BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

In the Matter of the Pennsylvania
Public Utility Commission
Investigation into Policies to Mitigate Potential Electricity Price Increases

Docket No. M-00061957

Reply Comments of
Constellation Energy Group Companies

I. INTRODUCTION

On June 22, 2006, the Pennsylvania Public Utility Commission ("Commission") held an En Banc Hearing on Policies to Mitigate Potential Electricity Price Increases ("Price Mitigation Hearing").[1] Once again, Constellation Energy Commodities Group, Inc., Constellation Generation Group, LLC and Constellation NewEnergy, Inc. (collectively, "Constellation") commend the Commission for their foresight and initiative to address the issues associated with the development of successful competitive markets in advance of the expiration of rate caps in the Commonwealth.

As we have indicated in several other submissions, Constellation believes the best way for the Commission to mitigate potential future price shock is to ensure that wholesale and retail competitive markets are allowed to work. The Commission should focus its efforts on creating stable and predictable rules of the road that will maintain the integrity of electricity service and foster competition. In many respects, this proceeding has become another platform for debate on the appropriate approach to the default service obligations of the electric distribution companies ("EDC") after the rate caps expire. Constellation continues to support the development of a basic and reliable default service procurement model that, if designed properly, should attract both wholesale and retail suppliers and create a downward pressure on prices needed to assure the benefits of competitive markets to non-shopping and shopping customers alike.

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[1] *Investigation Order on Policies to Mitigate Potential Electricity Price Increases,* Docket No. M-00061957 (Adopted May 19, 2006).

Furthermore, Constellation urges the Commission to continue to look to the wholesale market as part of the solution, and not the problem. High prices today do not mean high prices tomorrow. Thus, Constellation cautions the Commission against trying to predict and manage future fuel costs and electricity prices. Instead, the Commission should continue its critical efforts in developing and implementing the fundamental default service rules needed for a robust electricity market.

II. SPECIFIC COMMENTS

1. Default Service

a. For small customers, a New Jersey style descending clock auctions procurement is consistent with the goals of the Electric Generation Choice and Competition Act and the most prudent path for the Commission to pursue.

At the Price Mitigation Hearing, Vice Chairman Cawley and Commissioner Fitzpatrick asked parties to address in reply comments how the New Jersey Basic Generation Service ("BGS") model would effectuate the goals of the Electric Generation Customer Choice and Competition Act ("Competition Act").[2] In particular, two elements of the New Jersey model were highlighted: (1) the retail price is only changed once per year, and (2) only 1/3 of the total residential load is bid out each year.[3] They raised concern that these elements combined with the three-year procurement approach virtually eliminate shopping at the residential level.[4] Since "price stability" is not an expressly stated goal in the Competition Act, they questioned whether the New Jersey model would prevent the Commission from fulfilling the mandate of the Competition Act to develop a competitive retail market for residential customers.[5]

The Competition Act promotes many goals, including customer choice, the development of competition and markets, and the availability of electric service by a default supplier to customers who do not shop for an alternative supplier. First, the Competition Act promotes

[2] 66 Pa. C.S. § 2801, *et seq*.
[3] *Statement of Commissioner Terrance J. Fitzpatrick*, Docket No. P-00062212 (June 22, 2006) ("Fitzpatrick Statement) at p. 2.
[4] *Id.*
[5] *Id.*

customer choice by providing customers “direct access to a competitive generation market.”[6] Second, it promotes the development of competition and markets over traditional cost-based regulation – “competitive market forces are more effective than economic regulation in controlling the cost of generating electricity.”[7] Third, the Competition Act ensures the “availability of universal electric service” in the Commonwealth by requiring the EDC to provide default service to customers who do not shop for an alternative provider.[8] In fact, it specifically promotes default service to be reliable, available on reasonable terms and conditions, associated with high-quality customer service, and provided consistent with the level of protections currently afforded to low-income customers.[9]

From a plain reading of the Competition Act, “guaranteed price stability” is not a policy declared by the Pennsylvania General Assembly, as acknowledged by the Commissioners. However, the Competition Act does not prohibit the Commission from promoting stable prices as a matter of policy for smaller customers so long as the other policy goals of the Competition Act are not undermined. Indeed, the Commission can work appropriately within the parameters of the law and embark on a path that will further develop the wholesale and retail markets in a way that makes sense for Pennsylvania consumers.

