COMMONWEALTH OF PENNSYLVANIA

OFFICE OF SMALL BUSINESS ADVOCATE
Suite 1102, Commerce Building
300 North Second Street
Harrisburg, Pennsylvania 17101

William R. Lloyd, Jr.
Small Business Advocate

(717) 783-2525
(717) 783-2831 (FAX)

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HAND DELIVERED

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

Re: Implementation of Act 129 of October 15, 2008; Default Service
Docket No. L-2009-2095604

Dear Secretary Chiavetta:

I am delivering for filing the original plus fifteen copies of the Comments on behalf of the Office of Small Business Advocate, on the Proposed Rulemaking Order and Annex A.

Copies of the comments have been served on Elizabeth Barnes, via electronic mail. If you have any questions, please contact me.

Sincerely,

William R. Lloyd, Jr.
Small Business Advocate
Attorney ID #16452

Enclosures

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Implementation of Act 129 of October 15, 2008; Default Service	:	**Docket No. L-2009-2095604**
Proposed Policy Statement Regarding Default Service and Retail Electric Markets	:	**Docket No. M-2009-2140580**

INITIAL COMMENTS OF THE OFFICE OF SMALL BUSINESS ADVOCATE

The Electricity Generation Customer Choice and Competition Act ("Competition Act"), Chapter 28 of the Public Utility Code, 66 Pa.C.S. Ch. 28, provides that, after the recovery of stranded costs, generation rates are to be determined through market forces rather than through traditional rate base/rate of return regulation.

As originally enacted, the Competition Act required each electric distribution company ("EDC") to acquire electric energy "at prevailing market prices" to serve those customers who do not choose an electric generation supplier ("EGS") or whose EGS fails to deliver.[1] As required by the Competition Act, the Pennsylvania Public Utility Commission ("Commission") promulgated default service regulations at 52 Pa. Code §§54.181-54.189 to define the EDC's obligation.[2] The Commission also adopted a default service policy statement at 52 Pa. Code §§69.1801-69.1817. The default service regulations and policy statement became effective on September 15, 2007.

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[1] *See* 66 Pa. C.S. §2807(e)(3) (repealed)

[2] *See* 66 Pa. C.S. §2807(e)(2) (repealed). The regulations refer to an EDC as a "default service provider."

Subsequently, the act of October 15, 2008 (P.L. 1592, No. 129) ("Act 129") repealed the "prevailing market prices" standard and imposed a new requirement that the default service provider ("DSP") acquire default service electricity competitively through a "prudent mix" of contracts and at the "least cost to customers over time."[3]

By Order entered January 19, 2010, the Commission initiated a proposed rulemaking at Docket No. L-2009-2095604 to amend the aforementioned default service regulations to reflect the enactment of Act 129. The proposed rulemaking was published on May 1, 2010, in the *Pennsylvania Bulletin*, 40 Pa.B. 2267. In addition to proposing specific amendments to the current regulations, the Commission also posed a list of questions regarding the interpretation of various provisions of Act 129. Ordering Paragraph No. 5 invited interested parties to submit comments (including answers to the questions) within 30 days of publication.

By separate Order entered January 19, 2010, the Commission initiated a proceeding at Docket No. M-2009-2140580 to amend the aforementioned default service policy statement to reflect the enactment of Act 129. The proposed amendments to the default service policy statement were published on May 1, 2010, in the *Pennsylvania Bulletin*, 40 Pa.B. 2289. Ordering Paragraph No. 4 invited interested parties to submit comments within 30 days of publication.

The Office of Small Business Advocate ("OSBA") submits the following comments in response to the Commission's invitation. Because the OSBA's views on the proposed amendments to the default service regulations are linked to the OSBA's views on the proposed amendments to the default service policy statement, the OSBA has integrated its comments into one document.

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[3] *See* Section 3 of Act 129, amending 66 Pa. C.S. §2807(e).

COMMENTS ON THE REGULATIONS

§54.181. Purpose.

The proposed rulemaking retains the language indicating that non-shopping customers are to "have access to generation supply at *prevailing market prices*." (emphasis added) Act 129 repealed the "prevailing market prices" requirement. Therefore, "prevailing market prices" should be replaced by "the least cost to customers over time."

§54.184. Default service provider obligations.

The proposed rulemaking renumbers subsection (c) as subsection (d) and expands the cited authority to implement energy efficiency and conservation programs. The statutory mandate for energy efficiency and conservation programs is found in 66 Pa. C.S. §2806.1, which Act 129 added to the Competition Act. Therefore, the proposed addition of "and the amendments provided under the act of October 15, 2008 (P.L. 1592, No. 129) (Act 129) providing for energy efficiency and conservation programs" is redundant.

§54.186. Default service procurement and implementation plans.

(b)(1)

The proposed rulemaking amends subsection (b)(1) to track the language of 66 Pa. C.S. §2807(e)(3.2) regarding what constitutes a "prudent mix" of electric power. However, the proposed rulemaking omits the statutory requirement that the Commission hold a hearing before it determines that long-term contracts may constitute more than 25% of the default service load. The hearing requirement should be included in the regulation, in that the statute does not grant the Commission the authority to waive the hearing. In contrast, when the General Assembly intended to grant the Commission discretion over whether or not there is to be a hearing, the

legislature explicitly stated in 66 Pa. C.S. §2807(e)(3.6) that "[t]he commission shall hold hearings *as necessary* on the proposed [competitive procurement] plan." (emphasis added)

(b)(2)(iii)

The proposed rulemaking adds subparagraph (b)(2)(iii) to require that the "prudent mix" comply "with the requirements of subparagraph (b)(1)(iii)." The reference to "(b)(1)(iii)" should be simply to "(b)(1)," in that (b)(1)(iii) relates only to the requirements regarding long-term contracts.

(b)(5)

The proposed rulemaking renumbers subparagraph (b)(4) as (b)(5) and seeks to combine the requirements of 66 Pa. C.S. §2807(e)(3.1) and (3.2) into one subparagraph. As drafted, it is unclear that the requirement for competitive procurement applies to each of the possible products itemized in proposed subparagraph (b)(5). Under 66 Pa. C.S. §2807(e)(3.1), the requirement for the use of "competitive procurement processes" applies to all default service electric power acquisition, regardless of the specific product being acquired.

(d)

The proposed rulemaking retains the authority in subsection (d) for a default service provider to petition to amend its default service plan "to ensure the acquisition of sufficient supply *at prevailing market prices*." (emphasis added) It appears that the current regulation is intended to allow petitions only if changing a default service plan is necessary to reflect a material increase or decrease in wholesale market prices, *i.e.*, to align default service rates as closely as possible with market prices. In view of the replacement of the "prevailing market prices" standard with the "least cost to customers over time" standard, subsection (d) should be repealed.

§54.187. Default service rate design and the recovery of reasonable costs.

