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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

SUPPLEMENTAL TESTIMONY

STEVEN A. MITNICK

ON BEHALF OF
PENNSYLVANIA ELECTRIC COMPETITION
COALITION

PUC DOCKET NO. R-00973953
RE: JOINT PETITION FOR PARTIAL SETTLEMENT
OF PECO RESTRUCTURING PLAN

September 29, 1997

I. *INTRODUCTION*

Q. STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Steven A. Mitnick. My business address is 1530 Wilson Boulevard, Suite 900, Arlington , Virginia, 22209.

Q. DESCRIBE YOUR CURRENT POSITION AND PROFESSIONAL BACKGROUND.

A. I am a Senior Vice-President of Hagler Bailly. Hagler Bailly provides consulting services which combine energy industry insight and executive experience with rigorous economic, market, and business analysis and specialized engineering, environmental, and scientific expertise. Since 1980, we have advised clients in over 100 countries. These clients include corporations, financial institutions, multilateral development agencies, research organizations, law firms, public utilities, and governments. Major Hagler Bailly offices are located in Arlington VA (corporate headquarters), Boston MA, Boulder CO, Houston TX, Madison WI, San Francisco CA, Dublin (Ireland), Jakarta (Indonesia) and Paris (France). The firm is described in greater detail at our website, whose address is www.haglerbailly.com.

I began my professional career in 1976 as a consultant to the U.S. Environmental Protection Agency, U.S. Department of Energy, and U.S. Department of the Navy. In 1980 I founded an energy industry consulting firm, for which I served as President until I joined the firm of Putnam, Hayes & Bartlett in 1989 as a Senior Consultant. In 1991, I joined Science Applications International Corporation (SAIC) as a Vice President and the Chief Economist. In 1993, I left SAIC to join RCG/Hagler Bailly, Inc. as a Principal. I was promoted to the position of Vice President in 1994. In May 1995, following a

management buyout, the company name changed to Hagler Bailly, Inc., and in conjunction with this change, I became a Director of Hagler Bailly Consulting, Inc. Hagler Bailly Consulting, Inc. is a subsidiary of Hagler Bailly, Inc. In July 1997, Hagler Bailly effected a successful initial public offering and is now listed on the Nasdaq National Market as HBIX. From Spring 1996 through Summer 1997, I co-directed the firm's Law and Economics Practice. I was promoted to the position of Senior Vice President of Hagler Bailly Consulting in September 1997, reporting directly to Chief Executive Officer Henri-Claude Bailly.

Over the past 16 years, I have specialized in wholesale power market analysis and electric system modeling. I was, for example, the developer of REALTIME IV, a detailed multi-area and transmission-constrained chronological production cost model used by several utilities including Atlantic City Electric, UtiliCorp (and subsidiaries Missouri Public Service and WestPlains Energy), the Bahamas Electricity Corporation and Hoosier Energy, as well as the Missouri Public Service Commission. The model's development was funded in 1986 to 1988 by Potomac Electric Power and Virginia Power, who wished to improve their ability to simulate operations and costs of the PJM Interconnection (of which PECO Energy is a part) and their domestic generation and transmission systems. I was also the developer of RAMP UP, a computer-based tool for structuring power marketing deals, pricing power, forecasting forward electric prices, power plant valuation, and power plant competitive analysis. Several power marketing companies and electric utilities have purchased RAMP UP user licenses. Uniquely, RAMP UP has actual hourly data on the operations and estimated hourly data on the

costs of virtually every utility fossil fuel fired electric generating unit for the 22,000 hour period of January 1, 1995 through June 30, 1997.

I have testified as an expert witness in electric rate proceedings before the Federal Energy Regulatory Commission, District of Columbia Public Service Commission, Illinois Commerce Commission, Kentucky Public Service Commission, New Jersey Board of Public Utilities, New York Public Service Commission, North Carolina Utilities Commission and the Nova Scotia Board of Public Utility Commissioners. In 1991 to 1992, I was prepared as the economic damages witness on behalf of PECO Energy in a Federal Court litigation involving three other electric utilities; the case settled prior to trial. I recently served as the expert witness in an arbitration between a Pennsylvania electric utility and the non-utility generator affiliate of a different utility; this matter is ongoing.

I am quite familiar with the economics of the PECO Energy electric generation and transmission system and the PJM Interconnection in general. For example, in 1989 to 1990, I assisted PECO witness William Hieronymous in the preparation of his testimony before the Pennsylvania Public Utility Commission concerning the inclusion of Peach Bottom 2 costs in the calculation of base rates. As a contractor to PECO in 1991 and again in 1994, I assisted the company in its compliance with the Clean Air Act Amendments of 1990. I have modeled the PJM Interconnection system for General Public Utilities and other companies who are not PJM member utilities.

My clients over the last two years have been primarily senior officer teams of investor-owned electric utilities, firms that serve the utility industry and potential new

market entrants. I advise them in the areas of electric generation strategy, strategic repositioning and competition policy.

I received a Bachelor of Science degree in Physics and a Bachelor of Science degree in Political Science from Rensselaer Polytechnic Institute in 1974. Two years later, I received my Masters of Business Administration degree from The Wharton School, University of Pennsylvania. In 1980, at Georgetown University, I completed all the requirements for a doctorate in economics with the exception of a finalized dissertation. I completed qualifying exams in the areas of microeconomics, econometrics and the theory of public finance. In 1980 to 1982, I was a member of the faculty of the Georgetown University Economics Department. I taught undergraduate courses in microeconomics, macroeconomics and statistics.

I have published numerous articles on electric economics and policy, including in The Electricity Journal and Public Utilities Fortnightly. I am a member of the Editorial Advisory Board of The Electricity Journal. I have spoken at and chaired numerous electric industry conferences, including those including those sponsored by the National Association of Regulatory Utility Commissioners, Electric Power Research Institute and Edison Electric Institute.

II. OVERVIEW OF THIS TESTIMONY

Q. WHAT, GENERALLY, IS THE PURPOSE OF YOUR TESTIMONY?

A. I am testifying on behalf of the Pennsylvania Electric Competition Coalition (the "Coalition"). The members of the coalition are: Conectiv Energy, Enron and New Energy Ventures. My testimony focuses on the impacts of the PECO Energy proposal,

particularly those anti-competitive impacts that would, simply put, render the transition to competition meaningless in southeastern Pennsylvania. The proposal is not in the public interest.

I have also included a set of proposed modifications to PECO's proposal. In my view, these modifications, if added to the PECO proposal, would go a long way to mitigate the egregious anti-competitive elements. In the end, with these suggested improvements, I demonstrate that PECO can provide up-front customer rate discounts and still receive ample ratepayer funding (for stranded costs) to become a vibrant competitor in the 21st century, but not at the terrible cost of squelching the goal of competition — a clearly stated goal of the Governor, Legislature and this Commission. In fact, my proposals even on the most conservative basis, give ratepayers greater rate decreases than PECO's proposal.

Q. WHY IS THE PROPOSAL NOT IN THE PUBLIC INTEREST, IN SUMMARY?

A. The proposal:

1. Offers front-end rate reductions and write-offs which are more than paid for by associated tax savings and retention of the cost savings associated with securitization;
2. Would allow PECO to recover stranded costs through ITC and CTC customer charges which are <u>at least</u> $2 billion in excess of the agreed to level of $5.461 billion;
3. Sets customer credits (referred to as a "generation cap" in the proposal) below market costs;

4. Misallocates costs to transmission and distribution rather than to generation overhead/administrative and general accounts such that PECO as a competitor is subsidized;

5. Does not afford consumers the rate decreases they should receive nor the opportunity to save and benefit from the innovations of a competitive market; and

6. Firmly establishes PECO as an unregulated monopoly with the power to set prices and act as a perfect price discriminator.

Q. WHAT IS THE SINGLE MOST IMPORTANT CONCLUSION HERE FOR THE COMMISSION'S CONSIDERATION?

A. Approval of PECO's proposal without modification will destroy the promise of competition in electric generation in Pennsylvania.

Q. HOW DO YOUR MODIFICATIONS DIFFER FROM PECO'S PROPOSAL?

A. The modifications I have proposed provide additional rate cuts for consumers and, at the same time, allow generation credits that permit competition. This proposal is significantly superior to PECO's proposal while still allowing PECO to collect $5.461 billion in stranded costs. Additionally, in stark contrast with PECO's plan, my proposal enables (instead of prevents) competition and its consumer benefits.

Q. WHAT IS THE FORMAT OF THIS TESTIMONY?

A. Section III: General Analysis Of PECO's Proposal And Its Fundamental Problems

Section IV: Fundamental Problems Concerning The Proposed Competitive Transition Charge

Section V: Serious Anti-competitive Problems Concerning PECO's Proposed "Generation Cap"

Section VI: Fundamental Problems With PECO's Proposed Transmission And Distribution Charges

Section VII: Modifications to PECO's Proposal That Will Salvage The Commonwealth's Transition To Competition

Section VIII: The Default Customer Problems And Its Criticality

Section IX: Conclusions

III. GENERAL ANALYSIS OF PECO'S PROPOSAL AND ITS FUNDAMENTAL PROBLEMS

Q. SUMMARIZE PECO'S PROPOSED RESTRUCTURING PLAN.

A. PECO Energy is seeking approval for a comprehensive change in its tariffs to facilitate its required transition to a restructured electric utility industry. In response to an order of this Commission, PECO filed its restructuring proposal on April 1, 1997. It reached a negotiated settlement with nine of the 25 intervenors in this proceeding in late August. A host of participants in the proceeding have not agreed to the settlement including the Mid-Atlantic Power Supply Association, the Pennsylvania Electric Competition Coalition, the Pennsylvania Retailers Association and several groups representing environmental concerns.

PECO's original restructuring proposal included the following components:

- Unbundled rates;
- Competitive Transition Charges ("CTCs") and Intangible Transition Charges ("ITCs") at levels requested in its then pending securitization proceeding;
- $6.8 billion in transition and stranded cost funding for PECO by ratepayers;
- PECO's electric generation and its transmission and distribution divided into two separate corporate entities (which may be affiliates);

- A consumer education and universal service program; and
- 33% of PECO customers can freely choose their electricity supplier beginning in January 1999, 33% more beginning in January 2000, and the remaining 33% of all customers beginning in January 2001.

Highlights of the proposed change in tariffs in PECO's new plan (embodied in the Partial Settlement with nine of the 25 intervenors filed in late August) include the following:

- A much heralded up-front reduction in retail rates by 10% from their current high and levels, effective September 1998 (with the reduction decreasing to 5% in 2001, 2% in 2002, then disappearing);
- CTC charges said to generate $5.461 billion from 1999 through 2008;
- Accelerated collection by PECO of up to $4 billion of stranded cost funded through sales of securities, to be paid for over time by Pennsylvanians through the customer-funded ITC charges;
- Transfer of PECO electric generation assets to a generation affiliate at a hypothetical market value set by PECO of $2.303 billion;
- Slightly accelerated phase-in to competition with 66% of customers able to freely choose their electricity supplier beginning in January 1999 and the remaining 33% of all customers by January 2000 (i.e., two-thirds of customers are moved up by one year);
- Fixed 3.11 cents per kilowatt hour customer charge for transmission and distribution through 2003, locked in by PECO completely independent of actual costs;

- So-called "generation cap" on electric generation rates through 2008 (with critical anti-competitive implications as discussed below); and
- The extraordinary condition that this Commission accept all the terms of the PECO plan and agreement (with selected intervenors), in whole, without any modification or even further consideration.

