

STATE OF CONNECTICUT

DEPARTMENT OF PUBLIC UTILITY CONTROL

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CONTROL DEVELOPMENT AND :
REVIEW OF STANDARD SERVICE :
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COMMENTS OF RETAIL ENERGY SUPPLY ASSOCIATION

Introduction and Summary of Argument

The Retail Energy Supply Association (“RESA”) is a nonprofit organization and trade association that represents the interests of its members in regulatory proceedings in the New England, New York, Mid-Atlantic and Great Lakes regions. RESA’s members include providers of competitive supply products to electricity and gas consumers in the five New England states – including Connecticut – that have restructured their electric markets.¹ RESA previously participated in this docket as the Department of Public Utility Control (“Department”) reviewed plans of the electric distribution companies (“EDCs”) to procure power for their standard service and supplier of last resort (“SOLR”) customers effective January 1, 2007. RESA commends the Department for launching this review of “lessons learned” from the initial standard service and SOLR service auctions and is pleased to submit these comments in response to the Department’s Notice of Request for Written Comments dated December 5, 2006 (“Notice”).

¹ RESA member companies include Consolidated Edison Solutions, Inc., Direct Energy Services, LLC, Hess Corporation, Reliant Energy Solutions, Semptra Energy Solutions, Strategic Energy, LLC, SUEZ Energy Resources NA, Inc. and U.S. Energy Savings Corp. The opinions expressed in this filing may not represent the views of all members of RESA.

The Notice states that the principal purpose of the Department’s review is to assemble information that will aid Connecticut legislators in their upcoming deliberations on energy matters, including whether to make changes to the processes by which The Connecticut Light and Power Company (“CL&P”) and The United Illuminating Company (“UI”) procure power for their electric customers.² The Notice states that, in addition to evaluating possible modifications to procurement practices that could be made under the existing statutory scheme, the Department also wishes to explore alterations “that go beyond the current statutory structure.”³ To advance this inquiry, the Department has scheduled a technical meeting on December 18 to discuss: (1) whether standard service and SOLR service power should be procured as firm full requirements service or as disaggregated components thereof; (2) whether long-term renewable energy contracts would help stabilize prices; (3) whether the standard service portfolio should be comprised of both intermediate and long-term energy and capacity contracts; and (4) other potential alterations to the procurement processes.⁴ It also requested written comments on these issues due on the date hereof.

The significant rate hikes that have resulted from the EDCs’ most recent standard service and SOLR service procurements have understandably led the Department to seek ways to protect consumers from rising electricity prices and jarring rate shocks. It is important, however, that state policymakers not act hastily in response to these events and take actions that will harm consumers and the retail market over the longer term. It is also important to identify with as much specificity as possible the driving forces behind these rates increases before taking action.

² Notice, p. 1.

³ Id.

⁴ Id.

RESA is concerned that the Department may be proceeding too quickly to devise a prescription before an adequate diagnosis has been made.

The Department should avoid long-term contracts for several reasons. First, the allure of such contracts appears to be based on assumptions that are either unproven or that have been decidedly disproven in the past. One such assumption is that Connecticut can “bypass” the ISO New England, Inc. (“ISO-NE”) markets by entering into long-term energy contracts with generators. This assumption is based on the belief that generators will make decisions without regard to their opportunity costs. The second assumption is that electricity costs will rise not only in the short-term but also over the long-term and that generators or wholesale suppliers will be unaware of this dynamic. Many have assumed that prices will continue to rise on the belief that “things are different now” only to be brought back to reality when the market eventually responds to what are perceived to be sustained high prices, leaving those who went “long” in power with a serious case of buyer’s remorse.⁵ These are risky and unproven assumptions that can harm consumers.

A move to long-term contracts for standard service customers also misses the role that long-term contracts have played in creating the current situation. UI customers are facing significant rate increases precisely because the company entered into a three-year fixed price contract to serve its standard offer and transitional standard offer (“TSO”) customers. While

⁵ The California Public Utility Department made just such a mistake in the midst of its electricity crisis by locking into long-term contracts at what turned out to be the top of the market. These contracts were seen as a bad deal shortly after they were signed. See Paul L. Joskow, MIT, California’s Electricity Crisis (Sept. 28, 2001) p. 48 (writing in 2001 that California “is now saddled with tens of billions of dollars in long-term contracts that are likely to carry prices well above market levels”), available at <http://web.mit.edu/ceepr/www/2001-006.pdf>. See also James L. Sweeney, Stanford University, The California Electricity Crisis: Lessons for the Future (Summer 2002), p. 11 (stating that California adopted long-term electricity purchase contracts to address short-term problems at prices roughly twice as high as expected market prices), available at <http://www.nae.edu/nae/bridgecom.nsf/weblinks/MKEZ-5B7JJ2?OpenDocument>.

there were certainly benefits to those customers from paying a price that came to be well below current market prices, the expiration of that contract and the corresponding need to face the reality of the existing market have created a “crisis” that would not have existed if UI had chosen to price its standard offer and TSO service closer to the market throughout the term of those services. As discussed further below, and as RESA and other suppliers have advocated for some time, more current market pricing would also serve other important public policy goals that will either not be furthered or will be hindered by a more permanent move to long-term contracts. The choice of long-term contracts as a proposed solution to the current situation will only exacerbate the problems created by a reluctance to develop a true, robust retail market for all Connecticut customers.

