

**PENNSYLVANIA PUBLIC UTILITY COMMISSION
HARRISBURG, PENNSYLVANIA 17105**

**POLICIES TO MITIGATE
POTENTIAL ELECTRICITY
PRICE INCREASES**

**Public Meeting May 19, 2006
MAY-2006-C-0012**

**MOTION OF
COMMISSIONER TERRANCE J. FITZPATRICK**

Recent events in Pennsylvania, Maryland, and Delaware have shown that consumers of electricity can be exposed to sudden, dramatic price increases when long-term generation price caps, mandated or agreed upon as part of various state restructuring proceedings, expire. Here in Pennsylvania, the 4,400 customers of Pike County Light and Power Co. ("Pike") experienced an increase of over 70% in their total electric bill at the beginning of 2006. In Delaware, Delmarva Power Co. ("Delmarva") increased rates for residential customers by 59% effective May 1, 2006. In Maryland, residential customers of Baltimore Gas & Electric Co. ("BG & E") will face a 72% increase in their electric bills on July 1, 2006. Sudden price increases of this magnitude produce what is referred to as "price shock," making it very difficult for customers to adjust their budgets and their usage.

The extent to which customers will pay more for electricity following expiration of generation rate caps depends upon two primary factors: 1) the historic level of their utility's regulated rates, which formed the basis for capped rates at the beginning of electric restructuring, and 2) the level of wholesale energy prices¹ at the time the rate caps expire. Both factors are important.² With regard to the first factor, it is somewhat ironic that customers of utilities with high rates dating back to the period before restructuring are the least likely to suffer price shock. This is so because these customers have been paying higher prices for electricity all along. Regarding the second factor, timing is important because wholesale energy prices are volatile.³

¹ For purposes of this Motion, the term "wholesale energy prices" includes prices for related services such as capacity and ancillary services.

² Another factor that can impact these prices is the process in which a provider-of-last-resort (POLR) acquires electricity supply for non-shopping customers. This issue is being addressed in the rulemaking proceeding at L-00040169.

³ The possibility of differing outcomes when rate caps expire is illustrated by comparing the experience of Pike with that of Duquesne Light Co. ("Duquesne"). Historically, Duquesne's residential rates were very high—reflecting its investment in nuclear generating plants and the declining fortunes of the steel industry. Also, Duquesne's generation rate caps expired a few years ago, and Duquesne procured energy when wholesale prices were lower. As a result, Duquesne's customers now pay roughly 15% less for electricity service than they did when rates were capped—this result contrasts sharply with the 70% increase in the rates of Pike.

In all three of the examples listed above, regulators or elected officials took some steps to alleviate the burden on customers. In the case of Pike, this Commission approved an aggregation process that will bring modest savings to customers compared to the default service rates charged by the utilities, and the Commission is continuing to investigate other alternatives. In the Maryland and Delaware examples, customers will be given the opportunity to choose a phase-in of the price increases. Under these phase-in plans, the utilities will defer part of the retail price increase for two years and borrow money to cover the difference between what they collect in retail rates and what they must pay wholesale suppliers. In both cases, it does not appear that the utilities will be permitted, at least initially, to recover from customers the interest charges that the utilities will incur to borrow the money.

We should learn from these experiences of large, sudden price increases. We should begin now to develop policies to mitigate the social and economic harm that these price increases could cause.

Most consumers of electricity in Pennsylvania will continue to pay capped generation charges until the end of 2009 or 2010.⁴ While we cannot predict with certainty the future course of energy prices, a number of factors--including escalating demand, increased generator fuel prices,⁵ and more stringent environmental requirements--are currently pushing up prices for all forms of energy. By beginning to prepare now, it is clear that we will have many more tools to combat the social and economic impacts of a significant increase in electricity prices.

In order to begin the process of developing policies to mitigate higher electricity prices, I move that the Commission conduct an *en banc* hearing on June 22, 2006, on this issue. The purpose of the hearing will be to consider the ideas and perspectives of interested parties--consumers, competitive suppliers, utilities, and others. Interested parties should electronically file comments by June 15, 2006. This information could serve as a basis for appropriate actions by the Commission.

While this list is not intended to be exhaustive, the following ideas for combating sharp price increases should be addressed by those who participate in the hearing.

