BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Provider of Last Resort	**:**	
(POLR) Roundtable	**:**	**Docket No. M-00041792**
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COMMENTS OF PECO ENERGY
FOR THE POLR ROUNDTABLES

PECO appreciates the opportunity to submit these initial comments and participate with other stakeholders in the Commission's POLR Roundtables. PECO is pleased that the Commission has scheduled these Roundtables to focus on vital issues regarding post transition POLR obligations and to establish the related regulatory process.

As Commissioner Thomas noted in his March 4, 2004 Motion establishing the Roundtables, the Electricity Generation Customer Choice and Competition Act ("Competition Act") provides the Commission "significant flexibility in developing the rules governing POLR obligations." Such flexibility is critical because defining post transition utility service in these changing times requires reasonably balancing various interests and public policy goals in the context of a mix of regulated and unregulated services. These goals include ensuring fairly priced and adequate levels of reliable supply of electricity for customers; providing electric distribution companies ("EDCs") full cost recovery of the direct costs they incur to supply electric generation to their customers as well as adequate compensation for the risks they bear as the ultimate POLR provider;

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and promoting the continued development of both wholesale and retail competitive markets for electric generation.

PECO looks forward to working with the Commission and other stakeholders to develop a regulatory process that provides for continued reliable service for customers and is fair and reasonable for all participants.

I. Need for Regulatory Framework Providing for Review of Each EDCs' POLR Plans

PECO believes the primary goal of the Roundtables and subsequent rulemaking should be to develop a workable regulatory filing and approval process for POLR plans that provides due process for all stakeholders. This process must recognize the different circumstances that EDCs will face when they enter the post-transition POLR environment. Pennsylvania EDC generation rate cap expiration dates are staggered over more than seven years such that some Pennsylvania EDCs do not even reach the post transition POLR stage until 2011. In fact, the post transition period will not start for almost 75% of all Pennsylvania customers until 2009 or later. Because wholesale power markets are dynamic, rules and conditions can change over that seven-year period. Thus, the same post-transition POLR model could produce very different results depending on market conditions EDCs face when their transition period ends. EDC circumstances also vary because of differing customer mix and switching history, RTO membership, level of electric generation supplier ("EGS") activity, generation availability and mix, existence of affiliate generation or not, and service territory characteristics. As such, a “one size fits all” approach is not advisable.

Rather than attempting to develop and prescribe one standard model that would apply to all EDCs, the Commission should focus instead on establishing a uniform regulatory filing/approval process that will allow for POLR plans tailored to EDCs’ specific circumstances similar to the filing/approval process it employed successfully in developing electric and gas restructuring plans. The widely recognized success of Pennsylvania’s electric restructuring was in large part a function of the flexibility the Commission employed in considering and approving EDC-specific plans. If a similar approach were used for POLR service, POLR plans filed in the context of such a regulatory framework could then be reviewed and addressed by the Commission on an EDC-by-EDC basis. Such a tailored approach will enable the Commission and stakeholders to learn from models as they are developed and implemented in Pennsylvania and other jurisdictions, and as technology develops and customer desires and requirements change.

II. Common POLR Service Principles

There are a few common principles that are fair to all stakeholders and should govern the development of a workable regulatory filing and approval process for POLR plans:

(1) POLR Rates Must be Market-Based

To foster development of truly competitive retail markets, POLR pricing must be based upon market pricing. Section 2807(2)(3) of the Competition Act provides that energy needed to meet post-transition POLR obligations “shall be acquired at prevailing market prices.” “Prevailing market prices” should not, however, be narrowly defined solely as only a near-term index or hourly price (e.g. PJM spot market, or other real time trading hub published price) although in some situations it may be appropriate to define it as such. Rather, in markets such as PJM with sufficient wholesale market liquidity over a much longer period of time, a market-based POLR process could support a fixed, multiple-year POLR rate. This rate, for example, could be of three to five years duration, based on wholesale market forward prices for longer-term strips of power. Such a rate would provide price stability and certainty for POLR consumers desiring such an option.

(2) The Franchised EDC Remains The Ultimate POLR Provider

As will be explained in greater detail later, if an Alternative Wholesale POLR Provider defaults on its obligation to serve, the EDC will still be responsible ultimately for ensuring the delivery of an uninterrupted energy supply to customers physically located in its franchised distribution service territory. The EDC should be fully compensated for shouldering this risk and obligation, which means recovery of not only the cost of replacement power, but also administrative, legal and other out-of-pocket costs associated with procuring the replacement power *and* maintaining adequate customer service functions. The

EDC should not be expected to provide the service of back-up power procurement for Alternative Wholesale POLR Providers at less than full cost.

