BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

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

REPLY COMMENTS OF THE
OFFICE OF SMALL BUSINESS ADVOCATE
ON THE ADVANCE NOTICE OF FINAL RULEMAKING
AND ON THE PROPOSED POLICY STATEMENT

The Electricity Generation Customer Choice and Competition Act ("Competition Act"), 66 Pa.C.S. Ch. 28, provides that, after the recovery of stranded costs, generation rates are to be determined through market forces rather than through traditional rate base/rate of return/energy clause regulation. To that end, each Electric Distribution Company ("EDC"), or an approved alternative default service provider, is to acquire electric energy "at prevailing market prices" to serve those customers who do not choose an Electric Generation Supplier ("EGS") or whose EGS fails to deliver. *See* Section 2807(e)(3) of the Public Utility Code, 66 Pa.C.S. §2807(e)(3).

Section 2807(e)(2) requires the Pennsylvania Public Utility Commission ("Commission") to promulgate regulations to define the EDC's obligation under Section 2807(e)(3). To assist in the rulemaking process, the Commission convened the Provider of Last Resort ("POLR") Roundtable at Docket No. M-00041792 and sought written and oral comments from interested parties. The Office of Small Business Advocate ("OSBA") provided written comments and reply comments and made an oral presentation as part of the POLR Roundtable.

By Order entered December 16, 2004, the Commission closed the docket at M-00041792 and initiated a proposed rulemaking at Docket No. L-00040169. The proposed rulemaking was published on February 26, 2005, in the *Pennsylvania Bulletin*, at 35 Pa.B. 1421. On April 27, 2005, the OSBA filed initial comments. On June 27, 2005, the OSBA filed reply comments.

By Order entered November 18, 2005, the Commission reopened the public comment period. By Secretarial Letter dated February 8, 2006, the Commission requested interested parties to provide written comments on a specific list of questions and issues as well as on any other issues related to cost recovery under the act of November 30, 2004 (P.L. 1672, No. 213), known as the Alternative Energy Portfolio Standards Act ("AEPS Act"), 73 P.S. §§1648.1-1648.8. On March 8, 2006, the OSBA filed initial comments. On April 7, 2006, the OSBA filed reply comments.

By Order entered February 9, 2007, at Docket No. L-00040169, the Commission issued an Advance Notice of Final Rulemaking and invited comments by March 2, 2007. By a second Order entered February 9, 2007, at Docket No. M-00072009, the Commission issued a Proposed Policy Statement and invited comments by March 2, 2007.[1]

The Advance Notice of Final Rulemaking ("Regulations") and the Proposed Policy Statement ("Policy Statement") are inextricably linked, in that one contains the proposed final form regulations for default service and the other sets forth how the Commission proposes to apply those regulations. Therefore, the OSBA integrated its initial comments on the Regulations and the Policy Statement and filed identical comments at both Docket No. L-00040169 and Docket No. M-00072009.

[1] The Policy Statement was initially issued at Docket No. L-00070183. However, a February 13, 2007, Secretarial Letter advised that the correct Docket No. is M-00072009.

In addition to the OSBA, the following parties filed initial comments at Docket No. L-00040169, Docket No. M-00072009, or both: PV Now, National Energy Marketers Association ("NEM"), PennFuture, UGI Electric ("UGI"), Office of Consumer Advocate ("OCA"), Economic Growth through Competitive Energy Markets Coalition ("CEM"), Duquesne Light Company ("Duquesne"), PPL Electric Company ("PPL"), Richards Energy Group ("Richards"), Allegheny Energy ("Allegheny"), FirstEnergy, Constellation Energy Group ("Constellation"), Hess Corporation ("Hess"), Industrial Energy Consumers of Pennsylvania ("IECPA"), Direct Energy Services ("Direct"), Dominion Retail ("Dominion"), Consolidated Edison Solutions ("ConEd"), US Steel, Energy Association of Pennsylvania ("EAP"), Reliant Energy ("Reliant"), Citizens' Electric and Wellsboro Electric ("Citizens'/Wellsboro"), PPM Energy ("PPM"), PECO Energy ("PECO"), Retail Energy Supply Association ("RESA"), Strategic Energy ("Strategic"), and PSEG Energy Resources & Trade LLC ("PSEG").

The OSBA is filing these reply comments in response to the initial comments of some of the other parties. As with its initial comments, the OSBA is integrating its reply comments at Docket Nos. L-00040169 and M-00072009 and filing those reply comments in identical form at each docket number.

REPLY COMMENTS ON SPECIFIC PROVISIONS

§54.184. Default service provider obligations.
§54.185. Default service programs and periods of service.

Section 54.184(c) requires the default service provider ("DSP") to "continue the . . . energy conservation programs in effect in the EDC's certificated service territory or implement . . . similar programs consistent with the provisions of the . . . Competition Act . . . ." Section 54.185(d)(1) provides that a default service "procurement plan should . . . identify the means of satisfying the minimum portfolio requirements of the Alternative Energy Portfolio Standards Act . . . ."