⁴ The generation rate cap of PPL Electric Utilities Corp. expires at the end of 2009. The generation rate caps of PECO Energy Co., West Penn Power Co., Metropolitan Edison Co., and Pennsylvania Electric Co. are due to expire at the end of 2010, although Met Ed and Penelec, which are wholly-owned subsidiaries of First Energy Co., have recently initiated a proceeding in which they contend that circumstances exist which entitle them to raise rates before 2010. Combined, these five companies provide electricity to over 4.7 million customers in Pennsylvania.

⁵ According to the EIA, monthly natural gas prices at Henry Hub have increased from \$3.39/Mcf in January 1997 to \$7.18/Mcf in April 2006 (112% increase); Delivered natural gas prices to Pennsylvania city gates has increased from \$4.24/Mcf in December 1996 to \$10.72/Mcf in February 2006 (152% increase); Distillate (#2) oil prices used in combustion turbines in the New York region have increased from 72.808 cents/gal in December 1996 to 210.800 cents/gal in April 2006 (190% increase); Residual fuel prices (NY Harbor, 1% sulfur #6) has increased 52.22 cents/gal in December 1996 to 121.57 cents/gal in April 2006 (133% increase); Average delivered to utility plant coal prices in Pennsylvania, including long-term coal contracts, have increased from \$1.38/mmbtu in 1996 to \$1.58/mmbtu in 2005 (14.5%); Current Northern Appalachian coal spot prices, according to Coal News and Markets Report, have increased from \$22.50 per ton in July 2000 to \$42.00 per ton in May 2006 (87% increase).

1. Educate Consumers

A large part of the problem in the three examples of price shock cited above was that customers were not given sufficient advance notice of the possibility of higher electricity prices so that they could make gradual adjustments in their budgeting and their electricity usage. A consumer education program initiated well in advance of the expiration of the rate caps could help to remedy this.

A component of this education program could be to inform customers on a regular basis of the level of wholesale energy prices, and how their electricity bills would be affected if these prices prevailed at the time the generation rate cap expired. The staff of the Commission recently began to conduct this analysis, and in the future the results of this analysis could be made public.

2. Encourage Conservation

Encouraging and enabling customers to use electricity more efficiently would be a key strategy for helping customers to cope with higher electricity prices. Education regarding conservation could be one component of the consumer education effort. The Commission also welcomes comments on how pricing signals or changes in rate design can be implemented that would more effectively encourage conservation by electricity consumers. In addition, attention should be given to funding levels and other policies related to the Low Income Usage Reduction Programs (“LIURP”) administered by the utilities. More far-reaching policies could also be considered that would entail communication between the Commission and the General Assembly.

3. Reduce Peak Demand for Electricity

Policies that reduce demand for electricity during peak usage periods—usually hot summer afternoons—would help to reduce price spikes in the wholesale energy market, and to reduce overall energy prices.⁶ One of the biggest problems facing wholesale markets is the fact that consumers do not have a sufficient financial incentive to reduce demand as wholesale prices rise during peak usage periods. As the U.S. Department of Energy recognized in a report to Congress earlier this year, the main reason for this lack of “demand response” is the fact that the great majority of consumers pay prices that are averaged over the entire year.⁷

Among the strategies that could be considered to encourage demand response are adopting hourly pricing as the default service rate for large customers; establishing default service rates for customers that vary from season-to-season,

⁶ Currently, the Mid-Atlantic Distributed Resources Initiative and PJM are in the initial stages of undertaking a valuable research project to quantify the potential effects that demand response may have on the Mid-Atlantic region’s wholesale market efficiency and prices.

⁷ *Benefits of Demand Response in Electricity Markets and Recommendations for Achieving Them*, pages v-vii, U.S. Department of Energy (February 2006).

month-to-month, or even time-of-day; and encouraging or requiring installation of technologies such as thermostats that automatically reduce a customer's usage during peak periods.

In order to achieve some of these pricing strategies, it may be necessary to examine infrastructure changes to implement advanced meter technologies that allow more concurrent measurement of electricity usage, and the ability of consumers, utilities and other market participants to access this time-of-use information. The Commission is interested in comments on the economic, operational and reliability benefits and costs of such a system, and whether it is appropriate for utilities, at a minimum, to address such infrastructure changes in any rate case filing.