(b)

The proposed rulemaking amends subsection (b) to incorporate the language of 66 Pa. C.S. §2807(e)(3.9). However, as drafted, some words appear to be missing before "all reasonable costs" in the first sentence. In addition, the reference to "all reasonable costs incurred under 66 Pa. C.S. §2807(e)(3.9)" is erroneous. Section 2807(e)(3.9) is the statutory authority for recovery of reasonable costs incurred under the entirety of Section 2807 and under an approved competitive procurement plan. The costs themselves are not "incurred" under Section 2807(e)(3.9).

(h)

The proposed rulemaking renumbers subsection (g) as subsection (h), with regard to rates for demand side response and demand side management programs. It may be appropriate to update this language to incorporate any demand side-related requirements which stem from the enactment of 66 Pa. C.S. §2806.1 and 2807(f) regarding energy efficiency and conservation plans, smart meters, and time-of-use rates.

(i) and (j)

The proposed rulemaking renumbers subsections (h) and (i) as (i) and (j). In addition, renumbered subsection (i) eliminates the option that default service rates may be adjusted "more frequently" than on a quarterly basis for residential and non-residential classes with a maximum registered peak load of up to 25 kW. The repeal of the provision regarding the possibility of adjustments more frequently than quarterly is presumably intended to reflect the enactment of 66 Pa. C.S. §2807(e)(7), which provides that "[t]he default service provider shall offer residential and small business customers a generation supply service rate that shall change no more

frequently than on a quarterly basis." However, the renumbered subsection (j) continues to provide for the possibility of changes more frequently than quarterly for customer classes with a maximum registered peak load of 25 kW to 500 kW. There are at least three problems with the disparate treatment of non-residential customers based on their peak load.

First, for many default service providers, default service rates are the same for non-residential customers with peak loads above 25 kW as for non-residential customers with peak loads of up to 25 kW. For example, PPL Electric Utilities Corporation ("PPL") presently charges the same default service rate for secondary non-residential customers with peak loads of up to 500 kW. Pennsylvania Power Company ("Penn Power") includes customers of up to 400 kW on the same default service rate. Beginning on January 1, 2011, Metropolitan Edison Company ("MetEd") and Pennsylvania Electric Company ("Penelec") will follow the Penn Power model, *i.e.*, each will charge the same default service rate to all of its non-residential customers with up to 400 kW. At the same time, West Penn Power Company ("West Penn") and PECO Energy Company ("PECO") will each charge the same default service rate to all of its non-residential customers with up to 100 kW peak load.

Second, requiring adjustments more frequently than quarterly was part of a default service model intended to keep default service rates as closely aligned with wholesale market prices as possible. However, that model is inconsistent with the General Assembly's decision to replace the "prevailing market prices" standard with the "least cost to customers over time" standard.

Third, although 66 Pa. C.S. §2807(e)(7) does not define "small business customers," the Commission is apparently assuming that the General Assembly intended to adopt the definition of "small business customer" in 52 Pa. Code §54.2. However, it is at least arguable that the

legislature had a broader definition in mind. For example, the default service policy statement, at 52 Pa. Code §69.1811(a), refers to "small business customers of up to 25 kW in maximum registered peak load." This reference implies that "small business customers" may have a peak load of greater than 25 kW. Consistent with that implication, PPL's default service plan defines "*small* commercial and industrial customers" as non-residential customers with maximum load of up to 500 kW. Furthermore, Section 2 of the Small Business Advocate Act, 73 P.S. §399.42, defines "small business consumer" to include businesses with as many as 249 employees and to include customers in small *industrial* rate classes. It is unlikely that many small industrial customers have a maximum peak load of less than 25 kW. It is also unlikely that many small businesses with a maximum peak load of less than 25 kW have 249 employees.

Therefore, the option for more frequent than quarterly changes for customers with a peak load of 25 kW to 500 kW should be repealed.

§54.188. Commission review of default service programs and rates.

The proposed rulemaking repeals the requirement in subsection (d) that the Commission approve or disapprove competitive bid results within one business day. Repealing that requirement could cause wholesale suppliers to add a risk premium to their bids, thereby increasing default service rates. Furthermore, the Commission is proposing no change in 52 Pa. Code §69.1807(6), which states that "[i]n the default service regulations, the Commission has reserved a period of 1 business day to review the results of competitive procurements." To avoid a potential increase in default service rates and to maintain consistency with the default service policy statement, the one-day requirement for approval or disapproval of procurement results should be reinserted into the regulation.

COMMENTS ON THE POLICY STATEMENT

§69.1805. Electric generation supply procurement.

The Commission proposes to amend the introductory paragraph of Section 69.1805 to reflect the enactment of 66 Pa. C.S. §2807(e)(3.2), which explicitly designates short and long-term contracts as potential products in a "prudent mix" of electric power acquisitions. However, the amendment erroneously defines short-term contracts as "contracts up to and including 3 years in length." Section 2807(e)(3.2) implicitly defines short-term contracts as contracts of less than four years in length. Therefore, the statute allows the use of contracts of greater than three years but less than four years. The amendatory language should be revised to conform the definition of short-term contracts in the policy statement to the implicit definition in the statute.

The Commission proposes to retain its preference for contracts of one to three years to serve customers with less than 25 kW peak load and for contracts of one year to serve non-residential customers with 25-500 kW peak load. The continuation of these preferences is inconsistent with the repeal of the "prevailing market prices" standard and its replacement with the "least cost" standard. Furthermore, these preferences are inconsistent with Section 2807(e)(3.2) and (3.4)(ii), which allow the use of longer contracts whenever such use would enable the default service provider to acquire a "prudent mix" at the "least cost to customers over time." Therefore, these preferences should be repealed.

§69.1807. Competitive bid solicitation processes.

The Commission proposes no change in Section 69.1807(7), which recognizes the legitimate public interest in disclosure of bid results in at least some form. The availability of bid results to parties in default service proceedings facilitates informed debate about proposed procurement methodologies and schedules and about proposed contract lengths.

Although most default service providers do, or are proposing to, disclose procurement results in some form, there is no requirement that those results be disclosed in a uniform manner. Consequently, it is difficult to ascertain exactly how comparable the disclosed results really are, *e.g.*, whether they do or do not include items such as Gross Receipts Tax, losses, transmission, and administrative costs. Furthermore, finding the disclosed results on the default service provider's website can be very time-consuming.

Therefore, the Commission should amend Section 69.1807(7) to provide for disclosure of the procurement results on the Commission's website in a uniform format that facilitates comparison from DSP to DSP.

§69.1809. Interim price adjustments and cost reconciliation.
§69.1810. Retail rate design.

The Commission proposes no change in that portion of Section 69.1809(c) which authorizes more frequent than quarterly adjustments in default service rates if costs are diverging from revenues by more than 4%. Similarly, the Commission proposes no change in Section 69.1810, which allows rates for any class to be converted to a time of use design. These provisions should be amended to be consistent with Section 2807(e)(7), which requires that "[t]he default service provider shall offer residential and small business customers a generation supply service rate that shall change no more frequently than on a quarterly basis."

