
**TESTIMONY BEFORE THE HOUSE ENVIRONMENTAL
RESOURCES & ENERGY COMMITTEE**

**ON BEHALF OF THE
INDUSTRIAL ENERGY CONSUMERS OF PENNSYLVANIA
(IECPA)**

MAY 27, 2009

RE

**HOUSE BILL 2791 OF 2007/2008 SESSION
(PENNSYLVANIA POWER AUTHORITY)**

**Vic Sawicki
Air Products & Chemicals, Inc.
Rate Cap Expiration Committee Chairman for the
Industrial Energy Consumers of Pennsylvania**

Good afternoon Chairman George, Representative Hutchinson and members of the Environmental Resources and Energy Committee. My name is Vic Sawicki and I am testifying today on behalf of the Industrial Energy Consumers of Pennsylvania or IECPA. I am a Senior Energy Manager with Air Products and Chemicals, Inc., in Allentown, Pennsylvania, and I serve as the Chairman of IECPA's Rate Cap Expiration Committee. We appreciate the opportunity to testify before you today. IECPA supports the creation of a federal Commonwealth Energy Advocate and a Pennsylvania Power Authority as proposed in House Bill 2791 of the 2007/2008 session, if the power authority provides economic development power to large commercial and industrial customers in the Commonwealth, in addition to the other functions set forth in HB 2791. If this proposal is reintroduced during the current session, we urge the General Assembly to expand the purpose of the power authority to include the provision of economic development rates to large commercial and industrial customers that meet certain criteria and are willing to make a long term commitment to purchase from the Authority, rather than accessing the other supply alternatives that may be available through the anticipated retail supply market.

IECPA is a group of large industrial, commercial and manufacturing energy consumers, formed for the purpose, among others, of ensuring that adequate and reliable long term supplies of electricity are available in Pennsylvania at reasonable costs. IECPA members include 24 large industrials collectively employing over 43,000 Pennsylvanians. Electricity consumption represents a significant element of production and operating costs for our members. For example, electricity typically represents 70-80 percent of the operating costs of an industrial gas processing facility such as those owned by Air Products. Air Products has sole or partial ownership of five manufacturing facilities in Pennsylvania that are significant consumers of electricity, as well as a number of smaller manufacturing plants using a smaller amount of electricity and our corporate office in Allentown that

employs over 4,000 workers. At some of these facilities, electricity can account for as much as 70% of manufacturing costs. For IECPA's larger steel manufacturing members, a 1¢ per kWh increase in electricity rates can mean \$5 to \$10 million dollars in additional operating costs for the facility on an annual basis. Electricity costs are of critical importance to such operations. At a time when our national economy is already under stress, allowing the electricity rate caps in Pennsylvania to expire without a plan to mitigate the short term and long term impacts of the rate increases on the manufacturing base in Pennsylvania could be disastrous.

WHY PENNSYLVANIA NEEDS A POWER AUTHORITY

IECPA was, and is, a supporter of the restructuring effort to introduce competitive alternatives for the generation supply portion of the traditional bundled electric service. Assuring that Pennsylvania's business and industry remains competitive in the national and international markets was one of the main motivations for the adoption of the Electricity Generation Customer Choice and Competition Act in 1996. For example, the declaration of policy of the 1996 Act recognizes that "the cost of electricity is an important factor in decisions made by businesses concerning locating, expanding and retaining facilities in this Commonwealth" and "this Commonwealth must begin the transition from regulation to greater competition in the electricity generation market to benefit all classes of customers and to protect this Commonwealth's ability to compete in the national and international market place for industry and jobs."¹ These statements and policy goals remain as important and true today as they were in 1996, and we urge the Committee to keep them in mind as Pennsylvania addresses the currently-scheduled expiration of electricity rate caps over the next eighteen months.

