

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

PROVIDER OF LAST RESORT : Docket No. M-00041792  
(POLR) ROUNDTABLE :

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REBUTTAL COMMENTS OF THE  
OFFICE OF CONSUMER ADVOCATE

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## I. INTRODUCTION

The Office of Consumer Advocate (OCA) has been in attendance at all of the POLR Roundtable sessions and would, again, commend the Commission for conducting these informative sessions. The OCA has found the POLR Roundtable useful in learning about the different models for POLR service and in identifying the key policy issues raised by these models. The presentations, as well as the questions and answers, have been extremely helpful in crystallizing the issues that must be addressed as Pennsylvania moves forward in its restructuring process. But as Pennsylvania moves forward, the OCA urges the Commission to ensure that its focus is on implementing a process that will result in the lowest priced, reliable electric supply for all Pennsylvania consumers.

One key point from the POLR Roundtable is the need for flexibility in the regulations. As almost all of the presenters agreed, the markets in 2010 when the majority of Pennsylvania EDCs will enter the post-transition period could be far different from what we see today. There will be much development in both the wholesale and retail markets in the next several years. There will also be much to learn from the experience in other states as well as from Pennsylvania EDCs that are now pursuing alternative POLR strategies. The Commission may wish to consider issuing regulations that set forth key principles and guidelines to assist in developing POLR strategies rather than promulgating very restrictive regulations at this time. Regulations that allow developments and lessons to be incorporated into the POLR process over time would be most appropriate.

As a starting point, the OCA would recommend that the Commission regulations or guidelines reflect the following key attributes of a POLR service policy:

- POLR service should be managed to assure stable, reliable and affordable electric service;
- The EDC should be the primary entity responsible for the planning and procurement of POLR service;
- POLR service should reflect a diverse portfolio of electricity resources, including long term contracts, to assure balance, facilitate reliability, reduce the risk of short term volatility in prices, and mitigate the risk of other events;
- POLR service should be designed to reflect any applicable Commonwealth policies regarding renewable resources, energy efficiency, and demand response programs;
- POLR obligations should be met through acquisitions that enhance the development of competitive wholesale electricity markets.

The OCA would also note that the Commission may wish to provide guidance on a number of key policy and design matters as it moves forward. Some of these matters include:

- Whether POLR is basic "plain vanilla" service only;
- Whether pricing or tariff options, such as voluntary time-of day pricing or demand side response pricing offers, are appropriate POLR offerings;
- What forms of procurement practices are acceptable;
- What categories of the POLR's cost should be included in the POLR rate;
- Whether switching rules or restrictions are needed, and how best to design those rules if needed;

- What procedures should be followed for review of a procurement process and resulting POLR price.

Commission guidance on these issues could assist in limiting controversy over the design of the POLR Plans as the Commonwealth moves forward.

For residential consumers, the OCA continues to recommend a framework that will result in affordable, stable and certain prices for reliable service while bringing the benefits of the wholesale competitive generation market to residential customers.<sup>1</sup> It is the OCA's position that this can best be achieved by the electric distribution company (EDC) serving as the Provider of Last Resort (POLR). The EDC should provide this service by acquiring a portfolio of resources. The process of acquiring these resources should reflect a variety of competitive procurement methods and procedures, which could include auctions, competitive solicitations, entering into bilateral contracts and utilizing hedging techniques to mitigate volatility and risk. Given the differing circumstances of Pennsylvania's EDCs, such as their varying size, different RTO membership, varying rate levels and varying levels of shopping, the OCA recommends at this time that the Commission allow flexibility in its regulations so that each EDC can pursue a procurement strategy that best meets the needs of its customers.

