COMMONWEALTH OF PENNSYLVANIA
HOUSE OF REPRESENTATIVES
ENVIRONMENTAL RESOURCES AND ENERGY COMMITTEE

IN RE: HOUSE BILL 54 SPECIAL SESSION
ELECTRIC RATE CAP EXTENSION

STATE CAPITOL
ROOM G-50, IRVIS BUILDING
HARRISBURG, PA

TUESDAY, FEBRUARY 12, 2008, 9:00 A.M.

BEFORE:

HONORABLE CAMILLE GEORGE, CHAIRMAN
HONORABLE SCOTT E. HUTCHINSON, CO-CHAIRMAN
HONORABLE MARTIN CAUSER
HONORABLE H. SCOTT CONKLIN
HONORABLE GARTH EVERETT
HONORABLE ROBERT FREEMAN
HONORABLE MIKE GERALD
HONORABLE KATE HARPER
HONORABLE JOHN HORNAMAN
HONORABLE SCOTT HUTCHINSON
HONORABLE MICHAEL MCGEEHAN
HONORABLE RON MILLER
HONORABLE JAY R. MOYER
HONORABLE KATHY RAPP
HONORABLE DAVE REED
HONORABLE CHRIS ROSS
HONORABLE CAROLE RUBLEY
HONORABLE DICK STEVENSON
HONORABLE GREG VITALI
HONORABLE RANDY VULAKOVICH

ALSO PRESENT:
E. THOMAS KUHN

JANICE MAULFAIR, REPORTER
NOTARY PUBLIC

I N D E X T O T E S T I F I E R S

I N D E X T O E X H I B I T

CHAIRMAN GEORGE: The purpose of this hearing is to elicit testimony identifying proactive policies that will protect Pennsylvania from electric price volatility and to prevent soaring rate hikes before they occur or happen.

Of particular interest is Special Session House Bill No. 54 extending rate cap protections to residential, commercial, and industrial customers for a period of two years for each company that has not completed its cost recovery period.

As we are keenly aware, when electricity rate caps expire in June 2010 and June 2011, the citizens of this Commonwealth are sure to fall victim because of the crippling rate hikes that will inevitably result.

Looking outside of the Commonwealth to the neighboring states of Delaware and Maryland, the price of their electricity increased 59% and 72% respectively when the rate caps expired.

Special Session House Bill No. 54 allows the Legislature to move beyond basic utility restructuring and ensures reasonable and stable rates of these costs for procurement and system reliability that includes energy resource diversification and distribution of generation. I will now turn to my co-chairman, the gentleman, Chairman Hutchinson, for a few remarks.

CHAIRMAN HUTCHINSON: Thank you, Mr. Chairman. This is a very serious bill that we will be faced with this morning. And I look forward to our hearing and gathering information. And I hope that in the spirit of Abraham Lincoln and the things he stood for here, as we celebrate his birthday today, that we can remain cognizant of the free-market principles that he espoused as a President. So I thank you and I look forward to an informative session today.

CHAIRMAN GEORGE: I thank the gentleman. Before we get going with the meeting, I would hope the committee would introduce themselves. I will start at my furthest left. In front of me is the gentleman, Mr. Vulakovich.

State Representative Randy Vulakovich, 30th District, Allegheny County.

State Representative Chris Ross, Chester County.

State Representative Garth Everett, Lycoming County.

State Representative Marty Causer, McKean, Pottter, and Cameron Counties.

State Representative Kathy Rapp, Warren, Forest, and McKean Counties.

State Representative Greg Vitali, Delaware County.

State Representative Bob Freeman, Northampton County.

State Representative Mike Gerald, Luzerne and Monroe Counties.

State Representative Michael McGeehan, Philadelphia County.

State Representative Kate Harper, Montgomery County.

State Representative Ron Miller, York County.

State Representative Carole Rubley, parts of Chester and Montgomery Counties.

State Representative Dave Reed, Indiana County.

State Representative Scott Hutchinson, Venango County.

State Representative Camille George, Clearfield County.

State Representative H. Scott Conklin, Centre County.

State Representative Jay Moyer, Montgomery County.

State Representative Dick Stevenson, Mercer and Butler Counties.

State Representative John Hornaman, Erie County.

CHAIRMAN GEORGE: I thank you all. We have a full agenda this morning. Consequently, it is imperative that those presenting their testimony, please keep your presentation within the five-minute allotment. Your complete testimony should be submitted for the record.

I am also asking the Members to be very selective with their questions and interrogation. Please try to present them in a manner in which they can be answered either negatively or affirmatively.

We were to have Senator Boscola here. She released a co-sponsorship memo to herself and colleagues finding a laudable bill, as called for, a comprehensible and practical and progressive extension of the rate caps with the electric industry. She was to testify today but unfortunately cannot. We hope to hear from her at a future hearing.

Testifying today is Tyrone Christy, Commissioner of the Pennsylvania Public Utility Commission.

Commissioner Christy, will you come forward, please.

COMMISSIONER CHRISTY: Chairman George, Chairman Hutchinson, and Members of the Committee, thank you for the invitation to testify today on these important policy recommendations that will protect Pennsylvania consumers from substantial increases to electricity prices once the rate caps expire. Eighty-three percent of Pennsylvania consumers will be affected beginning in 2010.

I have three main points to make this morning: No. 1) The competitive wholesale market is broken and needs to be fixed; Point No. 2) The competitive market is broken and needs to be fixed; Point No. 3) The competitive wholesale market is broken and needs to be fixed.

As a result of the 1996 Competition Act at the PUC, we have lost virtually all oversight over the procurement of electricity and resulting electricity prices.

Prior to 1996, the PUC had regulatory oversight over the cost of power generation, all of which was tested by the just and reasonable standards. Electric utilities were obligated to engage in least cost planning subject to PUC review. This is all gone.

PUC protection of consumer interest has been replaced with solar alliance while the so-called competitive market forces deliver just and reasonable rates. The promise of the Act was that competition would lead to lower prices. This promise, I fear, will continue to be unfulfilled. Despite the fact that consumers have paid over $12 billion in stranded costs for generation, rates are not headed lower but they are headed substantially higher.

Despite having paid off the mortgage, customers are generally paying more once rate caps expire via market rates. What are these market rates that consumers will now pay? Are they the result of robust competition among selected generation companies? The answer is no. Market rates are largely defined by pricing structures artificially established by the PJM inter-connection which is an industry-driven power pool. PJM is not subject to usage or jurisdiction. It is only loosely overseen by the Federal Energy Regulatory Commission.

PJM has two pricing mechanisms, one for energy and one for capacity. On energy, it is called the single market regulatory price. All generators are paid the highest cost of generation at any given time despite the fact that the vast majority of generation is substantially less expensive than the last unit added to meet consumer loads. As an example, if you have a 10,000 megawatt demand, 9,999 can be supplied by a coal-fired plant at 2.5 cents a kilowatt hour. But since one more megawatt is needed, if it is a natural-gas fired unit at, say, 10.0 cents a kilowatt hour, then all 10,000 megawatts get the 10.0 cent credit.

In Pennsylvania, over 90 percent of our energy comes from coal and nuclear plants. Yet 35 percent of the time, these facilities are awarded natural-gas-rated pricing. This is the wrong pricing mechanism to produce fair rates for Pennsylvania consumers. We should be giving rates based upon coal and nuclear prices, not on high-cost natural gas. This is note a free-market-based pricing arrangement. It is a PJM-driven arrangement that costs consumers millions and rewards generators millions.

On the capacity side, I'm afraid it gets worse. PJMs recently created RPM pricing mechanism is supposed to provide incentives for new power plants. However, all existing generators are paid the RPM credit, while only a small amount of new resources have been added in the RPM capacity auction. Essentially it is a gift to all existing generating plants. Thank you for being a member of PJM. Here's your membership bonus.

Under the RPM mechanism, capacity costs for Pennsylvania will reach $2.2 billion in 2009-2010. The same units that just received over $12 million now conveniently start collecting another capacity payment. And we, the consumers, pay for it.

It is important to note that this credit is insufficient to encourage private industry to take the risk of financing the capital-intensive solid-fuel-fired facilities that could help stabilize power prices. To date, only one large solid-fuel-fired facility has been built in Pennsylvania since the passage of the 1996 Act; rather, the vast majority of the capacity additions are at the low capital cost natural-gas-fired facilities, which ironically only exasperate the PJM energy pricing problem.

The end result of all this is, we have unregulated and excessive generation rates that no longer bear any relationship to cost. We used to have low-cost generation in Pennsylvania dedicated to consumers, but we gave it away in 1996. Now it is largely in the hands of the utility affiliates.

My message here today is, unless there is an explicit recognition that the wholesale power market is broken, consumers will be exposed indefinitely. A rate cap extension would provide some short-term relief but it will not solve the bigger problem. So what do we do? I have a couple of considerations here.

First, perhaps consideration should be made for funding a PA legal effort to challenge PJM and FERC on the premise that the resulting electric prices are not just and reasonable. This is the approach taken by the Illinois Attorney General that led to the rate cap extension agreement of the two major utilities in that state.

Second, the PUC must be given the authority to require utilities to buy the lowest cost of power, included but not limited to performance-based, long-term contracts with new and existing generating facilities under competitive solicitations.

We need to secure our energy future by developing alternatives to PJM. House Bill 2201 takes steps in the right direction. Long-term contracts not only should be allowed, they should be strongly encouraged. Twenty years ago when I was with the Commission, we were able to offer long-term contracts and the response was overwhelming. Over 2000 megawatts of innovative slow-power production, renewable resources, and co-generation facilities were added to the Pennsylvania generation infrastructure under performance-based contracts.

Many of these projects, like the waste-coal projects, are still in operation today, producing power with capacity factors, loan access at 90 percent, at contract rates in the 67-cents-per-kilowatt-hour range. Not only did we add much more generation, but we literally turned away hundreds of projects because we only needed so much power at that time.

If we were to put out to the Clarion Call that we will offer long-term contracts, the same type of response is possible. Pennsylvania has resources that many states can only dream of having. It is the only tool that we have that can assure that needed base-load plans will be built for reliable electricity supply.

It is the only tool that can ensure that real competition is introduced into the PJM generation market. We can put the generation where needed, when needed, and have predictable long-term prices.

