COMMONWEALTH OF PENNSYLVANIA
BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Provider of Last Resort (POLR) Roundtable	))))	Docket No. M-00041792

COMMENTS OF PSEG ENERGY RESOURCES & TRADE LLC
FOR THE POLR ROUNDTABLE

PSEG Energy Resources & Trade LLC ("PSEG") appreciates the opportunity to submit these initial comments and participate with other stakeholders in the Commission's POLR Roundtable discussions. PSEG is pleased that the Commission has scheduled these roundtables to focus on crucial issues regarding post-transition POLR obligations and the appropriate track for the continued development of retail electric markets in Pennsylvania. PSEG submits that the Commission is at a crucial juncture with respect to the development of Pennsylvania's retail energy markets that may have a significant impact on the development of regional energy markets. Its decisions now could well shape the direction taken by Pennsylvania's energy markets for many years to come. PSEG urges the Commission to measure the available alternatives against both short-term and long-term objectives.

PSEG believes that the mature, highly liquid wholesale energy market in the PJM Interconnection, L.L.C. ("PJM") region provides the Commission with a significant opportunity to realize discernible benefits for consumers of electricity in Pennsylvania through a competitive solicitation for wholesale full requirements POLR service. Further, PSEG submits that, while it is appropriate for the Commission to be mindful of the impact that its decisions here will have on the development of retail competition in Pennsylvania, the Commission must balance its goal of nurturing nascent retail markets against the realities of the current competitive landscape, as well as the need to assure fair and reasonable electric rates for those Pennsylvania consumers for whom retail open access may not be a viable option. PSEG believes that the Commission can achieve progress in both areas if it proceeds in a measured manner.

I. Identity of PSEG Energy Resources & Trade LLC

Based upon FERC sales data for 2003, PSEG is among the twenty largest electric power marketers in the country. Its activities are focused primarily in the northeastern region. PSEG's parent company, PSEG Power LLC, ("PSEG Power") owns approximately 10,000 megawatts of capacity with the PJM region. PSEG's marketing activities center largely around, but not are based exclusively on, the generation assets of PSEG Power.

PSEG currently provides service to support the POLR requirement in a number of northeastern states. In New Jersey, where POLR service is known as "Basic Generation Service" ("BGS"), wholesale POLR supply was first procured through a competitive auction for the period commencing August 1, 2002. Since that time, New Jersey's BGS auction has cleared more than three billion dollars in sales on an annual basis. PSEG supports BGS service in New Jersey both indirectly as a wholesale supplier to winning BGS bidders and as a direct BGS supplier to the utilities. In addition, PSEG provides POLR services in Massachusetts and Connecticut and, recently, PSEG successfully participated in the request-for-proposal ("RFP") process employed by the Maryland Public Service Commission for the provision of POLR service in that state.

II. Comments

The comments of PSEG below generally follow the "POLR Roundtable Issues List" promulgated by the Commission.

A. Scope of POLR Service

The Commission's pursuit of its policy goals associated with the POLR obligation will necessarily require some balancing of competing objectives. The Commission must consider the needs of customers who, for whatever reason, are unwilling or unable to receive service from retail third-party suppliers. It must also consider the goal of providing a venue in which third-party suppliers are given the opportunity to compete fairly for customers through efficiency enhancements or by offering customers additional "value-added" services. Further, the Commission must also consider and pursue other societal goals such as reducing the environmental impact of energy production and increasing the conservation of energy use. The achievement of these goals may, at times, be at odds. While PSEG believes that progress can be made in all of these areas, the Commission should also recognize that attaining these goals will take time and that the Commission must set priorities with respect to different facets of the POLR obligation.

The Commission's first priority for POLR service should be to assure that Pennsylvania consumers not choosing a retail third-party supplier will retain access to reliable, reasonably priced electricity service. There are many reasons why retail third-party suppliers may not be interested in providing service to particular customers: location, credit history, less desirable demographics for marketing other services, load levels, load patterns and other factors. In addition, certain customers, for whatever reasons, may prefer not to receive service from a retail third-party supplier regardless of the economic incentives to do so. It is the responsibility of this Commission to assure that a reasonable alternative exists for all such customers. Providers of last resort should offer a reliable,[1] reasonably-priced, but "no frills" service to meet this need.

