McNees Wallace & Nurick LLC
attorneys at law

SUSAN E. BRUCE
DIRECT DIAL: (717) 237-5254
E-MAIL ADDRESS: SBRUCE@MWN.COM

June 15, 2006

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor
Harrisburg, PA 17120

VIA HAND DELIVERY

Re: Policies to Mitigate Potential Electricity Price Increases;
Docket No. M-00061957

Dear Secretary McNulty:

Enclosed please find for filing with the Commission an original and 3 (three) copies of the Comments on behalf of the Industrial Energy Consumers of Pennsylvania, PJM Industrial Customer Coalition, Duquesne Industrial Intervenors, Met-Ed Industrial Users Group, Penelec Industrial Customer Alliance, Penn Power Users Group, Philadelphia Area Industrial Energy Users Group, PP&L Industrial Customer Alliance, and West Penn Power Industrial Intervenors (collectively, "Industrial Customers") concerning the above-referenced proceeding.

As reflected on the attached Certificate of Service, all parties to this proceeding are being duly served. Please date stamp the extra copy of this transmittal letter and kindly return it to us for our filing purposes. Thank you for your attention to this matter.

Very truly yours,

McNEES WALLACE & NURICK LLC

By Susan E. Bruce
Susan E. Bruce

Counsel to Industrial Energy Consumers of Pennsylvania, PJM Industrial Customer Coalition, Duquesne Industrial Intervenors, Met-Ed Industrial Users Group, Penelec Industrial Customer Alliance, Penn Power Users Group, Philadelphia Area Industrial Energy Users Group, PP&L Industrial Customer Alliance, and West Penn Power Industrial Intervenors

SEB:mas
Enclosures
c: Mr. Shane M. Rooney (via electronic mail)
Certificate of Service

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Policies to Mitigate Potential Electricity Price Increases	:	Docket No. M-00061957

COMMENTS ON BEHALF OF

INDUSTRIAL ENERGY CONSUMERS OF PENNSYLVANIA
PJM INDUSTRIAL CUSTOMER COALITION
DUQUESNE INDUSTRIAL INTERVENORS
PENELEC INDUSTRIAL CUSTOMER ALLIANCE
PENN POWER USERS GROUP
MET-ED INDUSTRIAL USERS GROUP
PHILADELPHIA AREA INDUSTRIAL ENERGY USERS GROUP
PP&L INDUSTRIAL CUSTOMER ALLIANCE
WEST PENN POWER INDUSTRIAL INTERVENORS

David M. Kleppinger, Pa. Bar No. 32091
Susan E. Bruce, Pa. Bar No. 80146
McNEES WALLACE & NURICK LLC
100 Pine Street
P. O. Box 1166
Harrisburg, PA 17108-1166
Ph. (717) 232-8000
Fax (717) 237-5300
dkleppinger@mwn.com
sbruce@mwn.com

Dated: June 15, 2006

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I. INTRODUCTION

In response to the Pennsylvania Public Utility Commission's ("Commission" or PUC") Investigation Order entered May 24, 2006,[1] the Industrial Energy Consumers of Pennsylvania, PJM Industrial Customer Coalition, Duquesne Industrial Intervenors, Met-Ed Industrial Users Group, Penelec Industrial Customer Alliance, Penn Power Users Group, Philadelphia Area Industrial Energy Users Group, PP&L Industrial Customer Alliance, and West Penn Power Industrial Intervenors (collectively, "Industrial Customers") submit these Comments on mitigating potential electricity price increases. Because of the serious economic ramifications of increasing energy prices for all customers in Pennsylvania, Industrial Customers are encouraged by the Commission's investigation into this serious matter and offer a true retail customer perspective.

The focus of this proceeding is "to address issues and develop policies to mitigate potential electricity price increases upon the expiration of generation price caps."[2] The problems faced by Pennsylvania retail customers, however, go beyond the charge that the Commission set for itself in this proceeding. The objective of Pennsylvania's landmark Electricity Generation Customer Choice and Competition Act ("Competition Act" or "Act"),[3] which the Commission is charged with implementing, is "to benefit all classes of customers and to protect this Commonwealth's ability to compete in the national and international marketplace for industry and jobs."[4] As transitional rate caps expire, however, and Pennsylvania customers are exposed more directly to market forces, Pennsylvania's capability to realize the objectives of the Competition Act is in serious jeopardy. Instead of the lower prices expected through operation

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[1] *See Investigation Order on Policies to Mitigate Potential Electricity Price Increases*, Docket No. M-00061957 (Order entered May 24, 2005)("Investigation Order").
[2] *Id.* at Ordering Paragraph No. 1 (emphasis added).
[3] 66 Pa. C.S. §§ 2801, *et seq.*
[4] *Id.* § 2802(7).

of market forces, Pennsylvania retail customers in certain areas are already beginning to experience the sting of the high prices produced by PJM's Locational Marginal Price ("LMP")-based market (*e.g.*, in Duquesne and Pike County service territories). Through recent applications to the Commission, certain Pennsylvania electric distribution companies ("EDCs") would have that pain expand to even more Pennsylvania customers, despite promises of rate cap protection during stranded cost recovery periods.[5] Driven by a wholesale market that is highly sensitive to steep and volatile natural gas prices, Pennsylvania is on course to have a retail market in which electric service will not be available to customers "on reasonable terms and conditions" as expected by the Competition Act's framers.[6] Consistent with its statutory obligations under the Competition Act and its mandate to ensure "just and reasonable rates," the Commission should expand its mission to investigate steps to reduce electricity prices in the Commonwealth to benefit all classes of customers and protect Pennsylvania's ability to compete for industry and jobs.

Large commercial and industrial customers expected that restructuring would produce substantial public interest benefits, including: (1) aggressive competition among multiple generators for new construction opportunities, (2) short-term price stability, (3) long-term price reductions from traditional regulation through competitively bid new generation construction, (4) access to wholesale prices driven by PJM's cost-based system lambda split savings, and (5) improved ability to compete in the national and international marketplace for industry and jobs. Contrary to expectations, large commercial and industrials are faced with limited choices of alternative suppliers, minimal price and product innovation, looming expiration of long-term

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[5] *Pennsylvania Public Utility Commission, et al. v. Metropolitan Edison Company and Pennsylvania Electric Company*, Docket Nos. R-00061366, R-00061367, P-00062213, P-00062214, A-110300F0095, and A-110400F0040.

[6] 66 Pa. C.S. § 2802(9)("Electric service is essential to ... orderly economic development, and electric service should be available to all customers on reasonable terms and conditions.")(emphasis added).

price stability though rate caps, exposure to potential market manipulation and market power exertion, a wholesale electricity pricing system highly dependent on natural gas and oil prices, and an exodus of large commercial and industrial customers to traditionally regulated states. The robust competitive retail marketplace of multiple sellers and buyers never materialized. Ownership of generation resources, particularly peaking resources, remains concentrated in the hands of a few market participants, many of who directly or indirectly own transmission resources and fleets of base and intermediate generation. Absent corrective action, post-rate cap increases will be dramatic. Even during the Pennsylvania's rate capped transition period, rates for large commercial and industrial customers have increased substantially. For a large industrial customer on PPL's system, generation rates will increase by 100% from 2005 to 2010 based on current market forecasts. The large commercial and industrial customers in the Duquesne territory already experienced the rate shock of reported 25% and higher increases in electricity costs under Duquesne's POLR III plan and are exposed going forward to inflated electricity prices driven by a wholesale market design that exacerbates the impact of the run-up in natural gas prices. Pennsylvania's retail market (as well as other similarly situated states' markets) is simply not achieving the lower price, better service and innovation that were the primary objectives for reform.

