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November 17, 2008

VIA MESSENGER

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor North
Harrisburg, PA 17120

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Re: Reply Comments for the Pennsylvania Public Utility Commission's
Second En Banc Public Hearing on the Current and Future Wholesale
Electricity Markets, Docket No. M-2008-2066901

Dear Secretary McNulty:

Enclosed for filing at the above referenced docket are an original and ten (10)
copies of Reply Comments of Reliant Energy, Inc., as well as an electronic version on
disk. Please contact me if you have any questions.

Very truly yours,

Stanley Wolf
For Reliant Energy, Inc.

Enclosures

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Comments
of
Reliant Energy, Inc.
for the
PENNSYLVANIA PUBLIC UTILITY COMMISSION'S
***En Banc* Second Public Hearing on**
"Current and Future Wholesale Electricity Markets"

November 17, 2008

Reliant Energy, Inc (Reliant) appreciates the opportunity to participate in the Pennsylvania Public Utility Commission's (Commission) second *en banc* public hearing regarding the "Current and Future Wholesale Electricity Markets." The purpose of these comments is to respond to various statements and allegations made at the Commission's November 6, 2008 hearing. In these comments, Reliant will address issues relating to the price comparisons made by the parties, the single clearing price method of pricing, locational marginal pricing, PJM's capacity market, and utility long-term contracts.

I. Price Comparisons

Various parties in this proceeding assert that prices are higher where there are organized markets, and the market design of such markets is to blame.¹ A fair, accurate, thorough and informative comparison of retail (or even just wholesale) prices is a very complicated undertaking. It involves sorting out and precisely quantifying all relevant factors that can affect price, including, among other things, transmission costs, distribution costs, and stranded costs, fuel mix, fuel prices, generator vintage, environmental rules, rate caps, underlying contracts, congestion costs, and cross (or other) subsidies,² and then, finally, market design. There is no indication that any of the parties appearing at the November 6 hearing attempted, much less, successfully accomplished such an analysis.

¹ See comments of APPA at 3, PJMICC at 2, Alcoa at 5, and ELCON at 4-5.

² When questioned at the November 6 hearing, a witness could not state whether the prices being compared reflected cross subsidies.

That said, the following observations may be made concerning the assertion by APPA that retail electric rates are higher in states with deregulated markets³ and that this disparity is growing. First, APPA makes several important concessions (all at 3) that severely compromise its assertions from the onset, including:

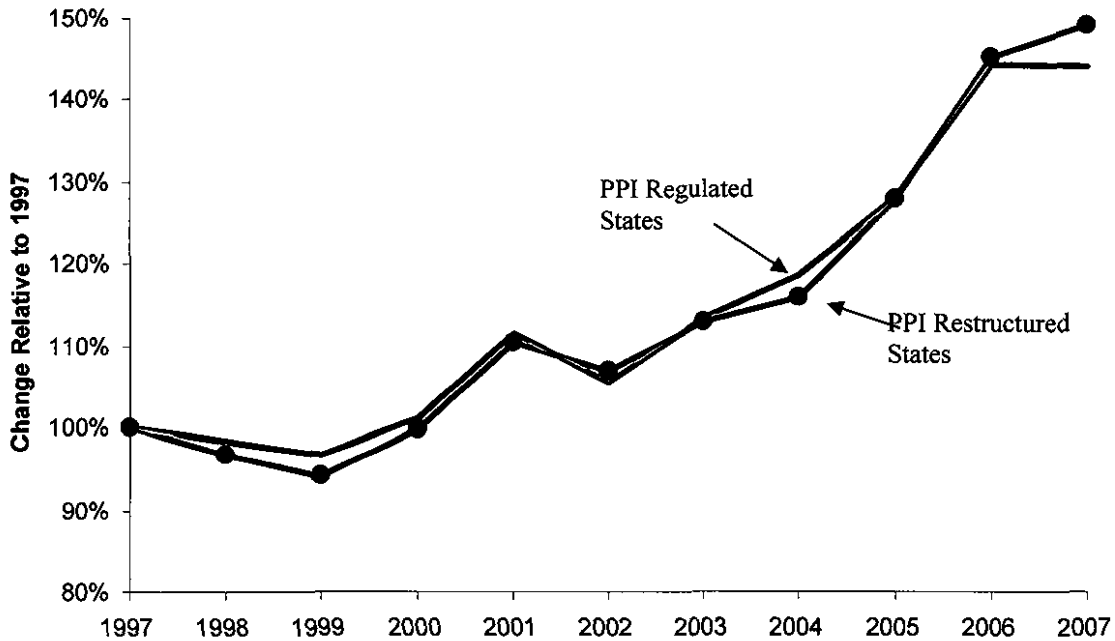
- “Electricity and other energy prices are rising across the country”
- “Most deregulated states started with higher prices”
and, most revealing,
- “The percentage increase in regulated and deregulated areas is the same.”