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[1] The goal of maintaining reliable service, of course, has several components. The need to maintain transmission and distribution infrastructure and to operate the system in accordance with NERC and PJM standards has been and

Second, POLR service should be designed to provide retail third-party suppliers with a level playing field on which to compete for customers. The design of POLR service should not inhibit customers from selecting retail third-party service when retail third party supply makes economic sense or when customers are desirous of receiving specialized services that only retail third-party suppliers may offer. For most customers, however, and definitely for the residential and small commercial/industrial customer classes, POLR service should *not* be designed for the purpose of promoting retail third-party supply service as a preferred option. Because, as discussed above, many customers are simply unable or unwilling to receive service from retail third-party suppliers, arbitrarily increasing the cost of POLR service through retail "adders" or other artificial economic incentives to encourage switching to retail third-party suppliers will, in many cases, simply penalize customers for whom retail third-party supply is not a feasible or desirable option. Moreover, for consumers who do switch, because retail third-party suppliers would be competing against an artificially high retail POLR price, they would be able to discount the POLR price and still realize windfall returns.

PSEG also submits that it should not be a Commission priority to allow direct access by POLR suppliers to individual retail customers at this juncture. In theory, retail POLR suppliers might be willing to offer discounted energy prices as a *quid pro quo* for "up-selling" opportunities to POLR customers. In addition, some customers might be interested in receiving the specialized services or other merchandising offers that may be provided through such arrangements. PSEG submits, however, that neither of these propositions has been

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should continue to be an obligation of the PJM and the EDCs. The obligation to maintain "generation adequacy" in accordance with PJM requirements, however, could be preformed by alternate providers. If, as PSEG proposes in greater detail below, the EDCs continue to have the legal obligation to provide POLR service, they will be considered "load serving entities" for PJM purposes. However, by adopting a "wholesale full requirements" model, as PSEG also proposes, whereby market participants would compete to become the full requirements *wholesale* supplier for a "slice" of the EDC's POLR load, this LSE obligation would be assumed contractually by the supplier.

demonstrated. Moreover, it is far from clear whether most customers wish to have new direct supply relationships foisted upon them abruptly and involuntarily. Finally, the adoption of such a model could undermine the development of retail third-party markets. If POLR service includes direct access to individual customers, it may so closely resemble retail third-party supply arrangements as to make retail service superfluous.

Third, the provision of POLR service should be consistent with, and to the extent possible, promote, societal goals such as environmental improvements and the conservation of resources. There is clearly the opportunity, within a competitive POLR program that promotes longer term contracts, to pursue goals such as encouraging the use of renewable resources. The size of the potential POLR market in a state like Pennsylvania, especially if nearby states have also created markets for POLR service that promote longer term contracts, provides a significant opportunity to facilitate the capital formation necessary to construct such projects. Fourth, POLR service must be designed in a manner that is consistent with "universal service" which, PSEG understands, must be offered by the EDCs for those customers with the economic inability to pay the full cost of electric services. Ideally, the EDC should be able to use the same supply arrangements for obtaining power to meet the requirements of "universal service" load as it uses for other POLR service.

Fifth, PSEG does not believe that the Commission's focus at the present time should be the reformation of retail market support functions or customer care functions. There may be some potential, after more mature markets develop, to allow certain aspects of these services to be performed by entities other than the EDCs. However, in order to avoid unnecessary disruptions and the additional costs that are inevitably incurred to get such functions operational for new entrants, these services should for the present remain the responsibility of the utilities.

B. Qualifications for POLR

As PSEG understands this issue as set forth in the POLR Roundtable Issues List, the Commission is seeking input as to whether the EDC or an "alternate supplier" should have the *ultimate* responsibility to provide POLR service. Or, stated differently, the question posed is whether, from the standpoint of *statutory* responsibility, the provider of last resort should be the EDC or some other party.[2]

PSEG submits that, with respect to this narrowly prescribed issue, the EDC should be the provider of last resort for the present. PSEG does not conceptually oppose the possibility that a company other than an EDC could be the statutory POLR. At this time, however, the EDCs are in the best position to assume this responsibility.

As PSEG envisions the preferred POLR model, the EDCs would select several *wholesale* providers through a competitive process each of which would serve the full requirements of an undivided portion of the POLR load, *i.e.*, a slice of the EDC's retail POLR obligation. Under this approach, the EDCs' main role would be to oversee the selection of the wholesale providers and then to monitor their compliance with the wholesale full requirements contract. The EDCs would also retain the billing and collection functions. The EDCs, however, would directly procure POLR supply from the market, and then only on a short-term basis, in the event of a default by the wholesale POLR supplier selected through the competitive process.[3] Any

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[2] At the risk of belaboring this point, PSEG wishes to draw a careful distinction between the "ultimate" responsibility for providing service and the provision of "default" service for customers that do not select retail third-party suppliers. While PSEG maintains that, at least for the present, the EDC should retain the ultimate responsibility for provider of last resort service, it also believes that the most efficient way for the EDC to provide such service in non-emergency situations would be through prearranged supply transactions with qualified suppliers. In a very real sense, therefore, the EDCs would shift much of the responsibility for POLR service away from themselves (and consumers) and onto other market participants.

