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Constellation Energy

March 8, 2006

VIA OVERNIGHT MAIL

The Honorable James J. McNulty
Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street – 2nd Floor
Harrisburg, PA 17120

RE: In the Matter of the Pennsylvania Public Utility Commission Implementation of the Alternative Energy Portfolio Standards Act of 2004, Docket No. M-00051865; Rulemaking Re Electric Distribution Companies' Obligation to Serve Retail Customers at the Conclusion of the Transition Period Pursuant to 66 Pa C.S. § 2807(e)(2), Docket No. L-00040169.

Dear Secretary McNulty:

Enclosed please find an original plus fourteen (14) copies of the "Initial Comments of Constellation Energy Group Companies" in the above-captioned proceeding.

Kindly date stamp and return the extra copy in the self-addressed stamped envelope. Please feel free to contact me with any questions.

Respectfully Submitted,

Lisa M. Decker, Esq.
Counsel
Constellation Energy Group, Inc.
(410) 468-3792

*On behalf of the Constellation
Energy Group Companies*

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

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| In the Matter of the Pennsylvania Public Utility Commission Implementation of the Alternative Energy Portfolio Standards Act of 2004 | : | |
| | : | Docket No. M-00051865 |
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| and | : | |
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| Rulemaking Re Electric Distribution Companies' Obligations to Serve Retail Customers at the Conclusion of the Transition Period Pursuant To 66 Pa.C.S. § 2807(e)(2) | : | Docket No. L-00040169 |
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**INITIAL COMMENTS OF
CONSTELLATION ENERGY GROUP COMPANIES**

I. INTRODUCTION

On November 18, 2005, the Pennsylvania Public Utility Commission (“Commission”) reopened the public comment period for the proposed Default Service regulations to consider the implementation of the Alternative Energy Portfolio Standards Act (“AEPS Act”) and to more fully examine the comments received from the Independent Regulatory Review Commission (“IRRC”).¹ Constellation Energy Commodities Group, Inc., Constellation Generation Group, LLC and Constellation NewEnergy, Inc. (collectively, “Constellation”) commend the Commission for its extensive information gathering related to its Default Service regulations in compliance with the Electricity Generation Competition and Choice Act (“Competition Act”).²

¹ *Commission November 18, 2005 Order Re: Default Service Rulemaking New Comment Period*, Docket Nos. L-00040169 and M-00051865.

² 66 Pa. C.S. § 2801, *et seq.*

In response to the Commission's February 8, 2006 letter ("February 8 Letter") in the above docketed proceedings, Constellation respectfully submits to the Commission its initial comments on issues 2 and 6 of the list of issues attached to the February 8 Letter, with regard to the relationship between the AEPS Act and the obligation of electric distribution companies ("EDCs") to serve retail customers through Default Service at the conclusion of the EDCs' respective transition periods.

Through its initial comments, Constellation urges the Commission to maintain carefully the integrity and competitiveness of wholesale and retail markets. Competitive markets function most efficiently when they reflect demand and supply dynamics and are not driven towards a particular outcome through regulatory or political intervention. Although Pennsylvania's energy markets are still in transition, customers have already benefited from competitive market prices. In a competitive market, it is the competitive wholesale and retail suppliers, not the EDCs (or their customers), who bear fuel price, market and technology risks, as well as much of the operational risks of providing delivered energy to consumers.

Constellation appreciates, however, that at times policymakers may wish to encourage development of specific new or experimental technologies because of the common good that is expected to result from such development and investment. Nevertheless, the best way for the Commonwealth to encourage advanced technologies is through targeted incentives, structured so as to support competitive wholesale and retail markets. The Commission can be a valuable leader in this effort to encourage specific types of generation; however, it must do so within its statutory confines and in a manner that advances Pennsylvania's vision of a robust competitive market.