In large measure, this failure is attributable to the pervasive influence of the wholesale market design and structure on retail prices. As explained in detail in Industrial Customers' Comments in the Commission's Investigation of the Competitive Market Conditions in Pike County Light & Power Company service territory, the LMP platform has proven itself to be a barrier to successful implementation of the Competition Act at the retail level. Market data and customer experience confirm that the wholesale LMP model has the unreasonable effect of

driving prices for all energy on the basis of the most expensive fuel source, which unfairly increases energy costs for all ratepayers, and at the same time, disproportionately increases revenues for owners of nuclear and coal-fired generation. Despite this wealth transfer from customers to generation owners, LMP has not been successful, according to PJM, in signaling where investment is necessary, which prompted PJM's Reliability Pricing Model ("RPM") currently under review at the Federal Energy Regulatory Commission ("FERC").[7]

The question that this Commission must ask itself in this proceeding is whether it can rely solely on PJM's LMP-based market to produce "just and reasonable" retail rates. While this Commission does not have direct authority over the wholesale market, it is empowered by the General Assembly to take action to protect Pennsylvania customers from the ill effects of immature or dysfunctional wholesale and retail markets. In these Comments and through the *en banc* process, Industrial Customers offer recommended steps for the Commission's consideration as well as some "brainstorming" ideas for further Commission investigation that may improve how the wholesale and retail markets operate in Pennsylvania. Industrial Customers do not presume to have all the answers, but it is evident that serious problems exist that, if not addressed, will have serious economic ramifications for the Commonwealth. Industrial Customers encourage the Commission to view this comment and *en banc* process as starting point for a comprehensive Commission investigation that develops an implementation plan, including recommendations for further legislative action as necessary, in order to fulfill the promise of the Competition Act.

[7] *See PJM Interconnection, L.L.C.*, 115 FERC ¶ 61,079 (2006).

II. INDUSTRIAL CUSTOMERS' DESCRIPTION

Industrial Energy Consumers of Pennsylvania ("IECPA") is an association of energy-intensive industrial companies operating facilities across Pennsylvania. IECPA's members annually consume in excess of 25% of the industrial electricity in Pennsylvania and employ approximately 75,000 workers at nearly 120 facilities across the Commonwealth. IECPA actively participated in the stakeholder process that led to the drafting of the Competition Act that established Pennsylvania's retail choice program and participated in many generic rulemakings initiated to implement the Competition Act.

Also sponsoring these Comments are coalitions of industrial customers receiving service from most of the Commonwealth's electric distribution companies: Duquesne Industrial Intervenors ("DII"); Met-Ed Industrial Users Group ("MEIUG"); Penelec Industrial Customer Alliance ("PICA"); Penn Power Users Group ("PPUG"); Philadelphia Area Industrial Energy Users Group ("PAIEUG"); PP&L Industrial Customer Alliance ("PPLICA"); and West Penn Power Industrial Intervenors ("WPPII").

PJM Industrial Customer Coalition ("PJMICC") is an *ad hoc* coalition consisting exclusively of large commercial and industrial end-users of electricity. PJMICC members operate manufacturing and institutional facilities in Pennsylvania and throughout the expanded PJM footprint, which encompasses all or parts of Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, Ohio, Tennessee, Virginia, West Virginia, and the District of Columbia. Several PJMICC members also operate manufacturing and institutional facilities located in parts of Virginia and North Carolina encompassed by the PJM South region. PJMICC member companies consume more than 9.5 billion kilowatt-hours of electricity annually. Several PJMICC members are currently also voting participants of the PJM Members Committee

and actively participate in the PJM committee structure. Given the direct interplay between the wholesale and retail markets, PJMICC joins IECPA and other Pennsylvania industrial coalitions in these Comments to share its experience in participating in the PJM stakeholder process and at the FERC regarding wholesale market issues that impact the cost for electricity paid by ultimate customers.

III. COMMENTS

A. Interplay of Wholesale/Retail Market

The success of Pennsylvania's retail market hinges on a vibrant and functional wholesale market. As highlighted in the Commission's Investigation Order, the prices established in the auctions and Provider of Last Resort ("POLR") Requests for Proposals ("RFPs") are predominantly set by the prevailing wholesale LMPs at the time the competitive processes are held.[8] Offers to individual retail customers, to the extent that they are made, are similarly influenced by LMPs. The degree and rate by which LMP has increased thus presents serious consequences for all retail customers. Due to the close nexus between wholesale and retail price, it is critical for the Commission to investigate and determine which market design and structure deficiencies contribute to retail customers' dissatisfaction. To this end, Industrial Customers offer their perspective on the shortcomings of the wholesale market and steps that may be taken at the retail level to promote a competitive market structure in Pennsylvania that achieves the objectives of the framers of the Competition Act.

[8] *See Investigation Order*, at 8.

1. Shortcomings of the Wholesale Market

a. *An LMP Market Design Is Too Sensitive to Volatile Fuel Costs.*

The LMP market structure appears to be more sensitive to increased fuel prices than other market structures. Thus, as part of this investigation, the Commission should examine whether regulated markets within the PJM footprint have better controlled the fuel price volatility than competitive markets and, if so, what can be learned from this experience.

LMP consistently drives short-term market outcomes toward pricing for all energy on the basis of the least efficient and most expensive fuel source, which is currently natural gas, regardless of whether that fuel source is used to produce all megawatt-hours of energy or only the last 0.1 megawatt hours of energy. The PJM Market Monitor's 2005 State of the Market Report indicates that higher natural gas, oil and coal prices were a significant source of upward pressure on LMP in 2005. Although 91.8% of the output in PJM was generated by nuclear and coal facilities in 2005 and only 5.6% was generated by natural gas-fired units, natural gas and oil units were on the margin in PJM 37% of the hours and thus set the market prices in those hours.[9] Because nuclear and coal-fired generators receive the LMPs set by natural gas, the value to customers of PJM's diverse range of different fuel types in its generation portfolio greatly diminishes. Rather than customers only absorbing higher natural gas prices for gas-fired generation, customers are suffering from those gas prices setting market price for billions of kWh generated by nuclear and coal facilities.

The Duquesne territory is a particularly relevant illustration of this situation. Before restructuring, Duquesne's generation fleet consisted primarily of coal and nuclear resources. Duquesne divested its generation to determine the stranded cost compensation that customers

[9] *See* PJM Market Monitoring Unit, 2005 State of the Market Report, at 86, 136 (Mar. 8, 2006).

would pay. Despite the continued location of those coal and nuclear generating units in the territory, Duquesne's customers now are paying rates driven by the higher cost natural gas units in PJM. The current generation supply rates available from Duquesne for a Rate L customer are 11.0693¢/kWh on-peak and 6.1749¢/kWh off-peak. Even Duquesne customers that purchase competitive supply have reported 25% (and higher) increases in electricity costs since the rate caps expired. Large commercial and industrial customers in Duquesne's territory will continue to be exposed to price increases while their competitors in other areas of Pennsylvania continue to have rate cap protection.

The Allegheny Energy ("AE") experience is also instructive in this regard because its operating company in Pennsylvania (*i.e.*, West Penn Power Company) continues to operate under rate cap while its Maryland operating company (*i.e.*, Potomac Edison Company) is exposed to market and its West Virginia operating company (*i.e.*, Monongahela Power Company) is still subject to rate base/rate of return regulation. Yet, all three operating companies "purchase" from the identical generating sources owned by the Allegheny family of companies.