PennFuture argued that each DSP should be held to a higher standard than proposed by the Commission. First, PennFuture recommended that each DSP be required to provide Energy Efficiency ("EE") and Demand Side Response ("DSR") programs which exceed what the DSP is already providing or will have to begin providing in order to satisfy the Alternative Energy Portfolio Standards Act ("AEPS Act"). PennFuture Regulation Comments, at 1-2, and PennFuture Policy Statement Comments, at 1-2. Second, PennFuture advocated a System Benefits Charge ("SBC") to finance EE projects. PennFuture Regulation Comments, at 3, and PennFuture Policy Statement Comments, at 3-4. Third, PennFuture called for 10% of the DSP's load to be under voluntary real-time pricing by 2010 and for the deployment by 2016 of the advanced metering necessary for all customers to utilize time-of-use pricing. PennFuture Regulation Comments, at 1 and 4, and PennFuture Policy Statement Comments, at 1 and 4. Fourth, PennFuture proposed the implementation of revenue decoupling. PennFuture Regulation Comments, at 1 and 3.

The initiatives proposed by PennFuture are already under consideration in a separate proceeding in which they can receive more intensive analysis than in the default service rulemaking. *See Investigation of Conservation, Energy Efficiency Activities, and Demand Side Response by Energy Utilities and Ratemaking Mechanisms to Promote Such Efforts,* Docket No. M-00061984 (Order entered October 11, 2006). Therefore, it would be premature for the Commission to amend the Regulations and the Policy Statement to incorporate some or all of PennFuture's proposals. However, in the event that the Commission decides not to defer consideration, the OSBA replies specifically to PennFuture's proposals, as follows:

- **EE and DSR in excess of the AEPS Act**

The AEPS Act requires that EDCs and EGSs include a specific percentage of electricity from alternative resources in the generation they sell to Pennsylvania customers. The level of alternative energy required gradually increases, based on a 15-year schedule set forth in the Act. While the Act does not mandate exactly which resources must be utilized and in what quantities, a designated portion must be met from one or more Tier I resources and a designated portion must be met from one or more Tier II resources.

The legislature placed EE and DSR programs in Tier II, along with waste coal, distributed generation systems, large scale hydropower, municipal solid waste, by-products of the pulping process and wood manufacturing process, and integrated combined coal gasification technology.[2] Therefore, the EDCs and EGSs have a choice of any combination of these alternative energy sources to meet their Tier II obligation under the AEPS Act.

The Commission probably has the authority under Section 1505(b) of the Public Utility Code, 66 Pa. C.S. §1505(b), to require EDCs (but not EGSs) to expand their EE and DSR offerings beyond what is needed to comply with the AEPS Act. However, adopting PennFuture's proposal to mandate additional EE and DSR programs would be inconsistent with the AEPS Act. The Act anticipates that an EDC will buy electricity (or alternative energy credits) from alternative energy sources listed in Tier II at competitive prices established in the marketplace. As such, there is no requirement that EDCs favor EE or DSR programs if they can meet their Tier II obligations through more cost-effective options. In contrast, PennFuture's

[2] Section 2 of the AEPS Act includes EE and DSR as subsets of demand side management ("DSM"). An EDC or an EGS presumably will purchase alternative energy credits to reflect the electricity saved through DSM.

proposal would give special status to EE and DSR relative to the other alternative energy sources.

PennFuture has apparently concluded that EDCs will not choose EE and DSR programs to meet their Tier II obligation because electricity from waste coal and municipal solid waste will be available on more reasonable terms and conditions than EE and DSR and, therefore, that EDCs will not implement new EE and DSR programs unless required to do so independently of the AEPS Act. If the Commission agrees with PennFuture that EE and DSR programs should be promoted over the other Tier II sources of alternative energy, then the Commission should ask the legislature to amend the AEPS Act by moving EE and DSR into Tier I. In that way, the market, rather than regulation, would pick the winners and losers from the menu of potential EE and DSR programs.

The Commission should also consider having the EGSs or independent energy management companies offer the EE and DSR programs instead of having the EDCs provide those programs. In the restructured environment, EDCs have an obligation to acquire default service electricity at a price that reflects the prevailing market. The Regulation contemplates that EDCs will fulfill this obligation, in significant part, by conducting a competitive solicitation for supply from wholesale providers. The wholesale providers will base their bids on factors such as how much supply the EDC needs in a “normal” year. A reduction in demand that results from individual customers’ response to a successful EDC-sponsored EE or DSR program will be seen in the wholesale market as a change in the EDC’s aggregate demand. If the EDC is aggressively promoting EE and DSR, wholesale providers may add risk premiums to their bids to account for the chance that the EDC will need less supply due to conservation, thereby undermining the benefits of the EE and DSR programs by increasing the default service rates.

- **System Benefits Charge**

According to PennFuture, the Competition Act provides statutory authority for the Commission to impose an SBC. The OSBA disagrees.

In *Lloyd v. Pennsylvania Public Utility Commission*, 904 A.2d 1010 (Pa. Cmwlth. 2006), *appeals denied*, ___ A.2d ___ (Pa. 2007), the Commonwealth Court upheld the Commission's decision that ratepayer financing of PPL's Sustainable Energy Fund ("SEF") was statutorily permitted. Specifically, the Court pointed to Sections 2802(17) and 2804(9) of the Public Utility Code, 66 Pa. C.S. §§2802(17) and 2804(9), as authority for environmental funding such as SEF.

