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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 Direct Energy Services, LLC

Dear Secretary McNulty:

Enclosed are the original and fifteen copies of the Direct Energy Services, 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
For WOLF, BLOCK, SCHORR and SOLIS-COHEN LLP

KJM/jls
Enclosures

HAR:67186.1/DIR023-216494

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

REPLY COMMENTS OF DIRECT ENERGY SERVICES, LLC

I. Executive Summary

Direct Energy Services, LLC ("Direct Energy") submits these reply comments to the Pennsylvania Public Utility Commission ("Commission") in accordance with the Commission's Investigation Order concerning policies to mitigate potential electricity price increases.

Direct Energy's reply comments respond to the comments filed by others in this proceeding and also to some comments made at the *en banc* hearing in this docket, held on June 22, 2006. In its initial comments, Direct Energy offered two suggestions for assisting in mitigating potential rate shock. Those were the development of a system where a customer could pay, at his or her discretion, a true "market price" for power today, and put the difference between the current tariff rate and the market price into an interest bearing savings account, held in the customer's name, at the utility. That savings account would be used to offset any energy payments to either competitive suppliers or the utility, made in the future, after the rate caps come off. The second approach offered by Direct Energy was to allow customers to move to a competitively priced option early by breaking out of their stranded cost obligations. The increase in energy revenue should offset the stranded cost payments lost from this pact.

The proposal and development of these two ideas contrasts greatly with the proposals of all of the utilities and several other parties that filed comments in this docket. Among the

utilities filing comments, there appears to be only one idea to mitigate rate shock that was offered by West Penn Power. The other utilities across the State filed similar ideas around the concept of long term utility default service offerings, which would continue to stifle the development of retail choice across the State. In fact, PPL went so far as to suggest that the Commission should prohibit rate shock mitigation steps such as the short term solution offered by Direct Energy in Pike County.[1] Direct Energy submits that prohibiting solutions like the one offered in Pike County would certainly not be in the best interest of those customers who find themselves in monopolized markets saddled with large price increases.

Many parties in this proceeding chose this forum to further argue points on default service. Direct Energy did not believe the intent of this forum was to provide further argument on default service. Direct Energy will, however, refute some of those arguments on default service design in these reply comments.

Direct Energy's references to default design issues in its initial comments were in direct response to the Commission's questions about efficiency, load curtailment, customer education and the like. They were also intended to address the very public concerns expressed by the citizens of Pike County and in other parts of the country about the lack of competitive options in the market, and to provide solutions to those concerns. Direct Energy proposed solutions that would invigorate competition, and force efficiencies into the market. Implementing these policies is the only long term solution to the customers' concerns. As indicated in Direct Energy's initial comments, customers are concerned about rising prices, but they are equally concerned about the lack of competitive options for electric service. This Commission can only fix the latter of those two problems.

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[1] PPL comments, pp. 8-9.

II. The Pennsylvania Restructuring Statute

The policy of the Commonwealth of Pennsylvania is Direct Access and Retail Choice for all customers. See generally, 66 Pa. C.S. Chapter 28 ("Choice Act"). This statute acknowledges that "[c]ompetitive market forces are more effective than economic regulation in controlling the cost of generating electricity."[2] It also states that all customers of EDCs "shall have the opportunity to purchase electricity from their choice of electric generation suppliers," and that the "ultimate choice of the electric generation supplier is to rest with the consumer."[3] The statute also states that the "generation of electricity shall no longer be regulated as a public utility service or function"[4] and, most importantly, that "if a customers does not choose an alternative electric generation supplier, the electric distribution company or commission-approved alternative supplier shall acquire electric energy at prevailing market prices to serve that customer."[5] All of these policy declarations and statutory directives are of particular importance in this proceeding because several of the comments filed in this proceeding suggest that the Commission adopt policies that are in direct conflict with these declarations and directives.

A. Competitive Forces are More Effective than Economic Regulation in Controlling the Cost of Generating Electricity.

Several parties in this proceeding presented varying themes around the central idea of long-term utility procurement for default service. Some recommended long-term auctions, some laddered procurement, and others offered to purchase and manage long-term power contracts in a very discreet manner. Generally, these products are variations of the auction model used in New

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2 66 Pa. C.S. § 2805(5).

3 66 Pa. C.S. § 2806(a).

4 *Id.*

5 66 Pa. C.S. § 2807(e)(3).

