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June 15, 2006

Via Federal Express

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

Re: Policies to Mitigate Electric Price Increases
Docket No. M-00061957

Dear Secretary McNulty:

Attached are an original and three copies of the Comments of Metropolitan Edison Company, Pennsylvania Electric Company and Pennsylvania Power Company in the above proceeding. These comments are filed pursuant to the Commission's Order adopted May 19, 2006, in this proceeding and in accord with your letter of June 7, 2006. A copy of this cover letter and the comments have also been e-mailed to Shane Rooney (srooney@state.pa.us) today.

Please direct any further correspondence on this matter to me.

Respectfully,

Stephen L. Feld

SLF:dka

Enclosures

cc: Shane Rooney

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

COMMENTS OF METROPOLITAN EDISON COMPANY, PENNSYLVANIA ELECTRIC COMPANY AND PENNSYLVANIA POWER COMPANY

To the Honorable Commission:

By an Investigation Order adopted on May 19, 2006, ("Order") the Pennsylvania Public Utility Commission ("Commission" or "PUC") initiated this investigative proceeding to address issues and develop policies to mitigate electricity price increases upon the expiration of generation price caps. Metropolitan Edison Company ("Met-Ed"), Pennsylvania Electric Company ("Penelec") and Pennsylvania Power Company ("Penn Power") (collectively, the "Companies") hereby submit these joint Comments pursuant to the Order. These Comments address the list of ideas contained in the Order and in the statement of Commissioner Shane.

Introduction

The Companies welcome this opportunity to present their views on these ideas especially in light of the Companies' recent and pending proceedings before the Commission on these subjects. The Companies are electric energy delivery companies that do not own generation assets[1] and must purchase all of the power required to serve their customers' provider of last resort ("POLR") needs. The provision of POLR service by the Companies is done with the objective, consistent with the Electricity Generation Customer Choice and Competition Act (66 Pa. C.S.A. §2801, *et seq.*) ("Competition Act"), that they recover their full costs, no more, no less, associated with such service. This objective is a key part of the respective Companies' proposals in their recent and pending proceedings before this Commission, and is in fact mandated by the Competition Act.

Penn Power is currently implementing the Commission's recent order (Docket No. P-00052188) pertaining to the acquisition of POLR generation service. Beginning January 1, 2007, Penn Power POLR customers will pay generation rates based on the results of two Requests for Proposals (RFPs), one concluded in early June 2006 and the other to be conducted in July 2006. Met-Ed and Penelec currently have transition cases pending before the Commission (Docket Nos. R-00061366, R-00061367, P-00062213 and P-00062214) that relate to some of the issues raised in the Order but involve a different time period. The Met-Ed and Penelec transition cases involve the period *prior* to the expiration of their rate caps whereas this current generic investigation is primarily focused on rate impacts *after* electric utilities' generation rate caps expire, generally in

[1] The only exception is Met-Ed which owns York Haven Power Company operating a 20MW hydroelectric facility.

2009 and 2010. (The proposed transition plans propose adjustments to, not elimination of, their respective rate caps in a manner believed to be consistent with their restructuring cases.)

The Companies are providing these Comments based on the knowledge and experience the Companies have gained not only following their respective restructuring cases in 1999 but also from their recent and current proceedings. These Comments are divided into the areas listed in the Order.

1. Educate Consumers

The Companies endorse the policy objective of creating a higher level of consumer understanding of electric energy matters. All stakeholders – customers, utilities, regulators, consumer groups, public advocates, generators, marketers - would benefit from a better informed citizenry. The issues in achieving the higher educational level include developing a message targeted to and timed for the appropriate audience, delivering the information efficiently and using the available resources most effectively. Regulated utilities have been repeatedly viewed as the funding source for education programs. As long as they have the ability to recover their costs on a current basis, the Companies believe that this past reliance on the utilities could continue. In fact, Met-Ed's and Penelec's proposed Government Mandated Programs Rider is a flexible mechanism which could be used to ensure adequate funding for appropriate educational programs.