The Court was not asked to rule on the Commission's decision to phase out SEF funding by the end of 2006. However, based on the Court's deference to the Commission's expertise regarding funding for 2005 and 2006, the Court presumably would similarly have deferred regarding the termination of funding. Therefore, although *Lloyd* recognizes that the Commission may approve environmental funding (with certain limitations), the Commission appears to have considerable latitude in determining if, and in what amount, a specific program should be funded.[3]

Contrary to PennFuture's assertion, *Lloyd* does not mean that the Competition Act gives the Commission the authority to impose an SBC on Small Commercial and Industrial ("Small C&I") customers. Rather, the Court's reliance on Sections 2802(17) and 2804(9) implies a limitation on environmental funding. Specifically, because both sections link "universal service" and "energy conservation," the Competition Act appears to authorize environmental funding *only* when that funding is shown to benefit *low-income* customers.

[3] It is unclear whether, and to what extent, the Commission's discretion has been limited by the AEPS Act. Although the Court acknowledged that that statute provides specific guidelines for SEF funding, the Court noted that the legislation had not been signed into law until after the record in the rate case had closed. *Lloyd*, 904 A.2d at 1026, fn. 27.

The Competition Act defines "universal service and energy conservation" as:

> Policies, protections and services that help *low-income* customers to maintain electric service. The term includes customer assistance programs, termination of service protection and policies and services that help *low-income* customers to reduce or manage energy consumption in a cost-effective manner, such as the low-income usage reduction programs, application of renewable resources and consumer education.

66 Pa. C.S. §2803 (emphasis added).

Thus, by definition, "universal service and energy conservation" programs are intended for low-income customers and *not* for business customers. Furthermore, Section 2804(8) and (9) provide for funding of only those programs which fit within the statutory definition of "universal service and energy conservation." Therefore, Section 2804(8) and (9) do not authorize the Commission to impose an SBC on Small C&I customers.

In addition, Section 2802(17) provides only for "*continuing* universal service and energy conservation policies, protections and services." (emphasis added) Therefore, Section 2802(17) does not require or authorize the expansion of such programs.

Notwithstanding the lack of authority under the Competition Act, Section 1505(b) may authorize the Commission to impose an SBC on all rate classes to fund EE programs. Specifically, Section 1505(b) states in pertinent part that "the commission may order the utility to establish a conservation or load management program that the commission determines to be prudent and cost-effective." Significantly, a program may be approved under Section 1505(b) only if the program is aimed at *energy conservation* or *load management* and only if the program is *prudent* and *cost-effective*.

Once a program has met the test for approval under Section 1505(b), Section 1319(a)(2) of the Public Utility Code, 66 Pa. C.S. §1319(a)(2), allows EDCs "to recover all prudent and reasonable costs associated with the development, management, financing and operation of the program." The costs presumably can be recovered through a surcharge (such as an SBC), but those costs are recoverable "only in accordance with appropriate accounting principles."

In short, Sections 1505(b) and 1319(a)(2) authorize the imposition of an SBC on Small C&I customers only to the extent that doing so would permit the recovery of prudent and reasonable costs for a program which is prudent and cost-effective. PennFuture's proposal does not satisfy either of those statutory requirements. First, PennFuture proposed a $146 million annual revenue stream without providing details about why $146 million is the necessary funding level, how that $146 million would be spent, what entity would make the spending decisions, and the extent to which that spending would benefit Small C&I customers. Second, even if the Commission adopts PennFuture's proposal to impose an SBC to fund EE programs, the SBC should not be applied on a uniform per kWh basis (as advocated by PennFuture) without evidence that Small C&I customers are likely to receive benefits from the SBC in proportion to their usage.

- **Real-Time Pricing**

The deployment of advanced metering would allow DSR programs such as hourly/real-time pricing to be implemented with the intent of helping to conserve energy. However, contrary to PennFuture's assumptions, hourly/real-time pricing would not conserve energy, would not be workable for Small C&I customers, and would be costly to implement.

Before the Commission considers extending an hourly/real-time pricing requirement to Small C&I customers, it should thoroughly research the representation by Duquesne Light Company ("Duquesne") that hourly pricing for its Large Commercial and Industrial ("Large C&I") customers has not significantly changed consumption patterns but, rather, has simply forced those customers to absorb more volatile prices or to purchase fixed-price service from an EGS.[4] In order for real-time pricing to produce significant energy conservation, the Commission must be legally able, and willing, to order EGSs not to supply customers with fixed rates for electricity. Otherwise, it is likely that most customers will simply purchase fixed rate service from EGSs rather than alter their consumption patterns in response to the market signals provided by real-time default service rates.

Even if Small C&I customers do not switch to fixed price service supplied by an EGS, real-time pricing is unlikely to alter their consumption significantly, if at all. For example, a restaurant needs to operate its heat and its air conditioning during the hours it is serving customers, even if that is the period in which market electricity prices are near their highest.

