BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Provider of Last Resort Roundtable

Docket No. M-00041792

Comments
On behalf of FirstEnergy Solutions Corp.

May 3, 2004

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Introduction

FirstEnergy Solutions Corp. (FES) submits these comments pursuant to the invitation extended by the Commission in the March 5, 2004, establishment of a Provider of Last Resort (POLR) Roundtable. FirstEnergy Solutions agrees with the Commission's base premise that retail electric markets will be significantly impacted by the design and pricing of default service, and that a level of regulatory certainty will be needed in retail electric markets in order for Pennsylvania consumers to continue to receive the benefits of competition.

The purpose of FirstEnergy Solutions' comments is to present perspectives on the topic of post transition POLR service in support of the Commission's development of a final rule set for POLR service. Towards achieving that end, FirstEnergy Solutions' comments include: (1) a proposed set of guiding principles; (2) a POLR Service definition; (3) a process recommendation by which EDCs would most efficiently procure generation service; (4) credit considerations; (5) discussion of retail issues; (6) a proposal for congestion management incentives; and (7) recommended treatment of NUG generation.

FirstEnergy Solutions Corp.

FES is an unregulated subsidiary of FirstEnergy Corp. engaged in the purchase and resale of electricity, both wholesale and retail. FES purchases all of the output available from generating units in Ohio, Pennsylvania, and Michigan that are owned and/or operated by The Cleveland Electric Illuminating Company, Ohio Edison Company, Pennsylvania Power Company, and the Toledo Edison Company. It also purchases output from FirstEnergy Generation Corp., an affiliated generation-only company. FES controls the output of approximately 13,000 MWs of generation in Michigan, Ohio and Pennsylvania.

FES participates in wholesale markets; purchasing and selling wholesale power pursuant to a market-based tariff accepted by the FERC. FES has a retail marketing business, which provides electricity, natural gas, and related energy services to retail customers. FES is a licensed electricity supplier in Ohio, Pennsylvania, New Jersey, New York, Maryland, Michigan, Delaware, and Washington D.C. Specifically, FES is licensed by the Pennsylvania Public Utility Commission as an Electric Generation Supplier (EGS). FES has also executed Supplier Agreements with most EDCs in Pennsylvania and is registered to conduct business within these EDC service territories.

The perspective which FES brings to these proceedings may be somewhat unique in that FES is currently a wholesale supplier through contractual arrangements of generation service to affiliated EDCs which retain the POLR obligation, a wholesale supplier in the New Jersey BGS auction, a retail marketer with retail customers in several

states including Pennsylvania, and also operates as a generator. Few other participants in this proceeding can speak from the variety of perspectives offered by FES.

POLR Principles

FES proposes the following guiding principles in order to assist the Commission in the development of final rules for POLR service. First, at a high level there should be uniform application of POLR principles to EDCs in the state. Items such as the definition of POLR service should be the same for all EDCs (a proposed definition is set forth below). There should be consistency in rate design philosophy - not necessarily in the detailed rate components. For example, all EDCs should have the seasonal characteristics of wholesale electricity prices reflected in their rates, but the monetary difference between a summer and non-summer retail rate should be allowed to vary by EDC. Additionally, there should be uniformity in the fundamental POLR model adopted for all EDCs in the State.

A second and related key principle is that although consistency should be sought at a high level, at the operational level, the detailed rules must be flexible enough to accommodate the fundamental differences that exist between EDCs. For example, not all EDCs in the State are in the same RTO, and the final rules must be flexible enough to accommodate the different rules and operational protocols of the relevant RTO.

A final guiding principle is that the EDC must retain the ultimate Provider of Last Resort obligation. In today's world, electricity is a vital necessity and there always has to be a single entity, which ultimately provides the expected service to customers. Conceptually, provision of POLR service could be assigned through contractual terms or

through regulatory order. However, there still has to be some entity which stands ready to provide the physical electric service customers require if the assignee does not or cannot perform. That entity, as a practical matter, must be the EDC electrically connected to the customer.

POLR Service Definition

As mentioned above, FES believes that the EDC must always be the provider of last resort. However, the generation service component of the total POLR obligation, can be procured competitively unlike other elements. In this context, FE proposes to define generation service to include the provision of energy, capacity and generation or market supplied ancillary services[1]. Others may advocate inclusion of more non-traditional generation related functions – billing, metering, service connections and disconnections, etc. – but we view this as not required or necessarily efficient. The incumbent EDC should retain all customer care functions.