(3) Alternative Wholesale POLR Service Providers Must be Financially Viable

An entity that provides wholesale POLR services does not necessarily have to be a generation owner. An Alternative Wholesale POLR Provider, however, must have the financial ability to be able to enter into wholesale contracts with others that do own and operate such generation or with other parties that have contracted for generation. In addition, the Alternative Wholesale POLR Provider must have sufficient financial strength to enable it to provide appropriate credit assurances to the EDC sufficient to cover the default risk that the EDC would necessarily face as the ultimate POLR provider.

The Commission must also establish a credit policy, which establishes unambiguously and in detail the requirements an Alternative Wholesale POLR Provider must satisfy at the outset to participate.

(4) The EDC Should Not Be Required to Shoulder The Cost of Alternative Wholesale POLR Provider Defaults

Any model that enables generation and power marketing companies to provide a portion of the wholesale requirements to the EDC for POLR customers will necessarily entail some risk of default. If default occurs, the EDC will have to obtain additional wholesale supply in its role as the ultimate POLR "backstop." Any POLR service model, therefore, should include mechanisms that enable the EDC "backstop" to recover any increased costs it incurs to cover the risk of such defaults. The Commission should not assume that the EDC will have an unlimited, free "call option" on any generation owned and controlled by its affiliated generation and power marketing company. Rather, any such affiliate will have already prudently managed its position and made other commitments and, therefore, likely would not have sufficient excess energy and capacity available to provide to the EDC in its backstop role.

(5) Switching Rules Are Necessary To Help Mitigate Risk

The core principle of retail competition is that EDC customers retain the right to obtain service from EGSs. Nonetheless, to help mitigate the cost associated with customer migration, there must be rules that minimize gaming of POLR offerings due to substantial differences in wholesale prices in summer and non-summer periods. One possibility is a rule restricting customers that switch from POLR service to an EGS from returning to POLR service until a full year after the switch (unless their chosen EGS goes out of business). Alternatively, customers that leave POLR service could be restricted from returning to that service between June 1 and August 31 of any year (again, unless their chosen EGS goes out of business). Another option may be to allow customers to return to POLR service, but to disqualify them from receiving a fixed price POLR offering. Such customers instead could be required to pay a price based on near-term, spot market prices – for example, the PJM daily real-time locational, marginal price for the PECO zone. The objective of any of these rules is to prevent customers, or EGSs on behalf of customers, from gaming the system by obtaining cheaper competitive supply in the non-summer months while still benefiting in the summer from fixed average annual POLR rates that are, therefore, far lower than the actual summer wholesale cost. Without such rules, both the Alternative Wholesale POLR Provider and the EDC would face unmanageable price and volumetric risk created by this kind of switching, which increases POLR service costs for all participants.

III. Regulatory Filing/Review Process

Any workable POLR service model must include a timely approval process for POLR pricing and, as The PJM Interconnection, L.L.C. ("PJM") noted in their comments at the April 8th POLR Roundtable, a time cycle that is consistent with the PJM planning year for those EDCs in PJM.

Approximately 18 months prior to the expiration of the respective EDC's rate cap, the EDC should file a POLR plan that details the POLR service model or models it proposes to adopt. This filing would include neither final pricing of the POLR service nor the specific volumes to be served under the approved models. It would, however, detail both the methodology for setting POLR prices pursuant to the proposed models and the timetable associated with that methodology. Under such a regulatory process for approving proposed POLR models and pricing methodology, wholesale suppliers would be better able to provide more efficient pricing to the EDC because in their price offer they would not have to cover any significant risk of subsequent market movements. Pricing resulting from appropriate application of approved procurement models and pricing methodology should not subject the EDC as the POLR provider to regulatory adjustment because of subsequent changes in market conditions. In addition to details about the implementation plan for the proposed POLR service models and the related pricing methodology, any filing would, at a minimum, also include details of relevant indices for any variable priced offering; duration of any fixed price offering; source of wholesale supply; and credit requirements.

Currently, most EDCs in Pennsylvania are operating under rate caps that expire at the end of a calendar year. Therefore, any new POLR arrangements will presumably begin on January 1 of the immediately following year. For EDCs who are members of PJM, however, POLR service contracts should be awarded on the basis of the PJM Planning Year (June through May) and not the calendar year. Products available in the wholesale markets are tailored to meet the needs of the load-serving entities ("LSEs") that must manage their planning year obligations, especially with respect to capacity and the financial instruments available from PJM to hedge congestion costs. Aligning the POLR procurement process with the PJM Planning Year is, therefore, the more efficient option, as it will enable potential providers to get a far clearer picture of the needs of the load they are competing to serve. An initial transition period with separate pricing for a period of months at the beginning of each EDC's POLR program may be necessary to align the EDCs' POLR procurement processes with the PJM Planning Year.

