



COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA PUBLIC UTILITY COMMISSION
P.O. BOX 3265, HARRISBURG, PA 17105-3265

IN REPLY PLEASE
REFER TO OUR FILE

February 27, 2003

To: Electric Distribution Companies
Electric Generation Suppliers
Office of Trial Staff
Office of Consumer Advocate
Office of Small Business Advocate
Other Interested Parties

Re: **Provider of Last Resort Working Group**

By this letter, Staff of the Pennsylvania Public Utility Commission is announcing the reconvening of the Provider of Last Resort (POLR) Working Group, which will meet on March 25, 2003 at 1:30 p.m. in Hearing Room 1, Commonwealth Keystone Building, Harrisburg, Pennsylvania. The POLR Working Group was initially formed in August 2000 to begin developing proposed rules that define the duties and rights of providers of last resort in the electric industry. As noted at that time, any consensus resolutions achieved by the POLR Working Group will be considered by the Commission in adopting proposed regulations governing provider of last resort service.

Statutory Provisions

Under Section 2807(e) of the Electricity Generation Customer Choice and Competition Act, 66 Pa. C.S. §2807(e), electric distribution companies (EDCs) have the full obligation to serve customers during the transition period. That obligation includes the connection of customers, the delivery of electric energy and the production or acquisition of electric energy for customers. As to the EDCs' duties following the transition period, the Commission must "promulgate regulations to define the electric distribution company's obligation to connect and deliver and acquire electricity." 66 Pa.C.S. §2807(e)(2). While the Act affords the Commission substantial latitude in developing the rules that govern this obligation, it clearly sets forth basic principles that must be followed by the Commission.

First, the Act establishes that after the transition period, electric consumers will continue to receive generation service from the EDC or a Commission-approved provider of last resort if either they do not choose an alternative electric generation supplier (EGS) or they contract with an EGS for electric energy that is not delivered. Second, EDCs or Commission-approved POLRs are obligated to "acquire electric energy at prevailing market prices." Third, the EDC or Commission-approved POLR must be permitted to "recover fully all reasonable costs." 66 Pa.C.S. §2807(e)(3). Although the Act contemplates the possibility of an alternative POLR providing default service to consumers, it does not set forth any specific parameters under which an alternative POLR may qualify or offer this service.

Initial Focus of Working Group

In view of the clear statutory directives, Commission Staff has determined to initially focus the efforts of the POLR Working Group on: 1) defining the EDCs' continuing obligations to connect, deliver and acquire electricity, 2) establishing a method for determining prevailing market prices, and 3) creating a mechanism for the full recovery of all reasonable costs by the EDCs. Development of regulations should consider the costs and risks borne by EDCs, as well as the importance of ensuring that consumers receiving generation service from the EDCs have appropriate levels of protection from the volatility of the wholesale market. Also, the limitations placed upon consumers who wish to access the competitive market should be minimized to the extent possible.

At subsequent meetings, Commission Staff plans to address the qualifications, standards, procedures and rules applicable to the approval, duties and obligations of alternative POLRs. We are hopeful that the results produced by the Supplier of Last Resort (SOLR) Working Group addressing the provision of natural gas supply service by an alternative SOLR, will be of value to the POLR Working Group in addressing these issues.

At the initial meeting of the POLR Working Group in Summer 2000, many participants expressed reservations about beginning to develop rules prior to gaining some experience with the way wholesale and retail electric markets are functioning. Nonetheless, some participants identified various issues that should be addressed in the context of developing such regulations. Based upon those discussions, as well as information gathered over the past two years, particularly as some EDCs have begun moving into the post-transition period, Staff has formulated a framework that will hopefully facilitate productive discussions upon which the POLR Working Group can move forward.

Rather than drafting proposed regulations and offering them as a "strawman proposal" at this time, Staff is setting forth some general concepts in this letter. Additionally, by Appendix A attached to this letter, Staff is proposing specific principles that we believe will provide a suitable starting point for discussion by the participants in the POLR Working Group.