ANSWERS TO THE QUESTIONS OF INTERPRETATION

1. What is meant by "least cost to customers over time"?

As originally enacted, the Competition Act required an EDC (labelled a DSP under the Commission's default service regulations) to acquire electricity for default service customers at "prevailing market prices."[4] The Commission construed this language as a mandate to align default service rates with market prices.[5] To facilitate that alignment, the Commission recommended the use of a combination of spot market purchases and contracts of one to three years in length to serve residential and small commercial and industrial ("C&I") customers, *i.e.*, C&I customers with maximum peak demand of less than 25 kW, and contracts of one year in length to serve medium C&I customers, *i.e.*, customers with maximum peak demand of 25 kW to 500 kW.[6] The Commission also recommended an increased reliance on spot market purchases and shorter-term contracts over time.[7] In addition, the Commission required that rates for small and medium C&I customers be adjusted no less frequently than quarterly.[8]

However, Act 129 made numerous changes in the original Competition Act. Some of those changes are inconsistent with some of the decisions made, and preferences expressed, by the Commission prior to the enactment of Act 129. The most significant change was the repeal of the "prevailing market prices" standard and the substitution of the requirement that default

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[4] *See* 66 Pa. C.S. §2807(e)(3)(repealed).

[5] *See, e.g.,* 52 Pa. Code §69.1802(a)(". . . structuring default service in a way that encourages the entry of new retail and wholesale suppliers."); and *Petition of Duquesne Light Company for Approval of Plan for Post-Transition Period Provider of Last Resort Service*, Docket No. P-00032071 (Reconsideration Order entered October 5, 2004), Concurring Statement of Chairman Terrance J. Fitzpatrick (". . . the very name of the service involved here—'provider of last resort' service—suggests that our primary focus should be on encouraging development of the market rather than on encouraging dependence on this service at the expense of the market.").

[6] *See* 52 Pa. Code §69.1805(1) and (2).

[7] *See* 52 Pa. Code §69.1805(1) and (2).

[8] *See* 52 Pa. Code §54.187(h) and (i).

service electricity be acquired through a "prudent mix" of spot, short-term, and long-term purchases designed to yield the "least cost to customers over time."[9]

The shift from "prevailing market prices" to "least cost to customers over time" does not appear to dictate a change in the way in which default service electricity is acquired. As interpreted by the Commission, a DSP met the "prevailing market prices" standard through competitive procurement (or by proving that its default service rates would be consistent with some other indicator of market prices).[10] Similarly, under Act 129, the DSP is required to meet the "least cost" standard through competitive procurement.[11] One thing that may have to change, however, is the Commission's commitment to retail competition.

The Commission has not yet explicitly decided the extent to which the replacement of the "prevailing market prices" standard means a de-emphasis on the goal of promoting a robust retail market.[12] Nevertheless, the Commission's decision in a case involving West Penn appears to indicate acceptance of the argument that the repeal of the "prevailing market prices" standard means that obtaining electricity at the "least cost to customers over time" is more important than aligning default service rates with market prices, *i.e.*, more important than promoting retail competition.

In West Penn's 2008 default service case, the company initially proposed to begin buying electricity in the fall of 2008 that would not be delivered until a period beginning on or after

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[9] *See* 66 Pa. C.S. §2807(e)(3)(repealed) and 66 Pa. C.S. §2807(e)(3.2), (3.4), and (3.7).

[10] *See* 52 Pa. Code §54.186(a) and (b) and 52 Pa. Code §69.1807.

[11] *See* 66 Pa. C.S. §2807(e)(3.1), (3.2), (3.4), and (3.7). There is a narrow exception in Section 2807(e)(3.1) to the competitive procurement requirement. Specifically, a DSP has the option of entering a bilateral contract which is not competitively bid, but that DSP then has the burden of proving that the contract price is consistent with wholesale market prices.

[12] *See, e.g.,* 66 Pa. C.S. §2802(3), (12), and (13); 66 Pa. C.S. §2804(2); 66 Pa. C.S. §2806(a); and 52 Pa. Code §69.1802(a).

January 1, 2011. However, after opposition from the OSBA and the EGSs, the company agreed to postpone the start of procurement until June 2009. In endorsing the initiation of procurement in June 2009, the Commission concluded, *inter alia*, that shortening the time between procurement and delivery would better align default service rates with market prices and, as a result, better promote retail competition.[13]

In February 2009, West Penn petitioned to accelerate the procurement schedule for residential customers, *i.e.*, to conduct the first procurement in April 2009 rather than in June 2009 and to move some residential purchases from 2010 to 2009. Despite opposition from the OSBA and EGSs, the Commission granted the petition on the grounds that buying earlier would enable West Penn to take advantage of a significant decline in electricity futures market prices for the time period during which the electricity would be delivered.[14]

In granting West Penn's petition, the Commission rejected the argument by the OSBA and the EGSs that West Penn was seeking to amend an approved default service plan and, therefore, Act 129 applied.[15] Instead, the Commission concluded that the acceleration was permitted under the default service plan approved in *West Penn I*.[16] Nevertheless, the Commission's substantive reasoning is consistent with the "least cost to customers over time" standard. Specifically, the Commission stated as follows:

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[13] *See Petition of West Penn Power Company d/b/a Allegheny Power for Approval of its Retail Electric Default Service Program and Competitive Procurement Plan for Service at the Conclusion of the Restructuring Transition Period*, Docket No. P-0072342 (Order entered July 25, 2008)("*West Penn I*"), at 37.

[14] *See Petition of West Penn Power Company d/b/a Allegheny Power for Acceleration of its Competitive Procurement Plan and Request for Expedited Consideration*, Docket No. P-00072342 (Order entered March 20, 2009)("*West Penn II*"), at 14.

[15] *See* 66 Pa. C.S. §2807(e)(6), regarding the effect of Act 129 on default service plans approved before the effective date of that act.

[16] *See West Penn II*, at 16-17.

There has been tremendous downward pressure on commodity prices since we approved the Company's default service plan last July. In that time, natural gas prices dropped from $13.31 to $4.23 and coal prices dropped from over $150.00 a ton to around $60.00 a ton. This downward pressure caused a precipitous drop in the price of electricity, which the Company and OCA calculated at over a forty percent decrease.

For these reasons, the Company and the OCA believe it is prudent to advance the Company's residential procurement schedule in order to take advantage of the current market conditions, which we may never see again.

As a Commission, we must be proactive in protecting Pennsylvania's consumers from high electricity prices. This mandate was made clear by the Legislature when it passed Act 129, which directed the Commission to make certain that electric distribution companies' default service plans are 'designed to ensure . . . the least cost to customers over time.'