4. Consider Alternatives for Avoiding Abrupt, Large Price Increases

One way to avoid sudden, abrupt retail price increases is to phase-in higher energy costs over a period of a few years. In the Delaware and Maryland examples discussed above, attempts to mitigate the impact of abrupt price increases took the form of allowing customers to choose a phase-in plan under which they would initially pay a retail price that reflected only part of the increase in wholesale prices, and they would make up the difference in later years by paying higher retail prices. This approach requires utilities to recover less than the full cost of energy in the early years, so they must borrow money to cover the temporary shortfall.

This approach of phasing-in higher energy prices by deferring costs has disadvantages for both utilities and customers. It may affect the credit rating of the utility because of uncertainty whether regulators will allow the utility to collect the deferred costs and interest. The utility's increased cost of borrowing puts further pressure on the utility to raise rates or to decrease spending on other activities, such as maintaining its infrastructure. In addition, if the deferral period extends beyond the timeframe of the energy purchases of the utility, then recovery of these deferred costs creates a greater risk of price shock in this future period.

While far from ideal, coupling a phase-in with a deferral of energy costs was one of the few options available for easing price shock in the Delaware and BG & E cases, because the expiration of the rate caps was already upon them. In most areas of Pennsylvania, the rate caps are scheduled to remain in effect for another three to four years, which may allow for consideration of other creative approaches to gradually, instead of abruptly, raise retail prices. For example, if a utility reasonably anticipates that, given its current rate levels and current wholesale prices, its customers will face a steep increase in retail prices when the generation rate caps expire, the utility may propose to begin to gradually move its retail prices toward market price levels prior to expiration of the rate caps. The additional money collected through implementation of this "early phase-in" plan, plus interest, could be used to reduce the magnitude of retail price increases when the rate caps expire.

An “early phase-in” has the disadvantage of requiring customers to begin to pay higher prices at an earlier date, but it avoids the negative financial consequences and risks resulting from a phase-in with a deferral of costs. The Commission is open to and welcomes comments on both of these phase-in plans, as well as any other creative alternatives offered by interested parties that would avoid future significant price increases.

5. Review Issues Concerning Programs to Assist Low-Income Customers

Under the Competition Act, electric utilities are required to offer universal service and energy conservation programs to make electricity service more affordable for low-income customers.⁸ The Act provides that these programs shall be “available” and “appropriately funded.”⁹ Also, utilities have a right to “fully recover” the costs from customers.¹⁰

As electricity costs increase, the adequacy of universal service and energy conservation programs must be evaluated. In making this evaluation, the Commission must consider the interests of both the beneficiaries of these programs and those who pay for them. This is a particular concern with regard to customers of modest means who are not beneficiaries of these programs. The information provided to the Commission on this issue could provide a basis for the Commission to communicate with the General Assembly regarding supplemental LIHEAP funding or other forms of assistance for low-income customers.

6. Review Interplay with the Wholesale Energy Markets

Retail competitive electric markets are inextricably linked to our wholesale energy markets and the recent events further highlight this fact. Unquestionably, the prices established in the auctions and the requests for proposals are significantly influenced by the prevailing wholesale prices at the time the competitive processes are held. Due to the nexus between the retail and wholesale electricity markets, a review of the current wholesale electricity market structure and its interplay with our retail market is also in order.

CONCLUSION

Combating potentially significant electricity price increases at the expiration of rate caps approved under electricity restructuring proceedings presents difficult policy choices. However, these choices will not get easier by waiting until the reality of higher prices is upon us. Pennsylvania is in the position of having some additional time to address this important issue for most consumers. By beginning now, this Commission can best fulfill its duty to protect the public interest.

⁸ 66 Pa. C.S. §2804(9), 66 Pa. C.S. §2803 (definition of “universal service and energy conservation”).

⁹ 66 Pa. C.S. §2804(9).

¹⁰ 66 Pa. C.S. §2804(8).

THEREFORE, I MOVE THAT:

1. The Commission hold an *en banc* hearing on June 22, 2006, on policies to mitigate potential electricity price increases, and interested parties should electronically file comments by June 15, 2006.
2. The Law Bureau prepare an Order consistent with this Motion.

DATE: May 19, 2006

**TERRANCE J. FITZPATRICK
COMMISSIONER**