Q. **DISCUSS IN GENERAL PECO'S ALLEGED CONCESSIONS (WHICH ARE REPRESENTED BY THE COMPANY AS THE PRIMARY BENEFITS OF THE DEAL FROM THE CONSUMER PERSPECTIVE).**

A. PECO is proposing to temporarily reduce by 10% the consumer rates that were in effect in December 1996. The reduced rates would be put in place beginning September 1, 1998. The reduction would continue for 28 months.

The Commission should take careful note that, notwithstanding the problems I discuss below with the 10% rate reduction, PECO warns that the reduction is not assured to be 10%. Certain legal impediments could allow PECO to unilaterally lower the reduction from 10% to 7%. PECO apparently believes that such impediments may presently exist.

Using PECO's projections, and after deducting the gross receipts tax, PECO would allegedly concede $106 million for four months in 1998 and $318 million in 1999 and 2000. PECO's rates would then reverse course and increase in 2001 and 2002, in PECO's proposal, but still remain a little bit below those in effect in December 1996. The claimed cost to PECO of these later year proposed rate reductions is $157 million in 2001 and $61 million in 2002. In January 2003, the PECO plan, remarkably, calls for rates to be right back up to their December 1996 level.

Thus, from September 1998 through December 2002, PECO would supposedly forego $960 million of revenue that it would otherwise have collected in the implausible event that the December 1996 rates could and would have been sustained for the next few years. Of course, that presumes that rates could actually be sustained at the 1996 levels.

To reflect the lower rates, PECO represents that it would immediately write down book assets by $2 billion. This too is hailed as a benefit for consumers. Yet, the benchmarks for this concession, most importantly, are PECO's own amended claim for stranded costs and its claim of $5.5 billion in stranded cost recovery.

Q. MORE SPECIFICALLY, WHAT ARE THE PROBLEMS REGARDING THIS SUPPOSED $2 BILLION CONCESSION OF PECO, AND WHY ARE THESE VITALLY IMPORTANT FOR THE COMMISSION TO CONSIDER?

A. During the restructuring proceedings, intervenors did argue that the fair stranded cost amount was several billions of dollars less than PECO's claim. This controversy remains unresolved today, as PECO presents a "take it or leave it" deal to this Commission.

The Company, however, deftly avoids a judgment about the fair amount of stranded cost recovery by this Commission or any objective party. Furthermore, its rhetoric frames the deal as if there were a significant concession on the part of PECO. But, perhaps most critically, as I will show below, the deal actually does not reflect the claimed $2 billion write-down.

In actuality, the PECO plan asks the Commission to accept in whole[1] is either rife with arithmetic errors or is disingenuous. For there is no credible way to start with the

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[1] I am advised by counsel that PECO's insistence that it may condition its settlement in this way is inconsistent with the Commission's paramount obligation to restructure PECO's rates and operations to respond to the Electric Competition Act.

all-important Table A: Schedule of System-wide Average Rate Decreases in the proposed settlement agreement and derive anywhere close to a $2 billion concession by the Company. Or, alternatively, there is no credible way to start with the $2 billion concession and derive Table A.

> PECO's proposed plan and agreement with some intervenors states:
>
> "PECO claims that it will have stranded assets and costs of $7.461 billion. Under the terms of this Partial Settlement, PECO shall be permitted to recover $5.461 billion of these total stranded assets and costs through a CTC or, at PECO's discretion, an ITC. PECO agrees not to seek recovery of at least $2.0 billion of its total stranded assets and costs . . . . The Joint Petitioners . . . request that the Commission expressly find, that the level of CTC charges provided herein is just and reasonable.

This language is remarkably careful. PECO merely claims a level of stranded costs. There is no requirement for the Commission or any objective party to validate the claim. PECO is enabled to impose various customer charges to fund a supposed $5.461 billion recovery, implying a concession of $2 billion, even though the actual recovery far exceeds that amount. But the bottom line is, this Commission is being required to accept without review the customer charges of Table A and the actual CTC rates by class, set forth in Appendix C.

Perhaps the coup-de-grace is that just five weeks prior to making this supposed $2 billion concession, PECO actually raised its stranded cost estimate by approximately $700 million (from $6.8 billion to $7.461 billion). The company's rationale for this late change (in its rebuttal case submission on July 18, 1997): "due principally to updated

analyses of the market value of its generation facilities." This late change end-runs Commission scrutiny if the Commission approves PECO's plan as proposed.

More important for my analysis, PECO witness Hill has made it clear that, notwithstanding this "update," the Company's actual stranded cost claim in this case remained at $6.8 billion. This amount, then, is the appropriate benchmark with which to measure the benefit to consumers of PECO's proposed asset write-off. If the proposal and its critical Table A represents stranded cost funding for PECO of $5.461 billion (which I show below it does not), then consumers would enjoy the fruits of a $1.3 billion PECO write-off ($6.8 billion stranded cost claim minus $5.461 billion stranded cost funding in the proposal), not $2 billion as PECO has claimed.

So, did PECO really concede $1.3 billion in stranded cost recovery? Or is this amount even less? In this testimony, I will show that the stranded cost concession by the Company is not meaningful.

Q. ARE PECO'S CLAIMED CONCESSIONS TO CONSUMERS AND THE BENEFITS OF THE PECO PROPOSAL BONA FIDE IN LIGHT OF THE RADICAL RESTRUCTURING OF THE ELECTRIC INDUSTRY PRESENTLY UNDER WAY?

A. It is essential, in order to answer this question, to employ a proper benchmark. The proposed agreement must be compared to the *but for* case. That is:

How can ratepayers expect to fare if the proposal is implemented?

versus

How can they expect to fare if the proposal is rejected by the Commission?

PECO has stated how, in its opinion, ratepayers would fare under the proposal. Throughout this testimony, I address serious problems with these representations. In

several key areas, the benefits of the proposal are greatly exaggerated and the risks understated if they are mentioned at all. However, I am most critical of the apparently disingenuous presentation of the Company, in which it proclaims the alleged benefits of the proposal assuming the status quo could persist indefinitely. This is, of course, folly.

Current customer rates of PECO are extraordinarily high by any standard, a multiple of the marginal cost of electric generation. In the massive restructuring of the electric industry presently well underway, nationally and internationally, these rates are clearly unsustainable. But for the settlement proposal (if it were implemented), customers of all classes and income levels will demand and they will receive fairer rates from the body politic. This most certainly will include small commercial and residential customers.

Q. IS THE PROPOSED RATE REDUCTION PROMISED TO CONSUMERS BY PECO REALLY A CONCESSION BY THE COMPANY OF $960 MILLION?

A. No. First, the rate reduction concession must be measured in the same fashion as the claimed stranded cost concession; that is, in terms of the net present value as of January 1, 1999. On this basis, the rate cuts are worth about $866 million, not the $960 million stated by PECO. That means a difference to ratepayers of $94 million or approximately 10% lower than PECO's claim.

The reduction in income will also generate a reduction in taxes, as PECO has a combined effective federal and state income tax rate of 41.493% (Brennan Rebuttal, Exhibit JFBr-1, nt. 3). The tax benefit from reduced rates would have a net present value over $300 million, the exact amount depending on the timing of the deduction for

the write-off of $2 billion of assets. This would leave PECO with a net cost due to rate reductions of less than $566 million.

Moreover, it is critical to recognize that under its plan, PECO keeps the benefits of the revenue requirements reduction due to securitization. With each $1 billion in securitization reducing PECO's costs by approximately 1%, the $4 billion authorized will reduce costs by 4% annually, or $132 million. For the "rate reduction" period of September 1, 1998 through December 31, 2002, the net present value of the cost savings is approximately $500 million. In addition, starting in 2003 after the "rate reduction" period, PECO continues to keep the cost reduction benefits for itself. Again, that nominal $132 million per year in approximate cost savings equates to approximately $440 million on a net present value basis.

Accordingly, through the tax savings and the securitization benefits that PECO proposes to keep, the rate cut not only costs PECO nothing, it actually creates a net present value benefit to PECO.

Q. WHAT ARE THE OTHER BENEFITS THAT PECO WOULD ENJOY FROM ITS PROPOSAL?

A. First, the $2 billion write-down will immediately reduce PECO's taxes in 1998 and 1999. The write-down is a non-cash event, but the tax benefit of the write- down is a cash event. Therefore the Company will experience an increase in net cash flow.

Second, PECO will receive a large capital infusion through its expected securitization of up to $4 billion of the agreed upon $5.461 billion, and a sizable reduction in risk.

Third, PECO has added a bonus to the settlement numbers. Paragraph 11 of the Agreement states: "the CTS contained in Appendix C hereto shall not be subject to reconciliation or true-up. As such, PECO bears the risk and is entitled to the benefits of changes in sales." Since PECO used a no-growth scenario to calculate CTC revenues over the entire period of the proposed settlement, there seems to be little downside risk to PECO. If actual electricity sales equal the numbers provided by PECO in its integrated resource plan (IRP), this bonus would have a net present value to PECO exceeding $400 million.

Fourth, the PECO proposal establishes a barrier to entry for competitors for many years. The generation cap does not reflect the actual costs of selling retail power, but is a residual calculated after costs have been arbitrarily assigned to every other element — transmission, distribution, the CTC and the rate cut. In effect, the rate cut comes out of generation revenues to the extent that PECO's maximum price is insufficient to recover costs of selling electricity to retail customers.

Q. IN SUMMARY, WHY SHOULD THIS COMMISSION NOT APPROVE THE PLAN AS IS, WITHOUT MODIFICATION OR EVEN FURTHER CONSIDERATION?

A. In exchange for a claimed write-off of stranded assets, PECO receives $4 billion in securitized funds, the ability to keep for itself several hundred million dollars of cost savings associated with securitization, and the opportunity to collect $2 to $3 billion of additional funds, as well as a tax write-off.[2] The rate cut, instead of providing benefits to

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[2] This analysis does not include any additional revenue PECO might recover associated with additional decommissioning costs (Settlement, ¶20) or universal service (¶26).

consumers, is actually paid for by these offsets and retained savings. The empty concessions provided by PECO are alone sufficient grounds to question the deal, but the anti-competitive aspects of the settlement make it contrary to public policy.

Gregory Sidak, PECO's witness, has stressed the importance of equal treatment for all players in a competitive electricity market. Unfortunately, he has ignored the possibility of an unequal playing field. PECO will begin competition with 100% of market share, the right to retain its brand name and goodwill without compensating ratepayers, and has now arranged to cripple competition for about eight years. By the time the rate cap has risen sufficiently to allow a potential competitor the opportunity to make a profit, PECO will have an eight year head start. While wholesale competition may be feasible, with few barriers to entry, the same is not true of retail competition. One need only look at AT&T's continued dominance of the long-distance market, despite higher rates than competitors, to see evidence of the value of incumbency in retail markets. It has taken over 10 years for vigorous competition to come to the long distance telephony market.