Jersey, which has proven to be inconsistent with the goal of customer choice. The New Jersey auction model – and others that mirror the New Jersey approach as proposed by several of the parties in this proceeding, including the utilities and some wholesale suppliers – amounts to nothing more than economic regulation of electricity supply.

While the price itself is not determined by the regulators, all other aspects of the supply function are, including how much to buy, what size blocks of power to buy, when to buy it and for how long. In essence, portfolio management, done on behalf of customers, is performed in a highly regulated fashion. In these models, regulators set up auctions on defined dates and procure power for defined periods of time. This economic regulation ultimately chooses the timing and make up of the portfolio of electricity products that the utilities must offer to their POLR customers.

Nowhere in this model do unfettered competitive forces act on behalf of customers to determine the products and prices delivered to them. Additionally, nowhere in this model do customers get to select any aspect of their power supply. And in these models, default prices will never represent true contemporary prevailing market prices.

B. Customers Shall Have the Opportunity to Purchase Electricity from their Choice of Electric Generation Suppliers.

The end result of the New Jersey model, as seen in New Jersey today, is a perpetual continuation of the utility monopoly over customers served by the utility under this default service approach. The New Jersey model and others like it are in direct conflict with the statutory language that all customers "shall have the opportunity to purchase electricity from their choice of electric generation suppliers." One needs only to look at the New Jersey market in total to see how to develop competitive markets. According to RESA's comments, *only 26* residential customers in the State of New Jersey are being served by competitive suppliers.

Conversely, about 65% of the hourly priced customers and 85% of the hourly priced load are served by competitive suppliers.[6]

PECO witness Mr. Schnitzer testified before the Commission at the *en banc* hearing on June 22 about New Jersey retail choice. When asked about the New Jersey situation and his thoughts on there being virtually no small customer migration in New Jersey, he replied:

> I would just urge that we not leap to a conclusion about exactly what would result from a New Jersey style approach. It is certainly the case that if you adopt a one-third, one-third, one-third rolling approach for small customers during a period of increasing prices, that that one-third, one-third, one-third will have you lagging what a spot price type of approach would be and to that extent, during that period, there might be diminished shopping credits relative to another approach.
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> But it is also the case that when prices go back the other way, the one-third, one-third, one-third will lag going down. And so I don't think that drawing the conclusion or creating the impression is that now and for all time that this approach would forestall retail competition would be a correct one.[7]

Mr. Schnitzer thus acknowledges that under the New Jersey approach, default prices will never represent true contemporary prevailing market prices. But he is wrong that this approach will not stymie retail competition, especially with regard to mass market customers in the residential and small commercial space. Like any business investment, entering a competitive energy market is a significant decision. It is a complex business, with many nuances and risks. It is probably because of these reasons that the utilities themselves have rarely ventured outside of their own service territories to offer competitive products and services. Any company entering these markets should expect to be able to develop its business in a stable manner, and

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6 New Jersey Electric Statistics CIEP Switching as of March 31, 2006 http://www.bpu.state.nj.us/wwwroot/energy/CIEP.pdf

7 Tr. 100.

the development of the business should not be dependent on whether prices are rising or falling – because that happens constantly, and unpredictably.

Mr. Schnitzer's logic is flawed on two fronts. First and most importantly, customer choice is most needed when prices are rising. Again, the customers of Pike County wanted choices as much as they wanted lower prices. Secondly, the flaws in Mr. Schnitzer's logic are revealed when applied to any other aspect of the energy supply chain (or any other capital investment). It is not likely that PECO would build a power plant if it could only sell its output in a declining price market. It is also not likely that a company would build a transmission line if it could only use it and recover its costs when the weather was colder than normal. Nor would anyone invest in advanced metering if it could only be used when the system wasn't constrained.

A competitive retail supplier needs to hire management personnel, procurement professionals, a sales staff and others. It needs to invest in systems and system development, invest in marketing campaigns and advertising, lease or buy office space, lease or buy office furnishings and equipment, and incur all other expenses and investments that any sustainable business must incur.[8] Suppliers will also invest in demand response systems and innovative products and technologies to enable customers to better manage their energy consumption.[9] It is just not a good business decision to make these investments for the business "opportunity" described by Mr. Schnitzer.

