BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

In the Matter of the Pennsylvania Public Utility Commission Rulemaking Re Electric Distribution Companies' Obligations to Serve Retail Customers at the Conclusion of the Transition Period Pursuant To 66 Pa.C.S. § 2807(e)(2)	: : : : : : :	Docket No. L-0040169

INITIAL COMMENTS OF MORGAN STANLEY CAPITAL GROUP INC.

Morgan Stanley Capital Group Inc. ("MSCG") respectfully submits to the Pennsylvania Public Utility Commission ("Commission") its initial comments regarding the proposed regulations filed in the above docket ("Proposed Regulations"), defining the obligation of electric distribution companies ("EDCs") to serve retail customers at the conclusion of their respective transition periods.

MSCG, a wholly-owned subsidiary of Morgan Stanley Dean Witter & Co., is a corporation organized under the laws of Delaware with its principal place of business in New York, New York. Pursuant to its authorization from the Federal Energy Regulatory Commission ("FERC") to sell wholesale power at market-based rates,[1] MSCG buys and sells wholesale power in the various markets throughout the United States. MSCG is or has been a standard offer/default service (or its equivalent) provider in Massachusetts, New Hampshire, Rhode Island and New Jersey, participating in bidding and request for proposals in each state. MSCG also has actively participated in standard offer/default service regulatory proceedings in Maryland, New

[1] *Morgan Stanley Capital Group Inc.*, 69 F.E.R.C. ¶ 61,175 (1994).

Jersey, Massachusetts, Illinois, Connecticut, Ohio, Maine and the District of Columbia. MSCG on May 19, 2004, provided an oral presentation to the Commission in Docket No. M-00041792 as a part of the working group process leading to this rulemaking proceeding.

Through its initial comments, MSCG urges the Commission to amend the Proposed Regulations to require that: (1) the EDCs create and submit competitive procurement process ("CPP") implementation plans based specifically on New Jersey's Basic Generation Service ("BGS") auction model[2]; (2) the EDCs together with all interested parties develop one, standard full services agreement ("FSA") for the provision of default service, to be entered into between the winning default service bidder(s) and the EDC in each EDC's respective CPP; (3) the standard FSA should be approved by the Commission and should include critical threshold terms such as bilateral credit, alternative guaranty and termination payment notional quantity provisions; and (4) the Commission's review of the results of an EDC's CPP auction be limited in time and scope.

I. Preferred CPP Model

Section 54.185(d) of the Proposed Regulations states that an EDC's default service implementation plan and CPP must be "fair, transparent and non-discriminatory." The best way to ensure a fair, transparent and non-discriminatory procurement is to follow the successful example laid out by New Jersey's web-based electronic, declining clock BGS auction process. Regulators, utilities, consumer groups and wholesale suppliers have become familiar and comfortable with the New Jersey process and view it as fair and predictable. Indeed, Ohio adopted, and Illinois likely will adopt, the New Jersey model. The Commission states in its Proposed Rulemaking Order that it "envisions the use of [RFPs] or auctions as potential [CPPs]

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[2] For smaller utilities, use of a request for proposal ("RFP") model similar to that in Maryland's Standard Offer Service ("SOS") may be offered as an option.

to meet these standards," but that it "realizes there may be other procurement processes that are appropriate." MSCG urges the Commission to commit at this time to the New Jersey-style auction process for the larger Pennsylvania utilities, and so amend the Proposed Regulations.

In order to assure the most fair and transparent CPP, and thus the greatest participation in CPPs by suppliers, the Proposed Regulations should be amended to allow each EDC to adopt only a New Jersey-style BGS auction. The New Jersey model involves a web-based electronic, declining-clock auction administered on behalf of the Commission and EDCs by an outside consultant, and has seen strong supplier participation and has yielded competitive results.

The New Jersey procurement process has been heralded as "one of the great successes of deregulation."[3] Indeed, the New Jersey Board of Public Utilities ("New Jersey BPU") President Jeanne M. Fox characterized the process as "extremely successful in getting the best price for consumers at the lowest possible wholesale cost,"[4] adding that wholesale bidding through an auction process "allows New Jersey's consumers to receive the benefits of competition at wholesale level . . . [and] provides an effective mechanism for securing the best price possible for ratepayers."[5]

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[3] Power Markets Week, *16 Win Bids to Supply N.J. . . . .*, (February 10, 2003). The Energy Power Supply Association ("EPSA") supported the results of the BGS procurement process, and an EPSA senior representative noted that, although some state officials were concerned with higher prices considering then-prevailing short-term prices and industry turmoil, the BGS wholesale supply price cleared lower than expected. *Id.*

[4] *N.J. Utilities Seek 12,500 MW; plan bid via internet for June 2004 deliveries*, Global Power Reports (October 30, 2003). Energy analysts have characterized the New Jersey procurement process as the "basis for a successful transition of basic generation services from a regulated environment to a market-based environment that today deliveries services at competitive prices, while at the same time ensuring that New Jersey customers experience no 'rate shock'". Energy Conservation News, Vol. 24, No. 11 (July 2002).

