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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

June 1, 2010

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
400 North Street – 2nd Floor
Commonwealth Keystone Building
Harrisburg, PA 17120

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

Dear Secretary Chiavetta:

Enclosed for filing please find an original and fifteen (15) copies of the Comments of West Penn Power Company d/b/a Allegheny Power in the above-captioned matter. This filing is made by express delivery and is deemed filed today.

Very truly yours,

John L. Munsch

John L. Munsch
Senior Attorney

JLM/bsm

Enclosures

cc: Elizabeth Barnes, Esq., Law Bureau (ebarnes@state.pa.us)

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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

COMMENTS OF WEST PENN POWER COMPANY d/b/a ALLEGHENY POWER

West Penn Power Company d/b/a Allegheny Power ("Allegheny Power" or "Company") submits Comments on the above-captioned Proposed Rulemaking Order concerning the implementation of changes to the Pennsylvania Public Utility Commission ("Commission") default service regulations required by the enactment of Act 129.

52 Pa. Code § 54.184 (Default Service Provider Obligations).

The Company points out that Section 2806.1(f)(2)(ii) contemplates that, if an EDC fails to achieve the EE&C reductions required by Act 129, then EE&C reduction responsibilities may transfer to the Commission to contract with a CSP provider. Section 54.184(d), as modified, assumes that energy conservation programs are always the responsibility of the DSP, which doesn't hold true in extreme circumstances.

Company responses to the Commission's questions:

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

[1] See 66 Pa. C.S. § 2807(e)(3.2), (3.4) and (3.7).

Allegheny Power believes that the "least cost over time" standard is a mandate for the Commission to approve default service procurement programs that are highly competitive, provide diversity of contract term and refresh themselves periodically through various bids to incorporate changes in the energy markets and overall macroeconomics on a continual basis. There is no measurement that can prove least cost since the energy market is always changing. EDCs should be striving to design default service procurement programs that provide retail customers with the best long-term opportunity for positive procurement value.

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

As mentioned in the response to Question No. 1 there is no measurement that can prove least cost since the energy market is always changing. EDCs and the Commission should be vigilant and nimble to adjust procurement plans to promote positive procurement value and reflect changes in the energy markets. The Company certainly does not suggest that a "managed portfolio approach" – a portfolio procurement approach that attempts to time or guess the market – is superior to a well-designed full requirements approach. Rather, whatever procurement approach is used, EDCs and the Commission should be alert to conditions that invite a plan modification. Such was the case with Allegheny Power's approved default service program at the beginning of 2009 when energy prices dropped over 40 percent from the previous year. Allegheny Power and the Commission worked together to allow the Company to procure approximately 67 percent of its residential customers' 2011 generation needs, with the result that a typical Allegheny Power residential customer's bill will increase only 4,1 percent over 2010 levels, assuming the remaining procurements are the same as the average price of the first four auctions.

3. *In order 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?*

Allegheny Power recommends that the Commission not incorporate provisions to ensure the construction of generation capacity. Pennsylvania EDCs (except Penn Power) are part of PJM, a vibrant multi-state competitive wholesale electricity market. As for considerations of adequate supply and subsequent reliability, PJM facilitates a coordinated transmission and generation planning process among stakeholders that effectively responds to reliability issues. Through the Regional Transmission Expansion Planning Process, the Regional Transmission Expansion Planning Protocol and the Reliability Pricing Model the PJM market sends market participants signals to spur the necessary development at the appropriate transmission system locations and thus ensure reliability. Requiring that new capacity be built in Pennsylvania outside of the

PJM planning process may lead to uneconomic development and additional costs.

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

Allegheny Power's position is that, if some form of long-term procurement for the construction of generation in Pennsylvania is mandated, then the procurement must be competitive and market based. Allegheny Power recommends that such procurement would be completed through a competitive RFP process and it should be open to new or existing generation located in Pennsylvania and be non-discriminatory to all generation fuel types.

