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June 1, 2010

Via Overnight Mail

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor
Harrisburg, PA 17120

RECEIVED

JUN 1 2010

PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

Re: **Comments of PECO Energy Company on Proposed Amendments to the Commission's Default Service Regulations and Policy Statement on Default Service and Retail Electric Markets – Docket Nos. L-2009-2095604 and M-2009-2140580**

Dear Secretary Chiavetta:

Enclosed for filing are the original and fifteen (15) copies of the Comments of PECO Energy Company on Proposed Amendments to the Commission's Default Service Regulations and Policy Statement on Default Service and Retail Markets in the above-captioned dockets.

Pursuant to Paragraph 6 of the Commission's Order, we have also forwarded an electronic copy to Elizabeth Barnes, Assistant Counsel, Law Bureau.

Kindly return a time-stamped copy of this cover letter in the self-addressed stamped envelope that is enclosed. Do not hesitate to contact me at 215-841-5974 should you have any questions regarding this filing.

Very truly yours,



Jeanne J. Dworetzky
Assistant General Counsel

Enclosures

cc: Elizabeth Barnes, Law Bureau (ebarnes@state.pa.us)

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JUN 1 2010

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION** PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

**IMPLEMENTATION OF ACT 129 OF
OCTOBER 15, 2008; DEFAULT
SERVICE**

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DOCKET NO. L-2009-2095604

**PROPOSED POLICY STATEMENT
REGARDING DEFAULT SERVICE
AND RETAIL ELECTRIC MARKETS**

DOCKET NO. M-2009-2140580

**COMMENTS OF PECO ENERGY COMPANY
ON PROPOSED AMENDMENTS TO THE COMMISSION'S
DEFAULT SERVICE REGULATIONS AND POLICY STATEMENT
ON DEFAULT SERVICE AND RETAIL ELECTRIC MARKETS**

Pursuant to the Notice of Proposed Rulemaking Order (the "Rulemaking Order") and Proposed Policy Statement entered in the above-captioned dockets on January 14, 2010, PECO Energy Company ("PECO" or the "Company") hereby submits its comments to the proposed amendments to the Pennsylvania Public Utility Commission's (the "Commission's") default service regulations, 52 Pa. Code §§ 54.181 *et seq.* ("Default Service Regulations"), and the Commission's Policy Statement Regarding Default Service and Retail Electric Markets, 52 Pa. Code §§ 69.1801 *et seq.* ("Policy Statement") intended to address changes to the Pennsylvania Public Utility Code (the "Code") resulting from the enactment of Act 129 of 2008 ("Act 129" or "the Act").

I. INTRODUCTION

PECO commends the Commission for initiating this Rulemaking and its consideration of amendments to the Policy Statement and believes these proceedings will significantly reduce uncertainties associated with Act 129's amendments to the Code. PECO agrees with most of the

Commission's proposed amendments, and provides specific comments below where PECO believes additional language or further clarification is appropriate.¹

PECO also responds to each of the Commission's additional questions set forth in the Rulemaking Order regarding the interpretation of certain Act 129 provisions. *See* Rulemaking Order, pp. 16-17. As reflected in PECO's comments, PECO believes that the general language of Act 129 with respect to default service provider ("DSP") obligations, such as a "prudent mix" of generation-supply contracts, is intended to provide substantial discretion to DSPs in formulating procurement plans and to the Commission in evaluating those plans. The Commission should therefore continue to consider default service programs on a case-by-case basis and avoid the adoption of a "one size fits all" prescriptive approach to the procurement of default service supply and Act 129's additional requirements.

II. SPECIFIC COMMENTS ON PROPOSED AMENDMENTS TO DEFAULT SERVICE REGULATIONS IN THE RULEMAKING ORDER

1. 52 Pa. Code § 54.182

PECO agrees with the Commission's proposed amendments to this Section.

2. 52 Pa. Code § 54.184

PECO agrees with the Commission's proposed amendments to this Section, but notes that the word "or" between Section 66 Pa. C.S. § 2807(e)(3.1)(III)(A) and (B) of the Code is not reflected in the Commission's proposed amendments. *See* Proposed Rulemaking Order, p. 23, § 54.184(c)(3). PECO believes that the word "or" should be inserted between the proposed Section 54.184(c)(3)(i) and (ii) for consistency with Act 129.

¹ For convenience of the Commission, PECO has also attached a "blackline" showing its specific suggested revisions to the Commission's proposed amendments. *See* Attachment A.

3. **52 Pa. Code § 54.185**

PECO agrees with the Commission's proposed amendments to this Section.

4. **52 Pa. Code § 54.186**

PECO agrees with the Commission's proposed amendments to this Section.²

5. **52 Pa. Code § 54.187**

PECO agrees with the Commission's proposed amendments to Section 54.187(a), but does not support the Commission's substitution of "may" for "shall" with respect to recovery of costs incurred for providing default service in Section 54.187(b).

