

**Before the
Consumer Protection and Professional Licensure
and Environmental Resources & Energy Committees
Senate of Pennsylvania
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**Testimony of
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Good morning Chairman Tomlinson, Chairman White, and members of the Consumer Affairs and Professional Licensure Committee and the Environmental Resources and Energy Committee. Thank you for inviting the members of the Public Utility Commission to share our thoughts on energy policy in Pennsylvania.

“Energy policy” is a broad term that may include transportation fuels, electricity, natural gas, and other types of energy. Most of my comments will be directed at electricity, because that is an issue within the jurisdiction of the PUC.

The biggest challenge we face with electricity is making the transition from paying capped generation prices to paying market-based prices. This transition, which will occur for most customers at the beginning of 2011, is part of the implementation of the electricity competition law approved by the General Assembly in 1996.¹ The impact of this transition on individual customers in Pennsylvania will vary because the prices that most customers pay now are based upon the regulated rates of their utility at the time competition was authorized. The customers who have paid the highest rates historically are the least likely to see significant increases when the caps are removed. The impact will also depend on the level of wholesale electricity prices between now and 2010. Based upon current wholesale prices, some customers would see little impact upon their retail rates, while other customers would experience increases of 30% or more.

The fact that retail prices for electricity may rise significantly for some customers when the rate caps expire is not surprising when you consider how long these caps have been in place, and how much has changed in the world of energy during that time. The restructuring settlements of the larger electric utilities provided that generation rates would be capped for over a decade. From a policy perspective, these caps have had benefits and drawbacks. The chief benefit is that, in the short term, the caps have lowered overall electricity costs in Pennsylvania relative to the national average. In 1996, the average price for electricity in Pennsylvania was 15% higher than the national average. In 2006, due in large part to the rate caps, average electricity prices in Pennsylvania were 2% lower than the national average (See Appendix “A”). These benefits have been substantial, but temporary.

The generation rate caps have had two drawbacks. They are responsible for the current depressed state of retail competition in the Commonwealth. In fact, the only areas of Pennsylvania where there is significant shopping are the Duquesne Light Co. and Pennsylvania Power Co. service territories, due to the fact that the generation rate caps of these

¹ The Electricity Generation Customer Choice and Competition Act, Act 138 of 1996, 66 Pa. C.S. §2801 et seq.

utilities have already expired. The second drawback of these long-term rate caps is the problem we face now – the potential for customers to suffer price shock as they face the impact of ten years' worth of changes in energy markets all at one time.

The energy world has changed dramatically since the rate caps were put in place roughly ten years ago. To illustrate this point, it is useful to examine what the impact on customers would be if the price of some other energy commodities had been capped from 1996 to 2006. Upon removal of these caps, the price of fuel oil to customers would increase by 57%; the price of unleaded gasoline would increase by 80%; the price of natural gas would increase by 88%; and the price of coal would increase by 91% (See Appendix "B"). In light of these dramatic changes in the prices of energy commodities, it is not too surprising that removal of the rate caps on electricity at the end of 2010 could lead to significant increases for some customers. At the same time, the Commission recognizes the difficulty these sudden price changes could pose for customers, and is taking steps to mitigate these impacts.

Recently, the Commission adopted an order in the "price mitigation proceeding." Under this order, the Commission will pursue a strategy of educating customers, encouraging conservation, reviewing low-income assistance programs, and encouraging plans that would give customers the option of phasing in significant increases. In addition, the Commission recently adopted final rules and a statement of policy regarding how utilities will purchase electricity for non-shopping customers when the caps expire. These rules and policy statement adopt a policy that utilities should purchase a variety of energy products over time to reduce the risk of sudden dramatic swings in prices due to events such as the hurricanes in 2005, which disrupted natural gas supplies and created dramatic increases in wholesale electricity prices.

Consumer education is going to be very important as we prepare for the end of generation rate caps. Many customers have not been giving much thought to their electricity bill or electricity usage during the rate cap period, and they should be encouraged to consider these issues before price increases show up on their bills. In particular, the Commission has decided that the circumstances warrant a statewide consumer education campaign, and we have announced that we will seek five million dollars for this campaign in our budget request for next year. When that request comes before you, I respectfully request that you give it serious consideration.

