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April 7, 2006

VIA OVERNIGHT MAIL

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

Re: Docket No. M-00051865
Implementation of the Alternative Energy
Portfolio Standards Act of 2004

Docket No. L-00040169
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)

Dear Secretary McNulty:

Enclosed please find for filing an original and fifteen (15) copies of Reply Comments of Strategic Energy in the above-referenced cases. A copy this day has been sent by electronic mail to Carrie Beale of your office. Thank you for your assistance in this matter.

Sincerely,

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JK:cb w/enclosures

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Implementation of the Alternative Energy Portfolio Standards Act of 2005	: :	**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**

Reply Comments of Strategic Energy

The Reply Comments of Strategic Energy, LLC (Strategic) will focus on the appropriateness of having electric distribution companies (EDCs) or other default service providers (DSPs) enter into long-term contracts for the supply of alternative energy resources and the affect of the alternative energy cost passthroughs by the EDCs.

Long-term supply contracts by EDCs or DSPs, whether for alternative energy or other generation supplies, will create an unlevel playing field for competitive EGSs that could destroy retail competition and would be contrary to the intent of the Competition Act.

Various parties have commented that the Commission should permit electric distribution companies (EDCs) and default service providers (DSPs --- collectively referred to as EDC/DSPs) to enter into long-term contracts to purchase alternative energy resources provided that the price is consistent with market conditions[1]or to ensure price stability[2]. Some parties indicate that long-term contracts are necessary for the development of alternative energy resources or other types of new generation.[3]

1. Long-term supply contracts involving EDC/DSPs will impede the fluid operation of a competitive retail supply market in Pennsylvania

If EDC/DSPs are permitted to enter into long-term wholesale supply contracts, default rates will begin to diverge from current market prices. This will cause the competitive retail supply market to destabilize.

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[1] Comments of United States Steel Corporation at page 3.
[2] Comments of the Office of Consumer Council at page 2.
[3] Comments of PennFuture at page 3.

If default rates that are based on long-term supply contracts are lower than short-term market prices, then customers will migrate away from the competitive market to the default supply. This could destroy effective retail competition, as many competitive EGSs may not be able to compete with default rates that are below short-term market prices.

If the converse is true, i.e., that default rates based on long-term supply contracts are greater than short-term market prices, customers will migrate to competitive retail suppliers. Then a problem would arise as to who pays for the high-priced default supply if a substantial amount of default customers move to competitive suppliers (see comments on new PURPA-style contracts below). As customers leave the default supplier, an ever-smaller base of default customers are left to absorb default rates that are above the current short-term supply market prices. This is an untenable result that would likely lead to new customer surcharges. Here the EDC/DSP likely gets a bailout, whereas in the above example of low-priced long-term default supply contracts many EGSs could be forced out of the competitive retail supply market without any recourse.

Squeezing EGSs out of the market in this manner could not be the intent of the Electric Generation Customer Choice and Competition Act (Competition Act). The Competition Act found that (a) it was in the "public interest to permit retail customers to obtain direct access to a competitive generation market"[4]; (b) "competitive market forces are more effective than economic regulation in controlling the cost of generating electricity"[5]; and (c) the procedures established under this chapter were to transition to "a structure under which retail customers will have direct access to a competitive market for the generation and sale or purchase of electricity."[6]

2. Long-term supply contracts by EDC/DSPs could result in a new wave of "PURPA-type" high-priced default generation supply contracts.

During the 1980s the Commission approved a wave of long-term PURPA[7] contracts that included pricing that was well above prevailing short-term market prices for that time. Arguably the Commission did not have much choice in approving those contracts due to the mandates of PURPA. Other states such as California also went down the path of approving many high-priced PURPA contracts. These contracts later became part of the basis for competitive transition charges as we moved into the era of retail electric competition.[8] Now that we are almost clear of those competition transition costs, we should not revert back into the realm of long-term utility-controlled generation contracts. This would impede the fluidity of the competitive retail market, and is not consistent with Competition Act's intent to facilitate retail electric supply competition.

[4] 66 Pa.C.S. Section 2802 (3).
[5] 66 Pa.C.S. Section 2802 (5).
[6] 66 Pa.C.S. Section 2802 (13).
[7] Public Utility Regulatory Policies Act of 1978.
[8] Duquesne Light has also recognized the uneconomic results of the PURPA contracts. See Comments of Duquesne Light Company at page 11.

3. **EDC/DSPs could corner the market for renewable generation sources.**

As discussed further in the next section, EDC/DSPs would not be corporately responsible for the credit risk associated with purchase of long-term generation supply. This risk would be passed onto customers, presumably default customers. This could likely result in EDC/DSPs being the preferred counter-party for alternative energy suppliers. EGSs could be left to scramble to pick-up short-term supplies at a higher price or being forced to pay the statutory "alternative compliance payment" for alternative energy sources, resulting in an unlevel playing field for EGSs.

