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. L-00070183

Comments of Strategic Energy

Strategic Energy, LLC (Strategic Energy) submits these comments in response to the Pennsylvania Public Utility Commission's (Commission) Advanced Notice of Final Rulemaking Order (ANOFR) and Proposed Policy Statement Order (Proposed Policy Statement) issued in the above captioned dockets. Strategic Energy is an Electric Generation Supplier (EGS) licensed to provide electricity and related services to customers throughout the Commonwealth of Pennsylvania. Strategic Energy is an active member of the Retail Energy Supply Association (RESA), which has also submitted comments in this proceeding. While Strategic Energy generally supports the positions reflected in RESA's comments, Strategic Energy offers these comments to supplement the RESA comments and to clarify Strategic Energy's individual position on these matters.

I. Introduction

Strategic Energy's comments are grounded on twenty years of experience in energy markets serving over 86,000 customer accounts in eleven states that have enacted retail choice. Strategic Energy has witnessed first hand what policies work and what policies fail in developing retail electric markets that deliver value and benefits to customers. Strategic Energy, either individually or through its trade association, has participated at virtually every step of the way in the Commission's proceedings to establish regulations for default service that will promote an effective retail electric market in Pennsylvania. Strategic Energy is eager for the establishment of sound policies and regulations for a market structure and default service framework that will enable robust and sustainable competition in Pennsylvania. Strategic Energy applauds the Commission for its diligent work in trying to arrive at effective default service regulations while also prudently considering overarching issues such as potential price increases that may be experienced upon the expiration of rate caps. Strategic Energy recognizes and appreciates the Commission's movement towards greater market responsive default service pricing and the Commission's recommendations on retail market issues.[1] These policies clearly signal the Commission's desire to remain on the path toward robust and sustainable competition. However, Strategic Energy respectfully urges the Commission to reconsider certain of its policy recommendations that threaten to negate these positive steps. The long-term portfolio procurement approach and the recommendation that EDCs offer customers the option to defer rate increases are both inconsistent with the intent of the Electric Choice Act that default service rates reflect prevailing market prices and inconsistent with the Commission's policies to promote energy conservation and demand response.

II. The Commission Should Reconsider the Long-Term Portfolio Procurement Approach

[1] Strategic Energy strongly supports the Proposed Policy Statement's recommendations for better information and data access, a Retail Choice Ombudsman, purchase of receivables and customer referral programs, and consistent supplier coordination tariffs. In addition, Strategic Energy supports other provisions of the ANOFR and Proposed Policy Statement as identified in RESA's comments (Section II, "The Commission Has Adopted Measures to Promote Retail Electric Competition and Customer Choice").

Strategic Energy asserts that default service prices based on long-term or laddered-in procurements result in prices that are substantially divorced from prevailing market conditions at the time service is taken and thus cannot meet the prevailing market prices standards of the Electric Choice Act. Strategic Energy recognizes that the Commission has tried to strike a delicate balance in calling for more frequent rate adjustments to provide market responsiveness and a portfolio procurement approach that includes long-term purchases to, presumably, provide a level of price stability for the initial post rate-cap default service programs. While Strategic Energy is encouraged that the Commission sees a path towards workable competitive markets, Strategic Energy has serious concerns that such a procurement approach may represent a roadblock in that path.

The Commission seems to recognize the faults of relying on long-term procurement:

> "An over reliance on long-term contracts would mute demand response, create the potential for future default service customers to bear future above market costs, and limit operational flexibility for DSP's to manage their default service supply."(Proposed Policy Statement at 3,4)

However, the Commission has missed one critical risk involved with long-term default service procurement—that of stifling competition by creating a barrier to market entry from EGSs. The blending effect of laddered procurements, especially if a significant portion of supply is acquired long-term, inevitably results in prices that are inconsistent with the true prevailing market price of electricity. Therefore, competitive suppliers such as Strategic Energy will be reluctant to invest and enter a market where there is significant risk that the benchmark default service rate, which suppliers must compete against, will be out of line with the prevailing market prices that make up a supplier's costs to provide service.

