



Duquesne Light

Our Energy...Your Power

March 2, 2007

VIA OVERNIGHT MAIL

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

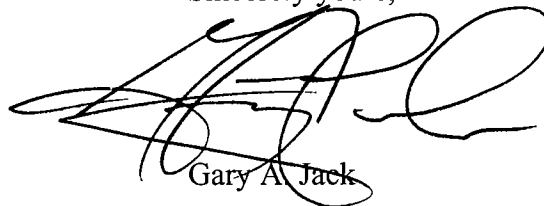
**Re: Rulemaking Re Electric Distribution
Companies' Obligation to Serve Retail
Customers at the Conclusion of the
Transition Period Pursuant to
66 Pa. C.S. § 2807(e)(2)
Docket No. L-00040169**

**Default Service Retail Electric Markets
Docket No. L-00070183**

Dear Secretary McNulty:

Enclosed are an original and fifteen (15) copies of Duquesne Light Company's Initial Comments in the above-referenced proceedings.

Sincerely yours,



Gary A. Jack

Enclosures

c: Shane Rooney (via e-mail)

**PENNSYLVANIA
PUBLIC UTILITY COMMISSION**

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

Default Service and Retail Electric Markets

Docket No. L-00070183

INITIAL COMMENTS OF DUQUESNE LIGHT COMPANY

Pursuant to the Pennsylvania Public Utility Commission's ("Commission's") Advance Notice of Final Rulemaking Order ("ANFRO") and Proposed Policy Statement, issued in these proceedings on February 9, 2007, Duquesne Light Company ("Duquesne" or the "Company") hereby submits the following comments.

BACKGROUND

Duquesne has extensive experience with post-transition default service. Duquesne has successfully implemented three default service plans and currently has a fourth default service plan pending before the Commission.

Duquesne's plans have supported the development of competitive retail markets, and its service territory has one of the highest levels of retail shopping in the United States. (See attachment A for U.S. retail shopping statistics.) Many industry observers point to Texas as having the most advanced retail markets in the country. According to a recent Texas commission report on the state of competition, "54% of electricity sold in the competitive market in Texas is supplied by providers other than the traditional

affiliated REP.”¹ By comparison, Duquesne has 54% of its total system load being supplied by alternative electric generation suppliers (“EGSs”). Duquesne also has a higher level of retail shopping than all of the utilities in New York.²

As retail markets continue to develop, Duquesne also has provided residential and small commercial and industrial (“C&I”) customers stable rates that are below the regulated rates in effect prior to its restructuring. Relative to the regulated generation rate caps approved in Duquesne’s restructuring case in May of 1998, residential and small C&I customers in Duquesne’s service area are expected to realize about \$950 million in savings (nominal dollars) over the 1999-2010 period, if the Commission approves Duquesne’s most recent default service plan. In addition, to the extent that customers have realized and will continue to realize even greater savings by shopping for electricity, the total savings resulting from Duquesne’s restructuring are even larger.

Duquesne presently provides default service by means of a bilateral contract with its affiliate, Duquesne Power. In order to fulfill its contract obligations for the default service supply requirements, Duquesne Power has negotiated contracts at prevailing market prices with competitive wholesale suppliers.

GENERAL COMMENTS

The ANOFR states at 21 that: “The experience of Duquesne shows that retail markets can work. Duquesne’s territory has the highest rate of customer choice in Pennsylvania.” Yet despite this success in Duquesne’s service territory, the

¹ Report to the 80th Texas Legislature, Scope of Competition in Electric Markets, PUCT, January 2007, at 51.

² Most New York utilities rely on a “portfolio” supply approach that the proposed rules are purporting to emulate. (ANFRO at 21.)

Commission's proposed rulemaking ironically would prohibit the current framework in place in Duquesne's service territory. While the Commission need not adopt the Duquesne model as the only default service model, the successful results of the Duquesne model strongly suggest that the Commission should at least allow that model to be an option for future consideration.

There are many principles in the proposed rules that Duquesne favors. Duquesne supports the Commission's recognition of the risk of being too prescriptive in its approach to this rulemaking. Accordingly, the Commission states it has not attempted to dictate the exact manner by which every default service provider ("DSP") will acquire electricity, adjust rates and recover its costs.³ Reserving some aspects of the regulation to a policy statement allows for greater flexibility as markets continue to change and represents sound public policy. Duquesne also supports the Commission's efforts for a gradual shift or transition to competitive markets while attempting to mitigate price shocks for retail customers. Duquesne further agrees that the Commission should tailor default service to reflect the market situation faced by different types of customers. Other provisions that Duquesne supports are noted in these comments on pages 22-24.

