

**STATE OF CONNECTICUT**

**DEPARTMENT OF PUBLIC UTILITY CONTROL**

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**CONTROL DEVELOPMENT AND :**  
**REVIEW OF STANDARD SERVICE :**  
**AND SUPPLIER OF LAST RESORT :**  
**SERVICE – PLAN APPROVAL : January 30, 2007**

**COMMENTS OF RETAIL ENERGY SUPPLY ASSOCIATION**

**Introduction and Summary of Argument**

These comments submitted by the Retail Energy Supply Association (“RESA”)<sup>1</sup> address the fundamental issues raised by the Department of Public Utility Control (“Department”) in its January 24, 2007 notice (“Notice”) soliciting stakeholder input about how long-term contracts for energy and capacity fit into Connecticut’s energy future. RESA commends the Department for seeking a frank assessment regarding the “differences, benefits and drawbacks” of long-term contracts taking the form of either contracts for differences (“CfDs”) or contracts for physical delivery (“Physical Contracts”).<sup>2</sup> The Notice seeks specific comments on how such contracts would impact retail competition, reliability, fuel diversity, price stability, the construction of new generation and standard service procurement. The Notice further directs commenters to incorporate regulatory, financial, practical and public policy perspectives into their recommendations.<sup>3</sup>

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<sup>1</sup> RESA member companies include Consolidated Edison Solutions, Inc., Direct Energy Services, LLC, Hess Corporation, Reliant Energy Retail Services, LLC, Sempra 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.

<sup>2</sup> Notice, p. 1.

<sup>3</sup> Id.

The Notice is general; RESA's comments are in the same vein. Key variables such as the number of megawatts ("MW") to be procured, the length of the contract term, and the pricing structure will obviously factor heavily into any comprehensive analysis of the impact of long-term contracts. These comments necessarily articulate RESA's preliminary views on these wide-ranging topics and are subject to modification as public policy discussions progress.

In Part I of these Comments, RESA contends that the Department should not allow electric distribution companies ("EDCs") to procure their standard service power supplies through long-term contracts with wholesale suppliers or owners of merchant power plants. Regardless of whether such contracts are structured as CfDs or Physical Contracts, they will ultimately hurt consumers by: (1) exposing them to the risk that the contract price will exceed market rates; (2) creating the potential for jarring rate shocks when the contracts terminate; (3) chilling a retail market that is just beginning to emerge; and (4) layering price risk premiums onto forecasted energy prices.

The Notice is silent on the pricing structure that would be used in the long-term contracts. RESA observes that a long-term EDC contract with a fixed energy price is really nothing more than disguised commodity speculation. It amounts to a bet placed by the Department or the EDC that future energy prices will be higher than those reflected in the contract. Aside from the serious problems discussed above that attend all long-term fixed price contracts, is it reasonable to expect that the Department or the EDCs will have superior information and insights into future market prices than the sellers, most of whom make their living by participating in energy and other markets?

Stimulating new generation is a different matter. If the Department determines that long-term CfDs or Physical Contracts for energy and capacity are necessary to induce construction of

desirable new generation, then it should explore the use of a long-term request for proposals (“RFP”) process similar to that underway in Docket No. 05-07-14PH02. The output from these newly-constructed facilities, however, should not be slated exclusively to supply EDC standard service load because such an approach would create the same adverse impacts discussed above. Instead, the output should be used in a manner that does not undermine emerging retail markets. A number of measures are available to achieve this result. For example, the Department could require the contracted output to be sold into wholesale markets or, alternatively, make such output available to both competitive retail suppliers and the EDCs in proportion to their respective customer loads. These ideas are expanded in Section II of these Comments.

Two fundamental principles support RESA’s positions. First, the goals to be achieved from redesigning standard service procurements (providing a transition to third party retail supply and a safety net for customers who for some reason do not select a competitive supplier) and the goals to be achieved from entering into new contracts with developers of new power plants (improving fuel diversity, reliability and energy price stability) have little to do with each other. Although the EDCs could theoretically enter into contracts with owners of existing generation facilities, these contracts cannot improve fuel diversity or enhance reliability because they do not add to the generation fleet. Moreover, they can do very little to address the link between gas and electricity prices. Contracts with facilities not yet built can positively impact fuel diversity, reliability and energy prices, but output from those facilities will not be available to deliver the desired benefits for three to five years or more.<sup>4</sup> Thus, policymakers who seek to

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<sup>4</sup> An optimistic timeframe would recognize that new legislation is probably required or desirable, followed by a one-year RFP process. This puts the start of construction for a new power plant at July of 2008 at the earliest. Creating meaningful change in fuel diversity and energy pricing requires the construction of either an IGCC coal plant or a nuclear plant. The permitting, design and construction complexity of such a project can easily take five years. The resulting in-service date for the new facility is July of 2014. Although a combined cycle gas plant can likely be built sooner, such a unit would leave untouched the problems of fuel diversity and natural gas dominating electricity pricing. Even the 2014 date is probably

address current standard service prices on the one hand and those who seek to influence reliability, fuel diversity and energy price stability on the other are tackling two completely different problems. Attempting to conjoin these two very different functions virtually ensures a solution that will not be suited to either problem.