Section 2807(e)(3.9) of Act 129 explicitly provides that "the default service provider **shall** have the right to recover, on a full and current basis, pursuant to an automatic adjustment clause under Section 1307 (relating to sliding scale of rates; adjustments), all reasonable costs incurred under this section and a Commission-approved competitive procurement plan." 66 Pa. C.S. § 2807(e)(3.9) (emphasis added). The certainty of recovery for default service costs under a Commission-approved procurement plan is critical to obtaining competitively priced default service supply, and any suggestion in the Commission's regulations that such costs may not be

² PECO notes that the Commission did not eliminate the term "prevailing market price" in revising Section 54.186 or other sections of the Default Service Regulations, including regulations addressing contingency procurements. *See* 52 Pa. Code § 54.186(a) ("A DSP shall acquire electric generation supply at prevailing market prices for default service customers in a manner consistent with procurement and implementation plans approved by the Commission."); 52 Pa. Code § 54.187(l) ("When necessary to procure electric generation supply before the implementation of a contingency plan, a DSP shall acquire supply at prevailing market prices and fully recover all reasonable costs associated with this activity that are not otherwise recovered through its contract terms with the default supplier."); *see also* 52 Pa. Code §§ 54.186(d), 54.187(i)-(k). In light of Act 129, PECO understands "prevailing market prices" in the Default Service Regulations to refer to (i) the price of generation competitively procured in accordance with an approved procurement plan; and (ii) in the case of contingency procurements prior to approval of a contingency plan, the price of generation purchased in PJM real-time energy markets.

recovered after plan approval, despite clear statutory language providing for such recovery, could have significant negative effects on the costs of default service supply contracts (reflecting higher perceived risk by suppliers of the possibility of non-payment) and on DSPs generally. The Commission does not provide any basis for the proposed substitution of “may” for “shall” in Section 54.187(b), and the amendments to this Section should be revised to conform to the express language of Section 2807(e)(3.9) of the Code.

6. 52 Pa. Code § 54.188

PECO agrees with the Commission’s proposed amendments to this Section.

7. 52 Pa. Code § 54.189

PECO agrees with the Commission’s proposed amendments to this Section.

III. RESPONSES TO RULEMAKING ORDER QUESTIONS

1. What is meant by “least cost to customers over time?”

Section 2807(e)(3.4) of Act 129 provides that a DSP’s prudent mix of default service supply contracts shall be designed to ensure adequate and reliable service at the “least cost to customers over time.” The phrase “least cost to customers over time” is not itself defined in the Act, but the Act does provide that “[c]osts incurred through an approved competitive procurement plan shall be deemed to be the least cost over time as required under paragraph (3.4)(ii).” 66 Pa. C.S. § 2807(e)(3.6).

While “least cost” is not precisely defined, the Act makes clear that satisfaction of the “least cost” standard is not a one-dimensional test; instead, the Commission must consider various factors to determine whether a proposed procurement plan meets Act 129’s requirements. Section 2807(e)(3.2) provides that the generation supply to be procured by DSPs through competitive processes must consist of a “prudent mix” of supply products, and while the

Act itself does not define “prudent mix,” it is linked to the Act’s definition of “least cost,” because a DSP’s prudent mix of contracts “shall be designed to ensure...adequate and reliable service [at] the least cost to customers over time...” 66 Pa. C.S. § 2807(e)(3.4). In adopting the Act, the General Assembly also recognized that consideration of “least cost” should “[take] into account any benefits of price stability.” *See* Act 129 of 2008 (Preamble).

The General Assembly’s directive that the “prudent mix” of supply products must be designed to ensure “least cost,” and that “least cost” should “[take] into account any benefits of price stability,” indicates that the risks to customers associated with a proposed procurement plan must be considered when evaluating the plan’s ability to satisfy the “least cost” standard. PECO believes that Act 129’s “least cost over time” provisions require a DSP to address how its mix of competitively procured contracts in a proposed default service plan will provide appropriate protection to default service customers from risks that could impact the cost of generation over time.³

Given the dynamic nature of electricity markets and the circumstances and competitive opportunities of each customer group, as well as the different default service generation supply pricing and price stability that may be desirable for different customers (e.g., hourly pricing for industrial customers and more stable pricing for residential and small-business customers), PECO does not believe there is a specific formula that can be applied to all DSPs to calculate the “least cost over time.” Instead, DSPs should be able to design procurement plans to achieve least cost which take into account, among other things, the specific needs of their customers and characteristics of their service territories. Consistent with Act 129, the Commission should then

³ *See, e.g.,* PECO Statement No. 3-S (Scott G. Fisher) in *Petition of PECO Energy for Expedited Approval of its Default Service Program and Rate Mitigation Plan*, Docket No. P-2008-2062379 (Order entered June 2, 2009) (“*PECO Default Service Order*”).

make individualized, “**specific findings**” that each DSP’s plan “includes **prudent steps** necessary to obtain least cost generation.” 66 Pa. C.S § 2807(e)(3.7) (emphasis added).