An important issue concerns how best to price the service to the retail customer. The OCA continues to recognize that there are two basic methods for pricing the service to the retail customer. Retail pricing for the service could reflect either a performance based, non-reconcilable market-based price, or a reconcilable clause with dollar-for-dollar recovery of actual

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<sup>1</sup> As in its Comments, the OCA will address POLR service for residential customers, as it anticipates that other customer representatives will be providing comments for the commercial and industrial customers.

costs. Each methodology has different effects on the competitive market, the EDC/POLR, and the regulatory process. For example, a reconcilable clause makes the shopping decision more difficult for the customer but it provides the EDC an assurance of recovery of each and every dollar that it spends on POLR service. Such a method, though, reduces the incentive to the EDC to contain costs, which implicates the regulatory process. On the other hand, a performance-based mechanism allows the customer to compare offers to a known and certain price, but requires that the POLR hedge its exposure and assume risk that must be reflected in the POLR price. Such a mechanism may present challenges in the regulatory process in determining the appropriate performance-based POLR price.

The OCA also notes that the POLR Roundtable has raised the issue of whether the introduction of more time sensitive or seasonally differentiated rates is appropriate. The impact of such changes on customers can be significant if these changes are mandated, rather than offered as voluntary options to the customer. Pursuit of these options, and the impact on customers, must be thoroughly explored. At this time, the Commission may wish to encourage further development of voluntary rate schedules for customers to test some of the principles underlying the call for such changes.

Several other POLR models have been forwarded by the participants in the POLR Roundtable for residential customers. While many participants agreed that residential customers should be provided stable, affordable pricing for POLR service, many of the presenters recommended models that would increase the price to residential customers, or make POLR service subject to volatile pricing, as a means of trying to force customers to shop. As the representatives of the New Jersey and Maryland Commissions recognized, however, residential

customers do not shop in large numbers and it is difficult for an EGS to efficiently serve this low use sector. Tr. 61-63 (Peter Yochum), 89-91 (Greg Carmean). As discussed in the OCA's Comments, and below, the OCA rejects the proposition that the goal of a POLR model is to force customers off of POLR service. Such models are not appropriate for residential customers and will not benefit residential customers either now or in the future. Causing economic disruption and harm to residential customers in the hope that such approach may some day attract market entrants is far from the purpose of the Pennsylvania Act. The Act was intended to make customers better off, not to increase their rates to entice retail market entrants.

The OCA will not respond to all of the Comments or Presentations of the other parties but will address some of the key issues raised by the Comments and Presentations. Specifically, the OCA will address keeping the POLR obligation with the EDC and reflecting the risk borne by the EDC in the POLR price; the use of wholesale auctions or competitive solicitations to acquire all supply in Pennsylvania; the use of adders and adjustment mechanisms to make POLR service expensive and unattractive for residential customers; and rate design changes such as mandatory seasonal pricing.

## II. REBUTTAL COMMENTS

### A. The EDC Should Serve As POLR And Should Recover Its Reasonable Costs, But Should Not Be Permitted To Recover A Return For Risks That It Does Not Bear.

At the POLR Roundtable of April 21, 2004, the incumbent electric distribution companies (EDCs) in Pennsylvania made their presentations to the Commission. The OCA finds itself in agreement with the EDCs that the provider of last resort in Pennsylvania must be the incumbent EDC in each service territory. As discussed in the EDC presentations, as well as in the OCA's Comments and presentation, the EDC will always be relied upon as the ultimate provider of last resort when other entities fail, and the EDC is the entity best situated, at least for residential customers, to provide customer care services. Additionally, the EDC should retain its obligation to assure compliance with the termination protections of Chapter 56, and it should be the only entity permitted to terminate service under Chapter 56.

In its presentation, the Energy Association of Pennsylvania (EAP) suggested that POLR should not be defined to mean the "Provider of Lowest Rate." Tr. 121 (Michael Love). EAP pointed to the risks and costs involved in providing the POLR service. Id. The OCA does not completely disagree, but would phrase it differently. The POLR rate should be the lowest, reasonable price for what the POLR is providing, reliable service available to all customers. The OCA agrees with EAP that there may be risks inherent in the POLR service and that the POLR provider should be compensated for those risks. The rules of the road that the Commission might establish for POLR service, such as switching rules, cost recovery, or length of pricing term, can also have an impact on the risk of providing the service. The OCA submits, however, that the POLR should not be compensated for risks that it does not bear.