¹ 66 Pa. C.S. § 2802(7) & (8)

If the rate caps are allowed to expire without a plan to address the impact, there is a high probability that customers' expectations of lower prices due to the restructuring efforts, and the correlating enhancement of our ability to compete in the national and international marketplace due to those lower prices, will not be met in either the short term or the long term due to the wholesale market design. Industrial consumers are sometimes asked why we are so critical of Pennsylvania's electricity situation in 2009 when we had been vocal supporters of the restructuring movement in 1996. The reason is simple. The Pennsylvania wholesale electricity market changed significantly between 1996 and 2009, and those changes do not benefit customers. At the time the original legislation was passed and the restructuring proceedings were conducted, we could not have anticipated the structural changes that would occur over the last thirteen years, nor the disastrous impact those changes would have on wholesale prices in our region.

As the Committee may be aware, there are competing studies and economic theories about whether the current wholesale market design is preferable to other alternative designs that would still ensure reliability, but result in a more equitable sharing of costs and benefits between customers and generation owners. I will not rehash those competing arguments here today; however, from the practical perspective of a business person that is looking at the bottom line impact of the market design, it is indisputable that the continuation of this design, together with the exposure of Pennsylvania customers to the full impact of this market, places our business and industry at a competitive disadvantage because the design is not uniformly used throughout the United States. The Federal Energy Regulatory Commission (FERC) is not mandating the expansion of this design into additional areas. Pennsylvania manufacturers are competing against facilities and regions that do not have this wholesale market design and in states that do not have retail competition. Moreover, many of our facilities are competing on a global basis. Pennsylvania businesses and

residential customers will suffer due to higher prices and unless the Commonwealth takes action both to significantly improve the wholesale market design and to provide alternatives to customers that produce a more reasonable rate. IECPA views a power authority as a part of the solution to help Pennsylvania business and industry in overcoming the challenges of those competitive disadvantages. Although it is not the entire answer to the dilemma of high electricity prices, it is a step in the right direction.

IECPA members supported the original retail industry restructuring initiative with the belief that the market would develop to meet customers' desires and demands for electricity products on reasonable rates, terms and conditions. Before reaching the decision to support a power authority, IECPA members explored other methods to obtain the reasonably priced electricity that we desire in the wholesale and retail marketplaces. Specifically, a group of companies has been exploring whether a bilateral contract is available that would meet our needs for appropriate electricity rates when the caps expire. We have been looking for arrangements to obtain long term price stability through contracts with generation owners or developers at reasonable rates that will still allow the suppliers to make a fair profit. We requested pricing structures based on the generation owner or developer's actual cost to produce the power, plus a reasonable profit.

The pricing that we were offered from entities that owned existing generation units did not conform with this structure, and instead was linked to the expected profit that the generation could earn if all of its power were simply sold in the PJM Locational Marginal Price (or LMP), that is the wholesale market clearing price for power in the short term "spot" market. We also spoke with companies that were looking to build new generation facilities; perhaps understandably, they requested each customer in the group to take on a long-term liability for "take or pay" obligations. Although this type of structure may be preferred by the supplier to provide the necessary

demonstration to financial backers of the viability of the project, most manufacturers can not withstand the strategic and accounting implications of a long term take or pay contract. In addition to the potential legal damages that a customer would owe if it ceased manufacturing prior to the expiration of the long-term commitment, the take or pay nature of the contract creates balance sheet implications, because, in some instances, the entire contract liability must be placed on the customer's books at the beginning of the contract. This prevents many industrials from entering into the types of contracts that appear to be necessary to support the development of a new generation facility. Moreover, the credit implications of those deals can be quite onerous. In a nutshell, we found that a legitimate, negotiable, bilateral market is not available to customers that fills their needs for appropriate electricity rates, terms and conditions.

A power authority could be an alternative for customers that want a long-term, cost-based supply service in exchange for a commitment to purchase supply solely from the authority. The authority could do this either through contracts with developers or through the purchase or construction of generation facilities, or a combination of both. This would represent another alternative for customers that can coexist with the ability of other customers to access the anticipated retail markets to obtain generation supply from other suppliers on a shorter-term basis, without a commitment to remain on the service. The power authority also can provide benefits to industrial customers who are not directly served by the authority and to residential and commercial customers through procurement as originally proposed in House Bill 2791, and through the implementation of other construction or investment strategies that would operate to decrease the overall prices for all customers in the PJM markets. I will explain each of these powers and functions in the next portion of my testimony.