In its original default service rulemaking, the Commission recognized the risks associated with developing overly restrictive rules:

The Commission is mindful of the risks of being too prescriptive in its approach to this rulemaking. Changes in markets, technology and applicable law may result in an approach that is too narrowly tailored to serve Pennsylvania’s interests. Accordingly, we do not attempt to dictate the exact manner by which every DSP will acquire electricity, adjust rates, and recover their costs.

Final Rulemaking Order, *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), Dockets No. L-00040169 & M-00041792 (Order entered May 10, 2007), p. 6. In this proceeding, consistent with that original understanding, the Commission has **not** proposed to modify the portion of its Policy Statement which provides that the Commission’s Default Service Regulations “are not designed to resolve every possible issue relating to the acquisition of electric generation supply, the recovery of reasonable costs, the conditions of service and the relationship with the competitive retail market.” 52 Pa. Code § 69.1802(a). The Commission should therefore affirm its understanding of the requirement for individual consideration of each default service plan under Act 129, including a case-by-case evaluation as to whether each default service plan includes a prudent mix of contracts designed to ensure default service supply at “least cost over time.”

2. What time frame should the Commission use when evaluating whether a DSP’s procurement plan produces least cost to customers over time?

In light of the meaning of “least cost over time” described in the preceding response, the

Commission should evaluate a DSP's procurement plan using a time frame consistent with the term of the plan, which the Commission has recommended as two years. *See* Policy Statement, § 69.1804. Alignment of the time frame of consideration with a plan's term length avoids the uncertainty of energy prices and other market developments inherent in the use of longer time periods. PECO does not believe that limiting the time frame to the length of the plan precludes consideration of potential on-going price stability benefits associated with laddering of contracts or of contracts that may commence during a plan and extend beyond the term of that plan, but the use of such contracts should be considered in light of their potential effects on future default service plans. *Cf.* Policy Statement, § 69.1805.⁴

Act 129 clearly does not envision an ex-post, after-the-fact review of a Commission-approved procurement plan since costs incurred pursuant to such a plan are deemed to be the least cost over time. 66 Pa. C.S. § 2807(e)(3.6). There are two principal reasons why an ex-ante review of a plan at the time of approval is appropriate instead of an ex-post review. First, if potential suppliers (and lenders) to a DSP believe that the DSP is exposed to the possibility of under-recovery or disallowance of costs based on an after-the-fact review, such entities may become concerned about the DSP's creditworthiness and their own request for payment. This concern will increase the DSP's cost of doing business and hence the rates that customers pay, as well as the prices that suppliers bid.

Second, supply products that provide price stability – such as full requirements contracts

⁴ “Long-term contracts should only be used when necessary and required for DSP compliance with alternative energy requirements, and should be restricted to covering a relatively small portion of the default service load. An over-reliance on long-term contracts would mute demand response, create the potential for future default service customers to bear future above market costs and limit operational flexibility for DSPs to manage their default service supply.” 52 Pa. Code § 69.1805.

– are often designed to protect customers from risks that could increase price levels. These price stability benefits are not captured in an after-the-fact analysis, to the degree that such an analysis focuses on the actual market outcome instead of all of the market scenarios that could have occurred. For example, if an abnormally hot summer had occurred and wholesale prices had spiked, then customers being provided default service supply with some degree of price stability would have been afforded protection against the associated electricity price volatility. The fact that wholesale prices did not spike in a particular year does not mean that it was not valuable to have protection in place against that risk.

3. In order to comply with the requirement that the Commission ensure that default service is adequate and reliable, should the Commission’s default service regulations incorporate provisions to ensure the construction of needed generation capacity in Pennsylvania?

No. As an initial matter, PECO notes that Act 129 did not repeal or otherwise alter the Declaration of Policy established in the Electricity Generation Customer Choice and Competition Act, 66 Pa. C.S. §§ 2801 *et seq.* (the “Competition Act”), which emphasized the benefits of greater competition in electricity generation and found that “competitive market forces are more effective than economic regulation in controlling the cost of generating electricity.” 66 Pa. C.S. § 2802(6). Furthermore, Act 129 does not include any requirement that a portion of default service supply be obtained from Pennsylvania generating facilities, and PECO does not believe that, under current law, additional regulations are required to permit PECO or other DSPs to own generation used in the provision of default service (including alternative energy systems, such as solar energy generation facilities).

Consistent with the Competition Act, PECO believes that the need for and construction of generation capacity in Pennsylvania is best determined by competitive markets, particularly in light of the Regional Transmission Organizations (“RTOs”) that serve Pennsylvania to ensure the

reliability of the regional electricity grids and the numerous mechanisms that these RTOs have established to meet this responsibility. Creating additional state regulations intended “to ensure the construction of needed generation capacity” would be unnecessarily duplicative of, and disruptive to, the RTOs’ programs and market mechanisms. In short, additions to the Default Service Regulations “to ensure construction” of generation that is not otherwise supported by competitive markets would be inconsistent with Act 129’s general provisions regarding competitive procurement⁵ and could lead to substantially higher electric rates for Pennsylvania customers.⁶

4. If the Commission should adopt a provision to ensure the construction of needed generation capacity, how should the default service regulations be revised?