In essence, the Company is proposing to move the procurement of six tranches of power for residential customers from 2010 to 2009, starting in April 2009. The Parties opposing this acceleration argue that there is no guarantee that electricity prices will be lower in 2009 than in 2010. We understand and appreciate this argument. We do, however, know for certain that today's prices are substantially lower than anyone could have predicted when the Commission approved the Company's procurement plan. In today's global economy, we cannot rely on this country's current recession to keep the commodity prices that drive the price of electricity low; it will only take a slight economic recovery by China, India, or any of a myriad of other industrial countries to cause commodity prices to begin to rise. Further, even with the advancement of these six tranches, which represent thirteen percent of the Company's total portfolio, the procurement schedule retains the diversification that is a key element of the portfolio approach.

It is our strong belief, therefore, that the risk of allowing the Company to procure power early is far outweighed by the increased certainty that comes with locking in prices closer in time to today's unarguably low rates, and that this acceleration contributes to ensuring 'least cost' rates for customers. We find it significant, in this regard, that the OCA—which represents the interests of the residential customers affected by the Company's proposal—strongly supports the Company's proposal.[17]

[17] *See West Penn II*, at 15-16. (footnotes omitted)

The premise underlying West Penn's petition was that futures market prices for 2011 and beyond would soon be rising, were likely to be higher in June 2009 and October 2009 than in April 2009, and were likely to be even higher in 2010 than in 2009.[18] Because the Commission expected market prices to be higher in 2011 (when the electricity was to be delivered) than in April 2009, the Commission implicitly recognized that residential shopping in 2011 could be significantly inhibited by default service rates that are below market prices. Therefore, by approving West Penn's petition, the Commission, in effect, concluded that the pre-eminent goal is "least cost to customers over time," regardless of the impact that pursuing that goal may have on retail competition.

2. What time frame should the Commission use when evaluating whether a DSP's procurement plan produces least cost to customers over time?

Act 129 is silent regarding the time period over which "least cost" is to be judged. Similarly, the statute does not explicitly prescribe the length of a default service period. Furthermore, by authorizing contracts of up to 20 years in length to serve up to 25% of the DSP's load, Act 129 contemplates that contracts may extend beyond the end of the default service period.[19]

However, Act 129 requires the DSP to "file a plan for *competitive* procurement" and to "provide electric generation supply service . . . pursuant to a commission-approved *competitive* procurement plan."[20] (emphasis added) Therefore, as a practical matter, the length of the default

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[18] To this point, it appears that the Commission's expectations about market prices in 2009 and 2010 have proved to be incorrect. According to West Penn, prices in the auction to serve the residential load actually were higher in April 2009 than in June 2009. Furthermore, prices in the October 2009 auction were lower than in the June 2009 auction. Similarly, prices in the January 2010 and May 2010 auctions were lower than the prices in any of the 2009 auctions. *See* Allegheny Energy news release dated May 21, 2010, captioned "Allegheny Power Completes Fifth Auction for Post-2010 Electricity Supply in Pennsylvania."

[19] *See* 66 Pa. C.S. §2807(e)(3.2)(iii) and (3.3).

[20] *See* 66 Pa. C.S. §2807(e)(3.6) and (3.1), respectively.

service period is limited by the availability of products in the competitive marketplace. In short, if the market for contracts of a particular length is illiquid, then the Commission can not find that such contracts would be *competitively*-procured and can not approve a plan that relies on the use of such contracts.

3. To comply with the requirement that the Commission ensure that default service is adequate and reliable, should the Commission's default service regulations incorporate provisions to ensure the construction of needed generation capacity in Pennsylvania?

No. The Competition Act does not authorize the Commission to require the construction of generation capacity. In fact, the only explicit authorization for construction by a DSP is to serve "customers with a peak demand of 20 megawatts or greater at one meter."[21] Significantly, the Competition Act specifies that "[n]othing in [the pertinent] paragraph requires or authorizes the commission to require an electric distribution company to commence construction or acquire an interest in a generation facility."[22] In addition, the pertinent paragraph specifies that "[t]he generation facility interests shall not be commission-regulated assets."[23]

Act 129 authorizes a DSP to propose long-term contracts but specifies that "[t]he default service provider shall have sole discretion to determine the source and fuel type" for generation supplied under such contracts.[24] Act 129 authorizes contracts of longer than 20 years upon explicit Commission approval.[25] Therefore, a DSP could presumably attempt to justify a long-term contract as a necessary incentive for the construction of generation capacity. However, as explained in the OSBA's answer to Question #2, the Commission can not approve such a

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[21] *See* 66 Pa. C. S. §2807(e)(5)(ii).

[22] *Id.*

[23] *Id.*

[24] *See* 66 Pa. C.S. §2807(e)(3.2)(iii).

[25] *See* 66 Pa. C.S. §2807(e)(3.3).

proposal unless there is a liquid market for contracts of such length. Therefore, as a practical matter, the *competitive* procurement requirement is likely to limit the Commission's ability to approve construction-related contracts.

Mandating the construction of additional generating capacity might have the effect of lowering future market prices of electricity, as long as the additional capacity did not simply displace other generating capacity that would have been built without a Commission mandate. However, mandating such construction through the default service procurement process would implicitly require that Pennsylvania customers pay the full cost of the additional generating capacity, even though the market benefits associated with the additional capacity would extend throughout the PJM marketplace.

4. If the Commission should adopt a provision to ensure the construction of needed generation capacity, how should the default service regulations be revised?

The Competition Act is based on the premise that "[c]ompetitive market forces are more effective than economic regulation in controlling the cost of generating electricity."[26] Furthermore, the Competition Act places the obligation on the DSP to acquire default service electricity through a "prudent mix of contracts . . . designed to ensure . . . [a]dequate and reliable service."[27] Therefore, the Commission's regulations should focus on determining if the DSP's competitive procurement plan will produce "adequate and reliable service."

[26] *See* 66 Pa. C.S. §2802(5).

[27] *See* 66 Pa. C.S. §2807(e)(3.4)(i).

5. Which approach to supply procurement—a managed portfolio approach or a full requirements approach—is more likely to produce the least cost to customers over time?

a. Basic features of the two approaches

There are fundamental economic differences between a "full-requirements approach" and a "portfolio approach."

Under a portfolio approach, the DSP (or a DSP's portfolio manager) procures *energy* in a variety of fixed capacity blocks, such as a 7x24-50 MW baseload block or a 5x16-50 MW on-peak block. With the fixed block contracts, the supplier provides a fixed quantity of energy regardless of the level of default service customer load in any hour or on any day. Suppliers of these products, therefore, face almost no *volumetric* risk, though they remain subject to risks associated with the variable costs of producing or purchasing the energy.

In addition, a portfolio approach typically includes purchasing some of the energy requirements on the spot market. These spot market purchases are designed to balance load fluctuations, on an hourly, daily, and monthly basis. Spot market purchases must generally represent a fairly significant share of the supply, to accommodate the possibility that customers will leave default service in order to "shop." If a DSP has locked in too much default service energy in the fixed blocks, it will need to sell the excess on the spot market, potentially at a loss. Under the portfolio approach, a DSP must also pay the regional transmission organization ("RTO") capacity charges, as well as procure network transmission service, ancillary services, and alternative energy credits.

