

ELECTRIC DEREGULATION AND RATE CAPS
**Before The Consumer Protection and
Professional Licensure Committee
Senate of Pennsylvania
February 7, 2007**

**Testimony of
Terrance J. Fitzpatrick, Commissioner
Pennsylvania Public Utility Commission**

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Good morning Chairman Tomlinson and members of the Committee. Thank you for the opportunity to share my thoughts on this important issue.

The Electricity Generation Customer Choice and Competition Act¹ was approved by the General Assembly and signed into Law by Governor Ridge in late 1996. At that time, I was a member of the staff here in the Senate, and I was involved in drafting and negotiating passage of the Act. The basic idea underlying the Act was to free customers to buy electricity from suppliers other than their electric utility, and to require the utilities to transport the energy to make these transactions possible. Industrial customers were eager to gain direct access to the emerging wholesale electricity markets, where prices were then lower than regulated retail rates.

This was an exciting time for the electric industry in Pennsylvania. We were one of the first states to embrace retail competition. Industrial customers led the push for the Act, and they were joined by some utilities who believed competition was inevitable. Initially, higher cost utilities opposed the idea, but they too came to accept competition when they were able to negotiate sufficient assurances of stranded cost recovery. In the end, there was a very broad consensus among consumer representatives, utilities, potential competitors (such as Enron), unions, and others that supported this legislation.

Moving ahead ten years to the present -- where are we now? Most of the utilities in the Commonwealth are still subject to generation rate caps and are still collecting stranded costs from customers. Where the caps have expired, the results have been mixed. In the Duquesne Light service territory, there is active competition for business customers, and the total price that Duquesne charges residential customers for all aspects of electric service is lower than it was ten years ago. In other areas, such as Pike County, which is served by Pike County Light and Power Co., the expiration of rate caps has resulted in steep price increases. In addition, with the exception of the Duquesne service territory, there is very little actual retail competition in Pennsylvania.

Nationally, the movement of states to allow retail competition halted in 2001. This was a result of the meltdown of the California retail competition program, the Enron bankruptcy and scandal, doubts about the competitiveness of wholesale markets, and increases in wholesale electricity prices driven by higher natural gas prices. Many of the states that allow retail competition do not have significant shopping because they continue to closely regulate the default supply prices offered by the utilities. Ohio is an example of this approach. Some other states have developed meaningful competition and customers have a choice among several competitive suppliers. These states have achieved this result by allowing the retail default service price to move with changes in wholesale prices. This policy has been controversial because prices for retail default service have risen more quickly in these states. Texas is an example of this approach.

¹ Act 138 of 1996, 66 Pa. C.S. §2801 *et seq.*

Here in Pennsylvania, the generation rate caps that still are in force for most of the Commonwealth are set to expire at the end of 2010. It is important to establish policies for dealing with this situation before the caps expire, and the Commission is scheduled to vote tomorrow on default service rules and policies, and on strategies to mitigate potential price increases.

Unfortunately, as we decide how to move ahead, the consensus that led to passage of the Act has unraveled. Representatives of customers no longer are eager to gain direct access to wholesale prices. When the Act was passed, it was widely assumed that wholesale market prices would always be lower than regulated retail prices. But experience has now shown that, at times, wholesale market prices can be higher than regulated prices, and that wholesale prices will always be more volatile and unpredictable than regulated prices. As a result, most customer groups now advocate rules to establish default service prices that are insulated from wholesale price fluctuations, even if that stifles the development of a competitive retail market and leads to continued dependence on regulated default service, contrary to the purpose of the Act.²

On the other hand, there are some large commercial customers who continue to support retail competition, and who advocate default service rules that will stimulate actual retail competition in order to attract multiple competitive suppliers. Attached to my testimony is a recent letter to Governor Rendell from several of these customers. In addition, retail marketers and owners of generation continue to support the establishment of pro-competitive rules and policies.

Another significant development over the past decade has been a growing concern over global warming. Electric generating plants that burn fossil fuels are a primary source of greenhouse gas emissions. This concern is one reason why the General Assembly passed the Alternative Energy Portfolio Standards Act. Many other states have adopted similar laws.

In the remainder of my time, I will address briefly four additional questions.

1. Why don't we have more shopping and competition?

The generation rate caps that have insulated customers from changes in wholesale market prices have impeded the development of sustainable retail competition. In the early stages of our competition program, wholesale prices were below regulated retail prices, and retail competition began to develop. In the spring of 2000, just fifteen months after competition began, over one-third of the electric load in Pennsylvania was served by competitive suppliers. However, later in that year wholesale market prices began to rise due to increases in the price of natural gas, and retail marketers could no longer compete with the

² "Competitive market forces are more effective than economic regulation in controlling the cost of generating electricity." 66 Pa. C.S. §2802(5).

capped generation rates of the electric utilities. By July of 2001, the amount of load that was shopping fell below ten percent, and it has remained at a depressed level since then. The Duquesne service territory, where the generation rate caps have expired, is an exception to this trend.

2. Where the generation rate caps have expired, why have retail prices gone up so much in some areas but not in others?

Whether customers will pay more or less when generation rate caps expire depends upon two primary factors—the level of a utility’s historical regulated rates, and the level of wholesale electricity prices at the time that a utility makes purchases to serve default customers. One of the ironies here is that the higher a utility’s historical regulated prices, the less likely it is that its customers will experience dramatic increases when they begin to pay market prices. The customers of Duquesne Light Co. were paying the second highest rates in Pennsylvania going into restructuring—this is one of the main reasons why their rates have dropped even though their rate cap has expired. In the Pike County situation, Hurricane Katrina drove natural gas prices and wholesale electricity prices to record levels at the time that the utility was seeking supply for default customers. This is the primary reason for the steep price increase for those customers.