POWERS AND FUNCTIONS OF POWER AUTHORITY

Purchase or Construction Generation Facilities

The purchase or construction of generation facilities would be a primary function of the authority, using a business model that can reduce the cost for recipients of its power, but also improving the prices in the wholesale markets. In our view, the FERC wholesale markets are not providing sufficient motivation to build baseload generation plants, which would bring the price down in the entire market by decreasing the reliance on inefficient natural gas and oil units. In fact, many believe that the current market design provides a disincentive for any existing generation owner to build or expand baseload capacity because the new construction would shift the supply-demand curve towards lower prices, and devalue any other existing generating units that are owned by that same company. Because the power authority has the purpose of providing the lowest cost resources to its subscribers and to the default service providers, as well as the goal of promoting overall lower market rates for Pennsylvania, the power authority has the motivation to build baseload generation units where and when needed. In addition to making the construction of the appropriate baseload facilities more likely, the authority could use a portion of the output for economic development purposes and to serve the default service needs of other customer classes.

In addition, overall market prices also could be reduced under the PJM model if efficient peaking generation units were sited strategically in Pennsylvania to relieve transmission constraints. In fact, one of the alleged justifications for the PJM energy market model was that it would send price signals to indicate where generation units are needed because the transmission system is constrained or insufficient generation exists to serve the load in the area, with the result that new suppliers would enter the market to relieve the constraint and thereby drive down prices. Again, a traditional developer may not have the motivation to build generation in those places due to the

devaluing impact it would have on other units within its existing generation fleet. The power authority, however, would have a different motivation - to build those units to minimize cost both for its customers and for others in Pennsylvania.

In addition to its salutary effects on the wholesale market, the power authority operates under a different business model than traditional generation merchant plants with access to different financing, which could include Commonwealth-backed bonds. In IECPA's estimation, the financing differences between a power authority and a merchant plant are the key reason why this proposal may be beneficial and lead to lower costs for its business and other consumers. First, the debt to equity ratios for the power authority can be higher than merchant business, and it could even be 100% debt financed. Generally, the cost of debt would be lower than the return that a shareholder for a merchant project would expect. Second, the "share holders" of the power authority are the citizens of the Commonwealth, rather than private investors seeking to maximize the value of the generating unit by selling into the locational marginal price market. This will enable the power authority, using a cost of service model, to price the output on a more stable and lower cost basis than a model which relies on the wholesale market for its purchases. Third, we would anticipate that the cost of debt for the power authority would be lower than the cost of debt that would be available to a merchant plant in the financial market place. As I mentioned previously, if these advantages and the willingness to price electricity on a more reasonable basis produce even a 1¢ per kWh price reduction for larger customers, this can have a substantial impact on a manufacturing facility's bottom line and profitability.

Enter Into Contracts With Generation Developers

As an additional function, the power authority can enter into contracts to purchase output from generation units or customers that construct on site generation units. As I previously discussed,

due to market conditions and balance sheet implications, it is difficult for the IECPA members to enter into the type of long term contracts that we desire with developers. The power authority can stand between the commercial and industrial customers that desire these types of deals and the developers of the project to ensure that the output will be needed. If a particular customer of the power authority ceases operation in Pennsylvania, that power can be used to supply additional customers with economic development needs. The power authority would also have the credit backing of the Commonwealth, which would minimize or eliminate the credit requirements placed on the individual customers. This will enable the authority to provide the developer with a stable price and revenue stream that is necessary to support a request for private financing for the project.

Provide Supply to Commercial and Industrial Customers for Economic Development Goals and Purposes

As originally proposed, HB 2791 authorized the power authority to procure supplies for default service customers, which would be passed on to the electric distribution companies to serve customers at cost. IECPA urges the General Assembly to expand the purpose of the power authority to include the provision of supply service directly to commercial and industrial customers for economic development purposes. This supply could be available to customers who are willing to enter into a long term commitment that can be tailored to their specific needs. The customer would be required to demonstrate the economic development purpose and goal that is furthered by the service, such as job creation, job retention and other factors. Specific criteria could be created for this offering, with the ability of the authority to also entertain other options that meet similar economic development goals. Attached to my testimony is a list of potential criteria that could be considered. Finally, it would be critical to ensure that there is competitive neutrality by ensuring that similarly situated and directly competing businesses are treated alike in terms of access to offerings

from the authority. Draft legislative language memorializing this concept is also attached for your consideration.

