

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Implementation of the Alternative Energy : Docket No. M-00051865
Portfolio Standards Act of 2004 :

Rulemaking Re :
Electric Distribution Companies' :
Obligation to Serve Retail Customers at the : Docket No. L-00040169
Conclusion of the Transition Period :
Pursuant To 66 Pa. C.S. §2807(e)(2) :

**COMMENTS OF DIRECT ENERGY SERVICES, LLC
CONCERNING ADDITIONAL ISSUES**

By Order entered November 18, 2005 at the above referenced dockets, the Commission reopened the comment period in the post-transition period Default Service rulemaking to consider additional issues primarily related to the Alternative Energy Portfolio Standards Act of 2004 ("Act 213" or "Act"). By Secretarial Letter issued February 8, 2006, the Commission requested written comments on eight (8) specific issues, and permitted comments on other Act 213 issues relevant to those listed.

Direct Energy Services, LLC ("Direct Energy" or "Direct") has been actively involved in the Commission's post-transition Default Service (POLR) roundtable discussions and rulemaking. With respect to Act 213, Direct Energy's primary concerns are that the Act be implemented in a competitively neutral manner and that the compliance thresholds be achievable. Direct's concerns are largely addressed by the Act's directive that the costs incurred under the Act are to be considered costs of generation supply under the post-transition POLR pricing standard of "prevailing market prices," and the force majeure provisions which permit

modification of the compliance obligation within a reporting period if alternative energy resources are not “reasonably available in the marketplace in sufficient quantities” for companies to meet their obligations.

Direct submits that these two provisions demonstrate that Act 213 is to be implemented in a manner that relies upon competitive market solutions rather than regulation. This, in turn, is entirely consistent with the directives in the Electric Choice and Competition Act¹ that the goals of the Choice and Competition Act are to be met through competitive market forces, as the Commission acknowledged in its Notice Of Proposed Rulemaking ("NOPR") order:

The Commission . . . finds that an appropriately crafted regulatory framework for POLR service **will serve the public interest by fostering a robust retail market for electricity**. The General Assembly’s policy findings regarding the overall costs of electricity, disparities in rates across service territories, and the importance of reasonable rates in attracting and retaining businesses **can best be addressed by ensuring the continued formation of a competitive marketplace for electricity**. 66 Pa. C.S. §§2802(4), (5), (6).

To foster a competitive market, any POLR service model must be carefully designed to avoid distortions to the market. POLR service, as the name suggests, should primarily serve as a **backstop to the competitive retail market**. . . . The Commission is proposing a POLR service model that avoids administrative determinations and **gives preference to market solutions**. The Commission finds that **with an appropriate design of POLR service, the market will provide the products and services that meet the needs of consumers**.²

Accordingly, Direct Energy reserves comment on the specific Act 213 issues for the reply comment period, and focuses these comments on the need to correct the fundamental problem with the Commission's proposed design and market structure of post-transition POLR service.

¹ Electricity Generation Customer Choice and Competition Act, 66 Pa. C.S. §§ 2801-2812.

² *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)*, Docket No. L-00040169, Order entered December 16, 2004, at 5 (emphasis added).

Despite the Commission's acknowledging the need to design post-transition POLR service to avoid distortions to the market and to give preference to market solutions, the Commission has proposed a long-term (one year or longer) "wholesale auction-derived default price" approach that distorts market price signals and therefore does not give preference to market solutions. Moreover, the "interim" POLR plans approved pending promulgation of the final POLR regulations adopt this approach (with the exception of Duquesne's Hourly Priced Service for Large Customers) and will therefore do nothing to advance their stated purpose of further "transitioning" rate-cap customers to market prices because retail customers will continue to be insulated from the prevailing market prices of electric power commensurate with the use of the power. Accordingly, Direct Energy submits comments concerning the following questions:

7. Should the Commission delay the promulgation of default service regulations until a time nearer the end of the transition period, as suggested by the Independent Regulatory Review Commission in its comments on the proposed regulations?
8. Does the Commission need to make any revisions to its proposed default service regulations to reflect the mandates of the Energy Policy Act of 2005?

I. The Commission should take as much time as is available to promulgate the default service regulations.

Consistent with the comments of the Independent Regulatory Review Commission ("IRRC"), the Commission should take advantage of the long lead time until the final regulations are needed to review which competitive retail markets are working – and which are not – and apply the lessons from these markets in developing its final regulation for post-transition POLR service.