Duquesne is concerned, however, that the proposed rules may have unintended consequences that will frustrate the Commission's objectives to facilitate retail choice and hinder the ability to provide customers with reasonable rates that mitigate rate shock. The Company respectfully requests the Commission to reconsider these features in light of these comments. There also are several portions of the proposed rulemaking for which Duquesne seeks further clarification.

³ ANFRO, at 5. However, Duquesne would note that contrary to this statement, the PUC rules propose to prohibit bilateral contracts as an acquisition option and require adjustments of rates for residential and small commercial customers at least quarterly.

a) Effective Date Needs to be Clarified

Duquesne requests that the Commission clarify the effective date of the proposed regulations. The Policy Statement at page 2 states that “the Commission anticipates that the initial guidelines will be applied to the first set of default service programs following the expiration of the generation rate caps...” This reference to generation rate caps seems to refer to 2011, when all Pennsylvania utilities will have completed their transition periods. In the ANFRO at page 11, the Commission refers to “the first default service program filed after the effective date of these regulations.” But the effective date is not clearly defined in the regulations.

Duquesne believes that the proposed rules should apply to POLR service provided in 2011 and thereafter when the vast majority of electric customers in the state transition from their generation rate caps to a post-transition period default service offering. Under this approach, all customers in the state would be affected by the rule changes at the same time and customer education and communication efforts can be effectively coordinated on a statewide basis. As the Commission is well aware, there are concerns about the present competitiveness of the electric energy market. If default service regulations are placed into effect now, they would apply only to a very limited number of Pennsylvania customers. Even if the Commission determines that wholesale solicitations are appropriate in future default service regulations, a state-wide or multi-jurisdictional solicitation process may prove to be the most economic and efficient means to procure default service supplies. The Commission should not require Duquesne, on a stand-alone basis, to implement these proposed rules. For these reasons, Duquesne recommends that the Commission provide that the default service regulations will not become effective

until the major electric distribution companies (“EDCs”) have completed their transition periods.

Further clarification in the regulations also is necessary so that they do not interfere with interim plans filed prior to the effective date of the Commission’s order. Duquesne is concerned that its planning and litigation process for default service rates effective January 1, 2008, is occurring at the same time as these rulemakings. Prior to the effective date of the default service regulations, EDCs should be permitted to present interim default service plans that will remain in effect until the beginning of 2011. The Commission also should acknowledge that each interim plan will stand on its own and will not bind parties that later litigate plans offered by other EDCs.

If the Commission decides to make the default service regulations effective at some earlier date than 2011, then Duquesne urges the Commission to clarify in the draft rules themselves (and not the policy statement) that interim plans filed or approved prior to the effective date of final regulations will not be subject to the regulations.⁴ This regulatory certainty is needed so that utilities will know that their filed or approved plan will not have to be altered in midstream or their submitted plan may be rejected due to finalization of these pending rules.

b) Prohibition of Bilateral Contracts Will Harm Customers and Retail Competition

The proposed rulemaking would forbid the use of bilateral contracts. Duquesne believes that this is an overly prescriptive approach. The Commission should permit

⁴ From a practical standpoint, it would be extremely difficult, if not impossible, for Duquesne to reach agreement on a bid process and bid documents and then to conduct multiple solicitations at different points in time to establish retail rates effective for January 1, 2008.

alternative supply procurement methods, especially methods that have already proven to be successful in benefiting customers and retail competition. Prevailing market prices may be established by comparisons with other market prices in the region, through a market price index formula, or by a solicitation. In fact, Duquesne already has experience establishing default service rates deemed to be in compliance with the Electricity Generation Customer Choice and Competition Act (“Competition Act”) using each of these different methods.⁵ The Commission explicitly recognized in Duquesne’s POLR III proceeding that “a competitive procurement process is not the exclusive method to arrive at a prevailing market price.”⁶

Wholesale solicitations do not necessarily provide the same level of price certainty to retail customers nor have wholesale solicitations proven to result in higher levels of shopping than currently experienced in Duquesne’s service area. In fact, Duquesne currently has significantly higher residential shopping levels than other jurisdictions that have relied on solicitations to establish default service prices. Duquesne also is concerned that repeated attempts to conduct RFPs limited to its service area have not produced a sufficient pool of bidders to establish a viable competitive wholesale market. While a solicitation process is *one* reasonable way to procure power, it is not necessarily the *most* reasonable method for all utilities under all market conditions.

