Pennsylvania Public Utility Commission

Provider of Last Resort Roundtable, Docket No. M-00041792

May 19, 2004

Presentation of
Morgan Stanley Capital Group Inc.
J. Aron & Company

Who we are . . .

- Morgan Stanley Capital Group Inc. and J. Aron & Company
  - Wholesale marketers nationally, including PJM
  - Industry leaders in risk management
  - Market and load serving sophistication
  - Preeminent investment banking firms
    - Morgan Stanley
    - The Goldman Sachs Group, Inc.
  - High credit quality institutions

Who we are (continued) . . .

- MSCG
  - SOS proceedings: MD, NJ, MA, CT, ME, DC
  - SOS provider in MA, NH, RI, NJ
  - 2003 BGS: won 7 FP (100 MW each) and 3 HEP tranches (25 MW each)
- J. Aron
  - SOS proceedings: MD, NJ, MA, DC
  - SOS provider in NJ and various utilities in NEPOOL
  - 2003 BGS: won 14 FP tranches (100 MW each)

POLR
Scope, Qualifications, Models

- What is "POLR" Service?
  - Basic retail service for customers that remain or return to the Incumbent EDC bundled supply and distribution service
  - Full requirements service
  - Service pricing and terms can differ by customer class
    - *E.g.*, real-time vs. fixed pricing
  - Includes all Customer Care functions

POLR
Scope, Qualifications, Models

- Who is the “POLR” for POLR Service?
  - Incumbent EDC: best positioned to continue provision of Customer Care functions including billing/collections
  - Alternative Supplier POLR in the future?
    - Must be creditworthy
    - Must be able to secure and pay for power
    - Must be able to provide Customer Care

POLR
Scope, Qualifications, Models

- POLR secures power in wholesale market
  - Competitive bidding/auction process among wholesale suppliers
  - “Term Averaging”: staggered procurements for portions of POLR load by customer class -- mitigates short-term price fluctuations
  - PA PUC must monitor and ensure that the Incumbent EDC merchant affiliates compete equally, directly and fairly with other potential non-affiliated wholesale suppliers for POLR load

POLR
Scope, Qualifications, Models

- Result: Full Service Agreement (FSA)
  - Load following wholesale contract(s) with POLR for specific POLR load by customer class and tranche
  - FSA terms of 1, 2 and 3 years
    - Mitigates market fluctuation impact
    - Longer-term contracts attract more bidders
  - Real transaction: EDCs should not be allowed to simply test the market

POLR Goals . . .

- To foster wholesale competition in order to achieve competitive, reasonable and sustainable retail prices for POLR customers
- Open regulatory process to develop rules, bidding structure and FSA
- Active participation of PA PUC Staff in developing bidding rules and FSA

POLR Goals . . .

- Wholesale suppliers need:
  - Seat at the table
  - Transparent bidding and evaluation rules
  - Rules that encourage participation and, thus, wholesale competition
  - FSA tracking industry standards (e.g., the EEI Master Agreement)
  - PA PUC sanction of results

Current approaches – New Jersey "BGS"

- Strong supplier participation; competitive results
- $27 million in consumer savings last auction
- Clock auction administered by outside consultant
- CIEP (real-time) and FP (fixed) price loads
- Wholesale contracting process
  - Parties participate in FSA drafting
  - FSA has a two-way termination settlement
  - FSA is a derivative for accounting treatment while maintaining accrual accounting for EDCs
  - FSA does not yet include bilateral credit provisions
- Alternative form of parental guarantee allowed

Current approaches Maryland “SOS”

- RFP process
- Wholesale contracting process
  - FSA does not yet satisfy FASB requirements for derivatives accounting treatment
  - FSA does not yet include bilateral credit terms
- No alternative form of guarantee allowed
- Impact on number of suppliers bidding, competition and wholesale prices and resultant retail SOS rates?

FSA Goals . . .

- FSAs that follow industry standards will attract more, high quality bidders
  - Enhances wholesale competitive participation and thus the likelihood of the lower prices for retail POLR customers
  - High credit quality bidders are critical, especially for long-term supply obligations

FSA Goals . . .

- Bidders may account for FSA contract risks by adding a risk premium to bid prices or decreasing bid participation – risks include:
  - Credit and settlement risk
  - Accounting and title transfer risk
  - Undue POLR load erosion risk
- Reducing contract uncertainty and risk for wholesale bidders likely will result in lower wholesale prices and, ultimately, lower prices for POLR customers

FSA Goals . . .

- With these goals in mind, the PA PUC should mandate the following key FSA terms

FSA: Bilateral Credit

- Like the EDC, the wholesale provider to the EDC POLR also will assume risk
  - Settlement risk (EDC non-payment)
  - Termination risk (EDC default)
  - EDCs can be downgraded or default
  - High quality bidders have internal credit requirements

FSA: Bilateral Credit

- FSA credit terms should apply equally to the EDC and wholesale supplier – *i.e.*, bilateral credit terms
- Industry standard EEI Master: contracting parties provide each other with adequate credit protection
- Credit assurance provided if
  - Downgrade in credit rating
  - Exposure due to market changes greater than credit limits

FSA: Two-Way Settlement

- All parties retain benefit of the bargain
- Non-defaulting party ("NDP") settles its position – recovery of replacement costs
- If NDP suffers a loss – DP makes up loss
  - *E.g.*, EDC as NDP required to purchase replacement power at a higher cost than FSA
- If NDP realizes a gain – NDP returns this unwarranted gain
  - *E.g.*, EDC as NDP secures replacement power at a lower cost than FSA
- Limitations to two-way payment may not be enforceable in bankruptcy

FSA: Notional Quantity

- Termination payment calculation terms
- Quantity of remaining services should be calculated using fixed quantities adjusted by formula based on the customer class usage in previous year
  - Renders FSA a derivative for mark-to-market (MTM) accounting
  - Maintains EDC accrual accounting of FSA
- See New Jersey FSA

FSA: Notional Quantity

- Benefits
  - Allows entities using MTM accounting to account appropriately for the FSA and related hedges
  - High credit quality financial institutions and other suppliers use MTM accounting
  - Allows such entities to participate fully in POLR wholesale bidding process (thus, increasing wholesale competition)
  - Normal purchase/sale exception remains allowing for continued EDC accrual accounting

FSA: Wholesale Contract

- FSA is an explicit wholesale contract
  - Title and risk of loss explicitly transfer to POLR at delivery point, not retail customer meter
  - Wholesale suppliers serve a fluctuating EDC load, not a particular retail customer
  - No privity of contract with a POLR customers

FSA:
Alternative Form of Guarantee

- If a parent guarantee is required for bidder participation or to support the FSA, PUC should allow providers to use alternative forms of guarantees
  - Most suppliers have a standard form that provides broad credit support

Load Erosion Risks

- PA PUC should balance goals to maximize retail choice and minimize POLR customer rates
- POLR load uncertainty creates risk and may lead to higher bid prices
- POLR load predictability allows wholesale bidders to offer a better price
- Carefully designed
  - Administrative charge (to allow POLR to recover costs)
  - Switching rules
  - POLR customer class designations

Conclusion

- MSCG and J. Aron appreciate the opportunity to set out threshold POLR model features and FSA terms that -- if adopted by the PA PUC -- will attract high quality wholesale bidders, increase wholesale competition and, thus, increase the likelihood of reasonable retail prices for POLR service customers.