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TESTIMONY

OF THE

ELECTRIC POWER GENERATION ASSOCIATION

before the

PENNSYLVANIA HOUSE REPUBLICAN POLICY COMMITTEE

HEARING ON

RATE CAP MITIGATION

PRESENTED BY

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March 17, 2008
Harrisburg, PA

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Chairman Turzai and members of the House Republican Policy Committee, good morning, and thank you for giving me the opportunity to testify on behalf of the Electric Power Generation Association[1] regarding electricity rate mitigation.

Eighty-five percent of the electricity customers in Pennsylvania are still paying electricity prices that reflect a cap on the generation portion of their bill. These caps are a byproduct of the Electricity Generation Customer Choice and Competition Act of 1996, and of settlements of utility restructuring cases under the Act. By the time that these caps expire in 2010 or 2011, they will have been in effect for thirteen or fourteen years.

The world has changed since 1996, and this is particularly true with respect to energy. Even if generation charges only increased by the general rate of inflation, they would be roughly 40% higher when the caps expire. But the prices of fuels used to generate electricity and of new electric generating plants have increased much faster than general inflation in recent years. From 1999 to 2007, the price of coal increased by 56% and the price of natural gas increased by 200%. In addition, a study released last month reveals that the cost of building a new electric generating plant in North America increased by 130% from 2000 to today. This means that a generating plant that cost $1 billion to build in 2000 would cost $2.3 billion today. The biggest reasons for these cost increases are surging demand for energy and infrastructure by developing countries such as China and India, and more stringent environmental requirements.

It is remarkable that the rate caps are insulating most electricity customers in Pennsylvania from these fundamental shifts in energy markets. In the short term, the caps have provided a huge economic benefit to customers. But the caps also have disadvantages, illustrating that government-imposed price controls are never a wise or sustainable long-term policy.

The prices customers are paying under the caps are artificially low – they do not reflect the fundamentals of energy markets today. The caps have inhibited the development of retail competition, because competitive suppliers cannot buy electricity in the wholesale market at prices that allow them to compete with the capped rates of the utilities. Because customers are paying artificially low prices under the caps, they do not have an appropriate incentive to conserve electricity, which is contrary to environmental and economic goals.[2] In addition, the caps have prevented customers from making gradual adjustments to changes in energy markets – a flaw that will require special measures such as phase-in plans (discussed below) to overcome. Finally, while Pennsylvania produces more electricity than is used here, we should remember that price controls generally contribute to scarcity of a product in the long run.

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[1] The Electric Power Generation Association (EPGA) is a regional trade association of electric generating companies with headquarters in Harrisburg, Pennsylvania. Its members include AES Beaver Valley, LLC, Allegheny Energy Supply, Cogentrix Energy Inc., Constellation Energy Commodities Group, Inc., Dynegy Inc., Edison Mission Group, Exelon Generation, FirstEnergy Generation Corp, LS Power Associates L.P., Mirant Corporation, PPL Generation, Reliant Energy, Sunbury Generation LP and UGI Development Company. These companies own and operate more than 149,000 megawatts of electric generating capacity, more than half of which is located in the mid-Atlantic region.

[2] The House of Representatives recently passed House Bill 2200, which is designed to stimulate conservation.

So what can the General Assembly do to mitigate the impact of higher prices on customers when the caps expire? My experience with this question dates back almost two years, to May of 2006. I was a member of the Public Utility Commission at that time, and along with my colleagues initiated a proceeding entitled "Policies to Mitigate Potential Electricity Price Increases."

The Commission ultimately adopted policies of educating customers, encouraging conservation, reducing peak demand for electricity, encouraging phase-in plans for higher prices, and reviewing the adequacy of low income assistance programs. I still believe that these policies constitute a sound strategy for both the Commission and the General Assembly to address higher electricity prices. For the purpose of my testimony today, I will focus on phasing-in higher prices, because that is the most concrete policy that can help the average customer through the transition to paying market prices.

Legislation to encourage electric utilities to phase-in higher prices in a competitively neutral manner would be in the public interest. Under a "late phase-in" plan, customers would not see any price increase until the caps expire, and the customer would then pay a price that is somewhat higher than before, but still not the full market price. Under this plan, the utility would be permitted to recover its carrying costs on the difference between what the customer pays and the market price.

A better type of plan is an "early phase-in" plan, in which customers begin to pay higher prices before the rate caps expire. In this situation, customers would earn interest on their early payments to help ameliorate price increases in later years. By beginning payments earlier, a more gradual introduction and smoother transition to higher prices is possible.

Any phase-in plan should be voluntary, but I believe that utilities should be allowed -- even encouraged -- to file early phase-in plans in which customers will be enrolled unless they act to "opt out" of the plan. My reason for favoring this type of plan is pragmatic: it is the best plan for the average customer, and participation will be maximized with an opt out approach. I recognize that some people do not favor an opt out approach because they are uncomfortable with encouraging people to begin paying higher prices before the caps expire. I respectfully submit, however, that we have entered a new era of higher energy and electricity prices, driven by worldwide trends that are beyond our control. In my view, sound public policy would help customers come to grips with that reality sooner rather than later to ease the inevitable transition to higher prices.

While policies that can help customers in the short term are important, it is just as important to consider policies that will promote reliable supplies of electricity at competitive prices in the long term. The key to accomplishing this goal is to maintain the Commonwealth's commitment to competitive electricity markets. Competition has greatly increased the operating efficiency of the generation industry. For example, nuclear generating plants operated roughly 70% of the time before wholesale

competition began, but they operate over 90% of the time now. Coal-fired plants have also improved their operating efficiency while reducing their operations and maintenance expenses.

This increased efficiency has reduced the need for expensive new plants, and has reduced the number of hours that plants using more expensive fuels must be operated. In light of this improvement in operating efficiency driven by the introduction of competition, it clearly would be unnecessary and counter-productive to return to a regulated approach by requiring the Public Utility Commission to create operation and maintenance standards for generating plants, as some in the labor community are advocating.

Maintaining a commitment to free, transparent competitive markets will create a stable environment for investment in generation and other forms of electricity infrastructure. On the other hand, the threat of government interventions such as extending rate caps or mandating long-term contracts with politically-favored technologies will deter investment.

Other policies that will encourage reliable, affordable electricity supplies include supporting the development of electricity infrastructure, and striving to achieve a reasonable balance between environmental and economic goals.

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