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July 20, 2006

VIA FEDERAL EXPRESS

James McNulty, Secretary
PA Public Utility Commission
Commonwealth Keystone Bldg.
2nd Fl., 400 North Street
P.O. Box 3265
Harrisburg, PA 17105-3265

Re: Policies to Mitigate Potential Electricity Price Increases;
Docket No. M-00061957 – Comments of Strategic Energy, LLC

Dear Secretary McNulty:

Enclosed are the original and fifteen copies of the Strategic Energy, LLC's Reply Comments for filing in the above-referenced matter. An electronic version has been emailed to Shane Rooney as required by the Commission's May 24, 2006 Order.

Sincerely,

Kevin J Moody

Daniel Clearfield
For WOLF, BLOCK, SCHORR and SOLIS-COHEN LLP

DC/lww
Enclosures

HAR:67169.1/STR163-210988

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

REPLY COMMENTS OF STRATEGIC ENERGY, L.L.C.

Strategic Energy, L.L.C. ("Strategic") hereby provides these Reply Comments to the Comments submitted by various parties to the Pennsylvania Public Utility Commission ("PUC" or "Commission") as well as testimony at the June 22, 2006 *en banc* hearing in this matter.

A. Introduction

Several parties in their comments, most notably Duquesne, have pushed aside the stated purpose of this investigation and have used it to launch a frontal assault on some of the seminal tenets of electric restructuring:

- Developing robust, sustainable retail electric competition is not only good for consumers, it's the policy of this Commonwealth;
- The Provider of Last Resort's role is to backstop the competitive market and not to actively compete with EGSs; and
- POLR prices must reflect the price that the POLR provider incurs when it procures power from the wholesale market (together with all reasonable costs of obtaining and delivering that power).

Each of these basic assumptions – all of which are firmly grounded in the Electric Competition Act itself – came under attack in the comments and the public hearing held to discuss those comments. The Commission has confirmed these basic assumptions. In the Duquesne Light Company POLR III order, the Commission determined:

> A primary innovation mandated by the Act was to provide customers with direct access to a competitive generation market. 66 Pa. C.S. § 2802(3). The reason for this change is the legislative finding that "competitive market forces are more effective than economic regulation in controlling the costs of generating electricity." 66 Pa. C.S. § 2802(5); *See*, *Green Mountain Energy*

> *Company, et al. v. Pa. PUC*, 812 A.2d 740, 742 (Pa. Cmwlth. 2002). Accordingly, a fundamental policy underlying the Act is that competition is more effective than economic regulation in controlling the costs of generating electricity. 66 Pa. C.S. § 2802(5).[1]

In the POLR NOPR, the Commission found that "[t]he General Assembly's policy findings regarding the overall costs of electricity, disparities in rates across service territories, and the importance of reasonable rates in attracting and retaining businesses can best be addressed by ensuring the continued formation of a competitive marketplace for electricity. 66 Pa. C.S. §§2802(4), (5), (6)."[2] The Commission concluded that "POLR service, as the name suggests, should primarily serve as a backstop to the competitive retail market. Therefore, POLR service should be basic generation service."[3] The Commission also determined that under an appropriately designed POLR service, "the market will provide the products and services that meet the needs of consumers."[4]

But, as several of the Commissioners stated during the public hearing, the Commission should not – indeed (as will be shown below) – <u>may not</u> abandon any of these policy pronouncements under the guise of "mitigating rate shock."

Before discussing in detail each of these issues it is useful to note that those who are attacking competition and urging a radical departure from existing POLR tenets are doing so on

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1 *Petition of Duquesne Light Company for Approval of Plan for Post-Transition Period Provider of Last Resort Service* ("*Duquesne POLR III Order*"), Docket No. P-00032071, Order entered August 23, 2004, at 6.

2 *Rulemaking Re Electric Distribution Companies' Obligation to Serve Retail Customers at the Conclusion of the Transition Period Pursuant To 66 Pa. C.S. §2807(e)(2),* Docket No. L-00040169, Order entered December 16, 2004, at 5.