In 1998, industrial consumers with an 85% load factor served in Pennsylvania, West Virginia and in Maryland by AE would have paid approximately the same in all three locations. In 2005, the same industrial consumer would be paying approximately $42/MWh in Pennsylvania but $56/MWh in Maryland, a difference of 33%. Although AE and West Penn have similar generation profiles, the Maryland customer now pays substantially more than the Pennsylvania and West Virginia customer by virtue of receiving service at a rate directly impacted by an LMP-based market.

b. *LMP-Based Wholesale and Retail Markets Prevent Long-Term Bilateral Contracting and Only Result in Contracts Based on Forward Natural Gas Curves.*

To make matters worse, FERC's original vision that a last-bid-in LMP spot market would set price for only a small amount of load, while bilateral markets would set price independent of the spot market, has not come to fruition. Although the FERC contemplated that the bilateral markets would influence spot market pricing, the exact opposite has occurred. Spot market pricing serves as a primary driver of pricing for bilateral contracts, to the extent bilateral agreements can be negotiated at all. Most, if not all, wholesale contracts are based on standard EEI or ISDA agreements with very little ability or appetite on the part of suppliers to change. Price quotes from retail suppliers are all premised on forward market curves that are, in turn, premised upon real-time spot prices with a premium. Individual generators are unwilling to enter into bilateral transactions at prices reflective of their actual cost plus a reasonable return (which one would expect under competitive conditions) due to the ready availability of a spot market where power can be "dumped" at higher prices. These outcomes are consistently opposite to what was intended by the General Assembly in moving to retail competition in Pennsylvania.

c. *Unbundling: The Sum of the Unbundled Component Elements of Wholesale Electric Service Must Be No Greater Than the Bundled Price Under Traditional Regulation.*

The fundamental expectation of unbundling was that the sum of the unbundled component elements of wholesale electric service would be no greater than the bundled price under traditional regulation. From the formerly bundled wholesale energy product, however, a myriad of revenue streams have been unbundled for generators, including energy payments, capacity payments, spinning reserve payments, reactive revenue requirements, black start

revenue requirements, and operating reserves. Evidence suggests that this unbundling produces greater revenue streams than the previously bundled service and creates more opportunity for gaming of the market rules to be used to create excessive revenues for generators, at the ultimate expense of retail customers.

The unbundling of electricity into multiple product offerings, each separately priced and paid for by customers, fails to comport with the General Assembly's understanding that competitive market forces would be more effective than economic regulation in controlling the cost of generating electricity. Even if efficiency gains may be achieved through the operation of competitive forces, no evidence has been adduced that the administrative creation of multiple electricity products has resulted in customers paying less for the unbundled service offering than for an otherwise bundled regulated offering.

d. *Susceptibility to Market Power.*

As discussed above, some erroneously suggest that increasing LMPs are merely a function of increasing fuel prices for the marginal units. Increased fuel costs may *partially* explain the upward LMP pricing trend, but it does not explain the whole story. Although the LMP market is highly sensitive to fuel price increases due to its last-bid-in clearing mechanism, the PJM market is also vulnerable to market power exercise. Market power concerns are further exacerbated by the unique nature of electricity. Experience demonstrates that reliability concerns can lead to generators being able to demand the higher of cost-based or market-based pricing.

The hallmarks of competitive markets – low/no barriers to market entry and exit, demand elasticity, ease of product deliverability, transparent market information, and unconcentrated generation asset ownership – do not appear to exist in the PJM region and have not, to date, been

overcome through market rule development. Substantial amounts of PJM generation are under the control of a few key market participants, many of which are also vertically integrated companies. Transmission constraints limit the amount of low cost capacity in the West that can be delivered to the East. Environmental and "NIMBY" problems make base load generation and transmission construction very difficult. Moreover, project-financing opportunities are limited in non-rate base states.

It is difficult to understand how electricity markets can, in fact, be truly "competitive," given the legacy of regulated, vertically integrated monopolies, the unique nature of electricity as a commodity, and the high levels of concentration in generation fleet ownership. FERC's grants of market-based rate authority for sellers in PJM have been based on the mere presumption that a competitive market exists, with no enunciated standard for that determination and no showing that reality actually comports with such a standard.

It is similarly difficult to understand how the LMP system is adequate to overcome the fact that the many owners of the transmission system own generation assets proximate to their transmission assets and thus have a financial incentive not to expand it. It is not surprising then that transmission owners without generation proximate to the congestion problems identified in the Baltimore-Washington corridor and New Jersey have stepped in to fill the breach.[10]

e. *LMP Is Not Working As Intended To Encourage Necessary Investment.*

PJM's recent RPM filing is the latest and most significant evidence that serious cracks exist in the wholesale LMP foundation upon which Pennsylvania's retail market depends. The FERC's blessing of the move from cost-based regulation to LMP at the wholesale level was

[10] *See, e.g., American Electric Power Service Corporation*, FERC Docket No. EL06-50-000; *Allegheny Energy Inc., Monongahela Power Company, The Potomac Edison Company, and West Penn Power Company*, FERC Docket No. EL06-54-000.

predicated on the FERC's view that cost-based ratemaking approaches had not provided good price signals for "efficient and cost-effective construction and location of generation plants."[11] RPM's introduction of a locational capacity component and artificial demand curve to solve expected sub-optimal investment in discrete areas makes clear that LMP is not working to achieve its objective of "send[ing] price signals that are likely to encourage efficient location of new generating resources, dispatch of new and existing generation resources, and expansion of the transmission system."[12]

LMP is apparently not functioning as intended because PJM now claims that such "efficient and cost-effective construction and location of generation plants" is not occurring under the LMP-based regime. PJM's call for a locational capacity signal must be viewed as evidence that LMP has fallen short in achieving its intended objective or that there are fundamental problems with other aspects of the PJM market design or with the implementation and administration of that design.

2. Effects of Wholesale Market Flaws

The ramifications of the wholesale market flaws identified herein unreasonably increases the cost to customers while providing windfall profits to certain generation owners. This was not the intent of the Competition Act.

a. *Increased Cost to Customers.*

Increased cost to customers is a key symptom of the market deficiencies highlighted above. Retail customer experiences with the LMP-based wholesale market differ sharply from the laudatory studies being commissioned by wholesale market participants and PJM Interconnection, L.L.C., itself, which trumpet the benefits of restructuring and expanding the

[11] *New PJM Companies*, 107 FERC ¶ 61,271, at n. 69 (June 17, 2004)(Opinion on Initial Decision and Order on Rehearing).
[12] *Pennsylvania-New Jersey-Maryland Interconnection*, 81 FERC ¶ 61,257, at 62,253 (Nov. 25, 1997).

PJM market model. To the extent that any such wholesale benefits are in fact realized (usually in the form of production cost savings, or heat rate efficiencies, and capacity factor improvement), they are not being seen or enjoyed by retail customers. As the Commission is presented with theoretical studies in this proceeding that tout the benefits of competitive markets, the actual price paid by electric consumers is the most effective and objective measure to gauge the success of electric competition at either the wholesale or retail level. In Order 888, FERC made clear that the success of electric supply industry restructuring is to be measured in consumer price.

> Today the Commission issues three final, interrelated rules designed to remove impediments to competition in wholesale bulk power marketplace and to bring more efficient, lower cost power to the Nation's electricity consumer.[13]

The FERC estimated that the potential quantitative benefits from electric supply industry restructuring would be approximately $3.8 to $5.4 billion per year of cost savings in addition to non-quantifiable benefits.[14] The "view from the trenches" is that customers are not realizing these quantitative benefits.

Industrial customers with facilities in regulated as well as restructured states can easily compare their monthly bills for each facility and thus have a valid and legitimate vantage point to recognize that restructured markets are not achieving their primary goal of reducing overall energy costs to customers. As highlighted in the Commission's Pike County investigation, Allegheny Energy, Inc., provides a good example of the interplay between retail and wholesale markets. Allegheny Energy has affiliates (doing business as Allegheny Power) that provide