The method of cost recovery that is granted the POLR, or that it selects if there are alternative approaches under the POLR regulations, has an impact on the degree of risk to the POLR. As to cost recovery, the EDCs also presented the two methods for recovery of POLR costs that the OCA discussed in its Comments – a performance-based, non-reconcilable price or a dollar for dollar recovery mechanism of the actual POLR costs. For example, Morgan O'Brien for Duquesne Light Company outlined a framework where a market-based price is established based on relevant market information. The Company must then manage its purchases in the market within that pricing parameter. If the Company is able to manage its purchasing and beat that price, it retains any benefit, but if it exceeds the price, it absorbs the amount in excess of the price. Tr. 213-216 (O'Brien). The OCA agrees that a performance based approach entails some risks, such as market risk, load risk, and switching risk, that must be managed by the POLR. The EDC has an obligation to manage these risks, and the reasonable cost of managing the risks should be reflected in the POLR price. Mr. Krall of PPL, on the other hand, supported a mechanism for dollar-for-dollar recovery of actual costs, including a reconciliation mechanism. This methodology ensures that the EDC recovers all of its costs and bears none of the risks of a fixed price service. A risk premium or return component would not be needed in this situation.

Where the OCA would urge caution, however, is in the consideration of proposals by some of the EDCs that combine actual dollar for dollar cost recovery with "retail adders" that allow the EDC to earn a return even though the EDC is provided actual, dollar for dollar recovery of all costs through a reconciliation mechanism. Allowing an EDC to earn a return on POLR service when it is guaranteed dollar-for-dollar recovery of its actual costs on a fully reconcilable basis is a windfall for the EDC who is assuming little or no risk of providing the POLR service.



This would be akin to allowing a natural gas company to earn a return through its purchased gas cost rate or allowing the electric utilities to earn a return through the old energy cost rates.

PPL witness Krall, in response to a question from Commissioner Thomas, aptly captured the fact that actual cost recovery mitigates the risk of POLR service and therefore reduces the need for any "retail adder." Mr. Krall noted:

COMMISSIONER THOMAS: One quick question. If I'm to understand the PP&L vision of POLR service, it doesn't seem to include a retail adder like some of the other testifiers have presented. Would you agree with that assessment or is there indeed a retail adder that I might be missing in the PP&L vision?

MR. KRALL: As we've proposed it, there's no retail adder. Our fundamental concern is that – and I think you've heard it is the comments of others who have added the retail adder – I think all of us share the common concern of risk.

POLR providers are going to be a huge risk, and it's not a risk that we're not aware of, because we've seen EGSs default. We've seen EGSs performing as something more than just a normal retail supplier, performing as a competitive default supplier. We've seen them fail. Ultimately, in other jurisdictions, we've seen distribution companies go into bankruptcy because of flawed rules. That is PPL's fundamental concern.

We are willing to stand in the shoes of the POLR provider, to be the POLR provider, but we need to be protected against risks that come from an obligation that we have no control over.

Now, if cost recovery is assured and there's a reconciliation mechanism to help assure that, then we feel that we've done a pretty good job of managing that risk and we're reasonably well protected.

If there aren't those kinds of assurances and there's the need to add an adder as an additional protection, then maybe that's the way to go, but our fundamental concern is one of risk.

COMMISSIONER THOMAS: . . . I guess what you're suggesting is, as long as you're protected from this risk by some sort of reconciliation mechanism if an EGS somehow doesn't show up, the burden switches back to PP&L and you just want to get your money back somehow.

MR. KRALL: That's our primary concern. . .

Tr. 159-160 (Krall).

The OCA submits that there is no need to include an adder with a return component if the POLR receives reconcilable, dollar-for-dollar recovery of actual costs. If, however, the non-reconcilable performance-based mechanism is used, there will be a risk premium associated with the POLR providing service on a non-reconcilable basis. Such risk premium should be included in the POLR price, but the POLR should then assume certain risks for the POLR period. As discussed in Section II.C., there is no basis in the Act or in policy to include other adders with hypothetical marketing costs or other EGS costs in the POLR rate.

Fundamentally, the OCA is in agreement with the EDCs that the EDC should remain as the POLR. The OCA also supports the POLR being fully compensated for the reasonable risks that it bears in providing the service. The OCA, however, does not support a POLR being compensated for risks that it does not bear or for costs that the POLR does not incur as part of providing service to its customers.