[3] It should be noted that, because a wholesale supplier may be experiencing problems and may even become unable to fulfill the terms of the supply contract, it does not inevitably follow that a "default" will occur. As discussed *infra*, the arrangements with the wholesale BGS suppliers should afford them with reasonable flexibility to find a

incremental costs of obtaining replacement supplies would then be passed through by the EDC to all of its POLR customers through a surcharge on the EDC's POLR rates.

Although an alternate supplier could theoretically serve this role, at present, the EDCs appear to be in the best position to manage the risk associated with potential supplier defaults. EDCs have the mechanisms in place to create deferred cost accounts and have extensive experience in dealing with regulatory bodies, such as the Commission, with respect to similar matters. Further, until experience is gained as to the likelihood of wholesale POLR supplier defaults, potential alternate suppliers will have great difficulty in pricing the default risk and thus may be unwilling to assume that risk without commanding a significant premium.[4]

C. POLR Service Models

The POLR Roundtable Issues List identified two basic potential models for the provision of POLR service. Under the "direct assignment to EDC" model the Commission would select POLR service from one or more of the EDCs. Under the "competitive assignment" model, POLR service would be assigned based upon the results of a competitive process open to EDCs and/or alternative suppliers.

As discussed above, PSEG believes that the EDCs should remain *ultimately* responsible for providing POLR service. The most efficient cost option for providing default service to customers that do not choose a retail third-party supplier, however, will be for the EDC to obtain wholesale full requirements service for an undivided portion of the retail POLR load. This

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replacement provider before a "default" under the contract actually occurs. In fact, PSEG is aware of instances for New Jersey BGS service, in which the winning bidder experienced difficulties during the term of the contract and avoided "default" through this mechanism. In those cases, the EDC was not required to assume or manage any additional risk. Defaults requiring direct intervention by the EDCs into the market will occur only after all other options available to the supplier have been fully explored.

[4] The significance of these factors, however, may change over time as the market (and the Commission) gain experience with POLR obligations in the post-transition environment. Accordingly, the question whether alternate suppliers should provide this type of service should be revisited at a future date.

option, which PSEG refers to as "wholesale competitive service," has been used successfully in New Jersey and Maryland and has recently been approved for use in the District of Columbia. By employing this option, the Commission will be taking advantage of the highly liquid and highly efficient PJM markets for energy and capacity.

The key element underlining any competitive selection process for wholesale POLR service should be "comparability": all proposals should be required to meet the same requirements and should be evaluated under the same standards. Specifically, the product to be procured under the competitive process should be clearly defined in advance and should permit participation by as many resources as possible consistent with the needs that must be satisfied. Further, the "variables" to be considered under the competitive process should be kept to an absolute minimum. In the New Jersey auction design for BGS, the number of variables has been reduced to one, namely the price. A more traditional RFP process, such as the process recently used in Maryland, however, can also yield competitive results.

It is necessary that, whatever process is used, there be a transparent scoring mechanism based upon objective criteria. In addition, while creditworthiness is a legitimate consideration, the mechanism should allow as much flexibility as possible in satisfying creditworthiness consistent with industry standards. Further, the process should permit participation by as many resources as possible consistent with the need that must be satisfied.[5]

The auction design used in New Jersey for the procurement of BGS offers many salutary features that should be considered by this Commission. First, under the New Jersey auction

[5] In general, PSEG recommends to the Commission the publication recently prepared by the Electric Power Supply Institute entitled "Getting The Best Deal For Electric Utility Customers" a copy of which is attached as Attachment A to this submittal. This booklet describes the crucial elements of a competitive RFP/auction process. By following the principles outlined in the EPSA materials, the results of competitive process can be expected to yield optimal benefits to consumers as well as to promote a healthy market in which producers and marketers can compete and sell their services.

design, price is the only auction variable because all other terms and conditions of service are defined in a "Master Supplier Agreement" approved by the New Jersey commission well in advance of the auction. As a result of this feature, the auction process is highly transparent and virtually immune to favoritism. Allowing an independent entity to conduct the auction, as is done in New Jersey, would provide even higher levels of confidence in the validity of auction results. Second, the New Jersey auction design model also provides the Commission with options to address any concerns regarding market power. In New Jersey, the review process of eligibility criteria entitles the independent "Auction Manager" to examine any relationships between bidding entities in order to ensure that each bidder is acting independently. Further, the New Jersey model requires the Auction Manager to reduce the auction size if insufficient supply is offered and includes bid load caps limiting the quantity that a bidder (including any associated bidders) can offer into the auction.[6] Third, the use of the "declining clock" model for the procurement of electric supplies on a statewide basis has been highly effective in New Jersey. It has resulted in the purchase of more than $3.0 billion dollars annually in supply from wholesale BGS suppliers and has attracted addition participants in each of the three years in which it has been held. Fourth, by creating a transparent process with a high degree of certainty that load serving obligations will be awarded, the auction attracts a large number of participants and a significant amount of potential supply at very attractive prices.