The Commission should recognize, however, that mandating long-term contracts does not necessarily guarantee customers the best price. Over reliance on long-term contracts could mute demand response initiatives and create the potential for future default service customers to bear future above-market costs based on contracts that no longer reflect market price.

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?*

Allegheny Power believes that the full requirements approach it currently employs is a form of managed portfolio because it provides customers with consistent long-term value and is fully compliant with the "least cost" requirements of Act 129.

Based upon the RFP agreement term, the service types being bid (residential, commercial, industrial), the utility zone within PJM and the amount of load available, each of the numerous wholesale suppliers active in the Pennsylvania market assemble their own portfolio to provide service. Full requirements supply from these unique market positions/portfolios is then offered by the various competing wholesalers to the EDC.

The RFP process into which wholesale suppliers bid their portfolios has the single selection criterion of best price based upon standardized terms and conditions that create a level playing field for bidders and a robust competitive market. The EDCs are then able to select the best 50 MW block pieces of each of the suppliers' portfolios to serve the load.

Thus, instead of the customers being served from just one managed portfolio, Allegheny's customers get the benefit of service based on the best pieces of many competing managed portfolios. Moreover, as opposed to locking into long-term agreements of 10 to 30 years, customers receive the best portions of several competing sources. This approach avoids the potential for current and future retail customers to bear above-market costs over an extended period of time, such as in the case of numerous PURPA facilities across the Commonwealth. Tapping the benefits of "managed portfolios" through periodic full-requirements bidding also encourages demand response and provides Allegheny Power and the Commission, through periodic review of the process, the ability to improve the process for the benefit of default customers on an ongoing basis.

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

Short-term and long-term contracts both have inherent risks. For residential and small commercial and small industrial customers the Company recommends a mixture of 40 percent short-term (1-year) contracts, 40 percent mid-term (3-year) contracts, along with ten percent spot market purchases and ten percent longer-term (5-year) contracts. This mix provides a balance to produce price stability and mitigates large price adjustments from changes in market conditions. For medium and large commercial and medium and large industrial customers the mix should be adjusted due to customers' retail market sophistication which in turn creates larger price premiums due to the volumetric risk associated with longer contract terms for these service types. Thus, the recommended mix for medium-sized commercial and industrial customers is 75 percent short-term (1-year) and 25 percent spot market purchases. For large commercial and large industrial customers the Company recommends 100 percent spot market purchases. The Company's experience with this load type in its Maryland jurisdiction supports its position that large commercial and industrial customers are sophisticated and that they are the customers most likely to shop.[2] They are also the most difficult service type for procurement of an economic fixed-price product.[3]

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[2] Historic peak load shopping percentages have ranged from 85% to 90%. Shopping statistics for all the Maryland EDCs can be found at http://webapp.psc.state.md.us/Intranet/CaseNum/submit_new.cfm?DirPath=\\Coldfusion\Electric%20Choice%20Re

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

The Company believes that carefully planned sets of procurement cycles, taking into account historic market behavior with calculated adjustments over time, provide customers with the best long-term procurement value. The procurement concept Allegheny Power has advocated in Pennsylvania, Maryland and Virginia is similar to what is known as "dollar cost averaging" ("DCA") in financial markets. From the investor's perspective DCA attempts to smooth out fluctuations in the financial market by investing the same amount of money at regular intervals. DCA avoids trying to time the highs and lows of the market. By applying the same principles to procurement of default service and averaging in the default service supply over several procurement cycles with several different procurement terms, the Company is able to mitigate extraordinary market events through a diversified portfolio of contracts, and over time provide Pennsylvania default service customers consistent portfolio value.

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?*

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[3] In 2004 Allegheny had several procurements for its large non-residential customers go unfilled for a 1-year agreement term due to the volumetric risk associated with the high shopping rate of this customer type. On 1/1/2006 the non-residential customers transitioned to spot market purchases exclusively for MD Standard Offer Service.