4. **The significant default/credit risk of long-term alternative energy supply contracts by EDC/DSPs could result in detrimental cost passthroughs to default customers. With cost passthroughs, credit/delivery risks are not likely to be priced into the initial supply prices accepted by EDC/DSPs .**

Strategic believes that EDC/DSPs should not enter into long-term contracts for alternative energy resources. An EDC or DSP can pass through to default customers all costs associated with long-term supply contracts. With a long-term supply contract, the purchase risks would be assumed by the default customers and not the EDC or DSP. One such risk is the risk of non-delivery, which can be substantial.[9] The longer the contract, the more risk is involved, the more unfair is the situation that allows the EDC/DSP to pass these costs onto future default customers. While at the same time EGS are left on their own to cover such risk, as it should be for all generation suppliers.

Competitive EGSs would be at a disadvantage in bidding for alternative energy supply contracts as they will be required to price delivery risk into their bid. This would cause competitive suppliers to offer a lower bid price to absorb any delivery or credit risks, potentially losing long-term alternative energy supply contracts to an EDC or DSP that could offer a higher initial supply price and pass these risks (should they materialize) on to default customers at a later time.[10] This results in an unlevel playing field for EGSs.

5. **EDC/DSPs should not be able to create <u>non-bypassable</u> surcharges if long-term contracts turn out to be uneconomic.**

As discussed above, long-term generation supply contracts with EDC/DSPs have the potential to be uneconomic compared to future shorter-term market prices. If such a result comes to fruition, customers that are not on default service (i.e., competitive supply customers)

[9] See, for example, Building a "Margin of Safety" Into Renewable Energy Procurements: A Review of Experience with Contract Failure (January 2006). Prepared by KEMA, Inc. for the California Energy Commission. The Abstract on page 2 states that "the data suggests that a **minimum** overall contract failure rate of 20 to 30 percent should generally be expected for large solicitations conducted over multiple years. (Emphasis in original.)
[10] If such a default occurs the EDC/DSP would just pass through to default customers any premiums associated with cover supplier, without any recovery risk to the EDC/DSP. Specifically, 66 Pa.C.S. Section 2807(e)(3) provides that in this situation the EDC/DSP "shall recover fully all reasonable costs."

should never be saddled with the obligation of paying surcharges on high-priced EDC/DSP supply contracts that they did not intend to use. Some EDCs believe that costs associated with long-term alternative energy supply contracts should be recoverable through a non-bypassable cost recovery mechanism.[11]

It is likely that competitive supply customers would not want the EDC/DSPs to enter into long-term contracts on their behalf. To saddle competitive retail supply customers with non-bypassable costs associated with EDC/DSP alternative energy contracts intended for default service would be patently unfair. Competitive supply customers wishing to rely on service from competitive EGS will not benefit from long-term supply contracts of EDC/DSPs. Therefore such competitive supply customers should not have to be concerned with being forced to pay for uneconomic long-term EDC/DSP supply contracts that they did not intend to use. A good example would be a customer that enters into a long-term multiple-year supply contract with an EGS. Such a customer should not be expected to pay a subsequent surcharge due to an uneconomic long-term supply contract entered into by an EDC/DSP. This dilemma can be avoided by simply not allowing EDC/DSPs to enter into long-term supply contracts.

6. Under no circumstances should an affiliate of an EDC or DSP be allowed to enter into supply contracts with their affiliated EDC or DSP.

The potential for self-dealing is evident and certainly the appearance of a potential self-dealing situation should be avoided. This type of protocol would enhance real competition in the state's generation and supply sector and would preserve consumer confidence in the integrity of the competitive supply system. Affiliates that should not contract with the EDC/DSPs should be broadly defined and include competitive supply affiliates, wholesale supply affiliates, or affiliated generation companies.[12]

7. The Commission should wait to assess the impact of federal renewable tax credits, which will likely result in a surge of alternative energy resources.

The federal Energy Policy Act of 2005 included substantial incentives for the development of renewable resources, including the extension of Section 45 tax credits for certain renewable energy projects that will be built and in service before December 31, 2007. It is our understanding that a significant number of renewable project developers are earnestly working to complete renewable projects before this deadline to take advantage of these tax credits.

[11] Duquesne Light in their comments suggests that "default service providers could enter into long-term alternative energy contracts, and recover costs using a separate non-bypassable cost recovery mechanism." Comments of Duquesne Light Company at page 11.

