

**BEFORE THE PENNSYLVANIA HOUSE
ENVIRONMENTAL RESOURCES AND ENERGY COMMITTEE**

Testimony of

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Regarding

Electric Rate Cap Expiration

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**Chairman George, Chairman Hutchinson
and Members of the Environmental Resources and Energy Committee**

My name is Sonny Popowsky. I have served as the Consumer Advocate of Pennsylvania since 1990, and I have worked at the Office of Consumer Advocate since 1979. Thank you for inviting me to testify here today at this important hearing.

We stand at a critical point in the history of the Pennsylvania electric industry. The generation rate caps that have long protected most Pennsylvania electric consumers will be coming off at the end of this decade. But they will be 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.

When the Pennsylvania electric restructuring law was enacted in 1996, it was widely believed that competition would drive **down** the price of generation. Indeed that was the whole point of restructuring, and that is why we allowed our utilities to recover billions of dollars of “stranded costs.” Stranded costs represented the difference between what our electric utilities invested in their regulated power plants, and the much lower amount that we thought those plants would be worth in the new competitive generation market. Rate caps were implemented as a type of safety valve, just in case rates did not go down as anticipated. The rate caps lasted only as long as the utilities were recovering stranded costs, and were designed to prevent the utilities from charging customers **both** for stranded costs **and** for higher than expected generation rates at the same time.

As it turned out, however, wholesale electric generation prices have increased substantially in the last several years. These increases have resulted from two factors: first, the large increase in the cost of natural gas and other fossil fuels that are used to run many of our power plants; and second, the manner in which wholesale prices are set in the PJM market in which most of our utilities operate. Because the prices paid to all power plants are based on the bids of the highest priced unit operating in any hour, the impact of high fossil fuel prices is multiplied. In addition, generation supplies have tightened, and PJM's response has been to develop a new rate mechanism for capacity that results in even higher prices being paid to generators. So, instead of generation rates coming down at the end of the rate cap periods, we now expect that rates will increase substantially in 2010 and 2011 for the great majority of Pennsylvania consumers.

The other mistaken assumption that many of us made when our restructuring law was passed in 1996 was that most customers would flock to lower-priced competitive retail suppliers. That is why the law included a requirement that customer choice had to be phased in over a three year period, so that all customers could not leave their utility immediately to shop in the competitive retail market. In fact, however, retail competition for residential customers has been very limited and the vast majority of residential customers continue to receive generation service at capped levels from the same utility that provides them with regulated distribution service.

So instead of entering a post-rate cap world in which residential customers would be choosing among an array of retail marketers who would be offering substantial savings from pre-restructuring regulated rates, we are faced with a situation where most residential customers will be purchasing generation from the same utility supplier they always have, at prices that are higher, not lower, than the previously regulated rates.

Even in 1996 however, the General Assembly recognized that at least some consumers might not be able, or might not choose, to switch to alternative competitive generation suppliers by the time rate caps expired. The 1996 Act therefore declared that each utility (or an alternative “default service” supplier designated by the PUC) retains the obligation to acquire generation for those customers who could not, or chose not, to receive generation service from an alternative supplier. Under the terms of the 1996 law, after the end of the rate cap “transition” period, the utility default service supplier would be required to obtain generation “at prevailing market prices” to serve those customers. This provision received relatively little attention in 1996 when the common assumption was that wholesale competition would drive down the cost of generation and that most customers would switch to retail competitors who would offer service at lower prices than the incumbent utilities. What we know now, however, is that the utility default service has been, and is likely to continue to be, the predominant service -- at least for residential customers -- for the foreseeable future.

That is why, in my opinion, we need to act.

Instead of simply acquiring energy at prevailing market prices to serve a handful of non-shopping residential customers, I believe that the role of our electric utilities as rate caps expire must be to secure a portfolio of generation resources to serve their residential customers at the lowest reasonable cost over time. This fundamental change in policy is contained in both House Bill 2201, sponsored by Representative McCall, and in Special Session House Bill 54, sponsored by Chairman George. Both of those bills would replace the “prevailing market prices” language in the current law with a requirement that utilities acquire a portfolio of resources for their default service customers that is designed to produce the lowest reasonable rates on a long-term basis. Under both of those bills the utility portfolio would include long-term, short-term and

spot-market purchases that would be acquired through a variety of methods including auctions, requests for proposals, spot market purchases, and bilateral contracts. Under these bills, it would be the utility's goal – it would be the utility's job – to seek out the lowest cost power for the utility's default service customers. The utility would then be permitted to recover the costs of that service from those customers.

I think it is particularly significant that both House Bill 2201 and Special Session House Bill 54 include long-term contracts as part of the utility's portfolio of resources with which it can serve its default customers. I believe that such long-term contracts may be necessary to bring new resources to Pennsylvania – and to the regional wholesale market – that are needed to prevent the continued upward spiral in wholesale prices that has stricken other nearby states when their retail rate caps expired. I am concerned that, in the absence of long-term contracts, it may not be possible for new market entrants to finance and build new generation that will be necessary to serve customers in the future. If we want new competitive entrants in the PJM generation market, then we cannot expect them to develop long-lived generation assets based solely on the availability of short-term contracts. To the extent that new generators can receive the benefit of a long-term contract for the sale of their product, they may be able to offer more reasonable long run prices than if they have to rely solely on short-term market results. Total reliance on short-term wholesale transactions is not producing the kind of new market entry that we need to provide stable and reasonable prices in the wholesale market.