Furthermore, under the portfolio approach, the DSP also must manage any financial transmission rights ("FTRs") that it is assigned by the RTO.

Finally, because the DSP is permitted to *reconcile* variations in its own costs, the DSP using the portfolio approach is not financially exposed to variations in either the level or price of its spot market purchases and is not exposed to fluctuations in the costs of the non-energy requirements. Therefore, in the portfolio approach, all of those risks are passed to default service ratepayers.

Under the full-requirements approach, ratepayers not only buy electricity, but they are implicitly buying price insurance for the duration of the contract. If market prices rise above the default service rate, ratepayers do not have to pay those higher prices because they pay only the default service rate. If market prices fall well below the default service rate, ratepayers can get the benefit of the lower market prices by shopping. However, this insurance comes at a cost. Because the full-requirements supplier has absorbed all of the volume variation risk (including the customer migration risk), as well as all of the risk of fuel price changes, congestion charges and fluctuations of non-energy costs, the supplier will necessarily include a risk premium in its bid price.

Some parties may attempt to engage in an after-the-fact debate over the value of specific insurance, based upon whether or not the insurance was used, *i.e.*, whether anything bad happened. In the case of the insurance provided by full-requirements contracts, if actual market results did not deviate far from prior expectations, such parties may conclude that there was no value in buying the underlying insurance. However, assuming that actual market results will match expectations and that there will be no unpleasant surprises is a very big "if." Therefore, there is value in buying the insurance, particularly when the price (premium) for that insurance policy was subject to competitive bidding.

b. Advantages and Disadvantages

There are advantages and disadvantages to both procurement methods. These two approaches not only have very different procurement strategies but also have very different cost and risk implications for default service ratepayers. A portfolio approach typically involves a higher percentage of short-term purchases. Specifically, full-requirements contracts usually have a duration of at least one year, whereas the portfolio approach usually involves a significant share of shorter-term fixed block and spot market purchases.

Moreover, as the likelihood of customer shopping increases, the need for more short-term purchases within the portfolio increases. The level of shopping following the expiration of Penn Power's rate caps illustrates that point. Specifically, Penn Power's residential shopping load increased from 0.0 to 4.7 percent of total residential load between January and June 2007, but the commercial shopping load increased from 4.4 to 45.3 percent within the same period. It would, therefore, be much more risky for a DSP to lock in 60 percent of commercial load through fixed block supplies than to do so for residential customers.

For example, suppose that a DSP using the portfolio approach enters into a set of three-year fixed block contracts for 60 percent of the commercial load. Suppose further that, early in the performance of this contract, natural gas market prices plummet, thereby causing electricity market prices to fall below the fixed block price. If a significant number of the default service commercial customers then choose to shop, the DSP will be forced to resell its excess supply on the spot market, and to recover the losses on that resale from a diminishing number of default service ratepayers through the reconciliation mechanism. Rising reconciliation charges could then cause even more commercial customers to shop, exacerbating the "stranded cost" problem.

To avoid such a scenario, a portfolio strategy for commercial customers would need to keep longer-term purchases to a minimum because of the likelihood of significant shopping. Therefore, default service ratepayers (particularly those in rate classes that are more likely to shop) would be subject to greater fluctuations in energy market prices under the portfolio approach than under a full-requirements approach.

In summary, if market price movements do not actually vary far from expectations, it is likely that a portfolio approach will produce lower average prices than a full-requirements approach. However, it is perilous to assume that there will be no major market surprises. For example, no surprises means that there will be no major changes in market prices due to fuel cost changes, no changes in transmission rates or RTO demand charges, and no changes in load due to economic activity (*e.g.*, the "Great Recession") or weather (*e.g.*, Hurricane Katrina). No surprises also means that there will be no significant changes in shopping, either as a result of customers' choosing to shop or customers' choosing to return to default service. It is the absorption of all of these risks by the wholesale supplier that causes wholesale full-requirements contracts to include a price premium above forward market prices. Significantly, the portfolio approach does not avoid these risks; it simply shifts them to the ratepayers.

c. Commission Precedent

The Commission has already addressed the issue of whether to use a full-requirements approach or a portfolio approach in procuring energy for default service customers.[28]

In that case, Penn Power, the Office of Consumer Advocate ("OCA"), the OSBA, and several EGSs filed a settlement. In the Opinion and Order entered January 2, 2008, the Commission approved that part of the settlement which provided for Penn Power to enter into

[28] *Petition of Pennsylvania Power Company for Approval of Interim Default Service Supply Plan: Supply Procurement for Residential Customers*, Docket No. P-00072305 (Order entered March 13, 2008).

full-requirements, load-following contracts for small business default service customers. However, the Commission remanded to the ALJ the portion of the settlement related to the procurement of default service supply for residential customers. As part of that remand, the Commission directed that Penn Power propose a portfolio approach for procuring power to serve the residential customers rather than the full-requirements, load-following contracts in the settlement.

On remand, Penn Power submitted a proposed portfolio approach for the residential customers. However, in an Opinion and Order entered on March 13, 2008, the Commission rejected Penn Power's portfolio approach for residential customers and directed that the residential customers' default service be procured through the full-requirements contracts as laid out by the parties in the settlement. Specifically, the Commission stated:

> Both procurement methods proposed would satisfy the Choice Act and our Regulations. Regrettably, neither method can guarantee lower prices. However, at this stage in the transition to competition, we believe it is wiser to proceed with the procurement method that will offer non-shopping residential customers some measure of price stability for the term of the contract. The PTC generated by the laddered full requirements approach will include some risk premium due to potential customer migration or other volumetric risk factors. However, wholesale suppliers are experienced in portfolio management and in the business of managing risks. Although we will adopt the full requirements approach, as presented in the settlement, we do so with the expectation that Penn Power will follow through with its commitment to further study the portfolio approach as it applies to the POLR III supply beginning June 1, 2011.
>
> Based on the foregoing discussion, the record before us, and the pleadings filed by the Parties, we find that the full requirements contract approach submitted with the Settlement, as modified by our January 2, 2008, Opinion and Order meets the requirements and standards of the Code, the Final Rulemaking Order, and the Policy Statement.[29]

[29] *Petition of Pennsylvania Power Company for Approval of Interim Default Service Supply Plan: Supply Procurement for Residential Customers*, Docket No. P-00072305 (Order entered March 13, 2008), at 13.

The Commission's legal conclusion in the Penn Power case predated Act 129. Significantly, however, the Commission found as a fact in that case that "neither [the portfolio nor the full-requirements] method can guarantee lower prices." Therefore, in the absence of empirical evidence that one approach consistently outperforms the other, there is no basis for changing the Commission's legal conclusion despite the switch from the "prevailing market prices" standard to the "least cost" standard.

d. Empirical Evidence

Much of the debate over the choice of a managed portfolio or a full-requirements contract has been conceptual. When empirical evidence has been offered, that evidence has been difficult to evaluate because it has usually involved procurement in other states by utilities about which the Commission and most parties have limited knowledge. Furthermore, that evidence has often involved the purchase of default service electricity for ratepayers whose right to shop is much more constrained than in Pennsylvania.