Moreover, real-time pricing would require the installation of time-of-use meters, which Duquesne estimated to cost $235 million for residential and Small C&I ratepayers.[5] Those costs would most likely be placed upon ratepayers and would generally have a larger percentage bill impact on smaller customers. Such a costly expenditure would not be prudent or cost-effective, in that time-of-use metering would not actually produce significant conservation.

The OSBA recognizes that some Small C&I customers may want real-time pricing. Therefore, the OSBA would not object if participation in a DSP-sponsored real-time or time-of-use pricing program were voluntary in nature and if all related program costs were recovered solely from participating customers.

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[4] *Policies to Mitigate Potential Electricity Price Increases*, Docket No. M-00061957, Duquesne Comments, at 3.

[5] *Policies to Mitigate Potential Electricity Price Increases*, Docket No. M-00061957, Duquesne Comments, at 7.

- **Revenue Decoupling**

The Commission lacks the legal authority to approve PennFuture's proposal for revenue decoupling.

Implementing revenue decoupling through a surcharge under Section 1307(a) of the Public Utility Code, 66 Pa. C.S. §1307(a), would interfere with traditional base rate regulation and would constitute single-issue ratemaking. Even though Section 1307 allows exceptions in certain circumstances, there is a general prohibition against single-issue ratemaking. As the Commonwealth Court stated, "Single issue ratemaking is similar to retroactive ratemaking and, in general, is prohibited if it impacts on a matter that is normally considered in a base rate case" except when the utility's costs are extraordinary and nonrecurring.[6]

Revenue decoupling does not fall within the exceptions for non-recurring and extraordinary expenses. Revenue losses sought to be recovered by a decoupling mechanism will be recurring, since PennFuture advocates energy conservation as a long-term policy. Revenue losses sought to be recovered by a decoupling mechanism will also not be extraordinary. A utility cost is considered extraordinary if it is not only "unanticipated but also a substantial, one-time expense or a substantial item that will not appear as a continuing expense and could otherwise never be recovered in rates."[7] That same principle is applicable to the type of revenue losses which revenue decoupling mechanisms seek to enable the utility to recover. As the

[6] *Pennsylvania Industrial Energy Coalition v. Pennsylvania Public Utility Commission*, 653 A.2d 1336, 1350 (Pa. Cmwlth. 1995); *See, e.g., National Fuel Gas Distribution Corp. v. Pennsylvania Public Utility Commission*, 464 A.2d 546, 567 (Pa. Cmwlth. 1983)(holding that the consideration of expense and revenue items in isolation could result in confiscatory rates); *Philadelphia Electric Co. v. Pennsylvania Public Utility Commission*, 93 Pa. Cmwlth. 410, 502 A.2d 722 (Pa. Cmwlth. 1985)(holding that there should be no line-by-line examination of items in a rate case and "an isolated item of revenue or expense may or may not be, without more, the subject of a refund or recovery.")

[7] *Popowsky v. Pennsylvania Public Utility Commission*, 869 A.2d 1144, 1153 (Pa. Cmwlth. 2005).

Commonwealth Court pointed out, "Although cases have not clearly defined the extraordinary exception by example, we know a weather-related expense caused by what is commonly referred to as an 'act of God' is considered extraordinary."[8] The losses sought to be recovered through a revenue decoupling mechanism will not be caused by an "act of God."

Furthermore, revenue decoupling may also be a violation of Section 1301 of the Public Utility Code, 66 Pa. C.S. §1301. Specifically, Section 1301 states in pertinent part that:

> Every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be *just and reasonable*, and in conformity with regulations or orders of the commission.

(emphasis added)

If EDCs were allowed to implement revenue decoupling (thereby reducing the risk to the EDC and reducing the cost of capital), there would be a violation of Section 1301 unless there were also a reduction in the return on equity awarded to the EDC. Unfortunately, PennFuture's proposal is silent on such a reduction.

Although Sections 1505(b) and 1319(a)(2) may provide legal authority for some of PennFuture's proposals, those sections do not authorize revenue decoupling. Specifically, Section 1319(a)(2) allows recovery of conservation-related costs "only in accordance with appropriate accounting principles." Because revenue decoupling would violate the general prohibition on single-issue ratemaking, implementation under Sections 1505(b) and 1319(a)(2) would be inconsistent with appropriate accounting principles. Furthermore, revenue decoupling would be inconsistent with the requirement that costs recoverable under Section 1319(a)(2) be prudent and reasonable, in that PennFuture has failed to provide a means for distinguishing between conservation-related revenue losses and non-conservation-related losses.

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[8] *Popowsky v. Pennsylvania Public Utility Commission*, 642 A.2d 648, 652-653 (Pa. Cmwlth. 1994).