The key to PECO's strategy is the rate structure built into this settlement. PECO was careful to claim that any modification would nullify the agreement, which suggests that the Company valued the rate structure as highly as an agreement on the value of stranded costs. PECO has good reason to insist on this clause, since it is possible to substantially modify the settlement proposal and still provide PECO with a NPV of $5.461 billion as of January 1, 1999. An accurate calculation of the transmission and distribution charges, a proper CTC charge, and replacing part of the CTC with a lower

cost ITC due to securitization would provide sufficient funds for a competitive consumer credit, as I will explain below.

IV. *FUNDAMENTAL PROBLEMS CONCERNING THE PROPOSED COMPETITION TRANSITION CHARGE*

Q. IN SUMMARY, WHY ARE PECO'S PROPOSED CTC RATES FATALLY FLAWED?

A. Under the proposed CTC/ITC rates included in Table A of its proposal, PECO would have an opportunity to recover stranded costs of $7.48 billion rather than the $5.416 billion amount represented in the proposal. This is an excess recovery of $2 billion. It is also in excess of any measurement of stranded costs in this case. Indeed, it represents a recovery in excess of 100% of the amount PECO would have received if it had prevailed on all points in its claim for recovery.

Q. WHAT IS THE BASIS FOR YOUR CONCLUSION?

A. I have performed a present value analysis of the CTC/ITC rates with and without securitization. I have also included further mitigation of stranded costs to reflect the tax benefits associated with the $2 billion write-off.

As summarized in Exhibit SAM-1, without securitization PECO will have the opportunity to overcollect stranded cost by $1.3 billion. This is based upon a discount rate of 8.71%, PECO's most recently filed load forecast (filed with the Commission in April 1997 as part of PECO's annual IRP filing), and the net present value at January 1, 1999.

When securitization is taken into account, the overcollection grows to $2 billion. This is based upon the requested level of securitization of $4 billion. I use the after tax

costs of 8.71% (PECO witness Brennan's rebuttal calculation) to discount the flow of income from the CTC, calculated as the original CTC charge minus the ITC cost associated with issuing securitized bonds. Since interest payments are included in the ITC charge, the discounted tax from the interest payments are added to the CTC and $4 billion received by PECO from the proceeds of the bond sale. Again, the IRP level of sales was used.

In addition, when the tax benefits of the $2 billion are accounted for, a present value mitigation potential of $500 million is calculated using the 8.71% discount rate. This is a conservative valuation of this figure as it only claims the savings in later years when income is likely to be higher.

Q. **WHY IS THE COMPETITIVE TRANSITION CHARGE OVERSTATED?**

A. As shown above, the CTC charge, as presented in Table A in the settlement, and supported by the documents in Appendix C, would overcompensate PECO by $850 million dollars on a present value basis, using the most conservative calculation, including a discount rate of 8.71% and no growth in demand over the ten years of CTC collection. Using the demand figures provided by PECO in its IRP, and a discount rate of 8.71%, gives PECO excess revenues of $1.3 billion. A discount rate of 7.15%, as recommended by the Commission in the Opinion and Qualified Rate Order would provide an additional $300 million of NPV to PECO (Docket R-00973877, May 22, 1997, hereafter referred to as the "Securitization Order"). The lower discount rate is appropriate for a stream of income which faces only the risk that demand, in the fact of declining electricity prices, would fail to grow at historical rates.

It is no wonder that PECO insisted in paragraph 11 of the settlement that the CTC would not be subject to reconciliation or true-up. PECO claims to bear the risk, and therefore would be entitled to the benefit, of changes in sales. In order to reduce the net present value of the PECO CTC to $5.461 billion (using a discount rate of 8.71%) annual sales would have to decline by 5.49% each year after 1999.

PECO has an economic incentive to encourage the lowest possible price forecast for energy and capacity to maximize the CTC. The lower the price forecast, the greater the calculated value of stranded generation units, the larger the CTC and the smaller the generation cap has to be to seem reasonable and still block entry. A higher energy and capacity price forecast would lower the stranded cost estimate and the associated CTC, while providing additional funds from potential sales. In this case, instead of receiving additional revenues guaranteed through the CTC, PECO would have to earn them by operating its generating units and competing on price. Since price projections are by nature speculative, as a matter of policy the Commission should be wary of low price projections, even if seemingly plausible, since they reduce the incentive for efficient operation by guaranteeing a greater proportion of generation value.

V. *SERIOUS ANTI-COMPETITIVE PROBLEMS CONCERNING PECO'S PROPOSED "GENERATION CAP"*

Q. FIRST, TO MAKE THIS MATTER CLEARER, EXPLAIN WHY THE SO-CALLED "GENERATION CAP" IS REALLY A CUSTOMER CREDIT.

A. Customer credits are the dollars that customers can use to shop for alternative power suppliers. The higher the credit, the better off Pennsylvanians will fare in a competitive

market. The initial average "credit" is 2.8¢ per kwh; this compares to a pilot credit of 3.9¢ on average and 4.4¢ for residential customers.

Q. WHAT ARE THE IMPLICATIONS OF A GENERATION CAP OR CREDIT THAT IS SET TOO LOW, AS IN PECO'S PROPOSAL?

A. I cannot be too blunt on this point. If this Commission allows PECO's proposed so-called generation cap, there will not be meaningful competition in southeastern Pennsylvania.

Q. WHY DOES PECO WANT A GENERATION CAP INSTEAD OF A CONSUMER CREDIT?

A. PECO calculated the generation cap as a residual after shifting costs of selling and marketing electricity to the distribution charge. PECO plans to recover funds through transmission and distribution, and has made the generation cap as low as possible to block competition. For the consumer who would not be interested in purchasing from a PECO competitor, it doesn't matter how the Company allocates the cost of service; he or she will pay the same final price. However, with regard to the consumer who wants the freedom to choose his or her electricity supplier, it makes a great deal of difference.

A Consumer Credit should be calculated exactly the opposite from the way PECO calculated the generation cap. First, assign the true cost to the transmission and distribution system, excluding all costs not directly related to these functions. Second, set the CTC and ITC charges so that PECO will receive only the Commission-determined level of stranded cost recovery, not a substantial hidden bonus. Third, an amount should be allocated for a Consumer Credit which is large enough to permit customers to shop for energy. Last, any residual should go the customer in the form of rate decreases; in other

words, the customer would keep the difference between the credit and the price charged by his or her chosen supplier.

Under PECO's proposal, the customer would have to pay PECO all the costs loaded into the transmission and distribution charges, as well as an excessive CTC, before shopping for a low cost supplier. This means that to get that customer's patronage, a competitor would have to cover all costs associated with retail service from this "generation cap," while PECO would be compensated for its generation overhead, uncollectible accounts, advertising expenditures, sales force and other expenditures through the transmission and distribution charges all customers must pay.

Under the Consumer Credit approach PECO could charge power marketers for unbundled costs which have been approved by the Commission for services that the marketer chooses not to supply. Power marketers would have to recover those costs in the price they charge consumers, but they would only pay for services they purchased from PECO, instead of the proposed anti-competitive "take or pay" policy proposed by PECO. Unbundling these various costs would encourage both PECO and competitors to lower these costs through increased efficiency in a competitive market. The whole point of restructuring is to maximize the extent to which formerly regulated functions are opened to the discipline of the marketplace. PECO's strategy is to maximize the extent to which it can shield its operations from this discipline.

Q. WHAT IS THE EFFECT OF THE SUBSIDY?

A. As Exhibit SAM-2 demonstrates, even using PHB's low projections of energy and capacity prices, PECO is subsidized in the sale of electricity until 2007. This calculation

ignores the various costs associated with the sale of retail electricity, which implies that the cost to PECO's distribution arm would be enormous unless there is some source of subsidization available to the company. The net present value of the subsidy through 2007, before accounting for overhead, sales and uncollectible accounts, ranges from $670 million, using Putnam, Hayes and Bartlett, Inc. (PHB) prices, to $967 million using an average of the three PECO sponsored energy and capacity price forecasts.

Q. WHAT IS THE SOURCE OF FUNDS TO SUBSIDIZE THIS PREDATORY, BELOW-COST PRICING?

A. The primary source is the excessive CTC charges, which are even greater than the subsidy given to PECO's generation credit.

Q. COULDN'T THIS PROBLEM BE SOLVED BY DIVERTING THE EXCESS CTC PAYMENTS TO INCREASING THE CUSTOMER CREDIT?

A. That would certainly be a good beginning, but it is also necessary to address the issue of the calculation of the Transmission and Distribution charges, the second source of subsidies for PECO.

VI. FUNDAMENTAL PROBLEMS WITH PECO'S PROPOSED TRANSMISSION AND DISTRIBUTION CHARGES

Q. IN SUMMARY, WHY ARE THE T&D CHARGES PROPOSED BY PECO SO UNFAIR?

A. PECO has misallocated costs to T&D which rightfully should be assigned to the customer credit. PECO has established a 3.11 cents/kWh T&D charge. The Coalition has determined that an accurate rate is 2.63 cents/kWh. We have not eliminated the difference. In fact we have added the difference between PECO's original claim of 3.29 cents/kWh and the 2.63 cents used by the Coalition to the customer credit (or "generation

cap" as PECO prefers). These are costs associated with delivering electricity at the retail level including 0.45 cents/kWh for production related A&G and common costs and 0.21 cents/kWh for production-related uncollectible accounts expenses (see Exhibit SAM-3). These are costs that alternative providers will have to face. They rightfully belong as part of the customer credit rather than as part of the T&D charge as a subsidy to PECO.

The whole concept that a T&D cap extension at 3.11 cents/kWh has value to consumers is totally fallacious. This rate is too high to begin with, does not account for load growth, future depreciation or the benefits of performance based ratemaking.

Q. IN MORE DETAIL, WHAT IS THE PROBLEM WITH THE TRANSMISSION AND DISTRIBUTION CHARGES?

A. PECO has included a number of items in these categories which should be assigned to other charges, or unbundled. As Coalition witness Paul Reising has demonstrated, PECO persists in allocating common overhead costs completely to transmission and distribution, on the grounds that these costs will not change when generation is transferred to an affiliate. In his response to Enron interrogatory I - 36, PECO witness Clemmer stated that certain of the A&G expense accounts were "allocated to the distribution function because such costs would continue unchanged, and would remain with, the regulated local distribution company after the functional unbundling." This assumption implies that cross-subsidization is built into PECO's cost structure. The removal of generation functions from the regulated entity should substantially reduce overhead if properly allocated. The distribution function could only have the same level of A&G expense if it maintained a 100% market share.

As Enron witness Paul Reising described in his direct testimony, the functional assignment of costs inappropriately attributed certain common costs only to the transmission and distribution functions. Examples of expense items which fall in this category include: (1) administrative and general expenses (other than property insurance and employee pensions and benefits that were allocated to functions), (2) general and common plant, and (3) intangible plant.

Assigning the costs attributed by Mr. Reising in Exhibit 3S, PDR-2, to transmission and distribution gave a combined charge of 2.63 cents/kwh for 1999. According to Mr. Reising, $82 million was attributable to uncollectible accounts attributable to energy production, items which should be unbundled from distribution. Independent power marketers should not have the cost of PECO's marketing efforts and PECO's collection problems added to their costs. The remaining costs were attributable to production A&G and common costs.