It stands to reason that if one price starts higher than another yet both increase at the same rate, then the gap will widen. Inflation alone will have that result. “Deregulated” states are also more likely to be states that are more dependent on natural gas for electricity.

Correcting for this shows very little difference in the rate of change between deregulated and regulated states.

³ Aside from the need to examine the many complicated cost factors mentioned above, APPA’s assertions, since they involve comparisons of states with organized markets and other states, involve controversial assumptions and definitions concerning what states are “deregulated” and which are not.

Rate of Change in Nominal Electric Rates in Gas-Dependent PPI Restructured and PPI Regulated States, 1997-2007



Source: Edison Electric Institute, Historical Statistics of the Electric Utility Industry Through 1992; Energy Information Administration State-Level Spreadsheets, 1990-2006; 2007 rates are from December 2007 Energy Information Administration Electric Power Monthly; Average rates are weighted by consumption in each state; Gas-dependent restructured states are from the ISO-New England, NY ISO, ERCOT, PJM East, and CA ISO market regions and include all PPI Restructured States except Michigan; Gas-dependent regulated states are defined as any regulated state where gas/oil generation comprises 30% or more of total generation output (FL, LA, NV, MS, and OK).

Embrace Electric Competition or It's Déjà Vu All Over Again, The NorthBridge Group, October 2008, at 37.

II. Single Clearing Price

APPA (at 5) objects to the results of Single Clearing Price (SCP) auctions as does PJMICC (at 3).

A. In General

SCP establishes an efficient market clearing price that does not price discriminate among resources providing the same commodity. SCP is a central feature of virtually all commodity markets, and there is nothing different about electric markets that requires its elimination. This is understandable since, in electricity markets as in commodity markets in

general, SCP provides accurate and uniform price signals to both producers (all generators in the electric industry both new and existing, regardless of type or technology) and consumers to inform their critical management decisions. In the electricity industry, such decisions include whether to build, upgrade, repair, do maintenance, or retire, or to install anti-pollution equipment or energy efficiency or demand response devices.

B. APPA's Bilateral Market Proposal

As a central feature of its "Proposal for Reform" (at 11), APPA proposes that, to reduce the pervasive price-setting role of RTO-run day-ahead and real-time markets, the majority of wholesale electricity transactions should take place under longer-term bilateral contracts⁴ entered into directly by LSEs. Initially, some issues should be clarified. First, APPA is not proposing to do away with RTOs. Even APPA recognizes (at 4) that "Properly structured, RTOs can provide numerous benefits to both wholesale and retail customers." Second, there is an important role for bilateral contracts in organized markets, and current RTO markets do not inhibit bilateral contracting, but APPA is wrong in suggesting that requiring an increase in bilateral contracts will reduce costs compared to current SCP markets because:

- Prices reached in a bilateral market (as adjusted for contract length, etc.) will tend towards what otherwise would have been the SCP of an RTO market, at least if the bilateral market is efficient.
- The costs of collateral are much, much higher for long-term fixed price contracts compared to spot market purchases, and the cost of any collateral is very high in the current environment.

⁴ Issues relating to long-term utility contracts are discussed below.

- Bilateral markets are less transparent than RTO markets, allowing for the potential exercise of market power.
- The cost of reserving transmission at a fixed price is much higher for long-term contracts.
- It is harder for small market participants to protect their interests in bilateral markets.

In any event, neither APPA nor anyone else has suggested a workable efficient alternative to SCP, as even APPA has stated that they do not want to return to traditional cost of service ratemaking⁵

C. The Portland Cement Proposal

At 6-9 of its filing, PJMICC provides a rough outline of the Portland Cement pricing proposal, which they offer as a substitute for the existing PJM market. In essence, the proposal would replace PJM's existing competitive market with a centrally planned procurement process with a twenty-year planning horizon. As proposed, the RTO would implement this process and enter into long-term contracts on behalf of all customers. The RTO would be responsible for not only developing numerous forecasts of load 20 years into the future, but making assumptions on load shapes, fuel costs, as well as impacts of future environmental requirements. Such forecasts and assumptions would be required for the RTO to compile an "efficient" portfolio of long contracts to meet the hypothetical customer needs. The Portland Cement proposal essentially takes the existing competitive market and replaces it with a series of long-term contracts administered by the RTO as system planner.