⁵ The Company started serving default service customers from its owned generation. Duquesne subsequently divested its generating assets and served its default service customers by means of negotiated full-requirements supply contracts with a non-affiliate during the POLR I and POLR II periods. In POLR III, Duquesne treated Large C&I customers differently from residential and small C&I customers. Large C&I customers were supplied with a PJM hourly market index formula rate. Alternatively, Large C&I customers could elect a fixed rate established by a solicitation. Meanwhile, POLR III residential and small C&I customers on default service were supplied at a three-year fixed price based on an agreement with Duquesne’s affiliate, where the rate levels were established based on comparisons with recent solicitations. Each of these methods to supply and establish default service rates was approved by the Commission, and, considered consistent with establishing rates at “prevailing market” prices per the Competition Act.

⁶ Reconsideration Order at 26.

c) The Commission Should Not Impose Mandated Quarterly Rate Adjustments For Residential and Small C&I Customers

The Commission proposes quarterly rate adjustments and reconciliation for residential and small C&I customers. The Commission should not impose mandated quarterly rate adjustments. Under such an approach, default service customers, not the default service supplier, will be responsible for market price risks. Attempts to frequently adjust retail rates for residential customers (e.g., in New York and Massachusetts) and attempts to rely on a portfolio approach with reconciliation (e.g., New York) have in many instances resulted in more rate shock for customers and less retail shopping than experienced in Duquesne's service area. Attachment B shows that residential customers in Massachusetts and New York have been exposed to more rate volatility than in Duquesne's service area, and in most cases, retail shopping is lower than in Duquesne's service area. "Massachusetts based the generation portion of the POLR service on the price of supply procured in wholesale markets through fixed-priced, short-term (three or six months) supply contracts. Rates for the generation portion of POLR service in the Boston Edison (north) territory increased from 7.5 to 12.7 cents per KWh from 2005 to 2006."⁷ Meanwhile, very few EGSs are providing residential customers with fixed price offerings and the level of shopping is substantially below that in Duquesne's service area.

The reliance on wholesale solicitations may severely limit the ability of retail EGSs to enter the market to provide the rate stability that small customers' desire. In several jurisdictions, customers have been exposed to short-term market price volatility,

⁷ Draft Report to Congress on Competition in the Wholesale and Retail Markets for Electric Energy, Docket No. AD05-17-000, Electric Energy Market Competition Task Force and the FERC, June 2006, at 71.

but retail shopping levels are lower than in Duquesne's service area. Customers then experience volatile retail rates and have few opportunities to mitigate that exposure in the competitive market. The Commission should not ignore this market evidence, and should allow for longer term default service rates for residential and small C&I customers, as long as those default service rates are based on prevailing market prices and promote retail competition.

SPECIFIC COMMENTS

a) Bilateral Contracts Should Be Permitted

The proposed rules prohibit bilateral contracts. Duquesne believes it is a mistake to exclude this option. DSPs should be allowed discretion in how they obtain electric energy at prevailing market prices. While a DSP must acquire electric energy at prevailing market prices, it should not be forced to procure its electric supply in a particular manner. A given procurement method may not be appropriate in all market circumstances for all customers. The DSP may obtain its supply through a bilateral agreement, structured bid solicitations such as auctions or requests for proposals ("RFP"), and/or spot market purchases. Other states allow DSPs discretion in how they obtain electric supply.⁸ Duquesne agrees with the Independent Regulatory Review Commission (IRRC) and other commentators that question the need to prescribe the manner in which electricity can be procured. (ANFRO at 13.) Section 2807(e) of the Competition Act

⁸ For example, DSPs in Texas and in New York, which have relatively high levels of retail shopping, do not rely on a mandated type of procurement process and have allowed DSPs discretion in how they obtain supply to meet their default service obligations. In contrast, recent experience in neighboring states demonstrates that structured solicitations may not always foster a robust retail market for electricity. In many cases, EGSs have been unable to compete in markets where solicitations are used to determine default service rates (e.g., Maryland, New Jersey, and Massachusetts).

