Commonwealth of Pennsylvania
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Consumer Affairs Committee

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Chairman Preston, Chairman Godshall and members of the Committee, my name is Lisa Crutchfield, and I am Senior Vice President of Regulatory and External Affairs for PECO Energy Company. Thank you for the opportunity to appear today and offer comments on House Bills 2200 and 2201. The energy issues addressed in these bills are of importance to our Company, our customers and the Commonwealth.

PECO, headquartered in Philadelphia, is the largest electric and gas utility in Pennsylvania, serving 1.6 million electric customers in Philadelphia, Montgomery, Bucks, Delaware and Chester Counties and 480,000 natural gas customers in the four counties surrounding Philadelphia. PECO employs over 2,100 people, and over the past 5 years, we have invested over $1.2 billion in operating expenses and infrastructure improvements. We are focused on operational excellence and providing our customers reliable electric service, and PECO is one of the safest utilities in the country. We are proud of the long-standing commitment to the communities we serve in southeastern Pennsylvania and are proud of the economic-development efforts and the community involvement of our company and employees.

Electric Markets in Pennsylvania

Benefits of Competition and Restructuring. Pennsylvania has been a leader in the nation by providing the benefits of electric competition to consumers. With the passage of the Electric Generation and Customer Choice and Competition Act in 1996, the General Assembly provided retail customers the right to choose which company supplies their electric generation.

Wholesale and retail competition has produced substantial benefits for Pennsylvanians. In addition to providing customers choice, competition has dramatically improved the operating performance and reduced the operating costs of generating units. Competition also has incented new generation, including alternative energy resources – in fact, over 8000 MWs of generation have been added in Pennsylvania since 1988 (a 23% increase in capacity).

Perhaps most significantly, restructuring shifted the risks of construction, operation and ownership of generation from consumers to investors.

As part of the transition to fully competitive retail markets, the electric utilities in Pennsylvania agreed to company specific restructuring settlements that reduced rates and capped them for varying terms. As a consequence of its settlement, PECO wrote off over $3 billion in above-market generation costs. While six utilities' rate caps already have expired and their customers are now paying market prices for power, PECO's and several other utilities' generation rates remain capped through 2010.

Pennsylvanians have benefited greatly from restructuring and capped rates. When adjusted for inflation, customers are paying 12% **less** for power than they paid in 1996. PECO has not had a general rate case since 1990. So, when generation rate caps expire in 2011, PECO's customers will have enjoyed over 20 years of rate stability.

Completing the Transition. PECO and other Pennsylvania utilities, however, cannot continue indefinitely to serve customers at capped rates. Rather, as envisioned by the 1996 Restructuring Act, utilities must eventually buy power at competitive market prices and charge customers accordingly. Electric prices, however, have gone up since 1996, when prices were first capped. Several factors, including escalating fuel costs, increasing material and labor costs, higher costs to build new generation, and new environmental regulation, are driving prices upward.

So, the challenge before us is how to bring electric prices in Pennsylvania to market levels without too much disruption.

PECO Supports Comprehensive Energy Legislation

PECO commends the General Assembly and the Administration for your leadership in developing a comprehensive package of legislation that will provide a framework for the transition to market pricing and, simultaneously, promote energy policy that protects the environment in Pennsylvania. We embrace the fundamental public policy position that customers want reliable service at reasonable prices, and the ability to budget for projected price increases. Consumers also want to protect the environment, and they look to their local electric utilities to provide assistance in conserving power and managing their energy usage and costs.

Electric utilities are committed to: (1) preserving competitive markets, because markets provide the best vehicle to procure reasonably priced power for customers, (2) recovering the full costs we incur to serve customers, and (3) assisting customers in managing their energy consumption as we transition to competitive market prices.

PECO believes House Bills 2200 and 2201 address these customer and utility interests by providing for (1) competitive procurement of power, (2) phasing-in rate increases, and (3) aggressive energy-efficiency and demand-response measures. The Bills, however, do not fully promote competitive markets or provide for full cost recovery. Nor do the bills envision utilities providing energy-efficiency and demand-response programs to their customers. For these reasons, PECO cannot support the Bills as written.

We respectfully offer, however, suggested language changes below, to amend the Bills so that they can preserve and promote competitive markets, provide for recovery of costs incurred, and allow utilities to provide conservation measures to their customers. We urge the Committee to consider our proposed changes and encourage the enactment of comprehensive energy legislation.