PECO witnesses Hill and Clemmer testified that if A&G and other common costs were allocated to generation, this would offset revenue and increase stranded costs. In fact, such an offset was made in PECO's new calculation of stranded generation assets, adding $400 million to PECO's amended claim. This conclusion is the result of a number of logical fallacies.

Generation costs consist of the cost of running each unit, and general overhead. In addition, to sell electricity at retail, additional costs must be incurred, ranging from line losses to bookkeeping, marketing and billing. The only number relevant to the calculation of stranded costs is the actual cost of operating a generating unit. The most

efficient producers in the market must cover their overhead costs, whether operating under regulation or competition. If overhead costs are added to offset PECO's generating unit revenues, they should also be added to the cost of competitors. If proper allocation of overhead costs raises PECO's operating costs above its competitors, mitigation requires that PECO increase its managerial efficiency to bring these costs down to the level of its competition.

The costs associated with selling electricity have no connection with stranded cost calculations. The value of PECO's generating units is determined from the expected revenue received in the wholesale power market. Retail sales, marketing and billing expenses are not part of generation costs. PECO's expenses in acting as a retailer should not be assigned to distribution, since these do not involve costs of operating wires and transformers. Rather, they are a separate category, consisting of a number of services which can be sold to power marketers, used by the company, or bypassed by competitors. Unbundling and identifying these costs would prevent PECO from engaging in cross-subsidization.

Q. **WHAT IS A REASONABLE LEVEL FOR THE CONSUMER CREDIT?**

A. This first depends on what items would be included in the costs to be included in the consumer's choice. If we are just including the cost of delivering retail power, given a wholesale energy and capacity price, one would choose a reasonable set of prices and then ramp them up to account for line losses, load factor, etc. However, if one is talking about the cost of all the services required to sell electricity to end-users, then marketing, billing and collection, customer service and administrative costs must be added to this

figure. If the Commission is concerned with encouraging entry, then that would suggest adding a margin to allow for the opportunity to make a profit.

To create a comparable number to those presented in the settlement, one starts with the wholesale price of energy and capacity. For the energy component of retail costs, the wholesale energy price must be adjusted by the average load weighting (1.088) and the line loss factor (.935). Capacity prices need to be converted to an hourly price, then adjusted for load factor (.60), line losses, and reserve margin. Added together, the *total* must be adjusted to account for the gross receipts tax of 4.4% to obtain a retail electricity price. Schedule SAM-3 provides the prices using the PHB and the PECO composite energy and capacity price forecast. It shows graphically that even at these base levels, competitors will not be able to sell power at levels that even match the generation credit.

However, this is only the cost of <u>delivering</u> energy and capacity to a customer. It does not include the other costs required to provide electric services, nor does it allow for a return on equity, that is, a profit. The problem with this approach is that it can only provide a <u>minimum value</u> which would allow an energy supplier to break even if the projected energy and capacity numbers are accurately predicted. A realistic Consumer Credit should be biased upward, because competition will discipline prices if it is set too high, but a low credit will discourage competition. PECO's proposed generation credits are even more anti-competitive when these costs are added.

Q. WHY IS PECO'S PROPOSED GENERATION CAP AN EFFECTIVE BARRIER TO ENTRY?

A. No competitor would be able to sell electricity in a market where it would have to accept losing money for many years. This is the prospect faced by PECO's competitors, restricted by the generation cap to selling at below cost to PECO customers. This discourages investments in marketing, such as advertising and development of a sales force, and construction of new generation. Smaller competitors simply could not survive under such a pricing regime, since they lack the capital resources to lose money for eight years. Therefore the result of the generation cap will be to effectively eliminate competition in this market until at least 2007.

One should not confuse the wholesale electricity market with the retail electricity market. Wholesale markets are generally contestable, since unless there are transmission constraints, any company which can reach a customer over the wires at a reasonable transmission cost can enter the market instantly. There are no sunk costs for the potential seller, since the wires are in place and selling costs are minimal relative to potential revenues.

Retail markets are local, requiring significant sunk costs (irreversible investments) to enter. Typical sunk costs include initial advertising, sales promotion and customer acquisition costs, sales force salaries and bonuses, the cost of discounting to attract customers, and interest on working capital. If the entrant fails to achieve a toehold on the market, she cannot recover these costs.

In addition, in a market dominated by a single established player, a new entrant will require the ability to offer electricity at a discount to the incumbent's prices in order to encourage consumers to "sample" the new "product." While "loss leaders" are

common in consumer markets, they are additional sunk costs which discourage entry. No company can afford to sustain significant losses to attract customers, since it is unlikely they will be unable to recoup these costs in a competitive market. To encourage entrants to incur the sunk costs associated with entering a market, there must exist the possibility of earning a rate of return that is sufficient to offset the risk of such difficult-to-reverse financial commitments.

Q. ISN'T IT TRUE THAT PREDATORY PRICING CANNOT WORK AS A STRATEGY BECAUSE TO RECOUP LOSSES, THE COMPANY WILL HAVE TO BE ABLE RAISE PRICES ABOVE MARKET LEVELS IN THE FUTURE?

A. Unlike normal predatory pricing, PECO has no need to raise prices at some future time to recoup its losses. The settlement was the result of negotiations which required that PECO make limited concessions to guarantee a set sum of stranded cost recovery, as well as additional benefits. These concessions, the rate cut and expansion of the CAP program, are sunk costs. The settlement, by establishing transmission and distribution rates that ensure cross-subsidization, and a CTC charge which recovers excessive funds, provides sufficient funding for PECO to recoup its losses. These funds are built into the agreement, and require no action after the expiration of the agreement by PECO to garner their recovery. When the generation cap reaches a price level which would allow entry in 2007, PECO will control almost 100 percent of the market. At this time PECO can charge above market prices for a few years, allowing its market share to erode while reaping monopoly profits.

Q. WHAT IS THE POTENTIAL VALUE TO PECO OF BLOCKING ENTRY BY COMPETITORS FOR MANY YEARS?

A. The value to PECO of the barrier to entry created by the proposed generation price cap may be understood in terms of the value of the avoidance of losses arising from the erosion of market share, revenue and profits potentially resulting from competitor entry.

To the extent that strategic choices exist at the discretion of the firm under open competition, a potential entrant may be viewed as holding an option to enter the market. This point, however, will be exercised only at or above the market trigger price (so as to absorb the costs and risk of entry).

The value of the incumbent firm's competitive entry barrier can be determined in terms of the amount of losses potentially avoid by not "selling" this call option to a potential entrant, in other words, by not allowing the potential entrant access to the option

A second source of value stems from the ability of the generation cap to discourage competitors from building additional generation in the PECO service area. Competitors are unlikely to invest in generation without the possibility of an economic market for their output. PECO will have $2-4 billion in securitized funds to pre-empt investment decisions of competitors when prices rise to competitive levels. This will allow PECO to maintain a dominant position in generation as well as sales in the region.

Although wholesale markets are generally contestable, there are two sources of potential value to PECO from discouraging investment in generation. Generators located a substantial distance from PECO must incur line losses to sell to PECO customers, whether directly or through marketers, providing PECO with the opportunity to garner

this margin (a 5% line loss would translate to about 1.2 mills, which doesn't seem like much until you multiply by PECO's total generation, giving a NPV over $200 million).

More importantly, in a bid system of dispatch, a generator who has a sizable market share of generation has the incentive and means to engage in strategic bidding. Strategic bidding involves using the return on all inframarginal units to determine the price at which marginal generation units will be bid. As the market price increases, it may be more profitable to bid marginal units well above their marginal costs, driving the market price up and increasing the return on the company's other units which are already generating. The company would prefer to see another firm's unit dispatched at a higher price than dispatch its own generator at a lower price. The result is higher prices for consumers, and higher profits for the firm with market power.

VII. PROPOSED MODIFICATIONS TO PECO 'S PROPOSAL THAT WILL SALVAGE THE COMMONWEALTH 'S TRANSITION TO COMPETITION IN PECO SERVICE TERRITORY

Q. WHAT CHANGES WOULD YOU RECOMMEND TO THE PECO PLAN TO MITIGATE ITS ANTI-COMPETITIVE ELEMENTS?

A. The key is to set the Consumer Credit at a level which reflects a realistic price path for energy and capacity, and account for the other costs of servicing customers. PECO has submitted three different price paths, determined by PECO's consultants. PECO of course, chose the lowest projected prices for energy and capacity, those generated by Dr. Hieronymus of PHB. I think it more reasonable to require that PECO stand by the average of the projections of their three consultants. It would set a bad precedent to encourage companies submitting testimony to the Commission to cherry pick their own experts' conclusions.

Moreover, since choosing a ten year price path is to some extent unavoidably speculative, public policy suggests that one should err on the side of a higher path in calculating the Consumer Credit. If it turns out that the Consumer Credit was set too high then market forces will force price below this level, lowering retail rates. In this case, there is "no harm, no foul." On the other hand, if the credit is set too low, then entry will be discouraged. PECO will maintain a monopolistic market share, and when the cap restraints are removed, will be able to exercise market power. Therefore, using the average of the price paths provided by PECO's chosen experts, instead of the lowest price path, is good policy.

This price path should then be adjusted to reflect the various costs required to convert wholesale electricity into retail electricity. Finally, the additional costs required to sell power to customers should be included in the cap, or in a separate unbundled fee, since PECO should not recover these costs from fees charged to independent marketers

Of course, it is necessary to retain the rate cuts that PECO promised as part of the settlement. The key to providing these cuts is the use of realistic values for transmission, distribution, and sales related expenses, and generation related overhead. Billing sales related expenses separately, and including generated related overhead (A&G) in the Consumer Credit would provide sufficient revenue to finance the CTC, the proposed rate reductions and an acceptable Consumer Credit.

Therefore, I suggest that transmission and distribution (T&D) be set at the lowest reasonable (historically allocated) level. Using a lower estimate for T&D prevents cross-subsidization, and will encourage increased efficiency in anticipation of Commission

review and the need to justify rate increases. PECO should have the burden of proof of its demand for a high transmission and distribution charge because of the anti-competitive nature of its claims stemming from the settlement rate structure and the real risk of cross-subsidization.

Q. HOW CAN YOU PROVIDE YOUR PROPOSED CONSUMER CREDIT?

A. The key is to honestly calculate the CTC and ITC charges. Assuring that PECO receive its $5.461 billion of agreed upon stranded costs merely requires treating the CTC as a residual, and ensuring that it is sufficient to collect that sum. Using the statute mandated "true-up" would ensure that PECO would receive its total mandated compensation.

PECO presumably determined the CTC using its projected after-tax cost of capital. PECO's after-tax cost of capital could be set at 8.42% as provided in Brennan's original testimony or at 8.71% in his rebuttal testimony. An alternative rate for the cost of capital is the 7.53% recognized by the Commission in the Securitization proceeding.

I question whether the cost of capital is the proper discount rate to use on a stream of riskless income. With stranded cost recovery under the true-up provision there is no risk that the future revenue stream promised by the statute will not be recovered. It is one thing for PECO to recover the net present value of its Commission mandated sum of stranded costs; but quite another to receive additional compensation for non-existent risk. Under this logic the discount rate would be related to the rate on 10-year Treasury bonds, an equivalent riskless asset. In 1996, the ten year Treasury bond had an average rate of 6.44%. Regardless of the merits of the cost of capital as the CTC discount rate, I used PECO's 8.71% cost as the discount rate in developing my alternative rate structure.