The type of audience for educational programs must be considered by the Commission when developing such programs. The Companies' experience is that many large commercial and industrial customers can, and do, closely monitor their electricity costs and manage them as they do other business costs. However, residential and smaller commercial customers are in many cases unaware of the institutional and regulatory changes which have occurred in the electric utility industry. Worse than the uninformed customer, however, is the misinformed consumer who requires even greater effort to properly educate to make reasonable decisions. The ultimate goal of any education program focused on the transition to market-based rates, regardless of the type of consumer, should be awareness of the causes for change in energy prices and the potential effects that these changes will have on individual electric bills.

The Companies believe that the Commission has a large role to play in providing objective information on the upcoming ends to transition periods and retail rate caps. The Commission has recognized that this process should begin well in advance to minimize or avoid the political and economic turmoil that other states have experienced when such periods have terminated.

The Companies believe that the Commission must educate customers about how projections of future electricity prices are inherently fraught with uncertainty and are not in any way a guarantee of actual prices. This is especially the case in the PJM market, which encompasses most of the Commonwealth of Pennsylvania, where volatile natural gas prices increasingly influence electricity prices. However, customers need sufficiently concrete information that will enable them to make well-informed decisions. An alternative to accomplish this objective may be to characterize a range of the change, based on recent historical periods, that consumers may potentially experience when market-based prices are implemented. An effective education/communication program will encourage consumers to make and pursue their own decisions to best manage the timing and quantity of electricity they consume in the future.

The costs of any communications/education program also could be assessed on entities that provide POLR service, i.e., electric utilities and successful POLR bidders. For the utilities these costs should be recoverable on a current basis through an adjustable rider under §1307 of the Public Utility Code (66 Pa. C.S. A. §1307). This mechanism allows flexibility in the amount available as needs change and ensures that there is no over- or under- recovery of these costs. Further, such a mechanism spreads the costs over a broad band of society so that no one group bears undue costs. Utilities which do not have a §1307 mechanism should be allowed to defer these costs for later recovery in their next distribution rate case or §1307 proceeding. Suppliers who bid in POLR auctions or RFPs should be provided in advance the unit cost (kWh or customer) of the educational funding that they will have to provide if they successfully bid. This method allows all suppliers to factor the cost of the education program into their bid prices so that they too are able to recover the costs of the program. It is vital that those providing the funding are fully reimbursed for these costs which benefit society as a whole and that disincentives to provide funding are not created.

2. Encourage Conservation

Several aspects of conservation programs should be considered when designing and implementing such programs. Energy conservation, particularly by low income households, becomes more critical in a market price environment and can be most effectively funded by utility customers through a §1307 adjustable recovery mechanism.

In addition, merely educating customers about conservation techniques without providing the proper incentives through adequate price signals will be ineffective. Only if customers actually experience the benefits of their conservation efforts by seeing lower consumption levels, and lower bills, will such programs have long term success. The Companies believe that the most effective price signals are direct market-based prices from generation suppliers and competitive energy providers. However, these suppliers often do not have sufficient incentives to promote conservation because their income usually depends on the volume of product they sell. Customers who choose to buy directly from energy providers ("shoppers") will determine their own level of comfort with conservation measures based on the structure and prices that their contracts provide. Customers who do not shop, i.e., POLR customers, will be dependent on the rate design of the utility which passes through the prices determined in a POLR procurement process. The Companies believe that the clearer the incentives in the rate structure, the better able customers will be to manage their usage and see the results of conservation efforts.

