

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

In the Matter of the Pennsylvania	:	
Public Utility Commission	:	Docket No. M-00061957
Investigation into Policies to Mitigate	:	
Potential Electricity Price Increases	:	

**INITIAL COMMENTS OF
CONSTELLATION ENERGY GROUP COMPANIES**

I. INTRODUCTION

On May 19, 2006, the Pennsylvania Public Utility Commission (“Commission”) adopted its order in the above docket to initiate the process of developing policies to mitigate higher electricity prices (“Investigation Order”).¹ Constellation Energy Commodities Group, Inc., Constellation Generation Group, LLC and Constellation NewEnergy, Inc.² (collectively, “Constellation”) commend Commissioner Fitzpatrick and the Commission as a whole for their foresight and initiative to address the issues associated with the development of successful competitive markets in advance of the expiration of rate caps in the Commonwealth.³

In response to the Commission’s request, Constellation respectfully submits to the Commission its initial comments on several of the issues in the Investigation Order as well as

¹ *Investigation Order on Policies to Mitigate Potential Electricity Price Increases*, Commission Docket No. M-00061957 (Adopted May 19, 2006).

² Constellation NewEnergy, Inc. also is jointly submitting additional Initial Comments with NRG Energy Center Pittsburgh.

³ 66 Pa. C.S. § 2801, *et seq.*

several raised by Commissioner Bill Shane in his Statement accompanying the Investigation Order.⁴

Through its initial comments, Constellation urges the Commission to be careful to maintain the integrity and competitiveness of wholesale and retail markets as the best way to mitigate rate shock, if any, that consumers may face upon the expiration of rate caps. As expressed in Commissioner Shane's Statement, competitive markets function most efficiently when they reflect demand and supply dynamics and are not driven towards a particular outcome through regulatory or political intervention.

II. COMMENTS ON SPECIFIC ISSUES

A. Issue 1: Educate Customers and Issue 2: Encourage Conservation.

In its Investigation Order, the Commission asks parties to comment on the value of an educational campaign in advance of the expiration of rate caps in order to educate customers on how to best manage their budgets. The Investigation Order also asks for comments on educating customers to encourage conservation as a strategy for coping with higher energy costs.

Constellation supports both of these initiatives. Constellation agrees with Commissioner Fitzpatrick that consumer education programs initiated well in advance of the expiration of rate caps can help customers to plan for and adjust to changes in energy prices.⁵ The Commission can play an important role in educating customers, particularly residential customers and low income customers, about how electricity markets work, the factors that contribute to energy prices, and how customers can help manage their energy prices. The Commission has in the

⁴ *Statement of Commissioner Bill Shane*, Commission Docket No. M-00061957 (May 19, 2006) ("Shane Statement").

⁵ *Motion of Commissioner Terrance J. Fitzpatrick*, Commission Docket No. M-00061957 (May 19, 2006) ("Fitzpatrick Motion") at p.3.

past, and can again, play an important role in educating customers about their ability to select alternative suppliers and about simple conservation measures.

B. Issue 3: Reducing Peak Demand for Electricity.

The Commission in its Investigation Order asks parties to comment on methods to reduce peak demand for electricity. In its explanation of the issue, the Commission mentions that strategies that could be utilized to encourage reductions in peak demand include, among other methods, hourly pricing for large customers and monthly or time-of-day pricing for default service.⁶ Monthly or hourly pricing for larger commercial and industrial customers will encourage more competitive markets by attracting competitive electric generation suppliers (“EGSs”), which will in turn exert downward pressure on EGS price offerings. However, Constellation urges the Commission to refrain at this time from implementing a monthly or time-of-day pricing structure for default service for residential and small commercial customers.

Residential and smaller customers are not in the same position to manage the risks associated with a default service product based on short term procurements. As compared to larger commercial and industrial customers, these customers have neither the resources nor the market sophistication to manage such risks nearly as well as wholesale suppliers. Moving to monthly or time-of-day default service for these customers will, in effect, shift to smaller customers those risks which suppliers could better manage in longer-term default supply auctions. Default supply auctions in Maryland and New Jersey each have experienced several years of successful operation, attracting numerous wholesale suppliers, providing competitive prices to residential customers and encouraging development of competitive markets in those

⁶ Investigation Order at pp.5-6. Consistent with the Commission’s proposed rules, by “larger commercial and industrial customers” Constellation refers to customers with a load equal to or greater than 500kw/hr.

states. The Commission should look to those states' models to ensure the regulatory certainty needed for procurement auctions to be successful.