PECO is under an obligation to mitigate the CTC and ITC charges to the extent possible, to minimize rates to consumers. This can be done by setting the ITC charge as if PECO issued $4 billion in securitization bonds. The ITC charge is simply the cost of paying off the bonds plus the approximately 2% additional cost of servicing debt and preferred stock and the issuance expense (see Securitization Hearing, p. 58.). I calculated this charge by assuming that the bonds will carry an interest rate of 7.5% (compare to a 1996 rate of 7.37% on Moody's AAA corporate bonds) and have a 10 year term. Since the associated interest payments are tax deductible, 41.389% of their value should be returned to ratepayers. The CTC can now be set at a level to return $1.461 billion, discounted at 8.71%, as of January 1, 1999. See Schedule SAM-6.

Exhibit SAM-7 demonstrates that even with PECO's unrealistic no-growth scenario, it is possible to provide a Consumer Credit which will encourage competition. Using PECO's own forecast of demand in its IRP would provide an opportunity to provide additional rate reductions or increase the Consumer Credit, as shown in Exhibit SAM-7A.

Remember that vigorous competition would reduce actual prices to consumers below the Consumer Credit if the latter is set too high, acting as an automatic rate cut.

Q. IS IT POSSIBLE TO GIVE PECO ITS FULL $5.46 BILLION RECOVERY, SET THE CUSTOMER CREDIT HIGH ENOUGH TO PERMIT REAL COMPETITION AND STILL GIVE THE RATE COSTS PROMISED IN PECO'S PROPOSAL?

A. Not only can you do that but it is possible to give <u>greater</u> rate cuts than in PECO's proposal. As SAM-8 shows, I propose minimum rate decreases of 14%, 10%, 5%, 3%, 2% over the next five years. These are significantly better than the minimum rate costs

PECO proposes. The rate reductions shown on SAM-8 represent an additional $172 million in rate reductions (in 1999 dollars), over and above the PECO Proposal. In addition, I am proposing that PECO flow through to its customers the cost savings arising from securitization which could be as much as $900 million (in 1999 dollars), for a total benefit to consumers of over $1 billion.

It is extremely important to understand that PECO has proposed its rate by setting its "generation credit" to freeze out competition. Thus, PECO's minimum cuts are likely to be the only cuts ratepayers will see. My proposal, on the other hand, allows a large enough customer credit to permit real competition. Thus, my proposal produces assured rate cuts and promotes healthy competition among many suppliers, which offers even greater cuts.

Q. WHAT ABOUT THE RATE REDUCTIVE BENEFITS IN PECO'S AGREEMENT GIVEN TO SPECIFIC CLASSES OF RATE PAYERS?

A. PECO's settlement contains two class specific programs of value. First, the proposal includes a very favorable universal service program for the low income ratepayers. That program is designed to be a substantial expansion for low income residential ratepayers.[3] Second, the proposal makes significant financial concessions to the category of large industrial customers in rate classes LILR, EER and Rule 46.

Q. DO YOU CHALLENGE THOSE PORTIONS OF THE PECO'S PROPOSAL?

A. We do not.

Q. ARE THEY INCLUDED IN YOUR PROPOSAL?

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[3] The only change that needs to be made is that the CAP rate benefit needs to be made portable so that low income customers in the plan similarly can benefit from competition.

A. They are.

VIII. THE DEFAULT CUSTOMER PROBLEMS AND ITS CRITICALITY

Q. DOES THE PECO PROPOSAL HAVE OTHER PROVISIONS THAT INCREASE THE NEGATIVE EFFECT UPON COMPETITION?

A. Yes. As stated earlier, the subsidized generation caps (as a result of excessive T&D and CTC/ITC rates) are too low to allow competition. But making this effect even worse is a provision in the Settlement that permits PECO to sell power to "choose not to choose" customers, default customers and/or customers not able to shop at "standard market rates" that reflect PECO's view of the "prevailing market" price at the time. As I understand PECO's position, PECO will be able to set this "standard market rate" at whatever level it believes to be appropriate based upon its own view of market conditions, so long as the price doesn't exceed the energy and capacity cap. These rates, which will be provided by PECO as the distribution company, could be set, according to PECO, without regard to what its actual costs of delivering power are, or even the prevailing wholesale cost of energy or capacity at any particular time. PECO claims that it will even be able to set one class of customers' rates at the cap while discounting another class's rates. Beyond this "standard market rate," I understand that the PECO claims that its distribution arm can even offer individual customers prices on a case by case basis.

Q. WHAT'S WRONG WITH PECO OFFERING LOWER PRICES?

A. Nothing, if they're not subsidized and predatory. But, I have already discussed how PECO's proposed "caps" already do not recover PECO's full retail price of power; to

allow further discounting can only exacerbate this cross-subsidy. Moreover, PECO's proposal would transform the PECO distribution entity into an unregulated competitive supplier and, in effect, transfer all of PECO's present customers to this one competitor. To allow PECO to pick and choose between which rate classes should be priced below the cap without tightly prescribed rules would be inappropriate. To allow PECO to set a price for an individual customer will allow PECO to offer lower prices to the first few customers who enter into agreements with PECO's competitors thereby freezing competition out with only a few customers getting any competitive benefits. Such a result is grossly unfair. Indeed, PECO would propose to offer "competitive" prices to fully a third of its customers even before they are legally permitted to shop. PECO's plan could very well lock in those customers to PECO by offering aggressive "market" pricing before competing suppliers even have a legal right to offer them any service. When this "market pricing" advantage is combined with the incumbency advantage PECO already possesses, there simply will be no chance for competition in PECO's service territory and what will remain is PECO as a deregulated monopoly.

Q. HOW CAN THIS COMPETITIVE UNFAIRNESS BE CORRECTED?

A. PECO's "standard market rate" and its customer credit should be the same, at least until there is demonstrated competition in its service territory. In all cases, the standard market rate should reflect a full retail cost of power including all the costs I have discussed above. To the extent that PECO wishes to offer competitive and market pricing options it can do so through its competitive supplier entities.

IX. CONCLUSIONS

Q. WHAT ARE THE IMPLICATIONS OF PECO'S PROPOSAL, RELATIVE TO THE HOPE OF THIS COMMISSION TO DEVELOP A COMPETITIVE MARKET, SHOULD THE PROPOSAL BE ALLOWED WITHOUT THE NECESSARY REPAIR?

A. As stated earlier, the subsidized generation credits (through both T&D and excessive CTC/ITC rates) are too low to allow competition. Even if this is not the case, PECO is established as a price setter without any checks and balances (see paragraph 33 of PECO's proposal). PECO can set the price of generation at any rate as long as it is below the posted cap. PECO can set one class of customers' rates at the cap while discounting another class's rates. As I understand it, PECO, as the distribution company, believes that it can even offer individual customers prices on a case by case basis.

Q. DOES THIS COMPLETE YOUR TESTIMONY?

A. Yes.

Exhibit SAM-1

CTC/ITC Overcollection

Year	CTC per PECO (Table A) - cents/kWh	PECO Fcst No Securitization - Stranded Cost Recovery (1)	IRP Fcst - No Securitization - Stranded Cost Recovery (1)	IRP Stranded Cost Recovery plus Tax Effect (2)
1999	3.04	935,706,753	962,260,539	513,641,792
2000	3.04	860,736,595	894,496,012	482,967,375
2001	3.14	817,818,323	861,904,909	483,162,754
2002	3.14	752,293,554	801,162,017	451,147,637
2003	3.14	692,018,724	744,702,249	419,574,739
2004	2.87	581,836,012	632,613,606	328,724,362
2005	2.77	516,569,755	567,545,131	281,413,783
2006	2.57	440,872,321	489,420,974	217,712,598
2007	2.47	389,768,886	437,218,286	176,721,746
2008	2.27	329,508,465	373,479,516	121,086,793
				4,000,000,000
Total Stranded Cost Recovery:		6,317,129,387	6,764,803,239	7,476,153,580
Stranded Recovery Requested:		5,461,000,000	5,461,000,000	5,461,000,000
Excess CTC Recovery:		856,129,387	1,303,803,239	2,015,153,580

Notes:

(1) Discount rate 8.71%

(2) Parameters for securitized calculation:
Securitized amount - $4 billion (73.25% of $5.461 billion)
Unsecuritized amount - $1.461 billion (26.75% of $5.461 billion)
2% issuance cost
Tax rate .415

Exhibit SAM-2

PECO Implied Subsidy on Energy and Capacity

Using PHB Projections

		1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
PHB Estimate - All Hours Energy		0.020	0.021	0.022	0.024	0.025	0.026	0.027	0.028	0.030	0.031
System Load Weighting		1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088
Line Loss		0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930
Energy Cost ($/kWh)		0.0236	0.0249	0.0261	0.0275	0.0289	0.0303	0.0317	0.0331	0.0345	0.0360
All Hours Capacity ($/kW-year)	16	16.0	27.0	45.4	46.7	48.1	49.6	51.3	53.1	55.0	56.9
Load Factor	÷ 5256	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Reserve Margin	x 1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18
Line Loss	÷ .93	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93
Unit Capacity ($/kWh)	.0036	0.004	0.007	0.011	0.011	0.012	0.012	0.012	0.013	0.013	0.014
Energy and Capacity		0.027	0.031	0.037	0.039	0.041	0.042	0.044	0.046	0.048	0.050
Gross Receipts Tax		0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956
Total		0.0288	0.0329	0.0388	0.0406	0.0424	0.0442	0.0461	0.0480	0.0500	0.0521
PECO Proposed		0.0280	0.0280	0.0320	0.0350	0.0370	0.0397	0.0407	0.0477	0.0537	0.0557
Undercollection per kWh		**(0.0008)**	**(0.0049)**	**(0.0068)**	**(0.0056)**	**(0.0054)**	**(0.0045)**	**(0.0054)**	**(0.0003)**	**0.0037**	**0.0036**
Undercollection in $000s (Nominal)		**$ (26,227)**	**$ (170,365)**	**$ (238,931)**	**$ (198,421)**	**$ (194,072)**	**$ (164,957)**	**$ (199,799)**	**$ (12,680)**	**$ 139,760**	**$ 138,531**

Exhibit SAM-2A

PECO Implied Subsidy on Energy and Capacity

Using PECO Average Projections

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Average - All Hours Energy	21.300	22.467	23.567	24.733	25.330	26.700	27.733	28.833	30.100	31.433
System Load Weighting	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088
Line Loss	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930
Energy Cost ($/kWh)	0.0248	0.0263	0.0276	0.0289	0.0296	0.0312	0.0324	0.0337	0.0352	0.0368
All Hours Capacity ($/kW-year)	21.3	29.7	45.2	47.5	48.7	50.6	52.2	54.4	55.8	57.4
Load Factor	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Reserve Margin	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18
Line Loss	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93
Unit Capacity ($/kWh)	0.005	0.007	0.011	0.011	0.012	0.012	0.013	0.013	0.013	0.014
Energy and Capacity	0.030	0.033	0.038	0.040	0.041	0.043	0.045	0.047	0.049	0.051
Gross Receipts Tax	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956
Total	0.0314	0.0350	0.0403	0.0423	0.0433	0.0454	0.0471	0.0490	0.0509	0.0530
PECO Proposed	0.0280	0.0280	0.0320	0.0350	0.0370	0.0397	0.0407	0.0477	0.0537	0.0557
Undercollection per kWh	(0.0034)	(0.0070)	(0.0083)	(0.0073)	(0.0063)	(0.0057)	(0.0064)	(0.0013)	0.0028	0.0027
Undercollection in $000s (Nominal)	$ (118,611)	$ (244,261)	$ (291,999)	$ (259,585)	$ (227,396)	$ (209,601)	$ (236,443)	$ (49,531)	$ 104,190	$ 104,570