Indeed, in December 2007, the Maryland Public Service Commission issued a report that concluded that the Commission should direct its utilities to enter into long-term contracts for new generation facilities both to preserve reliable service in Maryland and to help reduce generation rates in the long-term. The Maryland Commission was acting pursuant to emergency legislation

passed by the Maryland General Assembly in June 2006 after rate caps expired in parts of that state and rates increased for electric customers in the Baltimore area by 72 percent.

In Illinois, legislation was enacted in 2007 that abolished the short-term wholesale market price auctions that had resulted in massive rate increases when rate caps expired in that state. Instead, the legislation created an Illinois Power Agency whose job will be to “develop electricity procurement plans to ensure adequate, reliable, efficient, and environmentally sustainable electric service at the lowest total cost over time, taking into account any benefits of price stability.” In addition, utilities in Illinois agreed to provide refunds and credits to customers amounting to \$1 billion to offset a portion of the rate increases that occurred when the utilities implemented the auction-based generation price increases. Even more significantly, in my view, the utilities’ generation affiliates also entered into financial agreements with the utility distribution companies to guarantee reasonable prices for up to 3,000 megawatts of baseload generation to retail customers for the next five years.

Also in 2007, the Connecticut legislature passed, and the Governor signed into law, a major amendment to that state’s electric restructuring law. Under the new law, Connecticut’s regulated electric distribution companies must submit a plan to build new peaking generation on a regulated cost of service basis. The distribution companies are also required to develop a comprehensive plan for “the procurement of energy resources, including, but not limited to, conventional and renewable generating facilities, energy efficiency, load management, demand response, combined heat and power facilities, distributed generation and other emerging energy technologies to meet the projected requirements of their customers in a manner that minimizes the cost of such resources to customers over time and maximizes consumer benefits consistent with the state’s environmental goals and standards.”

Interestingly, just prior to last summer's legislative recess, our own General Assembly passed, and the Governor signed, House Bill 1530, which specifically allowed some of Pennsylvania's largest industrial customers to negotiate long term generation contracts with their electric distribution utility and, in certain cases, permits the electric distribution utility to build or acquire a generation facility to serve those customers. This legislation was promoted as a way to keep large industrial companies in Pennsylvania by providing an alternative to exposure to "prevailing market prices" that they will otherwise pay under the Pennsylvania restructuring law. The question now is why should only a few large industrial customers receive this protection, while all other consumers in Pennsylvania remain exposed to the type of short-term market pricing that has wreaked havoc when rate caps have expired in other states?

I think it is just common sense to require our utilities to follow a least cost approach to procurement of generation supplies for the great majority of customers – especially residential customers – who will likely remain customers of those utilities even after the rate caps expire. I also think it is common sense to require the use of a diverse portfolio of resources, including long-term, short-term and spot resources, rather than rely solely on short-term auctions, which have led to such extreme rate increases as rate caps have expired in many of our neighboring states.

It is not my position that the use of a portfolio approach will eliminate any need for rate increases in 2010 and 2011 when rate caps expire for the remainder of our Pennsylvania electric utilities. Even the most well-managed portfolio will reflect the fact that costs have risen in the wholesale markets in which our utilities will be acquiring the resources to serve their customers. It is my position, however, that our utilities must be required to provide stable, secure service to their customers at rates that reflect the lowest cost resources that are available to them over time

in the wholesale markets, and that we should begin to implement those requirements as soon as possible, rather than wait until after rate caps expire as has been done in other states. This is not a new idea in Pennsylvania, by the way. Our regulated natural gas utilities have been purchasing their gas supplies for residential customers in the competitive wholesale natural gas markets for decades and they have been required since 1984 to purchase that natural gas pursuant to a “least cost procurement” policy under Sections 1307(f) and 1318 of the Public Utility Code.

The fact that electric rates may be expected to rise even under the portfolio supply approach of House Bill 2201 and Special Session House Bill 54, brings me to the reason I also support House Bill 2200, which is also sponsored by Chairman George and which addresses the demand side of the electric rate equation. House Bill 2200 establishes goals for cost-effective programs to reduce growth in overall electricity usage and in particular to reduce energy usage in the peak 100 hours of the year. This latter goal is noteworthy because of the manner in which prices are established in the wholesale market and the disproportionate impact that high peak energy and capacity prices have on the costs that all Pennsylvania electric consumers ultimately have to pay.

I believe there is a substantial untapped store of energy efficiency and demand response resources that are less costly than much of our electric generation today. These energy efficiency and demand response resources will become even more cost-effective to consumers, however, if the cost of generation increases at the end of our rate caps. To the extent that the General Assembly can act now to help Pennsylvania consumers meet their future needs through cost effective energy efficiency and demand response programs, the benefits to those consumers can be substantial, particularly when the cost of carbon dioxide emissions are added to the cost of

electric generation from fossil-fueled power plants that set the wholesale market price of electricity in most hours of the year.

As the rate caps that have protected customers for the last decade expire, it is essential in my view that our utilities provide stable and reasonably priced generation service for the vast majority of customers – particularly residential customers – who continue to purchase generation service from their traditional utility supplier, and who are likely to continue to purchase that service from their utility for the foreseeable future. House Bill 2201 and Special Session House Bill 54 properly shift the focus of our utilities from simply purchasing generation and passing on to customers the “prevailing market prices” of that generation at a particular point in time, to a portfolio approach that considers the long-term as well as the short-term needs of customers.

As I mentioned at the beginning of my testimony, this is a critical time for the Pennsylvania electric industry and its customers. I want to thank you again for inviting me to submit testimony on these important issues and I look forward to working with the members of your Committee and the General Assembly as you address these extraordinary concerns.

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