In its comments, IRRC suggested that the Commission consider defer moving to publish its proposed rules as a final-form regulation immediately and instead take the opportunity to consider additional data and approaches (i) that have become available since the Commission drafted its proposal, and (ii) that may become available in the next few years before the major

utilities' transition periods expire at the end of 2009 (PPL) and 2010 (West Penn Power, Penelec, Met-Ed and PECO). IRRC listed five (5) reasons for its suggestion:

- The Commission's recognition that the retail and wholesale energy markets will continue to evolve between now and the expiration of the last EDC rate caps in 2010, and the difficulty of drafting regulations today that match tomorrow's markets
- The Commission's recognition that changes to Federal and State law could affect this rulemaking and, thus, have a dramatic affect on how energy companies acquire electricity
- The opportunity to gain knowledge from the experience of other states that are transitioning from a regulated to a competitive electric market
- The opportunity to use the experiences from the interim POLR plans established for those EDCs whose transition periods have ended
- The opportunity to use interim POLR plans to consider pilot programs

The Commission has accepted IRRC's suggestion in part by providing for additional comment on issues related to changes to Federal and State law – the Energy Policy Act of 2005 and Act 213. Direct suggests that the Commission embrace the opportunity to use the additional time available to learn from and apply the experiences from the interim POLR plans and other states' approaches that show which default service market structures are working and which are not – and to craft final regulations that will truly foster a robust retail market for electricity for all retail consumers in Pennsylvania. This approach permits the Commission to avoid problems related to premature action and benefit from the most recent information.³

³ For example, Ohio's post-market development period was to begin January 1, 2006. However, post-market development period regulatory solutions were put in place in 2000, only to be revisited and in some cases completely revamped in 2003 and 2004. *See, e.g.*, Public Utilities Commission of Ohio 2004 End of Year Review "Ohio Electric Choice Update" at http://www.puc.state.oh.us/puco/mediaroom/annualpublications.cfm?doc_id=1331. Thus, Ohio was required to revisit issues to deal with changing market conditions even before implementation of the state's statutory post-market development period plan could occur.

The experiences from the interim POLR plans approved by the Commission⁴ demonstrate that the annual or longer "wholesale auction-derived default price" approach does not foster the development of retail electric competition – and permit the market to provide the products and services that meet the needs of retail consumers - any more than the rate cap period "shopping credit" approach did. Current shopping statistics show that these long-term POLR procurements have produced virtually no competitive retail market development among residential and smaller commercial consumers in Pennsylvania.⁵ The POLR III 3-year fixed rates for Duquesne's residential and small commercial customers have actually resulted in less retail competition. The percentage of Duquesne's residential and commercial customers being served by EGSs during the last year of POLR II (2004) hovered around 24%. During the first year of the POLR III 3-year fixed rates, this percentage declined slightly to around 22%-23%, but as of January 1, 2006, has declined to 19.7%.⁶

The lack of retail market development for residential and small commercial customers in other states with long-term and "laddered" wholesale POLR procurements is the same.⁷ The Maryland PUC has squarely rejected one and two-year "blended" contracts for small business customers (Type II-B; peak load contribution (PLC) 100 kW or less). The Maryland PUC concluded that this approach "represents a step away from market-based rates, and the Commission find this [approach] inconsistent with the statutory requirement that the

⁴ The Commission has approved interim POLR plans for small market EDCs (Citizens Electric of Lewisburg, Wellsboro Electric Company, UGI Utilities - Electric Division, and Pike County Light & Power Company) and larger market EDCs (West Penn Power Company and Duquesne Light Company), and is currently considering Pennsylvania Power Company's interim plan.

⁵ See, OCA shopping statistics at <http://www.oca.state.pa.us/cinfo/instat.htm> .

⁶ *Id.*

⁷ See, <http://www.bpu.state.nj.us/energy/elecSwitchData.shtml> (NJ); <http://www.psc.state.md.us/psc/electric/enrollmentrpt.htm> (MD).

Commission create competitive retail electricity markets."⁸ The Commission also concluded that such blended contracts "could potentially make it more difficult for retail providers to compete in the market place."⁹ Direct suggests that the shopping statistics cited above demonstrate that the difficulty is not potential, but real.

The reasons long-term and blended wholesale procurements have not produced sustainable retail competition are two-fold. First, long-term wholesale POLR procurements reflect "prevailing market prices" only at the time of bidding. Second, these models do not produce lowest cost energy supply. The long-term prices include risk premiums that are not required in monthly procurements advocated by Direct Energy for residential and small business customers.