As explained in the response to Question No. 3, PECO does not believe the Commission should adopt any additional provisions in its Default Service Regulations to ensure the construction of generation capacity.

5. Which approach to supply procurement – a managed portfolio approach or a full requirements approach – is more likely to produce the least cost to customers over time?

The terms “managed portfolio approach” and “full requirements approach” are broad terms, and each generally refers to a wide spectrum of possible plans. For this reason, PECO does not believe the question can be resolved by the Commission in the abstract; instead,

⁵ For example, Act 129 requires that agreements for default supply between a DSP and its affiliate must be measured against wholesale electric markets, since “[i]n no case shall the cost of obtaining generation from any affiliated interest be greater than the cost of obtaining generation under comparable terms in the wholesale market at the time of the execution of the contract.” 66 Pa. C.S. § Section 2807(e)(3.1)(III)(B).

⁶ Implementation of the Public Utilities Regulatory Policy Act during the 1980s and 1990s, which mandated power purchases from certain qualifying generation units, burdened electric utilities and their customers with a huge overhang of long-term contracts for electric generation established at prices well above utilities’ actual avoided costs.

consideration of proposed procurement methodologies should be part of the evaluation of each default service plan in light of the specific circumstances of each DSP and its customers.

To date, the Commission has approved both approaches for procurement of a DSP's default service supply.⁷ The Commission has also approved plans involving a mix of procurement methodologies, including PECO's own plan in which PECO is procuring default service supply through fixed-price, full requirements contracts for 100% of its small and medium commercial customers and 75% of its residential customers, hourly spot-priced full requirements contracts for 100% of its industrial customers, and 25% of its residential load through a scheduled mix of block-energy procurements and energy balancing services from the energy markets operated by PJM Interconnection, L.L.C. ("PJM").⁸

While the specific circumstances must be considered in determining whether a default

⁷ See, e.g., *Petition of the West Penn Power Company d/b/a Allegheny Power for Approval of its Retail Electric Default Service Program and Competitive Procurement Plan for Service at the Conclusion of the Restructuring Transition Period*, Docket No. P-00072342 (Order entered July 25, 2008) (approving full requirements-based plan); *Petition of UGI Utilities, Inc. – Electric Division For Expedited Approval of a Default Service Procurement, Implementation and Contingency Plan*, Docket No. P-2008-2022931 (Order entered July 17, 2008) (approving plan including purchase of block energy); see also *Petition of UGI Utilities, Inc. – Electric Division for Approval of its Default Service Program Pursuant to 52 Pa. Code §§ 54.181-54.189, and Associated Potential Transactions with Affiliated Entities*, Docket No. P-2009-2135496 (Order entered May 11, 2010); *Joint Default Service Plan of Citizens' Electric Company and Wellsboro Electric Company*, Docket Nos. P-2009-2110780; P-2009-2110798 (Order entered February 25, 2010); *Joint Petition of Metropolitan Edison Company and Pennsylvania Electric Company for Approval of Their Default Service Program*, Docket Nos. P-2009-2093053, P-2009-2093054 (Order entered November 6, 2009); *Petition of PPL Electric Utilities Corporation for Approval of a Default Service Program and Procurement Plan for the Period January 1, 2011 through May 31, 2013*, Docket No. P-2008-2060309 (Order entered June 18, 2009); *Petition of Pike County Light and Power Company for Expedited Approval of Its Default Service Implementation Plan*, Docket No. P-2008-2044561 (Order entered February 5, 2009); *Petition for Approval of a Interim Default Service Supply Plan for Pennsylvania Power Company Remand Proceeding*, Docket No. P-00072305 (Order entered March 13, 2008); *Petition of Duquesne Light Company for Approval of Default Service Plan for the Period January 1, 2011 through May 31, 2013*, Docket No. P-2009-2135500 (Settlement approved by motion on May 20, 2010).

⁸ See *PECO Default Service Order*, pp. 6-8.

service plan is likely to produce the least cost to customers over time, there is a fundamental difference in the allocation of risks under a fixed-price full requirements approach as compared to a managed portfolio approach and this difference cannot be overlooked. Under either approach, the financial risks associated with providing full requirements default service still exist, but the choice of procurement approach affects who will manage and who will bear those risks. All else equal, managed portfolio approaches shift these risks from third-party suppliers to customers.

For example, suppose a DSP adopts a managed portfolio and procures fixed quantities of supply at fixed-prices. If market prices decline and default service customers exercise their option to switch to a competitive retail supplier, the remaining default service customers would find that an unexpectedly high portion of the default service supply portfolio is composed of above-market contracts, and these customers would need to pay for the above-market costs (or losses incurred in the sale of excess supply) through higher default service rates. This would further encourage default service customers to switch to competitive retail suppliers, thereby further driving up default service rates. In this cycle, default service rates tend to increase as market prices decline.