Before I discuss potential legislation regarding electricity policy, it is important to examine why electricity prices are increasing. The biggest reason is the increase in cost of fuels used to generate electricity -- coal and natural gas. Another reason is increasing congestion on our transmission system, caused by a combination of growth in demand coupled with decreasing investment in transmission over the past twenty years.

Increasingly stringent environmental requirements are yet another factor contributing to higher prices. With the recent action in Pennsylvania adopting regulations on mercury emissions that are more stringent than federal standards, and with the possibility of future federal and/or state action to regulate carbon emissions, I expect that environmental policy will push electricity costs higher in the future. This is not to say that these policies cannot be justified based upon their environmental benefits, but policymakers should recognize the reality that these policies will increase prices.

The administration of Governor Edward G. Rendell should be commended for its efforts in proposing new energy policies for Pennsylvania. Some of the ideas in the energy plan of the Governor are similar to policies the Commission is already pursuing in the proceedings that I mentioned earlier. Given the complexity of this subject and the limited time available, I will limit my comments to a few aspects of this plan.

First, this is a very complex area and I believe great care should be taken in crafting legislation. Having participated in the drafting and implementation of the electricity competition law, I have witnessed how important it is to give careful consideration to drafting. A deliberate approach, with input from all parties who are impacted by the legislation, will provide the best results.

Second, I am concerned over the approach of stating in minute detail how the Commission should define the duties of electric utilities in providing default generation service. This lack of flexibility is risky because it assumes that future events can be predicted with certainty. This approach is contrary to the tradition of giving the Commission latitude to make adjustments as circumstances change -- a tradition that I believe has worked well.

Third, the issue of long-term contracts should be considered. Proponents of the Governor's energy plan have claimed that the plan would allow large customers to enter into "stable" and "cheaper" long-term contracts with electricity suppliers. No doubt, this is in response to decisions of the Commission that have restricted the ability of an electric utility, in its role as the provider of last resort, from entering into such contracts with customers. These decisions were based upon several factors, including recognition of the need to link some retail prices to wholesale prices in order to develop more demand response in wholesale

markets. In addition, consistent with the policy that the supply service offered by the utility should be a back-up service -- a service of "last resort," in the words of the competition law -- the Commission reasoned that large customers would be free to enter into contracts of different lengths with competitive suppliers. These decisions have been supported by, among others, the market monitoring unit of PJM, Inc., which has cited them as examples of steps that need to be taken to improve the competitiveness of wholesale markets. In addition, these decisions have contributed to the development of a robust market with several competitive suppliers serving large customers in the Duquesne market. At the same time, I understand that the General Assembly does not take the concerns of these large customers lightly, because of their importance to the economy in Pennsylvania.

In considering this issue, keep in mind that electric utilities no longer own generating plants, so they must go into the wholesale market to buy the power that they sell to retail customers. Accordingly, it is not clear why it should be assumed that the utilities will be able to secure power on more favorable terms in the wholesale market than competitive suppliers. Many of these competitive suppliers are affiliates of utilities operating in other states, and should have the leverage to purchase electricity on terms as favorable as utilities. In addition, I am concerned that allowing utilities to offer such contracts will be interpreted as a lack of faith in the ability of a competitive retail market to provide benefits to customers.

If the General Assembly decides to move forward to allow utilities to offer long-term contracts to customers, careful consideration should be given to the language amending the competition law. The legislation to enact the Governor's energy plan contains language that appears to be inconsistent. On the one hand, it states that utilities may offer rates of any duration to customers, which I believe is the language that allows long-term contracts. On the other hand, however, the proposed legislation specifically restricts the ability of utilities to enter into long-term wholesale contracts. Without such long-term wholesale contracts, it is unclear how utilities could offer long-term retail contracts to customers without putting their financial health at risk.

Finally, the Governor's energy plan also calls for the initiation of a systems benefit charge on the electricity bills of customers at the rate of \$0.0005 per kilowatt hour. This charge will continue for thirty years to fulfill the obligations of a bond. The proceeds of the bond will be used by the Pennsylvania Energy Development Authority and certain other agencies for variety of uses, including providing additional subsidies to alternative energy projects, and to allow these agencies to engage in buying and selling energy commodities such as electricity and natural gas.