RESA's second guiding principle is that Connecticut consumers will realize the benefits of restructuring if, and only if, retail competition is allowed to flourish in the State. Thus, the Department should approach standard service procurements with an eye toward fostering retail competition. Such procurements should be crafted in a way to transition customers off the EDC generation services and into the competitive market where they can choose from a broad array of products to control their rising electricity bills. One need only look at the success of the telecommunications industry to realize that, left alone, competitive forces eventually bring the best pricing and innovation.

Section III builds on these principles to offer a broader perspective on the role of standard service and SOLR service in the State's energy future. Connecticut's recent history and current struggles are largely traceable to the structure of the EDC retail offerings. The EDCs and policymakers have tried to make these products attractive by charging rates that give the appearance of "beating the market," and offering consumers who stay out of competitive retail markets a price that does not reflect the true cost of electricity. Although this effort was undertaken with the best intentions, the actual results are consumers and legislators who are completely frustrated. Their anxiety is aimed at a diverse array of targets. Generators, EDCs, state regulators, federal regulators, retail suppliers and wholesale suppliers all have been blamed

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unrealistic, since it does not allow for any deliberative planning process in which stakeholders and policymakers can thoughtfully analyze how many MW of what kind of plant should be located where. Given the enormous investment associated with building baseload units and the long-term, largely irreversible, consequences of such a commitment, the planning process is an indispensable step.

for the State's current predicament: increasing energy prices, rate shock and an undeveloped retail market.

Some observers seem to want to stay in this "no-man's land" by taking steps that they believe will improve the standard service offering (including more extensive use of long-term contracts). These approaches are destined for failure. Only by letting retail competition flourish will all of Connecticut's consumers be able to realize lower electricity prices and enjoy pricing structures and services that meet their needs. And retail competition will flourish if the standard service is designed to track market prices as closely as possible. It's that simple.

### Comments

#### **I. USING LONG-TERM CONTRACTS TO FULFILL STANDARD SERVICE NEEDS WILL HURT CONSUMERS**

##### **A. Overview**

Long-term contracts for standard service will harm consumers in several ways. First, they bring the risk that contract prices will exceed future market prices, thereby causing consumers to pay more for electricity than they would pay through shorter-term contracts. Second, in the event that long-term contract prices are below market when the contract expires, they expose customers to rate shock and spawn negative media attention and political froth. Third, long-term contracts defeat retail competition and, consequently, deprive consumers of alternative product offerings that can help them control their energy costs. Fourth, long-term contracts undermine energy efficiency measures that also promote electricity cost savings, alleviate pressure on the grid, and foster other societal goals that are important to Connecticut's energy future. All of these problems exist whether the Department endorses a CfD or a Physical Contract for energy and/or capacity and, hence, both vehicles should be rejected as the means to procure standard service supplies. The Department should also reject long-term contracts with

wholesale suppliers because they yield expensive bid risk premiums in addition to the problems noted above.

**B. Long-Term Contracts Falsely Presume that the Market can be Predicted**

Events of the past three years have shown just how many factors affect the global energy markets. Extreme weather events, like Hurricanes Rita and Katrina, and political tension in energy-producing regions raise prices. Conversely, mild weather and relaxed political tensions tend to decrease prices. No one can claim to know with any certainty which combination of these variables and other key factors will occur and which will tend to dominate the energy markets. Yet, a move to long-term contracts inherently assumes that the markets can be predicted.

Authorizing EDCs to enter into energy contracts for several years for the purpose of serving their standard service load is fraught with risk. If the EDCs guess wrong and prices fall, ratepayers will be locked into higher prices for several years and will blame the EDCs, market participants, state and federal regulators and the Legislature for getting them into that predicament. If, by contrast, the EDCs guess right and prices rise during lengthy contract terms, ratepayers experience jarring rate shocks at the contract's end, which, too, creates public outcry and negative political and media events.

This latter point is painfully apparent from the extraordinary rate hikes experienced by customers of The United Illuminating Company ("UI") because of its entry into a three-year fixed price contract for its standard offer and transitional standard offer ("TSO") customers. While there were certainly benefits to those customers from paying a price that came to be well below current market prices, those benefits have not carried much weight over the past three months. The expiration of that contract and the corresponding need to

face the reality of the existing market created a “crisis” that would not have existed if UI had chosen to price its standard offer and TSO service closer to market. Simply put, there is nothing to be gained by trying to outguess the market. Instead of engaging in that impossible feat, the Department should order the EDCs to procure standard service power supply in the market on a regular, predictable schedule, allowing competitive suppliers to provide other alternatives.