The first point is illustrated by the present situation in the market of Pike County Light & Power Company ("Pike County"), which the Commission is presently investigating. The 70% increase in Pike County's POLR rates from 2005 to 2006 reflects the fact that the auction was conducted during a peak in natural gas prices. The second point is illustrated by the well understood principle in commodity markets that the further out purchases go, the larger the spread between "bid" and "ask" prices – and the thinner the relevant market becomes. As a market becomes thinner, it becomes less “liquid” and risk premiums increase. This lack of liquidity leads to locking in prices that are less likely to reflect market conditions the further out the purchasing goes, when delivery occurs. This, in turn, imposes a price risk premium on these customers that they do not realize, and that they might not be willing to pay if the choice were transparent, as with monthly procurement and pricing.

⁸ In the Matter of Default Service for Type II Standard Offer Service Customers, Case No. 9037, Order No. 80272 (September 20, 2005) at 1, 2-3.

⁹ *Id.* at 8.

The Commission should not ignore the reality of these experiences and simple economic principles, and establish in regulation a POLR service design and market structure that has proven not to foster the development of properly functioning and workably competitive retail electricity markets. Nor should the Commission succumb to the rhetoric that market responsive retail POLR prices – such as monthly prices for residential and small business customers, and hourly prices for large business customers – make retail POLR prices "ugly" or "unattractive."

It is hardly “ugly” to offer the lowest possible POLR price to non-shopping customers. As shown, monthly prices will have lower overall risk premiums and therefore will cost less over time than longer term procurements. Also, it is hardly “ugly” to provide retail consumers with a workably competitive retail electricity market in which they will be able to choose from a variety of products and services. Finally, it is hardly “ugly” to offer monthly priced POLR service simply because of the mistaken belief that the Choice and Competition Act entitles retail consumers to long-term fixed POLR rates in the post-transition period.

Indeed, nowhere in the Choice and Competition Act does it state that retail consumers are entitled to long-term fixed POLR rates in the post-transition period; Section 2802(9) states only that customers are entitled to electric service "on reasonable terms and conditions."¹⁰ In conjunction with the directive that electricity for POLR customers in the post-transition period is to be acquired at prevailing market prices – and the fact that prevailing market prices vary – Section 2802(9)'s directive must be interpreted to require more frequent changes in POLR prices than annually fixed rates. Otherwise, customers are provided with false market price signals that prevent the competitive market from delivering the products and services that meet the needs of retail consumers.

¹⁰ 66 Pa. C.S. § 2809(9).

This point about providing false signals to consumers is critical for getting the post-transition POLR market structure "right." In many markets that have chosen to go with a non-market responsive default service programs, such in Pike County, Delaware and Maryland, retail consumers have been faced with significant rate shock at the end of the fixed price period.¹¹ Rather than signaling over time the fact that prices can and will fluctuate, consumers are led to believe that prices are stable. In these markets, wholesale prices have already retreated somewhat from the high levels experienced at the singular point in time when those respective auctions were held. Yet because the POLR supply is contracted for a long period of time, the customers in those markets are now being burdened with above market electricity costs.

The Commission should reject the common arguments that residential and small business customers are not capable of tolerating the variability of monthly pricing; that the variability is frequent and extreme; and that the consumers are incapable of responding to changing prices in a manner that will impact prices. All of these assumptions are false. Natural gas prices for residential customers have changed quarterly for many years,¹² demonstrating that residential customers are accustomed to frequent energy price changes.¹³ Moreover, small consumers do modify their behavior when faced with price changes, and their responses ultimately impact the

¹¹ <http://www.state.de.us/governor/news/2006/02february/020706energyexecutiveorder.shtml#TopOfPage> (Delaware); http://www.psc.state.md.us/psc/aboutus/Press/MitigationPlanBGE_03062006.pdf (Maryland).

¹² See, 66 Pa. C.S. § 1307(f); 52 Pa. Code § 53.64(i)(5).