While a DCA approach to default service procurement relies heavily on a regimented structure of procurement cycles with various procurement terms being purchased to create a diversified portfolio of contracts, a well-designed plan must assume that changing circumstances may invite plan adjustments. As described in the answer to Question No. 2 Allegheny Power made a rapid adjustment to its plan in early 2009 to take advantage of rapidly decreasing energy prices. Thus EDCs and Commission must be vigilant to significant market fluctuations and act accordingly for the benefit of its customers. Over reliance on procurement of any contract term at any one point in time is generally viewed as counter-productive, but in a DCA model there can be significant market circumstances that justify moving up or delaying procurement cycles or certain contract terms.

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

Please see response to Question No. 8.

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?*

Please see the responses to Question Nos. 5, 6 and 7.

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?*

One-size does not fit all when procuring default service. Differing strategies by customer service type, taking into account wholesale and retail market sophistication, financial resources and retail market competition, should be considered. Please also see the response to Question No. 6.

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?*

If an electric product is not available for purchase to meet a certain portfolio need then, as part of an approved plan, a hedge option should be available for use if requested by the DSP. However, DSPs should not be required to enter into derivative hedge positions as part of their default service procurement plan.

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

Please see the responses to Question Nos. 6 and 11.

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

Bankruptcy of a wholesale supplier can have a positive or negative impact on an existing contract. The two scenarios would be that the contract price is more than the current market price and the DSP could replace the same electricity for less money or, on the other hand, the contract price is less than the current market price and the DSP would be required to pay more to replace the same power. Under the second scenario, where the replacement price is higher than the contract price, the DSP should be holding margin to help alleviate some or all of the loss. In a bankruptcy situation legal fees must also be added to the initial gain or loss on the contract.

From this point the EDC would want to determine the impact to individual contract types. For spot market purchases the impact of bankruptcy would most likely be minimal because the EDC would replace power under like market conditions.

For bilateral contracts the impact of bankruptcy would most likely be minimal because the EDC would replace physical power under like market conditions.

Under a financial contract, such as a swap or derivative, the financial position is not always netted under bankruptcy law, meaning that the contract is analyzed at the individual transaction or trade level. For example, suppose a contract contains a total of 10 transactions, six of which are in a liability position for $100,000 -- meaning this amount is owed to the bankrupt entity -- and four are in an asset position for $90,000 -- meaning this is owed to the non-bankrupt entity. In this situation the contract exposure, if netted, would be that the EDC would owe the bankrupt entity a total of $10,000 to close out or liquidate the agreement. Under certain contracts in which netting provisions are not recognized, the $100,000, from the example, is immediately due and payable to the bankrupt entity at the time of the bankruptcy, but the offsetting transactions of $90,000 under the same contract are not received until final liquidation or, in some instances, are never fully recovered.

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?* [4]

Reasonableness of the default service plan should be determined up front and not after the fact. If the Commission is uncomfortable with the discretion of a plan then the Commission should address it as part of the initial review process. Once a plan has been approved all costs incurred by the DSP under such approved plan should be recoverable on full and timely basis and not subject to after-the-fact disallowance except in the cases of fraud, collusion, or market manipulation.

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

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."*

As part of a full-requirement RFP process renewable obligations are included in the purchased product from the wholesale market. Allegheny Power believes spreading the renewable obligation across many winning bidders invites competition and creates opportunity for diversity of supply for renewables resulting in lower renewable pricing for the benefit of customers. For the spot market load that is served by the EDC, each EDC should be allowed to present plans to the Commission that allow for the procurement of renewable credits through a separate RFP process layering in competitively bid purchase contracts over time to serve the expected load and then transacting in the spot market to balance the load as necessary. Since the renewable market is not as liquid as the wholesale energy market, slightly longer contracts (up to 10 years) for limited availability renewable resources, such as solar, may be appropriate. Additionally, should the EDC execute upon its approved renewable program and still end up short of renewable credits to meet its obligation, and such credits necessary to balance its position are not available for purchase from the market, any alternative compliance payment made by the EDC should be fully recoverable by the EDC.

Dated: May 31, 2010

Respectfully submitted,

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