Procurement

H.B. 2201 provides for competitive procurement of power – through auctions, requests-for-proposals (RFPs) or bilateral contracts – utilizing a mix of long-term, short-term and spot-market purchases. PECO supports the use of competitive-procurement methods to ensure that customers receive the lowest prices for power. Staggered procurement and the use of contracts of varying lengths will appropriately hedge consumer risk and smooth price changes. Head-to-head competition, through open, transparent bidding, also will benefit from the existing competitive wholesale markets for power, thereby lowering costs.

Long-Term Contracts. PECO is concerned, however, that H.B. 2201 promotes an over-reliance on long-term contracts for the procurement of power. The Bill sets a 20%-of-customer-load limit on the use of contracts with a duration of 5 to 20 years, then the Bill virtually eliminates that limit by providing that the Public Utility Commission with the authority to "waive" the 20% limit by finding that the waiver would contribute to lowest cost service to customers (a standard that the Commission is obligated to pursue for all power purchases).

Reliance on long-term contracts carries several risks to consumers and utilities all driven by the fact that prices under such contracts, over time, will be out of line with then-current market prices:

- First, if the contract price is above market prices, customers will flee to lower-priced retail marketers, charging then-current competitive market prices. The above-market long-term contract costs the utility must pass on to customers will then have to be borne by the remaining customers, driving their costs even higher and, in turn, providing even greater incentive for them to abandon the utility serving as the default service provider.

- If the long-term contract price is above the market prices, then the utility risks a regulatory pressure to disallow recovery of the long term contract, notwithstanding the existence of statutory cost-recovery provisions.
- Further, if the above-market costs of long-term contracts are not recoverable from default service customers, they become "stranded" costs, which would then have to be recovered from all customers (whether shopping or not). Met-Ed is recovering tens of millions of dollars in such stranded costs for "QF" contracts it was required to enter into (and many utilities in New York, New England and California faced billions in stranded costs under long-term above-market contracts).
- If the long-term contract price is above market, the default supplier could face huge "mark-to-market" collateral requirements, if the contract includes bilateral credit requirements. Such requirements could significantly increase the utility's costs, and consequently the customers' costs.
- Conversely, if the long-term contract price is below then-current market prices, there is an increased possibility that the supplier will default on the contract. This exact situation occurred recently when Mirant declared bankruptcy and sought to avoid selling power to Pepco under contracts that turned out to have prices tens of millions of dollars below market. Thus, long-term contracts present asymmetrical risk – when contract prices are above market, utilities must honor and pay under the contract, but if contract prices are below the market, then suppliers (who typically establish separate corporate subsidiaries for each generating unit) can seek to void the contracts in bankruptcy and sell the power at market.
- Finally, if contract prices supporting default service are below market prices, retail competition is stifled.

The risk of long-term contract prices diverging from market prices is real. It is especially apparent when you realize that a $1/MMBtu change in natural gas prices can result in a 7-9% change in electric energy prices and in the past 5 years, we've seen gas prices in a range of $4/MMBtu (from $5/MMBtu to $9/MMBtu). PECO calculated the value of this risk assuming we entered into a long term contract for 10 years for 20% of the mass load and natural gas prices moved by $3/MMBtu yielding an $18/MWH price movement for power. PECO and our default service customers could be responsible for over $700 million in stranded costs due to this long term contract.

The difference between long term contract prices and market prices may further increase due to changes in load growth, retiring old generation plants or adding new plants, transmission constraints, outages, environmental regulation an other factors. It is also important to note that even a 5% difference between the utility prices built on long-term contracts and market can spur customers to shop.

Moreover, there is no evidence that long-term contracts will be cheaper than buying under shorter-term arrangements. In fact, the contracts may be more expensive, as suppliers struggle to predict many uncertain cost factors over a long time horizon (most notably, environmental regulation and fuel prices).

PECO is not opposed to purchasing power under long-term contracts for some reasonable portion of the load it serves. But, given the large risks, the amount should be limited and should be at the utilities' discretion, not at the direction of the PUC. Keep in mind, with respect to limits on long-term contracts, that a contract to purchase only 5% of the load for 20 years is equivalent in volume to a purchase of 100% of the load for a year – in either case a multi-billion dollar commitment.

Purchases from Designated Generation Sources. PECO also is concerned that, H.B. 2201 as written, may require utilities to purchase from certain generators favored by the PUC or interested parties. To avoid the government picking "winners and losers", the legislation should be amended in several ways:

(1) To make clear that the Commission may not order the default-service provider to procure power from a specific generation supplier, from a specific generation fuel type or from new generation only. Such a provision will ensure a level playing field for all generation suppliers and will promote full competition and, in turn, lower power prices for consumers. To the extent that the government favors certain generation for public policy reasons, that should be encompassed in legislation, such as the Alternative Energy Portfolio Standards Act of 2004, under which suppliers are required to provide increasing percentages of power from certain designated renewable fuel types.