[12] For example, Duquesne Light Company's affiliates include Duquesne Light Energy and Montauk Energy Capital including its subsidiaries Waste Energy Technology and GSF Energy. Among other things, Montauk and its subsidiaries own and operate landfill gas facilities and have experience in using landfill gas to generate electricity.

8. **Other states have met their renewables mandates without resorting to long-term alternative energy supply contracts by EDC/DSPs.**

Texas[13] and Massachusetts[14] have significant renewable energy goals that are currently in effect. These states have not experienced the need to approve any long-term renewable supply contracts by EDC/DSPs. In Texas, renewables have developed without long-term EDC/DSP supply contracts. To the contrary, Texas' renewables goals were revised upward by the state as progress on the initial goals has exceeded expectations.[15] Massachusetts has various incentive programs in place to foster renewables development, including the use of renewables floor prices to spur development.[16]

The Commission should take a "wait and see" approach to evaluate the progress of development of alternative energy resources. In the event that further incentives are needed, the Commission should consider a Massachusetts-style approach that provides incentives to alternative energy supply developers from proceeds of the alternative compliance payments or if necessary some other type of incentive that applies to all qualified renewables facilities or to all generation suppliers. The Commission should not create programs that apply just to EDC/DSPs but not to EGSs, e.g., long-term supply contracts with the ability to pass through risks of default only applicable to EDC/DSPs. Any such distinction could serve to impede the development of a fluid competitive retail electric supply market in Pennsylvania.

9. **Customers wishing to obtain price stability can and should lock-in long-term prices through a competitive EGS. This is consistent with the intent of the Competition Act.**

One of the primary benefits of a competitive retail electric supply system is to provide customers with potentially unlimited choices. The Commission should not favor long-term supply contracts by EDC/DSPs just because a current market cycle has experienced a price upturn. This is the nature of any competitive marketplace. More recently market prices have trended down from the highs experienced in the fall of 2005. Such price fluctuations define and create efficiency in the marketplace.

Customers that want price certainty can contract with EGSs. The Competition Act was passed to allow for and encourage just such a choice. The Competition Act found that

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[13] 25 PURA Section 25.173(h)(1) requires certain defined renewable capacity in the amount of: 2280 MW by 1/1/07, 3272 MW by 1/1/09, 4264 MW by 1/1/11, 5256 MW by 1/1/13, and 5880 MW by 1/1/15.
[14] The Massachusetts Electric Utility Restructuring Act (Chapter 164, Acts of 1997) requires certain defined renewables in the amount of 2.0% by 1/1/05, 2.5% by 1/1/06, 3.0% by 1/1/07, 3.5% by 1/1/08, 4.0% by 1/1/09 and increases of 1% per year thereafter until ended by the Massachusetts Division of Energy Resources.
[15] 2005 Report to the 79th Legislature, Scope of Competition in the Electric Markets in Texas, Public Utility Commission of Texas, January 2005.
[16] This floor price program is run by the Massachusetts Technology Collaborative (MTC). The MTC establishes periodic auctions as asks the renewables developers bid projects to be built based on receiving a certain floor prices from MTC. If the project is accepted, the project can use the floor price at any time or instead sell the output to the market if prevailing prices or higher. This floor price or price option is funded from proceeds derived from alternative compliance payments.

"competitive market forces are more effective than economic regulation in controlling the cost of generating electricity."[17] If the Commission begins to allow long-term supply contracts for EDC/DSPs, they will increasing become the primary electricity supply providers, potentially driving out competition, limiting choices for customers, and generally reverting back to the old way of the utility-dominated supply business. For the reasons expressed above, long-term contracts by EDC/DSPs can have the potential to destroy the competitive retail market structure that currently exists and does not further the intent of the legislature under the Competition Act to enhance a competitive retail market structure.

10. The meaning of "prevailing market prices" should be interpreted in a manner consistent with the legislative intent of the Competition Act to create and maintain a competitive retail market structure.

Pa.C.S. Section 2807(e)(3) provides that if a customer does not choose an alternative electric generation supplier, an EDC or DSP shall acquire electric energy at "prevailing market prices" to serve that customer and shall recover fully all reasonable costs. If EDC/DSPs enter into long-term supply contracts, EDC/DSPs will create a market disparity that is contrary to the efficient operation of a competitive supply market and the intent of the Competition Act. Therefore, to be consistent with the legislative intent to create a competitive retail supply market, EDC/DSPs should rely on prevailing market prices in the short-term supply market.

Respectfully submitted,

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Date: April 7, 2006

[17] 66 Pa.C.S. Section 2802(5).

CERTIFICATE OF SERVICE

I hereby certify that I have served a copy of this document upon each person designated on the official service list compiled by the Secretary in this proceeding by hard copy mailing or electronic mailing, where appropriate.

Dated at Pittsburgh, PA this 7th day of April, 2006.

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