Benefits for Other Customer Classes

Although my testimony has centered on the benefits to industrial customers through the power authority, the power authority can also benefit other customers, indirectly, as I have mentioned, by benefiting the wholesale market, but also, potentially, through the default service procurement as originally proposed in HB 2791, though we would suggest that the term of the power supply be commensurate with the term of the commitment from the customer to receive its power from the authority. IECPA also would be open to other ways that the power authority could provide a benefit to other customer classes, as long as there is an assurance that no interclass cost subsidization is created.

OTHER STEPS

I have focused primarily on the ways that the power authority, while coexisting with the wholesale markets, could assist Pennsylvania in bypassing the most detrimental effects of the federally-designed spot markets. However, IECPA also fully supports initiatives to advocate before PJM, FERC, Congress and other federal agencies for improvements to the market design. The creation of the Commonwealth Energy Advocate to represent retail ratepayer interests in those wholesale and federal fora as proposed in HB 2791 is a very important step to ensure that Pennsylvania's interests are considered. In our view, customer interests are currently underrepresented in these fora. IECPA has drafted some minor modifications to the language regarding the energy advocate from HB 2791 to ensure that the focus of the agency remains on encouraging rules to allow the wholesale electric power markets to operate efficiently, effectively

and in the best interest of retail customers. We will make that language available to any interested member of the Committee.

Finally, the creation of a power authority or implementation of market design changes by the Commonwealth Energy Advocate will take time. Customers in the PPL territory, however, are currently scheduled to see the potentially disastrous effects of the exposure to this flawed wholesale markets on January 1, 2010. As a result, the Committee may need to consider proposals such as a rate cap extension, rebates or other concepts to mitigate the imminent increase while the power authority and the commonwealth energy advocate get up and running.

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IECPA appreciates the opportunity to provide its views on HB 2791 and the potential benefits of a Pennsylvania Power Authority. I look forward to any questions that you may have.

**§ATTACHMENT TO TESTIMONY OF VIC SAWICKI
MAY 27, 2009**

ECONOMIC DEVELOPMENT ELIGIBILITY CRITERIA

(a) The criteria to determine whether a commercial or industrial customer is eligible to be served by the authority shall be as follows:

(1) To be eligible, a customer must be willing to commit to take all of its power needs for the account from the authority for a long term.

(2) Additional eligibility criteria shall include two or more of the following:

- (i) Be a manufacturer; or
- (ii) Be a large consumer of power in Pennsylvania; or
- (iii) Be a user whose electricity bill is a high percentage of their conversion cost (manufacturing cost less raw materials cost); or
- (iv) Use power at a high load factor on an annual basis; or
- (v) Help to create or retain a substantial number of jobs in Pennsylvania; or
- (vi) Help to maintain the profitability of a Pennsylvania business at risk; or
- (vii) Create new capital investment in Pennsylvania; or
- (viii) Have demonstrated a long term commitment to Pennsylvania, as evidenced by the longevity of operations; or
- (ix) Help other businesses in the Commonwealth to remain competitive by lowering their input costs; or
- (x) Help to retain a business at risk of moving to a location outside of Pennsylvania.

(b) The authority shall have discretion to allow eligibility based on criteria that are not specified in subsection a, provided that the grant of eligibility furthers similar economic development goals.

**PROMOTING ECONOMIC DEVELOPMENT WHILE ENSURING
COMPETITIVELY-NEUTRAL ACCESS BY CUSTOMERS TO OPTIONS**

The authority will support economic development, including the retention of jobs at existing commercial and industrial facilities, by offering generation supply options on a cost of service basis to eligible commercial and industrial customers that agree to waive the right to switch suppliers during the term of the contract. In performing this function, the authority will ensure that directly competing customers are afforded similar opportunities on generation supply offerings available from the authority. Customers shall be considered direct competitors if they make the same end product (or offer the same service) for the same general group of customers. Customers shall not be considered to be direct competitors if they produce only component products of the same end product.