In contrast, under a fixed-price full requirements approach, the amount of supply procured and the actual default service load always match during the delivery period of the supply product. The risks of providing default service supply over time – including customer migration to competitive retail suppliers, extreme weather patterns, changes in customer usage patterns, plant outages or transmission line outages, fuel price shocks, unexpected economic growth levels, and transmission congestion – remain with the supplier. Customers are not exposed to the financial costs associated with selling excess supply obtained under a managed

portfolio approach at a loss, or purchasing high-priced power in times of demand.

Furthermore, when bidders in fixed-price full requirements solicitations compete on the basis of price to supply the fixed-price full requirements products, the fixed-price full requirements approach can be designed to ensure the least cost to customers because bidders compete on the basis of the lowest price to satisfy **all** aspects of the default service customers' load requirements, including the management of a portfolio of supply contracts. Winning bidders in fixed-price full requirements product solicitations commit to assume, manage, and cover the costs and risks of default service supply at the lowest fixed price, thereby providing default service customers with the benefits of competition on all aspects of the full requirements supply obligation. Suppliers of the full requirements products (who typically have risk management expertise and are supported by sophisticated trading and portfolio management operations across market regions) can freely procure the products and follow the procurement strategies that they believe will result in the least-cost full requirements supply in light of these risks as well as other known requirements, such as Act 129's efficiency and conservation mandates. Any party that desires to be a winning bidder in such a solicitation must submit a bid price that reflects its best judgment about the least-cost means of satisfying the supply obligations. Therefore, it is reasonable to assume that bidders in full requirements solicitations will consider the costs and risks associated with all forms of supply, and their bid prices will reflect the benefits of any opportunity that they believe is the least-cost supply opportunity.

It is possible that a specific managed portfolio approach could prove, in hindsight, to be more or less expensive than a specific fixed-price full requirements approach over a given period of time. But, as discussed in PECO's response to Question No. 2, a hindsight analysis of managed portfolio and full requirements approaches may be misleading, to the degree that such

an analysis focuses on the actual market outcome instead of all of the market scenarios that could have occurred and the risks that were borne by suppliers under a fixed-price full requirements approach. Because full requirements suppliers are better positioned to manage these risks, the Commission should ensure that a full requirements procurement approach remains an option for DSPs in designing in future default service plans.

6. What is a “prudent mix” of spot, long-term, and short-term contracts?

As with “least cost over time,” a “prudent mix” of contracts is not specifically defined in Act 129. The Act provides that default service supply must be competitively procured, and that the competitive supply must include a “prudent mix” of spot, long-term, and short-term contracts. 66 Pa. C.S. § 2807(e)(3.1) & (3.2). The Act does not specify the percentage share of each type of product to be included in a “prudent mix.”⁹ Furthermore, the competitively-procured “prudent mix” must be designed to ensure “adequate and reliable service” at “the least cost to customers over time.” *Id.* § 2807(e)(3.4). Given these general mandates, PECO believes a “prudent mix” of contracts is also appropriately addressed on a case-by-case basis by the Commission in evaluating each DSP plan for several reasons.

First, as noted in PECO’s response to Question No. 1, “prudent mix” is clearly linked to “least cost,” and the General Assembly has recognized that consideration of “least cost” should “[take] into account any benefits of price stability.”¹⁰ In effect, under Act 129, a mix of contracts which does not take into account risks that could significantly increase costs to customers over

⁹ The Act states that “long-term” contracts are those of more than four and not more than twenty years and limits the percentage of long-term contracts to not more than 25% of the default service provider’s projected default service load unless the Commission, after a hearing, determines for good cause that a greater portion of load is necessary to achieve least cost procurement. 66 Pa.C.S. § 2807(e)(3.2)(III).

¹⁰ See Act 129 of 2008 (Preamble).

time is not a prudent mix. The implications of this are further discussed in PECO's response to Question No. 1.

Second, it is important to recognize that the "prudent mix" of contracts may differ for each customer class. The Commission has already provided clear guidance in its Policy Statement that what may be prudent for residential customers might not be considered prudent for large commercial and industrial customers, given the different circumstances of each customer group. *See, e.g.*, 52 Pa. Code § 69.1805 (recommending procurement of supply for residential customers through contracts of one to three years in length, one year contracts for small commercial customers, and hourly or monthly-priced supply for industrial customers). Using a tailored and separate supply procurement for each of the various customer classes is thus consistent with provisions of the Policy Statement which the Commission is not seeking to modify as a result of Act 129.

Third, the prudent mix of contracts may vary in future procurement plans as wholesale and retail markets evolve and technologies that allow customers to respond to hourly market price signals become further developed and deployed.