Since the delayed time for the construction of these new type of facilities is as long as five years, it will take time to develop these resources as an alternative to PJM. So the utilities and unregulated affiliates should be encouraged to voluntarily commit power from existing generating resources for a minimum of five to ten years. These can be long-term contracts that include escalation of price adjustment for changes in environmental regulations.

I truly believe that a contract can be developed that would be fair and balanced and agreeable to all parties involved.

Four, absence or uncooperative voluntary movement to recommit generation at fair, reasonable rates. Stronger measures might be needed. This could include establishing a Pennsylvania generator franchise tax on previously rate-based power plants equal to the RPM revenue that the plants receive from PJM. The revenues from this tax could be used to provide rebates back to Pennsylvania consumers.

I might add that this tax could be waived for those plants that would voluntarily recommit the generation at reasonably priced long-term contracts.

Finally, to give consumers some more immediate protection from rising electricity prices, we must expeditiously adopt a meaningful demand response and conservation program like HB No. 2200.

The best way to save money on your electric bill is by reducing your electricity consumption. We need to get consumers the tools to do this.

I could live with the program the administrator has designated in the Bill. But because 2010 is looming fast, I am concerned about the delays this might create by adding some level of bureaucracy. I would prefer that the Commission be given the explicit authority to expeditiously direct the EDC's to enter into programs that are surefire winners for consumers. There is much low-hanging fruit out there and we don't have much time to waste.

Thank you again for the opportunity to be here today. I would be happy to answer any questions you may have.

CHAIRMAN GEORGE: I thank the gentleman for his testimony. I assume you will stand for questioning?

COMMISSIONER CHRISTY: Yes. Thank you.

CHAIRMAN GEORGE: I will ask the committee to make the questions short and very direct and attempt an answer that can be either affirmative or negative.

The first gentleman, Representative Conklin.

REPRESENTATIVE CONKLIN: Thank you, Commissioner Christy.

When you look across and you look that Illinois had a 55 percent spike and Maryland had an approximately 72 percent spike, before I was a Representative, I was a County Commissioner in the County Commissioners Association and Pike County had almost devastation. One of the school districts had a 130% increase in electricity. If you couple that with the fact that the Associated Press analyzed approximately 17 deregulated areas, you found that 30 percent was the average increase. Is there any reason to believe that Pennsylvania will be any different when deregulation comes?

COMMISSIONER CHRISTY: No. All indications are right now that 30 percent would be some minimum number for increases in the overall prices that consumers will experience.

REPRESENTATIVE CONKLIN: Do you have any estimate?

COMMISSIONER CHRISTY: We're looking at – I think the numbers on PP&L are around 40 percent. And I don't have exact figures for the other companies, but they have assumed their type of generation numbers right now that they are charging consumers. And across the board where the PJM market is, I think it is fair to say that that's probably a good number to use for a lot of these utilities coming up.

I might add that these market rates are driven significantly by natural gas prices. And my fear is, if we get a spike in natural gas prices like we did around the Katrina time frame, these electricity prices will go up even more.

REPRESENTATIVE CONKLIN: Thank you.

CHAIRMAN GEORGE: Representative Ross.

REPRESENTATIVE ROSS: Thank you, Mr. Chairman. And I apologize because I'm going to have to leave shortly. I did appreciate getting the written testimony from the other testifiers, but I do have other commitments. A lot of committee meetings are going on.

My reaction actually to this testimony though is one of a little bit of surprise. You are declaring, Mr. Christy, that the whole subject of deregulation essentially has failed. But it is interesting that you are doing that when it has not really been implemented yet. And I say that with the awareness that we have been under price caps for this entire period of time. So only one-half of the deregulation has really occurred. We have deregulated the supply side but we haven't really deregulated the demand side yet.

The ratepayers in Pennsylvania have done well over the last number of years because those rates have been held down despite inflation, despite the statements that you have made in terms of the increase in gas prices, which are very substantial. But it seems to me impossible to accurately assess the effects of deregulation on stimulating generating capacity until we find some balance in the marketplace.

Am I wrong on this?

COMMISSIONER CHRISTY: To give perhaps some personal experience, I am a customer of Pennsylvania Power. And last year, our rate caps came off; and Pennsylvania Power conducted a solicitation to provide power to the older customers. And there was only one biter, and that was Pennsylvania Power's affiliate.

My rates went up 33 percent. Commercial and industrial customers' rates went up, some over 100 percent. All the commercials, I believe, were well over 50 percent. And at the initial start of the rates taking effect, there was nobody offering any competitive product, no one. Then after so many months, finally Dominion stepped up and said, we'll offer a 10 percent discount off your generation rate. And so, of course, I jumped on it and then the utility affiliate jumps in and matches it.

That's all you have for residential customers competition. So when I look at that experience, I'd say the competition – and I'll just say it – I think it has failed. It is not producing the competitive options for Pennsylvania.

REPRESENTATIVE ROSS: Thank you, Mr. Chairman. I would just observe, that sounds like the beginning of competition. Again, thank you.

CHAIRMAN GEORGE: The chair recognizes the gentleman, Chairman Hutchinson.

CHAIRMAN HUTCHINSON: Thank you. I guess my question is almost a follow-up to that, and I'm going to go to a statement that you made during your remarks. And this is pretty close to the remark, what you said, that Pennsylvania used to have low-cost power but we gave it away in 1996. I guess that really shocked me because having been a member in 1996, the main reason that Pennsylvania went to a competitive market was because our rates were so much higher than all our competitive states. And I understand today that we are much more competitive with surrounding states and with states that we deem competitors in the business marketplace and trying to bring businesses in. So would you clarify that statement a little bit more?

COMMISSIONER CHRISTY: Yes. When I say that we gave away the generation in 1996, it is important to know that PJM had pricing mechanisms in place in 1996 that produced artificially low power prices. And it was those artificially low power prices -- under the way they used to structure it, savings arrangement was one of the terms used for energy. And when you valued the generation in Pennsylvania under stranded cost, the stranded cost looked huge.

And I didn't believe in the PJM billing prices as being representative of proper market forces then, and I don't now.

But the PJM prices have been changed and changed to the benefit of generators. And as a result, I look at that and I say, we gave away the generation too cheaply in 1996,

As far as Pennsylvania rates can hurt other states, I thought we were in pretty good shape in 1996. We had a substantial amount of resources. A lot of the power plants were in place. We had healthy reserve margins and we were poised for relatively stable rates in Pennsylvania moving forward.

CHAIRMAN HUTCHINSON: That is just not how I recall things and how I heard from businesses and large users and small users across the board that were very concerned that Pennsylvania was totally out of the competitive pricing, just could not compete with other states. But I would have to look back at those numbers. But thank you for your testimony.

CHAIRMAN GEORGE: The Chair recognizes the lady, Representative Harper.

REPRESENTATIVE HARPER: Thank you, Mr. Chairman.

Just so you don't think it has anything to do whatever your answer is, I also have a voting meeting I'm going to run off to after this.

I thank you for your testimony. I was not here in 1996 and it seemed to me that you have a lot of good ideas that would entirely restructure the electric market. And some of those things, generation and sale, some of those things would involve not just, you know, Pennsylvania legislation but, it seems to me, Federal legislation, where changes actually at PJM may or may not be susceptible to legislation.

So here is what I am worried about. The bill that you are testifying about proposes extending the rate caps, and all of us are worried that Pennsylvania's consumers will see a spike once the rate caps come off.

I am wondering whether by delaying it for a few years we are just going to make that cliff so much bigger so that instead of a gradual spike, which the Pennsylvania consumers are going to have, if we extend it in 2013, they are just going to fall off the cliff and the rate increase will be astronomical.

What would you say to that?

COMMISSIONER CHRISTY: I would agree with you that the rate cap extension will perhaps just provide some short-term relief for the consumers. But there are structural fundamental issues here that have to be addressed in order to bring some stable rates for the long term. And you are right, if there were a rate cap extension, then a couple years later the issues could become even as big, if not bigger.

REPRESENTATIVE HARPER: Well, was I correct that some of the things you suggested would require Federal legislation or FERC approval or something like that?

COMMISSIONER CHRISTY: That's correct.

REPRESENTATIVE HARPER: Thank you, Mr. Chairman.

CHAIRMAN GEORGE: Representative Reed.

REPRESENTATIVE REED: Thank you, Mr. Chairman.

Commissioner, I would just like to follow up on Representative Ross's questions where he talked about the spikes, at least the spike that you have seen so far in your own home, with electricity prices deregulated. What is the average increase we have seen in the areas across Pennsylvania where rate caps have been removed for residential customers?

COMMISSIONER CHRISTY: Yes. I gave you the figures for Pennsylvania Power. The figures for Pike County were the initial subject, 2 percent adjustment. And the rates for the Duquesne Light, the residential customers have actually done a little bit better than the rates were in 1996, but the industrial customers have seen their rates almost double. One of the key things that are part of the '96 Act is that all the rates, there is no cross subsidies amongst customer classes. So in the case of Duquesne, you saw residential come down but then the industrials went up significantly.

UGI, I don't have those figures off the top of my head. I'll have to get back to you on that one.

REPRESENTATIVE REED: Okay. So for Duquesne Power, the residential customers are actually paying less today?

COMMISSIONER CHRISTY: That's correct.

REPRESENTATIVE REED: Than they were 10 years ago?

COMMISSIONER CHRISTY: That's correct.

REPRESENTATIVE REED: They might not be all that thrilled with implementing changes to the law that would actually see their prices go up, but I guess it depends on where you live across the Commonwealth.

When you look at the rate increases that you are talking about, the caps have been in place – when the caps come off -- for 13 or 14 years. And inflation just from 1996 until today would represent to the CPI a 37 to 40 percent increase in general inflation. Would it not seem reasonable, if you count the price of anything for 14 years, that inflation is going to have an impact and you are going to see an increase at the end of that 14-year period when that cap comes off? especially when you look at the price of coal has increased by 250 percent during that time, natural gas by 200 percent, oil by 300 percent, steel by 60 percent. Cable television has increased by 56 percent during that same time period. And we are not to expect there to be some inflationary increase during that time period?

COMMISSIONER CHRISTY: Sure. One can expect some level of escalation to your power prices. But one only has to look at the, as an example, Allegheny Registered Co-op that has generation similar to some of the generation that PP&L has, and the generation rates for that co-op are only in the 4.5 cent range. They have not experienced as dramatic increases that have been mentioned in terms of the inflationary statistics that you just mentioned.