We propose that generation service be further clarified to be the service necessary to meet the aggregate requirements of customers that have either not chosen a competitive electric generation supplier, or customers returning to POLR generation service from a competitive electric generation supplier, or customers whose competitive electric generation suppliers default. Moreover, these requirements should be the power requirements remaining after the effect of any demand response programs and interruptible or distributed generation load programs sponsored by either the EDC or RTOs.

[1] Ancillary services, in this context include: losses, spinning reserve, supplemental reserve, energy imbalance, regulation and frequency response, reactive supply and voltage control, black start.

Non-generation related ancillary services are generally comprised of operational and administrative charges for services provided by the RTO or NERC Reliability Council. These charges should remain the responsibility of the EDC, as the Load Serving Entity, with appropriate ability to recover these costs from its customers. This should result in lower POLR generation service prices since bidders no longer have to bear the risk that these costs will change. This also produces a more direct tie between the RTO/NERC performance to end use customers.

Competitive Procurement through an Auction

FES believes that of the alternative methods available to an EDC for the procurement of POLR generation service, a properly designed competitive wholesale auction process would be most efficient because it most effectively links retail prices to wholesale prices thereby mitigating price volatility to consumers.

Although the EDC retains the legal POLR obligation, generation service (as defined above) is the subset of POLR responsibilities that an EDC can and should procure from a competitive wholesale market. Relying on a wholesale competitive procurement process for these full requirement services has numerous advantages. An auction will result in a reasonably close relationship between POLR prices and competitive wholesale market prices. In addition, liquidity in the wholesale market would be enhanced by the increased participation of wholesale providers that are encouraged to enter the market through the generation service procurement process.

A descending clock auction would achieve the above listed goals and should be strongly considered as the format for the competitive wholesale POLR generation service

procurement process. The descending clock auction process would consist of soliciting indicative offers from qualified bidders in order to assess the potential number of bidders and the expected competitiveness of the process. Bidding would occur in a series of sequential rounds in which bids are placed for individual portions of an EDC's load referred to as a tranche. At the end of each bidding round, the price for the tranches would be reduced as long as bidders subscribe to more tranches than are available, continuing until the total number of tranche bids fall to a point where it equals the number of tranches being auctioned. All bids are binding, subject to certification of the auction results by the Commission.

There are several important advantages to the descending clock auction format. A descending clock auction assists bidders in their decisions by revealing information through the auction process and the auction structure allows bidders to revise their valuations and bids as the auction proceeds. As a result of auction feedback information and the opportunity to refine bids, some uncertainty is reduced, providing bidders an incentive to bid more aggressively, resulting in a lower price. The auction playing field is also levelized because the auction information is provided to all participants. The descending clock auction is considered an efficient methodology for winnowing down to the most efficient providers and provides for an increased level of price transparency.

Although the auction process procures generation service, the EDC remains the Load Serving Entity for all POLR customers. As a result of the auction, specifically in the contracts executed between each EDC and the auction winners, certain obligations normally assigned to a Load Serving Entity - e.g. capacity procurement - would be transferred to the winning bidders. However, FES believes that it is most efficient for the EDC to retain the responsibility for procuring Network Transmission Service for all

POLR customers. Since, Network Transmission requirements in the PJM market, are based on zonal peak loads, by leaving the responsibility for procuring Network Transmission Service with the EDC, the EDC will have some incentive to manage the zonal peak load through the implementation of cost effective demand management programs. Otherwise, no entity will have an incentive to promote cost effective load management programs that can reduce peak demand and costs to consumers.

In order to ensure a fully competitive environment all suppliers should be encouraged to participate in the auction process, including the affiliates of EDCs. In most cases, the generation resources owned by the affiliates are, and have been, the primary capacity relied upon to serve load in the EDC's control area. These capacity resources are normally strongly interconnected into the local transmission and distribution system and are most likely to be very competitive supply options. Established code of conduct rules and a sound auction format should dispel any concerns about affiliate participation. Conversely, not permitting affiliates to participate in the auction will result in fewer bidders, less supply being bid, higher auction clearing prices and increased cost to consumers. For these reasons, the states that have had successful wholesale auctions have allowed affiliates to participate.