As noted above, PSEG believes that the best way for the EDC to procure wholesale POLR supply is through a full requirements bundled electricity product for a slice of the EDC's retail POLR load. This would include responsibility to provide capacity, energy, transmission,

[6] Although not all economists see harm in allowing participants to bid at higher levels in an auction, the use of bid caps assures that no market participant will be in a position to abuse its market position. In addition, as discussed *infra*, including bid caps reduces the exposure of the EDC to credit support risks associated with an individual wholesale supplier.

ancillary services and load-following capability. There should, moreover, be no limits or minimum requirements associated with self-generation, spot market purchases, bilateral contracts or types of resources utilized by the supplier to meet its obligations. Because suppliers are differently situated and because they have different strategies for procuring supply, such limits or minimum requirements would favor some suppliers over other suppliers and, ultimately, would result in the inclusion of premiums to compensate for risk in many supplier bids. The EDCs, nonetheless, should carefully monitor the financial strength of wholesale POLR providers to assure that they remain within accepted industry norms.

PSEG submits, moreover, that adoption of the wholesale supply model for POLR service also provides an appropriate opportunity for the development of the competitive retail market and customer choice. Because POLR service is a "plain vanilla" service, retail third-party suppliers wishing to "up-sell" by offering specialized "value-added" services in addition to basic supply service will have the option to do so. Further, while PSEG believes that rates for POLR service for residential and small commercial/industrial customers should offer a degree of seasonality in order to mitigate migration risk, retail third-party suppliers should be able to attractively package service that more closely mirrors the load use profiles and needs of particular customers or to otherwise realize enhanced efficiencies in their service offerings.

D. Terms and Conditions of POLR Service

PSEG believes that POLR service should offer a degree of stability to residential and small commercial/industrial customers but that the length of POLR wholesale contracts should not be of such duration as to expose suppliers to excessive customer migration risk. In general, PSEG believes that a three-year contract term for full requirements wholesale service is reasonable. For example, in New Jersey, following a phase-in period, one-third of the statewide load will be bid out each year under a three-year contract. Thus, at any one point in time, each POLR customer is being supplied under wholesale POLR contracts resulting from three different auctions.

As noted above, PSEG believes that there should be a degree of seasonality in retail POLR rates between Summer and non-Summer periods in order to mitigate the effects of customer switching and potential “gaming” by customers. If seasonality in retail rates is not allowed at all, the effects of switching are likely to be so great as to result in POLR wholesale suppliers charging a significant premium due to the potential volatility of the load obligation.

PSEG does not believe, however, that all customers should necessarily be entitled to fixed seasonal rates. The largest commercial and industrial customers should generally be in a position to make their own supply arrangements or to make arrangements with retail third-party suppliers. For these customers, it is therefore appropriate that the retail POLR rates they pay reflect “locational marginal prices” (“LMPs”) in PJM. POLR wholesale service to meet the needs of these customers should be bid out separately from POLR service provided to residential and small commercial/industrial customers. PSEG does not believe, moreover, that “adders” are needed to further encourage shopping with retail third-party suppliers by such customers. The load profiles and other characteristics of the services used by these customers should provide ample opportunity for retail third-party suppliers to develop attractive service options including potential savings associated with demand control devices.

PSEG further submits that obligations for universal service and decisions regarding whether to terminate customers should remain with the EDC. Since the EDC would maintain the direct supply arrangement with POLR customers under the model that PSEG has proposed, the EDC would continue to have direct access to customers for collection efforts. Moreover, EDCs have much greater experience in collection matters associated with the provision of service to residential and small commercial/industrial customers and thus are best able to administer that risk in an efficient manner. Any uncollectible amounts with respect to both POLR service and universal service should be recovered in a "societal benefits" or similar charge on all distribution services.[7]

In addition, under the wholesale POLR supply model, the EDC will be able to obtain wholesale supplies for universal service in the same competitive process used for procurement of POLR load. From the standpoint of the wholesale supplier, there is no difference between POLR load and "universal service" loads. The only differences should be at the retail level as set forth in the respective tariffs for the services.