The Commission has expressed a strong aversion to point-in-time pricing,[2] and a preference for more frequent rate adjustments rather than adjusting prices all at once at the end of a default service plan's term of service. Strategic Energy submits that the Commission's adoption of a portfolio procurement approach that relies on long-term procurements suffers from the same failings as point-in-time pricing. Default service prices based on long-term procurements, whether based on a single procurement or a blend of multiple procurements, will skew the resultant price towards the price of the long-term "point-in-time" purchases, no matter how small the percentage of long-term supply. It is also important to note that a reliance on long-term procurements will in no way guarantee lower prices. A recent study conducted by Delmarva Power showed that relying on a long-term procurement would cost ratepayers as much as $5 billion more than procurements made through shorter term wholesale markets.[3]

Presumably, the Commission's preference for requiring some portion of long-term procurements is intended to produce price stability. However, it is clear that price stability was not the primary concern of the Commission because the ANOFR correctly provides for frequent adjustments. It is perplexing that the Commission would risk jeopardizing the path to robust competition for the goal of price stability when price stability clearly is not achieved under a long-term portfolio procurement approach with frequent rate adjustments. Strategic Energy recognizes that this is a compromise

[2] The ANOFR states, "The Commission discourages the practice of procuring all needed supply for a period of service at a single point in time." ANOFR at 4.

[3] http://www.delmarva.com/welcome/news/releases/archives/2007/article.aspx?cid=786

approach, however we respectfully submit that Pennsylvania would be better served by a clearer, unobstructed path toward workable competition.

That path can be paved by default service regulations that are conducive to market entry and provide for sustainable opportunity. A default service pricing structure must provide for default service rates that are not only *responsive* to prevailing market prices, but also accurately *reflective* of prevailing market prices at any given point in time. While default service prices that adjust quarterly and monthly may be market responsive, they fail to be market reflective if skewed by a significant portion of long-term supply. Strategic Energy submits that the clearest path for sustainable competition will provide default service rates that are either based on frequent shorter term procurements not skewed by the laddering or blending of long-term purchases or based on an appropriate market index that is reflective of prevailing market prices. Strategic Energy supports the pricing structure advocated in RESA's comments in this matter, which call for monthly adjusted default service rates for residential and small business customers and hourly priced service for larger customers with no fixed price option.

III. The Long Term Portfolio Approach Should Be Limited and Only Used As a Transition Measure

If the Commission remains committed to the long-term portfolio procurement approach, which Strategic Energy strongly advises against, we support the recommendation of Direct Energy that the long-term procurement approach should only be utilized as a limited transition for the initial post rate-cap default service programs. Strategic Energy supports Direct Energy's recommendation in this matter that a portfolio procurement approach may be appropriate only for *the initial post rate-cap default service program* under the following conditions:

1. Residential and small business customers with peak demand less than 25 kW should have quarterly adjusted rates that reflect a majority of default service supply acquired through quarterly procurements.
2. Medium business customers with peak demand between 25 kW and 500 kW should have default service rates that adjust at least quarterly and most, if not all default service supply is acquired through contracts no longer than three months in duration. The Commission should modify its Policy Statement to clarify that, after the initial default service programs, 100% of default service supply for this segment should be acquired through quarterly of more frequent procurements.
3. Large customers with peak demand greater than 500 kW should have hourly or day ahead default service rates.

This type of transition approach is consistent with basic approach reflected in the Proposed Policy Statement. The current Proposed Policy Statement signals an intention to phase out the use of long-term procurements.[4] Strategic Energy agrees that long-term procurements, if utilized at all, should be phased out, but this should be accomplished as quickly as possible after the conclusion of the first post-rate cap default service programs.

In addition to the recommendations above, Strategic Energy requests that the Policy Statement be modified to more clearly indicate that the use of long-term contracts should be limited. Strategic Energy agrees with the Proposed Policy Statement's pronouncement that long-term contracts should "be restricted to covering a relatively small portion of the default service load."[5] In the Proposed Policy Statement, the Commission states that EDCs should consider establishing default service rates for small customers with peak demand less than 25 kW by "procuring most fixed-term supply

[4] § 69.1805 of the Proposed Policy Statement states: "In subsequent programs, the percentage of supply acquired through shorter duration full requirements contracts and spot market purchases should be gradually increased…"

[5] Proposed Policy Statement at 3.

through full requirements contracts of one to three years in duration."[6] However, the ANOFR contains a provision at § 54.186(3) that would permit contracts whose duration extends beyond the default service program period. The Commission states in its Proposed Policy Statement that initial default service program periods should be for two to three year terms and subsequent programs should be for two years terms. The Commission's regulations and policy guidance appear inconsistent, because, the ANOFR would permit contracts longer than the two or three-year default service program term, while the Proposed Policy Statement recommends limiting contracts to at most three years in length. Strategic Energy urges the Commission to eliminate § 54.186(3) of the ANOFR that permits contracts with durations that extend beyond the default service program period and the Commission should clarify in its Policy Statement that long-term contracts used in the initial default service programs should be at most three-years in length.[7] Since the use of long-term contracts should only be used in the initial default service programs, subsequent plans should immediately phase out the use of long-term contracts.