3 *Id.*

4 *Id.*

the basis of factual fears about "rate shocks" which appear to be misplaced.[5] No company that is scheduled to emerge from the rate cap period in 2009-2010 has projected the kind of enormous hikes that have been seen in other jurisdictions or service territories. PECO is projecting a 11% increase in 2011;[6] PPL estimated a 20-30% increase;[7] and FirstEnergy, while not providing an estimate for its three companies, did not predict rate shock type prices. Increases of these magnitudes, while worth being prepared for, do not appear to justify the kind of drastic measures that some of the commentators have called for. Instead, the Commission would be well-advised to carefully monitor these price projections, perhaps requiring each company to continue to provide their best guess to the Commission on a periodic basis.

At the same time, Strategic continues to urge that the Commission redouble its efforts to pursue policies that are likely to permit the development of robust retail competition in the service territories in which rate caps will expire in the next several years. Strategic agrees that, generally, these efforts should be directed to increasing the supply (and diversity of supply) of electricity and decreasing the demand for electricity through energy conservation and reduction of peak demand, all of which can substantially lower electricity prices.[8] Both Strategic and other commentators have recommended a series of specific steps that will facilitate the development of robust retail competition. They include: encouraging the deployment of advanced metering

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5 Similarly, the assertions of substantial "rate shock" increases under Duquesne's POLR III plan, such as 25% and higher for Duquesne's large commercial and industrial customers, do not tell the whole story, and Strategic reserves the right to submit supplemental reply comments putting these assertions in the proper context.

6 PECO Comments at 2, 4.

7 PPL Comments at 3.

8 *See*, PennFuture Comments at 4.

technology; encouraging EDCs voluntarily to purchase the receivables of EGSs providing service in their territory; establishing POLR rates that reflect, as closely as possible, prevailing market prices; and educating consumers on energy prices and the retail electric market. Doing so is a "win-win" for Pennsylvania consumers in any event. If prices do rise significantly coming out of the rate cap periods, having competitive alternatives in place and available will serve as an important means of mitigating such increases. If prices rise less precipitously – or not at all – Pennsylvanians will benefit from vigorous price competition and the increased innovation in products and services that comes from a robust competitive retail market.

B. Long Term, Fixed Price POLR Contracts and Pricing Are Inconsistent With the Choice Act and Are Not the Best Way to Advance the Welfare of the Commonwealth.

Several parties have advocated the use of "laddered" wholesale auction procurement plans,[9] or the use of a "portfolio" of resources to prevent or ameliorate the potential harms of extraordinary electricity price spikes.[10] Others – in particular, Duquesne Light Company – have attacked the basic premises underlying Pennsylvania's electric restructuring efforts and have called for a *de facto* remonopolization ostensibly to "protect" consumers from these predicted hikes. Duquesne claims that its current POLR pricing formula has been bad for large commercial and industrial customers, and that a more appropriate question before the Commission (and the answer) are "[w]hat should we be doing to ensure that customers are provided reliable electric service at affordable rates? . . . The answer lies in long-term fixed contracts."[11] Similarly, several businesses and groups in the Pittsburgh area, obviously prompted

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[9] OCA, OSBA, PPL, PECO.

[10] OCA, Constellation.

[11] Duquesne Comments at 6.

by Duquesne, have supported Duquesne's advocacy, calling for long term contracts from the EDC as the "solution" to threatened price spikes.[12]

First, setting POLR rates on a long-term fixed basis does nothing, and can do nothing, to prevent price spikes – they are simply shifted to another day. Even if the point at which wholesale procurement is accomplished is expanded from one day to four, over several years, the potential that the market conditions at any particular point in time will have a significant influence on the fixed price is, obviously, reduced – but by no means eliminated. There continues to be the potential that the auctions will fix the prices at high points in the market.