Most Pennsylvania consumers have enjoyed more than a decade of capped, and in many cases below market, rates. While it is appropriate to transition Pennsylvania’s consumers away from rate caps to prices that are more reflective of market conditions, the Commission must be careful to make the transition as smooth as possible. A sudden shift to a retail market structure that is based on frequent and possibly dramatic prices swings could prove disastrous for Pennsylvania’s smallest consumers. Clearly, this result was not one that was envisioned by the General Assembly. Accordingly, Constellation generally supports the use of a New Jersey style BGS auction, conducted beginning three years in advance of the expiration of capped rates, for one third of the load each year, to mitigate sudden rate shifts. We believe this approach provides the Commission sufficient time to anticipate and manage potential rate increases at the retail level. Moreover, given that supply curves far in the future tend to be less impacted by short term events, we believe this approach may be a legitimate means of mitigating potential price shock or

[6] 66 Pa. C.S. § 2802(3)
[7] 66 Pa. C.S. § 2802(5)
[8] 66 Pa. C.S. § 2802(16)
[9] 66 Pa. C.S. §§§ 2802(9), (10), (11)

increases, particularly for smaller customers, and will avoid a situation in which the EDCs are required to procure supply for their load obligation during a single period.

Constellation encourages the Commission's favorable consideration of this mitigation proposal but would also highlight that this approach introduces at least one concern the Commission should carefully consider. By securing supplies beginning three years in advance, suppliers will assume the price risks associated with the forward supply obligation and presumably will execute their respective hedge strategies to manage the impact of changing market prices over time. However, suppliers have no ability to hedge or otherwise mitigate the impact of future Commission or legislative initiatives that introduce substantial large scale volumetric risks. More specifically, radical procurement substitutions such as those employed in Pike County require suppliers to consider how to price the unpredictable volumetric risk, such as large scale retail aggregation programs. Constellation recommends the Commission specifically insulate or otherwise limit volumetric risks from suppliers so as to preclude the need for volumetric risk premiums that could significantly distort auction prices.

Moreover, the Commission should resist any temptation to prolong the rate caps beyond the timeframes contemplated by the settlement agreements. To do so would extend the distortion of the marketplace while creating potentially large deferrals for consumers.

The Commission should strive to strike a balance where smaller customers are afforded some degree of price stability while also provided incentives to shop. The New Jersey three year approach is a model that strikes that balance and, in particular, balances the goals of the Competition Act because: (1) it provides smaller customers access to a competitive market; (2) allows the market to control the price of electricity through a wholesale competitive bid auction; and (3) provides "reasonable" terms of default service. No goals of the Competition Act are undermined by the New Jersey approach – (1) customers are not prevented from shopping for an alternative supplier; (2) prices are not set by administrative means or economic regulation; and (3) smaller customers are not provided unreasonable terms for default service.

The multi-year procurement approach utilized in New Jersey has achieved an effective balance between obtaining a competitive price and providing a stable product for default service customers. It has also created a "plain vanilla" basic generation product that allows retailers to compete through price and non-price offers alike. The Commission may even consider, as strongly supported by the Office of Consumer Advocate,[10] a portfolio approach to supply default service load for residential customers such as that utilized in New Jersey.

As a matter of policy, adopting a New Jersey style BGS approach in Pennsylvania should not be considered inconsistent with the development of a competitive market. First, residential consumers are using their "buying power" to realize the benefits of the competitive wholesale market. A BGS approach in essence allows the state to serve as an aggregator until such times as retailers are able to step in and effectively play that role. Secondly, retail competitors would still be able to compete against a known price. Finally, a BGS style auction will allow the wholesale market to mature and develop more sophisticated products that could lead to a more stable retail market. In this regard, the New Jersey approach could be viewed as a transition tool to a competitive retail market.

As acknowledged by Commission Fitzpatrick, the Competition Act does not mandate how frequently default service prices must change. It only mandates that the default service price meet the "prevailing market price" standard.[11] An auction or RFP procurement approach satisfies the "prevailing market price" standard because the basis of bids offered by suppliers into the auction reflects the prevailing wholesale market price for energy. Moreover, even within a three year approach, like New Jersey, prices may fluctuate more than once per year, such as seasonally. The frequency of price change is a policy decision to be made by the Commission. At first glance, it appears there is nothing particular about the New Jersey model that prohibits the Commission from tweaking the model to include more frequent price changes if it believes that such tweaks better provide residential customers with the incentive to shop.

b. For large customers,[12] monthly or hourly pricing should be the default service product because it will foster the development of a robust retail market and provide the best incentives for reducing peak demand for electricity.