[5] *New Jersey Basic Generation Service (BGS) Auction Locks in Competitive Generation Prices for Customers*, New Jersey Board Press Release (November 5, 2003).

The Proposed Regulations should require that the EDCs together convene a working group ("Working Group") including suppliers and other market participants in order to develop the CPP implementation rules ("CPP Rules") for a New Jersey-style auction process.

II. Development of the Standard FSA Including Important Terms

In addition to developing the CPP Rules, the Proposed Regulations should be amended to require the Working Group to develop one, standard FSA to be entered into between a winning supplier and the EDC in each EDC's respective CPP. The standard FSA should be approved by the Commission before the auction. The FSA, as a common set of contractual documents, also will serve to decrease uncertainty for the EDCs and suppliers, and provide the most time- and cost-efficient method of implementing CPPs for all EDCs in Pennsylvania. A greater number of suppliers will participate in each EDC's CPP if suppliers have a clear understanding of the contract terms and requirements default service supply.

The Commission recognizes the value of having a common structure for CPPs as evidenced by Section 54.185(e) of the Proposed Regulations which states that the Commission "may direct that some or all default service providers file joint default service implementation plans" and that, without such a directive, "some or all default service providers may jointly file default service plans." MSCG encourages the Commission to amend the Proposed Regulations to *require* that all EDCs or, at the very least, all larger EDCs file a joint default service implementation plan including a standard FSA. By eliminating complex contract negotiation for each of the EDCs, potential suppliers will be able to focus their bids to compete only on their price for default service supply, which, in turn, will lead to lower prices for consumers. The development of one, common FSA also will simplify the contemplated bid evaluation process since price will be the only factor for comparison of bids.

Critical to the success of either CPP model, moreover, is that the Proposed Regulations mandate that the following provisions be included in the FSA for default service supply.

A. Bilateral Credit

The Proposed Regulations in Section 54.185(i) require all CPPs to include "reasonable credit requirements . . . of any [supplier's] ability to perform." While this language may protect EDCs from the possibility of a supplier default, it does not fully protect consumers from the possibility of financial risks of all parties involved in procuring consumers' electricity. Like an EDC, winning suppliers 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, the Proposed Regulations should be amended to apply this rule for reasonable credit requirements to both suppliers and EDCs. The Proposed Regulations also should be amended to require that FSA creditworthiness and credit support terms should apply *equally* to the supplier and the EDC. These "bilateral" credit terms will serve to protect consumers as well as suppliers from the possibility of the EDCs' financial insecurity. This, in turn, reduces the likelihood that a risk premium will be factored into potential suppliers' bidding prices to account for credit risks and, in turn, increases the likelihood of lower default service prices.

Furthermore, high credit-quality bidders that may participate in a CPP 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 either 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 will reduce credit risk and therefore likely lead to greater participation of high credit-quality suppliers in the EDCs' CPPs. Without such terms, however, potential suppliers may reduce or forgo altogether their participation in bidding for default service or otherwise factor unilateral credit risk into their bidding prices.

B. Alternate Guaranty Process

To encourage wider participation in CPPs, the Proposed Regulations also should be amended to allow, as an option, for suppliers to submit their own alternate forms of guaranty (including for unlimited amounts) in order to meet the credit standards established in accordance with Section 54.185(i) of the Proposed Regulations. This "Alternate Guaranty Process" should track the successful New Jersey BGS process which continues to allow suppliers to use their own forms of guaranty or to propose modifications to the EDCs' forms. A similar option should be available in any Pennsylvania CPP for several reasons, including:

- Guarantors' standard forms of guaranty have already been through internal approval processes and can be executed in a short period of time;
- Certain suppliers may already have provided their form of guaranty to a Pennsylvania EDC or ts regulated affiliate for other transactions;
- Generally, guarantors are comfortable regarding the enforceability of their standard forms of guaranty; and

- The standard power marketer parent guaranties tend to guaranty an unlimited amount, which should be the preference of any counterparty.

The New Jersey BGS policy and modified guaranties accepted under that process include among various requirements for modified forms of guaranty the following important provisions, which also would be appropriate in any Pennsylvania CPP:

1. New York law and jurisdiction should apply to the Guaranty. New York has highly developed legal standards in this regard and is accepted in the industry;
2. The guaranty must be an unconditional guaranty of payment of all amounts due by a bidder to the EDC;
3. The guaranty may be terminated upon not less than thirty (30) days advance written notice to the EDC and termination will not discharge liabilities and obligations of the guarantor that have been incurred before the effective date of the termination;
4. The guaranty must not be subject to any monetary limit;
5. The guaranty must be a guaranty of payment and not of collection; and
6. Assignment of the guaranty is not be permitted except with the prior written consent of the EDC, except that the guaranty should be assignable without consent to a successor entity to the supplier's business and include a release of obligations if the successor assumes all obligations.

