

COMMONWEALTH OF PENNSYLVANIA

Office of Small Business Advocate
Suite 1102, Commerce Building
300 North Second Street
Harrisburg, Pennsylvania 17101

William R. Lloyd, Jr.
Small Business Advocate

(717)783-2525
(717) 783-2831 (fax)

April 13, 2010

**T estimony before the
Senate Consumer Protection and Professional L icensure Committee
on the E xpiration of R ate Caps**

In today’s economy, utility rate increases are especially unwelcome. However, the expiration of generation rate caps has had, and is likely to continue to have, an uneven impact across the state. Under the Competition Act, the post-cap rates of electric distribution companies (“EDCs”) are to reflect market prices because those rates are to be set through competitive procurement.¹ Therefore, the closer an EDC’s capped rates are to market prices, the smaller the impact will be when rate caps end. On the other hand, the farther an EDC’s capped rates are from market prices, the greater the impact will be when the caps end.

Experience of Individual EDCs

When the caps were imposed, the rates charged by PECO and Duquesne were the highest in the state and among the highest in the country. In contrast, the rates charged by West Penn

¹ “Competition Act” refers to the “Electricity Generation Customer Choice and Competition Act,” at 66 Pa. C.S. Ch. 28.

were the lowest in the state. The rates charged by PPL, MetEd, Penelec, and Penn Power fell in between those extremes.²

PPL

Because its caps expired at the end of 2009, PPL has attracted considerable attention. Unfortunately, PPL's customers have felt an extra jolt because the EDC's 2010 default service rates are above current market prices. Fortunately, it appears likely that PPL's default service rates in 2011 will actually be lower than they are now.³

PPL's current above-market generation rates result from a strategy—approved by the PUC and supported by most other parties, including the OSBA—to mitigate the post-cap rate increase by buying electricity for 2010 in 2007, 2008, and 2009. As a result of that strategy, PPL had already contracted for a substantial amount of its 2010 electricity before the recession drove down market prices.

PPL's experience underscores the risk involved in tinkering with the procurement schedule in the hope of timing the market. Sometimes, such a strategy will pay off in lower rates. Unfortunately, at other times, that strategy will result in higher rates.

Duquesne

Duquesne offers an interesting contrast to PPL. Duquesne's rates were much higher than PPL's when the caps were imposed. When they lost the protection of rate caps in 2002, Duquesne's customers were not subjected to the jolt which PPL's customers are currently

² One of the goals of the Competition Act was to eliminate (or at least mitigate) the competitive advantage or disadvantage to a business because of the EDC service territory in which that business was located. *See* Section 2802(4) and (6) of the Public Utility Code, 66 Pa. C.S. §2802(4) and (6). Principally because of congestion in the transmission system, post-cap rates are likely to be somewhat higher in eastern Pennsylvania than in western Pennsylvania. However, there should be much less difference in generation rates across the state than there was when each EDC was responsible for building its own power plants.

³ However, PPL's recently requested increase in distribution rates may more than offset the likely decline in generation rates for some customers.

experiencing. Furthermore, Duquesne's generation rates for residential and small business customers are lower now than they were when the caps were removed.

PECO

The PUC's analysis in January suggests that the experience of PECO's customers may be similar to Duquesne's. There are, however, some major caveats. First, PECO has requested an increase in distribution rates, which is likely to mean that small business customers' overall bills will increase even if generation rates are relatively unchanged when the caps expire. Second, PECO will be transitioning to flat generation rates for small business customers. As a result, the impact of the end of rate caps could vary widely within the small business community.

West Penn

The customers of West Penn Power should also experience a less severe jolt when rate caps expire than the customers of PPL have been experiencing. West Penn's caps were originally scheduled to expire at the end of 2008. However, a 2005 settlement extended the caps for an additional two years, with increases in the caps almost every year to ease customers to expected market prices. On the plus side, these gradual increases mean that the shock when the caps finally expire at the end of 2010 is likely to be relatively modest compared to PPL. On the negative side, West Penn's customers have been subjected to a steady diet of generation rate increases that PPL customers avoided.

MetEd/Penelec

According to the PUC's projections, rates for the customers of MetEd and Penelec could rise by more than 30% when the caps expire at the end of this year. However, the initial

procurements by these two EDCs will provide a more accurate indication of the magnitude of the class increases.⁴

Penn Power

The expiration of Penn Power's rate caps at the end of 2006 had dramatically different impacts on each customer class. According to the PUC, the average increases were in the 20 to 30% range for residential customers, in the 2 to 3% range for small commercial and industrial customers, and 50% or more for large commercial and industrial customers.⁵ These results demonstrate the efficiency of the competitive market in eliminating inter-class subsidies created under regulation. They also demonstrate that if one customer class is given a subsidy in order to ease the burden on that class, other customer classes will be forced to pay more.