Ideally, there should be a single statewide auction process with mandatory participation by all EDCs within the same RTO after the expiration of their individual transition periods. Within this single auction process each EDC would identify and procure its own needs. It is also important that the delivery period for the auction winners be consistent with the relevant RTO planning period. This, in practice, may mean that there should be a separate auction process for all EDCs in the same RTO instead of a single, statewide process, or at least, that all PJM auctions be held at the same

time. Additionally, we recommend the Commission work with other State Commissions to coordinate timing of the auction process with other states conducting an auction process in the PJM market. While, we do not believe a multi-state auction is either practical or desirable, we do believe that the auctions within a single market should occur within a fairly short span of time.

Finally, in order to obtain the best results from the auction, bidders must be given clear and unambiguous information regarding all EDC sponsored load management programs so that bidders can properly take those into account when calculating their offer prices. In addition, load management programs should only be permitted to be implemented if auction participants are made aware of the program prior to the auction. Otherwise bidders will necessarily factor this risk into the bid price leading to increased costs for consumers.

Credit

Credit support should not be only a requirement of generation suppliers, but should also be required of the EDCs. Such bilateral credit provisions should exist between an EDC and the winning auction bidders and the final rules should contain provisions providing the EDC with recovery of costs associated with providing credit support to suppliers.

Bilateral credit and collateral provisions are a common feature of the wholesale marketplace which unfortunately, the experience of the past ten years, has demonstrated are necessary for an effective wholesale market. If this is not similarly recognized in the auction design, bidders will be forced to "price" their perceived credit risk, and consumers will pay higher prices than otherwise.

Appropriate credit provisions for wholesale transactions are a market issue, as recognized by EEI in the development of the EEI Master Power Purchase and Sale Agreement – the standard master contract for wholesale electric transactions - and may not be satisfactorily addressed in isolation by a single state. For example, consider the following hypothetical situation. Assume two EDCs are owned by the same holding company but which are located in different states. Both EDCs procure their generation service through similar auction processes. Neither state requires that the EDC provide any credit support, under any circumstance, to the winning bidders in the auction process. Further assume that a single supplier is interested in bidding in both auctions. However, because it is faced with the prospect, if it is a winning bidder, of having an unsecured credit exposure to a single company (assuming the credit evaluation looks to the holding company), it must choose between the auctions, entering only one as a bidder. In this set of circumstances, one EDC potentially is harmed by having fewer bidders participate, less supply is represented in the process and theoretically its customers must pay a higher price than otherwise.

As this is a regional issue, the Commission should consider addressing this issue with their counterparts in other states. Failure to adequately design bilateral credit provisions throughout the region poses further risk to the efficiency of the entire market. Although the issue may not seem apparent today, in the future, as reserve margins shrink, there is a greater probability that market prices will be higher. If the state commissions choose not to pass this higher price on to consumers default by the EDCs becomes more likely.

Retail Issues

POLR generation service should be a basic or standard offer for all EDC customers who do not choose a competitive electric generation supplier, who desire to return to POLR generation service from competitive supply, or who are dropped by their competitive electric generation supplier. POLR generation service must be designed as a backstop, "plain-vanilla" generation service. As such, there should be only one POLR product that each customer can receive not multiple price plans. While there should be differences between customer classes, or rate tariffs, a single customer should not be able to choose between alternative pricing plans for POLR generation service.

In order to foster competition and send appropriate price signals to customers it is imperative that POLR generation service reflects a retail market price, whether fixed or variable. While the auction will provide the wholesale price for POLR generation service, that wholesale price must be converted to a retail price for customers, and include all appropriate incremental costs to the EDC, such as credit support costs mentioned above. It is important for all customers to see accurate and current retail prices that can be compared against competitive electric generation supplier prices and so they can make appropriate consumption decisions.

It is, however, appropriate to treat customer classes differently. Residential and small commercial loads should be met through an auction process that develops fixed prices for these customer classes. The price resulting from the auction should be translated into POLR generation service rates, by rate class, according to the EDC rate structure. This will afford residential and small commercial customers a measure of fixed

price stability over the auction term, as well as a benchmark against which to compare offers from competitive electric generation suppliers.