### **C. Long-Term Contracts Prevent Retail Competition**

In order for retail competition to develop and bring benefits for standard service customers, EDC rates must reflect wholesale price signals. Only in that way will customers have the information and incentives to turn to the competitive market for alternative offerings. Long-term contracts obliterate market transparency for customers, thereby obscuring the price signals upon which robust competition thrives. The problem for suppliers is not that Connecticut customers might get lucky and lock in long-term supply that could be below 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 under market at times, and some of which will be over market at other times) 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.

Lack of retail competition 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. For these reasons, 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 and so that retail suppliers are confident enough in the Connecticut market to commit resources in the State.

The importance of timely price signals to retail market development is underscored by the flurry of shopping that has followed the announcement of the SOLR service rates effective on January 1, 2007. Through the adoption of six-month procurements, SOLR service rates are more closely reflecting market rates. As a result, there has been a substantial increase in the number of consumers looking to switch to competitive suppliers, which dovetails well with the increased number of parties seeking to become licensed electricity suppliers or registered aggregators.<sup>5</sup> State policymakers should allow the retail market to gain footing in Connecticut and drive prices down through competitive market forces – an approach that has been proven for practically all other commodities. That goal can only be achieved for standard service customers if the procurement cycles for that load are shortened substantially.

#### **D. Long-Term Contracts Will Undermine Energy Efficiency**

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

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<sup>5</sup> Decision (Jan. 17, 2007), p. 2, Docket No. 06-10-22, DPUC Monitoring of the State of Competition in the Electricity Industry.

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. If there is ever a time that Connecticut should emphasize cost-effective DSM it is now. Greater use of DSM would not only allow consumers to take charge of their electricity bills, but it also would relieve pressure on the electric grid pending the construction of new generation. Long-term contracts would undermine these twin goals.

**E. Long-Term Contracts With Wholesale Suppliers Will Yield Expensive Risk Premiums**

If the Department requires EDCs to enter into long-term contracts with wholesale suppliers, standard service prices will rise in another way: wholesale suppliers will add expensive premiums to their bids to cover fuel price, migration and regulatory risks over the term of the contract.

The existence of this bid risk premium for even medium-term contracts was confirmed by a recent procurement conducted by NSTAR Electric for its residential customers. In its RFP, NSTAR Electric solicited bids for contract terms of one, two and three-years,<sup>6</sup> but selected one-year contracts because the risk premiums associated with the longer terms were too high.<sup>7</sup> Similarly, the Maine Public Utility Commission ("MPUC") solicited bids for terms of one, three, six and nine years for residential and small business customers of the Central Maine Power Company ("CMP") and the Bangor-Hydro Electric Company ("BHE"), stating that it wished to

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<sup>6</sup> NSTAR Letter to the Massachusetts Department of Telecommunications and Energy ("DTE") (October 5, 2006) at <http://www.mass.gov/Eoca/docs/dte/electric/nstarerb/dslet.pdf>.

<sup>7</sup> NSTAR Letter to the DTE (October 23, 2006).

compare the risk premiums associated with contracts of various terms.<sup>8</sup> The Department selected the winning contracts on January 9, 2007.<sup>9</sup> Though the bids remain sealed, it appears that the MPUC chose one-year contracts as the recently-announced prices for residential and small business customers of CMP and BHE are effective for only one year.<sup>10</sup>

#### **F. Contracts with Merchant Generators Yield Special Problems**

Some policymakers advocate having the EDCs enter into long-term contracts for energy and capacity directly with merchant generators for the purpose of supplying the standard service load. While this approach has some superficial appeal in that it eliminates the middleperson and can be structured to bypass the wholesale markets, it brings on a host of new practical problems. There is a world of difference between a load-following contract between an EDC and a wholesale supplier and a contract for the output of one or more identified power plants. First, there is the issue of procuring power when the source plant is off line for scheduled or unscheduled maintenance. Second, there is the problem of filling out the balance of the standard service load that is in excess of the amount contracted for by the generator. Finally, unless the contracted generator is a very low cost baseload unit, there will be times during the year when the contracted unit is not the most economical available resource. Problems such as these counsel against using such arrangements to supply the standard service load.

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<sup>8</sup> MPUC Order (Oct. 20, 2006), pp. 2-3, Docket No. 2006-591, Standard Offer Bidding Procedure for Central Maine Power Company and Bangor Hydro-Electric Company Residential and Small Non-Residential Customers.

<sup>9</sup> MPUC News Release (Jan. 11, 2007), New Electric Standard Offer Rates to begin in March for CMP and BHE Residential Customers.

<sup>10</sup> These rates are available on the MPUC web site at <http://www.maine.gov/mpuc/industries/electricity/sosmall0306/cmpbheresresultsmar07.htm>