Exhibit SAM-3

Transmission and Distribution (T&D) Reallocation

Cost in cents per kWh

PECO Proposal - T&D (1)	3.11
PECO Average System T&D (2)	3.29
Less: (3)	
Production-related A&G	0.45
Uncollectible Accounts Expense	0.21
Adjusted T&D (4)	2.63

Notes:

(1) Value in Table A.
(2) PECO functional cost of service analysis.
(3) Source: Reising Supplemental Page 5, line 6. These two components comprise the Energy Overhead allowance, .66 cents/kWh.
(4) T&D Base 2.58 cents/kWh, T&D Sales Expense .05

Exhibit SAM-4

Computations for PECO Implied Subsidy on Energy and Capacity

Using PHB and Average Projections
With and Without Energy Overhead

PHB STUDY	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
PHB Estimate - All Hours Energy	0.020	0.021	0.022	0.024	0.025	0.026	0.027	0.028	0.030	0.031
System Load Weighting	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088
Line Loss	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930
Energy Cost ($/kWh)	0.0238	0.0249	0.0261	0.0275	0.0289	0.0303	0.0317	0.0331	0.0345	0.0360
All Hours Capacity ($/kW-year)	16.0	27.0	45.4	46.7	48.1	49.6	51.3	53.1	55.0	56.9
Load Factor	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Reserve Margin	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18
Line Loss	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93
Unit Capacity ($/kWh)	0.004	0.007	0.011	0.011	0.012	0.012	0.012	0.013	0.013	0.014
Energy and Capacity	0.027	0.031	0.037	0.039	0.041	0.042	0.044	0.046	0.048	0.050
Gross Receipts Tax	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956
Total	**0.0288**	**0.0329**	**0.0388**	**0.0406**	**0.0424**	**0.0442**	**0.0461**	**0.0480**	**0.0500**	**0.0521**
PECO Proposed	0.0280	0.0280	0.0320	0.0350	0.0370	0.0397	0.0407	0.0477	0.0537	0.0557
Undercollection on Energy plus Capacity	**(0.0008)**	**(0.0049)**	**(0.0068)**	**(0.0056)**	**(0.0054)**	**(0.0045)**	**(0.0054)**	**(0.0003)**	**0.0037**	**0.0036**
Energy Overhead from T&D	0.0066	0.0066	0.0066	0.0066	0.0066	0.0066	0.0066	0.0066	0.0066	0.0066
GRT	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956
Adjusted Total with Energy Overhead	**0.0357**	**0.0398**	**0.0457**	**0.0475**	**0.0493**	**0.0511**	**0.0530**	**0.0549**	**0.0569**	**0.0590**
PECO Proposed	0.0280	0.0280	0.0320	0.0350	0.0370	0.0397	0.0407	0.0477	0.0537	0.0557
Undercollection on Energy plus Capacity	**(0.0077)**	**(0.0118)**	**(0.0137)**	**(0.0125)**	**(0.0123)**	**(0.0114)**	**(0.0123)**	**(0.0072)**	**(0.0032)**	**(0.0033)**

AVERAGE OF 3 FORECASTS										
Average - All Hours Energy	21.300	22.467	23.567	24.733	25.330	26.700	27.733	28.833	30.100	31.433
System Load Weighting	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088	1.088
Line Loss	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930	0.930
Energy Cost ($/kWh)	0.025	0.026	0.028	0.029	0.030	0.031	0.032	0.034	0.035	0.037
All Hours Capacity ($/kW-year)	21.267	28.733	45.200	47.500	48.700	50.567	52.167	54.433	55.833	57.367
Load Factor	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Reserve Margin	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18	1.18
Line Loss	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93
Unit Capacity ($/kWh)	0.005	0.007	0.011	0.011	0.012	0.012	0.013	0.013	0.013	0.014
Energy and Capacity	0.030	0.033	0.038	0.040	0.041	0.043	0.045	0.047	0.049	0.051
Gross Receipts Tax	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956
Total	**0.0314**	**0.0350**	**0.0403**	**0.0423**	**0.0433**	**0.0454**	**0.0471**	**0.0490**	**0.0509**	**0.0530**
PECO Proposed	0.0280	0.0280	0.0320	0.0350	0.0370	0.0397	0.0407	0.0477	0.0537	0.0557
Undercollection on Energy plus Capacity	**(0.0034)**	**(0.0070)**	**(0.0083)**	**(0.0073)**	**(0.0063)**	**(0.0057)**	**(0.0064)**	**(0.0013)**	**0.0028**	**0.0027**
Energy Overhead from T&D	0.0066	0.0066	0.0066	0.0066	0.0066	0.0066	0.0066	0.0066	0.0066	0.0066
GRT	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956	0.956
Adjusted Total with Energy Overhead	**0.0383**	**0.0419**	**0.0472**	**0.0492**	**0.0502**	**0.0523**	**0.0540**	**0.0559**	**0.0578**	**0.0599**
PECO Proposed	0.0280	0.0280	0.0320	0.0350	0.0370	0.0397	0.0407	0.0477	0.0537	0.0557
Undercollection on Energy plus Capacity	**(0.0103)**	**(0.0139)**	**(0.0152)**	**(0.0142)**	**(0.0132)**	**(0.0126)**	**(0.0133)**	**(0.0082)**	**(0.0041)**	**(0.0042)**

Exhibit SAM-5

ITC Collection Using PECO Sales

Dollars in 000s

Year	Sales per PECO Proposal	ITC - cents/kWh	ITC Recovery (NPV)
1999	33,569,358	0.0180	583,126
2000	33,569,358	0.0178	536,783
2001	33,569,358	0.0176	492,375
2002	33,569,358	0.0174	453,270
2003	33,569,358	0.0172	417,270
2004	33,569,358	0.0170	384,181
2005	33,569,358	0.0169	353,666
2006	33,569,358	0.0167	325,602
2007	33,569,358	0.0165	299,748
2008	33,569,358	0.0163	275,956

Total ITC Collection:	4,121,977
Stranded Recovery Requested:	5,461,000
CTC Recovery Required:	(1,339,023)

Exhibit SAM-5A

ITC Collection Using IRP Sales

Dollars in 000s

Year	Sales per PECO IRP	ITC - cents/kWh	ITC Recovery (NPV)
1999	34,522,000	0.0180	599,675
2000	34,886,000	0.0178	557,837
2001	35,379,000	0.0176	518,918
2002	35,750,000	0.0174	482,714
2003	36,125,000	0.0172	449,037
2004	36,498,000	0.0170	417,709
2005	36,882,000	0.0169	388,566
2006	37,266,000	0.0167	361,457
2007	37,656,000	0.0165	336,239
2008	38,049,000	0.0163	312,780

Total ITC Collection:	4,424,931
Stranded Recovery Requested:	5,461,000
CTC Recovery Required:	(1,036,069)

Exhibit SAM-6

CTC to Return $1.461 Billion

Dollars in 000s

Year	PECO Forecast Sales per Appendix C	Sales per IRP	Annual CTC Recovery - PECO Sales	Annual CTC Recovery - IRP Sales
1999	33,569,358	34,522,000	0.0067	0.0065
2000	33,569,358	34,886,000	0.0067	0.0064
2001	33,569,358	35,379,000	0.0067	0.0064
2002	33,569,358	35,750,000	0.0067	0.0063
2003	33,569,358	36,125,000	0.0067	0.0062
2004	33,569,358	36,499,000	0.0067	0.0062
2005	33,569,358	36,882,000	0.0067	0.0061
2006	33,569,358	37,266,000	0.0067	0.0060
2007	33,569,358	37,656,000	0.0067	0.0060
2008	33,569,358	38,049,000	0.0067	0.0059

Exhibit SAM-7

Alternative to PECO Proposed "Table A"
System-Wide Average Rates
Using PECO Sales from Appendix C (No Load Growth)

Effective Date	Transmission (1)	Distribution (2)	CTC or ITC (Sum, including ITC Tax Mitigation (3)	Consumer Credit * (4)	Total Bill Rate Cap (5) = (1)+(2)+(3)+(4)
	cents/kWh	cents/kWh	cents/kWh	cents/kWh	cents/kWh
January 1, 1999	0.38	2.25	2.10	3.83	8.57
January 1, 2000	0.38	2.25	2.11	4.19	8.93
January 1, 2001	0.38	2.25	2.12	4.72	9.47
January 1, 2002	0.38	2.25	2.14	4.92	9.68
January 1, 2003	0.38	2.25	2.15	5.02	9.80
January 1, 2004	0.38	2.25	2.17	5.23	10.03
January 1, 2005	0.38	2.25	2.19	5.40	10.22
January 1, 2006	0.38	2.25	2.21	5.59	10.43
January 1, 2007	0.38	2.25	2.23	5.78	10.65
January 1, 2008	0.38	2.25	2.26	5.99	10.87

* Comparable to PECO's "Energy & Capacity Cap"

Exhibit SAM-7A

Revision to PECO Proposed "Table A"
System-Wide Average Rates
Using PECO IRP Sales (Load Growth)

Effective Date	Transmission (1)	Distribution (2)	CTC or ITC (Sum, including ITC Tax Mitigation (3)	Consumer Credit * (4)	Total Bill Rate Cap (5) = (1)+(2)+(3)+(4)
	cents/kWh	cents/kWh	cents/kWh	cents/kWh	cents/kWh
January 1, 1999	0.38	2.25	2.09	3.83	8.55
January 1, 2000	0.38	2.25	2.09	4.19	8.91
January 1, 2001	0.38	2.25	2.09	4.72	9.43
January 1, 2002	0.38	2.25	2.09	4.92	9.64
January 1, 2003	0.38	2.25	2.10	5.02	9.75
January 1, 2004	0.38	2.25	2.11	5.23	9.98
January 1, 2005	0.38	2.25	2.13	5.40	10.16
January 1, 2006	0.38	2.25	2.14	5.59	10.37
January 1, 2007	0.38	2.25	2.16	5.78	10.57
January 1, 2008	0.38	2.25	2.18	5.99	10.80

* Comparable to PECO's "Energy & Capacity Cap"

SAM-8

Hagler Bailly Rate Savings

Year	T&D	Customer Credit	CTC	Rate	PECO's Current Rates	% HB Rate Decrease
1999	0.0263	0.0383	0.0209	0.0855	0.0995	14%
2000	0.0263	0.0419	0.0209	0.0891	0.0995	10%
2001	0.0263	0.0472	0.0208	0.0943	0.0995	5%
2002	0.0263	0.0492	0.0209	0.0964	0.0995	3%
2003	0.0263	0.0502	0.021	0.0975	0.0995	2%
2004	0.0263	0.0523	0.0212	0.0998	0.0995	0%
2005	0.0263	0.054	0.0213	0.1016	0.0995	-2%
2006	0.0263	0.0559	0.0215	0.1037	0.0995	-4%
2007	0.0263	0.0578	0.0216	0.1057	0.0995	-6%
2008	0.0263	0.0599	0.0218	0.108	0.0995	-9%

Note:
No flow through of tax benefit from write off.