II. COMMENTS ON SPECIFIC ISSUES

- A. **Issue 2: Do the prevailing market conditions require long-term contracts to initiate development of alternative energy resources? May Default Service Providers employ long-term fixed price contracts to acquire alternative energy resources? What competitive procurement process may be employed if the Default Service Provider acquires alternative energy resources through a long-term fixed price contract?**

Issue 6: May a Default Service Provider enter into a long-term fixed price contract for the energy supplies produced by coal gasification based generation if the resulting energy costs reflected in the tariff rate schedules are limited to the prevailing market prices determined through a competitive procurement process approved by the Commission?

It is certainly the case that renewable generation of the types that are included as Tier I and most of the Tier II alternative energy resources ("AER") do not require EDCs to enter into long-term, competitively procured, fixed price contracts ("Long-Term EDC AER Contracts") in order to develop such resources. Indeed, generation is being developed without such Long-Term EDC AER Contracts.¹ Integrated gasification combined cycle ("IGCC") and other technologies such as new nuclear generation, though, are relatively untested and therefore it is unknown whether such a generating facility can be constructed without a Long-Term EDC AER Contract or other incentives. Given the adverse effects that a Long-Term EDC AER Contract would have on the nascent competitive wholesale and retail markets in Pennsylvania, however, this Commission should refrain from allowing any Default Service Provider ("DSP" or "EDC") to enter into such a contract as a means of ensuring the development of an IGCC plant.

¹ In Pennsylvania, for instance, Reliant Energy operates a 521 MW facility which uses coal refuse to generate power, one the largest waste coal facilities in the world. Constellation itself has entered into 10-year contracts in order to obtain environmental credits necessary to satisfy the current and future AEPs-type requirements of other states. The experiences of other states may also be relevant. Just last month, Marina Energy signed a long term (20 year) supply agreement for renewable energy with the Borgota Casino in New Jersey to provide up to 5.5 MW of renewable power. This renewable energy project was contracted for in a state where the longest default service term is three years; prevailing market conditions did not require Long-Term EDC AER Contracts for default service in order to promote this project's implementation.

If the Commonwealth of Pennsylvania desires to actively facilitate the development of an IGCC plant within its borders, Constellation believes, as described below, that there are far superior ways to incent IGCC development that will not cause harm to the Pennsylvania wholesale and retail markets. Alternatively, if this Commission believes that the only way to foster development of such a plant is to provide the developer with a Long-Term EDC AER Contract, this Commission should adhere to certain principles also set forth below.

1. Preferred Means of Encouraging Investment in IGCC Technology

In lieu of Long-Term EDC AER Contracts, Pennsylvania should look to a host of market-neutral tools to encourage investment in and sustainability of IGCC projects in the Commonwealth, similar to those enacted and offered by the Federal Government in the Energy Policy Act of 2005.³ If the Commonwealth wants to support the advancement of IGCC technology projects (or any other alternative energy technology), it should do so through explicit technology-focused tools such as tax abatements, state grants, state guaranteed loans and other subsidiary programs funded directly from the Commonwealth that would improve the economic viability of IGCC as a technology without adversely affecting the competitive energy market. Such mechanisms would align appropriately the interests of Pennsylvania in advancing IGCC technology (or other alternative energy technologies), while minimizing the impact on competitive markets. As noted above, generation that would satisfy AEPS requirements already has been built in Pennsylvania using this approach. These projects, desirable for the types of technology they advance, were built in large part through an incentives approach, as described below.

³ Pub. L. 109-58, 119 Stat. 594 (2005), codified in 42 U.S.C. § 15801 (2005).

Incentives can be provided in a number of ways and can be made available to all developers of qualified generation within the state, thereby minimizing the adverse impacts on competition that might arise if the EDC develops such generation under a guaranteed rate-of-return financing structure. The Commonwealth could provide financing incentives to investors in IGCC or other new technology projects through various mechanisms, including tax credits, accelerated siting processes and loans (either from existing vehicles intended to finance such projects such as the Energy Harvest Program or the Pennsylvania Energy Development Authority). Market participants can and should compete for this funding.