The New Jersey auction model, long-term utility procurement, laddered contracts, multi-year procurement strategies and similar approaches are not tools to assist customers, to mitigate rate shock or to soften significant rate increases. They amount to nothing more than

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[8] In Texas, Direct Energy has more than 450 employees and nine (9) offices.

[9] In Texas, Direct Energy is offering innovative products and services to its customers, including green products and efficiency related products and services.

economically regulated rates that will continue to discourage and stifle competitive retail market development.

C. The Generation of Electricity Shall No Longer be Regulated as a Public Utility Service or Function.

Some of the more extreme suggestions to alleviate price shocks came from Duquesne Light, AK Steel and Allegheny County. AK Steel suggests that the Commission "return to a regime of utility regulation or ownership that keys the cost of power to the cost of producing power."[10] However, the Choice Act is clear. The policy of the Commonwealth of Pennsylvania is that of competitive energy markets, customer choice and direct access. The Commission does not have that authority to return to a regime of utility regulation and should flatly reject that suggestion by AK Steel.

Allegheny County suggests that the market is not working for Duquesne's large C&I customers. The County suggests that the "Commission work with our large public electricity distributor, Duquesne Light, to allow them to be able to enter into long-term contracts with industrial consumers in a way that mutually benefits the industrial consumer, the utility, and the common good."[11] Duquesne echoes this sentiment,[12] claiming that the "solution" to rate volatility is allowing Duquesne to offer long-term fixed rate POLR contracts.

Allegheny County and Duquesne are suggesting another form of re-regulation, one that obviously includes some type of rate class cross-subsidization. US Steel witness Mr. Navetta stated that US Steel is procuring at least some of its power from one or more competitive

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10 AK Steel Comments, p. 4.

11 Allegheny County Comments, p. 4.

12 Duquesne Light Comments, p. 6.

suppliers.[13] Obviously, US Steel has found some value from the competitive supply market, or it would be taking all of its supply from Duquesne Light. Mr. Navetta also testified that he believes Duquesne Light can offer lower prices than the competitors out in the market who must also buy supply just like Duquesne Light (which doesn't have any generation). The only way that Duquesne Light could offer a materially better price than the competitive market is through some type of cross-subsidy between rate classes, services or products.

Allegheny County further states that "Duquesne Light lacks the incentive to create excess profits in the short term, but has the expertise to negotiate contracts for reasonable rates for industrial consumers for the long-term."[14] The Choice Act does not prohibit Duquesne Light or any other utility from starting an affiliate competitive supply company. In fact, Duquesne Light has an affiliate retail electric supplier called Duquesne Light Energy ("DLE"). If Duquesne Light truly lacks an incentive to earn excess profits, and it possesses some competitive advantage in its "expertise to negotiate contracts for reasonable rates for industrials customers for the long-term" as Allegheny County suggests, Duquesne should move these incentives and skills into the DLE affiliate and provide that value to all of the industrial customers in its service territory through competitive and open markets. It should not be allowed use its perverse incentives and perceived skills to continue to monopolize the regulated customer base of its utility.

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[13] Tr. 66-67

[14] Allegheny County Comments, p. 4.

D. 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 or Commission-Approved Alternative Supplier Shall Acquire Electric Energy at Prevailing Market Prices to Serve That Customer.

The rate mitigation alternatives offered by the utilities and wholesale suppliers fail desperately on two fronts to meet the requirement in the Choice Act that "if a customer does not choose" an EGS, then the POLR supplier "shall acquire electric energy at prevailing market prices to serve that customer."[15] First, as described above, the New Jersey or other long-term procurement approaches supported by many in this proceeding never even allow the competitive market to develop in the first instance. As a result of the continued monopoly power of the utilities, the overwhelming majority of customers in this State have not even been able to make decisions to choose an alternative supplier, as prudent suppliers have not entered the majority of the Pennsylvania markets. Adoption of the "mitigation" recommendations made by the utilities, wholesale suppliers and others will mitigate nothing other than retail choice and competitive alternatives for customers.

Second, long-term contracts simply do not meet the "prevailing market price" standard outlined in the statute. PECO's own witness, Ms. Crutchfield, testified that "[t]oday's prevailing market prices may bear little resemblance to prices six months from now, much less three or four years down the road."[16] Ms. Crutchfield's statement, made in the context of customer education, urges the Commission not to take too aggressive of a position on customer education because energy prices are volatile. It should be very clear – and beyond argument – that long-term prices are not in any way reflective of "prevailing market prices" at any point in time when a customer

[15] 66 Pa. C.S. § 2807(e)(3).