does not expressly mandate that competitive bidding be used to procure electric generation supply for default service customers. Bilateral contracts are used by gas companies and electric utilities in Pennsylvania, New York, and in many other jurisdictions. The Commission even acknowledges “these bilateral contracts may very well reflect ‘prevailing market prices’” (ANFRO at 14), but then the Commission arbitrarily excludes the use of bilateral contracts and denies the value of such contracts even though they are pervasive throughout the industry. The Commission should not seek to impose a “one-size fits all” approach to procurement that may impose additional costs and/or risks on retail customers and may potentially harm retail competition. While the Competition Act requires the DSP to acquire electric energy at prevailing market prices, it does not mandate the methods by which it must procure its electric supply.

There are several possible methods to procure electric supply. Under one method, a DSP may conduct a formal structured solicitation (e.g., an auction or RFP) to obtain supply. Alternatively, a DSP could reach a bilateral agreement, or obtain supplies in competitive wholesale spot electricity markets. Furthermore, electricity supply may be procured in the form of fixed-price full requirements contracts that involve an all-in price for all of the customers’ electricity needs, or supply could be procured in the form of standard wholesale electric energy “block” products for a defined quantity in each hour. These block products are traded frequently in a liquid commodity market, but they do not cover certain risks associated with serving retail customers, such as uncertain customer usage and switching. Different procurement methods allocate risks differently between the DSP, wholesale suppliers, and retail customers, and no single method may be preferable in all cases for all customer types.

The Commission should not adopt and mandate a competitive supply procurement method that could be applied to all types of customers in all circumstances. For example, requiring that DSPs rely solely on structured solicitations to procure supply and ignoring other available methods leaves the Commission and the Commonwealth's consumers exposed to potentially significant price increases,⁹ the possibility that the procurement method may not be successful at attracting bids,¹⁰ and the chance that the development of retail competition will be stymied.¹¹

The DSP should have discretion in how it chooses to obtain its supply and how supply risks are most effectively allocated among the DSP, wholesale suppliers, and retail customers. In some states, default service supply for large C&I customers is procured in the hourly spot market and the cost is passed on to customers through a market index formula rate. Certainly, this method of procurement is not likely to be appropriate for residential customers who have very few opportunities in retail competitive markets and need more price stability in the design of their default service. Price stability can be provided to smaller customers with the use of longer-term supply contracts obtained through solicitations or through a bilateral supply agreement. A solicitation process is generally a more structured approach than a bilateral agreement, and the development of a solicitation typically involves settling upon a standard format for the terms, conditions,

⁹ In Maryland, the results from a March 2006 RFP resulted in significant rate increases for customers. PEPCO's residential customers faced an increase of 39% for a typical bill, for Delmarva Power & Light a 35% annual increase, and for Baltimore Gas & Electric, 72%. In Delaware, Delmarva Power & Light's proposed rates for residential customers resulting from a structured solicitation process increased the total annual bill by about 59% on average. In Illinois, the legislature is currently considering whether to reverse the rate impact from its most recent structured solicitation. In Pennsylvania, Pike County Light & Power customers faced a 129% increase in rates from their structured solicitation process.

¹⁰ For example, Duquesne did not receive any bids from wholesale suppliers at any price in its structured supply procurement process completed in March 2006 and only one bid in its procurement process completed in May 2006.

¹¹ In many instances, alternate retail suppliers have been unable to compete in markets where structured solicitations are used to determine default service rates (e.g., Maryland, New Jersey, and Massachusetts).

and bid procedures of the supply contract before the contract is put out to bid. The contract terms, conditions, and bid procedures can have a significant impact on the success or failure of the solicitation. They can affect the number of suppliers willing to participate, the resulting price levels, and the risks allocated to retail customers and winning bidders. A solicitation also requires time and funds to implement, and customers are exposed to market price movements during the regulatory proceedings and implementation period leading up to the solicitation. In contrast, if an EDC or another supplier is willing to assume certain risks and provide other benefits to retail customers in a bilateral supply agreement (e.g., by holding its fixed-price offer open while regulators consider the proposed rate levels), then the bilateral agreement may be the preferred procurement method. The bilateral agreement may allow an EDC and retail customers to “know the price” and customer rate impacts in advance of a lengthy regulatory review period rather than require the Commission to approve a solicitation process with an uncertain future price outcome with only one business day to assess the reasonableness of the results.