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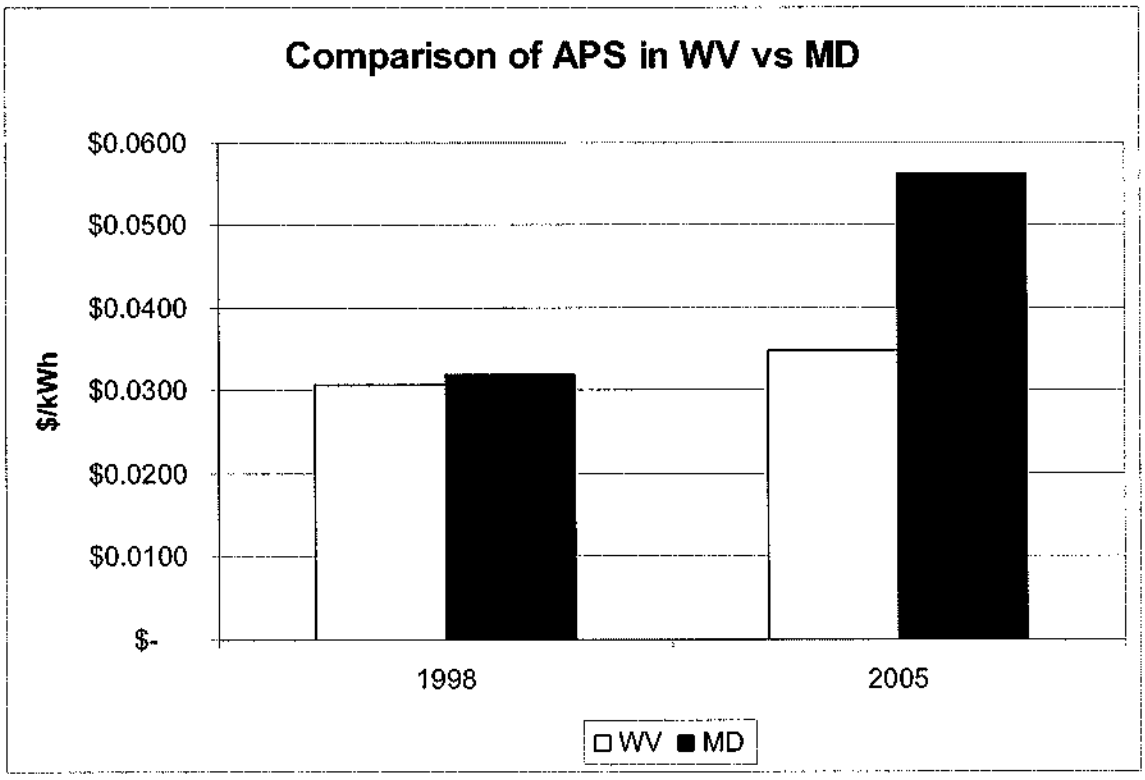
[13] *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmission Utilities*, Order No. 888, [1991-96 Reg. Preambles] FERC Stats. & Regs. ¶ 31,036, at 1 (1996)("Order No. 888"), *clarified*, 76 FERC ¶¶ 61,009, 61,347 (1996), *order on reh'g*, Order No. 888-A [1996-2000 Regs. & Preambles] FERC Stats. & Regs. ¶ 31,048 (1997), *order on reh'g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), *aff'd and remanded sub nom. Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom. People of the State of New York and Public Service Commission of the State of New York v. FERC*, 122 S. Ct. 1012 (2002).

[14] *Id.* at 3.

jurisdictional utility services in Maryland, which is dependent on PJM's LMP-based market, and West Virginia, which is subject to cost-of-service regulation. A comparison of current prices paid by an industrial customer with facilities in both the regulated West Virginia and the restructured Maryland demonstrates that increased fuel prices cannot alone explain the upward trend in LMPs.



The chart above shows Allegheny Power charges to industrial customers (assuming an 85% load factor) in both Maryland and West Virginia in 1998 and 2005. West Virginia consumers paid, and continue to pay, a fully bundled, regulated cost-of-service based rate with fuel costs passed through to customers. In contrast, although Maryland consumers paid rates on a comparable basis to West Virginia consumers in 1998, they now pay a rate driven by LMP. As indicated in the above chart, costs to the customer in Maryland are now approaching double what they are for an identical customer located across the West Virginia line. Although West

Virginia may have a different mix of generation than the PJM market, it still would be subject to fuel price increases (*e.g.*, coal).[15] Given the wide disparity between Maryland's and West Virginia's current prices, it is reasonable to question whether PJM's LMP market design may be a contributing factor to increasing LMPs.

Because the cost of electricity is a significant factor in whether businesses locate, expand and stay in Pennsylvania, the Commission is well served by this investigation into mitigation, if not avoidance, of what has occurred in Maryland and elsewhere. As the General Assembly determined in passing the Competition Act, "the cost of electricity is an important factor in decisions made by businesses concerning locating, expanding and retaining facilities in this Commonwealth." The Act further mandates that the transition to greater competition must "protect this Commonwealth's ability to compete in the national and international marketplace for industry and jobs." Without action to reduce electricity prices, the Commonwealth will be severely disadvantaged in its ability to compete in the national and international marketplace for industry and jobs.

b. ***Generator Profitability.***

Although capacity revenues have declined in the last three years, energy revenues have increased due to the higher cost of natural gas for most of the marginal units in the PJM energy market. For all but the marginal units, increased market-clearing prices have yielded increased inframarginal revenues to baseload and mid-merit units. Although marginal units may be running at short-run marginal cost (as one might expect), individual units with low marginal

[15] The 2005 PJM State of the Market Report indicates that both higher natural gas prices as well as oil prices were a significant source of upward pressure on LMP in 2004. *See* PJM Market Monitoring Unit, 2005 State of the Market Report, at 95 (Mar. 8, 2006).

costs are undeniably profitable in the energy market.[16] With increasing natural gas costs, and natural gas-fired units setting the market-clearing price, they stand to do only better. As set forth in the PJM Market Monitor's *State of the Market Report*, if a unit with marginal costs of $30 per MWh had operated during all hours when the LMP exceeded $30 per MWh, it would have received about $72,000 per installed MW in net energy revenue in 1999, about $60,000 in 2000, about $78,000 in 2001, about $52,000 in 2002, about $110,00 in 2003, about $121,000 in 2004.[17] In 2005, such a unit would have received $241,977 per MW-year in net revenue from the Energy Market alone, nearly double the amount received in 2004.[18] Certain generators in the PJM market are thus receiving substantial contributions to fixed cost recovery under the LMP-based regime. These contributions are separate from, and in addition to, stranded cost recovery, contributions made by bundled retail customers in non-open access states, and the benefit of asset transfer at book value from the restructuring proceedings in Pennsylvania.

Set forth below are some illustrations of generation owners' enthusiasm for market-based rates from Pennsylvania EDCs with affiliates that own generation.

- Allegheny Energy, Inc., has pronounced to investors that the key drivers of its revenue increase are higher prices and market-based rates in Maryland.[19]
    - Allegheny Energy projects that Maryland's and Ohio's transition to market-based rates in 2006 will increase its pre-tax income by $90 million.[20]

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[16] *See* PJM Market Monitoring Unit, 2004 State of the Market, at 71-74 (Mar. 8, 2005)("2004 State of the Market Report"); Synapse Energy Economics, Inc., *Capacity Revenues for Existing, Base Load Generation in the PJM Interconnection, A Pennsylvania Case Study (*June 10, 2005)(prepared for PA Office of Consumer Advocate) (http: // www.synapse-energy.com / Downloads / Synapse-report-pa-oca-cap-rev-pjm-06-05.pdf)("Synapse Study").

[17] *See* PJM Market Monitoring Unit, 2004 State of the Market Report, at 74 (Mar. 8, 2005).

[18] *See* PJM Market Monitoring Unit, 2005 State of the Market Report, at 121 (Mar. 8, 2006).

[19] *See, e.g.*, Allegheny Energy, Inc., 3rd Quarter Financial Results Presentation (Oct. 28, 2005)(http://library.corporate-ir.net/library/87/874/87440/items/171404/Slides%20for%20Earnings%20Release%20Call-FINAL.ppt).

[20] Allegheny Energy, New York Investor Meetings, at 9 (May 23-25, 2006)(http://phx.corporate-ir.net/phoenix.zhtml?c=87440&p=irol-presentations).

- With the addition of 3.5 million MWH transition to market in Maryland in 2009, Allegheny Energy expects to increase its pre-tax income by an additional $60 million.