Finally, the degree to which a "prudent mix" of contracts will ensure adequate and reliable service is not easily generalized. While delivery of default service supply through an RTO such as PJM helps to ensure that there are numerous mechanisms in place to maintain reliability, the contract and credit requirements which a DSP requires suppliers to satisfy can play a significant role in ensuring that suppliers are appropriately qualified and capable of performing their obligations. Because credit requirements and related contractual provisions will typically vary among DSPs given specific circumstances, the supplier contracts a DSP proposes to use require individualized review.

For these reasons, the Commission should continue to allow the definition of “prudent mix” to be flexible to accommodate these realities, and should not now place unnecessary constraints on the definition of “prudent mix,” in addition to the mandates included in the Act.

7. Does a “prudent mix” mean that the contracts are diversified and accumulated over time?

PECO understands this question to be addressing a procurement approach in which a series of energy supply contracts are entered into and essentially layered over time, thus creating a “diversified” and “accumulated” mix of contracts. Such “diversity” of contracts is not the same as the “prudent mix” of contracts required by Act 129, since having “different types of contracts” does not necessarily ensure a less risky portfolio and may actually result in a more risky portfolio. In contrast, fixed-price full requirements contracts include significant additional risk mitigation benefits for customers by ensuring a fixed-price for service regardless of customer migration, usage patterns, electricity price levels, unanticipated transmission congestion costs, weather, etc. A mix of different types of energy supply contracts does not, by itself, replicate the risk mitigation benefit provided by a fixed-price load following product portfolio.

The fact that “diverse” contracts may be accumulated over time also does not ensure that such contracts are more “prudent.” Procurement over a longer period of time can result in higher (or lower) rates than if the procurement events are held at a single time because prices can drop (or climb) significantly over the course of several months or years. Laddering of contract delivery periods may provide greater rate stability and may involve procurement at different points in time, but the benefits of that approach depend upon the specifics of the plan of each DSP and its customers and whether the supply of such laddered contracts is obtained through sufficiently competitive processes from qualified suppliers. The Commission should therefore

not mandate any specific “diversity” of contracts beyond Act 129’s existing “prudent mix” requirements nor order any general contract accumulation strategy, but retain its discretion to consider such alternative procurement approaches.

8. Should there be qualified parameters on the prudent mix? For instance, should the regulations preclude a DSP from entering into all of its long-term contracts in one year?

No. The details of procurement parameters should be addressed in each DSP’s individual plan. *See* PECO’s response to Question Nos. 6 and 7.

9. Should the DSP be restricted to entering into a certain percentage of contracts per year?

No. The details of the amount of contracts a DSP enters into in any given year should be addressed in each DSP’s individual plan. *See* PECO’s response to Questions Nos. 6 and 7.

10. Should there be a requirement that on a total-DSP basis, the “prudent mix” means that some quantity of the total-DSP default service load must be served through spot market purchases, some quantity must be served through short-term contracts, and some quantity must be served through long-term contracts?

PECO does not believe that there should be a fixed requirement of spot, short-term, and long-term contracts on a “total DSP basis,” and there is no such mandate under Act 129. The choice of product categories in a procurement is itself a component of the prudence of the mix of supply contracts for each customer class, i.e., long-term contracts are generally inappropriate for default service supply for industrial customers, who are sophisticated in their energy use and have a variety of shopping opportunities. The Commission should retain its discretion to consider the prudence of the supply mix for each customer class and, therefore, for the DSP as a whole. *See* PECO’s response to Question Nos. 6 and 7.

11. Should there be a requirement that some quantity of each rate class procurement group’s load be served by spot market purchases, some

quantity through short-term contracts, and some quantity through long-term contracts? In contrast, should a DSP be permitted to rely on only one or two of those product categories with the choice depending on what would be the prudent mix and would yield the least cost to customers over time for that specific DSP?

PECO does not believe that there should be a fixed requirement of spot, short-term, and long-term contracts for each rate class for the same reasons set forth in PECO's responses to Questions Nos. 6, 7, 10, and 13.

12. Should the DSP be required to hedge its positions with futures including natural gas futures because of the link between prices of natural gas and the prices of electricity?

A DSP should not be required to enter into futures contracts but should be permitted to do so if the DSP establishes that such contracts are integral to a "prudent mix" of supply contracts. While properly structured futures contracts (including natural gas futures contracts) can provide some protection against price changes in wholesale electricity markets, such contracts do not themselves address the wide range of risks associated with the actual provision of default service over time, including customer migration, usage patterns, and weather. Furthermore, PECO notes that while there is a link between prices for natural gas and prices for electricity, it is a complex relationship and not direct. Futures contracts therefore should not be mandated as part of a procurement plan.

13. Is the "prudent mix" standard a different standard for each different customer class?

The Act's "prudent mix" language applies to all customer groups. However, each customer group is different, so the appropriate default service product mix for one customer group will likely differ from that for another customer group. For example, large commercial and industrial customers have more opportunities to shop for competitive supply and, generally speaking, are better prepared to make informed supply decisions than residential and smaller

non-residential customers. As a result, it may be reasonable for the larger customers to be provided default service based on spot market purchases and prices, since the benefits of default service price stability are generally less for the larger customers. In contrast, residential and smaller non-residential customers generally have less sophistication regarding electricity markets. Residential and smaller non-residential customers may therefore require a default service product mix that involves a greater degree of fixed pricing in order to better ensure default service price stability. Please refer to PECO's responses to Question Nos. 6 and 7.

