

**TESTIMONY**

**OF THE**

**ELECTRIC POWER GENERATION ASSOCIATION**

**Before the**

**HOUSE ENVIRONMENTAL RESOURCES AND ENERGY COMMITTEE**

**HEARING ON**

**POLICIES TO RESPOND TO HIGHER ELECTRICITY PRICES**

**PRESENTED BY**

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**July 22, 2008**  
**Pittsburgh, PA**

Good afternoon Chairman George, Chairman Hutchinson, and members of the Committee. Thank you for giving me the opportunity to testify on behalf of the Electric Power Generation Association<sup>1</sup> regarding policies to respond to higher electricity prices.

Caps on the generation prices charged by utilities serving 85% of the customers in Pennsylvania will expire at the beginning of 2010 and 2011. It is likely that customers will experience significant price increases upon the expiration of these price controls, although the percentage of increase for individual customers will vary depending upon the level of their utility's historic rates.

The question you are asking in this hearing is, "What should the General Assembly do about these upcoming price increases?" But just as a doctor must diagnose a medical problem before prescribing a treatment, the General Assembly must determine why electricity prices are increasing before enacting policies to address these increases.

My testimony can be summarized as follows:

- Electricity prices are rising throughout the country – in both states that allow competition and in states that retained traditional regulation – because of increases in the cost of fuels used to generate electricity, and in the cost of building new power plants. Policies that make sense in this situation are those that help customers make the transition to paying market prices – policies such as educating customers, giving customers options to phase-in higher prices, encouraging conservation and reductions in peak demand for electricity, and reviewing the adequacy of low income assistance programs.
- In my view, it is simply wrong to blame higher electricity prices on electricity competition, on PJM's wholesale pricing rules, or on generators of electricity. Policies that are based on these mistaken beliefs – policies such as extending price controls, imposing new taxes on generators, creating new state bureaucracies to buy electricity, and modifying federally-regulated wholesale power contracts whenever market conditions change – will lead Pennsylvania in the wrong direction, and will cause higher prices and less reliable service down the road.

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<sup>1</sup> The Electric Power Generation Association (EPGA) is a regional trade association of electric generating companies with headquarters in Harrisburg. 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 LP, PPL Generation, Reliant Energy, Sunbury Generation LP, Tenaska Inc., and UGI Development Company.

## **Why electricity prices are rising**

Electricity prices are rising everywhere, not just in states that allow competition to supply electricity to customers. Attachment “A” to my testimony is a chart compiled by Dr. Susan Tierney that shows price increases in all the states and the District of Columbia between 1995 and 2007. The chart shows clearly that both restructured (i.e. competitive) states and non-restructured states have experienced increases. This demonstrates that competition is not causing higher electricity prices.

Along the same lines, a recent article in *USA Today* (“Price jolt: Electricity bills going up, up, up,” June 16, 2008) reported on price increases in six states, only one of which allows competition. The article concluded – correctly – that these increases are due to higher costs for fuels used in generating plants, and higher costs to build power plants and other types of electricity infrastructure.

From 2000 to 2007, the cost of building a new power plant in North America increased by 130%, driven by increases in the prices of commodities such as steel (up 70%), copper (up 300%), aluminum (up 70%), cement (up 40%), and electric wire (up 60%). During this same period, the cost of coal rose 56%, and the price of natural gas rose 200%. These numbers are conservative because spot market fuel prices have nearly doubled in 2008.

## **Policies to ease the transition to market prices**

It is a hard reality that Pennsylvania cannot control the global conditions – surging demand for energy and commodities in countries such as China and India – that are driving up the underlying costs of producing electricity. Pennsylvania can, however, help customers adjust to higher prices by providing phase-in options, helping customers to conserve and reduce their peak demand, and providing assistance to low income customers.

The idea behind phase-in plans is to allow customers to adjust to higher prices gradually by introducing increases over a number of years rather than all at once. One option is a “ramp up” plan under which a customer agrees to begin paying somewhat higher prices before the price cap expires, and this extra revenue is set aside – with interest – to allow for a smoother transition to a full market price. Another option would be that the customer begins paying a somewhat higher price, but not a full market price, when the cap expires. This price would be increased gradually in later years to recover the full market price and carrying charges.