[16] PECO St. No. 1 (Crutchfield), p. 7.

may choose to use default service (or be forced back to default service). By PECO's own words, long-term default procurement cannot be consistent with the statutory directive of the Choice Act. Accordingly, PECO should not be suggesting this type of default policy.

The explicit way in which the Choice Act states the default service obligation is entirely consistent with the other Retail Choice and Direct Access policy declarations and directives in the Choice Act. The "if" statements in the Choice Act – "[i]f a customer contracts for electric energy and it is not delivered" and "if a customer does not choose an alternative electric generation supplier" – clearly demonstrate the General Assembly's intent and underlying assumption that many, if not most, of the customers in the markets would be served electricity by competitive suppliers. The "prevailing market prices" standard, therefore, has to be the current and contemporary market price when the anomalies of supplier exit and "slow to move" customers occur. As explained by PECO witness Crutchfield, multi-year POLR procurement cannot meet the "prevailing market prices" standard of the Choice Act. For example, in the situation where a supplier exits the market and the customers are returned to POLR service, it is not logical to believe that those customers would be receiving "prevailing market prices" under a multi-year procurement if the return happened after the first month of the POLR period. The General Assembly could have stated the default service obligation in any number of ways to be a competitive option, but it did not. Instead, the General Assembly stated the obligation to explicitly coincide with the policy declarations and directives of Retail Choice and Direct Access.

III. The Volatility Concerns

A. Multi-year Procurement Does Not Protect Against Volatility.

As mentioned above, several of the parties in this proceeding[17] have suggested that the approach to mitigate rate shock is to implement a strategy of long-term procurement for default service. These comments offered the suggestion (without any proof) that these long term contracts protect customers from rate shock and price volatility. However, it is this long-term procurement model that has caused consumer outcry in Pike County, Maryland and Delaware. It is this model that has caused customers in those markets to be saddled with significantly higher rates – and these customers will continue to be saddled with these rates for two or three years, clearly debunking the rate shock elimination myth. Even customers in Maryland's PEPCO territory are seeing price increases of nearly 40% in their third year of New Jersey-style procurement.

Clearly, customers in Pike County, Maryland and Delaware have all been struck with high default prices, and rate shock as a result of multi-year procurements. They have also been exposed to extreme levels of volatility. Volatility is a fairly complex measurement. At the simplest level in this context, it is the variation in price from a theoretic "average price" over a period of time. Without hard numbers, no one can say with certainty that the laddered and long-term products are less volatile than a monthly product. They may offer less frequent price changes, but that has no bearing on the level of volatility the prices exhibit. Clearly, over a period of two months, a monthly priced product is more volatile than a fixed price product that doesn't move in that same period. But in most months, the volatility of the monthly priced service will be low. But, if after some period of time, that fixed price product increased by 60%

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17 *See*, for example, the comments of PECO, PPL, Duquesne Light, Constellation Group, FirstEnergy, OCA and DEP.

or 70% or even 80%, as has happened this year in the jurisdictions referenced above, then that "fixed price" product becomes very "volatile." If that 70% increase were compared to a monthly price that trended up over time, and varied by plus or minus 10% every month, the "fixed price" would be more volatile than the monthly price.

B. Volatility Should Not be Perceived or Understood as "Bad".

Some in the electricity industry have portrayed volatility as "bad." The implications in the comments supporting the long-term default service contracts all portray volatility as bad. Volatility is neither good nor bad. It just is. Volatility is a word that has often been used as a scare tactic. As is being done in this proceeding, it is often used by parties in the energy industry to argue for long-term contracting, rate stabilization, and other anticompetitive measures. Long-term procurement policies do not – and cannot – mitigate volatility in the long run. In fact, in some cases, like Pike County, Maryland and Delaware, the long-term contracts have exacerbated the volatility. The only thing that long term default procurement policies mitigate is customer choice.

At the *en banc* hearing, Edison Electric Institute testified that the main cost driver of electricity price increases is fuel.[18] The multi-year contracts can put a hedge on that fuel. At the end of the contract, prices will rise or fall, to follow fuel prices. If the default service provider made a "good" hedge, customers may be happy because they have "below market" power, but they will be ill-informed, and not equipped to use energy efficiently.[19] If it was a "bad" hedge,

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18 Tr. 75.