Pennsylvania is blessed. We have a lot of generation in place and paid for by the consumers. And the fuel price is just one small component of what it really costs to generate power.

If I am not mistaken, co-ops are subject a little bit differently than the rate cap issue, depending on which co-op you are actually operating within. In some of them, it has more of an impact than others. So for some of them, you wouldn't see that spike or you wouldn't have that same impact that we have seen on the traditional utilities over the last decade or so.

REPRESENTATIVE REED: A followup question; that is, something you proposed was a generation franchise tax on generators across the Commonwealth. That kind of mystifies me a little bit when we are looking at ways to expand the capacity in Pennsylvania. And you suggested what we need to do to get more power under the grid to bring a more competitive model to bring down prices or a solution that you proposed to that is we should tax generators, and that is definitely a way to bring more capacity into the market.

I guess my suggestion would be that instead of taxing generators, what we should be doing at the state level and what we have the opportunity to perhaps do at the state level is we could actually cut the gross receipts tax and actually have a dramatic impact on each and every consumer's electricity bill across the Commonwealth. And the State Government can do that without impacting the free-market system. So that would be more of a suggestion, I guess, than a question. But I think that is something for the Administration and for the Legislature to consider hopefully in the upcoming months.

Thank you for your testimony, Mr. Commissioner.

COMMISSIONER CHRISTY: Thank you.

CHAIRMAN GEORGE: Our 1996 law requires through prevailing market rates after the rate caps expire. Since you were appointed to the PUC, you must be aware that several states are trying to change their dereg laws. Are they going the way of prevailing market rates?

COMMISSIONER CHRISTY: Do I think that across the board that it is fair to say I don't see any state that is rushing to do deregulation right now that's not deregulated? And these market rates, which I spent a considerable amount of time discussing, it is not a true market rate. It is the market is broken.

And there are plenty of groups and organizations that are attacking these rates as being unjust and unreasonable. And I think you will see more movement toward that as we move forward here and you will see a lot more action at FERC in this regard.

CHAIRMAN GEORGE: Thank you for your presentation.

The Chair and the Committee thank you for taking time to present to us. We hope you make yourself available to all legislators and this committee so that we can hopefully bring about a positive conclusion to the matter.

COMMISSIONER CHRISTY: Thank you.

CHAIRMAN GEORGE: Our next testifier is the gentleman, Sonny Popowsky, Consumer Advocate of Pennsylvania.

The gentleman may proceed.

CONSUMER ADVOCATE POPOWSKY: Thank you very much, Chairman George, Chairman Hutchinson, Members, and staff of the committee.

My name is Sonny Popowsky, I am the Consumer Advocate of Pennsylvania. I have been the Consumer Advocate since 1990, and I have worked at the Office of Consumer Advocate since 1979. I want to thank you for inviting me to testify here at this important hearing.

I think everyone would agree that we stand at a critical point now in the history of the Pennsylvania electric industry. The generation rate caps that have long protected Pennsylvania consumers will be coming off at the end of this decade. But I think they are coming off in a world that is much different from the one that many of us expected when the General Assembly passed, and Governor Ridge signed, the landmark Pennsylvania Electric Restructuring Law in 1996.

The time has come, in my opinion, for the General Assembly to re-examine and amend certain provisions of the 1996 Act in light of current realities. So what are those realities?

First, I think – and I would agree with Chairman Hutchinson – that when the law was passed in 1996, it was widely believed that the purpose of restructuring was to drive down the cost of generation. It was to drive down the price of generation. I think that was the whole point of restructuring. And then remember, that's where we gave the utilities stranded costs.

We paid, as Commissioner Christy said, $12 billion in stranded costs which was supposed to represent the difference between what it cost to build those plants versus the much lower amount that we expected the plants to be worth when competition hit; that is, competition was going to drive down the price. And in order to keep those utilities from being harmed, we allowed the recovery of stranded costs.

Now, rate caps though – rate caps were a safety valve. They were only intended to last as long as the utilities were recovering stranded costs. The idea was that if the utilities were recovering stranded costs because of lower market prices, we shouldn't also allow them to recover higher market prices, if that occurred.

So we put a cap on the rates so that the companies couldn't recover both stranded costs and high market prices. And those rate caps expire. They have been expiring across Pennsylvania as the stranded costs were collected.

Now, as it turned out, again, as Commissioner Christy mentioned, the wholesale generation prices have actually gone up in recent years. They haven't gone down. So our assumption turned out to be – my assumption, all of our assumptions turned out to be incorrect.

That, I think, is for two reasons. One is the higher cost of fossil fuel, particularly natural gas, which has driven up the cost of natural-gas-fired electricity and fossil-fuel-fired electricity. And that is compounded by the manner in which PJM assesses rates, which, again, as Commissioner Christy said, is based on the highest cost in any given hour. So all the power that is operating at a given hour is paid as if it were incurring the highest cost. So the wholesale rates have gone up, particularly in the last three or four years, instead of going down.

The other mistaken assumption I think we made back then was that we were concerned, oddly enough, that people would rush into the competitive market, that everybody would switch to competitors. We were so concerned, as you recall, that we put in a provision that said that only one-third of the customers could switch each year. That is one-third, one-third, one-third, so that everybody wouldn't just rush out and go to these low-cost marketers who would have access to lower-cost generation.

Again, we were mistaken about that. So where we're coming out now as the rate caps end is, instead of an array of competitive marketers offering lower-priced power, basically with some exceptions, we see customers coming out into the world where they will continue to be served by their traditional electric utility at prices which unfortunately look like they are going to be substantially higher than the prices that we had hoped for.

Now, that is why, in my opinion, we need to act. And what I think we need to do is to just recognize that particularly for residential customers, the great majority of residential customers are going to continue to be served by their utility. And the important thing now, I think, is for us to work with the utilities, work together to try to figure out a way to overcome the kind of problems that Commissioner Christy mentioned in the PJM market.

I think, Chairman George, you mentioned that the law said that utilities would provide service at prevailing market prices, again, for their default customers, the customers who don't shop.

Back in the days when we thought that there was only going to be a handful of customers that were going to continue to be served by their utility and we thought the prices ought to be lower, the prevailing market price standard might make sense.

What I think that we should do, though, and what you do in House Bill 54 and what Representative McCall does in House Bill 2201 is switch sway from that prevailing market price standard and switch to a requirement that utilities acquire the lowest-cost portfolio of the lowest-cost resources that would provide the lowest rates over time. That is what we do in the natural gas industry today.

As you recall, Chairman George, in 1984, the National Gas Act here was amended and it required that the utilities acquire their generation in the competitive wholesale market but they do it at the least cost. There is a least-cost procurement standard in the natural gas law. I think that is what we need in the electric law. And, again, this is in House Bill Special Session 54 and it is in House Bill 2201, that utilities will be required to purchase their generation to serve all those residential customers at the lowest cost over time.

Again, let me agree also with Commissioner Christy. Part of that portfolio, as you look at the portfolio language both in House Bill 54 and House Bill 2201, we are talking about a mix of long-term, short-term, and spot-market purchases. We don't want to just wait until December 31, 2010, and roll the dice and have an auction, which is what they did in Baltimore and Delaware and in Pike County.

What we want to do is we want our utilities to go out today, starting today, to acquire resources, including the kind of long-term resources that we absolutely need. We need them for two reasons: One is they provide a level of stability for customers in their rates and, two, they provide the kind of incentive we need to bring new entrants into this generation market.

That has been the biggest disappointment, to me at least, that we haven't seen the kind of competitive wholesale generation that we hoped for. We haven't seen the new generators coming into Pennsylvania to build new facilities. And one way I think we can do that is to have long-term contracts to be a part of that mix.

Remember, if the utilities are going to be serving 80 percent, 90 percent, 95 percent of the residential customers, let them put together a portfolio of resources to serve those customers, including bringing in new resources through long-term contracts.

Again, to pick up on your question, Chairman George, other states that have come out of their rate caps unfortunately waited until after they came out of their caps, but they found similar things.

In Maryland, the Maryland Commission just issued a report in which they said, we're going to order our utilities to enter into long-term contracts. They are not going to re-regulate them, but they are going to order them to go out into the market and enter into new long-term contracts to get some plants built in Maryland. Similarly, in Connecticut, the utilities have been directed. The utilities themselves have built new peaking generation facilities that will be charged at basis of cost, not on the basis of market rates.

In Illinois, Commissioner Christy mentioned, they created an Illinois Power Agency to purchase generation rather than rely on those sort of roll-the-dice auctions that I mentioned.

Even in Pennsylvania, don't forget, just last year in House Bill 1530, you passed legislation that allows some of our largest industrial customers to enter into long-term contracts with their utilities and even allows the utilities to acquire or build new resources on a long-term basis to serve those residential customers.

Now, my question to you is, if that is good for the large industrial customers in order to keep them in Pennsylvania, shouldn't we do something similar for residential customers, have a long-term portfolio?

Finally, the other thing we can do, I think – and it would be fun to do now for House Bill 2200, which, again, is sponsored by you, Chairman George – is to develop demand-site resources because that is the other thing we can do today to help reduce those price spikes in the future. That's the best way for customers to reduce their own bills, to use energy wisely; and I think House Bill 2200 is a good start at moving us toward that.

In closing, again, I want to thank you. I think this is an urgent time. I hope the General Assembly will not just pass House Bill 2200 but will also look at the least-cost procurement language in House Bill 54 and in House Bill 2201 so that we can at least start today to move towards a system where our customers will bid the lowest-cost service that is available to them, reliable service at a reasonable price.

So with that, I will close and be happy to answer any questions you have.

CHAIRMAN GEORGE: I thank the gentleman.

I will look to the gentleman, Representative Reed.

REPRESENTATIVE REED: Thank you, Mr. Chairman,

I just want to follow up on your suggestion for requiring least-cost portfolios or portfolios that result in the least cost for the consumer in the end.

It would appear that this Legislature and this Governor actually acted in a direct opposite direction to that particular goal in the past couple years when it passed alternative portfolio standards, because the alternative portfolio standards are generally not the lowest-cost power that can be implemented in the State of Pennsylvania. And actually now there are proposals out there in the Governor's energy and independence strategy that would increase the profile standards for solar energy, which of all the alternative standards that are in the original APS legislation is probably one of the highest-cost types of energy to procure.

Would you then suggest that that would not be a direction that we should move in regard to the solar and should we then explore revamping or revising the APS standards that were passed and signed into law a couple years ago?