⁵ In the press release issued in Public Power Daily when APPA's "Consumers in Peril" paper was released in February of 2008, APPA CEO Mark Crisson stated that "APPA is not interested in returning to rate-based regulation or eliminating competition."

Reliant believes this is an extreme approach, won't result in lower costs to customers and is a step in the wrong direction. As was pointed out by PJM's Andy Ott, the Portland Cement Proposal would require the employees of the RTO to "make decisions moving forward about the state of everything and the one thing we can guarantee there is the central planner would get it wrong."⁶ In this time of significant change in environmental policy and advances in energy efficiency and demand response, it would be a large step backwards to adopt a centrally planned approach that locks customers into long-term obligations based on assumptions that will most certainly be wrong.

III. Locational Marginal Pricing

Several parties object to the Locational Marginal Pricing (LMP) pricing feature of PJM's system, an essential feature of RTO pricing that most RTOs already have or plan to implement.

LMP is one of three major components (along with capacity and ancillary service payments) to provide appropriate price signals for investment. Because the market utilizes a hard price cap of \$1000/MWh, prices are not allowed to reach economic levels. In order to address this shortcoming, the market utilizes the capacity market to complete the price signal. While a LMP-only world is possible, it requires adequate demand response and the elimination of price caps, and neither of these are feasible in PJM at this time.

LMP provides a critical benefit to the system by indicating where constraints exist and where action to reduce congestion will have the greatest value over time. Accordingly, LMP is very useful to system-wide and local transmission and reliability planning.

⁶ May 7, 2008, Transcript of the Federal Energy Regulatory Commission Technical Conference, Capacity Markets in Regions with Organized Electric Markets, Docket No. AD08-4-000, *et al.*, at 108.

With regard to APPA's claim that LMP has not led to the construction of facilities to ease congestion, Reliant notes that many significant transmission upgrades are being planned or are under construction, that Demand Response will ease existing congestion more in the future as technological innovation allows it to become more widespread, and that a major part of the problem is the difficulty of siting generation and transmission, a problem that exists regardless of market design.

ELCON asserts (at 5-6) that sending price signals based on marginal costs is meaningless if both the supply and demand sides of the market will not or cannot respond to those signals in ways that deliver tangible benefits to consumers. This may be true in principle but it does not describe what is happening in PJM. As described below, there has been substantial investment in building new and maintaining old generation facilities in PJM in recent years, partly as a result of PJM's Reliability Pricing Model, as explained below, and partly due to the revenues available from PJM's LMP energy and ancillary services markets, since an investor in generation must consider all revenues available to it. In addition, PJM's demand response programs (in the form of capacity, energy, and ancillary services demand response opportunities available directly for consumers), smart meters and other innovations allow demand to respond more and more to market signals to the benefit of all. Demand would respond even more to wholesale price signals if retail rates were structured more to reflect those wholesale prices.

IV. Locational Capacity Markets

APPA complains about PJM's locational capacity market, its Reliability Pricing Model (RPM). APPA (at 6) asserts that there have recently been "dramatically escalating capacity prices."

It is worth reviewing the chain of events that led to RPM. Prior to RPM, PJM's capacity market was not allowing generators to recover their costs. Buyers understandably enjoyed these low prices but prices below replacement cost cannot continue indefinitely in a growing market. After several years working with stakeholders to develop a new capacity market, PJM filed a version of RPM on August 31, 2005. In an order issued April 20, 2006,⁷ FERC recognized that PJM's existing capacity market was flawed because it did not result in prices high enough to ensure the construction of facilities necessary to retain reliability, and found it thus to be unjust and unreasonable, and established procedures to address the issues posed by PJM's filing. After many months of negotiation among the parties, FERC approved the current capacity market by approving a settlement that had the support of most participants on PJM's system, including most market participants in Pennsylvania.⁸ In an order issued September 19, 2008,⁹ FERC recently has affirmed its support of the current RPM market by rejecting the complaint filed by APPA and others concerning the interim RPM auctions.

⁷ PJM Interconnection, L.L.C., 115 FERC ¶ 61,079 (2006).

⁸ PJM Interconnection, L.L.C., 117 FERC ¶ 61,331 (2006), *order on reh'g*, 119 FERC ¶ 61,318 (2007).

