BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

In the Matter of the Pennsylvania Public Utility Commission Provider of Last Resort Regulations and Roundtable	: : : :	Docket No. M-00041792

REPLY COMMENTS OF
J. ARON & COMPANY
AND
MORGAN STANLEY CAPITAL GROUP INC.

J. Aron & Company ("J. Aron") and Morgan Stanley Capital Group Inc. ("MSCG") appreciate the opportunity to participate in the ongoing Provider of Last Resort ("POLR") roundtable process. MSCG and J. Aron provided initial comments in the form of a presentation on May 19, 2004 as part of this roundtable process. MSCG and J. Aron hereby submit to the Pennsylvania Public Utility Commission ("Commission") reply comments regarding the development of POLR regulations. The Commission should adopt early on and as part of any rulemaking: (1) a wholesale POLR model; and (2) a wholesale model utilizing a Full Services Agreement ("FSA") between the winning wholesale bidder(s) and the electric distribution company ("EDC"), including critical threshold terms such as bilateral credit provisions and a notional quantity provision as part of the FSA termination payment calculation.

I. Preferred POLR Model

Certain commentors in this proceeding promote a retail POLR model. J. Aron and MSCG maintain that a wholesale, not retail, POLR model would best serve the needs of electric customers in Pennsylvania. Both the New Jersey Basic Generation Service auction and the Maryland Standard Offer Service process adopted such a wholesale model. It appears that the

District of Columbia is also likely to adopt a wholesale approach. As stated in our initial presentation, a well-designed wholesale procurement process will increase the likelihood of lower-cost wholesale supply contracts with Pennsylvania EDCs and, thus, low-cost POLR service to Pennsylvania consumers because:

(1) High credit-quality wholesale suppliers will be attracted to compete head-to-head on the basis of wholesale price to supply the POLR load;

(2) The risk to POLR residential and smaller commercial consumers of wholesale price volatility will be dampened and mitigated through staggered wholesale procurements to serve the POLR load and varying FSA term lengths (for instance, 1-, 2- and 3-year) for fixed-prices with the wholesale supplier bearing the risk of price volatility;

(3) Wholesale bidders have the ability to manage wholesale price risk effectively in wholesale markets through bilateral contracts and other financial tools and hedging strategies and, thus, can make lower-priced offers to the EDCs; and

(4) A wholesale model imposes the risks of providing wholesale power on the providers while leaving the responsibilities and attendant risks of the retail customer relationship with the EDCs – institutions that have a breadth of experience in dealing with retail issues.

II. Important Terms for the Full Services Agreement

Critical to the success of a wholesale model, however, is that the Commission mandate early in the POLR development process and as part of any POLR rulemaking that the following provisions be included in the FSA for wholesale POLR power.

A. Bilateral Credit

Like an EDC, wholesale providers for the EDC POLR service also will assume risks, including settlement risk (*i.e.*, EDC non-payment) and termination risk (*i.e.*, EDC default). As with any other entity in an agreement for the supply or purchase of power, an EDC can face events that lead to an EDC's credit standing downgrade or contractual default. Thus, FSA creditworthiness and credit support terms should apply equally to the EDC and wholesale supplier. This reduces the likelihood that a risk premium would be factored into wholesale bidding prices to account for credit risks and, in turn, increases the likelihood of lower POLR prices.

Furthermore, high credit-quality bidders that may participate in a wholesale power auction for POLR service have internal rules that govern their ability to enter into contracts. These rules often require particular credit terms and limit the entities' financial exposure to counterparties. Many of these entities utilize bilateral credit terms included in the industry standard EEI Master Power Purchase and Sale Agreement ("EEI Master") through which contracting parties provide each other adequate credit protection. In the EEI Master, credit assurance is provided if there is a downgrade in a party's investment grade status or if a party's exposure due to market changes is greater than its credit limits with the counterparty.

Bilateral credit terms such as the EEI Master standard terms would reduce credit risk and therefore likely lead to greater participation of high credit-quality wholesale providers in the wholesale POLR procurement process. Without such terms, however, potential suppliers may reduce or forgo altogether their participation in bidding for POLR service or otherwise factor unilateral credit risk into their wholesale bidding prices.

B. Notional Quantity

The idea of "notional quantity" refers to termination payment calculation terms in the FSA. Specifically, upon early termination of an FSA, the quantity of remaining services should be calculated using fixed quantities adjusted by a formula based on that particular customer class's usage in the previous year. Notional quantity calculation was effectively included in the FSA developed for New Jersey. The Commission should adopt a provision very similar to that in New Jersey, such as the following:

> In order to avoid doubt regarding a commercially reasonable calculation for the purposes of calculating the Settlement Amount by the Non-Defaulting Party, the quantity of amounts of Energy, Capacity and other services to have been provided under the FSA for the period following the Early Termination Date (the "Termination Quantity") shall be deemed those quantity amounts that would have been delivered on an hourly basis had the FSA been in effect during the previous calendar year, adjusted for such SOS load changes as have occurred since the previous calendar year.

Such language establishes a notional quantity – a quantity that can be calculated – for the purposes of determining the amount of services that would have been provided over the FSA term.[1] Application of a notional quantity is beneficial because it allows the wholesale shipper to treat the FSA as a derivative for the purpose of mark-to-market ("MTM") accounting. High credit-quality financial institutions and other potential suppliers of POLR use MTM accounting as it allows them to account appropriately for the FSA and related hedges. By adopting such notional quantity language, bidders using MTM accounting are more likely to participate fully in a wholesale POLR bidding process because they can appropriately account for the FSA and related hedges. This would increase (1) bidder participation, especially by high credit quality institutions; (2) wholesale market liquidity; (3) the likelihood of wholesale competition and lower wholesale price bids; and thus, (4) the likelihood of lower POLR prices for consumers.

[1] J. Aron and MSCG will provide the Commission with greater detail regarding this issue in subsequent filings if requested by the Commission.

III. Conclusion

For the reasons stated above, J. Aron and MSCG urge the Commission to adopt a wholesale POLR model and mandate as part of any rulemaking that the eventual FSA must include critical threshold terms such bilateral credit and a notional quantity for the termination payment calculation. MSCG and J. Aron appreciate the opportunity to participate in this collaborative process in order to develop the best possible solution for affordable, reliable POLR service for Pennsylvania's electric customers.

Respectfully submitted,

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