¹³ Direct is not suggesting that a gas cost recovery type process be used to adjust retail electric POLR prices. The Commission has confirmed that, for many reasons, this process does not reflect prevailing market prices. *Investigatory Gas Competition Report*, Docket No. I-00040103, Order entered October 6, 2005, at 4-5 ("The record indicates that natural gas distribution companies tend to act as price leaders in their respective service territories because many customers are not aware that that the commodity price of natural gas, i.e., the 'Price to Compare' or 'PTC,' is a quarterly reconcilable price, based on projections, rather than a fixed annual price. . . The regulatory lag in establishing and implementing quarterly price adjustments by natural gas distribution companies tends to mask the current market price of natural gas.").

overall marketplace. For various reasons, gasoline prices reached record highs in the fall of 2005. Consumers saw those prices posted in front of each and every gas station and responded by altering their driving behaviors in such a manner that consumption was reduced. In a few weeks' time, gas prices dropped dramatically, demonstrating that small consumers can respond to price signals and that their responses can affect prices. With respect to electricity usage, it is not necessary that residential or small business customers be invested in advanced metering technologies in order to respond to market prices. But they must know what those market prices are if they are to respond at all and not be deluded into believing that electricity prices do not fluctuate or that they cannot respond to prices and positively affect their energy expenditures.

Finally, there is an increasingly impressive body of evidence that default pricing which more accurately reflects actual changes in retail energy prices on a basis that is closer to "real-time" than annual (or even less frequent) wholesale auctions helps to promote the development of a competitive market and provides benefits to all consumers. Direct has conducted two studies of hourly or monthly energy pricing which also demonstrates this. In the first study of residential customers of Boston Edison Company (BECO), Direct compared the energy costs that residential customers would have experienced under BECO's default service rates to the costs if procurement had been from the hourly day ahead market (with 5% of the energy demand procured in real time). The results are surprising: if residential customer default service had been priced on the basis of day ahead energy market prices (as described above), these customers would have saved nearly \$11 million – approximately 10% – compared to the prices they actually experienced using the actual, fixed default energy prices in place in 2004.

Direct made the same comparison for PECO's residential customers from 2000-2004. Again, these customers would have paid less if they had been subject to a monthly average price. The result: customers would have realized savings of as much as \$171.6 million over the 4-year

period – again, a savings of approximately 9.4%. This study also shows that the few higher priced months are more than offset by the more lower priced months, so customers are better off over the year.

Recent evidence also shows that in each deregulated market in which POLR prices are reflective of market prices, competitive suppliers will vie to serve residential customers. . This is happening in Texas, where over 35% of residential load and 28% of residential customers are not with the default provider, representing over 1.7 million households.¹⁴ If residential customers (or for that matter, any customers) want long-term and/or fixed-price contracts, the market will supply those products. If these customers want contracts of varying lengths, the market will supply those products as well. Some residential customers may, however, be able to tolerate a relatively few higher priced months of electricity in order to obtain the long-term cost benefit from the lowest possible POLR service. These customers may choose to remain on the monthly POLR service without the cost associated with long-term contract premiums. EGSs are also vying for residential customers in the markets of New York utilities without fixed price default service for residential and small business customers.¹⁵

With respect to larger business customers, the Commission need look no further than Duquesne's Large Customer market for proof that hourly pricing is the post-transition POLR service market design that will foster the development of the competitive retail electric market for these customers. Duquesne's Fourth Compliance Filing in its POLR III case discloses that as of December 31, 2005, over 90% of the Large Customers (peak demands of 300 kW and above) and over 96% of the Large Customer load (excluding Rule 4 Load) is served by electric

¹⁴ See, http://www.ercot.com/mktinfo/retail/trans_rpt/Number_Premises_Switched_EOM_2005_12.ppt .

¹⁵ See, http://www.dps.state.ny.us/Electric_RA_Migration.htm

generation suppliers.¹⁶ This demonstrates that EGSs and the competitive market have responded as the Commission anticipated.¹⁷

The evidence from other states is the same. Where large business customers have: (1) only hourly POLR service pricing, as in Maryland and New Jersey; or (2) no price-regulated default service, such as in Texas, the competitive retail market has responded with products and services these customers want, thus providing greater opportunities for retail competition as well as greater financial savings and enhanced products and services for these customers, as well as system reliability and environmental benefits. In Maryland, approximately 80% of large commercial customers – those whose default service is hourly pricing – are being served by competitive retailer suppliers.¹⁸ In one Maryland utility service territory, the number of large customers being served by competitive suppliers exceeds 90%. In New Jersey, nearly 65% of the customers with hourly priced default service are being served by competitive suppliers. Thus, where default prices reflect prevailing wholesale market prices, the retail market has developed and retail suppliers have engaged with customers to deliver the products and services the customers desire.