- In discussing its key drivers of margin growth to investors, PPL projects that the "remarketing of POLR supply" in 2010 when its rate caps expire will pump up its supply margin from $1.98 billion to $2.75 billion, a staggering 40% increase.[21]

- Exelon Generation reported to investors that it enjoyed a 22% return on equity in 2004 due in part to higher inframarginal generation revenues.[22] In a recent presentation to investors, Exelon Corporation boasted of the "upside from end of below-market contracts in Illinois and Pennsylvania and re-pricing of forward market sales."[23]

Thus, as the Commission considers steps to improve the functioning of Pennsylvania's market, it must also recognize the substantial economic benefits that accrue to generation owners when LMPs are high, particularly for heavily depreciated assets subject to stranded cost recovery, which is the case for a vast amount of generation in Pennsylvania. With the reality of staggering cost increases to Pennsylvania retail customers and the impact on the Commonwealth's economic competitiveness, it is legitimate and within the Commission's statutory obligation to question whether the transition to retail competition is balanced "in a manner that is fair to customers, electric utilities, investors, the employees of electric utilities, local communities, nonutility generators of electricity and other affected parties."[24]

3. Retail Solutions to Wholesale Market Problems

As the Commission is well aware, industrial customers were leading proponents to bring competitive market forces to bear on the closely regulated electric utility industry. That

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[21] *See* PPL, First Quarter Earnings Webcast (May 4, 2006) (http://www.pplweb.com/investors/research+tools/Financial+Presentations.htm).

[22] Exelon Corporation/Public Service Enterprise Group European Investor Meetings (May 9-13, 2005)(http://library.corporate-ir.net/library/12/124/124298/items/152963/exc_050505.pdf).

[23] Exelon Corporation and Public Service Enterprise Group, Morgan Stanley 13th Annual Global Electricity and Energy Conference, at 3 (Mar. 15-16, 2006))(http://phx.corporate-ir.net/phoenix.zhtml?c=124298&p=irol-presentations).

[24] 66 Pa. C.S. § 2802(8).

advocacy was driven by a desire to 1) gain access to the wholesale price (one calculated on a cost-based split savings approach); and 2) the need to compete for new generation sources to avoid high-priced construction like Limerick and Beaver Valley nuclear stations. The wholesale platform upon which that competition occurs, however, is absolutely critical to restructuring's ultimate success in harnessing competitive forces to produce lower energy costs than regulation. Experience suggests that the existing market framework is simply not accomplishing the fundamental goal of "lower prices to the Nation's electricity consumers."[25] Nevertheless, whether or not you are an "acolyte" of LMP,[26] LMP is the reality in which the current wholesale market works. The challenge facing this Commission and other state commissions in PJM is thus improving the platform upon which wholesale and retail competition occurs without intruding on the FERC's jurisdiction. For example, what steps can the Commission take to promote long-term contracting at prices other than forward natural gas curves? Consistent with the Commission's statutory obligations, Industrial Customers encourage the Commission, in conjunction with the FERC, PJM, Organization of PJM States, and other affected stakeholders, to develop such strategies that fit within the restructured paradigm. This will require creative thinking outside traditional market or regulatory behaviors.

Because of the effects of the last-bid-in LMP clearing mechanism as well as the prospect of RPM's demand curve's operation, the Commission should work cooperatively with other state agencies to facilitate the construction of low-cost generation in Pennsylvania. Consideration

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[25] *Regional Transmission Organizations*, Order No. 2000, 65 Fed. Reg. 809 (Jan. 6, 2000), FERC Stats. & Regs, Regulations Preambles ¶ 31,089 at 31,025 (1999), *order on reh'g*, Order No. 2000-A, 65 Fed. Reg. 12,088 (March 8, 2000), FERC Stats. & Regs. ¶ 31,092, *petitions for review pending sub nom., Public Util. Dist. No. 1 of Snohomish County v. FERC*, Nos. 00-1174, *et al.* (D.C. Cir.).

[26] *See Motion of Commissioner Bill Shane*, Investigation of a Fact-Finding Investigation of the Competitive Market Conditions re Pike County Power and Light Company, Docket No. P-00052168, at 2 (Jan. 27, 2006).

should be given to the creation of a public power authority for this purpose. Such an entity may help to reduce the costs and complexity for generators to site, connect and construct.

The Commission could also facilitate the siting of new generation by identifying several locations and "pre-approving" them for generation construction. As part of this process, the Commission could specify attributes that would improve the costs and competitiveness in the electricity markets. Specifically, the Commission could require bidders to construct such generation to meet qualifications such as fuel type, facility size, attributes such as base-load, mid-merit, etc. In an effort to reduce market concentration, the Commission could also specify that bidders may not already own more than a specified percentage of the generation in Pennsylvania. Such an approach is consistent with Commissioner Shane's interest in issues the Commission may undertake to identify solutions to system congestion, such as incentive ratemaking to share the benefits of lowering LMP or other financial incentives to relieve transmission congestion.

Another avenue by which this Commission may improve the fundamentals of the wholesale market is by promoting demand response. An underdeveloped demand side of the wholesale market has plagued the PJM market.[27] PJM has made strides to improve the demand-side of the market through its Load Response Programs and integration of demand more fully into the PJM markets. Yet, barriers continue to exist in EDC tariffs that limit Pennsylvania retail customers' ability to participate in such beneficial programs. The Commission has direct authority over these tariffs, and Industrial Customers urge the Commission to direct EDCs to promptly eliminate such restrictions.

[27] *See* PJM Marketing Monitoring Unit, 2005 State of the Market Report, at 27 (Mar. 8, 2006).

Last but certainly not least, Industrial Customers encourage the Commission to expand its participation in the PJM stakeholder process, either directly or through the Organization of PJM States, and remain engaged at the FERC. In the restructured market, this Commission has little discretion to influence retail electric prices that are produced by the LMP-based market, except by being at the table when the rules that produce such LMP results are under consideration. Decisions are being made in the PJM stakeholder process that directly influence wholesale market prices. The Commission's visibility and role in the PJM stakeholder process should be intensified to promote the objectives of the Competition Act. Active Commission participation is particularly critical at the current time, as certain PJM stakeholders seek in the PJM Governance Working Group to limit end-use customers' voting rights in the stakeholder process to further consolidate such power in the hands of generation and transmission owners. If these efforts are successful, the demand-side check to suppliers' interests in the PJM stakeholder process would be severely compromised.

Although none of these suggested recommendations cure the underlying concerns with the wholesale market in the short term, action can – and should – be taken by the Commission to improve the fundamentals of the wholesale market, given the current expiration of rate caps for several Pennsylvania EDCs and the looming expiration for others. Meanwhile, Industrial Customers strongly encourage the Commission to work in cooperation with FERC, PJM and any other applicable ISO/RTO, Organization of PJM States, and stakeholders to promptly address the very real problems with the wholesale market in order to create a construct that achieves the goal of electric restructuring: market efficiencies resulting in lower energy costs than regulation otherwise would produce.

B. Alternatives To Avoid Large Price Increases

The Investigation Order sets forth several alternatives as tools to avoid abrupt, large price increases. Industrial Customers commend the Commission for anticipating these issues. As discussed above, Industrial Customers submit that the Commission should consider improvements and approaches to positively effect change in the wholesale market as the primary tool to avoid abrupt, large price increases when the transitional price caps expire and to mitigate the impacts on the customers in Pennsylvania that already face the volatility of the wholesale market.

An alternative suggested by the Investigation Order is phasing in the higher energy costs over a period of a few years, either after the rate caps expire or through an "early phase-in." With respect to phasing-in higher energy prices through deferrals, Industrial Customers agree with the "pros" and "cons" of this approach set forth in the Investigation Order. Ultimately, the appropriateness of the approach may depend on the wholesale market prices at the time the rate caps expire, given the disadvantages for both utilities and customers. For example, suppose (as expected) wholesale prices at the time price caps expire are significantly above then-existing retail rate levels but are projected to decrease over time due to infrastructure investment. Under this scenario, phasing-in the rate increase may serve the public interest. Similarly, those Pennsylvania EDCs (such as Duquesne) who already completed stranded cost recovery should be required to procure wholesale supply for all customer classes in a manner that mitigates the impact of market price swings and to offer all customer classes fixed, stable and reasonable generation supply rates.

Industrial Customers have grave concerns, however, with the second alternative suggested in the Investigation Order: an early phase-in of the expected rate increase. Many

reasons exist that dictate that this option must not be pursued. First, the Competition Act and the framework of each electric distribution company's restructuring plan achieve an important balance between EDCs' and ratepayers' interests as Pennsylvania's retail generation market develops. If one element of those restructuring settlement agreements is opened up for change, the careful balance among competing stakeholder interests will be wholly vitiated. The rate levels set forth in the restructuring settlement agreements were in consideration for, among other things, stranded cost recovery and merger concessions. If the rate levels in the agreement would "come into play," each and every other aspect of the restructuring settlement agreements would be "fair game." This would create a regulatory quagmire on top of the existing problems with retail and wholesale competition.