Finally, revenue decoupling would compromise the role played by lower utility bills in encouraging conservation. Specifically, revenue decoupling would make it difficult for consumers to see the full benefit of reducing consumption. As Electricity Consumers Resources Council ("Elcon") Executive Director John Anderson wrote, "The belief that consumers will undertake conservation or energy efficiency efforts without being rewarded with lower bills is somewhere between counterintuitive and ludicrous. If a utility's earnings are held constant and consumption is reduced, that translates into higher rates for consumers. The utility doesn't care how much power it sells, but decoupling dampens the incentive for consumers, large or small, to engage in energy efficiency if such efforts do not result in lower electricity bills."[9]

§54.186. Default service procurement and implementation plans.

The initial comments demonstrate that the parties continue to disagree profoundly about the meaning of "prevailing market prices" in Section 2807(e)(3) and about how to acquire default service electricity in compliance with that statute. Although there are significant differences within each group, the argument appears to have coalesced around three basic positions.

First, the EGSs generally favor short-term contracts, spot market purchases, and time-of-use pricing. In their view, the statute requires that default service rates be set as close as possible to the market price at the time the electricity is consumed.[10]

Second, a cross-section of parties generally favors an auction or Request for Proposals ("RFP") on a statewide basis. Advocates of this approach argue that a coordinated auction or

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[9] *Elcon Paper Criticizes Decoupling for Eliminating Utility Risk*, Greenwire, March 1, 2007.

[10] This group includes ConEd, Direct, Dominion, Hess, NEM, Reliant, RESA, and Strategic.

RFP (with minimal variations from DSP to DSP) will maximize participation by wholesale suppliers, thereby yielding lower rates than a single DSP is likely to obtain on its own.[11]

Third, another cross-section of parties generally favors allowing each DSP to design its own portfolio. The advocates of this approach tend to be skeptical of an auction or RFP, support significant reliance on long-term bilateral contracts, and believe that DSPs can assemble blocks of electricity without paying the risk premiums likely to be added by bidders in an auction or RFP.[12]

For two reasons, the OSBA did not include in its initial comments a full-blown statement of its arguments in favor of a statewide auction or RFP. First, the Commission indicated that comments were to focus on the changes made to the prior draft of default service regulations and were not to revisit issues parties had advocated in prior filings and, in effect, had lost. Regulations, Conclusion at 24. Second, the OSBA concluded that the Commission had reasonably balanced the greatly divergent views of the parties. In that regard, the OSBA was especially encouraged by the Commission's heavy reliance on competitive procurement through auctions or RFPs, the Commission's authorization of (and possible future directive for) coordinated procurement, and the Commission's commitment to procurement by rate class.

In these reply comments, the OSBA will respond to the most significant objections by the other parties to the Regulations and Policy Statement.

[11] This group includes the OSBA, Constellation, Allegheny, First Energy, PPL, and PECO.

[12] This group includes the OCA, IECPA, US Steel, Duquesne, and UGI.

- **The OCA/Duquesne/UGI Model**

In its initial comments, the OSBA agreed with the requirement in Section 54.186(b)(4) that all default service electric generation supply (unless purchased on the spot market) should be acquired through a competitive procurement process. As the OSBA pointed out, *requiring* competitive procurement is the easiest way to assure compliance with the "prevailing market prices" standard in Section 2807(e)(3). OSBA Comments, at 3-4.

The OSBA also recommended either the deletion of the reference in Section 54.186(b)(1) to "long-term costs" or the addition of language clarifying the circumstances under which the "long-term costs" will be relevant to approval or disapproval of a procurement plan. Including "lowest reasonable long-term costs" implies that a plan will have to satisfy two standards rather than one, *i.e.*, it will not only have to meet the statutory requirement by providing for the acquisition of energy "at prevailing market prices" but it will also have to satisfy a non-statutory requirement by providing for the acquisition of energy "at the lowest reasonable long-term costs." OSBA Comments, at 4-5.

In contrast, the OCA, Duquesne, and UGI argued for significant changes in the Regulations. In effect, their comments advocated for what amounts to a "least cost procurement policy," similar to the one which governs the acquisition of natural gas for default service customers.

For example, the OCA embraced the "long-term costs" standard. OCA Comments, at 39-40. The OCA also argued that a DSP should be allowed to acquire energy from a non-affiliated generator without having to engage in an auction or an RFP. OCA Comments, at 12. Consistent with that argument, the OCA proposed to define "competitive procurement process" to include a bilateral contract negotiated at arms length without an auction or an RFP and, apparently, without any requirement that the DSP explore the possibility that a better deal might be available from another wholesale supplier. OCA Comments, at 39, 41, and Appendix A. Furthermore, the OCA proposed to allow long-term contracts for non-alternative energy and to allow contracts to be awarded on the basis of factors other than price. OCA Comments, at 39-40 and 58.[13]

Although the OCA/Duquesne/UGI model might reduce the volatility of default service electric rates, it essentially would substitute regulation for the discipline of the market. Such a substitution is not permitted under the Competition Act as that statute is presently written. Although there are legitimate arguments regarding the point in time at which the default service rate must be the "prevailing market price," rates set without *any* competitive solicitation can not properly be characterized as "prevailing." Furthermore, in approving the Competition Act, the General Assembly declared that "[c]ompetitive market forces are more effective than economic regulation in controlling the cost of generating electricity." *See* Section 2802(5) of the Public Utility Code, 66 Pa. C.S. §2802(5). Finally, adopting the OCA/Duquesne/UGI model would ignore what were perceived in 1996 as the weaknesses of regulation, *e.g.,* with regulation, the "[r]ates for electricity in this Commonwealth [were] on average higher than the national average." *See* Section 2802(4).