This more recently available information should convince the Commission that the way to get the post-transition POLR market structure "right" is to require monthly priced POLR service for residential and small business customers, and hourly pricing for large business customers. The experiences from the retail market structures that are working demonstrate that this the post-transition POLR market structure that will both satisfy the legal standards governing

¹⁶ Docket No. P-00032071, Duquesne Fourth Compliance Filing (January 9, 2006) at 10-11.

¹⁷ *Duquesne POLR III*, Reconsideration Order entered October 5, 2004, at 24: "The record in this proceeding provides strong support for the proposition that the competitive market in Pennsylvania will respond to Duquesne's POLR service in a manner that creates more and better energy services and products for large customers than are currently available."

¹⁸ See, <http://www.psc.state.md.us/psc/electric/enrollmentrpt.htm> .

post-transition POLR service and foster the development of a properly functioning and workably competitive retail electricity market, as envisioned by the Choice and Competition Act. Importantly, prices that better reflect the actual cost of using electricity as the customer uses it encourage customers to use energy efficiently and help customers understand the value of demand response and energy conservation. This, in turn, helps to mitigate peak prices and thus has other advantages that ultimately benefit all electricity consumers and users of electric grid by helping to delay, defer, or reduce the need to build additional generation and transmission infrastructure. Finally, given that monthly and hourly priced default service will be priced more closely to the underlying movements in the wholesale markets, competitive retail suppliers will have an on-going opportunity to bring innovative products to end-use consumers, as in Texas and New York (in markets where there is no fixed rate default service).

II. The Commission should revise its proposed default service regulations to reflect the mandates of the Energy Policy Act of 2005.

The Commission is considering revising its proposed regulations to reflect the mandates of Act 213, and should do the same with respect to the Energy Policy Act of 2005 ("EPACT"). EPACT requires states to consider five (5) standards in the Public Utility Regulatory Policy Act ("PURPA") concerning net metering, smart metering, interconnection, fuel source diversity and fossil fuel plant efficiency.

Most relevant to this rulemaking for post-transition POLR service are the areas of smart metering and time-based rates. Examples of the time-based rates envisioned by EPACT include time-of use pricing, critical peak pricing and real-time pricing.¹⁹ It is clear that time-based utility pricing is the public policy of the United States, and it should be equally clear that time-based

¹⁹ *Id.* (adding 16 U.S.C. § 2621(d)(14)(B)).

utility POLR rates are entirely consistent with the standards governing post-transition POLR service.

Thus, time-based POLR rates should be incorporated into the Commission's post-transition POLR regulations because this pricing structure will spur the development of the competitive retail electric market. Competitive retail suppliers will be able to compete more efficiently against prices that follow more closely actual wholesale market costs. Competitive suppliers can offer products secure in the knowledge that default prices will more or less follow the market. Whether the competitive suppliers offer long-term or shorter term fixed price products, or products that vary in accordance with the market – or a combination thereof – the suppliers will be able to offer products that will be attractive to consumers, thereby giving consumers additional incentives to shift to competitive offerings. As IRRC stated in its comments: "[E]lectric energy acquired at true prevailing market prices and sold to customers at rates that reflect those prices is the most appropriate way to bring true choice and competition to the citizens of Pennsylvania."²⁰

III. Conclusion

Direct Energy submits that the Commission should defer immediately moving to promulgate its post-transition POLR service regulation in final form, and take the opportunity to learn what default service market structures are working and – more importantly, not working – and use that information to develop final regulations that will develop sustainable retail electric competition in Pennsylvania. Direct submits that where post-transition POLR service for larger business is priced on a real-time basis while the price for residential and small business customers reflects monthly market prices, robust retail electric competition will flourish in Pennsylvania. The Commission should adopt this approach in its regulations to give

²⁰ IRRC Comments at 1, §1.

competitive markets the chance to work as envisioned by the Choice and Competition Act - and not die a premature death caused by the market distortions of stranded cost collections, rate caps, long-term POLR procurements and fixed-rate POLR service.

Respectfully submitted,

A handwritten signature in black ink that reads "Kevin J. Moody". The signature is written in a cursive style with a large, prominent "K" and "M".

Kevin J. Moody, Esquire
Wolf, Block, Schorr & Solis-Cohen LLP
212 Locust Street, Suite 300
Harrisburg, PA 17101
(717) 237-7160

Counsel for Direct Energy Services, LLC