C. Issue 5: Consider Alternatives for Avoiding Abrupt, Large Price Increases.

In its Investigation Order, the Commission asks about ways to avoid “sudden, abrupt retail price increases” and correctly identifies the advantages and disadvantages of phasing-in higher energy costs before the end of the deferral period. The question to consider, then, is what steps the Commission now needs to take to complete the transition to competitive markets in Pennsylvania. Because the Commission has the foresight to ask these questions now, it is uniquely positioned to avoid the political turmoil confronting customers and policy makers in Maryland and elsewhere that are facing the expiration of long-standing price caps as world energy prices rise.⁷ Price caps have had the effect of sheltering customers from the effects of rising energy prices and, in a rising price environment, precluding entry by new market participants.⁸ Thus, the real challenge facing the Commission is to avoid unnecessary rate shock while continuing to promote the development of robust competitive markets that will ultimately provide the best way for customers to manage energy costs.

While customers everywhere are facing increasing energy costs, it is undisputed that well-functioning competitive markets put downward pressure on prices and provide efficiency and environmental benefits to consumers.⁹ In evaluating what options to pursue, the

⁷ Recent experience in Maryland indicates that an abrupt, significant increase in residential prices can be politically untenable. While it impossible to time the market, experience in Maryland suggests that as Pennsylvania gets closer to the end of its transition period, the Commission should carefully consider whether and how preemptive measures can ensure a minimally disruptive transition to market based prices. Such preemptive measures could include adjusting rates prior to cessation of a transition period or other mechanisms to blend prices over some period of time.

⁸ It is important to note that high prices that emerge from lifting price caps is being blamed on competition, when precisely the opposite is true: price caps are the most pervasive form of regulatory intervention and suppress competitive market signals.

⁹ CERA, *Beyond the Crossroads*, 2005; Global Energy Decisions, *Putting Competitive Markets to the Test*, 2005.

Commission's primary goals must be to ensure that market forces are allowed to work and to foster competition. However, Constellation cautions the Commission against trying to predict and manage fuel costs and electricity prices in the future. As Commissioner Fitzpatrick correctly notes, "we cannot predict with certainty the future course of energy prices."¹⁰ In a competitive market, prices inevitably rise and fall; natural gas prices were lower in March and early April than they were last winter or they are now.

It simply is not possible for regulators (or anyone else) to accurately predict the perfect moment to buy or sell at the lowest possible price. Therefore, the Commission should focus its efforts on creating stable and predictable market rules designed to establish reliable default service procurement, as well as policies that promote the development of competitive retail markets. A well-designed procurement model should attract both wholesale and retail suppliers and create the downward pressure on prices needed to assure that even non-switching customers are well served by competitive markets in Pennsylvania. Market rules should also encourage participation by existing retail suppliers and entry by new suppliers as well as the development of new and innovative products so that competitive markets can provide benefits to those customers interested in shopping for energy supplies.

There is plenty of evidence that trying to "manage" markets to the perfect outcome is fraught with danger. California's initial strategy of forcing utilities into daily spot markets was flawed, as was its reaction of proceeding to lock-in longer-term contracts at the top of the market. Pennsylvania should avoid these extremes and design a procurement model that balances procurements over a reasonable period such that customers do not face rate shocks or wild price swings but realize the benefits of competition. The Commission should also consider

¹⁰ Fitzpatrick Motion at p.2.

when and how to implement competitive procurement plans to complete the successful transition to competitive markets.

D. Issue 6: Review Interplay with the Wholesale energy Markets.

The Commission also asks parties to review and comment on “the current wholesale electricity market structure and its interplay with [Pennsylvania’s] retail market.”¹¹ In addition, Commissioner Shane in his Statement specifically asks parties to consider: (1) multiyear contracts for default energy service supplies, similar to those used in New Jersey’s portfolio structure;¹² and (2) whether it is “reasonable public policy to make default service ‘ugly’ simply to encourage fixed price offers from competitive [EGSs].”¹³ Maintaining carefully the integrity and competitiveness of wholesale and retail markets through well designed default service procurement models for each of Pennsylvania’s EDCs will provide the most competitive default service prices and thus best serve to mitigate rate shock, if any, that consumers may face. However, it is important to keep in mind that wholesale market policies are continuing to evolve in PJM Interconnection, LLC (“PJM”) as the Commission works to transition to competitive retail markets in Pennsylvania. Numerous issues that will ultimately shape the competitiveness of wholesale procurements in Pennsylvania are under discussion with PJM and at the Federal Energy Regulatory Commission (“FERC”).

The PJM Annual State of the Market Report clearly and comprehensively documents the continuing competitiveness of the PJM markets. Nonetheless, continued improvement is necessary and in fact is underway in two key areas: (1) capacity market development and scarcity pricing; and (2) market mitigation. Pennsylvania has been actively involved in the PJM

¹¹ Investigation Order at p.8.

¹² Shane Statement at p.2.

¹³ Shane Statement at p.3.

processes (both informal stakeholder and more formal processes at FERC) and Constellation urges the Commission to continue to participate in these forums and support wholesale market development in PJM.