Under any of the above procurement methods, regulators are able to determine whether the resulting supply rates represent prevailing market prices. Prevailing market prices may be established by comparisons with other market prices in the region, through a market price index formula, or by a structured solicitation.¹² Various versions of a market index formula have been implemented around the country to establish market-

¹² In fact, the Pennsylvania Commission has previously approved post-transition period default service plans for Duquesne that relied on different supply procurement approaches and different methods to establish prevailing market prices.

based default service rates, including for New York State Electric & Gas,¹³ Rochester Gas & Electric,¹⁴ the State of Illinois,¹⁵ and the State of Texas.¹⁶ Regulators can also determine whether proposed rates reflect prevailing market prices by comparing and benchmarking the proposed rates with prices that have resulted from solicitations for default service supply in other service areas.

Given the potential customer benefits of allowing various supply procurement methods and the ability to determine whether the resulting rates represent prevailing market prices using any of a variety of methods, the Commission should clarify that the "prevailing market price" standard in the Competition Act can be satisfied through a variety of supply procurement methods rather than restrict the Commonwealth to a single or dual supply acquisition approach.

The Commission has stated in its order that the public interest can best be served by modeling certain portions of the default service rules on its form of regulation of natural gas supply. (ANFRO at 4.) Certainly, gas companies in the Commonwealth can and do enter into negotiated bilateral contracts for their supply. Likewise, electric power plants, whether regulated or unregulated, enter into not only competitive solicitations and purchases from the spot market, but also large and extensive bilateral contracts. DSPs

¹³ NYSEG offered customers fixed retail rates for a two-year period based on forward electric prices. Joint Proposal, Petition of New York State Electric & Gas Corporation for Approval of its Electric Price Protection Plan at 32-33, Case 01-E-0359 (NYPSC Jan. 2002).

¹⁴ RG&E offers customers fixed retail rates for one year based on forward electric prices. Electric Rate Joint Proposal, Proceeding on Motion of the Commission as the Rates, Charges, Rules and Regulations of Rochester Gas and Electric Corporation for Electric Service at 15-17, Case 03-E-0765 (NYPSC Mar. 9, 2004).

¹⁵ Illinois utilities offered non-residential customers a power purchase option service based on a forward market index. Both residential and non-residential customers that shopped received a market value energy credit based on a forward market price formula, through January 1, 2007. Commonwealth Edison Company Retail Tariff, Rider PPO Power Purchase Option – Market Index, Tariff Sheet at 151.1-15.

¹⁶ Senate Bill 7, the Texas electric restructuring law, specified that a retail affiliate of the incumbent utility must provide Price to Beat ("PTB") service. PTB is comprised of a non-fuel "base rate" plus a fuel factor. While the base rate was frozen, the fuel factor was subject to a market index adjustment mechanism linked to natural gas prices.

should have the same flexibility in purchasing their electric supply as gas companies do. If a DSP is able to enter into negotiations with different suppliers that provide benefits to retail customers and the DSP can demonstrate that the resulting rates reflect prevailing market prices, why would the Commission want to prohibit this as an option? The exclusion of the use of bilateral contracts will unnecessarily harm customers.¹⁷

Duquesne disagrees with the statement made by the Commission that competitive solicitations are “the optimal method of acquiring electricity” since they include “a direct exposure to market forces.” (ANOFR at 14.) This implies that bilateral contracts do not include a direct exposure to market forces. This is simply not true. A DSP acquiring energy under a bilateral agreement is going to be aware of market prices – whether spot market, futures or recent solicitations – and its supply options, including competing offers from other electric suppliers. In any event, the DSP clearly has the burden of proof to demonstrate to the Commission that the proposed default service rates represent prevailing market prices.