IV. EDC As The Ultimate POLR Provider

The Competition Act provides that a POLR may be either "an electric distribution company or commission-approved alternative supplier." (66 Pa. C.S.

§ 2807 (e)(3)) One of the common POLR service principles noted above, however, is that even if an alternative supplier is approved by the Commission to act as a POLR provider, under PJM rules the EDC remains the "ultimate POLR" provider and should be compensated under any model the Commission adopts for fulfilling that important obligation.

That the EDC(s) always retain the risk of having to meet their customer's generation supply needs regardless of contractual arrangements with alternative "POLR" suppliers, is one of the lessons learned from experiences with PECO's Competitive Default Service ("CDS") and Market Share Threshold ("MST") programs. In the CDS Program, although the winning bidder, New Power, negotiated in good faith to supply electricity for three years to almost 300,000 of PECO's residential customers, just over a year later New Power went bankrupt and defaulted on its CDS commitment and exited the Pennsylvania electric retail market. At the time of default, all of New Power's customers were returned to PECO POLR service. Similarly, U.S. Power & Gas submitted a winning bid to serve over 17,000 of PECO's small commercial MST customers, but only six months later decided to stop serving any PECO customers. Had U.S. Power & Gas not found another supplier willing to serve its customers under the terms of the MST Program, those customers also would have been returned to PECO POLR service.

Comments by PJM at the April 8th POLR Roundtable underscore the inevitability of the EDCs' role as the "ultimate" POLR provider. PJM observed that under its rules the EDC is always the "ultimate backstop" under the various procurement models. For example, one PJM rule provides that if an EGS defaults in its payment, PJM will act to minimize losses to all its other members by promptly shifting the EGS's load obligation to the incumbent EDC, which PJM deems to be the load serving entity. The bankruptcies and defaults of other EGSs, Utilimax and Utility.com, provided clear examples of the effect of this rule in the Pennsylvania retail markets.

Because of experiences in PECO's CDS and MST programs, and PJM's rules, PECO does not support the adoption of any model that would depend upon an alternative supplier providing all of the "retail" POLR obligations, which include customer care functions such as turn on, shut off, billing, call centers, Chapter 56 compliance, Universal Service, and complaint resolution. Such a "retail" model not only ignores the reality that the ultimate POLR obligation rests with the EDCs, but also is costly to implement and economically inefficient and highly risky. For example, if the Commission were to approve an alternative supplier to fulfill all the retail POLR obligations, it might still feel compelled to require the EDC to continue to be prepared to provide all the customer care functions identified above in the event the alternative provider were to default on its obligations. This would be highly inefficient and uneconomic, as it would necessitate substantial duplicative costs that ultimately all consumers would have to pay. Alternatively, the Commission could relieve the EDC of all such obligations associated with an alternative POLR provider's customers. But for the same reason – the real possibility of a default by the alternative POLR provider – without such redundancy the consequences of such a default would impose unacceptably high risks.

In PECO's electric restructuring proceeding in 1997, an Enron affiliate, Enron Energy Services, submitted a similar alternative retail POLR provider model, in which it proposed to "step into the shoes" of PECO to serve as the POLR; however, within several years the Enron affiliate had chosen to exit the Pennsylvania market. The Commission should consider lessons learned from the Enron, New Power, Utilimax, and Utility.com experiences, and should move forward to create a regulatory framework that will allow for the development of POLR plans tailored to each EDC's circumstances.

V. Wholesale Alternative POLR Provider

PECO does support consideration of a **wholesale** POLR model in which the EDC procures at least some of its wholesale energy supply resources needed to serve the POLR load from suppliers in the wholesale market (such suppliers are referred to herein as an "Alternative Wholesale POLR Provider"). To help ensure reliability of supply for customers, certain essential terms and conditions must be established. Specifically, Alternative Wholesale POLR Providers at a minimum should satisfy the following criteria:

(1) Comply with the PJM Interconnection creditworthiness standards;

(2) Be members in good standing of PJM capable of meeting all applicable PJM obligations of load serving entities and have

all necessary regulatory approvals to enable sales to the EDC; and

(3) Provide the EDC appropriate credit assurance for the term of the contract, including, for example, cash collateral, to be held by the EDC or an irrevocable standby letter of credit from a highly rated financial institution.