CONSUMER ADVOCATE POPOWSKY: Let me go back to the APS because I think that is certainly a fair question.

In my opinion, the APS actually was a reasonable approach. When you are talking about long-term, the problem with the short-term markets today, what you will see is, if utility generators are building anything, what they are building is these natural gas plants and the market price on the PJM goes up and up and up and that gets charged to everybody to the extent that you can diversify those resources.

So, for example, it may cost more to build a windmill up front than it costs to build a natural gas plant, but the cost of the energy from that windmill is zero so that that actually has an effect. When they are operating it, it will lower the cost.

The other thing is, I really think it is inevitable – and maybe not everybody here agrees. But I think it is inevitable that the Federal Government within the next couple of years will move towards regulating carbon dioxide emissions. And if we are going to be in the situation where the cost of carbon dioxide is included in the cost of generation, then we will be very glad that we have built resources that don't emit carbon dioxide, such as renewable resources. I think that it is reasonable to include – in fact, I think it is preferable to include within the mix of resources a reasonable level of renewable resources.

I guess I should say when I talk about least cost, I mean least cost over time, and that would include the cost of reducing carbon dioxide emissions and other pollutants.

REPRESENTATIVE REED: With least cost over time, should we not also take into account the supply and demand side of the equation of the cost economically of us not being able to meet consumer demand for electricity? because right now, about 56 percent of our electricity comes from coal, about 35 percent comes from nuclear in Pennsylvania. So we are in excess of 90 percent.

And I am not sure if we are going to be able to get enough windmills in the Commonwealth of Pennsylvania or enough solar technology to ever totally go away from that sort of demand. So it would seem to me that if we cannot operate in a vacuum that we have also got to look at the supply and demand side of the economic equation as well in a long-term strategy.

CONSUMER ADVOCATE POPOWSKY: Absolutely. I agree with that. I think that has been the mistake we have made time and again is we put all our eggs in one basket, and I think we need a diversity of resources. And the only thing I think I would say about coal is, I think the price of coal will soon include the cost of carbon dioxide and that just has to be taken into account.

But other than that, I absolutely agree that we need a diversity of resources and that, just as you mentioned, that is exactly why the Maryland Commission and the Maryland Legislature have stepped up and said, we have actually a crisis on our hands. The generators are not coming in and building new facilities and we are going to order our utilities to enter into these long-term contracts to get some stuff built.

REPRESENTATIVE REED: One final question very briefly. John Hager, president of PENNFUTURE, in front of a House Consumer Affairs Committee hearing actually talked about the need for the rate caps to come off because then it forces the consumer into the situation of actually having to decrease demand and conserve energy. What are your thoughts on that?

Do you believe the rate caps should be extended because the supply and demands, under the equation, if we bring down demand, that can have a dramatic impact on our strategy as well?

CONSUMER ADVOCATE POPOWSKY: Again, as Commissioner Christy said, I really focused on the longer-term solution, which is to come up with a least-cost portfolio. If the lowest-cost portfolio provides prices that are somewhat higher than current rates, then I think we are going to have to face them at some point, whether it's 2010 or 2012.

I don't like the idea of raising rates as a way of – you know, if those rate increases are not appropriate, certainly we don't want to raise rates just as a means of reducing demand. But what I do think you can do within the structure that we have is to develop the lowest-cost resources, make those available to the customers. And then when they see that price, they can decide what to do. And, hopefully, even at today's prices, there is a lot of low-cost energy efficiency and demand programs that could be implemented and that aren't being implemented today, and I think they would be forwarded by us by House Bill 2200.

REPRESENTATIVE REED: Environmental regulations are generally one of the significant, at least in the last couple years, cost drivers behind increasing the cost of electricity production, not just in Pennsylvania but across the nation really. Have you taken a look at which environmental regulations we should be looking at and asking or revising or revamping? I mean, obviously they are driving at least a large significant portion of that portfolio.

CONSUMER ADVOCATE POPOWSKY: That is somewhat out of my area of expertise. What I focused on though is to recognize that if you think that there is going to be an environmental regulation like carbon dioxide, then you shouldn't blind yourself to that fact and you should recognize today that those costs will be incurred in the future and that should affect your planning. And if we take that into consideration, we have a better likelihood of producing the lowest-cost portfolio for customers.

REPRESENTATIVE REED: Thank you.

CHAIRMAN GEORGE: If there are no further questions, we thank you for coming.

CONSUMER ADVOCATE POPOWSKY: Thank you.

CHAIRMAN GEORGE: My question is – and Representative Reed sort of asked it but I want to drill down a specific answer on this one thing – do you or do you not think we should extend the rate caps for a couple of years?

CONSUMER ADVOCATE POPOWSKY: Well, I would be happy to see the rate caps extended. I would be happy to see a phase-in of the increase in order to have those costs reduced. But the fact is, I was there in 1996, and the agreement we made in 1996 and that I signed is that the rate caps would extend as long as the stranded cost. And my goal and my focus has been on what to do when the rate caps come off, whether they come off in 2010 or 2013.

CHAIRMAN GEORGE: I just have a question, if you will, sir. During that several months prior as deregulation was being drafted and discussed, how much time and attention was focused on what would happen after the rate caps came off?

CONSUMER ADVOCATE POPOWSKY: I think that was our biggest failure. I think that we spent a lot of time with the short term.

But on the one hand, we were afraid that we would bankrupt utilities. We had competition but the prices were so low that it would force the utilities into bankruptcy. So that is why we spent a lot of time on stranded costs, and we even securitized the stranded costs.

On the other hand, we were so worried that everybody would shop that we put in this three-year phase-in so that customers could call. And if you remember, Governor Ridge insisted that we put in a provision to protect the State's Commonwealth tax revenues. There was a provision that was put in there because we were so afraid that the customers would shop. We put a lot of time on those issues, and I regret that.

Thank you.

CHAIRMAN GEORGE: If there are no further questions, we are now pleased to welcome the gentleman, Carl Wood, Regulatory Affairs Director of the Utility Workers Union of America and former Commissioner of the California Public Utility Commission.

Mr. Wood will be introduced by the gentleman, Bill George, president of the Pennsylvania AFL/CIO. Welcome.

MR. GEORGE: Good morning, Chairman George. My name is Bill George.

It is good to see you this morning, Chairman George, Chairman Hutchinson, and Members of the committee. We thank you for this opportunity.

Joining me to my right, just in case you have any questions, is the president of Local 29 of the IBW that represents utility workers throughout Western Pennsylvania and utility workers through the IBW's network of representation and a lot of our facilities here in the State of Pennsylvania.

I am really honored for us to have a friend and a colleague with the experience that your next testifier will be giving, and that is Carl Wood, who is the National Director of Regulatory Affairs for the Utility Workers Union of America.

He started out his life as a steelworker, like I was, back in – well, I won't tell you when – a long, long time ago and worked his way up through a number of college degrees and got involved with the utility workers and finally became the PUC Commissioner of California and served there from 1999 to 2004 and has the experience of many of your PUC members and knows many of your past and present PUC members from the National Organization.

So it is really my pleasure to introduce to you Carl Wood, the National Director of Regulatory Affairs for the Utility Workers Union of America.

DIRECTOR WOOD: Thank you for that introduction. I am here representing the Pennsylvania AFL-CIO. My testimony will reflect my experience and observations both as a representative of organized labor and as a Utility Commissioner responsible for consumers and the public interest. My focus is getting good outcomes in terms of rates and service for the working people and working businesses of Pennsylvania. Every Pennsylvanian is concerned that rates are going to escalate in the near future, driven by profiteering by energy sellers. Any legislation enacted by the Pennsylvania Legislature should explicitly re-assure the people of Pennsylvania that their state government is working hard to provide safe and reliable electric service at affordable, just, and reasonable rates. That should be the sole goal of state policy.

HB 54 of the First Special Session makes a good beginning, and I want to commend the authors. Extending existing rate caps, as the bill proposes, is less radical than it sounds, as I will discuss below. Describing a long-term procurement plan process is also important, although the bill's failure to squarely address deregulation and to eliminate it is a mistake.

Pennsylvania is faced with an immediate crisis of escalating rates, directly caused by deregulation and by decisions of the Federal Energy Regulatory Commission (FERC), which has become a major player in Pennsylvania because of deregulation decisions made by this Legislature. Before describing the AFL-CIO's affirmative program, I will address some common defenses of deregulation, as articulated by the FERC Chairman, Joseph Kelliher. This will provide context and specificity for suggestions to improve Special Session HB 54.

I am an opponent of deregulation. Recently, FERC Chairman Joseph Kelliher criticized opponents of deregulation as rarely offering clear solutions, describing some of their criticism as inchoate. I will respond to Chairman Kelliher's justifications for high electric prices and to his rationalizations for perpetuating deregulation within his area of responsibility to the public. And I will suggest approaches to consumer protection that are within the grasp of this Legislature through amendments to SS-HB 54.

Pennsylvania is an important laboratory for the justification of deregulation based on the presence of so-called competition. Pennsylvania has today and has had for many years a significant surplus of domestic electricity supply over its domestic electricity demand, a condition that ought to lead to falling prices and vigorous price competition. Further, this generation is largely depreciated – its capital investment has been largely recovered in rates – and is therefore inexpensive to own. Under traditional ratemaking, this should result in low prices, as it should under so-called competition. Rather, Pennsylvanians have already experienced huge increases in rates and are being warned of more severe rate shocks to come. This is completely counterintuitive.

By extending rate caps, SS-HB places this phenomenon, rising prices at a time of surplus and a fractured relationship between prices and costs, directly at issue. Basic economics would appear to support the extension of rate caps. The bill places the burden of justification on sellers who would seek to violate basic economics.

Pennsylvania recently placed all of its electric generation pricing decisions under Chairman Kelliher's authority through the divestiture of existing generation facilities by state-regulated utilities to third parties and the substitution of wholesale transactions priced through sellers' strategic bids for direct dispatch of the lowest cost local supply mix.

Unlike California, which did not permit complete divestiture and thus has a core quantity of low-priced electricity to buffer price gouging, Pennsylvania has not retained pricing authority over any category of generation resource. According to FERC, the abundant Pennsylvania supply mix can be withheld from service to Pennsylvania.

Without SS-HB 54, Pennsylvania is faced with making retail rate decisions reflecting its abundant local existing generation that are completely infected with the systematic pro-seller bias of the current FERC. The fear of rate shock that is affecting this Legislature stems directly from an accurate perception of complete exposure and vulnerability to price gouging under the auspices of the FERC, despite the state's adequate, indeed over-abundant resources.

