March 2, 2007

VIA FEDERAL EXPRESS

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

Re: Default Service and Retail Electric Markets – Docket No. M-00072009;

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;

Policies to Mitigate Potential Electricity Price Increases Docket No. M-00061957

Dear Secretary McNulty:

Enclosed please find an original and 45 copies of the consolidated Comments of Allegheny Power in the above-referenced proceedings. A copy of the consolidated Comments has been provided by electronic mail to Shane Rooney at the email address shown below. This filing is made by Federal Express and the filing date is deemed to be today, March 2, 2007.

Very truly yours,

John L. Munsch

John L. Munsch
Senior Attorney

Enclosures
cc Shane Rooney (srooney@state.pa.us)

BEFORE THE PENNSYLVANIA PUBLIC UTILITY COMMISSION

Default Service and Retail Electric Markets	:	**Docket No. M-00072009**
	:	
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**
	:	
Policies to Mitigate Potential Electricity Price Increases	:	**Docket No. M-00061957**

COMMENTS OF ALLEGHENY POWER

Pursuant to the Commission's directions, West Penn Power Company dba Allegheny Power ("Allegheny Power" or "the Company") provides herein its consolidated Comments in the above-referenced dockets in response to: (1) the Proposed Policy Statement with respect to default service and retail electric markets, entered on February 9, 2007 ("Policy Statement"); (2) the Advance Notice of Final Rulemaking Order with respect to utilities' obligation to serve, also entered on February 9, 2007 ("Rulemaking"); and (3) the Tentative Order on mitigating price increases, entered on February 13, 2007 ("Tentative Order").[1] Allegheny Power fully supports the Commission's objective of integrating default service with retail electric markets in a way that provides a smooth and beneficial transition to retail customers. To that end, this Commission in May 2005 approved an Amended Settlement revising Allegheny Power's restructuring agreement that accomplished just such a transition. The Commission, as

[1] In giving further review to the three issuances together, as recommended in the Policy Statement, one important goal should be to achieve consistency in the definition of terms used within them.

well as all the parties to the settlement, recognized the importance of the ramp-up built into the settlement in order to allow customers to move toward market prices for electricity in manageable phases rather than through one large increase in their bill. As discussed in Section 4 below, Allegheny Power has subsequently recommended this approach in other jurisdictions where it does business, and believes it is the optimal approach to continue to apply here in Pennsylvania.

In these Comments the Company suggests ways in which the policies and procedures outlined in the Policy Statement, the Rulemaking, and the Tentative Order can (with modifications where required to achieve the results intended) be implemented. Specifically, Allegheny recommends:

- Supply for default service should be procured by seeking standardized wholesale products that are already available in the PJM markets, and using one or another of the two procurement models already successfully in use in the region.
- Different customer classes can have different supply contract durations and different price change frequencies without having to create expensive and convoluted supply "portfolios" separately for each utility and each customer class.
- Default service should be priced to recover all the costs of providing the service, including an appropriate return, and should be kept simple in design, rather than used as a platform for promoting other, non-market public policy goals.
- Ramping up prices gradually to market, starting before the end of price caps, is by far the best solution for customers to the "rate shock" problem.

1. Overview – Reaping the Benefits of Retail and Wholesale Competition.

From the outset of electric restructuring in Pennsylvania in 1996, the goal has been to enable retail customers to capture the benefits of competition in the retail and wholesale markets for electricity. The Commission captures this point succinctly in the Policy Statement at § 69.1802(a): "The goal of default service regulations is to bring competitive market discipline to historically regulated markets ... by structuring default service in a way that encourages the entry of new retail and wholesale suppliers." It is clear that wholesale competition in the PJM markets has been a strong success, spurring efficiencies in power plant construction and operation over the last decade that regulated regimes had been unable to secure. This has been especially true in Pennsylvania, where recent analysis shows that[2]:

- Pennsylvania's consumers are paying 12 percent less for electricity today (inflation-adjusted) than they did in 1996.
- Thanks largely to new construction, power plant capacity has increased by 23 percent between 1998 and 2005, while usage has only grown at 15 percent.
- Due to more efficient operation, Pennsylvania's nuclear power plants have increased output by 1.7 million MWh above pre-restructuring levels.

Customers in Pennsylvania have thus reaped tangible, significant advantages from being able to access the competitive wholesale markets, and an overriding objective of electric restructuring policy going forward needs to be to preserve and enhance those benefits.