There are really only two ways to avoid the kind of rate shock caused by the expiration of UI’s long-term standard offer and TSO contract. One is to move even farther away from current market pricing, making contracts longer and “laddering” them to attempt to avoid the adverse impact when those contracts expire. The negative consequences of this approach, as discussed below, are many. They include: higher prices in the form of substantial risk premiums, failure to provide incentives for cost-effective conservation, efficiency and demand response measures; and the elimination of the innovation and downward price pressure that a true competitive market brings. The second option is to unleash the power of the competitive retail market by encouraging the Legislature to adopt an approach to standard service procurement that keeps prices more current with the market which, in turn, will result in a host of competitive options for these customers, as has been seen in other states such as New York and Texas.

For all of these reasons, RESA strongly urges the Department to refrain from recommending that long-term supply contracts be included in the standard service portfolio,

whether they are contracts with generators or wholesale suppliers. Instead, the Department should work toward shortening the procurement cycles for standard service customers to no more than six months, and encourage the Legislature to give it the authority to adopt an even more current procurement schedule for standard service, such as a monthly pricing approach. The Department also should launch an investigation into the viability of real-time pricing (“RTP”) for SOLR customers for the reasons described herein.

The Notice also invites observations on general procurement practices. RESA therefore urges the Department to also consider other changes that should be implemented in 2007 at the Department or at the Legislature. Specifically, RESA recommends as follows: (1) the Department should direct the EDCs to purchase standard service and SOLR service pursuant to full requirements contracts; (2) the Department should carefully consider comments of Morgan Stanley Capital Group, Inc. regarding risks caused by Department rejection of the results of otherwise valid procurements; and (3) the Department should eliminate existing customer switching restrictions as they are unnecessary and anticompetitive.

Comments

I. LONG-TERM SUPPLY CONTRACTS

The Notice invites interested persons to comment on whether long-term contracts should be included in the standard service portfolio along with intermediate-term contracts. The short answer to this question is no; the risk involved in long-term contracts is simply too great and would elevate stability over all other policies (including keeping prices as low as possible, developing a robust retail market, avoiding rate shock and encouraging cost-effective conservation and demand response) for standard service customers. RESA therefore urges the

Department to reject long-term contracts and, instead, adopt shorter-term contracts for standard service customers.

A. Long-Term Energy Contracts Between EDCs and Merchant Generators

The power supply for EDC customers has traditionally been procured within the context of the wholesale power markets administered by ISO-NE. Recently, however, some have advocated bypassing that market through negotiation and execution of bilateral energy contracts between EDCs and merchant generators as an integral part of the standard service procurement process. Proponents of these contracts suggest that generators would sell energy to the EDCs at a price that is closer to their actual costs of production rather than the ISO-NE market clearing price. Although RESA questions whether this is an attainable goal, particularly as it pertains to existing generation units for which recovery of capital costs remains difficult, the Department should carefully consider the impact of these long-term contracts on Connecticut's retail markets and consumers.

The bilateral contract approach is predicated on the assumption that merchant generators would find it desirable to enter into long-term energy contracts with EDCs at or near their marginal cost of production, thereby foregoing the energy revenues that can be derived from the ISO-NE market or from bilateral contracts that mirror market. There is no reason to believe that generators would be willing to forego those revenues with respect to existing generation units, particularly if they believe that energy market prices will remain high. These generators also may find it undesirable to participate in the regulated Request for Proposal ("RFP") that is required for standard service procurements when they can simply sell their energy into the market or enter into bilateral contracts with suppliers. Developers seeking to build new plants may be more willing to share their energy margins with the EDCs if their capital costs are being

recovered separately, but that issue should be addressed in other RFP proceedings, such as the one underway in Docket No. 05-07-14PH02. But one thing is clear: entering into long-term bilateral contracts that lock standard service customers into a fixed energy price for years to come should not be part of the standard service procurement framework. That is because such long-term contracts: (1) are based on guesswork and would unnecessarily lock customers into higher rates when market prices fall; (2) would stymie development of retail competition; (3) could produce rate shock at the expiration of the contract; and (4) preclude price responsive behaviors that are induced when customers are exposed to the changing seasonal cost of electricity.

B. The EDCs Cannot Foresee Future Market Trends

The only way that it makes sense for the Department to authorize multi-year contracts – whether they are bilateral energy contracts with generators or wholesale supply contracts - is if it could assure itself that the prices in existence at the point of procurement will be considerably lower than future market prices. That is an impossible task, particularly when the planning horizon extends over multiple years.

Commodity prices move up and down in unpredictable ways, and neither the EDCs nor any other market participant can claim to accurately predict future price trends.