B. Wholesale Auctions Or Competitive RFPs Are Appropriate Methods For Procuring Supply If Not Solely Short Term Based, But Exclusive Reliance On These Methods May Not Be Appropriate At This Time.

A number of participants, including owners of generation, EDCs, and representatives of other state Commissions, discussed an approach to meeting the POLR obligation that relies upon annual wholesale auctions or requests for proposals (RFPs) by either

the Commission or the POLR to obtain supply. The Commission heard of experience with this approach from representatives of the New Jersey Board of Public Utilities and the Maryland Public Service Commission, as well as bidders in these processes and EDCs whose affiliates participated in those processes. The OCA agrees that the use of wholesale auctions and competitive solicitations are procurement methods that should be employed by the EDCs. The experience to date has shown the results to be generally competitive, and the protocols for the differing types of auctions continue to be refined as lessons are learned. The OCA does not believe, however, that sole reliance on any single one of these methods for the entire Commonwealth is the right course for Pennsylvania at this time.

Initially, the OCA would note that a sole reliance on short term products to serve 100% of POLR supply is not appropriate. As Mr. Krall of PPL, Mr. Henderson of PSEG and Ms. Fernandez of FERC all noted, total reliance on short term contracts through auctions or solicitations is not beneficial to customers or to the wholesale markets. Tr. 9 (Fernandez), 152 (Krall), 390 (Henderson). Short term auctions result in volatile prices and can reflect market perturbations or the short term impact of world events. As Mr. Yochum from the New Jersey BPU noted, New Jersey is moving to a series of three year contracts based on these concerns. Tr. 67 (Yochum). In reaction to these concerns, the D.C. Public Service Commission recently adopted default service rules that require the EDC to acquire a portfolio of contracts for POLR service in which at least 40% of the contracts are for a period of three years or more. In the Matter of the Development And Designation of Standard Offer Service in the District of Columbia, Formal Case No. 1017, Order No. 13115(Order on Reconsideration entered March 1, 2004), Attachment A, p. 4, Rule 15DCMR §295.2(a).

The OCA again agrees with PPL that if an auction approach is utilized, either by the Commonwealth or by an individual EDC, the goal of the auctions should be to acquire a portfolio of resources that will result in relatively stable pricing and to divide the supply into tranches that cover time periods of varying lengths, both short term and long term. Tr. 153 (Krall). Mr. Henderson of PSEG also recommended acquiring a portfolio of contracts of one to five years in length and Mr. Krall recommended including lengths up to ten years. Tr. 390 (Henderson) and 152 (Krall). As both Mr. Krall of PPL and Ms. Fernandez of FERC noted, long term supply contracts may be needed to create the assured revenue stream for generators that would facilitate the construction of new generating plant. Tr. 9 (Fernandez), 152-153 (Krall). Any competitive procurement process must secure an appropriate portfolio of resources and should include the possibility of long term supply commitments.

The OCA remains concerned that the sole reliance on a single annual wholesale auction for all EDCs' POLR supply in the Commonwealth may not be practical and may not produce the best result for customers in Pennsylvania. First, unlike other states that have moved to this model, not all Pennsylvania EDCs operate in the same RTO. Differences between the RTOs in terms of level of development and market structure may make it impractical for the Commission to require a statewide wholesale auction process as the exclusive method of supply procurement.

Second, the OCA echoes the concerns expressed by PJM about simultaneous auctions for large volumes of POLR load obligation occurring in the same basic time frame in each state. As Mr. Bladen from PJM noted:

I think it is also important to look at timing. The timing of when a program is designed to be implemented, and then when it is intended to be reviewed, is very important. PJM has a planning year that's been used as the basis of programs to date. There is growing concern about whether in fact, if all programs are designed based on that planning year, we might in fact encounter problems as a result of the overly consistent timing and the impact on wholesale markets as a result.

Tr. 23 (Bladen). See also, Tr. 25, 30-32 (Bladen).