Some comments asserted that the default service provider should be able to provide a long-term, fixed price to large commercial customers because hourly pricing is "ugly" and

[10] Initial Comments of the Office of Consumer Advocate, dated June 15, 2006, Docket No. M-00061957, at p.2.
[11] 66 Pa. C.S. 2807(e)(3)
[12] Consistent with the Commission's proposed rules, by "larger commercial and industrial customers" Constellation refers to customers with a load equal to or greater than 500kWh.

merely forces the customer to shop for a fixed price service. Further, some parties suggested that hourly pricing is not a more effective tool to encourage peak demand reduction.

Constellation believes that hourly pricing for larger commercial and industrial customers reflects a "plain vanilla" default service model and is the appropriate provider of last resort ("POLR") policy. Hourly pricing for larger commercial and industrial customers will encourage more competitive markets by attracting competitive suppliers, which will in turn exert downward pressure on retail prices. EDC's should not be permitted to enter into negotiated retail rate arrangements with their consumers as suggested by some parties. Such arrangements should be the exclusive province of the competitive market where competitors (including the competitive affiliate of an EDC) can compete on a level playing field to bring value to consumers.

Additionally, the clearest way to provide incentives for customers to reduce peak demand for electricity is through real time pricing that allows customers to see the wholesale cost of power and respond effectively. Since few customers are able to respond in real time, as recognized by the Office of Small Business Advocate,[13] or want to tie risk management to volatile prices, these customers will have incentives to either bid their load into the day-ahead market or bilaterally contract for a fixed price of power with a competitive supplier.

2. The Duquesne Market

Contrary to the assertion of several parties at the public hearing, the Duquesne market is maturing in a manner that is bringing the benefits of competitive markets to commercial and industrial consumers. Competition for commercial and industrial consumers is fierce. There are 21 active suppliers in the Duquesne service territory[14] and nearly 90% of the industrial load is purchasing electricity from alternative suppliers.[15] Competition is real, intense and maximizing value to those large consumers who are willing to educate themselves and response to the most attractive offers. Retail price increases are attributable to increases in fuel costs and other factors in PJM – not a lack of competition.[16]

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[13] Initial Comments of the Office of Small Business Advocate, dated June 15, 2006, Docket No. M-00061957 at pp. 2-3.
[14] http://www.puc.state.pa.us/utilitychoice/listofsupp.aspx?ut=ec&ShowSupp=3
[15] Duquesne Light Company, Fourth Compliance Filing, dated Jan. 9, 2006, Docket No. P-000302071.
[16] Crampton and Stoft, *Uniform-Price Auctions in Electricity Markets*, Mar. 18, 2006, at Sect. 4.

Parties to this proceeding who appear to seek to have their generation rates subsidized to below market levels should seek other means of achieving that goal. The Commission has a charge to develop a competitive market place that will bring the value of competition to Pennsylvania's consumers. POLR policy and other Commission policies should support the development of the market – not the development of below market rates for one customer or one class of customers. Such arrangements are an anathema to the market and simply can not exist in a regulatory scheme that must fulfill the mandate of the Competition Act.

III. CONCLUSION

Once again, Constellation applauds the Commission's foresight in opening this proceeding. The Pennsylvania market is entering a very critical stage that will ultimately determine the success or failure of this transition. We urge you to stay focused on the market and what it will take to develop the market rather than near or long term price impacts. Pennsylvania has been at the vanguard of the moment to restructure electricity markets and the Commonwealth has worn that distinction appropriately and well. As a company that wants to be an integral part of a Pennsylvania where competition is robust, Constellation urges the Commission to develop the rules of the road along the lines contemplated in these comments.

Respectfully submitted,

/s/ Lisa M. Decker
Lisa M. Decker, Esq.
Counsel
Constellation Energy Group, Inc.
111 Market Place, Suite 500
Baltimore, Maryland 21202
410-468-3792
Lisa.Decker@constellation.com

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