(2) To clarify that default suppliers can pursue negotiated bilateral contracts at their option, and that the PUC cannot order that default suppliers enter into such contracts but rather can only direct default suppliers to procure power through competitive auctions or RFPs. Such clarifications will preserve competitive markets and ensure that customers enjoy the lowest available prices for power.

(3) To underscore that utilities may, at their option, procure power through "full-requirements," or "load-following" contracts (utilizing auctions and/or RFPs), as opposed to being required to assemble and actively manage a "portfolio" of "block" and other products, some potentially designed to favor certain generators. Under load-following procurement contracts, suppliers are allocated the financial risks of changes in market prices and in customer load (due to weather and customers switching). Suppliers are better equipped to manage these risks. In contrast, placing such obligations on default service providers will require that costs be incurred

to staff up portfolio-management functions, to expose providers to hindsight second-guessing, and ultimately will place risks on customers.

Phase-In

PECO supports the phase-in of the initial generation rate increase following the expiration of rate caps to allow customers to manage the transition to competitive market rates (which, for PECO, will by 2011 have been in place for 15 years). The phase-in plan must be workable for customers and provide full cost recovery for the utilities. H.B. 2201 as currently drafted, does not establish such a plan. In particular, PECO is troubled that the language could be applied in a manner that imposes hundreds of millions of dollars in losses on utilities. Thus, the provisions of H.B. 2201 should be amended and clarified in certain key respects:

(1) If the 15% limit on price increases remains in the legislation, then utilities will need up to three years after the initial three-year phase-in period to fully recover their deferred costs, resulting in a 6 year plan,

(2) Language should be added to specify interest, at the statutory rate of 6%, on deferred charges, and

(3) Phase-in plans should be limited to residential and small-commercial customers, and not for large industrial customers who are in a position to negotiate customer specific contracts with competitive suppliers to manage their energy costs.

PECO continues to believe that a "pre-payment" plan will provide customers the best way to manage the generation price increases, and we support the provisions of H.B. 2201 that provide for such plans (and participation by customers on a voluntary basis).

Smart Meters

PECO supports the section of H.B. 2201 that provides for a phased-in deployment of smart-meter technology and the availability of time-of-use rates for all customers. Such offerings will provide customers with tools to help enable them to manage their energy consumption and future price increases.

We propose one clarification with respect to the Bill's language – namely, that costs to prematurely retire meter assets and to terminate contracts are fully recoverable as a cost of deploying smart meters. In PECO's case, it has a lease arrangement with a meter vendor for the provision of meter assets and services that expires in 2013. If that contract is terminated to comply with a statutory mandate to install smart meters over the next few years, PECO will incur tens of millions of dollars in contract costs. We need to recover the costs due to this government mandate.

Energy-Efficiency and Demand-Response Programs

PECO supports the development of energy-efficiency and demand-response programs to assist customers in conserving power and using energy more efficiently, especially as we near the end of generation rate caps. These programs also bring environmental benefits in reduced production of fossil-generation emissions. In our view, we must set aggressive, yet realistic, targets and ensure that expenditures are made in reasonable amounts and in a cost-effective manner.

Program Administration by Utilities versus a Third-Party Program Administrator. H.B. 2200 contains such provisions. PECO is concerned, however, about the program structure envisioned by the Bill. In particular, PECO prefers that the local electric utility develop and offer energy-efficiency and demand-response programs to its customers as opposed to the programs being managed by a third-party program administrator.

Several points are worth highlighting on this issue. First, PECO already has in place a number of energy-efficiency and demand-response programs. We educate consumers in seasonal bill inserts, press releases and postings on the company's website about how they can conserve energy. PECO market kits with energy-saving devices such as compact-fluorescent light bulbs and shower heads to our customers. In addition, we have a number of customers enrolled in various mandatory and voluntary economic-curtailment programs. PECO also spends over $6.5 million annually on energy efficiency and conservation for its low-income customers udder the Low Income Usage Reduction Program (LIURP). In fact, PECO's LIURP program, which assists some 8,000 customers annually, recently received recognition from the American Council for an Energy Efficient Economy (ACEEE) as one of the nation's best energy-efficiency programs.