19 Inefficient use of energy strains the distribution and transmission systems, potentially requiring upgrades and other changes that might not be required if customers saw a real market price. It also results in inefficient use of generation resources, pushing peak demand up higher. These results are, of course, exactly the opposite of the results that the Commission should be seeking.

customers will be worse off financially than they should have been because they have "above market" priced power, yet they will have no competitive alternatives to choose from to deal with the higher prices.

Under the ruse of protecting customers from volatility, multi-year contracts will not provide customers with supply choices when they need them most. But volatility can benefit a customer greatly. A market following default price that many describe as a "volatile" default price, if implemented in BGE in Maryland, in Delmarva in Delaware, or in Pike County, Pennsylvania, would have default prices lower today than they are currently. It is logical then to conclude that today, those customers would perceive volatility as "good." Direct Energy witness Mr. Lacey testified at the *en banc* hearing that customers at a public hearing in Pike County asked why the Pike County prices couldn't follow the market like the New York prices.[20] These customers were asking for volatility in their default service price.

IV. Customer Education and Information

Several parties have suggested some type of advanced metering and/or infrastructure improvements to facilitate demand response and conservation.[21] Direct Energy fully supports these investments and improvements in the markets. However, in order to achieve any benefit from these investments, customers must see a varying price. It does limited, if any, good to let a customer know that real time energy prices are really 35 cents per kWh and expect any type of reaction from them if they are only paying 10 cents per kWh. In fact, it incentivizes the exact opposite behavior that society would desire at that point. Customers will consume more than they would optimally, because the price is below where it should be, and they will have perfect

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[20] Tr. 167.

[21] These parties include, but are not limited to, Constellation NewEnergy and NRG, DEP and PennFuture.

information to prove it to themselves. A properly designed default service is of utmost importance to achieving a net positive investment on advanced metering infrastructure. On the other hand, for a customer taking a fixed price product from a competitive supplier, with advanced metering the supplier can provide additional products and services that create demand response incentives because the supplier is incentivized to offer these types of products and services – whereas the utility is not, because it has a vested interest in more throughput.

V. Price Mitigation Plans

The Commission opened this docket to investigate price spike and rate shock mitigation alternatives for customers, among other things. Few meaningful price mitigation alternatives were presented in the initial comments in this proceeding. Direct Energy provided two feasible alternatives. Additionally, Direct Energy stated that if the long term markets were established properly, competitive suppliers would come in and likely offer products and solutions that are unforeseen right now, which would help alleviate customers' burdens. Just the mere presence of competitive suppliers would empower customers with choices, and they could choose the supply, products and contracts that best meet their needs.

Direct Energy is supportive of implementing a plan now that could, at the customers discretion, be used in some manner to "soften the blow" of potentially higher prices when the rate caps come off. In the event that the Commission should allow a price mitigation plan to be offered by the utilities, Direct Energy believes that it should be aimed at the one-time problem of exiting the retail choice/rate cap transition period. Going forward, customers should have faith that there will be a market reflective default price and that a robust, sustainable competitive retail market providing a number of products and services available from a variety of retail providers will develop. RESA suggested in its comments that any mitigation measure that is adopted by the Commission should be presented to customers on the regulated portion of the bill, so as to

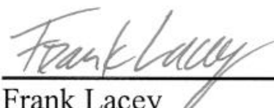
not distort the energy markets. Direct Energy fully supports this position. Additionally, any mitigation measure must not override the policy declarations and directives of the Choice Act in any way.

IV. CONCLUSION

Direct Energy submits that developing a mitigation plan that does not run afoul of the Choice Act could be a positive near-term enhancement to the development of competitive energy markets in Pennsylvania. More importantly, implementation of a default service plan and a competitive market infrastructure that is fully consistent with the Choice Act will facilitate the entry of new market participants and convey long-term benefits to electricity customers in Pennsylvania.

Direct Energy commends the Commission for recognizing that some modifications to the current market structure may be necessary to alleviate some customer concerns about the end of rate caps. Direct Energy appreciates the opportunity to participate in this proceeding and to comment on these important issues. Direct Energy looks forward to working with the Commission and all stakeholders to develop a successful and retail electric market that will bring the economic forces of competition and the innovative products enabled by competition to the benefit of electricity consumers throughout the Commonwealth of Pennsylvania.

Respectfully submitted,



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