Strategic Energy submits that there is already sufficient evidence to demonstrate the effectiveness and appropriateness of hourly pricing for large business customers, and thus, hourly pricing without a fixed price option is the most appropriate rate structure for these customers. In the Duquesne Light Company service territory, where hourly priced service has been instituted for large customers, 96 percent of those customers have

[6] § 69.1805 (1)

[7] This recommendation is consistent with the recommendation of IRRC that "only a limited portion of the energy purchased [for default service supply] be for a term of service greater than 12 months and that the term of service be no longer than 36 months."

switched to competitive suppliers. Furthermore, Strategic Energy asserts that the Commission clarify that hourly pricing should remain in effect for EDCs, such as Duquesne Light Company, that have already implemented hourly pricing. The Commission should clarify that the ANOFR's mandate that large business customer rates adjust at minimum monthly, should not be viewed as reason to turn back the clock on a pricing structure that has very successfully stimulated competition in the Duquesne Light Company service territory.

IV. Reconciliation

Strategic Energy urges the Commission to reconsider its recommendations in the ANOFR and Proposed Policy Statement that default service providers utilize an adjustment clause to reconcile default service costs. The Commission has recognized that the reconciliation process used in the gas industry creates a barrier to competition: "the manner in which the PTC was formulated and is adjusted to correct over- or undercollections [ ] constitutes a barrier to supplier participation in the retail gas market."[8] Furthermore, one of the primary goals of electric restructuring and the transition to competitive markets was to shift risks away from ratepayers. Requiring EDCs to procure default service through a portfolio of purchases including long-term procurements, while simultaneously guaranteeing default service cost recovery through reconciliation, essentially saddles ratepayers with the same type of risk that existed under inefficient cost-based regulation. If the Commission eliminates the long-term portfolio

[8] Docket No. I-00040103, *Report to the General Assembly on Competition in Pennsylvania's Retail Natural Gas Supply Market*, October 2005, p. 61.

procurement approach, reconciliation should not be necessary, because EDCs would be able to accurately set rates based on the results of the individual auctions or solicitations.

V. Retail Choice Improvements

As noted earlier, Strategic Energy strongly supports the Commission's recommendations for improvements to competitive retail markets at § 69.1812-69.1817 of the Proposed Policy Statement. Better information and data access, consistent billing options, purchase of receivables and customer referral programs, consistent supplier tariffs and the establishment of a retail choice ombudsman will all serve to help develop the competitive market in Pennsylvania. Strategic Energy respectfully recommends that the Commission go a step further and affirmatively state that the public interest will be served by requiring rate ready billing, purchase of receivables and customer referral programs for each major Pennsylvania EDC.[9] Currently, the Proposed Policy Statement only provides for the consideration of such programs. Similar programs have proven successful in stimulating competition in other jurisdictions, especially in New York. Furthermore, Strategic Energy asserts that purchase of receivables and customer referral programs are useful tools in promoting retail competition for not only residential customers, but small business customers as well. Therefore, Strategic Energy supports making these programs available to small business customers in each of the major EDCs.

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[9] Strategic Energy recognizes that the relatively small amount of load in some EDCs may make such programs uneconomic to implement. Therefore, Strategic Energy recommends that these programs only be required for the major Pennsylvania EDCs, including Duquesne Light Company, Allegheny Power, Pennsylvania Power and Light Company, Philadelphia Electric Company, and the First Energy companies (Penn Power, Metropolitan Edison, and Penelec).