3. <u>Reduce Peak Demand for Electricity</u>

The concept of reducing peak demand often is viewed only in the context of peak demands without consideration of peak prices. While there is a modest correlation between the level of demand and the level of prices, it is simply not the case that the highest prices always occur at the time of peak demand. At times of high prices, informed customers will act in their economic interests to reduce their demands or otherwise act to lower their costs if they know they will directly experience, in the form of lower electric bills, the benefits of such reductions. Although mandatory hourly pricing for large customers is probably an effective way from a theoretical standpoint to tie management of demand to cost reduction, its implementation must be balanced by several important practical considerations. Foremost among these is the impact of potentially higher and volatile rate levels on industrial customers with the concomitant consequences on the state's economic development efforts and employment levels. In addition, customer acceptance levels must be considered because the degree of "buy-in" by customers has a direct bearing on their response to supposed market-price signals.

As with conservation programs, a rigorous cost/benefit analysis is required to determine whether to implement any demand response program, especially a mandatory program. The failure of past programs can be traced in many cases to the conventional wisdom that demand-side management programs are inherently "good." Customers need to see tangible benefits that outweigh the costs and inconvenience that they bear in implementing these programs. The costs to implement demand response programs from the Commission's perspective should clearly produce tangible benefits that exceed the associated costs. The recipient of these benefits should also bear the costs. In cases where the benefits do not exceed the costs, the resources devoted to the program can and should be dedicated to more productive uses.

The implementation of advanced meter technologies for smaller customers that currently do not use such technologies must be coordinated with appropriate price signals so that the technology produces actual benefits. The widespread existence of generation rate caps has prevented such technologies from producing benefits in excess of the costs for most customers. Market-based pricing of generation may very well change this situation and make it economical for customers to invest in such technologies. Utilities have little incentive to invest in these technologies at the present time because they generally do not produce tangible benefits for customers or the companies commensurate with the investment. The capital needed to fund all potential infrastructure uses is not unlimited. Allocation of capital for advanced metering or other demand side programs must compete, in terms of potential customer benefit, with other infrastructure needs. Our experience has been that competing uses of capital for other infrastructure related to the distribution and transmission systems may yield greater benefits for the utilities and their customers. In the event that the Commission determines that investment in advanced meter technologies is necessary and cost-effective in a market-based pricing scenario, the costs of that investment need to be recovered in a full and timely manner.

The utilities' role in direct demand reduction programs for shopping customers creates a potential legal complication that the Commission should consider. Electric generation suppliers who arranged for power supply to shopping customers with whom they have supply contracts may have justifiable concerns with a utility demand reduction program. By exercising direct load control over shopping customers' demand, the utility is putting itself between the supplier and the customer and directly affecting the contractual arrangement without the consent of at least one of the contracting parties. The utility is without knowledge of the supply arrangements or pricing structure of the particular contract which may not be impacted by peak prices or peak demands. This legal issue involving shopping customers should limit the use of demand reduction programs to those customers who voluntarily participate in programs to manage their electric costs. Mandatory demand management programs implemented by the utility should not apply to shopping customers unless electric generation suppliers ("EGSs") are required to participate.

4. <u>Alternatives for Avoiding Abrupt, Large Price Increases</u>

The Companies endorse the objective of transitioning capped prices to market-based prices through administratively determined processes. The burden of developing the details of the transition should be on the individual utility since the circumstances of each company are different because of rate levels, customer mix, contractual commitments, and other factors. The transition plans must account for these varied circumstances.

For example, although designed to meet supply issues provided in the Met-Ed and Penelec's restructuring settlements, the transition plans proposed by Met-Ed and Penelec also accomplish the objective of moving customers closer to market-based prices while retaining caps and flowing to customers the benefits of past procurement decisions. These plans do not involve any pre-payments by customers or deferral of power supply expenses by the two companies. However, while this type of transition plan may not work for other utilities, it does for Met-Ed and Penelec because of their specific situations.

The Companies do not believe that the concept of artificially requiring customers to pay higher rates earlier, with a rebate at a later time, is a viable long-term solution. Such a program would create a liability that bears no relationship to actual costs incurred, either now or in the future. This and similar concepts tend to perpetuate the lack of accurate, market-based price signals that should drive customer behavior to understand and properly manage energy use in a market-based energy price environment.