14. What will be the effects of bankruptcies of a wholesale supplier to default service suppliers on the short and long term contracts?

All else equal, the financial damages due to supplier default stemming from bankruptcy is clearly greater for long-term contracts than it is for short-term contracts because there is more load to be covered through contingency procurements under defaulting long-term contracts and more time for the difference between contract prices and market prices paid. In either case, credit and collateral provisions in supply agreements between a DSP and its suppliers must be designed carefully, and should involve requirements for the supplier to post an amount of collateral commensurate with both the amount of supply to be provided under the contract and the risk of divergence between market prices and contract prices. For example, in the supply master agreements approved by the Commission for use between PECO and its wholesale full requirements suppliers, PECO calculates its exposure to each supplier across all contracts with that supplier based upon estimated supply quantities and changes in the forward prices for energy in PJM markets. PECO has the right to request additional collateral from a supplier should that exposure exceed the credit granted to a supplier and the collateral (e.g., cash or a letter of credit) previously posted by a supplier, and failure to post such collateral constitutes an event of default and entitles PECO to damages.

If this type of credit requirement were not imposed on suppliers, customers would be exposed to greater risks because suppliers may not be incented to perform under all conditions, e.g., when spot prices are higher than expected and a supplier may be able to realize greater returns by selling contracted supply into the spot market. The risk of such “opportunistic breach” is greater under long-term contracts, which involve longer time periods during which market price levels may change.

15. Does Act 129 allow for an after-the-fact review of the “cost reasonableness standard” in those cases where the approved default service plan gives the EDC substantial discretion regarding when to make purchases and how much electricity to buy in each purchase?

No. Once the Commission has approved a default service plan, Act 129 provides only for review of procurement plan costs in two specific circumstances: where, after hearing, a DSP is found to be at fault for (1) not complying with the Commission-approved procurement plan; or (2) committing fraud, collusion, or market manipulation with regard to generation supply contracts. *See* 66 Pa. C.S. § 2807(e)(3.9).

16. How should Section 2807(e)(5)’s requirement that “this section shall apply” to the purchase of AECs be implemented?

Section 2807(e)(5) generally provides that Section 2807(e) “shall apply” to the procurement of any type of energy by a DSP for electric generation service, including energy or alternative energy credits (“AECs”) required to satisfy the requirements of the Alternative Energy Portfolio Standards Act, 73 Pa. C.S. § 1648.1 *et seq.* *See* 66 Pa. C.S. § 2807(e)(5). With respect to AECs, PECO believes that this provision is intended to ensure that the framework of competitive procurement established by Act 129 is also applied to the purchase of AECs. DSPs should therefore acquire AECs (either as part of generation supply or separately) through such competitive mechanisms as auctions and requests for proposals, and such procurements should

be in accordance with a Commission-approved plan.

AECs should also be procured through a “prudent mix” of contracts designed to ensure “least cost over time,” but there is no requirement for a “prudent mix” to also address adequacy and reliability since those generation service-related components are not related to AECs or AEC compliance obligations. *See* 66 Pa. C.S. § 2807(e)(3.4); 73 Pa. C.S. § 1648.3. As with the procurement of generation service, “least cost” is not a precisely defined concept when applied to AECs, but establishing “least cost” for AEC procurements should take into account the benefits of price stability for customers: wide variations in AEC pricing could have significant effects on retail rates, since the costs of AECs procured by EDCs will be recovered from customers. *See* 73 Pa.C.S. § 1648.3 (providing for cost recovery for AEPS compliance). Therefore, procurement of all AECs through short-term, “spot” purchases should be avoided; at the same time, EDCs should also avoid using only long-term contracts for AEC procurement, since such results could “lock in” high AEC prices even as technological improvements (e.g., declining costs of solar photovoltaic cells) and growth in renewable energy generation lowers market prices for AECs.

Given the developing nature of the AEC markets and increasing AEPS requirements, PECO believes that the Commission should permit a variety of procurement plans for AEPS compliance. DSPs should be able to obtain AECs from full requirements suppliers as part of default service supply as well as enter into long-term AEC contracts and short-term, “spot” contracts to address potential shortfalls at the end of an AEPS compliance year. The Commission should therefore interpret Section 2807(e)(3.5) flexibly to both facilitate AEPS compliance and help ensure “least cost” to customers for AECs.

IV. SPECIFIC COMMENTS ON PROPOSED AMENDMENTS TO DEFAULT SERVICE POLICY STATEMENT

1. 52 Pa. Code § 69.1803

PECO agrees with the Commission's proposed amendments to this Section.