R-00973953
R-00973953C0001-C0007

PECC St. 2

Phil.

10-15-97
GS

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

SUPPLEMENTAL TESTIMONY OF

B. JEANINE HULL

ON BEHALF OF
PENNSYLVANIA ELECTRIC COMPETITION
COALITION

PUC DOCKET NO. R-00973953
RE: JOINT PETITION FOR PARTIAL SETTLEMENT
OF PECO RESTRUCTURING PLAN

SEPTEMBER 29, 1997

Q. **MS. HULL, PLEASE STATE YOUR NAME AND GIVE YOUR BUSINESS ADDRESS FOR THE RECORD.**

A. My name is Jeanine Hull. My business address is 1350 New York Avenue NW, 11th Floor, Washington, DC 20005.

Q. **MS. HULL, PLEASE DESCRIBE YOUR CURRENT POSITION AND PROFESSIONAL BACKGROUND.**

A. I am a principal and the founder of Strategic Energy Advisors. SEA provides consulting services to utilities, other energy companies, financial institutions, other consulting firms and law firms.

Before forming SEA, I was Vice President and Assistant General Counsel for LG&E Power Marketing, Inc., (LPM), one of the largest power marketing companies in the US. At LPM, I was involved in the development of ten independent power projects. In addition, I established and developed a number of LPM's products as well as LPM's electricity trading practices and procedures.

I wrote the strategic vision for LG&E Energy, parent company of LPM, and presented it in testimony before Congress. I also drafted the language in the Energy Policy Act that provides transmission access for wholesale power supplies.

Prior to joining LG&E Power, I was a project finance counsel in Washington DC, nuclear and electricity counsel to the Energy and Commerce Committee of the US House of Representatives and directed the strategic planning activities of the California Energy Commission.

Q. **PLEASE DESCRIBE THE PURPOSE OF YOUR TESTIMONY.**

A. I am testifying on behalf of the Pennsylvania Electric Competition Coalition. The testimony sets forth my views concerning how power suppliers will react to PECO Energy Company's rate restructuring proposal.

Q. PLEASE DESCRIBE PECO'S RATE RESTRUCTURING PROPOSAL.

A. PECO is seeking approval for a comprehensive change in its tariffs to facilitate its transition to a restructured electric utility industry. PECO filed its restructuring proposal on April 1, 1997.

It reached a negotiated settlement with nine of the 25 intervenors in the related rate restructuring proceeding in late August. This partial settlement is referred to as the PECO Proposal.

Highlights of PECO's original restructuring proposal include the following:

- Placing its generation assets into a separate subsidiary or division from its transmission and distribution assets, charging customers for each separately;
- Recovering its stranded costs; and
- Allowing 33% of its customers to choose their electricity supplier beginning in January 1999, 66% beginning in January 2000 and all customers beginning in January 2001.

Highlights of the proposed change in tariffs in the PECO Proposal include the following:

- Reducing retail electric rates by 10% for the 28 months September 1998 through December 2000. Thereafter, retail rates would increase. Rates

would reach December 1996 levels in January 2003 and may continue to increase thereafter;

- Recovering stranded costs through a customer charge that begins at 3.04 cents per kwh in 1999.
- Advancing the collection of up to $4 billion of the stranded costs through sales of securities;
- Accelerating the phase-in to competition with 66% of customers able to choose their electricity supplier beginning in January 1999 and all customers beginning in January 2000; and
- Accepting ceilings on transmission and distribution rates through 2003 and on generation rates through 2008. Such ceilings combined with a fixed charge for stranded cost recovery place a ceiling on the total cost of electricity from PECO.

Q. PLEASE DESCRIBE THE PROPOSED RATES CONTAINED IN THE PECO PROPOSAL.

A. There are separate charges for (a) generation, (b) transmission and distribution and (c) stranded cost recovery.

When customers choose an electricity supplier, their choice will only involve the commodity portion of the rate or what is referred to as generation. Only this amount, the generation credit, can be avoided by customers. Customers will continue to obtain transmission and distribution services from PECO and pay PECO for those services.[1] In

[1] This does not include "non-wire" services, such as metering and billing which, if the (continued...)

addition, all of PECO's customers will pay a charge to allow PECO to recover its stranded costs.

PECO proposes that its generation charge, combined with its charges for T&D and stranded costs, total 10% less than its rates on December 31, 1996. The average PECO customer paying 9.95 cents per kwh for electricity at the end of 1996 would pay PECO 8.95 cents per kwh beginning in September 1998. This rate would remain constant through the end of 2000.

Of that 8.95 cents, the PECO Proposal proposes allocating 2.80 cents for the cost of generation, 3.11 cents to T&D charges and 3.04 cents to recover stranded costs.

Q. WHAT IS YOUR REACTION TO THE ALLOCATION OF CHARGES IN PECO'S PROPOSAL?

A. The proposed allocation will severely impair the ability of competing energy suppliers to sell electricity to PECO's customers. It is highly unlikely that competing energy suppliers will be able to acquire and resell generation in PECO's territory for less than the generation credit of 2.80 cents per kwh.

Q. HOW CAN YOU SAY THAT WHEN COMPETITION IN PECO'S TERRITORY HAS NOT YET STARTED?

A. Today there is a wholesale market for power that can be delivered into PECO's territory. Power from utilities elsewhere in the Mid-Atlantic area and from Ohio, for example, is offered for sale each day. It is purchased by investor-owned and municipal utilities and resold to their customers.

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[1](...continued)
PaPUC authorizes it, could be provided by alternative providers.

The wholesale market for electricity can be viewed as having two parts. One part is a spot market. The spot market involves sales of electricity for delivery the next day or even the next hour. In the spot market, power is sold, delivered immediately thereafter by the seller and then resold by the purchaser.

The other part of the wholesale market for electricity involves long-term sales. Utilities enter long-term purchase and sale agreements regularly. Such agreements commit one utility to buy and another to deliver power over an extended period. There typically are penalties for failure of the seller to deliver the electricity to the buyer.

At times, the price of electricity in the spot wholesale market does decline below 2.80 cents per kwh. However, a supplier competing with PECO will need long-term sources of electricity. To compete with PECO, a supplier would have to have arranged firm sources of electricity for delivery over three, four or five years or for even longer terms.

The current market price for electricity in and around PECO's territory for delivery during 1999 and 2000 is materially higher than 2.80 cents per kwh. Moreover, the current market price for electricity for delivery in future years is higher than the allowance for generation proposed by PECO. In addition to the higher commodity price in the current physical and forward markets, there are additional costs associated with the retail delivery of power. As shown in the table below, these additional costs would make the actual costs to marketers even higher. Finally, rates are expected to increase in the future.

Q. **WHAT DO YOU SEE HAPPENING TO THE STATE OF COMPETITION IF THE PROPOSED GENERATION OR COMMODITY RATES CONTAINED IN THE PECO PROPOSAL ARE ADOPTED?**

A. There is no question that the proposed credit will delay competition for sales of the electricity commodity until market prices are close to or below the rates proposed in the PECO Proposal.

The PECO Proposal calls for the commodity credit to double over the ten year period from 1999 to 2008. The proposed credit increases from 2.80 cents in 1999 and 2000, to 3.20 cents in 2001, 3.50 cents in 2002, 3.70 cents in 2003, 3.97 cents in 2004, 4.07 cents in 2005, 4.77 cents in 2006, 5.37 cents in 2007 and 5.57 cents in 2008.

Based on data and information available in the marketplace today from participants (both buyers and sellers) and current price quotations, the current price for power to be delivered in 1999 through 2003 is higher than the credit proposed the PECO Proposal.

Q. **ARE YOU SUGGESTING THAT ONLY HIGHER RATES WILL PROMOTE COMPETITION IN PENNSYLVANIA?**

A. No. The <u>total rates</u> consumers would pay need not be set higher than the levels proposed in the PECO Proposal including the 10% reduction from current rates for 28 months. However, those rates consist of several components. It is the allocation among the components that needs to change for competition to take place in PECO's territory.

The PECO Proposal calls for average rates in 1999 and 2000 of 8.95 cents per kwh, 9.45 cents per kwh in 2001, 9.75 cents in 2002 and 9.95 cents in 2003. The PECO Proposal allocates the amounts shown to the generation credit in my previous answer. It proposes to allocate the balance of the charges to pay for transmission and distribution

and stranded costs. This allocation, not the total of the consumer charges. will impede competition.

Q. WOULD CONSUMER RATES CHANGE IF THE ALLOCATION AMONG THE RATE COMPONENTS WERE DIFFERENT THAN THE ALLOCATION PROPOSED IN THE PECO PROPOSAL.

A. Consumer rates could actually decline if the proposed credit for generation was higher even while the proposed total of generation. T&D and stranded costs remained the same.

When suppliers can buy electricity for less than the proposed allowance for generation, the consumer can realize savings. When competing suppliers buy electricity for less than the generation allowance, the total price paid by the consumer will include the supplier's costs of generation and a markup for administration and operations. Competition among suppliers will keep the markup modest. Under these circumstances, the total costs paid by the consumer should be less than the total costs proposed in the PECO Proposal

Q. HOW DOES THIS PROPOSED ALLOCATION IN THE PECO PROPOSAL COMPARE TO THE ALLOCATION OF PECO'S RATES BEFORE RESTRUCTURING?

A. It is much different. Today, without restructuring, about 70% of PECO's costs are attributed to generation. By contrast, the PECO Proposal proposes to allocate only 31% (2.80 cents of 8.95 cents) to generation. This is less than half of the allocation to generation that is in effect before restructuring.

This proposed generation credit -- not the level of total rates -- places a severe ceiling on the price the competitors can charge when seeking to compete with PECO. It is the credit that prevents competition. Because the generation credits are set so low,

prospective competitors are frozen out of PECO's territory. They will not be able to compete until, as the years pass, the proposed credit for generation rise.

The PECO Proposal proposes that suppliers seeking to serve PECO's customers compete, not with each other but with an arbitrary allowance or credit for generation. Ultimately, genuine prices are set in the market. Because the generation credits are below market prices, the market is not allowed to operate. Prices would be set by administered prescribed numbers contained in the PECO Proposal.

Q. HOW WILL COMPETING ENERGY SUPPLIERS RESPOND IF THESE GENERATION CREDITS ARE APPROVED BY THE PUC?

A. Setting PECO's credits for the generation component at below the market price will seriously deter competition.

Consumers are not likely to change suppliers without realizing benefits from the commitment to a new supplier. Consumers need an incentive to offset the uncertainty of dealing with a new supplier. Consumers need an incentive to give up the option to choose a different supplier later. Consumers need an incentive to undertake the extra effort involved in switching suppliers.

Suppliers seeking to compete with PECO must offer customers immediate and meaningful savings. Speaking from my experience as a consumer and observing the behavior of others, consumers need to realize a minimum of five to ten percent savings before they will change suppliers. In this context, of course, I am referring to overall savings, not savings only on the generation component.