Implementing a portfolio structure that encourages EDCs to enter into energy contracts for several years is nearly indistinguishable from gambling. If the EDCs guess right and prices rise during lengthy contract terms, ratepayers may appear to have obtained a benefit for a period of time, but that benefit is diminished greatly by jarring rate shocks at the contract's end. If, by contrast, the EDCs guess wrong and prices fall, ratepayers will be locked into

higher prices for several years. In either scenario one thing is certain; the actual price over the next several years will be different from today's prediction.

Events of the past three years have shown just how many factors affect the global energy markets and how difficult those factors are to predict, either individually or in the aggregate. Mild weather, recession, and relaxed political tensions lead prices in one direction. Extreme weather, economic expansion, and conflicts in key energy-producing regions take prices the other way. No one can claim to know with any certainty which combination of these things will occur, and which will tend to dominate when it comes to energy markets. The best way to avoid guessing wrongly – and very expensively wrongly – is not to guess at all, and procure standard offer supply in the market for all customer classes on a regular, predictable schedule, allowing competitive suppliers to provide other alternatives.

C. Long-Term Contracts Undermine Retail Competition and Energy Conservation and Expose Customers to Rate Shock

1. Retail Competition

A robust retail market will not likely emerge for standard offer customers in the near term because of the three-year procurements sanctioned by the Department in its June 21, 2006 Final Decision in this docket.⁶ Extending the terms of standard offer supply contracts beyond three years would virtually rule out the possibility of competitive options for standard service customers for the foreseeable future.

In order for retail competition to develop for these customers, standard offer rates must reflect wholesale price signals. Only in that way will customers have the information and incentives to turn to the competitive marketplace for alternative offerings. Long-term contracts insulate customers from market prices, thereby obscuring the price signals upon which robust

⁶ Decision (June 21, 2006), p. 14, Docket No. 06-01-08PH01.

competition thrives. The problem for suppliers is not that Connecticut customers might get lucky and lock in long-term supply that will be under-market for several years, making it difficult for retail competitors to sell. Rather, the problem is that the “boom and bust” cycle caused by long-term procurements (some of which will be a good deal for customers, and some of which will be bad) prevents suppliers from making the long-term commitment to a market that is essential to robust, efficient competition. This is especially true in the mass markets, which require much more substantial investments in operations and customer care than do larger commercial and industrial markets.

Longer term contracts may not seem like a problem if Connecticut hits a home run with its long-term electricity contracts. It is a problem, however, if Connecticut strikes out and customers need access to a wide range of experienced suppliers to meet their need for cost effective and reliable electricity and ancillary services. A supplier would be very reluctant to make the necessary long term investment if the next long-term contract could substantially reduce or eliminate its customer base. It is far better to supply the regulated utility offering through predictable, regular procurements of as short a duration as possible, so that customers receive accurate and timely price signals. In such a market, if customers favor long-term stability, competitors will provide it and at a more reasonable cost than through a “one size fits all” EDC model based on multi-year procurements.

2. Conservation

The State’s energy policy should emphasize the importance of conservation demand side management (collectively referred to as “DSM”) to attain a reduction in peak load. Long-term contracts and the average prices attendant to them risk destroying DSM and undermine incentives for customers to implement cost-effective DSM initiatives. If customers are on a

long-term fixed price that is below market, they will receive the wrong price signal – that power is cheaper than it really is – and not develop DSM improvements they otherwise would have made. (The scenario in which the long-term contract price is above market is not much better from the customer’s perspective, as the inaccurate price signal may cause customers to invest in DSM measures that are not economically efficient in the long run.). The Massachusetts Department of Energy Resources (“DOER”) emphasized these points in a recent filing at the Massachusetts Department of Telecommunications and Energy (“DTE”).

DOER has petitioned the DTE to conduct an investigation into dynamic pricing for all customers in the Commonwealth in DTE Docket No. 06-101 (“Massachusetts Dynamic Pricing Docket”).⁷ Specifically, DOER recommends that the DTE explore real-time pricing (“RTP”) for all large customers because it is the most effective way to induce price-responsive behaviors that yield real savings to consumers.⁸ To support that conclusion DOER cites a study by ISO-NE, which concludes that adoption of RTP for the Commonwealth’s large C&I customers could save at least \$125 million per year.⁹ DOER further recommends that the Department explore time-of-use (“TOU”) rates for all other customers to spawn energy conservation and peak load reduction on a larger scale.¹⁰ The Department should likewise review the viability of RTP and a broader application of TOU rates in Connecticut instead of focusing on long-term contracts.

3. Rate Shock

Continued emphasis on long-term contracts disregards the role that they have played in creating the current crisis with respect to electricity rates. When wholesale market prices

⁷ DOER Petition, p. 6, DTE Docket 06-101.

⁸ Id. at 15 (stating that “RTP achieves the highest level of efficiency because prices always reflect contemporaneous marginal supply costs”).

⁹ Id. at 41.

¹⁰ Id. at 6.