⁹ Maryland Public Service Commission, *et al.*, v. PJM Interconnection, L.L.C., 124 FERC ¶ 61,276 (2008), *order on reh'g*, 119 FERC ¶ 61,318 (2007).

There is good reason to believe RPM has been successful at procuring the resources necessary to preserve reliability at a reasonable price. The following table enumerates the additions to PJM capacity that have resulted from RPM, most of which are not new generation, which is not surprising when efficient single clearing price market signals are available:

Changes in PJM Capacity Since Implementing RPM
(through the 2011-12 planning year, as of May-2008)¹⁰

Types of Capacity	Installed Capacity MW
New Generation	3,368.6
Generation Upgrades	4,052.7
Generation Reactivations	529.7
Forward Demand Resources	2,035.1
Cleared ICAP from Withdrawn Retirements	3,914.1
Net increase in Capacity Imports	<u>2,847.0</u>
Total Impact on Capacity in 2011-12 Delivery Year	16,747.2

Thus, the *minimum* estimated impact of the RPM implementation on the availability of capacity in 2011-2012 compared to what would have happened absent the implementation of RPM is more than 16,700 MWs. In addition, the Brattle Group report notes the sizeable commitment of assets to stay on the system along with impressive growth in the interconnection queue.¹¹

¹⁰ Source: PJM 2011-2012 RPM Base Residual Auction Results, May 15, 2008.

¹¹ Review of PJM's Reliability Pricing Model, The Brattle Group, June 30, 2008, at 13-43.

Dr. Kenneth Rose makes a somewhat different argument against RPM and other RTO markets. He asserts (at 8) that providing energy, capacity, ancillary services, FTRs, etc., separately results in higher costs than when one company supplied them all together. However, Dr. Rose makes this bald statement without providing any supporting numerical or even qualitative analysis. To be true, one would have to believe that the generation and delivery of power is a true monopoly, which would necessitate regulation. The history of regulation is not one to which any party wants to pay a return visit.

V. Utility Long-Term Contracts

Several parties advocate increased use of utility long-term contracts. APPA (at 12), for example, claims that restructured states can reduce their purchases from the spot markets through the imposition of requirements on their utility LSEs for longer-term contract portfolios and/or utility construction of new power plants. Alcoa (at 9) also believes that the Commission should encourage longer-term contracts.

However, many considerations indicate that requiring utility long-term contracts is not the answer, and there is no need for the Commission to repeat the mistakes of the past:

- Utility long-term contracts require speculation as to long-term costs, prices and usage. Even relatively short-term prices can be very hard to predict accurately. For example, a utility long-term contract entered into even in July of this year based on 3-year NYMEX Henry Hub natural gas strip contracts would be much higher than one entered into today, since those gas prices have decreased from \$12/MMBtu (\$11.9972/MMBtu as of July 1) to less than \$7.50/MMBtu (\$7.4173/MMBtu as of November 12) currently. Thus such a

contract executed in July would have locked-in Pennsylvania customers to unnecessarily high prices for the length of the contract.

- Utility long-term contracts have led to fantastic stranded costs historically – billions of dollars in Pennsylvania and other states.
- Conversely, utility long-term contracts can operate as rate caps if they are below market and can thus lead to very unpopular price spikes upon their expiration.
- Utility long-term contracts hide the price signals necessary for robust energy efficiency and demand response measures.
- Utility long-term contracts are significantly more expensive in a tight capital market, such as the one we are currently experiencing.
- How many long-term contracts must a utility enter into? For what portion of their load? How long must they be? How are they to be mandated or encouraged? How is this all to be determined? Must the inefficiencies of the failed Integrated Resource Plan process be reintroduced?
- Relied on for an extended period, utility long-term contracts will destroy the competitive wholesale market, and thus eliminate the innovation and efficiencies of merchant generation.
- Utility long-term contracts could also destroy the competitive retail market, thus eliminating opportunities for customer choice which most consumers would like to keep.

- Utility build generation includes all the risks identified above for long-term contracts plus risks of construction cost increases.

Some may believe that the rigid price stability of utility long-term contracts is beneficial because they assume that price variability is both undesirable and unavoidable, and that it is something consumers don't have experience with. However, consumers deal every day with many products and services whose prices vary. A competitive retail market is the best way to allow consumers to choose whether to fix their prices or to float with the market. The goals of ACT 129 will be more efficiently met when retail customers receive price signals which will more accurately indicate what energy efficiency devices and demand response measures are cost efficient.

VI. Conclusion

In conclusion, Reliant respectfully requests that the Commission consider these comments in its review of Pennsylvania's wholesale electricity markets.