Further, the Commission has stated that procurement plans should have the objective of obtaining the lowest reasonable long-term costs. (§ 54.186 (b)1.) Duquesne agrees with that statement and believes, in many instances, bilateral contracts will result in lower costs for customers. It is true that a DSP opting to enter into a bilateral contract has a higher burden to show the Commission that it in fact is obtaining power supply at the prevailing market price. Many utilities will not desire to take this

¹⁷ Wholesale suppliers participating in structured solicitations also typically require retail customers to bear additional risks. In the solicitations conducted in New Jersey and Maryland, if a wholesale supplier defaults during the contract period, the utility is allowed to recover incremental replacement costs from retail customers. In Maryland, retail customers bear the costs associated with certain customer switching risks, as well as the risk of a failure to secure bids, the risk associated with auction pricing anomalies, and the risk of wholesale supplier default.

risk, and will rely on a structured solicitation for its own protection, since there is less risk for the DSP with a solicitation. But if this Commission is truly concerned about obtaining power at the lowest cost for its customers and the DSP is willing to assume this higher burden of proof, bilateral contracts should be permitted as an option.

Finally, the Commission's logic for excluding the use of bilateral contracts does not apply to Duquesne. The Commission notes in a footnote "that most Pennsylvania EDCs have wholesale energy supply affiliates with substantial generation assets" and that "permitting the routine use of bilateral contracts would allow an EDC to negotiate a contract with its affiliate, with all the potential risk and conflicts this would entail." (ANFRO, Footnote 4, at 14, emphasis added.) In response, Duquesne notes that it is not in the same situation as "most Pennsylvania EDCs" since it does not have energy supply affiliates that possess substantial generation assets.¹⁸ While bilateral contracts with an affiliate may require more regulatory oversight to assure fairness,¹⁹ they are routinely used across the United States as a supply option and should not be prohibited. Given Duquesne's situation, it is not necessary to incur the costs associated with conducting multiple wholesale solicitations each year or to eliminate the possibility of customer benefits provided by a bilateral contract in order to address the concerns associated with "wholesale energy supplier affiliates with substantial generation assets." Duquesne simply does not have substantial generation assets. The PUC should reconsider this matter and permit the use of bilateral contracts.

¹⁸ Duquesne owns only 104 MW, recently purchased on September 1, 2006, none of which is used or proposed to be used for POLR service.

¹⁹ In addition to Commission oversight, the Federal Energy Regulatory Commission ("FERC") has jurisdiction over all wholesale sales of power by public utilities, including those between affiliates and non-affiliates. (FPA Sec. 205). FERC reviews affiliate power supply transactions and Duquesne must demonstrate that it will ensure no harm to consumers or wholesale competition from any affiliate power supply deal.

b) The Proposed Frequency of Rate Adjustments For Small Customers Is Not Appropriate at this Stage of Market Development

In the summary of changes, the Commission states “we do not attempt to dictate the exact manner by which every EDC will acquire electricity, adjust rates and recover their costs.” (ANFRO at 5.) But then, the proposed rules, contrary to that statement, require mandatory rate adjustments on a quarterly basis or more frequently for all customers up to 500 kW (§54.187). The Commission should reconsider as Duquesne believes mandated frequent rate adjustments for small customers, when combined with laddered contracts and reconciliation, is inappropriate, will harm retail customers and will not benefit retail competition.

1. Frequent Rate Adjustments for Small Customers Will Harm Retail Customers

The Commission claims that regular adjustments to default service rates will ensure that rates track prevailing market prices and customers will not experience large changes in rates. (ANFRO at 4). Duquesne disagrees for several reasons. First, the laddering of contracts at different points in time and blending them into default service rates when coupled with reconciliation of costs and revenues from prior periods will mean that at any point in time retail rates likely will not reflect current market prices. Second, this interpretation of prevailing market prices incorrectly limits it to short-term market products and ignores the fact that prevailing market prices may exist for longer term products. Third, market evidence from other jurisdictions (including New York and Massachusetts) indicates that retail customers have experienced significant changes in their default service rates when they have been exposed to frequent rate adjustments.

(Attachment B shows that these rates have been much more volatile than the default service rates in effect in Duquesne's service territory.)

Retail and wholesale markets are still evolving. Given the volatility of electric prices, the uncertain development of competitive retail markets for smaller customers, and the customers' preference for fixed prices, residential and small C&I customers should continue to be able to be offered a fixed rate default service. Smaller customers, and especially residential customers, do not want to be exposed to short-term wholesale market price volatility while competitive retail markets continue to develop.²⁰ Customer switching among residential customers, in particular, has been slow to materialize. Most utilities with retail access in the United States have more than 95 percent of their residential load remaining on utility default service. At this stage of market development, EGSs can not be relied on to provide fixed price certainty to all residential and small C&I customers. The Commission should not assume that EGSs will suddenly appear, offer fixed price services at reasonable prices to all customers, and remain in business for years into the future.

