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APPLICATION OF AEP TEXAS
CENTRAL COMPANY FOR
AUTHORITY TO CHANGE RATES

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COMMISSION
OF TEXAS

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INITIAL BRIEF OF THE ALLIANCE FOR RETAIL MARKETS

The Alliance for Retail Markets (ARM) files its Initial Brief to address the issue of headroom, as raised by AEP Texas Central Company (TCC) in this proceeding. ARM reserves the right to address other issues in reply brief, as necessary.

IX. Other Issues

B. Headroom

The need for adequate headroom in the TCC service area during this transitional phase of the competitive retail electric market is paramount. From the perspective of a competitive REP targeting price-to-beat customers, headroom is the measure of the attractiveness of its price offer in comparison to the affiliated REP's price to beat. The level of retail competition in any given service area is roughly proportional to the amount of headroom available there. In areas in which there is a significant level of headroom, competition for price-to-beat customers will occur because it is economically rational for competitive REPs to engage in advertising, marketing, and sales efforts to entice those customers to switch service. In contrast, in areas in which the level of headroom is insignificant or negative, competition will be minimal (if it exists at all) because it is not economically rational for competitive REPs to target price-to-beat customers.¹

TCC asserts that the level of headroom in its service area is currently greater than the amount of headroom that existed at the outset of retail competition (*i.e.*, January 1,

¹ ARM Exh. 1 at 5-6, lines 15-5 (Direct Testimony of Vanus J. Priestley).

2002), even after factoring the impact of its proposed rate increase in this docket.² This assertion suggests that the Commission should not be concerned about the impact that TCC's requested rate increase will have on headroom in its service area. The Commission, however, should not adopt this cavalier view. Regardless of how headroom is calculated, it is axiomatic that any increase in TCC's non-bypassable base rates will result in less headroom if the rate increase becomes effective prior to an adjustment of the affiliated REP's price to beat pursuant to PURA § 39.202(k) and P.U.C. SUBST. R. 25.41(g)(3).³ TCC witness Mr. David G. Carpenter admitted as much in his rebuttal testimony and on cross-examination.⁴ Therefore, ARM avers that the Commission should be mindful of the impact that any increase in TCC's non-bypassable base rates will have on headroom in this proceeding.

ARM also contends that TCC's headroom analysis is flawed for three reasons. First, the definitions in P.U.C. SUBST. R. 25.41 (the price-to-beat rule) upon which TCC relies to purportedly demonstrate that the level of headroom has increased in its service area since the commencement of retail competition are static in nature, that is, they depict only a snapshot of headroom, at best. Stated another way, they do not capture the dynamic, real-time nature of headroom in the competitive retail market. As ARM witness Mr. Vanus J. Priestley testified, while the approach embodied in P.U.C. SUBST. R. 25.41 for defining "headroom" and "representative power price" may be helpful for general benchmarking purposes, it does not take into account headroom's sensitivity to customer-specific considerations and to various cost factors in the actual marketplace.⁵ While some of the cost factors affecting headroom are relatively stable, others can be extremely volatile, such as the wholesale price of electricity. The wholesale price of electricity is

² TCC Exh. 4 at 13, lines 15-20 (Direct Testimony of David G. Carpenter); TCC Exh. 27 at 30, lines 1-5 (Direct Testimony of Jennifer L. Jackson).

³ These provisions in PURA and the price-to-beat rule contemplate adjustments to the price to beat *after* the true-up proceeding. Given the jurisdictional deadline in this docket, any increase in TCC's non-bypassable base rates resulting from this docket would occur *before* TCC's true-up proceeding. See Hearing on Merits Tr. at 216, lines 14-17; Hearing on Merits Tr. at 217-218, lines 18-12 (March 2, 2004).

⁴ TCC Exh. 66 at 37, lines 15-16 (Rebuttal Testimony of David G. Carpenter); Hearing on Merits Tr. at 217-218, lines 25-12 (March 2, 2004).

⁵ ARM Exh. 1 at 5, lines 9-12 (Direct Testimony of Vanus J. Priestley).

generally the most significant component in the pricing of retail electric service. Consequently, any volatility in the wholesale price of electricity will result in volatility in headroom.⁶ This dynamic characteristic, however, is not captured in the aforementioned definitions in P.U.C. SUBST. R. 25.41. Furthermore, the definitions in the price-to-beat rule do not comprehensively reflect the real-world nature of headroom in other respects. On cross-examination, TCC witness Mr. Carpenter agreed that those definitions do not necessarily account for all costs of doing business that might impact the margin between the price to beat and the costs that competitive REPs incur in serving retail customers.⁷

Second, even if one assumes the appropriateness of TCC's use of the definitions in the price-to-beat rule to compute headroom for the purpose stated, TCC's headroom analysis is nevertheless flawed given the manner in which it has computed current headroom under the rule. As already stated, TCC relies upon the definition of "headroom" in P.U.C. SUBST. R. 25.41(c)(3) in comparing the level of headroom at the outset of retail competition with the level of headroom in existence today. P.U.C. SUBST. R. 25.41(c)(3) defines "headroom" as "the difference between the average price to beat ... and the sum of the average non-bypassable charges ... and the representative power price." P.U.C. SUBST. R. 25.41(c)(9) then defines the "representative power price" as the simple average of two components: (1) the result of a request for proposal for full requirements service of ten percent of price to beat load for a three-year period, and (2) the price resulting from the affiliated power generation company's capacity auctions for baseload capacity entitlements.