2. 52 Pa. Code § 69.1805

PECO believes that this Section should be further clarified to provide that short-term contracts may be up to four years in length to conform to Act 129's definition of long-term contracts.

3. 52 Pa. Code § 69.1806

PECO agrees with the Commission's proposed amendments to this Section, but suggests clarification that the reference to Act 129 is intended to incorporate only Act 129's additional alternative energy-related requirements set forth in Section 2814 of the Code.

V. CONCLUSION

PECO appreciates this opportunity to comment on the Commission's proposed revisions to the Default Service Regulations and Policy Statement Regarding Default Service and Retail Electric Markets and to respond to the Commission's additional questions on the interpretation of Act 129. PECO looks forward to working with the Commission and other stakeholders as the amendment process moves forward.

Respectfully submitted,


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Dated: June 1, 2010

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ATTACHMENT A

PECO ENERGY COMPANY
PROPOSED REVISIONS TO COMMISSION AMENDMENTS

I. Proposed Revisions to Amendments to Default Service Regulations

§ 54.184. Default service provider obligations.

....

(c) Following the expiration of an EDC's obligation to provide electric generation supply service to retail customers at capped rates, if a customer contracts for electric generation supply service and the chosen electric generation supplier does not provide the service, or if a customer does not choose an alternative electric generation supplier, the default service provider shall provide electric generation supply service to that customer pursuant to a Commission-approved competitive procurement process that shall include one or more of the following:

(1) Auctions.

(2) Requests for proposals.

(3) Bilateral agreements entered into at the sole discretion of the default service provider which shall be at prices that are:

(i) No greater than the cost of obtaining generation under comparable terms in the wholesale market, as determined by the Commission at the time of execution of the contract[-]; or

(ii) Consistent with a Commission-approved competition procurement process. All agreements between affiliated parties shall be subject to review and approval of the Commission under 66 Pa. C. S. §§ 2101-2107 (relating to relations with affiliated interests). The cost of obtaining generation from any affiliated interest may not be greater than the cost of obtaining generation under comparable terms in the wholesale market at the time of execution of the contract.

....

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]§ 54.187. Default service rate design and the recovery of reasonable costs.

.....
(b) The costs incurred for providing default service [~~+~~shall~~+~~~~may~~] be recovered through a reconcilable automatic adjustment clause under Section 1307 (relating to sliding scale of rates; adjustments), all reasonable costs incurred under 66 Pa.C.S. § 2807(e)(3.9) (relating to obligation to serve) and a Commission-approved competitive procurement plan. The use of an automatic adjustment clause shall be subject to audit and annual review, consistent with 66 Pa.C.S. § 1307(d) and (e). [default service rate schedule. The rate schedule shall be designed to recover fully all reasonable costs incurred by the DSP during the period default service is provided to customers, based on the average cost to acquire supply for each customer class.]

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II. Proposed Revisions to Amendments to Policy Statement Regarding Default Service and Retail Electric Markets

§ 69.1805. Electric generation supply procurement.

A proposed procurement plan should balance the goals of allowing the development of a competitive retail supply market and also including a prudent mix of arrangements to minimize the risk of over-reliance on any energy products at a particular point in time. In developing a proposed procurement plan, a DSP should consider including a prudent mix of supply-side and demand-side resources such as long-term, short-term, staggered-term and spot market purchases to minimize the risk of contracting for supply at times of peak prices. Short-term contracts are contracts up to and including 3|4 years in length. Long-term contracts are contracts [neither less|greater than 4 years [nor|in length but not greater than 20 years|-in length]. Long-term contracts should only be used when necessary and required for DSP compliance with alternative energy requirements, and should be restricted to covering a relatively small portion of the default service load. An over-reliance on long-term contracts would mute demand response, create the potential for future default service customers to bear future above market costs and limit operational flexibility for DSPs to manage their default service supply. The plan should be tailored to the following customer groupings, but DSPs may propose alternative divisions of customers by registered peak load to preserve existing customer classes.

§ 69.1806. Alternative energy portfolio standard compliance.

.....
In procuring electric generation supply for default service customers, the DSP shall comply with the Alternative Energy Portfolio Standards Act (73 P. S. [~~§-§-~~§§ 1648.1—1648.8 and related provisions of Act 129, October 15, 2008, P.L. 1592, No. 129 codified at 66 Pa. C. S. § 2814]). [The Commission's default service regulations neither prohibit nor mandate the use of long-term contracts to satisfy the alternative energy portfolio standards obligation. In satisfying this obligation, a DSP's procurement strategy should reflect the incurrence of reasonable costs.]

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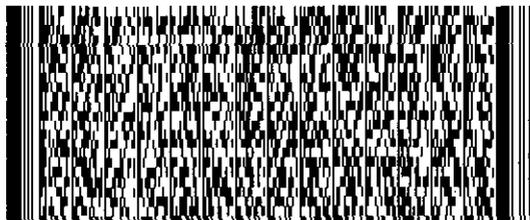


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