However, the Commission will have the opportunity to compare the results of Pennsylvania DSPs' differing procurement plans over several years. In that regard, PPL, PECO, MetEd, and Penelec will be acquiring default service electricity for small business customers via a combination of full-requirements contracts and spot market purchases through May 31, 2013. At the same time, these DSPs will be procuring default service electricity for residential customers through a variety of spot market purchases, energy block purchases, and full-

requirements contracts.[30] During that same time period, Citizens' Electric Company ("Citizens'") and Wellsboro Electric Company ("Wellsboro") will be using an actively-managed portfolio to serve both residential and non-residential customers.[31] In addition, UGI Utilities, Inc.—Electric Division ("UGI") will be using an actively-managed portfolio to serve residential customers and a combination of spot market purchases and full-requirements contracts to serve small business customers.[32]

Therefore, the Commission will have Pennsylvania-specific empirical evidence to help determine whether one procurement methodology consistently outperforms the other. The Commission will also have Pennsylvania-specific empirical evidence to help evaluate whether different contract lengths, different percentages of spot market purchases, or different procurement dates consistently yield significantly different default service rates. Until it has assembled and analyzed that evidence, the Commission should not change its prior conclusion that both the managed portfolio approach and the full-requirements approach satisfy the Competition Act.

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[30] *See Petition of PPL Electric Utilities Corporation for Approval of a Default Service Program and Procurement Plan for the Period January 1, 2011 Through May 31, 2014*, Docket No. P-2008-2060309 (Order entered June 18, 2009); *Petition of PECO Energy Company for Approval of Its Default Service Program and Rate Mitigation Plan*, Docket No. P-2008-2062739 (Order entered June 2, 2009); and *Joint Petition of Metropolitan Edison Company and Pennsylvania Electric Company for Approval of Its Default Service Programs*, Docket Nos. P-2009-2093053 and P-2009-2093054 (Order entered November 6, 2009).

[31] *See Joint Default Service Plan for Citizens' Electric Company of Lewisburg, PA and Wellsboro Electric Company for the Period of June 1, 2010 through May 31, 2013*, Docket Nos. P-2009-2110798 and P-2009-2110780 (Order entered February 26, 2010).

[32] *See Petition of UGI Utilities, Inc.—Electric Division For Expedited Approval of a Default Service Procurement, Implementation and Contingency Plan*, Docket No. P-2008-2022931 (Order entered July 17, 2008); *Petition of UGI Utilities, Inc.—Electric Division For Approval of a Default Service Rate and AEPS Implementation Plan*, Docket No. P-2008-2063006 (Order entered January 22, 2009); and *Petition of UGI Utilities, Inc.—Electric Division for Approval of a Default Service Program Pursuant to 52 Pa. Code §§54.181-54.189, and Associated Potential Transactions with Affiliated Entities*, Docket No. P-2009-2135496 (Order entered May 11, 2010).

6. What is a "prudent mix" of spot, long-term, and short-term contracts?

Act 129 provides that the procurement of electricity for default service shall contain a "prudent mix" of spot market, short-term, and long-term contracts. However, it is not clear from the provisions of Act 129 whether the "prudent mix" means that each of the three categories of contracts must be included in the default service program for each DSP or whether the mix is to depend on what would be "prudent" for each individual DSP. Nevertheless, the Commission answered that question when it approved the current default service plan of Pike County Light & Power Company ("Pike") even though that plan relies entirely on spot market purchases, *i.e.*, the plan includes no long-term contracts and no short-term contracts.

Specifically, Pike argued (and the Commission explicitly agreed) that *long-term* contracts would be imprudent for Pike under the terms of Act 129. Furthermore, by deciding that the default service rate would be based on spot market prices, the Commission, in effect, also found that *short-term* contracts are not prudent for Pike as long as Direct Energy's aggregation program is in effect and the default service load remains small. Because Direct Energy is likely to continue serving most of Pike's customers under the aggregation program for the entire default service period, Pike will need to procure only a minimal default service load and can do so on the spot market without the risks associated with either long-term or short-term contracts.[33]

7. Does a "prudent mix" mean that the contracts are diversified and accumulated over time?

In 2005, Pike acquired its entire default service load for two years on a single day following Hurricane Katrina. As a result, ratepayers were hit with increases of more than 70

[33] *See Re: Petition of Pike County Light and Power Company for Expedited Approval of its Default Service Implementation Plan*, Docket No. P-2008-2044561 (Order entered March 23, 2009).

percent on a total-bill basis.[34] In large part because of that experience, the Commission has subsequently required DSPs to conduct multiple procurements to purchase default service electricity for the same delivery period.[35] That requirement should be retained. However, the Commission should not further mandate the timing of procurements or the mix of products unless there is compelling evidence that some particular procurement schedule or product mix consistently yields higher or lower default service rates than other procurement dates or product mixes. As explained in the OSBA's answer to Question #6 the Commission will have the opportunity to compile and analyze relevant evidence through May 31, 2013.

8. Should there be qualified parameters on the prudent mix? For instance, should the regulations preclude a DSP from entering into all of its long-term contracts in one year?

The Commission has already approved procurement plans for most DSPs through at least May 31, 2013. Those plans differ with regard to the mix and length of contracts, the timing of purchases, the percentage of load to be purchased in each procurement, and the percentage of load that can be awarded to any single wholesale supplier. Rather than deciding now whether or not to *mandate* specific parameters for the composition of the "prudent mix," the Commission should defer this decision until it has had the opportunity to analyze the results from those plans.

9. Should the DSP be restricted to entering into a certain percentage of contracts per year?

The Commission has already approved procurement plans for most DSPs through at least May 31, 2013. Those plans differ with regard to the mix and length of contracts, the timing of purchases, the percentage of load to be purchased in each procurement, and the percentage of

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[34] *See Petition of Direct Energy Services, LLC for Emergency Order Approving a Retail Aggregation Bidding Program for Customers in Pike County Light & Power Company's Service Territory*, Docket No. P-00062205 (Order entered April 20, 2006), at 2.

[35] *See, e.g.*, 52 Pa. Code §69.1805(1) and (2).

load that can be awarded to any single wholesale supplier. Rather than deciding now whether or not to *mandate* specific parameters for the composition of the "prudent mix," the Commission should defer this decision until it has had the opportunity to analyze the results from those plans.

10. Should there be a requirement that on a total-DSP basis, the "prudent mix" means that some quantity of the total-DSP default service load must be served through spot market purchases, some quantity must be served through short-term contracts, and some quantity must be served through long-term contracts?

Prior to Act 129, the Commission recommended against acquiring default service electricity through any contracts longer than three years unless a longer contract were necessary for the procurement of electricity or credits from alternative energy facilities.[36] However, Act 129, in effect, defines short-term contracts as contracts of four years or less and allows long-term contracts to extend for up to 20 years.[37] Furthermore, Act 129 makes no distinction between permissible contract lengths on the basis of whether the contracts are for default service electricity (regardless of the energy source) or are for credits from alternative energy facilities.