1. Default Service.

In considering the role of default service contracts, the Commission should strive for a balance that provides ratepayers rate stability, allows suppliers to compete in a non-discriminatory manner for customers, and permits customers to choose the electric service they believe will be most economical or desirable based upon their particular needs. Default service should be neither “ugly” nor “pretty,” but simply a “plain vanilla” option that allows non-switching customers to see the benefits of wholesale competition and the downward pressure that competition puts on energy prices.

Constellation supports Commissioner Shane’s enthusiasm for competitive procurements such as those in New Jersey. As explained by Commissioner Shane:

New Jersey has attempted to manage rapidly escalating energy prices through the use of staged multi-year long-term contracts. By using a portfolio of contracts, New Jersey has been able to cushion the impact of volatile energy costs on consumers.¹⁴

Constellation notes that “long-term” contracts of the length that have been utilized in New Jersey achieve an effective balance between obtaining the most competitive price and providing the most stable product for default service consumers. Moreover, the Commission may consider, as suggested by Commissioner Shane, a portfolio approach to supply default service load for residential customers such as that utilized in New Jersey. The risks to residential customers of price fluctuations, including drastic price increases, can be mitigated through a

¹⁴ Shane Statement at p.2.

portfolio approach of contracts with varied terms, which ties the costs of default service more closely to changing market prices, while continuing to offer reliable supply.

Regardless of whether the Commission chooses to support a portfolio approach for residential customers, Constellation believes that the Commission should be careful in choosing the term lengths of default service contracts due to (1) issues regarding the lack of liquidity in the market for contracts of more than three years in length, (2) the lack of available tools for hedging such contracts and (3) regulatory uncertainty affecting the PJM market.

Currently, the wholesale market overall is not sufficiently liquid to support default service contracts with term lengths greater than three years, although there is a fairly liquid market for energy beyond that period. A default service contract, however, requires both ancillary services and reserves in addition to energy and those markets are not sufficiently liquid outside of the three year period. Liquidity for those additional products is expected to develop over time, but it would be premature to seek contracts today for a full requirements service over a longer time frame. A longer-term auction is likely to result in suppliers including a higher risk premium in order to compensate for that illiquidity, which will add additional costs to consumers.

In an illiquid market, there is a dearth of product offerings due to a lack of buyers and sellers. This, in turn, results in buyers and sellers being less willing to enter into transactions, as each views the long-dated uncertainty differently. Sellers are likely to demand a bigger risk premium and buyers are likely to demand steeper discounts. The result is that the market becomes less efficient and this reduction in efficiency may reduce the benefits of competition. Greater liquidity in a market (such as that in shorter term markets) means there are many buyers and many sellers, which leads to competitive, downward pressures on prices. This creates

greater incentives for buyers and sellers to develop and trade energy products with innovative structures and competitive prices. Bidders obtaining supply from such competitive, liquid markets pass the benefits of more competitive market prices directly to consumers through more competitive bids for default service supply. If the Commission were to seek contract terms of five years, consumers may be harmed because they would pay higher costs for default service through supplier bids that reflect the higher costs for acquisition of products from an illiquid wholesale market.

In addition, suppliers are faced with a limited pool of long term hedging tools, such as financial and physical contracts. If market participants are unable to hedge their positions for long term contracts, they are less likely to participate in markets for such contracts. With respect specifically to default service supply, for instance, bidders will have to reflect in their default service bid prices their risks for being unable to hedge their entire obligation.

Finally, illiquid markets result also from an enormous number of regulatory uncertainties that currently exist in the PJM market for which resolutions are expected by 2008. Currently a number of structural changes are being proposed in PJM, especially related to its capacity construct, transmission rates and the implementation of marginal losses. Because it is unclear how these proposed changes to the PJM market will be structured and function, and because there is no pricing history regarding such market constructs, market participants (including default service bidders) may be extremely reluctant to commit themselves to longer term contracts (or else, as noted above, charge very large risk premiums). For these reasons, until these new PJM rules have been implemented and market participants have had adequate time to gain experience operating under them, Constellation strongly urges the Commission to choose

procurement processes that obtain supply contracts with one to three year terms, perhaps through a laddered portfolio approach for residential customers as utilized in New Jersey.

2. Locational Marginal Prices

Commissioner Shane raised certain issues regarding incentives to reduce Locational Marginal Prices (“LMPs”). LMPs are not “bad” or “good;” they merely reflect the costs associated with producing and delivering energy from the point of production to the ultimate consuming load. These costs would exist regardless of LMPs’ existence. However, the benefit of LMPs and the system that creates LMPs – security constrained dispatch – is that they make pricing information transparent on a near-instantaneous basis – a benefit previously unavailable. Furthermore, LMPs reflect two components of the cost of energy: the price of energy (or the variable cost, which is related to the fuel used to produce electricity), and transportation (transmission) costs.