According to the OCA, numerous other states are moving away from a competitive procurement model and toward the "least cost procurement" approach advocated by the OCA, Duquesne, and UGI. OCA Comments, at 59. The OSBA shares the OCA's apprehension about the potential "fly-up" to market when the remaining rate caps expire. However, the OCA has presented no evidence that its preferred model would have avoided the rate shock experienced in other states or that the model would result in lower rates in Pennsylvania in the second, third, and

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[13] Both Duquesne and UGI are generally supportive of the positions articulated by the OCA. *See, e.g.,* Duquesne Comments, at 3, 5-6, 8, and 13, and UGI Regulation Comments, at 5-6.

subsequent years after the caps have expired. The real "problem" is that generation rates have been capped for so long that (not surprisingly, in light of fuel price changes) they now lag well behind market prices. Unfortunately, because the EDCs no longer own the generating capacity needed to serve their default service load, there is no apparent way to force the EDCs to provide default service electricity at the (presumed) below-market, embedded costs associated with the plants they used to own.

Without *real* competitive procurement, ratepayers could be charged in excess of the market price at a time when alternative service is unavailable from an EGS. Significantly, however, both Duquesne and UGI argued that reconciliation (and, consequently, prudence review) should not be required. Duquesne Comments, at 25, and UGI Regulation Comments, at 7. Under no circumstances should a DSP be permitted to enter wholesale contracts without competitive bidding *and* without prudence review. Without prudence review, the DSP would be able to pass the costs of such wholesale contracts through to its default service ratepayers even if cheaper alternatives would have been available.[14] Armed with that knowledge, the DSP would have an inadequate incentive to assure that it strikes the best deal possible.

In addition, by allowing each DSP to propose its own unique default service plan in perpetuity, the OCA/Duquesne/UGI model would likely lead to considerable variability in default service rates across the Commonwealth. Such a result would be contrary to one of the goals of the Competition Act. Specifically, the General Assembly concluded that differences in

[14] At a minimum, a DSP should be required to prove that the length of the contract, the location of the generating plant(s), and the type of fuel were prudent. The DSP should also be required to prove that there were no other reasonable alternatives available at a better price or from a more reliable supplier.

generation rates should not be a critical factor in determining the EDC service territory in which a business locates or expands and should not give a business located in one EDC service territory a significant advantage over competitors located in other EDC service territories.[15]

Service from an EGS would be a possible "safety valve" if the OCA/Duquesne/UGI model produced default service rates which were measurably above the market price. However, the availability of such competitive service for residential and Small C&I customers is questionable, at best.

First, the EGSs argued that more, not less, frequent adjustments in default service rates are necessary in order to develop a robust retail market. Therefore, adoption of the OCA/Duquesne/UGI model could mean that few, if any, EGSs would remain in Pennsylvania. Second, even though its default service rates "flew up" to market on January 1, 2007, UGI reported that there are *no* EGSs offering service in the UGI territory. UGI Regulation Comments, at 3. Third, despite the huge rate increase for default service customers of Pike County Light & Power Company on January 1, 2006, the only EGS activity is the result of a Commission-approved "opt-out" aggregation program that drew few bidders. Fourth, although the average Duquesne Small C&I customer with a peak load of 5.1 kW to 25 kW is paying an above-market rate (principally because of the demand charge), fewer than 20 % of the customers in that category are shopping. Whether the reason is the absence of competitive offerings or inertia on the part of the ratepayers, the Duquesne experience suggests that Small C&I ratepayers will likely not have the EGS "safety valve" available if the OCA/Duquesne/UGI model inflates default service rates. Fifth, according to IECPA and US Steel, there may not be enough

[15] The General Assembly approved the Competition Act, in part, because "significant differences exist among the rates of Pennsylvania electric utilities" and because "[t]he cost of electricity is an important factor in decisions made by businesses concerning locating, expanding and retaining facilities in this Commonwealth." *See* 66 Pa.C.S. § 2802(4) and (6), respectively.

competition to prevent EGSs from charging Large C&I customers an above-market rate for fixed price service. IECPA Regulation Comments, at 8-9, and US Steel Regulation Comments, at 5-6. If there is not adequate competition among EGSs to serve Large C&I customers, there is not likely to be adequate competition among EGSs to serve Small C&I customers.

- **Below-Market Rates for Large C&I Customers**

Both IECPA and US Steel supported many of the concepts which are part of the OCA/Duquesne/UGI model. However, IECPA and US Steel also proposed below-market rates for at least some Large C&I customers. Logically, if some customers, or customer classes, are permitted to pay below-market default service rates, other customers, or customer classes, will have to pay above-market rates.