The targeted incentives approach is superior to other options for a number of reasons. First, financing incentives allow all market participants to compete on an equal basis, for instance to build an IGCC plant, while not transferring the operational/ technology risks to customers as would occur if the EDC were responsible for such costs under traditional cost-of-service ratemaking. Second, through AEPS requirements, the owner of the IGCC plant would be able to enter into bilateral contracts with wholesale and retail suppliers who need to obtain renewable energy credits. If the generator is not commercially successful, penalties and remedies would be resolved among the contracting parties, and instead of being passed through to and paid for by Pennsylvania consumers. Third, through this competitive process it is likely that the most efficient projects will be awarded such financing incentives. Fourth, the costs associated with the IGCC will be appropriately socialized among all Pennsylvania consumers, recognizing that all Pennsylvania consumers benefit from the introduction of new technology to the generation resource mix in the Commonwealth. No individual EDC load zone will pay a higher price for such new technology generation, unlike the scenario in which an IGCC plant is financed through an individual EDC's Default Service plan, perhaps through a non-bypassable

charge. Rather, because there is a recognized overall societal good being mandated, the cost of meeting the environmental requirements will be shared by all Pennsylvania consumers equally.

While Constellation recognizes that these types of incentives may be outside the purview of the Commission, Constellation recommends that the Commission pursue the further development of these types of incentives with the appropriate governmental agencies as the preferred approach for encouraging investment in new IGCC technology.

2. Problems with Long-Term EDC AER Contracts for Default Service

Contrary to the incentives approach described above for the construction of new facilities, allowing an EDC to enter into Long-Term EDC AER Contracts for Default Service will violate the “prevailing market prices” standard of the Competition Act and undermine the competitive market.

a. Long-Term EDC AER Contracts will violate the Competition Act.

The Competition Act states that if a customer does not choose a competitive supplier, then the EDC “shall acquire electric energy at *prevailing market prices* to serve that customer”⁴ The Commission thus has a statutory duty to promulgate Default Service regulations that are consistent with the “prevailing market prices” standard.⁵ The Commission recognized this situation in its conclusion in the Duquesne Light POLR III decision that a six-year price was inconsistent with the “prevailing market prices” standard.⁶ Accordingly, both the Competition Act and Commission precedent appear to prohibit an IGCC owner from entering into a Long-Term EDC AER Contract .

⁴ Competition Act at § 2807(e)(3) (*emphasis added*).

⁵ Competition Act at § 2807(e)(2).

⁶ *Petition of Duquesne Light Co.*, Docket No. P-00032071.

Moreover, the General Assembly has concluded that “the generation of electricity will no longer be regulated as a public utility function”² and has given the Commission the authority to provide a means for the EDCs to procure power for Pennsylvania’s non-shopping consumers at “prevailing market prices.”³ While the Commission has proposed that EDC costs of compliance with AEPS requirements would be recovered as a cost of generation supply consistent with the AEPS Act, neither the Competition Act nor the AEPS Act appears to grant authority to the Commission with respect to Default Service procurement to order EDCs to enter into Long-Term EDC AER Contracts for a specific generation type. Rather, through the AEPS Act, the legislature appears to reserve for itself the power to establish renewable portfolio requirements instead of delegating such responsibilities to the Commission. As noted above, given the legislature's apparent intent to reserve for itself authority over renewable requirements, the legislature may be receptive to recommendations from the Commission regarding promotion of new AER development, including IGCC, through an incentives approach.

b. Long-Term EDC AER Contracts will have a detrimental effect on competitive markets.

Given the existing statutory framework in the Commonwealth, this Commission should not allow developers of IGCC plants to enter into Long-Term EDC AER Contracts as the means of ensuring the development of an IGCC plant. In addition to violating the express language of the Competition Act, allowing such contracts will undermine the intention of the Competition Act to promote sustainable competitive markets. For instance, allowing the EDCs to enter into Long-Term EDC AER Contracts will likely undermine the benefits that would result from the competitive procurement process currently contemplated by the proposed Default Service

² Competition Act at § 2802(14).