While retail choice has had a spottier record to date in Pennsylvania – mainly due to the continuing constraint of default service price caps – there have been notable

[2] *See* Colin Cain and Jonathan Lesser, The Pennsylvania Restructuring Act: Economic Benefits and Regional Comparisons (Bates White, LLC, February 2007) at EX-1 and EX-2.

successes. In Duquesne Light's service territory, for example, almost half of the commercial customer load, and over 86% of the industrial load, is served by competitive retail suppliers.[3] Moreover, in other states where price caps have been gone for some time, such as for most customer groups in Maryland, non-residential retail shopping has taken firm hold.[4]

Default service is intended to be a backstop to retail choice for customers, not a replacement for access to the benefits of retail competition. Accordingly, default service should be a simple, "plain vanilla" product, because it is more efficient to provide differentiated, specialized products and services to those customers who want them through the competitive retail market. In particular, complex or experimental product alternatives, or ones that would be expensive to create and/or administer should generally be provided to customers through the competitive retail markets, where the customers who want those alternatives can affirmatively choose them, rather than using default service to force such products on all customers.[5]

That said, default service should be structured to be able to capture the benefits of wholesale competition for those customers who choose not to choose a competitive retail offering. Designing default service to take advantage of competitive wholesale processes keeps prices down for customers on the service, and ensures that **ALL** customers – those who shop, and those who choose not to – reap the benefits of the new competitive electricity markets. A proper default service design that is efficient but not artificially

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[3] *See* PA Office of Consumer Advocate, Pennsylvania Electric Shopping Statistics January 1, 2007 (1-12-07).

[4] *See, e.g.*, Maryland Public Service Commission, Maryland Electric Choice Enrollment Monthly Report for Month Ending January 2007 (93.9% of Large C&I, 66.5% of Mid C&I, and 30.0% of Small C&I load served by retail suppliers).

[5] The obvious exception to this rule is where building the specialized feature into the default design provides tangible benefits to the broad group of customers. Time-of-use rate offerings are a clear example of this type of beneficial feature.

under-priced (and therefore does not interfere with retail market access) makes the largest set of benefits available to the widest set of retail electric customers.

2. Designing Effective Default Service Procurement.

The two goals of keeping default service simple and using it to capture the benefits of wholesale competition, discussed above, actually complement and reinforce each other. Allegheny Power has learned over the past several years, having participated in wholesale procurement processes in several different states, that the best way to obtain favorable price outcomes in the wholesale electricity markets is to specify standard products to be obtained from the wholesalers, products that the PJM wholesale market already has experience in providing. As the Commission observed in the Policy Statement at § 69.1802(a), "[g]reater diversity of suppliers will benefit ratepayers and the Commonwealth." To the extent that the default service design can incorporate already well-established standard product definitions and parameters on a statewide basis – or, even better, on a regional basis -- the more wholesale suppliers will be able and willing to make offers, the more supply will be offered, and therefore the more wholesale competition will put downward pressure on prices for default service customers.[6]

Standardizing the default service product that is purchased in the wholesale market does not necessarily lock one into a single procurement mechanism, however. Rather, over the last several years, two different procurement models have been

[6] In Maryland, for example, where the equivalent of default service is procured using uniform statewide rules to buy PJM-standard 50 Mw blocks, competition has been intense among the suppliers, with 16 wholesale suppliers successfully qualifying in the 2006 bidding, and 12 suppliers serving some portion of the load. *See* Maryland Public Service Commission Case No. 8908, The Commission Staff's Report/Observations on the Standard Offer Service Bidding Process and Results for 2006-2007 (Sept. 1, 2006).

successfully used in multiple states – the New Jersey reverse auction model ("Auction"), used for example in that state and Illinois, and the Maryland Requests for Proposals model ("RFP"), used for several years not only in that state but also the District of Columbia and Delaware, and by Allegheny Power here in Pennsylvania. Wholesale suppliers in PJM are very familiar, and seem very comfortable, with both models, and so the adoption of either procurement model in Pennsylvania should help maximize our access to the wholesale markets. Indeed, it both procurement models could be used in Pennsylvania, one by some utilities and the other by others, preferably with both models using the same statewide master contract for the final purchases made. So long as there is just one uniform set of RFP rules statewide, and one uniform set of Auction rules statewide (with those rules conforming, to the extent practicable, to the rules for the same model as used elsewhere in PJM), Pennsylvania can deploy both procurement models and still attract the many wholesale bidders who have become accustomed to using those models elsewhere in the region.

The reason to use rules that the wholesale suppliers are familiar with and know how to bid under, is to attract as many offers as possible at the best prices possible. It follows, therefore, that a key feature of the default bid design, under each model, is that the lowest price is the decision criterion by which offers should be evaluated. Simply put, customers benefit most when load is procured under the rule that the lowest price wins. Attempts to second-guess the market by, for example, artificially setting price targets or restricting the amount of load that a qualified bidder can serve are both futile and contrary to the interests of customers, as the inevitable results are to impede access to the wholesale market and drive prices up.