In spite of the significant increase in costs for underlying fuel commodities, the PJM Market Monitor has stated that the percentage increase in LMPs is not nearly as high as the percentage increase in underlying fuel costs.¹⁵ This means that there exists significant competitive pressure on electric generation owners to keep their prices down. On the other hand, it is possible to reduce that portion of LMPs that results from congestion costs associated with transporting energy from the point of its production to the point of its consumption. Congestion is caused when, pursuant to transmission constraints, PJM cannot deliver the most economical generation to a load in need, making it necessary for PJM to run more expensive units, whose power can then be transmitted to the load.

¹⁵ 2005 *State of the Market Report*, PJM Market Monitoring Unit (Mar. 8, 2006), at pp.95-96.

It is important to note that at times, while LMPs may be high in a particular area, the total dollar cost for the entire PJM region is likely to be cheaper than it would have been without a security run dispatch system, which produces LMPs. Demand management tools can help decrease congestion by decreasing the demand for energy during times of constraint on the system. To have effective demand response, however, it is critical to have scarcity pricing – *i.e.*, a pricing construct where, during times of energy scarcity, prices will be allowed to rise to high levels. This in turn will provide consumers with the ability to genuinely respond to prices.¹⁶

In addition, there are two other important ways to reduce congestion: building more generation in the load pocket, or increasing transmission capability into the load pocket so that cheaper (or in some cases, merely the required) generation can be delivered to the load pocket. That said, there often are times where it makes no sense to make these larger types of investments because they may cost consumers more overall in the long run. It is important to look at the total costs of congestion and the total costs of the new investment. In some cases, maintaining existing levels of congestion is the more desirable outcome because it occurs only during certain periods of the year and ultimately costs consumers less than construction of new infrastructure.

Constellation notes that PJM is engaged in an extensive re-vamping of its transmission and generation planning to consider precisely under what circumstances investments will prove economical to reduce LMP costs related to congestion on the system.¹⁷ While PJM is committed to ensuring construction of the right transmission and generation where necessary, it also is very

¹⁶ Studies show that demand responds most effectively when prices reach into the thousands of dollars per megawatt-hour, and currently PJM has a \$1000 cap. Thus, the Commission may want to explore the possibility of gradually raising the bid offer cap in PJM in order to incent demand management. Additionally, for demand response management to work efficiently, it should respond to and be paid according to the same market price signals that impact generators.

¹⁷ PJM plans to file its Economic Planning Process shortly with the Commission.

mindful that regulatory intrusions into the marketplace which force investment can seriously undermine confidence in the market, which will cost consumers more in the long run. Any type of incentive to generate investment must be very carefully conceived to ensure that it does not discriminate among or between investment types (*e.g.*, among various types of generation investments or between generation and transmission investments). Constellation therefore respectfully suggests that it is premature for the Commission to take any action at this point to try to incent investment to reduce congestion until the PJM process has been given some time to test its effectiveness.

In addition, Constellation notes that PJM also is in the process of restructuring its capacity markets. Constellation is supportive of PJM's proposed Reliability Pricing Model ("RPM"), which seeks to identify load pockets that require more generation investment and provide appropriate incentives for investment in new and existing generation that is needed to maintain a reliable PJM system. Moreover, the RPM construct is deliberately structured to allow it to transfer to an energy only market when revenues from the energy market are sufficient.¹⁸ Constellation commends the Commission for its involvement in RPM and encourages it to remain committed to participation in the on-going stakeholder processes that are addressing the problems that RPM attempts to solve.

Finally, it is critical that the Commission understand that in many instances parties have the opportunity to hedge against congestion costs but decline to do so for a variety of reasons. Parties hedge against congestion in several ways, including through: bilateral contracts that provide for fixed capacity and energy prices, financial transmission rights purchases from PJM, generation construction, and/or generation self-scheduling. Constellation believes that retail

¹⁸ In RPM, capacity prices are reduced correspondingly as generators collect higher revenues in the energy and ancillary services markets.

consumers will be best hedged against congestion through competitive default service procurement processes, pursuant to which suppliers take on congestion risk in return for providing full requirements services at a fixed price. While such programs cannot protect consumers from higher fuel commodity prices which underlie the cost of electric production, such procurement processes can protect consumers through the most economical means to manage congestion – transferring congestion costs to suppliers.

III. CONCLUSION

Constellation applauds the efforts of the Commission to thoughtfully consider the steps needed to complete the transition to competitive markets in Pennsylvania. As the Commission has clearly recognized, competitive markets provide a host of benefits to consumers and are the best way to manage rising energy costs. Pennsylvania already has made great strides in bringing the benefits of competition to its citizens; the challenge of successfully sustaining that task is now before this Commission.

Respectfully submitted,

/s/

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