The OSBA emphasizes that nothing in the Competition Act states or implies that the legislature intended that Small C&I customers should subsidize the default service rates of any other customer classes. For example, Section 2802(6) of the Public Utility Code, 66 Pa. C.S. §2802(6), states the legislature's finding that the cost of electricity influences decisions by businesses about where to locate and whether to expand or retain facilities. That finding applies to Small C&I customers and not just to Large C&I customers. Furthermore, Section 2802(7) states that the Competition Act is intended "to benefit all classes of customers." Finally, just as with Large C&I customers, every dollar a Small C&I customer must pay for electricity is a dollar which is not available to expand the business, hire more employees, or increase pay and benefits. With those admonitions in mind, the OSBA replies specifically to the comments of IECPA and US Steel.

First, both IECPA and US Steel proposed that DSPs negotiate default service rates for Large C&I customers under the authority granted by Section 2806(h) of the Public Utility Code, 66 Pa. C.S. §2806(h). IECPA Regulation Comments, at 6; IECPA Policy Statement Comments, at 9; and US Steel Regulation Comments, at 5-6. Presumably, these negotiations would yield below-market rates for some customers. In effect, these favored customers would receive service at a price below the DSP's cost of purchasing the power, thereby creating a revenue shortfall which would have to be made up by other customers. As such, this proposal runs afoul of the Commonwealth Court's decision in *Lloyd*, which specified that cost is the "polestar" criterion for setting utility rates. *See Lloyd*, 904 A.2d at 1020.

Furthermore, this proposal is similar to the default service discount issue decided by the Commission in *Petition of Pennsylvania Power Company for Approval of Interim POLR Supply Plan*, Docket No. P-00052188 (Order entered April 28, 2006). In *Penn Power*, at 89, the Commission agreed with the OSBA that any discounts in default service rates are to be funded within the bid class of customers benefited by the discounts. Therefore, if the Commission adopts the negotiated rate proposal, the Commission should make clear that the resulting discounts must be funded by other Large C&I customers and not by Small C&I customers.

Second, US Steel argued that DSPs should have the discretion not to procure default service electricity by customer class. US Steel Policy Statement Comments, at 3-4. Presumably, US Steel's goal is to achieve default service rates which are below-market and to shift the resulting revenue shortfall onto other customers.[16] In *Penn Power*, at 25-26, the Commission rejected the slice-of-system procurement approach US Steel appears to be advocating and opted, instead, for bidding by rate classes. As the Commission observed in *Penn Power*, at 25, bidding by rate class "would assure that the average [default service] rates for each class would be

[16] Such shifting would be easier for US Steel to accomplish if all customers were to be included in a single bid class.

consistent with the prevailing market prices." In view of its holding in *Penn Power*, the Commission should reject US Steel's proposal.[17]

- **The EGS Model**

Although there are significant differences in the specific proposals of the EGSs, the centerpiece of their position is that default service rates need to change more frequently than proposed by the Commission.[18] Although they do not articulate their strategy in this way, the effect of the EGSs' position is to use customers' distaste for "volatile rates" as an inducement to switch from default service to service from an EGS.

The Competition Act expressly states that "all customers of electric distribution companies . . . shall have the *opportunity* to purchase electricity from their choice of electric generation suppliers." (emphasis added) However, the Competition Act makes clear that "[t]he ultimate choice of the electric generation supplier is to rest with the *consumer*." (emphasis added) *See* 66 Pa.C.S. §2806(a). Nowhere does the Competition Act explicitly or implicitly empower the Commission to influence that choice by making default service rates "as ugly as possible." Instead, the Competition Act requires that electric service be "available to all customers on *reasonable* terms and conditions." (emphasis added) *See* 66 Pa.C.S. §2802(9).

Finally, making default service rates too volatile could exacerbate the rate shock which is anticipated when the remaining rate caps expire.

[17] If US Steel's proposal were approved, it would be necessary to develop a methodology for translating slice-of-system wholesale rates into cost-based retail rates for each class. US Steel neither acknowledged the issue nor proposed a solution.

[18] *See, e.g.*, ConEd Comments, at 2; Direct Comments, at 4-6; Dominion Comments, at 4; Hess Comments, at 4-5; NEM Regulation Comments, at 3; Reliant Comments, at 8-9; RESA Comments, at 2-4; and Strategic Comments, at 2 and 5.

<u>§54.187. Default service rate design and the recovery of reasonable costs.</u>

- **Flat rates**

In its initial comments, the OSBA agreed with the Commission that demand charges and declining block rates are inconsistent with the way DSPs acquire energy in the wholesale market and that they complicate comparison shopping, particularly for Small C&I customers. In addition, the use of demand charges and declining blocks could have the effect of pricing default service to low load factor customers above market and pricing default service to high load factor customers below market (as is already the case in Duquesne). Under that scenario, the low load factor customers will be overpaying for default service but will not be attractive to EGSs, while the high load factor customers will be attractive to EGSs but will have little, if any, incentive to shop. OSBA Comments, at 8-9.