Second, utility provision of energy-efficiency and demand-response programs fits naturally with the services we provide to our customers. In fact, enhancing our relationship with our customers is a primary reason PECO wants to provide these programs. PECO is committed to implementing robust conservation programs. There appears to be concern from some quarters that utilities will not effectively deploy energy-efficiency programs. Our performance belies that. Moreover, we accept the imposition of aggressive performance targets and accountability for results.

Third, utility provision of these programs will provide the same economic-development benefits to Pennsylvania as third-party administration will. Note in this regard that PECO intends to utilize contractors for implementation of its programs.

Fourth, third-party administration will entail the creation of government oversight and added cost for consumers to be offered these programs. Keep in mind that a 2% cost cap applied to distribution company revenues, totals a budget for energy-efficiency and demand-response programs in excess of $300 million a year.

Finally, I note that the California PUC, which oversees by far the most comprehensive set of conservation and load reduction programs in the country, carefully examined the question of whether energy-efficiency programs should be administered by a third party and concluded that the programs are better managed by utilities. Attached to my testimony are excerpts from the California PUC's Order.

Conclusion

Thank you for the opportunity to present PECO's views on the policies outlined in H.B. 2200 and H.B. 2201. Both pieces of legislation address the critical issues to ensure we continue to provide consumers benefits from competitive electric markets and deploy products and service to protect the environment. We look forward to continuing to work with you to craft comprehensive energy policies for Pennsylvania.

Excerpts from California PUC Order on Administrative Structure for Energy Efficiency (January 27, 2005), concluding that utilities are better able than third-party administrators to manage energy-efficiency programs:

"[W]e would have significant concerns about the degree of control we could exert over third parties under an independent administrative structure. The Commission has broad regulatory authority to ensure and enforce the IOUs' [utilities'] compliance with our policy rules and requirements . . . . In contrast, the proposals for independent administrators in this proceeding rely on contractual authority. This form of authority is potentially weaker, more complex, and less flexible than relying on our regulatory powers. In particular, we would have limited recourse in the event that the programs do not deliver the requisite energy savings or the program administrator fails to perform in other ways. " (page 59)

"In order to meet our goals for energy efficiency, we must have the authority to hold the administrator(s) fully accountable for delivering energy savings without recourse to litigation. We believe this authority is clearly established with our regulatory oversight of the IOUs, but considerably less certain under the proposals for independent administration." (Pages 60-61)

"[W]e believe there are significant impediments to putting independent administration in place that will introduce considerable delay and uncertainty into the process, thereby undermining California's ability to achieve the Energy Action goals. . . . [E]xperience persuades us that we should carefully consider the potential legal and implementation challenges inherent in moving to the independent administrative structure." (Page 67)

"In addition to the legal risks described above, the administrative proposals . . . create other substantial implementation challenges. Developing and overseeing the RFP program for program administrator . . . is a significant and time-consuming task. During our restructuring, our effort to develop an RFP for an administrator of market transformation programs . . . took many months to accomplish and involved Commission staff, CBEE board members and a team of technical and administrative contractors. . . ." (Pages 73-74

Start-up of this structure would also be an expensive undertaking. The . . . proposal estimates that independent administration . . . would require 25 full-time professional staff. . . . This estimate is extremely conservative. . . . Not only would each administrator require staffing to oversee the standard offer contractors and perform general administrative duties and responsibilities required by the Commission (e.g., tracking expenditures and performance, reporting requirements), but the Commission would need to increase its staff to oversee contracts with potentially dozens of individual administrators throughout the state." (Pages 74-75)

"Moreover, . . . these proposals fail to recognize the huge fiduciary responsibility that would need to be assumed by the program administrator or administrators. These entities would be responsible for management of over $400 million annually. The required level of fiscal control and the business systems needed to support that control are complex and expensive. . . . There are few non-IOU organizations with an understanding of the energy efficiency business that have managed anywhere near that level of funding. Even if the organizations responding to the RFP for program administrators demonstrated the required level of fiscal control and business systems, we are skeptical that they could accomplish these functions with a total staffing of 25." (Page 75)

"In contrast, returning IOUs to a lead role . . . will not create the legal risks described above. . . . Transitioning from staff to IOU responsibilities would involve a relatively short transition period, and could be accomplished at an orderly pace that would not disrupt program delivery. . . . We are confident that the IOUs have the requisite expertise and capability to administer energy efficiency consistent with . . . the goals we establish in this proceeding. That experience has demonstrated to us that IOUs can meet aggressive savings goals under an administrative structure that holds them accountable for program results." (Page 79)