VI. Default Service Provider

Strategic Energy supports the provisions in the ANOFR that allow for the assignment of the default service obligation to an alternative entity other than the EDC. Strategic Energy also supports the change to § 54.181 to clarify that an alternative default service provider, such as an EGS, will also be entitled to full recovery of reasonable default service costs. However, Strategic Energy asserts that the EDCs should eventually exit the role as default service provider to complete the transition to a fully competitive retail market. Strategic Energy recognizes that maintaining the EDCs' default service obligation may be an appropriate starting point provided that the Commission's regulations and policies envision the transition of the default service obligation to appropriate qualified competitive EGSs that wish to assume this obligation. Strategic Energy respectfully submits that the ANOFR and Policy Statement should be modified to effectuate this transition. First, Strategic Energy submits that the Commission should include in its Policy Statement a recognition that the ultimate "end-state" for retail competition will be a world in which the EDC no longer provides default generation service and all customers actively shop for generation supply as they do for other goods and services. Next, the Commission should consider modifying its regulations to provide greater flexibility to EGSs that wish to assume the role of default service provider. For example, § 54.183 provides for a process where the default service provider may be changed in certain circumstances, but the provision assumes that there must be only one default service provider in a given service territory. Strategic Energy asserts that if there is more than one qualified petitioner that wishes to assume the role of default service provider, then the Commission should apportion the default service load obligation to each qualified petitioner on an equal basis, or divide the default service load obligation in some other manner agreed to by the qualified petitioners. Furthermore, § 54.183 assumes that an alternative default service provider must assume an EDC's entire default service obligation. Strategic Energy submits that a petitioner should be allowed to petition the Commission to assume only a portion of an EDC's default service obligation. For example, an EGS that serves only commercial and industrial customers should be allowed to assume the default service obligation for just those market segments. Both of these requested modifications are consistent with the approach taken in Texas where there may be more than one provider of last resort for a given service territory and a competitive supplier may volunteer to become a provider of last resort for a specific market segment (such as residential, small non-residential, medium non-residential, or large non-residential). These modifications would help encourage competitive suppliers to assume the role of default service provider.

VII. Bilateral Contracts

Strategic Energy supports the Commission's decision to limit the use of bilateral contracts for default service procurement to contingency situations, such as in the event of supplier default. As the Commission correctly recognizes, competitive solicitations and spot market energy purchases are more consistent with the intent of the Electric Choice Act.

VIII. Cross-Subsidization

Strategic Energy strongly supports the ANOFR and Proposed Policy Statement's requirement that all default service costs be included in default service rates and not EDC distribution rates. This will prevent EDCs from cross subsidizing default service costs through non-bypassable distribution rates. Strategic Energy recommends that the Commission also seek to prevent, through a stricter Code of Conduct requirement, the cross-subsidization of EDC affiliated EGSs. In some service territories, the EDC affiliate EGS has obtained substantial market share with relatively few independent employees and resources. Strategic Energy is concerned that EGSs marketing in their affiliated EDCs' service territories may operate at a competitive advantage to other EGSs without proper competitive safeguards in place to prevent cross subsidization. Strategic Energy asserts that the Commission should require competitive safeguards to provide the necessary functional or structural separation to prevent EDCs from directly or indirectly cross-subsidizing or conveying services or benefits at below fair market value to affiliate EGSs marketing in their respective service territories. Strategic Energy recommends that the Commission establish a proceeding or to consider stricter Code of Conduct requirements to prevent such anticompetitive cross-subsidization or abuse of affiliate relationships.

IX. Price Mitigation

Strategic Energy is aware of the Commission's Tentative Order on Price Mitigation issued February 8, 2007, and we applaud the Commission for its focus on consumer education in that order. Strategic Energy is encouraged that the Commission has not mandated a prescriptive price mitigation mechanism such as a rate freeze or requiring that rate increases be phased-in. The Proposed Policy Statement recommends that default service providers offer rate mitigation options to residential and small business customers if total retail rates under a default service program increase by more than 25 percent following the expiration of the EDC's rate cap. The Proposed Policy Statement recommends that these customers be allowed to pre-pay or defer some portion of the increase. Strategic Energy strongly urges the Commission to reconsider its recommendation for rate deferral options. Deferring rate increases will distort price signals and separate customers from the true cost of electricity, which will impede the development of a competitive market and dampen conservation and demand response. Strategic Energy submits that the Commission should focus its price mitigation policies on educating customers about anticipated rate increases and encouraging customers to pre-pay these increases before rate-caps expire.

X. Conclusion

Again, Strategic Energy applauds the Commission for its work in addressing these difficult issues. It is evident that the Commission has carefully considered an array of diverse viewpoints. Strategic Energy is encouraged by the Commission's movement towards market responsive pricing and its recommendations to stimulate retail competition. While Strategic Energy is gravely concerned that the long-term portfolio procurement approach will be a significant barrier to the development of competition in Pennsylvania, we offer the aforementioned recommendations to help clear the path towards robust and sustainable retail markets which will deliver choices and value to all of Pennsylvania's electricity consumers.

Respectfully submitted,

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