These are simple and reasonable requirements that will help ensure reliability of supply for customers and the maintenance of required operational performance standards.

VI. Possible POLR Service Models

There are several procurement models that Pennsylvania could use to provide POLR service to customers. These models can vary in design by rate class, EDC service area, and other factors. They include:

(1) Competitive Request for Proposal ("RFP") process, which culminates in negotiated wholesale power purchase agreements ("PPAs") between an EDC and one or more affiliated and/or non-affiliated suppliers.

(2) Competitive auction process, which also culminates in a wholesale PPA between an EDC and multiple affiliated and/or non-affiliated suppliers.

(3) Negotiation of market-rate PPAs, perhaps over several years, with multiple affiliated and/or non-affiliated suppliers.

(4) A combination of the above – for example, a multi-year negotiated PPA for a base amount of load, and a competitive solicitation for the remainder; or a negotiated multi-year PPA for certain customer classes (e.g. residential and small commercial) and a competitive solicitation for other customer classes.

The models must be able to operate effectively in periods of both increasing and decreasing market prices and in periods of large or shrinking reserve margins.

VII. Components of "Prevailing Market Prices" for POLR Supply

As noted earlier, a common POLR service principle is that POLR rates must be market based to promote development of truly competitive retail markets. Under any POLR Service Model, the following are examples of key components of "prevailing market prices" for a full requirements load following POLR supply product:

- Energy – cost of base load and load-following energy.
- Capacity – market cost of capacity needed to meet PJM obligations.
- Congestion – cost resulting from differences between locational prices at generation sources and the points at which loads receive service.
- Transmission – PJM Open Access Transmission Tariff costs including network transmission service, PJM administration charges, and ancillary services paid for by load serving entities in PJM.
- Balancing – cost of energy obtained in the spot market to balance scheduled energy and actual retail load.

- Migration Risk – cost associated with the “call option” created for customers by a POLR rate, which allows customers to leave and return to the POLR service.
- Load Uncertainty Risk – cost resulting from changes in EDC’s load due to weather and forecasting deviations.
- Line losses – the cost for energy lost as a result of the transmission and distribution of electricity, either average cost or marginal cost.
- Scheduling and Administrative – the cost of planning energy deliveries to meet hourly loads and costs associated with implementing and administering a POLR program.
- Credit -costs associated with credit and credit-related defaults.
- Customer education - the cost of any Commission-mandated customer education programs.
- Non-Transmission Ancillary Services - all other non-transmission ancillary services required by PJM for LSEs to provide retail generation service.
- Environmental Costs – costs associated with legislatively mandated initiatives to improve the environment.
- Taxes – all applicable taxes and any material changes thereto.

VIII. Terms and Conditions of POLR Service

POLR rate designs must take into consideration the market conditions and other relevant circumstances in effect when the EDC’s POLR plan is submitted.

Because EDCs will serve as the “ultimate backstop” there must be POLR offerings for all rate classes.

For residential/small commercial POLR customers, PECO supports a long-term fixed price tariffed option. Any fixed-price POLR offering would still be market-based, as it would reflect forward wholesale prices for a period of time corresponding to its term. To avoid the previously discussed gaming risk, however, any fixed rate offering must properly protect against shifts in price risk from the customer to the POLR provider inherent in such an offering. Residential and small commercial customer prices likely should continue to be stated on a per KWh basis, with capacity costs recovered through the energy charge. Dependent upon the switching rules adopted, a short-term spot market price option might also be offered for these customers.

For large commercial/industrial (“C&I”) customers, PECO advocates a tariffed spot market hourly price POLR option. For such customers, separate capacity (demand) and energy components should continue to be built into any variable pricing option. A fixed price POLR option would only be available by contract.

IX. Conclusion

PECO appreciates this opportunity to provide its initial comments regarding the issues to be considered in establishing a workable regulatory filing and approval process for EDC POLR plans that provides for continued, reliable service for customers and is fair and reasonable for all stakeholders. As observed by market participants, and as highlighted in the April 8th POLR Roundtable, market conditions and available market models have changed markedly since electric restructuring was implemented in Pennsylvania in 1997. Significantly, the expiration of Pennsylvania EDCs' generation rate caps is staggered through 2011, with almost 75% of customers not entering the post transition phase until 2009 or later. As such, the primary objective of this Commission should be to establish a POLR plan regulatory filing and approval process that allows for consideration of various POLR service models to reflect prevailing circumstances and market conditions at the time of each EDC's rate cap expiration.

The Company looks forward to a productive exchange with the Commission and other stakeholders concerning these vital issues.