C. Notional Quantity

The idea of "notional quantity" refers to termination payment calculation terms in the FSA. Specifically, the Proposed Regulations should require that, 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 included effectively 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 Default Service 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.[6]

Application of a notional quantity is beneficial because it renders the FSA a derivative for the purpose of mark-to-market ("MTM") accounting. This type of provision also maintains accrual accounting of the FSA for EDCs or any other winning bidder using accrual accounting. High credit-quality financial institutions and other potential suppliers of default service use MTM accounting as it allows them to account appropriately for the FSA and related hedges. By requiring such notional quantity language, bidders using MTM accounting are more likely to participate fully in a CPP because they can appropriately account for the FSA and related hedges. This would increase bidder participation and diversity, wholesale market liquidity, the likelihood of increased competition and lower price bids and, thus, lower default service prices for consumers.

D. Independent Third-party Oversight

Section 54.186(d) of the Proposed Regulations allows the Commission the option to use an independent third-party to oversee and monitor the CPPs. The Commission should amend the

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

Proposed Regulations to require the use of an independent third-party consultant to run the CPPs, such as that utilized effectively by New Jersey in its BGS auction process. New Jersey not only effectively utilizes an independent third-party CPP monitor in its BGS auction process, but appoints an independent auction manager as well. The independent manager and monitor provide to potential bidders added assurance that the auction will run as planned, and will be transparent and fair. Moreover, the independent manager and monitor relieve the New Jersey BPU and EDCs of the burden of running the CPP. The Commission should amend the Proposed Regulations to require the use not only of an independent third-party monitor, but of an independent third-party CPP manager as well.

III. Commission Review of CPP Results

Section 54.186(f) of the Proposed Regulations lays out the method in which the Commission will review the results of an EDC's CPP. The Proposed Regulations state that the time period for the Commission's review *will be not less than* three (3) business days, and that the specific time period allotted for review will be identified in each EDC's approved CPP implementation plan. In addition, with respect to the scope of Commission review, the Proposed Regulations in Section 54.188(e) state only that the Commission will conduct a review and reject a CPP's results due to non-compliance with the approved CPP implementation plan.

The Proposed Regulations should be amended, however, to limit more specifically the time and scope of the Commission's review. As in New Jersey's BGS process, the Commission should finalize CPP results within two (2) business days after an EDC's CPP ends and announce concurrently the final prices and winners. The Proposed Regulations should not allow the Commission to delay announcing winners or otherwise provide for a review period, unless there is evidence of a rule violation or other misconduct.

If the Proposed Regulations state prior to commencement of the CPPs the Commission's intention to announce the auction results and winners promptly, bidders will rely on this added certainty when they formulate their bids. When suppliers place their bids, they must hedge their positions to support the price they bid. The longer it takes the Commission to finalize the auction results, the more risk the bidders take with respect to their hedge positions. Suppliers must factor that risk as a premium into the bid price. Thus, if the Commission establishes rules ensuring finality of auction results quickly, substantial risk premiums to cover regulatory uncertainty and delay can be avoided.

The Commission's option to review a CPP's results creates a financial risk for potential winning suppliers. Under the Proposed Regulations, a bidder faces little or no certainty -- and thus significant risk -- when it formulates its supply and hedging strategy and is awarded load to serve through a successful, cleared auction, but faces still the possibility that the Commission will reject the bid for discretionary reasons, including perhaps for reasons related to the auction clearing price level. A potential supplier cannot effectively hedge the regulatory risk associated with awarded load without incurring price risk on its hedge position if it ultimately does not need the hedge position because the Commission rejects the CPP results. This risk may result in higher offer prices from suppliers. Moreover, such risk may be so high as to cause suppliers to limit their participation or refrain altogether from participating in the auction. Adopting more specific regulations limiting the acceptable reasons for rejecting auction results only to bidder wrongdoing or material auction implementation flaws will mitigate supplier risk and result in better price discovery, more robust participation and, in turn, a more competitive default service price for customers.

IV. Conclusion

MSCG appreciates the opportunity to provide its initial comments with respect to the Commission's Proposed Regulations. If the Proposed Regulations, CPP Rules and FSA are designed correctly, the EDCs' CPPs will attract sufficient quality market participants in a manner that will allow the Commission to bring reasonably-priced default service to Pennsylvania's retail consumers.

Respectfully submitted,

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