doing so because of federal tax law. In order to fix this problem, H.R. 4, the House-passed energy policy bill, amends the U.S. tax code to defer taxes on the sale, and eliminate taxes on the spin-off, of transmission facilities for transmission-owning companies that seek to join FERC-approved RTOs. The House should be commended for acting promptly on this issue by passing H.R. 4 last summer. The Senate should follow suit.

Congress also should shorten the depreciable lives of property used in the transmission and distribution of electricity. To assure upgrading and building of adequate transmission capacity, EEI recommends that new, and the resale of, transmission depreciable lives should have a cost recovery period of 7 years.

It is worth noting that the economic stimulus bill recently enacted by Congress includes a provision that should help encourage transmission additions. The bill includes a bonus depreciation provision that will permit electric companies to immediately expense 30 percent of the cost of certain “qualified property” placed in service in a three-year period, and extends the deadline for capturing the depreciation deduction until January 1, 2006. It also contains provisions that would apply the bonus depreciation provisions to repairs and reconstruction of property already placed in service. While primarily designed to promote transmission facility upgrades, the bill may also help promote some construction of new gas-fired generation, which can be brought online relatively quickly.

In addition to the demonstrated need for new capital formation for generation and transmission, our industry anticipates the need for new capital formation to upgrade and modernize our distribution infrastructure through the use of shorter depreciable lives.

Conclusion

The electric industry is one of the most capital intensive in the nation. The industry is undergoing significant changes, from vertically integrated companies with regulated monopolies to diverse companies operating in competitive markets. These changes, plus other recent events, have caused capital investment to lag. Therefore, it is critical that Congress and other policymakers continue to pursue measures that will promote capital investment in the electric industry, which will encourage the development of badly needed new generation and transmission facilities.