However, regulatory overview of the process, to make sure that the procurement rules are followed, is both possible and desirable. Having a Commission-appointed monitor oversee the bidding process, perhaps followed by a prompt Commission affirmation that the process was followed,[7] still allows market forces to work to set the most efficient prices, and can in fact be beneficial by giving wholesale bidders enhanced faith in the integrity of the process.

Using one or two standard procurement models for default service, based on those already successfully employed throughout PJM, is a much more efficient approach than having each utility design, for each customer class, a unique procurement "portfolio" using multiple procurement methodologies and obtaining a variety of different types of products, for at least four reasons. First, and most fundamentally, the premise behind recent arguments for a complex "portfolio" approach to default service is that it is possible for a complex "portfolio" to provide better prices than the markets. This is simply untrue, and contrary to all the evidence that led Pennsylvania and other states to seek access to the benefits of retail and wholesale competition in the first place.

Second, designing a multitude of individualized "portfolios" of different methods and products, utility by utility and customer class by customer class, will generate substantial administrative costs for the utilities, wholesale bidders, and the regulators, and also expose the utilities to regulatory risks that will impact cost of capital. All these costs will be borne by the utilities' customers, more than negating any notional "benefit" from having the "protection" of a complex "portfolio."

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[7] In states that use the RFP model, for example, the regulators generally review the bidding results within two days – long enough to determine if the rules were properly followed, but not so long that the wholesale suppliers have to build significant risk premiums into their bids to reflect the delay waiting to know if the contracts will be allowed to go forward.

Third, procuring some default service supply outside the Auction or RFP framework undercuts supplier interest, and therefore competition, in those competitive procurements. In other words, taking supply out of the competitive procurement process will tend to drive up prices for the load left in the procurement, thus again imposing higher prices on customers.

Finally, to the extent that an overly-complicated "portfolio" approach is urged as a mechanism for pursuing policy goals unrelated to default service price to customers – goals like promoting demand response or use of certain types of generation – those goals can be more efficiently, and more fairly, be pursued through competitive retail offerings and/or through distribution-side programs, as is discussed in more detail in Section 3 below.

The alternative to a complex "portfolio" approach, however, should not be to lump all customers together into a single slice-of-system procurement. Allegheny Power has had good experiences, under the RFP model for example, with soliciting bids separately for different aggregated groups of similar customer classes (*i.e.*, all small commercial customers together, but separately from larger commercial customers), when the bidding is all conducted at the same time and under uniform rules. Supply contract durations can vary by customer class groupings (and/or even consist of mixes of contract terms for each group), and the expiration dates of the contracts can be staggered so that only part of a customer class's load turns over at any one time. So long as the contract durations are kept sufficiently uniform among the different utilities so that the benefits of standardized product procurement can be maintained – and so long as the contract lengths and turn-over are coordinated with the PJM planning process, which is a key feature to

fitting efficiently into the existing wholesale market – there is substantial flexibility to craft class- and utility-specific configurations.

A last point on default service design, intimately connected to the issues of contract length and turnover, is the issue of how frequently default service prices should change. In some jurisdictions this issue has been the topic of fervent (even fevered) debate, with some parties arguing that frequent price changes are necessary to protect access to the retail markets, while other parties urge the need to protect customers from excessive short-term price volatility. The problem with these debates is that both sides have a point, but either position taken to an extreme is wrong. Customers do benefit from price responsiveness in default service, and also benefit from having short-term volatility smoothed by avoiding too-frequent price changes. The key is to find, for each customer class, the point where price-change frequency is "just right" – not too quick, but not too slow. The general market experience is that residential and small commercial customers tend to favor a slower pace of price changes than larger commercial and industrial customers.

3. Market Design That Benefits Customers

Preserving access to the benefits of retail choice needs to remain a main guiding principle behind design of other features of the Pennsylvania market rules going forward. Thus Allegheny Power supports efforts to improve the retail market, such as working groups to refine retail market rules.

Key to making retail choice viable is making sure that default service prices are not set artificially too low, so that (as under current price caps in many areas) the retail

marketers simply cannot match or beat default prices and still stay in business. Default service needs to be priced so as to recover **ALL** the utility's costs of providing the service, plus an appropriate return, the same as retail suppliers must price into their offerings. For Allegheny Power, at least, the first step in that pricing process – allocating the cost of service between generation and transmission/distribution functions – has already been properly accomplished, so there is no need to waste time and resources re-plowing that furrow.