SS-HB 54 should begin to systematically reduce exposure to FERC-jurisdictional wholesale markets. Otherwise, its strongest provisions are mere palliative measures, temporarily reducing pain but not fundamentally addressing the underlying malady, which is deregulation.

Although Chairman Kelliher states that it is impossible to return to direct state control of generation pricing, his statement is actually oversimplification and rhetorical overkill. Two important steps are (1) articulating clearly a specific state policy of public accountability for essential services and (2) reasserting control over new electric utility investment through a public strategic planning process that guides infrastructure investment and procurement of electricity for residents and businesses. This can, over time, provide a means of minimizing costs and rate recovery.

The strategic plan is broader than the procurement plan described by SS-HB 54, which is little more than a list of permissible contract formation procedures. The provisions of SS-HB 54 that describe the elements of the procurement plan should include a specific directive to invest directly in supply, along with an appropriate mix of contracts. Investment in demand reduction and conservation should be included as elements of the procurement plan.

Each of these elements, supply and demand reduction, are long-lived, permanent programs and facilities that should not be opportunities for profiteering or short-timer investment strategies and paybacks. Over time, direct investment will reduce the state's reliance on the divested legacy fleet of power plants and put the state in a better position to bargain for control of costs and service.

Electric utilities should be directed to begin a program of direct investment in power plants on both existing and new footprints within the state with public agency participation and utilizing horizontal relationships, joint ventures and partnerships, among load-serving entities. Vertical integration under conditions of transparency and state regulatory control should be encouraged going forward.

The Federal Power Act facilitates Pennsylvania's interest in this regard by explicitly exempting from FERC's authority facilities for the generation of electric energy. FPA Section 201(b), California has used this provision to develop state law operation and maintenance standards for power plants and to restrict power plant sales by utilities.

Pennsylvania should assert the power reserved to it by Congress in the FPA to require power plants located here to operate in a manner that eliminates any possibility of shortage or disruption through withholding, shoddy maintenance, or gaming and manipulation of energy dispatch. This would include regular reporting about future operational plans at the power plant level and compliance with those plans and reports about operating, maintenance, and capital addition costs for power plants located in Pennsylvania.

Pennsylvania should direct co-location of utility-owned, cost-of-service regulated power plants on footprints located in Pennsylvania. Such a program would advance the goal of economic and job development in Pennsylvania and would assure control over Pennsylvania's participation in next-generation electricity supply technologies. SS-HB could condition approval of a procurement plan on compliance with state-promulgated operation and maintenance standards.

Chairman Kelliher places primary blame for rising electric rates on rising fuel prices, particularly natural gas. This should not matter in Pennsylvania since natural-gas-fueled electric generation is a negligible portion of Pennsylvania's electric supply mix.

Since 1990, the proportion of oil- and gas-fired generation in Pennsylvania's electric supply mix has remained at a constant 4 percent to 6 percent. Coal and nuclear have remained at a stable proportion of over 90 percent. Coal and uranium are purchased typically under long-term supply chain arrangement, including vertical integration of fuel supply and transport, that reflect cost minimization principles and that buffer their cost from volatile short-term price movements.

Price movements in natural gas should not be relevant to Pennsylvania. However, Chairman Kelliher wants to permit owners of non-gas-fired generation to reprice the output as if fueled with high-priced natural gas through their bidding strategies.

Computer models suggest that natural gas power plants are on the margin in the FERC's price-through-bid process and therefore set the price for all output.

Pennsylvania is thus the victim of an economic theory that has little relevance to its specific supply/demand balance or generation supply mix. Chairman Kelliher would like to assert that Pennsylvania has no recourse or redress for this unfortunate circumstance. But again, he has oversimplified.

As part of the long-term procurement plan described in SS-HB 54, Pennsylvania can require utilities to specify the long-term fuel arrangements that will supply their customers and should require any third-party suppliers to demonstrate secure fuel supplies that (1) minimize costs and (2) assure a degree of reliability. Such fuel plans should be long term and should be a condition for approval of any supply contracts obtained pursuant to a procurement plan. Procurement plans should specify generating units that will supply output and permit Pennsylvanians to benefit from the gradual diversification of fuel mix that will occur as next generation.

A final argument is that vigorous assertion of long-term state interests through proactive state regulation may prevent investment needed for both new supply and global warming response. This is fallacious. State-required direct investment in new supply by state-regulated utilities is a straightforward approach that reflects state policy concerning new and advanced technologies and fuel diversification.

Investment has been lagging in some portions of the deregulated merchant sector that Chairman Kelliher wants to promote. That is understandable. Electricity supply projects are capital intensive and must be supported by revenue streams secured by retail load over the decades needed to recover investment.

Competitive markets where retail load is uncertain do not supply the requisite secure support for new investment. Rather, the ability to manipulate prices by creating artificial shortages, such as we are seeing in Pennsylvania, suggests that investment strategies that maintain shortage and locational market power will predominate.

Pennsylvania’s equivocation on ending retail competition, which no longer has any supporters among consumers, is the problem. The only meaningful response to uncertainties about capital recovery is to end deregulation and secure the relationships among buyers and sellers that will secure financing and thus lower risks and financing costs.

In order to create incentives for investment while defending deregulation, Chairman Kelliher wants to promote price escalation and profiteering in the PJM interconnect, which independent Pennsylvania utilities such as Duquesne Light and Power are seeking to escape, so far unsuccessfully. There is no assurance that price escalation will, in fact, result in local supply projects. That result is a mere theoretical prediction, no more than speculation.

This is an unjust and unreasonable approach to capital formation as compared with state-level generation investment directives reflecting state-level policy choices and state-controlled long-term pricing with capital costs minimized over the long term, particularly in a state which already has significant surplus of cheap legacy generation. The alternative approach has been utilized for decades by municipal utilities and cooperatives.

Dynamic sectors, like renewable projects, have financial guarantees in the name of renewable portfolio standards or renewable content standards adopted under state law that guarantee a sales level. In the case of renewable technologies, which are promoted as a matter of policy, the reciprocal element of cost minimization and the prevention of profiteering by developers of the preferred technologies ought to be included in state law under regulation by the Pennsylvania PUC.

Exclusive reliance on wholesale markets subject to the jurisdiction of FERC, as SB 2201 appears to assume, is a fundamental error based on profoundly mistaken assumptions.

SS-HB 54 includes direct investment in generation regulated at the state level but needs to go farther. The jury is no longer out on whether FERC's current regime for regulating wholesale markets has failed.

In December, 41 groups representing the entire gamut of American consumers, from AARP to the Ohio Hospital Association to the Wisconsin Paper Council, requested the FERC to undertake a fundamental examination of the failure of organized wholesale markets to provide just and reasonable rates for consumers. Their specific concerns reflect issues raised by numerous utilities and Commissions throughout PJM and include assertions that sellers are earning super profits in FERC-supervised organized markets beyond what is lawful under the legal just and reasonable standard; rates that consumers are paying in RTO regions where the super profits are being earned are higher than rates in regulated areas due, in part, to seller market power; increases in prices and super profits have not attracted new investment in supply; FERCs rate-making methodology is based on presumed conditions that are at variance with reality, including market power, significant barriers to long-term contracting and significant barriers to market entry and exit.

The issue is not whether wholesale markets exist or are competitive by somebody's definition however at variance with reality. The issue – practically, ethically, and legally – is whether the rates that sellers demand and receive are just and reasonable. Consumers all over the country agree that they are not. FERC has not yet responded.

Reducing Pennsylvania's exposure to wholesale markets, where rates are based on bidding strategies and gaming, provides some protection to Pennsylvania's public from depending on the mercy of profit-maximizing marketers, empowered to raise rates to unconscionable levels by a federal bureaucracy for whom cost transparency, accountability, and rate moderation seem to be foreign concepts.

Reducing exposure is accomplished by direct investment in generating facilities by state jurisdictional electric distribution utilities, financed through utility and public mechanisms.

As indicated above, this is a necessary element of any plan for procurement of electricity in Pennsylvania. SS-HB 54 should be amended to make direct investment by vertically integrated distribution utilities, subject to traditional rate regulation by the PUC, a preferred option for electric supply.

But for the immediate present, FERC does set prices; and Pennsylvania ought to be at the FERC, arguing vociferously for just and reasonable rates that reflect the low actual costs of Pennsylvania-located power plants.

The Ohio PUC (PUCO) recently told the FERC that it intends vigorously to protect Ohio consumers through enforcement activity and that it requires access to wholesale market data in real time, including bidding patterns that might show collusion or gaming.

The Pennsylvania PUC's capabilities in this area should be strengthened, including giving it a specific responsibility to assure that wholesale rates and contracts are specifically determined by the FERC to be just and reasonable on a cost-of-service basis before giving them effect in retail rates and directing the PUC to utilize all of its legal authority under the Federal Power Act to get information bearing on the just-and-reasonable issue and bring it to the FERC and the federal courts.

The Pennsylvania PUC should be directed to strengthen its working relationships with its counterparts in Ohio, Maryland, New Jersey, Illinois, and the other PJM states in these efforts. Until wholesale markets are providing just and reasonable rates under traditional cost-of-service principles, reducing exposure to wholesale markets through direct investment and long-term negotiated contracts where possible and aggressively pursuing remedies at FERC are needed to reassure Pennsylvania's consumers that state government is doing the best it can to protect them.

Energy supply is Pennsylvania's key economic infrastructure in the most basic sense. As infrastructure, the energy supply system represents a permanent investment in Pennsylvania's economy made by the people of Pennsylvania, who live and work here, for their own well-being. It is a capital-intensive activity, backstopped by the ability of Pennsylvanians to pay the costs over the full economic life of the facilities they build. It should not be an occasion for speculative profiteering by traders or other short-timers. Utility profits should be re-invested in Pennsylvania's long-lived energy infrastructure.

HB 2200 and 2201 represent an important beginning, but only a beginning, at regaining control over investment in the state's energy infrastructure.

The Utility Caucus of the State Labor Federation has developed a set of principles for managing that infrastructure which we believe should guide your deliberations on these important bills. The principles will strengthen and improve conditions within the utility industry for both workers and consumers.

I want to sketch the principles briefly, discuss them, and suggest specific amendments to SS-HB 54 that will strengthen the bill and reflect the concerns of the AFL-CIO.