More to the point, permitting POLR rates to be established on the basis of long-term fixed prices is simply not permitted under the Electric Choice Act. Such prices will, by definitions not reflect the cost of purchasing generation at "prevailing market prices" as the statute requires. While in Duquesne's last POLR proceeding, the Commission approved relatively short-term (three years) fixed price POLR rates for residential and small commercial customers, the Commission determined that those rates were justified by Duquesne by data which purported to show that the rates were consistent with prevailing market prices.[13] At the same time, the Commission ruled definitively that longer term POLR pricing terms were not permitted under the "prevailing market price" requirement:

> A six-year term is too long a period of time for the proposed POLR III Plan. The Excepting Parties are correct that one cannot establish a fixed price for a six-year term and comply with the

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12 US Steel, AK Steel, Allegheny County, Allegheny Conference on Community Development.

13 *Duquesne POLR III Order* at 22; *Duquesne POLR III Order on Reconsideration* (October 5, 2004) at 9.

> Act's mandate that POLR supply must be acquired at *prevailing* market prices.[14]

Therefore, we know that a long term (more than three year) fixed rate contract cannot satisfy the "prevailing market price" legal requirement.

Long-term POLR fixed prices are also extremely bad policy because they will definintely stymie the development of a competitive market. As Commissioner Fitzpatrick recognized during the public hearing, long-term fixed price POLR contracts hurt competition because such pricing creates an artificial price standard against which EGSs cannot compete. Competitors never can be certain whether the fixed price is going to be too high or too low relative to the market; nor can they be sure that whatever relationship exists today will continue to exist into the future. As a result, EGSs simply cannot make the investment decisions necessary to enter such a market on a sustained basis. That is why jurisdictions which have utilized long-term default rates have seen little, if any, competitive alternatives.[15]

Several commentators complained that the PUC's POLR policy "prevents" large business customers from entering into long-term energy contracts with Duquesne.[16] This, of course, is completely untrue. Large C&I customers in Duquesne's service territory are completely free to obtain power under long-term contracts from Duquesne – <u>just not from Duquesne's POLR service</u>. During the public hearing, Commissioner Cawley pressed one industrial customer for an explanation as to why his company was advocating for a long-term contract from <u>Duquesne's</u>

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14 *Duquesne POLR III Order* at 16.

15 NEM Comments at 17-18; RESA Comments at 5; Direct Energy Comments at 8; Reliant Energy Comments at 8-9.

16 AK Steel, US Steel, Allegheny County, Allegheny Conference on Community Development.

POLR service as opposed to another EGS – including a Duquesne affiliate. Fairly stated, no rational answer was forthcoming. As one commentator observed at the public hearing, the long term (perhaps below cost) deals available to industrial customers (and not available to small business and residential customers) in the past were a product of the old regulated regime and are simply not available in today's markets.[17]

What could be different about a long-term contract provided by Duquesne as POLR as opposed to Duquesne as EGS (or some other EGS)? The only possible difference is that the customer believes that the rate from Duquesne's POLR service will not reflect all costs and, therefore, will be subsidized by Duquesne's remaining customers, either through POLR rates or distribution rates. Obviously, such a subsidized rate is simply no longer legal or appropriate. If industrial customers believe that they need subsidized rates to be competitive, then such subsidies should be made in explicit, government sponsored and funded "economic development" initiatives. So long as the economic development grants were competitively neutral, EGSs (such as Strategic) would not oppose them. To the same effect, Strategic does not oppose the industrial customers' proposed "State Power Authority" concept – so long as any power generated or facilitated by the Authority was available on equal terms and conditions to be bought and resold by all retail providers, including Strategic. However, when economic development subsidies are hidden in the cloak of "long term contracts" which do not reflect all costs of providing the service, the result will be extremely anti-competitive.

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[17] Tr. 52 (Hanger).