³ Competition Act at § 2807(e)(3).

regulations. With the presence of Long-Term EDC AER Contracts for the supply of Default Service, suppliers in the competitive market also no longer will have the benefits offered by a level playing field for market competition. Instead, one supplier (“Long-Term Supplier”), under such a Long-Term EDC AER Contract, will be guaranteed an opportunity to supply Default Service load for a significant period of time at a guaranteed rate, thus allowing the Long-Term Supplier to earn a rate of return on its investment, an opportunity not available to any other market participant. All other Default Service suppliers, for example, will be at risk for all of their costs, without the assurance of a guaranteed future “tranche” of load or a guaranteed sale of megawatts, a result that unfairly favors certain suppliers.

The Commission must be careful not to harm competition, especially in the event that EDCs are directed to enter into Long-Term EDC AER Contracts. If, in spite of the language and the intent of the Competition Act as well as the Commission’s own precedent, the Commission requires EDCs to execute Long-Term EDC AER Contracts, the use of such Contracts must be reconciled with the Default Service procurement process adopted by this Commission. For instance, the Commission could consider whether to include any such contracts in its Default Service procurement process such that suppliers would bid to both supply the load and receive a percentage of the entitlement resulting from the Long-Term EDC AER Contracts.

Moreover, it is equally imperative that the Commission design a process that ensures that any Long-Term EDC AER Contracts are competitively procured and not automatically awarded to the EDC. Any Long-Term EDC AER Contracts should be available for all suppliers to bid on and the process should be designed in a way to encourage multiple bidders. In addition, any procurement process resulting in Long-Term EDC AER Contracts must also meet the standards set forth by the Federal Energy Regulatory Commission in *Boston Edison Re: Edgar Electric*

Co., in the event that an EDC's affiliated alternative energy resources are able to participate and win the right to supply load through such procurement.⁷ Finally, in order to minimize retail price distortions as a result of entering into such contracts, the amount of default load available for Long-Term EDC AER Contracts should be minimized and limited to 5-10 % of the EDC's peak load, and the length of the contract should be no more than 10 years. The risk of market distortion would be minimized if the percentage of load available and the length of the contracts entered into for such load are limited appropriately.

Moreover, the Commission must be cognizant of the fact that, to the extent such contracts are more expensive than other supply in the market, i.e., "above market," there is a risk that new stranded costs are created and that ultimately the Commission will be faced with resolving the apportionment of such costs. Thus, Constellation recommends that the Commission consider carefully the ramifications of any decisions that result in the EDCs contracting directly for new generation supply.

Finally, while the Commonwealth may have other policy considerations regarding encouragement of IGCC technology, Constellation feels it may be premature to reach the conclusion that Long-Term EDC AER Contracts are necessary at this time to meet the goals of the AEPS Act. The AEPS Act has been in effect for just over a year and many market participants are still evaluating its compliance requirements. Moreover, IGCC is only one of seven different forms of generation that can be considered a Tier II resource and the Commonwealth is over a decade and a half away from the day when 10% of a Load Serving Entity's load needs to come from Tier II resources. Thus, it is likely too soon to determine whether market forces will not bring about enough desired development of new technology to

⁷ 55 FERC 61,382 (1991).

meet the AEPS requirements. The Commission should consider whether this is the appropriate time to commit its consumers into an extended obligation that is inconsistent with the letter and spirit of the Competition Act.

B. Advanced Notice of Final Regulation

Given some of the policy changes that are being contemplated by the re-opening of this rulemaking, Constellation respectfully requests that the Commission provide an Advanced Notice of Final Rulemaking to offer parties an additional opportunity to comment before final publication of regulations. Although Constellation does not agree with the IRRC that these regulations should be delayed more than they already have been, Constellation feels that such an advanced notice is critically important.

III. Conclusion

The Commission must be guided by the fact that competitive markets function most efficiently when they reflect demand and supply dynamics, and are not driven towards a particular outcome through regulatory or political intervention. While there are many options available to state governments to encourage certain behaviors or outcomes, such options cannot and should not be deployed if they undermine dynamic market forces of supply and demand. Pennsylvania has the ability to be a leader in environmentally friendly generation as well as electric restructuring. The Commission should ensure that it achieves the right balance in order to maintain these positions, and does not rush to conclusions that would compromise one for the other, especially where other tools exist to further both, hand-in-hand.

Respectfully submitted,



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DATED: March 8, 2006