The more difficult issues relate to how (and whether) market design should reflect other policy goals beyond gaining for customers the cost savings and choice flexibility benefits of retail and wholesale electric competition. For example, default service seems to be the wrong tool to use to try to pursue fuel diversity. Rather, that goal is better promoted through statewide and region-wide programs, as Pennsylvania is already working on through renewable portfolio standards, and as PJM has already achieved through its current diverse generation mix. Individualized fuel diversity goals, utility by utility and customer class by customer class, would be a very expensive and inefficient approach to what should be a much more broad-based policy initiative.

Demand response efforts to make more efficient use of energy are also very desirable, as reducing demand also helps put downward pressure on electricity supply prices. Here again, however, default service design is at best a very inefficient and expensive tool to use, and one where the risks of undercutting the wholesale bidding process is a major danger. Demand side initiatives work better on the distribution side of electric service, where they can (and should) be designed to function in a competitively

neutral manner, so that demand-based alternatives offered by retail suppliers have a full opportunity to develop.

Allegheny Power respectfully disagrees with the idea of eliminating demand charges. Such a change seems contrary to the idea of promoting more efficient energy use, and also is out of step with developments in PJM to more accurately price capacity products. Moreover, and not least, the Company believes that eliminating demand charges may result in appreciably higher costs for our customers. At a minimum, more examination is needed before such a change is implemented, and a phased-in approach may be necessary to ease impacts on customers' bills and on utility costs.[8]

Finally, with respect to customer education, the Company supports the Commission's determination that full cost recovery should be provided. Here yet again, however, the issue of how much we are going to **INCREASE** costs to customers in pursuit of marginal benefits in market design needs to be closely considered. Among other things, the cost recovery mechanism(s) employed need to be efficient, and Allegheny Power respectfully suggests that mixing the expenses of statewide and local education campaigns (aimed at all customers, presumably) in with the costs of residential customer assistance programs is neither a fair nor an efficient approach. Moreover,

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[8] Allegheny Power has similar concerns about elimination of declining block rates. This proposed change does at least fit into an effort to improve demand response. However, here again there may be significant cost impacts for customers, and a more deliberate, and perhaps phased in, approach to the topic seems warranted.

Elimination of demand charges and declining block rates raise yet another important customer impact issue – the cost and complexity of modifying utility billing systems to reflect these changes. Other proposals under discussion, such as new metering regimes and cap-related rate deferrals, trigger the same concern. Overhauling utility billing systems is extremely expensive, and thus increases costs for customers. Such an overhaul also takes time, which needs to be factored into both the benefit analysis and the implementation timetable for any change proposal. Finally, making material changes to the complex billing systems risks unintended consequences – including, but by no means limited to, increased billing problems and resulting customer complaints. All these types of costs have to be weighed against the estimated relative benefits of any of these market change ideas.

whichever mechanisms are adopted should provide for automatic reconciliation on a periodic basis (perhaps through an annual true-up mechanism) so as to avoid having to trigger a full-blown rate case every time the campaign parameters or costs change.

4. Providing a Smooth Price Transition

Focusing on costs naturally leads to consideration of energy price mitigation for retail customers. As discussed above, we need to be careful that some of the proposed "cures" for current perceived deficiencies in market design do not make price problems worse for customers. Similarly, we need to avoid the cost deferral trap that has been probably the most vexing problem in the continued evolution of electric restructuring.

Experience in other jurisdictions has confirmed that the original model for restructuring used in most states had one large flaw – long-term price caps to "protect" customers during the transition period. The problem with the price cap approach is three-fold: (1) while default service prices are capped at artificially low levels, retail suppliers cannot compete and so no market transition occurs; (2) demand response efforts are undercut when electricity prices are kept artificially low; and, (3) when the caps expire, the price of default service can suddenly shoot up to levels that customers – particularly residential customers who are financially disadvantaged or on fixed incomes – have great difficulty immediately adjusting to. Thus Allegheny Power applauds the Commission's determination to be proactive in finding a solution to the price cap problem before a crisis arises.

The solution to price caps is **NOT** more price caps. Extending caps just continues the interference with retail market development and conservation, and piles up a bigger

obstacle for customers to face in later years. Recent events in Maryland provide a stark illustration of the latter point. Last summer, when a six-year price cap for residential customers of Baltimore Gas and Electric ("BGE") was about to expire and customers faced a 72% increase (due to wholesale market price increases that had occurred while the cap was in place), the Maryland legislature imposed a further 15% cap on the increase, and told BGE to collect the deferred balance, with carrying charges, over ten years. What will be the consequences of this new price cap be for BGE's residential customers? In return for immediate protection from a short-term price shock, those customers will be paying over-market prices **FOR A DECADE** – for up to ten years starting January 2008, those customers will be paying the normal market rate for power, **PLUS** the amortized deferrals, **PLUS** the carrying costs that the utility incurred in having to borrow money to pay the purchase power costs that customers were able to defer from their rates. In short, price caps lead to higher prices and more pain for customers, harming rather than easing the long-run transition to competitive market access.