Large commercial and industrial customers should receive variable price POLR generation service tied to hourly wholesale market prices – if, and only if, an appropriate transparent hourly price is available and any market power concerns have been adequately mitigated. For these customers, the auction process essentially becomes the procurement of capacity. This group should include all commercial and industrial customers with loads greater than 500 kW. Setting the threshold for large commercial and industrial customers at 500 kW ensures that customers such as retail chain stores are included in this category. These types of customers are arguably more sophisticated and willing to make informed choices with respect to their generation supply. It is important for this group of customers to see in their POLR generation price, the true cost of service based on each individual customer's usage patterns. Setting the level at 500 kW will also have a positive effect on customers' willingness to participate in demand response type programs. It is important to note that this model of variable price POLR generation service has worked well in other jurisdictions such as New Jersey, Maryland, and Texas.

POLR generation supply prices should, optimally, be set through an annual auction process, with the delivery period for winning bidders being set from one to three years. This helps to strike a balance between price stability and having the price accurately reflect then current, and sometimes volatile, wholesale market conditions.

Retail prices for all POLR customers should reflect both the prevailing market price of energy, determined by the auction, plus costs associated with administering POLR service. This includes an appropriate retail adder to be recovered by each EDC to compensate it for both costs and risks associated with the provision of POLR service.

This ensures that POLR prices are truly reflective of retail market prices and do not discourage economic shopping. Both New Jersey and Maryland incorporate this important feature as part of their POLR designs. Maryland's retail adder is applied to all customers, but differs by customer class. New Jersey has a 5 mil adder for all customers larger than 750 kW.

In the current environment of capped generation rates, EDC support for customer switching restrictions, minimum stay periods, and exit fees is understandable. However, these EDC concerns can be relaxed in a post-rate cap auction environment where bidding can take into account factors such as seasonal rates. Switching restrictions are artificial constraints that hamper competitive market development and place a penalty on customers that wish to choose an alternate supplier. Other jurisdictions, such as New Jersey, have successfully dealt with this issue. There are no switching restrictions for any customer class. BGS auction bids incorporate customer migration or shopping risk and EDC rate structures incorporate seasonal rates. With an auction procurement process all EDCs that currently do not reflect the strong seasonal patterns of wholesale electricity prices in their rate design should be required to do so. With seasonal rates, the need to impose onerous switching restrictions on any customer class will be eliminated. One of the main arguments the EDCs have made historically that supports the switching restrictions currently in place is that competitive suppliers would sign customers up with "donut" contracts. In a "donut" contract, the term is from the fall through the spring, and then the customer is returned to the EDC for the (higher priced) summer months. This argument regarding "donut" contracts is eliminated with seasonal rate structures as long as the strong seasonality of wholesale prices is properly reflected in the retail rate tariffs.

It is also important for the Pennsylvania PUC to seek uniformity in rate design, to the extent practicable, across EDCs. The EDCs should have the same types of rates for each customer class although the billing determinants will be EDC specific. Some examples of uniformity are grouping of similar sized customers into rate schedules and seasonal rates using the same time frames.

Finally, any rate design changes contemplated by an EDC must be done only in concert with the auction process. This ensures there will be no mid-stream changes in consumers' price to compare and facilitates the ease of comparing POLR generation service with alternative supplier offers over a known timeframe.

EDC Incentives to Control Congestion

Typically an EDC is also a transmission owner which operates its transmission system, or instructs the RTO to operate its system, to maintain reliability and to minimize the direct cost contribution to the customers. The direct costs of an EDC include capital recovery and annual operations and maintenance costs. In addition to these direct costs, an EDC may impact the final cost to the customers in their region by action or inaction that impacts the intra-zonal congestion.

Types of EDC activities that may impact congestion include capital investments, operation practices, maintenance scheduling, and coordination activities of the transmission owner (TO). The EDC needs to have an incentive (described below) to try to minimize intra-zonal congestion. Without this incentive, an EDC will operate its system based only on reliability and direct cost control. This incentive needs to include a

cost recovery mechanism for the EDC for increased capital and O&M expenses made to minimize congestion and, therefore, decrease the overall cost to the customers.

Reducing congestion will have the benefit of improving the reliability of the electric delivery system. Since congestion is caused by physical constraints on the delivery system, minimizing or eliminating these constraints can enhance the system integrity. It will also enhance the development of competitive retail markets, since congestion is emerging as a major risk for any supplier, a risk which is increasingly difficult to quantify and hedge.