1. The Electric Distribution Companies' Obligation to Serve must be enforced. The General Assembly must enact legislation that restores the PUC's authority to direct EDCs to fulfill their social obligation to provide affordable energy for consumers, including low-income consumers, and enable it to hold utility companies accountable for operation, maintenance, and safety standards.

2. The EDC's duties should include planning for and investing in future generation and energy needs. The Provider of Last Resort (POLR) concept is not adequate and lets the utilities avoid their responsibilities to find the most economical energy for customers who do not shop for power. Conservation programs make good sense.

There needs to be information that is open and transparent on cost and price.

3. Legislation should be enacted that would allow for EDCs to build new generation on cost-of-service recovery, including amortization under a utility facility timeframe of 30 years, not 10 years like other market investments. This would reduce consumer exposure to unfair rates.

4. Legislation is needed to address FERC's lack of planning for energy markets and their failure to set wholesale energy rates that are just and reasonable.

5. There is a serious potential for a labor shortage in all of the utilities, and the state should address the workforce development issue that utility companies face across the state in a comprehensive manner.

6. It is imperative to adopt state-level operating and maintenance standards for generating facilities to ensure reliable electric service; to guarantee a safe, skilled, and trained workforce; and to prevent short-term market price volatility and manipulation.

SS-HB 54 requires each utility that serves retail load to develop a procurement plan with a reasonable planning horizon as part of its obligation to serve. It makes consumers the financial backstop for the plan by mandating cost recovery for energy acquired in accordance with the plan.

2807(e)(3) Further, it presumes that energy acquired pursuant to the plan is deemed to be the lowest reasonable rates on a long-term basis.

2807(e)(6) Unfortunately, the options for consumers under the

HB 2201 plan process are more limited than current law, and the bill fails completely to articulate furnishing reliable service as an element of the obligation to serve.

Current law requires utilities to produce or acquire electric energy for their customers as an element of the obligation to serve.

Section 2807(e)(1) This requirement is unchanged by HB 2201, but the procurement process envisioned by the bill omits the direct production of energy as an element of energy supply. This is a mistake.

Rather than limiting utility options, the current range of options, including direct production and direct investment in supply, should be preserved. The obligation to serve in 2807(e) should be expanded to include maintaining an appropriate reserve margin and meeting explicit inspection, maintenance, and repair requirements for transmission and distribution facilities.

The duty of the Pennsylvania PUC in this regard should be concomitantly clarified by amending Section 2804(1) to direct it expressly to develop operation and maintenance standards for transmission and distribution facilities and for facilities for the generation of electric energy located in Pennsylvania. This will give consumers a specific operational commitment that PAPUC and utilities will attend to reliability.

That concludes my testimony. I am prepared to work with you and your staff to develop language to embody each of the suggestions I have made today.

CHAIRMAN GEORGE: Representative Rubley.

REPRESENTATIVE RUBLEY: That is what we need to correct. We just said the utility will charge prevailing market price, and that will be sufficient. And I think that is where we need to change our focus today.

CHAIRMAN GEORGE: Sir, you know well that the Act is covered and it is called the Competition Act. It could probably fall on one bus and all the individuals in Pennsylvania could go on with another company.

In fact, I can explain that. You called six different companies and no one would take you. That was because that Competition Act just didn't work.

Now, secondly, on what you were talking about as far as stranded costs, some of the plants that were sold were as much as three times more than the stranded cost; isn't that true?

DIRECTOR WOOD: In the case of, as I recall, the one utility, one of the utilities had sold its plants. It was able to sell the plants. And then those plants turned around and were sold at a big profit just six months or eight months after that, as I recall. So the value of the plants has gone up. No question. And the value of those plants on the PJM has gone up.

CHAIRMAN GEORGE: The Competition Act didn't work out for the plants.

DIRECTOR WOOD: I think that even – and I know Representative Ross had to leave – but even Representative Ross's point where even the states where the rate caps have come off in terms of residential competition, we haven't seen a lot of residential competition in the rest of the country, even after the rate caps come off.

And I think that is partly because it is so difficult. It is more difficult than we anticipated to actually go door-to-door. There's not enough savings to generate a lot of residential competition even in the states where the rate caps have come off.

But there has been some competition. There has been competition in Duquesne and now in Pennsylvania Power, but I still think the great majority of residential customers in Pennsylvania will continue to be served by their utilities, just as the great majority of natural gas customers continue to be served by their utilities.

CHAIRMAN GEORGE: But from the information that you would bring, that any of us could read, the other states that have ventured into this are now looking very hard for release of what has taken place because of deregulation.

DIRECTOR WOOD: I think the trend is definitely – as I said in my written testimony, there are a number of states, Connecticut, Rhode Island, Maryland, Delaware, Illinois, that haven't rejected competition; but what they have done is they tried to put in place the kind of procedures that I have been talking about, which is to get the utilities back into the business of making sure that their customers at least have access to the lowest-cost power that is out there.

CHAIRMAN GEORGE: I thank you for your testimony. The Committee thanks you. Are there any questions?

DIRECTOR WOOD: Thank you.

CHAIRMAN GEORGE: Are there any questions?

Representative Rubley.

REPRESENTATIVE RUBLEY: Thank you, Mr. Chairman, and thank you for your testimony this morning on this very, very important topic.

You seem to be saying also that we should be looking at long-term contracts down the road. And as we heard from Commissioner Christy earlier, he strongly disagreed with the provision of House Bill 2201's cap of only 20 percent. Do you agree with that position, that it should be a greater amount, a higher amount than 20 percent for long-term contracts?

DIRECTOR WOOD: I don't believe that legislation should place any cap on the amount of long-term contracts. But I would further call your attention to the part of my testimony in which I also called for utility direct investment and power plants to move back, at least in part, to utility-owned generation as part of reducing the overall exposure to the markets.

Long-term markets tend to be effective to some degree. Therefore, long-term contracting is not the sole solution, but it certainly is part of it.

REPRESENTATIVE RUBLEY: Thank you very much, Mr. Chairman.

CHAIRMAN GEORGE: I thank the lady.

REPRESENTATIVE REED: I want to focus on part of your testimony. I understand you were involved in your position in California.

If you could expand for us the meaning of state-promulgated operation and maintenance standards. What kind of things does that include, and did it include you in your work in California?

DIRECTOR WOOD: Yes. As you may recall, if you were playing close attention – and I imagine you were – during our energy crisis that ran from about May of 2000 until June of 2001, a significant part of that involved the failure of independent, that is, non-utility, generating plants to offer into the market and therefore creating what our commission determined to be an artificial shortage of power.

There were various reasons that were offered for that occurring. One of the reasons was just holding back until prices came down. That had a bad smell to it, and a lot of the generators in this market were reluctant to offer that as a reason. However, there was a certain anarchy of scheduling of outages so that during part of the year, about 40 percent of the fleet of generating plants in California were out of service at one time.

In addition to that, in times of extremely tight electric, certain units mysteriously came down. These are old plants. I used to work in them myself. I was head of the union that represented our plant workers in Southern California, Edison.

It is not hard to concoct a reason for a plant to go down. You have a hot outboard fan bearing on a unit and you can say that we're not going to continue to run the unit for you or we will decide to run the unit. In the old days, the utilities faced with a crisis would continue to run the unit and risk losing their fan motor.

Under these market conditions, the market would deliberately withhold power to drive prices up. Therefore, in a special session, the California Legislature passed a piece of legislation that created a committee to establish operation and maintenance standards for all large power plants in the state, both utility-owned and non-utility-owned; that is, independent power plants.

I became chairman of this committee. And it was made up of myself, as representative of the PUC; the chairman of the Electricity Oversight Board; and the third, an independent expert who was chosen by the two of us. And that was a retired Southern California Edison Utility executive.

And we developed, with the help of the independent system operator in California, a set of standards for the operation and maintenance of power plants. Those were then passed on to the Public Utilities Commission which adopted them as regulation, and then the committee went out of business. And at the present time, those are in effect.

The State Legislature authorized additional staff of the PUC to actually enforce these provisions, which included both announced and unannounced inspections as well as inspections whenever there was a power plant that went out of service without prior notification. And since that time, we have not had a problem with the rolling blackouts and the withholding of power in California.

REPRESENTATIVE REED: I have a particular followup, and you may not be able to answer it directly now but if you could get it for us.

I understand there was a staffing component of inspectors that had to be hired. Would you have any idea of how many people were hired, how big that operation was put in place to oversee these regulations?

DIRECTOR WOOD: Yes. I once knew the exact number. It's been a couple of years. It's in the range of 20 to 25, as I recall.

REPRESENTATIVE REED: That's all I needed. Thank you.

CHAIRMAN GEORGE: Has the gentleman concluded?

DIRECTOR WOOD: Yes.

CHAIRMAN GEORGE: Anybody else? The gentleman, Representative Reed.

REPRESENTATIVE REED: Thank you, Mr. Chairman. I guess, to begin, I would just like to go back to catch a phrase that has been used by two or three testifiers so far where it seems as though everybody is seeking just and reasonable rates, which I think everybody is looking for across the Commonwealth. I would just like to know your definition of what a just and reasonable rate exactly would be.

DIRECTOR WOOD: Yes. As you know, the term just and reasonable is both an explicit requirement of the Federal Power Act and has been since 1935. The exact words of the statute, as best as I can recall them, are, The wholesale rates shall be just and reasonable.

Rates that are not just and reasonable are unlawful.

That's the words in the Federal Statute. That has not been modified or changed by any substantive energy legislation in the United States. That applies to wholesale rates.

As a term of art, just and reasonable historically has a relationship, first of all, to the cost of producing whatever the commodity is or the service that is under the standard, in this case electricity.

And so the application by the first Federal Power Commission and then later its successor, the FERC, was, for many years, that it would be cost-based plus a reasonable level of profit. And that constituted just and reasonable.

A number of years ago, the FERC decided that they would determine what would be just and reasonable, and that continues to be a litigation which has currently been resolved in the Federal Courts.

REPRESENTATIVE REED: The term just and reasonable has quite a history and we've heard an awful lot about the definition. I guess what I am looking for is, what would be a just and reasonable rate increase since the prices have been capped and frozen for 14 years and inflation during that time, general inflation, the CPI, represents about a 40 percent increase? I'm looking for a dollar figure.