Also, no confusion should exist that rates during the transition period are static. In the restructuring process, the Commission wisely anticipated the issue of avoiding abrupt, large price increases through transition periods that gradually increases prices. During each EDC transition period, rates for retail customers are steadily and significantly increasing, in many cases based on market price projections.[28] Set forth below is an indexed depiction of the forecasted rate increase for a PPL industrial customer during the transition period, not including any future distribution rate increase, with 2003 serving as the base year.

2003	2004	2005	2006	2007	2008	2009	2010
1.00	1.00	1.07	1.12	1.12	1.12	1.12	2.27

This index, designed to maintain confidentiality of information, reflects the fact that rates for a PPL industrial customer could increase by approximately 227% from 2003 to 2010. To require an early

[28] *Opinion and Order re Petition of West Penn Power Company for Issuance of a Second Supplement to its Previous Qualified Rate Orders Under Sections 2808 and 2812 of the Public Utility Code*, Docket Nos. R-00039022 and R-00973981 (Order entered May 11, 2005).

phase-in of speculative future increases to this already staggering increase simply adds insult to injury.

For large commercial and industrial customers in West Penn Power Company service territory, generation rates increase from 2006 to 2010 by 5%, 5%, 5%, 14%, and 11%, with a compounding effect such that the generation rate increases for a large commercial or industrial West Penn customer by 45% in five short years and amounts to an existing phase-in. Adding a new, "early phase-in" of market-driven prices on top of these steadily increasing retail rates will produce precisely the price shock that the Commission seeks to avoid.

Finally, an "early phase-in" fails to reflect the time value of money and frustrates large customers' budgeting plans. Particularly for a large commercial and industrial customer, the amount of money at issue would likely represent a substantial sum. Anticipating future rate increases may not be the most cost-effective use of that money. Provided that customers are educated on future rate levels, commercial and industrial customers in particular should be trusted to allocate their resources efficiently to serve their business purposes. Moreover, many large customers, for whom energy represents a major cost of operation, have already made business decisions, including capital investment plans, based on their understanding that generation rates for the duration of the transition period would be as already approved by the Commission in restructuring settlement agreements. Changing those expectations at this point would substantially change the economics of such business decisions, subverting the Competition Act's policy guidance supporting "orderly economic development."[29]

[29] 66 Pa. C.S. § 2802(9).

As the Commission proceeds with this investigation, Industrial Customers encourage the Commission also to consider the following as steps to avoid abrupt, large price increases for retail customers:

- Extend rate caps where there is a stranded cost recovery "overhang";
- Follow the settlement rate cap period with a rate stabilization phase-in period;
- Facilitate large commercial and industrial customers bypass of the retail market (and the retail market "mark up") through direct access to the wholesale market;
- Obtain discounted blocks of "market development power" for large commercial, industrial and institutional development in recognition of the reality that "the cost of electricity is an important factor in decisions made by businesses concerning locating, expanding and retaining facilities in this Commonwealth";
- Ensure that POLR service is not punitive in nature for any customers and represents a real and legitimate option for large commercial and industrial customers that are unable to secure viable competitive alternatives;
- Authorize flexible tariff pricing and flexible rates, including negotiated, contract-based tariffs, pursuant to Section 2806(h) of the Restructuring Act;
- Correct non-cost based allocation of costs to retail customers;
- Encourage utilities to expand off-peak hours to encourage off-peak use. Require utilities to validate on-peak hours; off-peak hours should be chosen by transparent actual customer usage and not be an arbitrary utility decision; and,
- Ease line extension policies regarding customer contribution amounts and fixed costs.

Implementation of such strategies will help to mitigate "price shock" until the wholesale and retail markets produce prices that comport with the objectives of the Competition Act.

Customers have realized little of the promise of retail competition; they certainly should not be subject to "price shock" during the transition period as they continue to pay substantial stranded costs to EDCs with affiliates earning hefty, if not windfall, profits in the LMP-based energy market. To that end, the rate caps and rate levels mandated by the Competition Act and restructuring

settlement agreements must be preserved. They serve a critical function in protecting ratepayers, and efforts to increase generation rate levels during the transition period must be firmly denied.

C. Reduce Peak Demand for Electricity

As set forth in the Investigation Order, policies that reduce demand for electricity during peak usage periods – usually hot summer afternoons – would help to reduce price spikes in the wholesale energy market and reduce overall energy prices.[30] In this regard, the Commission expresses concern that "consumers do not have a sufficient financial incentive to reduce demand as wholesale prices rise during peak usage periods."[31] The Commission attributes this lack of "demand response" to the fact that the great majority of consumers pay prices that are averaged over the entire year.

While this may be true for many Pennsylvania customers, the Commission ignores that PJM has developed successful programs for customers designed to reduce the peak demand for electricity. Many large commercial and industrial customers in Pennsylvania participate in these programs and, in so doing, help to reduce the peak demand for electricity and provide valuable system benefits. From January through November 2005, over 450 MW of Pennsylvania load was registered in PJM's Economic Load Response Program and nearly 295 MW of Pennsylvania load was registered in PJM's Emergency Load Response Program.[32] From June 2005 to August 2005, this load provided nearly 25,000 MWh in load reductions. PJM's Load Response Programs thus are an exemplary illustration of the benefits of the "carrot" approach to load management as opposed to the "stick." Efforts should be made by the Commission to reduce

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[30] *Investigation Order*, at 5.
[31] *Id.*
[32] *See* http://www.pjm.com/committees/working-groups/dsrwg/dsrwg.html (Feb. 6, 2006, meeting materials, "Load Response Activity Report: January through November 2005")(last visited June 9, 2006).

barriers to entry to these valuable demand-side response programs, including eliminating EDC tariff restrictions that limit Pennsylvania retail customer participation.

The Investigation Order further fails to consider that many large commercial and industrial customers already take proactive steps to manage their peak load such that it does not coincide with PJM's peak in an effort to reduce the demand charge component of their rates. No quantifiable evidence has been presented in this or other proceedings that hourly pricing for default service for large customers is a more effective tool to encourage peak demand reduction for large commercial and industrial customers than existing approaches and programs.

In his Statement, Commissioner Shane was correct in questioning "whether it is reasonable public policy to make default service 'ugly' simply to encourage fixed price offers from competitive Electric Generation Suppliers."[33] The Competition Act requires that electric service should be available to all customers on reasonable terms and conditions.[34] Hourly pricing subjects a customer to arbitrary price increases, which can detrimentally affect load usage. Similarly, the volatile market may result in higher than expected prices. Because large customers utilize significant amounts of electricity, this can result in significant budget expenditures. If larger customers are unable to specifically determine and plan for these budgetary expenses, the overall production process for these customers may be hindered. Particularly in the absence of a vibrant retail market, requiring a POLR pricing strategy that hobbles large customers' ability to do business in the Commonwealth is directly inconsistent with the Competition Act, which recognizes that electric service is "essential ... to orderly economic development."[35]

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[33] *Statement of Commissioner Bill Shane*, Re: Motion of Commissioner Fitzpatrick: Policies to Mitigate Potential Price Increases, at 3 (May 19, 2006).
[34] 66 Pa. C.S. § 2802(9).
[35] 66 Pa. C.S. § 2802(9).

If required to receive hourly prices, large customers would be forced into the competitive market in order to obtain fixed price options. Because EGSs will be cognizant of that fact, EGSs will have the opportunity to raise their fixed prices significantly above what the market would otherwise bear merely because the competitive market would be the only option for customers seeking fixed price options. Customers will also be deprived of the fixed "price to compare" that can act as an important source of discipline on the prices that EGSs can demand in the market. As a result, large customers would be subject to unjust and unreasonable rates from EGSs as a direct result of the lack of a fixed price option for POLR rates.