The Commission has not yet explicitly decided which of the following three options is required by Act 129:

Option A. Each *rate class procurement group* in a DSP's default service plan must be served through a "prudent mix," which includes some quantity, *i.e.*, a quantity greater than zero, of spot market purchases, some quantity of purchases through short-term contracts, and some quantity of purchases through long-term contracts.

Option B. There is no requirement that each individual rate class procurement group in a DSP's default service plan be served by some quantity of spot market purchases, some quantity of purchases through short-term contracts, and some quantity of purchases through

[36] *See* 52 Pa. Code §§69.1805 and 69.1806.

[37] *See* 66 Pa. C.S. §2807(e)(3.2) and (3.3).

long-term contracts. However, on a *total-DSP basis*, the "prudent mix" requirement means that some quantity of the total-DSP default service load must be served through spot market purchases, some quantity must be served through short-term contracts, and some quantity must be served through long-term contracts.

Option C. There is no requirement that some quantity of each rate class procurement group's load or some quantity of the total-DSP load must be served by spot market purchases, some quantity must be served through short-term contracts, and some quantity must be served through long-term contracts. Instead, a DSP is permitted to rely on only one or two of those product categories, with the choice depending on what would be the "prudent mix" and would yield the "least cost to customers over time" for that specific DSP.

Despite the absence of an explicit decision in a litigated case, the Commission appears to believe that Option C is all that Act 129 requires.

For example, the Commission approved a settlement in which Pike is serving its default service load entirely through the spot market. Most of Pike's customers receive generation service under an aggregation program provided by Direct Energy. Even if that aggregation program were considered "default service," the aggregation period is only two years and, therefore, would be a short-term contract under Act 129. In any event, none of Pike's default service customers (including the Direct Energy aggregation customers) are being served under a long-term contract.[38] In support of forgoing a long-term contract, the DSP argued, and the OSBA agreed, that a long-term contract would not be prudent because of Pike's unique circumstances.[39]

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[38] *See Re: Petition of Pike County Light and Power Company for Expedited Approval of its Default Service Implementation Plan,* Docket No. P-2008-2044561 (Order entered March 23, 2009)("*Pike*").

[39] *See Pike*, at 15, fn. 6.

The settlement in *Pike* is not precedential from the standpoint of the settling parties.[40] However, the Commission could not have approved the settlement if the Commission believed that the settlement was contrary to law.[41] Therefore, as a precondition for approving the settlement, the Commission necessarily concluded that neither each procurement group, nor each DSP on a total-company basis, is legally required to include purchases from the spot market *and* purchases through short-term contracts *and* purchases through long-term contracts.[42]

The OSBA agrees with the Commission's conclusion.

11. Should there be a requirement that some quantity of each rate class procurement group's load be served by spot market purchases, some quantity through short-term contracts, and some quantity through long-term contracts? In contrast, should a DSP be permitted to rely on only one or two of those product categories with the choice depending on what would be the prudent mix and would yield the least cost to customers over time for that specific DSP?

As explained in the OSBA's answer to Question #10, the Commission has already decided that there is no legal requirement that the "prudent mix" for each rate class procurement group must include some quantity from spot market purchases, some quantity from short-term contracts, and some quantity from long-term contracts. Therefore, a DSP should be permitted to

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[40] *See Pike*, at 14.

[41] *See, e.g., Pennsylvania Public Utility Commission v. C S Water & Sewer Associates*, 1991 Pa. PUC LEXIS 141 (Order entered July 22, 1991), wherein the Commission approved a settlement on the grounds that the settlement would "foster, promote and serve the public interest, and represent a fair, just, reasonable and equitable balance of the interest of [the utility] and its customers." Significantly, prior to gaining Commission approval of the settlement, the parties agreed to a modification which eliminated a provision the administrative law judge had determined to be contrary to law.

[42] In addition to amending 66 Pa. C.S. §2807(e), Act 129 added Section 2806.1, imposing energy conservation requirements on EDCs. By Section 2806.1(l), the General Assembly expressly exempted EDCs with fewer than 100,000 customers, *i.e.*, UGI, Pike, Citizens', and Wellsboro, from these conservation requirements. In contrast, the General Assembly did not expressly or impliedly exempt Pike or any other EDC from the "prudent mix" requirements of Section 2807(e). Therefore, Pike's unique circumstances are not a basis for applying a different legal standard to other DSPs than the Commission applied to Pike.

rely on only one or two of those product categories, depending upon what would be prudent for serving each rate class procurement group and what would be likely to yield the least cost to the customers in that group over time.

12. Should the DSP be required to hedge its positions with futures including natural gas futures because of the link between prices of natural gas and the prices of electricity?

The Commission has already approved procurement plans for most DSPs through at least May 31, 2013. Those plans differ with regard to the mix and length of contracts, the timing of purchases, the percentage of load to be purchased in each procurement, and the percentage of load that can be awarded to any single wholesale supplier. Rather than deciding now whether or not to *mandate* hedging relative to natural gas futures, the Commission should defer this decision until it has had the opportunity to analyze the results from those plans.

13. Is the "prudent mix" standard a different standard for each different customer class?

As explained in the OSBA's answers to Question #10 and Question #11, the "prudent mix" may vary from DSP to DSP and from rate class procurement group to rate class procurement group within a single DSP's default service plan.

From the OSBA's perspective, long-term contracts will usually not be part of a "prudent mix" for small C&I customers and especially not for medium C&I customers. Specifically, the goal of minimizing long-term default service rates through the use of long-term contracts, *e.g.*, by locking in what appear at the time of purchase to be favorable market prices, is inconsistent with the goal of letting customers switch in and out of default service freely. Although a long-term contract for small and medium C&I customers could be load-following (with all risks borne by the wholesale supplier), such a contract would likely be very expensive because of the

shopping risk. Unfortunately, the alternative, *i.e.*, a contract for a fixed block of power on a non-load-following basis, could lead to disastrous results.

For example, assume that a DSP decides that "least cost to customers over time" means that it should procure default service electricity from a new coal-fired baseload plant (with carbon capture), and that the DSP enters into a contract for output from such a plant. While the plant is being constructed, natural gas prices fall significantly and electricity market prices plummet, thereby rendering the coal plant contract uneconomic. If all the default service customers are entitled to shop and a significant number of them do shop, the DSP will be forced to collect the uneconomic contract cost from a diminishing number of default service ratepayers. The rates paid by those non-shopping customers would be higher than the market price of electricity. Such a result would be very similar to the rate increases imposed on customers as a result of the high-cost nuclear plant investments and non-utility generation ("NUG") contracts in the days of full regulation.