C. Comments That POLR Service Should Not Be Made "Ugly" Misperceive the Nature of POLR Service as a Backup

In a similar vein, several commentators, as well as Commissioner Shane, have suggested that EDCs should be offering competitively attractive alternatives to customers as part of their "POLR" rates, including long-term, fixed price contracts.[18] They have suggested that EGS arguments that such offerings – from the EDC – are not permitted, are an attempt to make POLR service "ugly" with the object of forcing the disgruntled customers to shift to a competitive suppliers offering the same type of long-term, fixed price contacts that EGSs have claimed are barred as POLR offerings. Strategic respectfully submits that these suggestions misperceive the true nature of POLR service under the Choice Act. As the name implies, POLR (or default) service was designed to be a backup or backstop to assure universal availability of generation service for customers who, for whatever reason, could not or did not wish to participate in the competitive market. The description of POLR service in the Choice Act confirms this:

> If a customer contracts for electric energy and it is not delivered or if a customer does not choose an alternative electric generation supplier, the electric distribution company . . . shall acquire electric energy at prevailing market prices to serve that customer and shall recover fully all reasonable costs.[19]

Thus, the Act not only dictates the means of supply to be used by the POLR provider ("acquire electric energy at prevailing market prices . . . and shall recover all reasonable costs"), but also dictates the category of customer to whom the service is directed – customers who have contracted for electric energy that is not delivered <u>or</u> customers who do not choose an EGS.

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18 Duquesne, PPL, Allegheny County, Allegheny Conference on Community Development.

19 66 Pa. C.S. § 2807(e)(3).

Neither of these activities suggest a customer who is actively marketed or solicited by the EDC to subscribe to its POLR service.

Moreover, setting the POLR rates as a market tracking default rate is extremely important to the development of competitive alternatives – in each instance in which such a rate has been established the level of competitive supply has gone up dramatically. In addition, market tracking default rates provide important signals to customers about the true cost of energy – which helps to promote conservation and energy efficiency regardless of whether a customer subscribes to that rate or obtains a fixed price contract from an EGS. Even when the customer obtains service from an EGS under a fixed rate contract, the existence of a market based default rate gives the customer ongoing knowledge of how he or she is doing relative to the market and serves to provide important price signals to the customer that can result in the customer adjusting energy usage to take advantage of future price changes or to engage in additional conservation measures.

Even though it appears clear that POLR service should be a default service which provides a market priced alternative for customers who, for whatever reason, cannot or do not avail themselves of the competitive market, customers have voiced concerns about the pricing structure that appears to be required for such a service. The main concern appears to be that a pricing structure that reflects changing market prices does not provide the certainty that these customers desire. Some of the EDCs have suggested that it is even unfair or anticompetitive to limit the EDC from offering desirable generation products if customers want these products.

While Strategic understands these concerns, it believes that market priced, truly default POLR rates are required by the Act. On the other hand, there is nothing in the Choice Act or appropriate POLR policy that would limit the EDC from providing attractive electric generation products or services through a separate affiliated EGS. If customers are desirous of long-term, fixed rate supply contracts from "the utility," there is nothing to stop an EDC from offering such contracts through the utility's affiliated EGS. Because this option is available (and, in fact, has been used by Duquesne Light, as one example), it is difficult to understand why large industrial and commercial customers continue to request such service offerings from the EDC's POLR service, unless they believe that the POLR rates will be artificially lower due to being subsidized by remaining customers through their distribution and POLR rates. How else can their interest in a fixed POLR rate be explained?

But there is no reason that Duquesne Light, for example, will be able to procure power in the wholesale market on a long-term basis and deliver it at a rate that is going to beat the rates which any other EGS could offer unless the offered POLR rate is not covering all of the POLR costs and, instead, other customers are subsidizing in some manner the price being offered. Obviously, such subsidized rates are unfair to remaining customers and anticompetitive and cannot be tolerated.

As noted above, however, Strategic is not opposed to economic development initiatives in which industrial or commercial customers receive attractive rates in order to convince them to locate or expand their businesses in Pennsylvania, so long as such opportunities are available on a competitively neutral basis.

Respectfully submitted,

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