The headroom calculations used by TCC to reflect the level of headroom in its service area at the commencement of retail electric competition—that is, those filed in Docket No. 24195⁸ by TCC's predecessor integrated electric utility, Central Power and Light Company (CPL)—employed the simple averaging methodology in the rule to compute

⁶ *Id.* at 6, lines 15-20.

⁷ Hearing on Merits Tr. at 213, lines 17-23 (March 2, 2004).

⁸ Docket No. 24195, *Application of Central Power and Light Company to Implement the Fuel Factor Component of Price to Beat Rates*.

the representative power price.⁹ In contrast, the calculations presented by TCC to reflect the level of headroom that would exist in its service area after the Commission's approval of its requested rate increase are not computed using the rule's simple averaging methodology. Rather, TCC uses only the results of the capacity auctions to determine the representative power price used to calculate the current level of headroom. Consequently, TCC's calculations purportedly reflecting the level of headroom today do not comply with P.U.C. SUBST. R. 25.41(c)(9), and they are inconsistent with the headroom calculations filed in Docket No. 24195 that are employed for comparison purposes.

Third and finally, TCC's current headroom calculations are flawed because information about wholesale electricity and natural gas prices call the reliability of those computations into question. As already stated, changes in the price of wholesale electricity will result in fluctuations in the amount of headroom available to competitive REPs. In his direct testimony, ARM witness Mr. Priestley demonstrated the volatility of the price of wholesale electricity over the test year in showing how the weighted average daily Market Clearing Price of Energy (MCPE) in the ERCOT zone applicable to TCC fluctuated within a range of \$541.70.¹⁰ He also demonstrated the volatility of natural gas prices—which are closely linked to electricity prices in ERCOT—over the course of the test year as well.¹¹ Moreover, Mr. Priestley showed how wholesale electricity prices had materially changed between September 2003—the time frame of the capacity auctions employed by TCC to compute current headroom—and early February 2004, when he prefled his direct testimony. In view of the 11.5 percent increase in the price of natural gas from mid-September 2003 through February 6, 2004, he concluded that TCC's headroom calculations were outdated.¹² Based on the information about wholesale

⁹ It should be noted, however, that while CPL's computation of the representative power price in Docket No. 24195 appeared to follow the definition in P.U.C. SUBST. R. 25.41(c)(9), the Commission did not adopt or approve any headroom calculations in Docket No. 24195. *See* Docket No. 24195, Order on Rehearing (Feb. 8, 2002).

¹⁰ ARM Exh. 1 at 6-7, lines 20-3; Exhibit VJP-1 (Direct Testimony of Vanus J. Priestley).

¹¹ *Id.* at 7, lines 4-7; Exhibit VJP-2.

¹² *Id.* at 10-11, lines 19-4; Exhibit VJP-3.

electricity and natural gas prices in Mr. Priestley's direct testimony, it is clear that TCC's static computations of current headroom do not capture the price dynamics that can substantially affect the level of headroom at any given time. Therefore, those calculations cannot be used for the purpose proffered by TCC.

Aside from advocating that the Commission not use TCC's headroom calculations for the reasons stated, ARM also contends that it is not necessary for the Commission to ascertain the level of headroom in the TCC service area for purposes of this proceeding, as a legal matter. Indeed, both TCC witnesses Mr. Carpenter and Ms. Jackson stated on rebuttal that there is no requirement that TCC provide headroom calculations in this docket.¹³ Moreover, the definitions in the price-to-beat rule upon which TCC have relied are included in the rule for purposes of adjusting the price to beat pursuant to P.U.C. SUBST. R. 25.41(g)(1)(E), not for the purpose for which TCC has employed them here. As stated earlier, however, the Commission should nevertheless be mindful that any increase in TCC's non-bypassable rates will result in a corresponding decrease in headroom.

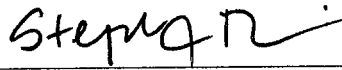
For these reasons, ARM submits the adoption of the following proposed findings of fact and conclusion of law:

- FOF1: Any increase in TCC's non-bypassable base rates will result in less headroom if the rate increase becomes effective prior to an adjustment of the affiliated REP's price to beat pursuant to PURA § 39.202(k) and P.U.C. SUBST. R. 25.41(g)(3).
- FOF 2: Because TCC's headroom analysis is flawed, its headroom calculations should not be adopted.

¹³ TCC Exh. 66 at 37, lines 10-11 (Rebuttal Testimony of David G. Carpenter); TCC Exh. 90 at 23, line 14 (Rebuttal Testimony of Jennifer L. Jackson).

COL 1: Nothing in PURA, the Commission's rules, or the Commission's rate filing package require the Commission to ascertain the level of headroom in the TCC service area for purposes of this proceeding.

Respectfully submitted,



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Certificate of Service

I, Stephen J. Davis, certify that a copy of this document was served on all parties of record in this proceeding on April 5, 2004, by regular mail, facsimile transmission or hand-delivery.



Stephen J. Davis.