I question whether this proposal for a systems benefit charge is good public policy. While proponents seek to minimize the impact of this new charge upon customers by saying that it will only cost the average customer an additional \$5.40 per year, the total amount to be raised--\$850 million--is substantial by any measure. This raises the question of how the proposed uses of this \$850 million fit into the spending priorities of state government.

In my view, it should not be a high priority to provide additional subsidies to alternative energy projects. The developers of these projects already receive federal tax incentives and benefit from the mandate, contained in the Alternative Energy Portfolio Standards Act², that electricity suppliers must purchase increasing percentages of alternative energy products.

In considering spending priorities, I believe it should also be kept in mind that there are serious issues in Pennsylvania and in the United States generally, regarding the condition of our transportation and utility infrastructure. The American Society of Civil Engineers has issued a report card on infrastructure, and has assigned Pennsylvania a grade of D. I have become particularly interested in infrastructure issues, and I have written a paper on the challenges that we face. To give just one example of infrastructure needs, we still have combined sewer overflow systems in many of our larger communities, which discharge untreated sewage to our streams during heavy rains. I hope this illustrates the point that the decision to begin a systems benefit charge should not be made without considering other needs that our citizens may be required to fund in the coming years.

Thank you for the opportunity to testify, and I would be happy to respond to questions.

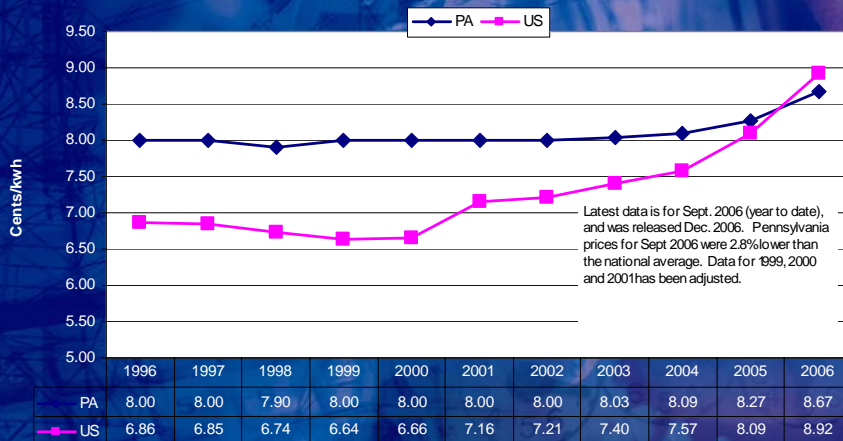
² Act 213 of 2004, 73 P.S. §1648.1-1648.8.



Average Electric Prices PA and U.S.

Data from EIA Electric power
monthly and annual reports

Average Electric Prices PA and U.S.

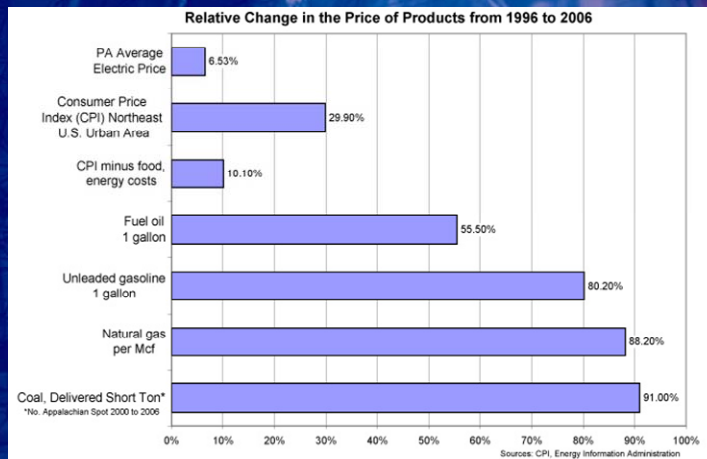


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APPENDIX A



Electric Prices Compared to Inflation, Other Commodities



All of the data contained in the graph was obtained from the Bureau of Labor Statistics. The average price of Pennsylvania electricity was obtained from the U.S. EIA.