In New York, where most utilities change retail rates monthly based on a portfolio of supply contracts, customers have been exposed to volatile rates, and still most residential customers remain on default service despite numerous efforts to promote retail shopping.²¹ The New York Consumer advocate describes how it is almost impossible for ordinary customers to compare competitive electric service company (called "ESCO") prices with monthly utility default service rates. "Fluctuating rates make it impossible for

²⁰ This position is based on the review of testimony, public utility filed comments, and papers prepared by residential and small customer advocates in Pennsylvania and nationally.

²¹ Many utilities have implemented purchase of receivables programs, retail access credits, referral programs and extensive customer education programs in order to stimulate retail competition.

ordinary consumers to compare ESCO rates with default service rates. This lack of price transparency allows ESCOs to market their service based on short-term ‘bait and switch’ techniques, brand name attraction, or in protest to unreasonable price spikes from the current provider.”²²

By comparison, Duquesne has reset its supply rates to market levels every few years as it moved from POLR I to POLR II to POLR III and in its most recent POLR filing. This frequency of resetting rates has resulted in manageable rate impacts for customers at each reset and customer shopping.²³ Unlike other utilities both within and outside Pennsylvania that have abruptly moved from long-term generation rate caps to solicitations, Duquesne has successfully avoided sharp rate increases and provided customers with stable rates over time.

Some may argue that customers should experience frequent rate adjustments for economic efficiency reasons, if not for competitive reasons. This argument is dampened, however, to the extent that default service rates could reflect “stale” prices due to laddering and/or reconciliation. Providing customers dynamic and volatile price signals to encourage economically efficient load response is especially difficult for residential and small C&I customers unless expensive smart metering is implemented. In some jurisdictions, customers experience significant price volatility with little economic benefit. In the absence of cost-effective enabling technology (e.g., advanced metering, communications, and metering data management systems) for smaller customers, there is

²² Public Utility Law Project Comments in its Opposition to the Motion to Dismiss at 10, Case 05-E-1222, 2006.

²³ Duquesne’s residential shopping levels are 9th in the United States based on amount of residential shopping load.

little benefit to sending customers volatile market price signals,²⁴ and in the absence of EGSs willing to serve that market, there is little customers can do to mitigate the impact of volatile market prices.

The DSP should be permitted to establish market-based default service rates that vary hourly or are fixed for periods of up to multiple years depending on the level of market development and the needs of different customer types. The durations and pricing structures of default service supply agreements may vary across customer types and across service areas. The term “prevailing market prices” should not be defined narrowly to limit electricity default service only to short-term market prices (e.g., a quarter or less) for all types of default service customers in all situations.²⁵ It is especially important that the Commission clarify that the intent of the Competition Act is not to expose residential and small C&I retail customers in the Commonwealth to significant market price volatility at a time when few alternatives exist in the competitive retail market.²⁶

The Commission should acknowledge that prevailing market prices may include the prices of long-term fixed price default service products, and should not be limited

²⁴ Without such technology, utilities must take metered usage and allocate it to hours in the month using deemed load shapes regardless of the customer’s actual usage. Therefore, there is little economic incentive for a customer to change consumption without the necessary enabling technology to support those actions. Utilities also typically have limited ability to communicate price signals in advance to allow customers to respond to short-term price signals. Monthly prices are billed long after consumption occurs and price information is not revealed until after-the-fact. Furthermore, while there have been numerous studies and pilot programs attempting to measure customer response to market prices, the specifics regarding the magnitude of price movements, the frequency and timing of price movements, how prices are communicated to customers, and specific customer characteristics may impact the ability of customers to respond to the market prices even with the appropriate enabling technology.

²⁵ In the POLR III Order, the Pennsylvania Commission found that Duquesne had established, by a preponderance of the evidence, that its proposed rates for residential and small C&I customers satisfied the Competition Act’s requirements that such rates reflect prevailing market prices for the three-year term period beginning January 1, 2005, through December 31, 2007.