Additionally, EDCs should have an incentive to address is system line losses. The same issues apply here that apply to congestion. An EDC's focus on reliability and cost control alone may not provide the best price to the customer since the financial risk of line losses will be borne by the auction winners. Therefore, EDCs should receive cost recovery for investments and annual O&M expenses that help reduce system line losses.

Cost recovery as discussed above will allow the EDC to make expenditures to minimize congestion and losses, but otherwise will not give the EDC any particular incentive to proactively look for solutions or select the most fost-effective solution. One method to give EDC's such an incentive would be a type of performance based rate structure. If an EDC demonstrates that it has created overall cost reduction for its customers, it should be given some percentage of the benefit as an incentive. For losses this amount could be determined by a comparison with historical losses within their zone. Congestion may be more difficult to measure, but EDC's could propose to the Commission methods of demonstrating improvements to congestion to receive performance-based compensation. The maximum benefit could be capped at the EDC's rate of return to prevent significant over-collection or gaming by an EDC. This method

would give the incentive to the group most qualified to find improvements in the distribution and sub-transmission system.

NUG Generation

The EDC will continue to be responsible for taking the output from all NUGs within its service territory pursuant to PURPA and existing contractual requirements. This includes all energy, capacity, ancillary services, renewable energy, and any other attributes provided by the NUGs. The EDCs will have the responsibility of selling the output from the NUGs, and should be allowed to recover any amounts paid for the NUG power above the amount procured by selling the power - including any administrative costs associated with liquidating the NUG power. By allowing the EDC to claim and liquidate all of the NUG attributes, including renewable attributes, the retail customers would realize a reduction in any above market costs that would need to be recovered.

Summary

As the Commission works towards creating a sound set of fair rules governing POLR service for the approaching period of full generation competition, FirstEnergy Solutions offers these key recommendations for consideration.

- **There is only one entity, the EDC, that can be relied upon to fulfill Provider of Last Resort obligations.** Although provision of POLR generation service can theoretically be assigned, as a practical matter there would always be risk that the assignee would fail to perform, with such default falling upon the EDC as the party

electrically connected to the customer. The EDC simply cannot unilaterally make the business decision to exit the business as can other entities.

- **Rules governing POLR generation service should promote uniformity and consistency across the EDCs in the State.** POLR generation service should be identically defined for all EDCs, rate design philosophy should be consistent, and the final POLR model adopted should be fundamentally uniform across all EDCs.

- **Each customer should have only one option for POLR service based on their rate schedule.** POLR generation service is intended to be a security backstop for customers in need of a generation supplier and offering a customer multiple POLR product options is unnecessary and does not facilitate the development of competitive retail markets.

- **Residential and small commercial customers should receive POLR generation service at fixed seasonal prices while large commercial and industrial customers should receive POLR generation service at prices reflecting hourly wholesale market prices.** It is appropriate for POLR products to be tailored to specific customer classes. This provides residential and small commercial customers a measure of fixed price stability reflecting seasonality and a simple benchmark to use when considering competitive generation offers. Large commercial and industrial customers are generally more sophisticated in terms of making informed generation supply decisions. It is important to have these large customers see POLR generation prices that match the true cost of service based on their usage patterns.

- **A single statewide auction process with mandatory participation by all EDCs within the same RTO should be used to procure the generation-related products needed to offer POLR generation service.** This would be an efficient process effectively linking POLR generation service prices to wholesale prices resulting in lowest cost to consumers.

- **Bilateral Credit provisions should exist between an EDC and the winning auction bidders.** Without such provisions, bidders will add contingency to cover perceived credit risk, increasing the price to consumers. This is a regional issue that requires multi-state coordination.

FirstEnergy Solutions thanks the Commission for this opportunity to share our perspectives on these important issues.

Appendix A

William D. Byrd Bio

William Byrd is Director, Commodity Supply Planning at FirstEnergy Solutions Corp..

In his current position, he is responsible for long-term supply planning, wholesale origination, evaluation of wholesale markets, and the acquisition and divestiture of generating assets.

Bill began his career at Ohio Edison Company in 1977 as an economic analyst. He has held supervisory positions in Economic Studies, Rates, Capacity Planning, Market Research, Wholesale Marketing, FirstEnergy Trading (a former subsidiary of FirstEnergy Corp.) and in Enterprise Risk Management.

A native of Virginia, Bill received a BA from Florida Southern College and a MA in Economics from the University of Chicago.