Another factor that can contribute to large, extended retail price increases is where the default supplier purchases -- at a single point in time -- all of the energy needed to serve customers for a multi-year period. In order to avoid this situation, it may be better to stagger purchases over time and make more frequent adjustments to the retail prices. This is the policy direction that I expect the Commission to follow.

3. What is the Commission doing?

The Commission opened a proceeding last summer to examine what we could do to moderate potential price increases when the caps expire, and how we could prepare customers to cope with higher prices. Our main focus in this proceeding is on customer education, energy conservation, tools to allow customers to phase-in price increases, and the impact on low-income customers. The Commission is scheduled to consider an order in this proceeding at tomorrow’s Public Meeting, and I believe that the steps we take will help customers.

The Commission will also consider tomorrow rules and policies governing default service once the caps expire. The Commission will take additional comments on these issues because we are changing course from the proposed regulations that were issued over two years ago. The biggest change is that instead of just issuing regulations, we will propose to issue both a statement of

policy and regulations. Addressing some issues in a statement of policy will give the Commission more flexibility to make changes in light of experience here in Pennsylvania and in other states. This is similar to an approach that has been used with success in New York.³

Conclusion

There is no question that establishing effective retail (and wholesale) competition has proven to be more difficult than anticipated at the time the Competition Act was passed. At the national level, promoters and opponents of electricity competition cite competing studies and continue to debate whether customers have benefited from competition.

With the rate caps set to expire in Pennsylvania by the end of 2010, in my view, it is the Commission's duty under the Competition Act to follow a course that will lead to effective retail competition. I believe that this can be implemented in a gradual, deliberate manner that minimizes disruption to customers. But the ultimate goal must be effective competition.

If the General Assembly finds that there are now more important goals than establishing competition, then it may be appropriate to reevaluate the Competition Act. Whatever course you take, I will do my best to faithfully execute laws passed by the General Assembly, regardless of my personal policy views.

Thank you again and I would be happy to respond to questions.

³ See, Statement of Policy on Further Steps Toward Competition in Retail Energy Markets, Case 00-M-0504, N.Y. Public Service Com. (August 25, 2004).

January 19, 2007

The Honorable Edward G. Rendell
Governor of Pennsylvania
225 Main Capitol Building
Harrisburg, PA 17120

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Dear Governor Rendell:

The electricity customers who have signed this letter strongly support the development of competitive electricity markets and encourage the Commonwealth of Pennsylvania to maintain its commitment to policies which allow for the continued evolution and implementation of such markets, especially the Commonwealth's competitive retail market. Electricity competition has contributed to Pennsylvania's remarkable economic growth and provides the best route toward energy independence. In addition, wholesale and retail electric markets will bring about and sustain the most competitive prices for consumers.

In Pennsylvania, we collectively represent 4,411 facilities and over \$120 million in annual electricity costs as consumers of electricity. Electricity is one of the most substantial costs to our business operations which ends up impacting our 122,000 employees in the state and thousands of Pennsylvania customers who visit our stores each week. A number of our facilities have realized savings on electricity by participating in the competitive market.

We urge you to encourage policies that allow consumers to choose from the best and broadest array of choices in electricity products and services.

We believe that regional competitive wholesale markets for electricity with independent oversight, as we have in the PJM marketplace in Pennsylvania and 12 other states, provide access to generation at the lowest available cost, promote transparency and reliability, enhance the nation's transmission infrastructure, and provide price signals that promote sound investment decisions regarding generation, transmission, demand response, and energy efficiency.

Our companies' collective experiences in Pennsylvania and many other states reflect that well-designed, competitive electricity markets allow our businesses to recognize substantial savings on electricity costs, which can in turn be passed on to customers through lower priced consumer goods and services. Fostering policies in Pennsylvania and our region which allow commercial electricity users to manage their energy purchases in an efficient manner is critical to achieving such savings.

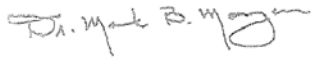
The goal of all policymakers should be to ensure reasonably priced and reliable electricity for consumers. Competition keeps costs as low as possible, drives innovation, and produces the benefits customers are seeking. This is true whether you're talking about telecom services or the changes in the automobile industry in the last quarter century. It is also true for electricity.

It's easy to forget what the world was like before competitive forces took hold. Consumers demanded the right to choose their own energy supplier, recognizing that competition imposes maximum downward pressure on prices, that competitive pressures do not exist in a regulated vertically integrated monopoly structure that lacks competition, and that they were paying far more for electricity commodity services than would be the case in a competitive market.

There was less incentive for utilities to save money than there is under competition, and no opportunity for captive customers to choose a lower cost provider. Many of these captive customers were the businesses -- small and large -- that create jobs and grow the economy.

We respectfully request that you and your Administration continue developing policies that allow such benefits to be achieved and that allow customers the ability to fully participate in competitive wholesale and retail electric energy markets in the Commonwealth of Pennsylvania. We participate in markets for virtually all goods and services, and believe that electricity competition is the path forward for Pennsylvania.

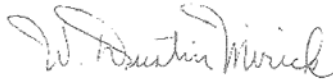
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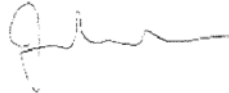
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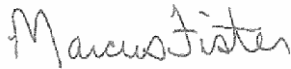
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