Therefore, it would arguably not be "prudent" to include purchases through long-term contracts as part of the "mix" of serving a small business procurement group that includes the larger, high-load factor customers that are most likely to shop. Because medium-sized, higher load factor C&I customers have demonstrated just such a higher propensity to shop, long-term contracts may very well be "imprudent" for rate class procurement groups with substantial medium C&I customer load.[43]

[43] For example, nearly 50 percent of Penn Power's load for customers with peak demand between 100 and 500 kW was served by EGSs within five months of the transition to market-based default service rates in January 2007.

14. What will be the effects of bankruptcies of wholesale supplier to default service suppliers on the short- and long-term contracts?

The Commission's current default service regulations specify that "[a] default service program must include . . . [c]ontingency plans to ensure the reliable provision of default service when a wholesale supplier fails to meet its contractual obligations."[44] Because of this requirement, each DSP must have a plan in place if a wholesale supplier fails to deliver on a contract of any length, whether because of bankruptcy or any other reason.

As an additional protection against wholesale supplier default, the OSBA has advocated that individual default service procurement plans include a cap on the quantity of load that can be awarded to a single supplier.

15. Does Act 129 allow for an after-the-fact review of the "cost reasonableness standard" in those cases where the approved default service plan gives the EDC substantial discretion regarding when to make purchases and how much electricity to buy in each purchase?

A DSP, or the DSP's portfolio manager, will likely have little incentive to try to minimize the overall cost of default service supply, compared to the incentives faced by a full-requirements wholesale supplier. Because the full-requirements supplier must meet the full load at a fixed price, every dollar that it can save by reducing costs is another dollar of profit (or of reduced loss). Furthermore, the winning bid price for the full-requirements supply is minimized by competition among wholesale suppliers. Under the portfolio approach, the supplier of the fixed price blocks also has an incentive to minimize its costs. However, the DSP itself generally has little economic incentive to minimize the *overall* cost of default supply by modifying the portfolio to address changing market circumstances, because the DSP is able to recover its costs in full through the reconciliation mechanism.

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[44] *See* 52 Pa. Code §54.185(d)(5).

A traditional regulatory remedy for such a lack of economic incentives would be to subject the DSP to an after-the-fact prudence review. Such a review would at least require that the DSP explain its strategy, including any deviations from the basic procurement plan. Requiring a prudence review should cause the DSP both to prepare defensible analyses of its portfolio purchases and to exercise more caution before engaging in risky procurement strategies.

The Commission's current default service regulations do not explicitly provide for an after-the-fact review of the "prudence" of a DSP's procurement decisions.[45] Similarly, Act 129 indicates that the DSP is entitled to recover the contract price of default service electricity as long as the contract resulted from a Commission-approved competitive procurement process and also did not involve fraud, collusion, or market manipulation.[46]

However, in explicitly allowing recovery of default service costs only if those costs are "reasonable," Act 129 may have left the door open to an after-the-fact review, at least in those cases in which the approved default service plan gives the DSP substantial discretion regarding when to make purchases and how much electricity to buy in each purchase.[47] Under those circumstances, guaranteed recovery of the DSP's costs to acquire electricity would eliminate any economic incentive for the DSP to control those costs.[48]

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[45] *See* 52 Pa. Code §54.188(d), which indicates that the Commission usually will not deny a DSP recovery of its procurement costs, *e.g.*, as long as the DSP adheres to its approved default service plan. However, Section 54.188(d) also provides that recovery is limited to those purchase costs which are "reasonable."

[46] *See* 66 Pa. C.S. §2807(e)(3.8).

[47] *See* Section 2807(e)(3.9), which provides the DSP with the right to recover "all *reasonable* costs" incurred under Section 2807 and under an approved competitive procurement plan.

[48] Without an after-the-fact prudence review in those circumstances, the ratepayers would be forced to pay for any unsuccessful efforts by the DSP to "outguess the market."

If there is substantial discretion granted to the DSP or its portfolio manager regarding what to buy and when to buy it, it is impossible for the Commission to determine in advance that the DSP's procurement decisions will result in "reasonable" costs. Therefore, the "reasonable" cost requirement precludes the Commission from approving a procurement plan that provides the DSP with substantial discretion in the nature and timing of default service purchases. Without an after-the-fact prudence review, the only basis on which the Commission can make the required finding of "reasonableness" at the time of approval of the portfolio plan is to specify a relatively limited range of product types and quantities which can be purchased and to specify relatively narrow windows in which those products must be purchased.

Advocates of actively-managed portfolios sometimes point to procurement by the natural gas distribution companies ("NGDCs") as an appropriate model for electric default service. Significantly, the procurement decisions of an NGDC are subjected to an annual after-the-fact prudence review.[49] There is no obvious policy reason for failing to impose a similar prudence review on the procurement decisions of a DSP. Furthermore, although Act 129 does not set out a detailed process for an after-the-fact review of a DSP's decisions under a managed portfolio, the statute also does not explicitly preclude such review.

16. How should the requirement that "this section shall apply" to the purchase of AECs be implemented? Section 2807(e)(3.5) states that ". . . the provisions of this section shall apply to any type of energy purchased by a default service provider to provide electric generation supply service, including energy or alternative energy portfolio standards credits required to be purchased, etc."

The quoted statutory language mandates that the DSP use competitive procurement to acquire either default service electricity from alternative energy sources or alternative energy credits ("AECs"). As explained in its answers to Question #10 and Question #11, it is the

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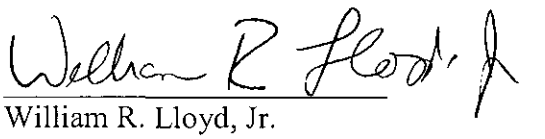
[49] *See* 66 Pa. C.S. §§1307(f), 1317, and 1318.

OSBA's position that there is no legal requirement that some quantity of the default service load be purchased through the spot market, some quantity be purchased through short-term contracts, and some quantity be purchased through long-term contracts. As also explained in those answers, it is the OSBA's position that the "prudent mix" of procurement products may vary from DSP to DSP and from rate class procurement group to rate class procurement group within a single DSP. Therefore, the "prudent" way to conduct competitive procurement of default service electricity from alternative energy sources and the "prudent" way to conduct competitive procurement of AECs may well vary from DSP to DSP and from rate class procurement group to rate class procurement group.

From the OSBA's perspective, it would be efficient to include the acquisition of AECs as part of the full-requirements contracts serving the default service load of small business customers. Although the OSBA has agreed to proposals by some DSPs to carve out the procurement of solar AECs, the OSBA is unaware of any empirical evidence that such a carve-out will result in any lower cost to customers over time than if solar AECs were included as part of the product to be delivered by wholesale suppliers under full-requirements contracts.

WHEREFORE, for the reasons set forth above, the OSBA respectfully requests that the Commission revise the proposed amendments to the default service regulations and the proposed amendments to the default service policy statement in accordance with the foregoing comments.

Respectfully submitted,



William R. Lloyd, Jr.
Small Business Advocate
Attorney ID No. 16452

Office of Small Business Advocate
Suite 1102
300 North Second Street
Harrisburg, PA 17101
(717) 783-2525

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