Not only is an "ugly" POLR service for large customers against sound public policy, it would also be unfairly discriminatory.[36] Under the Public Utility Code and Commission regulations, different classes of customers can be treated differently as long as a cost-causation methodology is the basis for this different treatment. When the discrimination of these customers is not based upon cost causation, the discrimination becomes unjust and unreasonable. Requiring large customers on default service to receive only hourly pricing would discriminate against this customer class by subjecting only these customers to a volatile market, arbitrary price increases, and artificial market prices. Although some large industrial and commercial customers may in fact prefer an hourly priced POLR rate and providing this as one option is appropriate, many large commercial and industrial customers have inadequate resources to cope

[36] When considering a mandate that large customers receiving POLR service receive hourly pricing, the Commission must also consider the recent passage of the Alternative Energy Portfolio Standards Act ("AEPS"), which effectively prohibits the offering of only an hourly priced mechanism for large commercial and industrial customers. AEPS requires extensive tracking to determine whether energy purchased by an EDC or an EGS meets the requirements of the Tier I or Tier II alternative energy resources. If large commercial or industrial customers have only the option to obtain POLR service via an hourly priced mechanism, these customers' energy needs will have to be satisfied via purchases from the spot market, which cannot be tracked to determine whether the electricity purchased comports with the requirements of AEPS. Mandated hourly pricing for POLR service would thus thwart successful AEPS implementation.

with this type of pricing methodology and would prefer to avoid arbitrary price increases. Accordingly, all customers must be offered at least one fixed price POLR option; no customer should be forced to pay hourly prices.

As the Commission considers rate design modifications to reduce peak demand for electricity, Industrial Customers urge the Commission to avoid implementing any punitive rate designs for industrial customers and instead mobilize the industrial sector through incentives, consistent with the Competition Act's intent. Large customers are being made uncompetitive by further increases to their energy bills. Given the requirements of the Competition Act and sound public policy as well as the availability of PJM and tariff programs for large customers to reduce their peak load, the Commission should focus its efforts in this regard to the specific type of load that is driving the peak, which during the summer period is generally residential air conditioning load as suggested by Commissioner Shane. Rates for such load should be aligned such that those customers that are driving peak load bear cost responsibility; this is not currently the case.

D. Encourage Conservation

The Investigation Order suggests that "[e]ncouraging and enabling customers to use electricity more efficiently would be a key strategy for helping customers to cope with higher electricity prices."[37] Industrial Customers support such efforts to facilitate more efficient energy use. Not only would conservation help customers to "cope" with higher electricity prices, but also, more importantly, conservation can serve as an effective demand-side response to apply downward pressure on the supply side of the market, thereby reducing energy prices, which is the overriding objective of the Competition Act.

For such an initiative to be successful and comply with the intent of the Competition Act, however, efforts to encourage conservation should be more in the nature of providing "carrots" to

[37] *Investigation Order*, at 4.

customers as opposed to "sticks." Returning to the Competition Act's intent, this landmark legislative initiative was designed as a vehicle to address the fact that rates for electricity in Pennsylvania are on average higher than the national average. Thus, any rate design developed to encourage conservation that is punitive in nature and calculated to coerce customers to conserve energy or use energy more efficiently would subvert the intent of the Competition Act to reduce prices for customers. The Competition Act recognizes that electric service "is essential to the health and well-being of residents, to public safety and to orderly economic development, and electric service should be available to all customers on reasonable terms and conditions."[38] It would be patently unreasonable to use a punitive rate design to encourage conservation, which would thwart, *inter alia*, the Competition Act's economic development goals.

Moreover, a severe rate design intended to coerce conservation fails to recognize that many industrial customers located in Pennsylvania have historically been proactive in improving their own facilities' energy efficiency. As set forth in the Competition Act, rates for energy in Pennsylvania have, for some time, been higher on average than the national average. Consistent with the Commission's reasoning in the Investigation Order, many large commercial and industrial customers took action to conserve energy and improve efficiency in an effort to control high energy costs. To implement a severe rate design now with the intent to force conservation would be patently unfair to those customers who acted early and responsibly to implement energy conservation.

A more reasonable approach would be to offer incentives to customers to encourage conservation. As recognized by Commissioner Shane's Statement, the financial (as well as

[38] 66 Pa. C.S. § 2802(9).

environmental) benefits of energy conservation are "numerous."[39] Any rate design to encourage conservation should thus directly reflect these benefits. This approach serves the public interest goals identified in the Investigation Order while still honoring the Competition Act's economic development objectives.

As a final point, the Commission should not rely excessively on conservation and energy efficiency as a silver bullet to mitigate electricity prices. With load growth and current congestion levels, no doubt should exist that a concerted plan, such as that discussed above, must be developed and promptly implemented to ensure that generation, transmission and demand-side response resources are sited where and when economically efficient. Absent such action, the effects of PJM's LMP/RPM system will present serious cost challenges for Pennsylvania ratepayers that cannot be solved through improved efficiency alone.

E. Customer Education

Industrial Customers recognize the importance of customer education in the restructured market. With effective customer education, customers are empowered to make informed decisions about their energy options and plan appropriately for price changes. Customer education is also an important tool to promote effective demand response and conservation.

Industrial Customers also share Commissioner Shane's concern that education on the intricacies of electric competition may not be received with much enthusiasm, particularly if few competitive alternatives are available. For this reason, consumer education must be part of a much larger plan to improve the functioning of the wholesale and retail markets. Key to promoting customer education is ensuring that the platform for retail competition is not unduly

[39] *Statement of Commissioner Bill Shane*, Re: Motion of Commissioner Fitzpatrick: Policies to Mitigate Potential Price Increases, at 2 (May 19, 2006).

complex for customers to understand. For example, "Prices to Compare" must be readily available, easy to track and not so convoluted as to preclude meaningful price comparisons.

Ultimately, customer education alone will not reduce LMPs, the overall economic impact of high electric prices or customer frustration with the electric competition. A comprehensive strategy to improve the functioning of the wholesale and retail market is necessary to inspire customer confidence that market-based retail rates satisfy the requirements of the Pennsylvania Public Utility Code and the objectives of the Competition Act.

F. Issues Concerning Programs To Assist Low-Income Customers

The Competition Act requires electric utilities to offer universal service and energy conservation programs to make electricity service more affordable for low-income customers.[40] As part of this investigation, the Commission seeks comment on the adequacy of such programs as electricity costs increase, considering the interests of the programs' beneficiaries and those who pay for them.[41] Industrial Customers do not oppose such an examination but also note that commercial and industrial customers do not receive any direct or indirect benefit from such programs nor are they eligible to participate in them. On this basis, cost-causation principles dictate that only the residential customer class be allocated any costs for supplemental LIHEAP funding or other forms of assistance for low-income customers. Recent Commission precedent supports such cost allocation methodology.[42] Accordingly, any Commission guidance to the General Assembly on this issue should reference that any costs for supplemental LIHEAP funding or other forms of assistance for low-income customers not be allocated to large commercial or industrial customers.

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[40] 66 Pa. C.S. § 2804(9); *id.* § 2803 (definition of "universal service and energy conservation").
[41] *Investigation Order*, at 8.
[42] *See Pa. PUC v. PPL Electric Utilities Corporation*, Docket No. R-00049255, Final Order (Dec. 22, 2004).

IV. CONCLUSION

Industrial Customers advocating competitive markets for electricity were driven by a desire to obtain access to wholesale prices and a need to develop competition for the ownership and construction of new generation sources in order to avoid historic cost overruns. Unfortunately, neither of these two objectives have been attained given that the wholesale price sought by industrial customers has been converted to an LMP pricing construct as opposed to a cost-based split savings construct and no significant base load generation has been constructed by competing sources within traditional utility service territories. The Commission is presented with an extremely difficult challenge in converting the electric industry to competitive markets given the ten years of experience we have had to date. During that time, we have learned that the commodity known as electricity is significantly different than any other commodity. At least three primary features differentiate the commodity of electricity from nearly any other commodity. These three features are:

(1) Electricity has become an essential need for the American public as required to run our appliances, keep us cool in the summer, warm in the winter, and allow us to manufacture our products. As a result, the electricity commodity market will always be subject to political and regulatory overlays due to the absolute need to maintain reliability.