To provide 10% savings over PECO, a supplier would have to reduce the rate in 1999 and 2000 by 0.89 cents from 8.95 cents per kwh to 8.06 cents. To provide 5%

savings, a supplier would have to reduce the rate in 1999 and 2000 by 0.45 cents from 8.95 cents to 8.50 cents. The supplier is only competing on the generation component of the rates. Thus, to provide that 10% savings to PECO's customers in 1999 and 2000, the supplier would have to reduce the generation price by 89 cents, or 32%, from 2.80 cents to 1.91 cents per kwh. To provide 5% savings in 1999 and 2000, the supplier would have to offer generation at 2.35 cents per kwh.

Since suppliers will lose money if they simply match the credit proposed in the PECO Proposal, if the suppliers charge less than the proposed credit to induce consumers to switch, then the suppliers will lose even more money.

Q. PLEASE DISCUSS THE FACTORS THAT WILL CAUSE THE SUPPLIERS TO LOSE MONEY.

A. The allowances in the PECO Proposal are adopted, a supplier serving a PECO customer would lose money for the following reasons:

First, the current market price of electricity is higher than the proposed generation allowances in the PECO Proposal. This condition pertains to generation prices proposed for at least the first five years after restructuring. Thus, a supplier today seeking to purchase electricity for delivery in 1999 through 2003 could not acquire the commodity for less than the generation credits proposed in the PECO Proposal.

Suppliers do not compete in markets where the cost of goods sold is higher than the ceiling price for which they can sell.

Second, customers need motivation to switch from PECO. Thus, the supplier has to offer a price that is meaningfully lower than the price from PECO. The supplier faces larger losses if it offers the commodity at a price even lower than that proposed in the

PECO Proposal. However, only by making such an offer would a supplier expect a consumer to switch from PECO.

Third, there are non-commodity costs involved in operating a power marketing company. The supplier has to pay for marketing, sales and promotion. The supplier has to invest in customer information systems for billing. The supplier has to have a complete infrastructure for operations including buying, scheduling and delivering the electricity. The supplier incurs the cost of purchasing financial instruments to hedge its delivery obligations in sales contracts. Finally, the supplier has to earn a margin on its investment to provide a reason to pursue the market.

The PECO Proposal's allocations for T&D would allow PECO to recover administrative costs such as billing its customers. There is no corresponding provision for the prospective competitor to recover its administrative and operating costs. The supplier has to create a positive margin between the sales price and the cost of the commodity to pay such costs. As we have seen, the margin between the ceiling price and the cost of the commodity is actually negative.

Q. WILL THE WHOLESALE PRICE OF POWER DECLINE AND CAUSE COMPETITION IN PECO'S TERRITORY TO FLOURISH?

A. If the allocation for generation were adequate, the price for power in PECO's territory could be expected to decline. If the allocation allowed competition, suppliers would have an incentive to invest in new generation to serve PECO's customers. Such generation would employ state-of-the-art technology and offer PECO's customers the lowest costs of generation available today.

The allocation of prices for generation in the PECO Proposal does not encourage competition to develop for a number of years. Even new combined cycle gas facilities with heat rates below 7000 could not produce electricity for less than the generation allocation proposed in the PECO Proposal.

Thus, the PECO Proposal not only deters competition, but it also discourages new plants from being constructed to serve PECO's customers: New plants would increase the supply of electricity and reduce the prices consumers pay in the future.

Q. WHO BENEFITS FROM ALLOCATING RELATIVELY SMALL VALUES TO THE GENERATION CREDIT AND RELATIVELY LARGE VALUES TO THE T&D AND STRANDED COST ELEMENTS OF RATES?

A. PECO benefits. The proposed credits for the generation component create a low price ceiling for prospective competitors. When competitors cannot supply electricity for resale at prices less than that low ceiling, competition will not materialize. PECO continues to have its profitability protected as though restructuring had not taken place.

At the same time, PECO benefits from the restructuring. PECO can use the period before competition becomes a reality in its territory to sign long-term contracts with its most attractive customers. Finally, it has the opportunity to make sales in other territories as they open to competition. In addition, it will receive a huge cash infusion from the proposed securitization from stranded costs, which will cushion it from some of the inevitable consequences of increased competition.

Q. WITH THE PROPOSED RATES, DO YOU EXPECT ANY TRANSACTIONS INVOLVING COMPETITORS TO PECO TO BE COMPLETED?

A. Yes, I expect that there may be some.

Some suppliers seek a presence in the vital Pennsylvania market and complete a few visible transactions at a loss which they are prepared to accept. Robust competition creating choice for many customers would be much more problematic. In addition, some long-term sales may take place. The proposed charge for generation from PECO increases over time. As PECO's generation rate increases, competing suppliers have more of an opportunity to deliver savings to PECO's customers.

Q. PLEASE DISCUSS THE OPPORTUNITY FOR LONG-TERM SALES.

A. The opportunity for long-term sales will be quite limited for a number of years.

The customer needs savings in each year of a long-term contract before it will switch suppliers. Without savings in the early years, the customer will delay choosing an alternative to PECO.

Alternative suppliers cannot purchase electricity for delivery in 1999 and 2000 for as low as 2.80 cents per kwh. In addition, power available for sale today for delivery in 2001, 2002 and 2003 costs more than the proposed generation credits from PECO during those years. Moreover, forecasts of power prices suggest that the cost of power for delivery in 1999 through 2003 in PECO's territory will increase.

A supplier signing a long-term sales contract that will lose money in the early years will need to make up the losses in later years. Such losses include the cost of working capital during the years the supplier loses money.

Q. CAN YOU QUANTIFY THE DIFFICULTY OF MAKING COMPETITIVE SALES THROUGH LONG-TERM CONTRACTS.

A. Yes. The table below distills the problem suppliers have agreeing to long-term sales given the rates in the PECO Proposal.

TABLE ONE (data in cents per kwh)

	PECO Credit	Market Price	Line loss, taxes & penalties	Admin Costs	Loss	W Capital at 10%	Loss per Year	Total Loss
1999	2.80	3.40	0.20	0.20	(1.000)	0.035	(1.035)	(1.035)
2000	2.80	3.50	0.20	0.20	(1.100)	0.039	(1.139)	(2.174)
2001	3.20	3.60	0.20	0.20	(0.800)	0.028	(0.828)	(3.002)
2002	3.50	3.70	0.20	0.20	(0.600)	0.021	(0.621)	(3.623)
2003	3.70	3.80	0.20	0.20	(0.500)	0.018	(0.518)	(4.140)

While prices are volatile, the numbers in this table are a fair representation of the situation of the PECO Proposal creates.

The second column in Table One is the proposed rate for generation from PECO in each year noted in the first column. (This is the same price a customer will receive from PECO if he does nothing. This price does not offer the customer any incentive to switch from PECO to another supplier. The price would have to be lower to interest a customer in another supplier.)

The third column presents an estimate of the current market price for electricity in each of the same years. While prices are volatile, this is an estimate of the current costs of blocks of power for delivery on a firm basis throughout the year for twenty-four hours per day.

The fourth column presents allowances for line losses, gross receipts taxes and load factor penalties. The fifth column presents allowances for costs the supplier incurs to serve the retail market, including an allowance for a profit margin.

The sixth column presents the annual loss or gain from the sale of electricity at PECO's rates when purchasing the electricity at the market price. As shown, for the years 1999 through 2003, the supplier loses money. Such losses occur even though the customer does not realize any savings from the competing supplier. If the supplier reduces the price by enough to provide an incentive to the customer, the supplier's losses will increase.

The seventh column presents an allowance for the annual cost of working capital required after selling the electricity at a loss.

The eighth column is the loss each year including the cost of the working capital, and the ninth column is the cumulative loss over the years.

In the table above, the supplier's total costs (other than the cost of generation) total $2.00 per kwh over the five years. The cumulative loss over that same period is four times as large as the total costs of the supplier's operation.

Q. CAN YOU OUTLINE TERMS OF A LONG-TERM CONTRACT THAT MAY PROVIDE A SUPPLIER WITH A FINANCIAL INCENTIVE TO PURSUE PECO'S CUSTOMERS?

A. I can and will describe the terms of such a contract. However, it is important to understand both that few customers would accept such a contract and that few suppliers are in a position to offer such a contract.

A long-term contract that may offer a financial incentive to the supplier and savings to the customer could have the following terms:

Term	Ten years from 1999 through 2008.
Rates	5% less than PECO's rates for generation throughout the ten year period.
Early Termination	Early termination is permitted only if the customer returns the losses incurred by the supplier in the early years plus a suitable return on that capital.

Q. WHY WOULD SUCH TERMS BE UNACCEPTABLE TO THE CUSTOMER?

A. Customers recognize that the electric utility industry is going through an unprecedented period of change. They know that such a large change introduces a great deal of uncertainty, particularly over a ten year term.

Given the uncertainty, it is highly unlikely that many customers would find these terms compelling. The terms above provide the customer with 5% savings on the generation component but less than 2% on the overall cost of electricity. To obtain modest savings, the customer is committing itself, and forfeiting its options, for an extended period.

Q. **WHY ARE FEW SUPPLIERS IN A POSITION TO OFFER SUCH TERMS?**

A. First, as shown by Table One, even matching PECO's generation rates will cause the supplier to lose money. If the price of electricity is 5% less than PECO's rates, the cumulative loss increases.

Suppliers do not purposely enter long-term contracts to lose money. With the forecast of the cost of generation included in Table One, the supplier loses money. Only a supplier that expected generation to cost considerably less than the cost forecast in Table One would enter into a long-term contract under these conditions. Otherwise, it could not expect to profit from delivering power for ten years at 5% less than the proposed rates in the PECO Proposal.

Second, when selling electricity, suppliers typically protect themselves from changes in market conditions by purchasing a like amount of electricity. The market for wholesale electricity with terms of four and five years is thin. Not all power generators offer to sell electricity today for delivery five years from today. Thus, it would be difficult to hedge a long-term contract with the terms outlined above.

If the supplier entered the contract without knowing the source of its supply in the later years, the supplier would be taking a material risk. For taking such risk, the supplier would have to be paid a premium. This would raise the price required. Given the price ceilings inherent in the PECO Proposal, the likelihood that the supplier could enter a profitable sale is made more remote.

Q. **WHAT OTHER TRANSACTIONS WILL TAKE PLACE IF THE RATES IN THE PECO PROPOSAL ARE ADOPTED?**

A. Those transactions that do not, right fro : supplier will be artificial sales and purchases. For ex ne supplier with the option to cause the customer to PECO's rate for generation.

Thus, the customer will take ele plier and enjoy savings only at times that the supplier c lower than PECO's rate. Otherwise, the customer y from PECO.

Suppliers may pay customers fo fashion. However, such contracts are options, no contracts. The supplier in such an arrangement is a t. The supplier is agreeing to look for opportun e lower than PECO's price. The customer will p ier only if such opportunities happen to develop.

Q. PLEASE CONCLUDE WITH A SUM CONSEQUENCES OF A RATE ORD OSED IN THE PECO PROPOSAL.

A. First, competition among electricity supp layed for three, four or five years beyond the expe

Second, new, state-of-the-art ele will not be built until competition is a re

Third, PECO's customers will b s until competition is a reality in PECO's

Q. **DOES THIS END YOUR TESTIMONY?**

A. Yes.