In their initial comments, several other parties also expressed support for ending declining block rates, demand charges, or both. *See, e.g.*, CEM Comments, at 2; Constellation Comments, at 2; Dominion Comments, at 10; Duquesne Comments, at 24; and RESA Comments, at 4. However, numerous parties either defended declining block rates and demand charges or advocated a phase-out rather then a flash-cut elimination. *See, e.g.*, Allegheny Comments, at 11; EAP Comments, at 9-10; FirstEnergy Comments, at 11; IECPA Regulation Comments, at 2 and 9-11, and IECPA Policy Statement Comments, at 2; OCA Comments, at 27 and 68; PECO Comments, at 10-12; and US Steel Regulation Comments, at 7.

The OSBA agrees that a phase-out, rather than a flash-cut elimination, may be appropriate in some cases. However, the OSBA continues to support the Commission's conclusion that declining block rates and demand charges should ultimately be eliminated.

Even if the proponents were able to produce evidence that flat energy rates are not consistent with market prices under some circumstances, that evidence could not justify the perpetuation of the rate design embedded in an EDC's existing generation rates. The declining blocks and demand charges in present tariffs were based on the cost of serving the EDC's load with the power plants owned by the EDC prior to restructuring.[19] If declining blocks, demand charges, or time-of-use charges are to be used in post-cap generation rates, they must be based on the market cost of purchasing the EDC's class load from the universe of suppliers from which the DSP acquires electricity on the wholesale market. Furthermore, under no circumstances would it be lawful to force Small C&I customers to subsidize any revenue shortfall caused by the inclusion of declining blocks or demand charges in the generation rates of residential or Large C&I customers.

Finally, IECPA suggested that eliminating declining block rates could cause problems with the Price To Compare ("PTC"). Specifically, IECPA is concerned that Section 54.187(c) could be construed as prohibiting transmission rates to vary on the basis of both energy and demand. IECPA Regulation Comments, at 15. Such an interpretation would be inconsistent with the Transmission Service Charge design approved by the Commission in the recent Duquesne and MetEd/Penelec transmission and distribution rate cases. The OSBA assumes that Section 54.187(c) was intended to ban declining block rates for the *generation* portion of the PTC and not to require the entire PTC to be calculated strictly on the basis of energy. To avoid confusion, the OSBA recommends that Section 54.187(c) be amended to make clear that the

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[19] It is likely that, in the last rate case for each EDC (either prior to restructuring or as part of the restructuring process), the EDC and one or more other parties proposed separate cost of service studies ("COSSs"). Therefore, the revenue allocation approved by the Commission (and embedded in present rates) probably reflects either a compromise among the competing COSSs or the adoption of a disputed COSS. Furthermore, whatever COSS was adopted, the revenue allocation likely deviated somewhat from that COSS in the name of gradualism.

transmission portion of the PTC is to be calculated, collected, and reconciled in accordance with the EDC's last transmission rate case.[20] Under no circumstances would it be appropriate for the existence of demand-related transmission costs to determine a DSP's generation rate design.

- **Customer Classes**

In its initial comments, the OSBA strongly endorsed the Commission's decision to require procurement by rate classes. As the OSBA pointed out, procurement by rate class is an efficient, market-based method to avoid interclass subsidies. The OSBA also expressed conditional support of Section 54.187(h), wherein the Commission grouped a new small business class (*i.e.,* those with registered peak demand of less than 25 kW) with the residential classes for purposes of procurement. As the OSBA pointed out, the cost to serve the small business customers in this new class is generally similar to the cost to serve the residential classes. However, the OSBA emphasized that its support was based on the assumption that the resulting wholesale price for the entire group (residential and the new small business class) would not be translated into separate retail rates, such that the new small business class subsidizes one or more of the residential classes. OSBA Comments, at 11-12.

Although the OCA does not object to the creation of this new small business class, the OCA recommended that the class be addressed separately from the residential classes in the Regulations. OCA Comments, at 61. Presumably, it is the OCA's position that the new small business class should not be bundled with the residential classes for purposes of procurement. Unfortunately, without such bundling, it is unclear whether the load for this new class would be

[20] There should be an exception in the case of default service plans such as Penn Power's, in which default service electricity is acquired by rate class, the wholesale suppliers are responsible for transmission costs, and the default service rates are not unbundled into generation and transmission components.

large enough to attract wholesale bidders and large enough to be divided between at least two procurements during the year.

In addition, PPL argued that basing this new small business class on registered peak demand would cut across existing rate schedules and might require the transfer of a customer during a default service period if the customer's peak demand were to change. According to PPL, the prospect of such transfers could result in an additional risk premium on wholesale bids.[21] PPL Regulation Comments, at 15-16.

The OSBA continues to believe that there is merit in the Commission's proposal. However, in view of the comments from other parties, the OSBA recommends that the Commission permit, but not require, each DSP to propose whether to create such a class and to propose with which other classes, if any, the new class should be bundled for purposes of procurement.

[21] It appears that PPL's concerns could be substantially mitigated if customers were transferred into, or out of, the new small business class before (but not during) a default service period.

CONCLUSION

The OSBA respectfully requests that the Commission revise the Final Regulations and the Proposed Policy Statement in accordance with the recommendations set forth above and the recommendations set forth in the OSBA's initial comments filed on March 2, 2007.

Respectfully submitted,

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