(2) Electricity demand is extremely inelastic in that most manufacturing companies are desirous of producing their product as opposed to closing facilities and sending home employees when prices are high. Similarly, homeowners and commercial operations need to be cool in the summer and warm in the winter. As a result, while demand-side management programs and load response programs are absolutely critical in

this marketplace, Industrial Customers question whether demand elasticity can ever be sufficient to act as a viable market check on the supply side.

(3) Due to the capital intensive nature of generation, high levels of market concentration are likely to continue, particularly among owners of generation fleets that include base, intermediate, and peaking capacity. As a result, any market design will remain susceptible to market power either directly or indirectly.

If the Commission remains cognizant of these three distinguishing features of the electricity commodity market, it can better focus its attention on the problems that have prompted this investigation. The Comments and Reply Comments to be received by the Commission at this docket are only the beginning, and Industrial Customers encourage further action consistent with the comments and suggestions contained herein. In particular, Industrial Customers suggest the following be considered:

1) A proactive role by entities like the Commission, the Department of Environmental Protection, the Department of Community and Economic Development, and the Organization of PJM States, Inc. ("OPSI"), in helping facilitate true, long-term bilateral contracting between generators and customers on a basis that essentially bypasses the wholesale LMP market construct in favor of a cost plus pricing of those bilateral contracts;

2) To the extent that individual generation projects are the recipient of Commonwealth resources in the form of favorable siting permits, low-cost financing, or other assistance, such generation projects need to be encouraged by the appropriate Commonwealth agencies to execute long-term bilateral contracts with Pennsylvania-based customers on a cost plus pricing basis;

3) Actively investigate the viability of a Commonwealth public power authority to take advantage of the low-cost fuel resources available in the Commonwealth that need to be retained on a cost plus basis as opposed to a spot market LMP sales basis;

4) Seek and locate project sites to facilitate new generation construction for the benefit of Pennsylvania consumers and conduct RFPs to construct at those sites within certain defined criteria including a requirement to engage in long-term bilateral contracts with prospective Pennsylvania customers on a pricing basis other than forward natural gas or LMP price curves;

5) For Commonwealth-assisted projects, condition RFP respondents to specify percentages of generation in Pennsylvania in order to encourage diversity and ownership of generation sources;

6) The Commission and OPSI should take a proactive approach at the FERC and within the PJM stakeholder process to help facilitate the initiatives listed above; and,

7) In the short-term, the Commission should (a) extend rate caps where stranded cost recovery continues; (b) initiate utility-by-utility investigations to consider rate stabilization phase-in periods beyond the rate cap expirations; (c) facilitate market development power to retain potential lost customers and employment; and, (d) allow EDCs to engage in flexible and negotiated pricing and rates on a contract basis consistent with the Competition Act.

While many of these concepts are innovative in nature, such innovations may place the Commonwealth of Pennsylvania in a leadership position among states that have pursued restructured electricity markets. To keep these innovative concepts in perspective, a worthwhile exercise for the Commission would be to engage a study on a post-fact basis of the outcome of

the various restructuring settlements by comparing the market price forecast underlying the stranded cost awards to market price realities and assess which participants in the restructuring process have benefited more than when the bargain was initially struck. This may place in better perspective the frustration of Industrial Customers who, in exchange for the rate caps, permitted the generation assets to be transferred to nonregulated subsidiaries at book value and paid stranded costs based on the market price forecast at that time. To the extent those market price forecasts were too low, stranded costs have been "overpaid" and the non-POLR load sales out of the assets transferred at book have realized market prices well in excess of forecast. With these realities in mind, pursuing the innovative opportunities outlined above is important for the future success of the Commonwealth.

Industrial Customers appreciate the Commission's consideration of these Comments and look forward to the next steps in this critical investigation. As discussed herein, Industrial Customers do not presume to have all the answers, but serious problems exist that, if not addressed in the near-term, will have serious economic repercussions for the Commonwealth.

Such a process must continue with all deliberate speed, given that solutions will require time to implement and the dates of rate cap expiration are fast approaching.

Respectfully submitted,

By _____

David M. Kleppinger
Attorney I.D. #32091
Susan E. Bruce
Attorney I.D. #80146
McNEES WALLACE & NURICK LLC
100 Pine Street
P. O. Box 1166
Harrisburg, PA 17108-1166
Ph. (717) 232-8000
Fax (717) 237-5300
dkleppinger@mwn.com
sbruce@mwn.com

Counsel to Industrial Energy Consumers of Pennsylvania, PJM Industrial Customer Coalition, Duquesne Industrial Intervenors, Met-Ed Industrial Users Group, Penelec Industrial Customer Alliance, Penn Power Users Group, Philadelphia Area Industrial Energy Users Group, PP&L Industrial Customer Alliance, and West Penn Power Industrial Intervenors

Dated: June 15, 2006

CERTIFICATE OF SERVICE

I hereby certify that I am this day serving a true copy of the foregoing document upon the participants listed below in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant).

VIA FIRST-CLASS MAIL

Eric Thumma
Department of Environmental Protection
400 Market Street
P. O. Box 2063
Harrisburg, PA 17105-2063

John R. Shaddock, President & CEO
Shared Services Consortium, LLC
6 Kacey Court, Suite 204
Mechanicsburg, PA 17055

Robert McCullough
McCullough Research
3816 S.E. Woodstock
Portland, OR 97202

David Magnus Boonin
1210 Pine Street
Philadelphia, PA 19107

Douglas L. Biden
Electric Power Generation Association
800 North Third Street, Suite 303
Harrisburg, PA 17102

Kevin J. Moody, Esq.
Wolf Block Schorr & Solis-Cohen LLP
213 Market Street, 9th Floor
Harrisburg, PA 17108-0865

Jay L. Kooper
Hess Corporation
One Hess Plaza
Woodbridge, NJ 07095

Stacey Rantala
National Energy Marketers Association
3333 K Street, N.W., Suite 110
Washington, DC 20007

Ariel C. Lager, Esq.
Customized Energy Solutions, Ltd.
100 N. 17th Street, 14th Floor
Philadelphia, PA 19103

William R. Lloyd, Jr., Esq.
Office of Small Business Advocate
Suite 1102 Commerce Building
300 North Second Street
Harrisburg, PA 17101

Irwin A. Popowsky, Esq.
Office of Consumer Advocate
Forum Place, 5th Floor
555 Walnut Street
Harrisburg, PA 17101-1923

J. Michael Love, President & CEO
Energy Association of Pennsylvania
800 North Third Street, Suite 301
Harrisburg, PA 17102

Mark Baird, Director
Midwest Regulatory Affairs
Reliant Energy, Inc.
7642 W. 450 N
Sharpsville, IN 46068

Martha Duggan, VP Business Development
Constellation New Energy
111 Market Place, 7th Floor
Baltimore, MD 21202

Timothy W. Merrill, General Manager
NRG Energy Center PBG LLC
111 South Commons Avenue
Pittsburgh, PA 15212

William Patterer
PECO Energy Company
2301 Market Street, S15-2
Philadelphia, PA 19103

Paul Russell, Esq.
PPL Electric Utilities Corp.
Two North Ninth Street
Allentown, PA 18101

John Laudenslager
Duquesne Light Company
Mail Drop 15-3
411 Seventh Avenue
Pittsburgh, PA 15219

Ramona Cataldi, Esq.
Klett Rooney Lieberr Schorling
240 North Third Street, Suite 700
Harrisburg, PA 17101-1503

David Hughes
Citizen Power
2121 Murray Avenue
Pittsburgh, PA 15217-2105

Cynthia Menhorn
Allegheny Power
800 Cabin Hill Drive
Greensburg, PA 15601

John L. Munsch, Esq.
Allegheny Power
800 Cabin Hill Drive
Greensburg, PA 15601

Maureen Mulligan
33 Greening Life Lane
Shermansdale, PA 17090

Susan E. Bruce

Dated this 15th day of June, 2006, in Harrisburg, Pennsylvania.