The definition we can find elsewhere, and I can research that with the stature. But what is a justifiable rate increase after a 14-year cap, in your mind?

DIRECTOR WOOD: It is whatever is justified based on the actual costs of production of electricity, not necessarily flowing from the general rate of inflation, which only partially influences the cost of electricity.

I guess if you look at some of those numbers I talked about a little bit earlier, a couple of components that drive the cost of electricity, at least in Pennsylvania, with 56-some odd percent of our energy coming from coal – coal has increased by 250 percent; natural gas, which we talked about a little bit earlier, 200 percent; oil, the gasoline to drive the trucks to get the coal to the plants, increased by 300 percent. So it seems like the cost drivers would be increasing even more than that 40 percent during that time frame.

I mean, if you really don't have any idea what you believe is a just and reasonable cost increase or price, that's okay. I can understand that. But it just seems like that is a term that has been brought out a great deal lately, at least today, and it doesn't seem like anybody actually wants to put a dollar figure to that.

So if we are not able to put a dollar figure to it, how do we know that these rate increases are not just and reasonable?

The simple answer is, we can't know that because since deregulation, we have taken away from the Public Utilities Commission the authority to determine the underlying costs. So we have to speculate from the outside.

A couple things that can be said, however, a major part of the generation in Pennsylvania comes from nuclear. The cost of generating nuclear power has not gone up very significantly. I would imagine probably the security side of nuclear probably has increased pretty dramatically since 9/11, especially.

But, again, you don't know. You're freely admitting that you don't know that the rates or the prospective rate increases, when the counts come off, are going to be just and reasonable or not. You don't know if they're going to be too high. And at the same time, you don't know if they're going to be too low either. So the consumers could actually make out in the end of it.

REPRESENTATIVE REED: We had the example earlier where Duquesne Light, there were some customers who have actually seen a price decrease from the 1996 rates.

I'll just move on since we don't seem to be coming to a whole lot of conclusion on actually a definition of just and reasonable.

You talked a little bit about economics in the fourth paragraph of your testimony. And just to begin that real quickly – and this is kind of a side question – do you believe caps should be extended indefinitely?

DIRECTOR WOOD: I think that rate caps should be extended until such time as the state manages, through other means, to reduce its exposure to poorly regulated wholesale markets.

REPRESENTATIVE REED: Okay. Back to the basic economics for a second here. You talked about basic economics would appear to support the extension of rate caps. Now, that really doesn't jibe all that well with what I learned in economics in college.

When you look at the free market system of supply and demand – and, in fact, when you look at – we were talking about folks earlier not really shopping for electricity, you know, different suppliers in their personal lives. And I thought about that statement for a little bit because I have never shopped for my own electricity. I just pay the bill that comes to me, and I don't really question it.

And when I stepped back and I thought about that for a second, it seems to me there would be a pretty significant reason why I wouldn't care personally to shop around for a different supply company. But it is because caps have been in place for 14 years where the free market system has not actually been in place.

Basic economics would not apply to the system that we have had for 14 years because you are restricting the cost of the product. And by restricting the cost of the product, demand would be artificially inflated and supply would generally be artificially decreased.

So we haven't had a free market system for about 10 or 11 years right now. By the time rate caps come off, it will be 13 or 14 years. So I'm a little bit mystified by how basic economics would extend into this because we haven't seen them applied for 14 years.

And then you go on to talk about how we should end deregulation. Ending deregulation would just take us back to the days where we had a pure monopoly within the state of Pennsylvania, which runs certainly in direct opposition to the free market system. So when we talk about basic economics, why and how are you justifying we should extend the rate caps?

DIRECTOR WOOD: Representative, that is a long question. I am tempted to give a very, very long answer. I suspect that the Chairman wouldn't allow me to do that.

First of all, I can't match your academic background in economics. I am an electrician by trade. I picked up a little economics along the way. And one of the things that keeps coming up is that economic theory, however it is presented and whichever school it falls into, always starts out with certain ideal constructs and then when applied to specific situations or commodities deviates from those constructs according to the demands of the particular situation.

Electricity is a very special commodity and service. It is very different from an ideal commodity like corn or hog bellies or some of the other things that are traded on the commodity markets. The reasons that it is different are that it has no substitute for many of its uses. You can't run your computer on natural gas.

Supply and demand have to be in perfect balance at every instant. That is something that I notice as an economist. It is something that frequently economists ignore. It is something that consumers cannot easily, in a short term, adjust their usage.

And we learned that in California very spectacularly during the summer of 2000. Rates in the San Diego area went up by about threefold and the reduction in usage at the conclusion of that period, when we finally recapped the rates, was no more than 10 percent.

Because I don't have a background in economics, I borrowed an economics textbook from my niece and looked up the term elasticity; and there is a simple formula for elasticity. You could probably quote it. I can't quote it off the top of my head.

But I plugged in the numbers and the numbers that we experienced in California, plugged that into the textbook formula, and came out with electricity being an almost perfect inelasticity commodity. In the short term, at least, there is no elasticity. Therefore, there is almost no ability of the market to respond to changes in consumer demand in the short tem.

In the longer term with respect to supply, what we found was that even though – you're talking about price signals. Wholesale prices in California went up well over 1000 percent, not just momentarily or for a few hours, but over a year, for a long, long protracted period.

As a result of those price signals, we saw very little new construction of power plants. We saw a lot of proposals, but we didn't see Wall Street coming in with the money to finance them.

It wasn't until the State directed the utilities to start financing power plants themselves once again that we saw new power plants built so that we have the Mountain View Plant in Southern California, Edison, San Diego Gas and Electric, several plants that were built ultimately with ratepayer funds for the utilities. That was the solution to the failure of the market in California, to build two power plants.

CHAIRMAN GEORGE: We are running short.

REPRESENTATIVE REED: It's really more of a comment. Obviously, some of the folks that have been out there without college degrees are probably a little bit brighter than some of the folks with college degrees, it has been my experience, especially amongst the younger generation of late.

And in fact, my dad is a former TV repairman and factory worker right now. And just to give you an example of I think why we see folks not shopping around for electricity – and perhaps this is a better way of putting it than the question I worded a little bit earlier – when he dealt with looking at Internet capabilities for his household, originally he only had the opportunity to have Comcast because he was in a pretty rural community. Verizon DSL was not available, so he had to pay the monopoly price of Comcast.

When Verizon entered into that market, should rates have been capped and they had the exact same rates, the exact same product, he would have had no incentive to switch from Comcast to Verizon because the price was going to be the same. Human nature would take over and he would make no change.

However, because rates are not capped and they were different prices, he shopped around at that point and said, I can get the same basic product from Verizon and dollars cheaper a month. Then he made that decision. Should rates have been capped and been exactly the same, he would have had no incentive to shop around.

And I guess, I would say, that once the rate caps come off and true competition enters the market and there are two choices, then you are going to see folks become a little aware of what decisions they are about to make about their electricity provider and shop around for the best rates. And I would venture to guess that you are going to see rates go down from where they are predicted to be. So thank you for your testimony.

Thank you, Mr. Chairman, for being a little bit lenient with the time.

DIRECTOR WOOD: I appreciate Dave's comments here but maybe one day I will go to Indiana and he and I can have a debate in front of his constituents on free market versus a market that really satisfies the public and talk about what is the best for them. And free markets have been around a long, long time and we need to have a good debate about what's best for America.

CHAIRMAN GEORGE: Let me thank the presenter for his patience and for his presentation. I think that we gain much out of these types of deliberations. I thank you for giving us the courtesy of coming before us. Thank you very much.

DIRECTOR WOOD: Thank you very much.

CHAIRMAN GEORGE: Our next presenter will be John Laudenslager. He will be presenting on behalf of Morgan O'Brien, the president of Duquesne Light Company.

Welcome, Mr. Laudenslager.

MR. LAUDENSLAGER: Thank you and good morning, Chairman George and Chairman Hutchinson.

The last time I talked with Morgan, he was in a snowbank somewhere near Pittsburgh. So I apologize that he couldn't make it in this morning. And I guess that snow is coming this way so we better think about whether to stay here an extra day or come back later on today.

I want to speak on behalf of Duquesne Light and Morgan O'Brien and Director Wood. I have known him for 37 years, so I hope I can speak well enough on his behalf as well.

I think that Morgan would say that we have a unique perspective that we would like to offer you today. Morgan and I, we work for a utility company that is not a major player in the generation business. We are a distribution and transmission company only.

I work for a company where deregulation has worked and I think there are some reasons that I am going to hopefully share with you of what we think makes sense.

We have been without rate caps for over five years, since 2002, when our rate caps came off our residential customers and shortly thereafter off of all of our customers. But residential and small business customers today have rates that are lower than they were fifteen years ago. And those rates will stay at that rate through 2010, to the end of our current supply period.

Duquesne Light has already gone through the transition that many people talk about and look forward to. We have gone through that transition from rate caps to competitive prices; and it has been enormously successful, we believe.

We have the situation in Pennsylvania that occurred from a crossroads. And rate caps, as you all know, are going to come off for everybody at the end of 2009 or 2010. But the wholesale markets, which in Pennsylvania is mostly the PJM regional transmission organization, are not customer-friendly. This is our experience. In fact, I will describe PJM as weighing heavily and most times exclusively in favor of generators rather than customers.

I have a couple examples of this and some of these are very short and some I have already mentioned here before about PJM and how it sets its hourly prices.

The highest-bidding generator sets the wholesale price of electricity in any hour whose production is called upon to meet that hour's energy needs. Thus, you can have lots of low-cost production plants like Pennsylvania has and the price for an electron used by a customer in any hour will still be expensive because the price is set by the most expensive power plant in the region. We talked about that several times.

Prior to deregulation, regulators set the price of power based upon the historical cost of production of each utility. Customers have a blended rate for generation, some high costs and low costs, because there is a portfolio of generation that each utility has. We'll talk about portfolios a little later because that's how we think we have been successful. In the case with deregulation, as PJM has designed it, customers pay the highest price.

The wholesale price of electricity also includes an artificially inflated price for the capacity value of those generating plants. This is PJM and FERC and this is one of the things that Duquesne Light is very seriously fighting about, in fact, when we failed to meet PJM and to move to another regional transmission organization just because of these inflated prices for the price of capacity.

This charge is above the price of electricity actually consumed. For our customers, one day in August, when the peak is created, sets the price that customers have to pay all year long. And they paid it regardless of whether that plant is running or not or whether they use it or not. That is the price that is artificially set by PJM.