²⁶ Most states in the U.S. either have not adopted or have suspended efforts to implement retail competition due to concerns about higher market prices and customer exposure to market price fluctuations. In states where retail competition has been implemented, the vast majority of residential and small C&I customers remain on default service provided by the EDC.

only to short-term market prices. On one hand, the proposed rules wisely do not prohibit the use of long-term supply contracts; however, on the other hand, they require DSPs to adjust retail rates at least quarterly. As people throughout the nation are painfully aware, large increases in energy prices, such as those experienced recently, are extremely difficult to control and manage. This is especially true given that the vast majority of residential and small C&I customers in Pennsylvania remain on default service and have very limited affordable alternatives to utility service. Rates for these customers should be based on longer-term supply products in order to provide some level of rate stability while competitive wholesale and retail markets continue to develop. At the same time, these rates should reflect the prevailing market prices for those longer-term supply products, including any associated costs and risks, in order to provide an opportunity for retail competition to further develop. In this way, residential and small C&I customers can benefit from price stability, while being served at prevailing market prices that allow competitive retail markets to continue to evolve.

The Competition Act clearly does not specify the term of potential default service products, and it should not be interpreted by the Commission to force all default service customers in the Commonwealth onto rates that expose these customers to short-term market price volatility with little opportunity to mitigate this exposure in an immature competitive retail market.

2. Frequent Rate Adjustments for Small Customers Will Not Benefit Retail Competition

It is ironic that the Commission states that the experience of Duquesne shows that retail markets can work (ANFRO at 21), and then proceeds to require Duquesne to

procure power and adjust rates in a manner that would undermine its successful development of a retail market. The Commission asserts that a PTC fixed for long periods of time, will stifle competition. (ANFRO at 21.) Yet Duquesne has fixed its PTC for residential and small C&I customers for three-year periods during both the POLR II and POLR III plans and has relatively high levels of customer shopping.

Retail rates should represent the prevailing market price levels at the time they are proposed, taking into account all of the costs and risks associated with providing default service to retail customers for the time period those rates are in effect, be it monthly, yearly, three years, etc.

It simply is not true that frequent adjustments of retail rates necessarily will result in more shopping among small customers. The Commission assumes that EGSs will respond by entering the market and offer customers fixed prices. (ANFRO at 22.) This is a huge assumption with grave consequences if the Commission is wrong and especially risky at this stage of market development. In Massachusetts, default service rates were adjusted frequently yet there is very little shopping among residential customers. In New York, while rates adjust monthly for most customers, still residential shopping is lower than in Duquesne's service territory in many cases. Unlike in Duquesne's service area, EGSs do not have a fixed price benchmark to compete against.²⁷

As the statute provides, "... the electric distribution company or Commission-approved alternative supplier shall acquire electric energy at prevailing market prices to

²⁷ Stable default service rates will not necessarily harm or promote retail competition. Stable rates can be set at below market levels, at market levels, or above market levels with differing impacts on retail competition. In some cases, a fixed price default service may provide a benchmark against which EGSs may compete and allow EGSs to market "known savings" off of that benchmark. If variable default service rates are unknown in the future, then it becomes difficult for an EGS to guarantee savings while providing the customer price security.

serve that customer and shall recover fully all reasonable costs. 66 Pa. C.S. §2807(e).

There is no support at all legally that prices must be updated quarterly, monthly or whatever time period one may choose to be “prevailing market price”.

It is Duquesne’s recommendation that the Commission not force DSPs to adjust rates on a quarterly or more frequent basis for residential and small C&I customers with limited opportunities to mitigate their exposure to volatile market prices. Certainly the Commission should be able to entertain a possible suspension of any automatic adjustment based on alternative proposals or agreements. The Commission needs the flexibility to be able to adopt such an approach and entertain varying frequencies of price adjustments. A DSP should be allowed to propose a frequency of rate adjustment that is tailored to the customer needs and market circumstances at the time of its filing. In general, more sophisticated customers in a more developed retail market should be exposed to more frequent rate adjustments. But given the current stage of retail market development for small customers, the Commission should not prescribe quarterly rate adjustments. The proposed rulemaking appears to have gone from one extreme (e.g., fixed rate caps for ten years as was approved as part of utility restructuring) to another (i.e., quarterly rate adjustments). Duquesne’s past POLR plans demonstrate that a more moderate approach may better achieve the Commission’s objectives of mitigating rate shocks for customers and facilitating a competitive retail market. The Commission should gather through its experience from various utilities over a period of time to determine, at a future date, whether it desires to mandate more frequent rate adjustments or whether it desires to permit continued flexibility and experimentation with rate adjustments.