General Principles

a. Acquisition of Supply

As a general principle, Staff believes that EDCs should be required to fulfill their obligations to acquire generation supply in a way that minimizes those costs. Specifically, Staff submits that EDCs should have the duty to make reasonable forecasts and assumptions about the amount of load that will need to be served and to make appropriate arrangements to acquire the supply needed to meet that load. The reasonableness of procurement decisions should reflect each EDC's individual circumstances and be consistent with providing reliable supply services to its consumers. To the extent that the EDC's efforts are reasonable and prudent, Staff is of the view that they should be permitted to fully recover their supply costs, as well as other reasonable costs associated with acquiring that supply.

b. Magnitude of scrutiny

The magnitude of scrutiny to which EDCs' procurement decisions or calculations of reasonable costs should be subjected is an area that Staff believes will need to be flexible to reflect changing market conditions. While a thorough review of an EDC's procurement policies and practices will likely be warranted in the early phase of the post-transition period, it is envisioned that over time, a more cursory review with increased reliance on the market will be appropriate. Therefore, Staff hopes to develop regulations that allow for some flexibility in this process as confidence in the wholesale market evolves.

c. Recovery of reasonable costs

With respect to the full recovery of reasonable costs, Staff believes that at least three basic approaches warrant discussion within the POLR Working Group. Each of them is described below.

One option is to identify in the regulations all categories of costs that may be recovered by EDCs relating to the acquisition of supply, and then subject the EDCs to a periodic review of the reasonableness of those costs. In such a proceeding, the Commission would consider whether the costs the EDCs seek to recover fall within the defined categories, were prudently incurred and are reasonable in light of the circumstances that existed when the procurement decisions were made.

A second option is to perform calculations within the Working Group that estimate the amount of costs (including an amount associated with risks) that an EDC would incur above the "prevailing market price," in connection with the acquisition of supply. That estimate would then be used to establish a mark-up percentage that an EDC may add to prevailing market prices. Using the latter approach of allowing EDCs to use an "adder," a periodic review of the EDCs' practices would focus upon whether supply was procured through reasonable arrangements in appropriate amounts at the prevailing market prices.

A third option is to allow, or possibly require, an EDC to utilize competitive bidding for the supply needed to serve its retail customers. If the wholesale market is sufficiently developed, a "request for proposal" process could be utilized as the sole means for verifying the reasonableness of the costs incurred by the EDC to acquire supply at prevailing market prices.

By identifying these options, Staff does not seek to preclude other proposals from being advanced, such as an approach that relies upon performance-based ratemaking concepts. Additionally, Staff suggests that the possibility could exist for EDCs to use one or more of the available approaches.

Staff also believes that different rules for cost recovery might be justified depending upon the classes or types of customers being served. For example, large commercial and industrial customers arguably need less regulatory protection than residential and small business customers. While the statute does not differentiate between these groups of customers, it would be possible to develop ways of ensuring that classes of customers are called upon to pay reasonable costs that were incurred by the EDC to acquire energy on their behalf at prevailing

market prices. At a minimum, Staff is of the view that some discussion of making such a distinction is warranted.

Another variation in cost recovery that Staff views as worthy of discussion is for customers who return to the EDC after being served by an alternative EGS when the return results in the EDC incurring significant supply costs on those customers' behalf. Rather than spreading those costs across all POLR customers, it seems reasonable to have the additional costs borne by the returning customers. Those costs could be offset or eliminated through commitments by the customers to stay with the EDC for a period of time or through payments of a premium for short-term service that is provided to the customer.

As to the POLR prices, Staff believes that EDCs should generally be afforded some flexibility in presenting a price structure that gives customers the option of paying a fixed or variable price. Similarly, EDCs should be free to offer real-time pricing alternatives to consumers. Regarding the frequency of adjustments when variable prices are imposed, Staff prefers to avoid a situation where EDCs may adjust it on a frequent basis, such as every month, particularly for residential and small business customers. Rather, Staff believes that EDCs should typically be limited to quarterly adjustments of their prices so that wholesale price spikes do not have an immediate and significant impact on customers' prices. Compared to monthly adjustments, this approach would be more manageable for consumers since there would be a greater opportunity for the effects of a price spike to be moderated over a longer period of time.

Other Issues for Consideration by Working Group

In addition to issues relating to the qualification of and provision of default generation service by alternative POLRs, Staff is aware of several other matters that will need to be addressed by the POLR Working Group at subsequent meetings. Those issues include but are not limited to: switching issues/minimum stay provisions, POLR marketing, customer care functions and consumer education.

Other important topics for discussion include the name of the service that EDCs will be obligated to provide, and a name for the cost-recovery mechanism that is utilized. Participants are welcome to offer their ideas. Some names that Staff has considered for the service include: provider of last resort service, basic default service, standard energy service, basic generation service, standard supply service, and generation supply service. For the cost-recovery mechanism, possible names include generation acquisition price, basic generation service price, and standard offer price. Ideas and preferences of the participants in the Working Group are welcome.