PJM has set the price in this manner to encourage the building of new power plants. One take on this approach on this is that it is designed to pay a big premium to power plant owners in the hope that if you pay them enough, they will eventually build more plants.

The market is not regulated and one ramification of this is that no regulator oversees and no one else oversees the building of future energy needs for customers. So the response to this lack of oversight results in over-inflated payments for the value of the power plants.

It would seem to me that if you are paying a high price for a plant, it will be hard to encourage me to build more plants and increase the supply and therefore reduce the price that I'm getting for that plant.

It just seems kind of contradictory.

These two issues along with the wholesale markets will make the price of electricity higher for customers for the next five years and the foreseeable future.

Adding greatly to this problem, something specifically that Duquesne Light is concerned about, is the way energy utilities need to buy and procure for the customers the way in which it is bought and priced.

Regulators support auctions and RMP requests for proposals. While this intuitively seems like it encourages competition and it is the best way to get the lower prices, auctions so far have not resulted in low prices.

And that is true for us in Duquesne Light's territory for the last five years. It is true for the auctions that have taken place and the RMPs that have taken place. Those prices have been higher than the prices Duquesne Light Company has been able to secure for its customers.

For the past five years, Duquesne Light has kept its customers' rates low by entering into multi-year market-based contracts, again, market-based contracts. We do not own any generation. We have no vested interest in the generation prices going high. So we have had multi-year market-based contracts, a portfolio of supplies.

The reality of the situation in Pennsylvania is that the generation owners are affiliates of many of the regulated utilities. And while this issue alone creates a great amount of obvious conflict, there are truly just a small number of generation owners competing in these auctions. The generation companies and the unregulated affiliates of the utilities are reaping record profits and are publicly predicting higher earnings in the future. There is a reason for that. The regulated utilities' customers are paying record prices.

For the past five years, Duquesne Light has kept its customers' rates low by entering into multi-year, market-based contracts with electric suppliers. We have found suppliers who are long on generation and have been able to negotiate prices that are lower than they were during the time of regulation. Our customers have been offered fixed prices and stable prices. Our current residential customers have three-year fixed prices to 2010 that are lower than they were 15 years ago.

Some proposed legislation and current PUC regulations would put limitations – we talked about that 20 percent limitation – on how we procure power, that we couldn't do long-term bilateral contracts, negotiated contracts, that everything would be required to be done on a bid basis through an RPM officer. And, again, it hasn't resulted in lower costs.

Be assured that in Duquesne's case, we currently have 20 negotiated contracts in the market at the right time to provide that power as prices move on and fixed over the next three years for our customers to 2010, 20 contracts.

And a certain piece of legislation would say, you can't do that. You can only go out to your auction, which we know around us in in Pennsylvania Power and the PP&L area and other areas has resulted in higher prices than we were able to secure for that same period to such an extent that we would be unable to procure energy for our residential and small business customers through this method.

Be assured that these limitations will result in significant electric bill increases for my customers in Allegheny and Beaver Counties.

Morgan was involved, as some of you were. I wasn’t. But Morgan was involved back when the original deregulation was created. And he recalls that the goal of the legislation at the time was reliable service at the lowest price. Or as someone referred to it, the lowest reasonable price over time.

Unfortunately, what we have gotten up until now is customers paying extremely high prices and not getting anything extra for it because the market bias towards generators exists and not for these customers. Customers in that concept have seem to have fallen out of the equation.

I know you are concerned about the rate hikes your constituents are expected to face. And I believe the best way to avoid unnecessary hikes is to stop the train and take some time to study all the issues.

Don’t be in a hurry to pass legislation just for the sake of passing new legislation. Our recommendation is to put the entire electric restructuring legislation on the table, spend the next six months or so studying all the viable alternatives of designing an electric market.

Be careful and thoughtful of any changes in course, but design an electric market that will provide customers in Pennsylvania the best product at the lowest price. The answer may not be as simple as choosing between a regulated model versus a competitive market model.

Thank you. I will be glad to answer your questions.

CHAIRMAN GEORGE: I thank you very much.

Representative Vulakovich.

REPRESENTATIVE VULAKOVICH: Thank you, Mr. Chairman. Thank you, gentlemen.

A couple quick questions. One is, the rate caps have already, if I understand it correctly, come off in Duquesne Light's service area; is that correct?

MR. LAUDENSLAGER: Yes. The rate caps were taken off in 2002. At that time, we paid down our stranded costs and rate caps were removed.

REPRESENTATIVE VULAKOVICH: And if you can give me the price change once the rate caps came off?

MR. LAUDENSLAGER: Our residential customers, when the rate caps came off, saw a 22 percent reduction.

REPRESENTATIVE VULAKOVICH: Now, in other areas of the country and even Pike County in Pennsylvania, which is part of, I think, the New York grid, which is why Pike County came off sooner than just about everyone else, can you give me an analysis of, say, Maryland where the average increase when the rate caps came off was about 65 percent? What was the basic difference that you saw a price reduction – or not you, but your customers – and that did not happen or has not happened in other areas where the rate caps came off?

MR. LAUDENSLAGER: Well, I'm not an expert on the other areas. But I can say two things that I think are true. One is that when the rate caps came off and that stranded cost that was charged customers came off the bill, that it reduced it by 22 percent.

I think the main reason for that – and I think somebody talked about it earlier – Duquesne was one of the few if not the only utility that made a decision to sell its power plants. We sold the power plants in 2000 on the open market and at that time, it was a great market for selling. Everybody was trying to buy power plants. The price was perhaps inflated.

But as a result, our customers gained from that because we were able to then pay down the stranded cost from the proceeds of those sales much faster than we would have ordinarily. That is why in 2002 rather than 2005, 2006, as was originally planned, our rate caps came off.

Since that time, however, we have been doing negotiated contracts. We haven't depended upon – and again, I'm not an expert in the area of Pike County and Maryland and others. But I think that some have at least claimed that the timing of the auctions, that those areas went through – the RPS was ill timed or it was time for a hurricane.

What Duquesne Light has done since 2000 and actually in

2002 is negotiated contracts with suppliers at various times of the market. And when you do that, you build a portfolio of generation supply, some amount of megawatts you buy on a five-days-a-week, eight-hours-a-day; some you buy 24 hours a day by 7; some you buy on a short-term three-, six-month process; some on a longer term, a year, and year and a half, two, three years, to build a portfolio so that you, in fact, build that graph to suppliers.

We think that all uses or all methodology of competition, competitively procuring by whatever means you can, not just large fees or auctions, in whatever means you can to get the lowest price to the customer over time is the way to go.

Our test has always been, if we can get the lower price in the market for our customers, that is a success.

REPRESENTATIVE VULAKOVICH: Thank you.

Final question, I guess you could say: Was there a strategic decision by Duquesne based on what you just talked about in selling off your generation or did you just get a little bit lucky in how the circumstances worked out or did you foresee this as being resolved?

Just go into why Duquesne sold off the generation and others did not, because I would be interested to know, What was the strategic rationale behind that?

MR. LAUDENSLAGER: Well, I always like to be a little lucky and look good, but the reality is that Duquesne Light is a relatively small company, 800 square miles in the Pittsburgh area.

We had the power plants. We were the first ones in the nuclear power plants in the United States and we had our troubles and problems with those plants over time. We also had two 100 percent-owned power plants – actually, three power plants at Cheswick and a unit.

That is all the plants we had. And we felt at that time – and Morgan O'Brien was one of the people driving that process – that we would not be a small player in a very big market and that we did not have a portfolio of power plants that we thought made sense.

We would be small compared to, say, Duquesne Power and Southern Company, some of the bigger companies, PP&L and others that have multi-state or multi-national generation. So we felt that it was not a business we needed to be in or could be in and be liable, simply because the coal power plants that we had at the time, which are still operating, by the way, were older plants, 35, 40 years old.

So we made that conscious decision that it would be a good thing to sell those plants because we weren't going to add to the plants. Again, we weren't going to add more generation to other power plants.

The other thing – and I will be very honest with you – is that – and people behind you will say this – well, part of the reason was that you sold at that time in the market because you needed to get a good price and you could reduce your high prices because Duquesne Light, along with Philadelphia Electric, was one of the highest prices in the state. That was part of the decision as well. We felt that we could get a very good price for our plants and bring down that stranded cost, and the cost for our customers was our reason.

REPRESENTATIVE VULAKOVICH: Thank you, John. Thank you, Mr. Chairman.

CHAIRMAN GEORGE: If my memory serves, at one time, your company wanted to join the Allegheny, is that not correct?

MR. LAUDENSLAGER: That's correct. We did. In fact, I was, for a whole nine months, sequestered in a building somewhere half-way between Greensburg and Pittsburgh working on one of the teams that we were trying to get that merger to them.

And I'm sure there are a lot of reasons, many of which I don't know, why we didn't go through with that merger. But at the time, I think one of the reasons Duquesne let it just sit was it was of the opinion it needed to get out of the generation market. Allegheny was not of that mind.

And who was right or wrong? That was one of the things that maybe didn't make this come together as quickly as we thought.

CHAIRMAN GEORGE: I thank the gentleman for his presentation.

MR. LAUDENSLAGER: Thank you.

CHAIRMAN GEORGE: Come again.

We received a statement from the following, which will be attached, from Lawrence T. Simon, chairman and chief executive officer of Penn Regional Business Center, a project of the Synchrium Group.

If there is no further business, I thank all who have participated.

(Statement of Lawrence T. Simon, Chairman and Chief Executive Officer of Penn Regional Business Center, the Synchrium Group, marked for identification as Exhibit No. 1)

CHAIRMAN GEORGE: If there is no further business.

REPRESENTATIVE RUBLEY: I have one suggestion, Mr. Chairman. Maybe you are thinking of this already. But this is one of the most important issues our residents throughout the state are going to be facing in the next few years, and I wondered if we could schedule some other hearings.

I would love to have PJM come in and be able to interview them and other major utilities, and I just think it would be helpful if we could do it on a day that we are not in session and competing with so many other committee meetings.

CHAIRMAN GEORGE: I can explain the difficulty to you of having a meeting on a day of session. Most legislators have three or four committees, and see what has happened.

You can be sure that if it stops raining and the water doesn't raise, we are going to have other hearings, one in the east and one in the west.

If there is no further business before this committee, this committee is adjourned.

(Whereupon, the hearing concluded at 2:00 p.m.)