Mr. Krall of PPL also expressed concern with simultaneous auctions in many states that overlap:

With regard to timing, while it might be convenient to conduct auctions annually so that POLR pricing can be established on an annual cycle, PPL Electric believes that some consideration needs to be given to the sequencing of auctions among EDCs and even among states, and the likelihood that suppliers might bid less aggressively in the first series of auctions and more aggressively in the last of that series. This could lead to consumers in one EDC or in one state being disadvantaged relative to others.

Tr. 152 (Krall).

Third, as Mr. Yochum from New Jersey and Ms. Fernandez from FERC highlighted, the wholesale markets are volatile and timing could be everything. Tr. 67 (Yochum), 10 (Fernandez). With a prescriptive wholesale auction approach, the auction, by necessity, has little flexibility in its timing. In PJM, to match with the PJM planning year for such a large volume of supply, the time frame for the auction is narrowed further. Mr. Yochum explained the concern:

One of the problems with the auction process, the way we do it, is it takes place or it starts the first Monday in February each year. That could be a high point, a low point. You don't know where you are going to be in the pricing cycle. If you recall, in February of 2002, we were very nervous about that last year as the country

was obviously going to be invading Iraq and we just didn't know if we were going to do that the week before the auction, but it certainly could have had a big effect on the price that we ended up getting in the auction if it had come sooner.

Tr. 67 (Yochum). As the Commission is aware, in an auction process, the Commission and the EDC have little option when it comes to accepting the auction results. As Mr. Yochum noted, New Jersey is moving to longer term contracts to mitigate this impact. Tr. 67-68 (Yochum). There is still much to learn about how best to address these risks in an auction process.

At this time, the OCA supports the use of wholesale auctions as one means of procuring supply, but not as the sole means of procuring supply for each EDC in the Commonwealth. A statewide auction does not appear to be a practical option for Pennsylvania given the diversity of the EDCs and the different RTOs that some of our EDCs must operate in. The OCA would recommend that the Commission allow the EDC flexibility to determine the most practical procurement method given its circumstances.

C. Making POLR Service An "Ugly Service" Whether Through Excessive Retail Adders Or Volatile Pricing Is Not Contemplated By The Pennsylvania Act.

A number of participants in the POLR Roundtable have called for POLR service to be made expensive and "ugly" through inclusion of retail adders that drive up the price or through volatile pricing schemes such as frequent price changes based on an index or a spot market price. As set forth in the OCA Comments, the Pennsylvania Act does not support the notion of a POLR service that is "ugly" or unreasonable in some misguided attempt to increase shopping numbers. The goal of the Pennsylvania Act was to provide reliable service to consumers at lower prices than what they would pay under the prior regulatory model. The Act does not require that a customer switch to an EGS to receive this benefit. Rather, the Act gave

customers access to competitive generation market through either an EGS or through the POLR acquiring generation at prevailing market prices. A fundamental protection of the Act, however, is the POLR service and the assurance that electric service will be available on reasonable terms and conditions. 66 Pa.C.S. §2802(9).

The OCA submits that forcing the rates of all POLR customers to excessive levels in order to promote competition, as some participants have recommended, not only distorts the concept of competitive markets, it is bad public policy. Access to competitive markets was one of the tools chosen by the General Assembly to keep rates down. Forcing rates up so that EGSs can compete confuses the ends sought by the General Assembly with the means of achieving those ends. Perhaps best said by Mr. Henderson of PSEG, POLR rates should not be raised through retail adders based on a promise that it will be better some day. Mr. Henderson commented:

Retail adders. It's an interesting problem. We're obviously a wholesale participant in the market. We think they should be discouraged if they're not cost based. Retailers who come and ask for adders simply to, let's say, fulfill the promise of a future world where there will be lots of retail competition, they're asking for a subsidy; and I think it's that simple. Why make electric service ugly to your consumers on the promise that it will be better some day? That's not to say we don't support retail competition. We're a gigantic supplier to many of the retail participants in the markets. It just doesn't seem to make economic sense to penalize customers.

Tr. 391-392 (Henderson).