Conclusion

It is our hope that at the upcoming meeting, interested parties will be prepared to offer their general views on the proposed principles set forth by Staff so that we are able to ascertain areas of consensus and identify where significant differences in positions exist. Additionally, we envision an open discussion of contentious issues, enabling Staff to better understand the

rationale underlying the conflicting positions of the various stakeholders. We also expect that parties will raise other issues they believe need to be addressed by the Working Group.

Following this meeting, Staff plans to begin drafting proposed provisions and to determine which issues require further input from the Working Group. Consideration will be given to whether written comments, the formation of subcommittees, or further meetings of the Working Group are desirable on these issues. To that end, stakeholders are encouraged to offer their thoughts during the upcoming meeting as to the next step for addressing specific issues that must be further explored.

If you have any questions, please feel free to contact me at 717-772-8883 or by e-mail at kmoury@state.pa.us. We look forward to your participation in this POLR Working Group and are hopeful that these efforts will result in consensus resolutions that produce language for inclusion in proposed regulations adopted by the Commission.

Please note: If you wish to remain on the mailing list for this Working Group and your company or organization is unable to send a representative to this meeting, please let me know by sending an e-mail to my address noted above.

Sincerely,

Karen Oill Moury
Deputy Executive Director

cc: Executive Director Smith
Commission Offices/Bureaus

APPENDIX A

Proposed Principles of Commission Staff for the Development of Provider of Last Resort Regulations by the Provider of Last Resort Working Group

A. Obligations of EDC

1. Absent the approval of an alternative POLR, an EDC's obligations to connect, deliver and acquire electricity should continue.
2. EDCs should have an obligation to acquire electric energy at prevailing market prices for all customers who: a) do not choose an alternative supplier, b) return to the EDC for generation service, and c) contract with an EGS for electric energy that is not delivered.
3. EDCs should continue to perform all customer care functions.

B. Prevailing Market Price

1. EDCs should be required to acquire generation supply through an approach that minimizes those costs, by 1) incorporating reasonable assumptions about the amount of load that will need to be served, 2) making appropriate arrangements to acquire the supply that will be needed to meet that load, taking into account their individual circumstances, and 3) considering the need to continue providing reliable supply service to their consumers.
2. EDCs should be afforded flexibility in the way they assemble their portfolio of energy to meet the needs of electric consumers on their systems (i.e. through requests for proposals, long-term bilateral contracts, spot market purchases), provided that they demonstrate that the reasonableness and prudence of their acquisition decisions and purchases.
3. Different indices should be utilized to determine "prevailing market price" for energy and other related services procured by EDCs. These indices should include PJM locational marginal prices, Bloomsburg day-ahead prices, NYMEX PJM futures prices, and the results of any competitive bidding process utilized to obtain supply.

C. Reasonable Costs

1. EDCs' cost recovery should include all reasonable costs associated with the acquisition process.
2. Categories of recoverable costs should include: energy, capacity, transmission, ancillary, congestion, scheduling charges, as well as administrative/infrastructure costs associated with procuring supply, such as personnel, computer, facility,

administrative support, and costs incurred to bear or avoid risks associated with uncertainty in prices and demand.

D. Cost Recovery Mechanism

1. Cost recovery could be handled in a variety of ways, such as:
 - a) by requiring the EDCs to demonstrate in an annual proceeding their reasonable costs, using a pre-defined list of recoverable charges.
 - b) by the Commission establishing a specific percentage that can be added to the prevailing market price of supply to cover these additional costs. This approach would involve an upfront determination of approximately what adder would be necessary to cover these costs, based upon the calculations that are now available.
 - c) by allowing the EDC to recover the reasonable costs incurred through a competitive bidding process for acquiring supply.
2. EDCs should be required to offer consumers the option of a price that is reconciled annually to reflect actual, reasonable costs incurred to acquire energy at prevailing market prices, using a computation year that is established by the regulations.
3. EDCs should have the flexibility to offer consumers a fixed rate or variable rate and to make real-time pricing options available to consumers.
4. EDCs should be permitted to adjust prices on a quarterly basis, particularly if significant shifts occur in the wholesale market prices during the computation year.
5. Consumers should be afforded alternative cost recovery mechanisms that reflect their particular usage patterns or pricing needs and preferences. For instance, seasonal prices or flat prices that are not reconcilable should be available to consumers who wish to avail themselves of those pricing structures.
6. If annual filings are employed, a process should be established to limit the scope of the proceeding and to expedite review of the filing by the Commission. Over time, the proceeding should be streamlined to the point where EDCs establish the POLR rates and file a tariff which goes into effect, subject to complaints that might be filed against it.