The pre-payment concept is a manner of financial engineering whereby the timing of money flows is altered to the inherent detriment or benefit of different constituencies. By contrast, the transition plans of Met-Ed and Penelec only request that retail rates reflect the true costs being incurred by the Companies (tempered by embedded lower cost procurements and a current price ceiling), with continued, although higher, rate caps in place as a consumer protection measure for four years.

The Commission should endorse the use of portfolio concepts in utilities' decisions for the procurement of power for POLR load. There are examples of this approach already in use in Pennsylvania and New Jersey. To the extent that utilities are encouraged or mandated to enter into long term contracts to meet POLR requirements, the Commission must be prepared to allow recovery of those costs in the event market prices fall and customers leave POLR service for short-term, lower-priced, market-based supply from electric generation suppliers. It is imperative that the Commission adheres to its own policies and avoids after-the-fact, hindsight-based prudence reviews that devolve into mere second guessing.

5. Issues Concerning Programs to Assist Low-Income Customers

The burden of current universal service programs has historically fallen on the utilities and their customers. Although each utility has some level of universal service costs built into their rates, there exists a tension between the expanding needs for such programs and continuing funding. In the most fundamental terms these programs are social welfare programs that should be adequately and fully funded through government revenues. However, this has not been the case and the hodge-podge of federal, state, local, charitable agency, utility customer and utility shareholder funds comprise the sources of the dollars for these programs.

The implementation of market-based pricing will no doubt affect low-income customers to a greater extent than those with higher incomes. Recognizing this need in their transition case proposal, Met-Ed and Penelec have proposed a Universal Service Rider that will ensure adequate funding of universal service programs in their service territories while at the same time providing for appropriate and timely recovery of the costs of these programs. In the absence of adequate, continuing funding through governmental revenues, a §1307 approach provides an effective means to fund universal service programs in the transition to market-based rates. Commission efforts to place greater responsibility for funding these programs on governmental revenues would be appropriate in order to spread the costs of these programs on the citizenry as a whole, rather than primarily on utility customers.

6. Interplay with the Wholesale Energy Markets

The Commission recognizes that the retail energy market is inextricably linked to wholesale market prices. The policy objectives of the Competition Act will never be achieved until the value of electricity as determined by the competitive wholesale market is reflected in retail prices to consumers. Prolonging or creating new administrative mechanisms that continue to insulate the linkage between wholesale and retail market prices will merely foster new issues and is contrary to the objectives of the Competition Act.

The Commission should seek to ensure that the characteristics of wholesale prices are reflected in retail POLR rates. These characteristics include, but are not limited to, seasonality, weekday versus weekend, and on-peak versus off-peak. The translation of these factors into retail rates must be tempered by consideration of practicality. For example, metering costs may dictate that the degree of incorporation of these wholesale pricing characteristics into rates for individual customer classes will differ.

Mandatory hourly pricing for large customers may be appropriate but issues of customer acceptance are critical to success. In addition, large commercial and industrial customers provide substantial employment and economic development benefits that must be weighed against the financial effect of implementing mandatory hourly pricing. The Companies' large customers have made it very clear to us that they do not desire to be exposed to the vagaries of hourly electricity prices and, as Commissioner Shane has pointed out, experience has shown that mandatory hourly pricing for POLR service merely may force the customer to shop for fixed price service. The result is that shopping level statistics improve but consumption decisions do not necessarily change and are not linked to hourly prices.

Conclusion

The Companies commend the Commission for embarking on this important investigation to better prepare Pennsylvania for competitive energy markets. The timing of this proceeding shows the foresight of the Commission and its desire to fashion reasonable solutions to issues that are critical to the state's long-term economic well-being. The Companies look forward to working with the Commission and other stakeholders as this proceeding evolves.

Respectfully submitted,

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