Equally important, artificially raising POLR rates to try to force customers to switch could harm the majority of residential customers who cannot or do not choose to leave the POLR. The impact could be most severe on those that are low income or payment troubled. An

EGS does not have an obligation to serve *all* customers, and as Mr. Geller of PULP pointed out, EGSs might not seek out or serve credit troubled customers. Tr. 445 (Geller). These customers would simply pay higher rates with no opportunity to obtain savings. POLR prices should not be set in a manner that would force those customers who have the most difficulty paying their bills to pay the guaranteed highest rates.

Additionally, POLR service should not be made "ugly" by introducing volatility such as through frequent price adjustments during the course of a year. Proposals in the Roundtable for frequent price adjustments in the POLR rate introduce volatility to residential customer's generation prices even though these customers have little opportunity to respond to such volatility. The notion of sending price signals to lower use residential customers must be viewed with caution since sending these types of price signals is unlikely to have the economic impact typically associated with the benefits of such an approach or to force customers to an EGS. Instead of being able to respond or to shop, residential customers could end up paying higher and higher rates to the POLR as wholesale market volatility is flowed through to them, even though the POLR provider may have hedged its portfolio and is not exposed to the volatility in the wholesale markets. Such adjustments, particularly when at the sole discretion of the POLR, just serve as a windfall to the POLR.<sup>2</sup>

Customers will switch to an EGS when the EGS offers them something of value, whether it be a value added service that they desire or a lower rate. Mr. Henderson of PSEG captured this important point as follows:

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<sup>2</sup> The OCA would note that while a similar approach in Texas by Reliant has resulted in about 15-17% of Reliant's residential customers shopping since January 2002, Reliant's total rates have increased 30% for an average customer.



I would say if you want to develop a regulatory environment where you're going out of your way to switch, I think that's a mistake. If you have solicitations that run one, two and three years, markets go up, markets come down. We happen to be in a high cycle right now. Again, as these solicitations play out in the future, retail providers will be able to compete against a portfolio of one to three-year durations when prices come down. That's letting the market determine when they can do it. Customers will switch if retail providers can give them some added service, something that they can't get through, effectively, what's a simple POLR service delivering them price. But I think to design a system where you provide subsidies to retail marketers solely to say that customers will switch seems to be a mistake; your consumers are going to pay for those subsidies.

Tr. 395.

As both the EDCs and the OCA have noted, POLR service is not without risk, and providing reliable POLR service will have a cost. POLR customers are not the "low hanging fruit" that was once thought. The important element of POLR service is to ensure that the POLR acquires appropriate and reliable supply through the competitive wholesale generation markets at the lowest reasonable cost for the service that is being provided.

- E. Changes In Rate Design For The Residential Customer Class Should Be Considered On Their Own Merits And Not As A Simple Solution To Gaming Or As A Means Of Exposing Residential Customers To Price Signals To Which They Cannot Respond.

A number of presenters, particularly retail EGS participants, have urged a move to the use of seasonal rates for residential customers rather than the imposition of switching rules as a means to deter "gaming." Gaming by residential customers is not the problem. The problem that has been identified is when EGSs either fail, or determine that it is not in their interest to serve residential customers during high cost periods. A move to seasonal rates should be decided on its own merits rather than as an easy solution to gaming.

Others have suggested a move to seasonal rates, or more time of day pricing for residential customers to expose these customers to "price signals." As the OCA discussed in its Comments, residential customers typically are the least able to respond to such price signals. Exposing residential customers to such rate designs can have a significant economic impact on the customers that must be fully considered. The OCA would note that another approach is the use of a performance based pricing mechanism that more closely aligns the incentive for price response with the POLR. The incentive is then provided to the POLR to introduce demand side response programs to residential customers that are well-designed and beneficial to the customers and the system. The incentive is also provided to the POLR to engage in the necessary education advertising to attract customers to these beneficial rates.

As described in the OCA's Comments, there are significant issues that must be explored before moving to seasonal rates or time of day rates as a mandatory pricing structure for residential customers. The Commission should proceed cautiously and explore all alternatives before reaching a decision on these matters.

### III. CONCLUSION

The OCA thanks the Commission for this opportunity to present Rebuttal to some of the key issues raised by the POLR Roundtable. The OCA looks forward to continuing discussions of these important topics and to working with the Commission and the stakeholders as the Commission develops its regulations.

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