Testimony on HB 2201
Daniel W. Allegretti
Vice President, Regulatory and Legislative Affairs
Constellation Energy Resources

Introduction

Constellation appreciates the opportunity to testify on HB 2201 and share our experience in markets – both retail and wholesale – around the country. As the largest competitive *wholesale* and *retail* power provider in North America, our views are shaped by our activities in every retail access state or province and every wholesale market in North America. We also own generation of all fuel types (from renewable to fossil and nuclear) as well as a number of facilities in Pennsylvania. A listing of our generation assets is attached.

However, since we also serve more than 40,000 MWs of customer demand while owning slightly more than 12,000 MWs of supply, we understand how to serve customers through a variety of contractual arrangements of various lengths in term. This ability to optimize supply and demand is a constant effort on our part and requires the investment of many skilled personnel. Constellation invites any member of the legislature or staff to come visit our trading operation in Baltimore to gain an appreciation of what is required to optimally manage our various commitments and to ensure adequate and competitively priced supply.

Support for Objectives of the Legislation

Constellation commends the sponsors of the legislation for their efforts to meet the challenge of providing incentives that will encourage adequate investment, an environment that will yield the best outcome for customers over time and rules that will result in the most ecologically-friendly energy supply. Many of the proposals in the legislation are commendable, including consumer education, time of use rates and smart metering. Some of the proposals, while well intended, may have unintended consequences. Constellation offers the following review of HB 2201 in the hopes of modifying the legislation so that it may better meet customers' needs.

"Prevailing Market" versus "Lowest Reasonable Cost"

The change in objective for default service procurement from "prevailing market" to "lowest reasonable cost" is problematic. While it is Constellation's view that "prevailing market" prices will result in "lowest reasonable cost over time," it should be pointed out that "lowest reasonable cost" is a very subjective standard. *Lowest reasonable cost to whom? Lowest reasonable cost over what time period?* As discussed below, what seems like a low cost at the time a transaction is entered into may no longer seem to be so at a later time in the market cycle. While lowest reasonable cost is an understandable goal to articulate to the citizens of Pennsylvania, Constellation is concerned that, as a new legal standard, it will only lead to acrimonious litigation at the Public Utility Commission that will make Pennsylvania a less inviting market in which to participate and subsequently result in higher prices.

Long-term Contracts as part of Default Service Procurement

Some have asserted that long-term contracting by regulated utilities is necessary to enable developers to finance new generation investment. This is a solution in search of a problem. An obvious example of how things are getting built right now here in the Commonwealth without a utility contract is Constellation's recently announced 5-year agreement with Pepco Holdings, Inc. ("PHI"). This contract will allow PHI to move forward with the development of its 520 MW combined cycle power plant in York County without putting Pennsylvania ratepayers at risk for the investment. Constellation and other companies have been signing long-term contracts around the country for new plant output, especially from renewable resources, without the need for any regulatory mandates. Hedge funds, private equity and balance sheet financing have changed the model of project finance, which used to rely exclusively on long-term contracts.

Others, however, have maintained that long-term contracts are necessary to obtain lower prices. Constellation notes that bids in competitive solicitations (auctions, RFPs, etc.) may include some portion of supply that is obtained through a long-term relationship. However, to specify a portion and length of time for long-term contracts as part of default service procurement may very well result in higher rather than lower prices. The experience of regulators and utilities in this country implementing the Public Utility Regulatory Policies Act of 1978 is a sobering reminder of the perils of predicting the future and obligating ratepayers to long-term investments. The PURPA law required that utilities enter into long-term (20 years or more) power purchase agreements based on forecasts of "avoided costs" determined at the time. These forecasts later turned out to be well above the market cost of power and the contracts became part of billions of dollars in stranded costs allocated to customers.

An analogy from the real estate market may be instructive: recall interest rates of the early 1980s, where rates as "low" as 14% were being offered to homebuyers. Many new homeowners jumped into fixed interest rate mortgages driven by the fear that interest rates would continue to rise. Imagine being stuck with a mortgage at 14% these days? This may be exactly what locking into a long-term contract in this high commodity market (not only power, but oil, steel, other metals) may appear a few years hence.

If the legislature believes it is absolutely necessary to specify long-term contracting as part of the procurement process, Constellation would suggest a limitation of contracting length of *no more than 5 years.* The demarcation here is based on our experience that forecasting market conditions beyond 5 years (difficult enough) becomes increasingly an exercise that is more art than science. Indeed, it is perhaps for this reason that liquidity (numbers of buyers and sellers) for "futures" natural gas contracts in the New York Mercantile Exchange (NYMEX) drops considerably beyond 5 years, as that market's participants do not believe that the market beyond 5 years is very easy to determine.

Rate Mitigation

Constellation supports the concept of rate mitigation for areas coming off rate caps that anticipate large increases in rates due to the long transition period from capped prices to market prices. It is not in anyone's interest to shock customers such that they reject the concept of competition and all the benefits that it ultimately provides. Constellation has experience in this matter in several other states and commends the sponsors that the key element of a transition – a specific "opt-in" to a rate mitigation plan -- has been embraced. This, combined with adequate education, will mean that the competitive market will open while giving customers the option to have rates rise at a less rapid pace.

Conclusion

Pennsylvania has been a leader in electric choice for over a decade. It is understandable that, as the Commonwealth finally moves to full competition, some adjustments to make the final transition palatable may be desired. At the same time there is also an opportunity here to be responsive to other objectives, such as promoting energy efficiency and alternative energy resource markets. Constellation believes that all of these objectives can be met while providing for a robust competitive wholesale and retail market in Pennsylvania. Competition, in Constellation's view, will be the ultimate method of customer protection and provider of reliable services that result in efficient energy use and investment in new technologies.