Evaluation of Mitigation Proposals

Procurement Approaches

There has been an ongoing debate over whether full-requirements contracts or managed portfolios will do a better job in yielding default service rates that are both low and reasonably stable. There has also been a debate over whether significant reliance on long-term contracts will result in higher or lower default service rates. However, the choice of procurement strategy is unlikely to make a dramatic difference in default service rates over time. The rate impact accompanying the expiration of rate caps is primarily a function of electricity market prices relative to each particular EDC's capped rates rather than a function of the procurement strategy.

⁴ The results of these procurements have not been announced.

⁵ Although the overall impact on small commercial and industrial customers was modest, some customers in that class experienced sizable increases because they had been paying discounted rates which were well below the class' average rate. Other customers within the class experienced sizable increases because of the elimination of the demand charge and declining block rates.

It is important to recognize that, just as the recession drove down market prices, a robust recovery could drive them back up. For that reason, some may argue that “EDCs should buy now, before the economy improves.” Unfortunately, such a strategy is likely to succeed only if the sellers of electricity are less knowledgeable about the direction of the market than are the EDCs which are buying that electricity. Furthermore, such a strategy ignores the risk premium which appears to increase the selling price if the electricity is purchased well in advance of delivery.

Shopping

The PUC has encouraged customers to “shop” for electricity from an electric generation supplier (“EGS”) as a way to mitigate post-cap rate increases. However, shopping does not guarantee lower rates than an EDC’s default service rates.

At the present time, shopping may be a good option for PPL’s small business customers. However, that situation is an anomaly. Because PPL’s 2010 default service rates are above-market, many of these customers may be able to find an EGS rate for 2010 which is lower than PPL’s default service rate. Nevertheless, those shoppers should be cautious about entering into contracts which lock them into higher EGS rates in 2011, because PPL’s default service rates are likely to go down.

Power Authority

The OSBA has not closely examined any of the proposals for a power authority. Because an authority is not required to make a profit or pay income taxes, it is possible that an authority can finance, build, and operate power plants more cheaply than private developers or the generation affiliates of the EDCs. On the other hand, the combination of competitive procurement and the profit motive may give private developers (and unregulated generation

affiliates of EDCs) an incentive to control costs more aggressively and to operate power plants more efficiently than a public authority.

Municipal Aggregation

Depending on the load profile and the timing of the purchases, a municipal aggregation program may sometimes be able to obtain a lower rate for customers than available through an EDC's default service. However, the OSBA does not believe that municipal aggregation programs can consistently outperform the EDCs' default service procurements.

One way a municipal aggregation program can have an advantage over EDC default service is if all customers in the municipality are required to participate in the aggregation. In that way, the suppliers to the municipal aggregation pool face much lower migration risk than EDC default service suppliers and may, therefore, be able to offer lower prices. However, such an approach is not consistent with the Competition Act, which gives each individual customer the right to choose a supplier.⁶

Therefore, if municipal aggregation is allowed, the OSBA recommends that it be subject to the following conditions. First, just as a municipality must seek competitive bids to undertake a construction project or to purchase equipment, a municipal aggregation program should be required to purchase electricity through competitive bidding. Second, bidders should not be able to "sweeten the deal" by offering the municipality a new dump truck, funding for a recreational facility, or some other incentive unrelated to the cost of electricity. Third, customers should not be included in the aggregation program unless they affirmatively opt into it. Because of their individual load profiles, some small business customers may be able to do better than the aggregation rates by shopping on their own.

⁶ See Sections 2806(a) and 2807(d)(1) of the Public Utility Code, 66 Pa. C.S. §§2806(a) and 2807(d)(1).

Merger

The unregulated generation affiliates of West Penn, MetEd, Penelec, and Penn Power have been a potential source of lower cost power in competitive procurements for western Pennsylvania EDCs. Therefore, the PUC should carefully scrutinize the proposed merger of First Energy and Allegheny Energy.⁷ At a minimum, the PUC should advocate before the Federal Energy Regulatory Commission against any concentration of generation resources which would give the merged entity the ability to affect future wholesale prices.

Once again, thank you for the opportunity to testify. I will be happy to respond to any questions.

⁷ MetEd, Penelec, and Penn Power are owned by First Energy. West Penn is owned by Allegheny Energy.