The way to avoid rate shock, Allegheny Power respectfully suggests, is through non-by-passable mechanisms that are simple to administer and competitively neutral. One extremely promising such approach is to build a "ramp" over the price cap expiration point, gradually increasing prices both before and after the cap expiration date so that, over a period of time, customers get to – but never have to pay more than – the market price. Allegheny Power recently proposed just such a mechanism in Maryland, where the Company's residential price caps are due to expire at the end of December 2008. Current estimates are that, when the caps expire, Allegheny Power's residential customers in western Maryland could face an increase in a magnitude similar to the 72%

increase experienced by BGE. Allegheny Power's Maryland proposal is that, instead, prices increase by 15% in 2007 and another 15% in 2008. Then, in 2009 and 2010, all the increase collected in 2007 and 2008 – plus all the interest earned on those increased collections – would be credited to customers, thus keeping their increases in 2009 and 2010 at or below 15% per year. By the end of 2010, customers would be at market rates, having worked up to them gradually over four years.

The advantages of this type of ramp-up approach over a cap-and-defer approach are clear-cut: under the Allegheny Power proposal in Maryland, customers **RECEIVE** the benefit of interest earned on the initial increases, instead of having to pay years of interest on deferrals, and the customers **NEVER** have to pay above-market rates because there is no deferral balance that has to be paid down. Also, while Allegheny Power will make absolutely no money on the ramp-up plan, it also does not have to increase borrowings to cover deferrals, thus avoiding possible negative impacts on cost of capital that would drive the price of all facets of utility service up for all customers. The superiority of the ramp-up approach over continued misguided use of price caps can be seen in the fact that every single member of the Western Maryland delegation to the Maryland Legislature has endorsed the Company's ramp-up proposal and sent a letter to the Maryland Public Service Commission urging its prompt adoption. Allegheny Power believes that the same strategy can and should be adopted by the Commission here in Pennsylvania.

Conclusion

The Commission is to be highly commended for the thorough, reasoned, and expeditious attention that it continues to give to the critical issues of electric restructuring transition. Here in Pennsylvania, thanks in large part to the deliberate yet flexible approach that the regulators and the stakeholders have brought to the process of bringing the benefits of retail and wholesale competition to customers, we have an opportunity to avoid some of the missteps and regressions that customers in other jurisdictions have suffered.

In some states, electric restructuring has faltered, especially at the delicate point when long-term rate caps built into the original restructuring design have been about to expire. Voices have been raised to decry restructuring as a failure, and demand a return to complex, command-and-control regulatory schemes that try to re-create, in the new world of multiple markets and numerous market participants, the cost-based ratemaking rubric that only worked (and even then not efficiently) in the old world of vertically integrated utilities. The choice, these advocates of re-regulation claim, is between protecting customers and allowing markets to function.

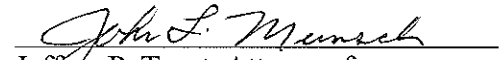
Pennsylvania can and should avoid the huge strategic error posed by this false choice. The reality is that markets and customer protection are not opposites, but rather one and the same – the best way to provide the best prices, and the most advantageous array of services, to customers is through continuing to give them the greatest possible access to retail and wholesale electric competition. The overall policies articulated in the Policy Statement, the Rulemaking, and the Tentative Order all clearly support moving

forward to enhance customers' benefits from retail and wholesale electric markets, and not vainly attempting to retreat to a world that no longer exists.

The issue, therefore, is not whether to move forward with electric competition, but rather what are the best techniques for doing so. In these Comments, Allegheny Power has tried to point out, based on its experience in Pennsylvania and in other states, how this can be accomplished in the context of the issues raised in the Commission's three issuances. In sum, the three most important points are: use standard products to obtain the best prices in the wholesale markets; use the markets and/or distribution service, not default service procurement, to pursue social goals; and forestall rate shock with timely ramp-ups to market, not through costly and counter-productive continuations of price caps. These approaches, Allegheny Power respectfully suggests, will provide the best experience for retail customers as the markets continue to evolve and their benefits continue to grow.

Respectfully submitted,

Date: March 2, 2007

By: 

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