E. Full Recovery of Reasonable Costs

The EDCs should be allowed to fully recover all of the reasonable costs related to obtaining POLR-related service. If the Commission adopts a competitive process such as that espoused by PSEG, it will be able, with a high degree of confidence, to assure itself at the end of the competitive procurement process that the wholesale supply rates under which POLR service is being provided are reasonable. In addition, it is important to recognize that EDCs should be given a reasonable degree of flexibility to procure replacement supplies in the event of a default by a wholesale POLR supplier. Further, EDCs should also be required to have developed and have obtained Commission approval of a contingency plan for implementation in the event of a supplier default.

[7] In the event that such surcharges are insufficient to cover payment of all wholesale POLR/universal service supplier obligations in a given billing cycle, they should be placed in a deferred account for later collection. Conversely, if the EDC has overcollections because the assumed level of uncollectibles is less than anticipated, the overcollections should also be placed in the deferred account.

The issues list also expressed a concern that POLR services might "disrupt the competitive retail market." PSEG's comments have addressed this issue in several areas. In general, PSEG believes that a wholesale supply approach for POLR service as described above should permit the development of a robust competitive retail market. PSEG wishes to stress, however, that the Commission should not lose sight of its statutory obligation to provide POLR service at reasonable rates to customers who are unwilling or unable to obtain supplies from competitive retailers.

F. Adjustment & Reconciliation of POLR Rates

Under the design suggested by PSEG, there should never be a need for the adjustment or reconciliation of the *commodity* component of wholesale POLR rates. Wholesale suppliers would be required to lock in the commodity price for power by entering into contracts with the EDCs. Accordingly, those rates would never be adjusted up or down regardless of market fluctuations. Further, as discussed above, over- or under- collections at the retail level associated with non-payment or slow payment by retail customers should be reconciled by a universal charge on all distribution customers.

PSEG does believe, however, that it would be reasonable to allow adjustments for certain changes in the *non-commodity* component of wholesale POLR service. Thus, for example, it would be reasonable to allow a change in POLR rates in order to accommodate an upward or downward change in PJM transmission rates. If this is not allowed, POLR suppliers are likely to add a premium to their offers in order to address that risk.

G. Default of POLR Service Provider

The risk for potential default by wholesale suppliers should be minimized by the adoption of creditworthiness requirements by the EDCs consistent with industry norms and the close monitoring of those requirements. While the implementation of such measures does not afford complete protection, it goes a long way towards ensuring that the risk of default by suppliers remains within manageable parameters. Further, EDCs should have the contractual right to take action against POLR suppliers in the event they fail to maintain proper credit support without having to wait for the supplier to default in providing service.

As discussed above, PSEG also believes that the use of bid offer caps may be a desirable feature of the competitive process for acquiring POLR services as a measure to assure against the potential exercise of market power. The adoption of this measure, moreover, would also reduce the potential impact of credit support problems that may be experienced by a given supplier. Limiting a given supplier's share of load also limits the size of the potential supply obligation the EDC could potentially incur due to a default by that supplier.

PSEG further recommends that the contractual arrangements between the wholesale suppliers and the EDCs should offer the maximum degree of flexibility to enable a POLR wholesale supplier to find a replacement supplier in the event it becomes unable to perform its obligations. Thus, the contract should offer flexible assignment options and, if Commission approval is required to effectuate an assignment, an expedited process for obtaining such approvals should be implemented.

In the event a default does occur, the EDC must be given the authority to take the necessary steps to ensure the continued provision of service. As noted above, the EDCs should have a Commission-approved contingency plan in place to address that possibility. Since almost the entirety of Pennsylvania is located within one of the most liquid short-term electricity markets in the world, EDCs should not experience difficulty in the short-term in obtaining the supplies needed to cover the default of a BGS supplier.[8] The EDCs, nonetheless, should take steps as quickly as reasonably possible following a default to place longer-term supply arrangements into effect through a competitive process in order to stabilize rates. In addition, the EDCs should be required to offer the POLR load subject to the default to other wholesale POLR suppliers.

H. Implementing POLR Roles/Transmission Issues

PSEG acknowledges that a phase-in of any POLR mechanism will be necessary. To the extent that market power may remain a concern, as discussed above, the Commission can design

[8] PSEG notes that Duquesne Light has recently announced its intention to join PJM.

the competitive process so as minimize its potential exercise. Finally, PSEG strongly supports customer education regarding POLR service prior to implementation of a POLR program.

Respectfully submitted,

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