With regard to encouraging conservation, reducing peak demand, and providing assistance to low income customers, the House has passed legislation that reflects these policies. Earlier this year, the House approved House Bill 2200, which provides targets for conservation and reducing peak usage, and includes a

schedule for providing advanced meters to all customers. This Bill is pending in the Senate. In addition, Governor Rendell recently signed Special Session House Bill 1, which provides funding for alternative energy, for conservation measures, and for \$40 million in state funding for the Low Income Home Energy Assistance Program. This is not to say that more could not be done on these issues, but these are significant steps already taken by the House.

### **Response to claims that flawed wholesale markets are causing higher prices**

Some argue that electricity prices are rising in Pennsylvania because of flaws in the wholesale markets administered by PJM Interconnection, and that the profits earned by some generators prove that wholesale markets are not competitive. These arguments are not supported by the facts.

Representatives of some large industrial consumers criticize the single price auction that PJM conducts to facilitate sales of electricity in the spot market. Under this mechanism, generating plants submit bids at their marginal operating cost, and PJM accepts these bids from low to high until demand is met. All bidders are then paid at the level of the “market clearing” or highest bid. The main alternative to a single price auction is a “pay as bid” approach; however, experience has shown that this approach leads to higher prices because it results in sellers speculating about where the market will clear (the market value of their product) rather than simply bidding at their marginal cost.

All seven of the regional transmission organizations (such as PJM) that oversee wholesale electricity markets in the United States now use a single price auction, some after experimenting with a pay as bid approach or other alternatives. The single price auction encourages generators to get the greatest output from their plants at the lowest operating cost. An expert study concluded that the improved efficiency of nuclear plants alone due to these market incentives saves Pennsylvania customers \$122 million annually.<sup>2</sup>

The improved operating efficiency that is driven by the single price auction doesn't just lower operating costs of baseload generating plants. Greater availability of this low-cost generation reduces the overall need for higher cost generation, thus lowering costs for the entire market. In its effects on market prices, increased output from baseload coal or nuclear plants due to increased efficiency is equivalent to a reduction in demand or to building new baseload power plants.

It is also argued by some critics that wholesale markets must not be competitive because of the profits earned by some generators. These arguments are not accurate. PJM's market monitoring unit has consistently concluded that

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<sup>2</sup> Cain and Lesser, *The Pennsylvania Electric Restructuring Act: Economic Benefits and Regional Comparisons*, Bates White LLC, February 2007.

wholesale electricity prices are competitive based upon an analysis of the costs that generators face to build and operate plants. In fact, the hard truth is that over the period since PJM's organized markets began operating in 1999, wholesale prices were not generally high enough to allow investors to recover the costs of building new power plants. This is not a good situation, because it will eventually lead to shortages of electricity; however, the situation is now beginning to improve due to reforms of PJM's pricing rules.<sup>3</sup> However, these facts certainly refute any argument that wholesale electricity prices have been inflated and uncompetitive.

Since organized wholesale markets began to operate, some generators have been profitable, some have been only marginally profitable, and some have gone into bankruptcy. As in any competitive industry, the success of individual firms depends on their strategy and how well they execute it. The market value of generating plants built in the past has gone up as the cost of building new plants has increased, but that does not provide a basis for criticizing the owner of these plants or concluding that competition has failed. Moreover, generators should not be punished for operating their plants efficiently.

In giving my views on wholesale markets, I have done my best to simplify a complex subject. I will answer any question you have to the best of my ability. However, given the harsh criticisms of PJM by some parties, I encourage you to hear from PJM itself regarding its market rules. While generators do not always agree with PJM's policies, I can testify from my experience over many years as a PUC Commissioner that PJM is made up of an extraordinarily dedicated group of people who care deeply about keeping the lights on and ensuring competitive electricity prices. I believe that you would benefit from hearing PJM's views.

### **Response to specific policies advocated by critics of electricity markets**

Since the legislative debate on electricity issues began last year, a number of policies have been proposed that are based upon the belief that markets have failed. Some of these policies are in pending legislation and some are not, such as the policies outlined by some Senate Democrats a few weeks ago. In the interest of time, I will address these policies in abbreviated fashion.

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<sup>3</sup> In the wholesale market, purchasers (generally, utilities and competitive suppliers who then resell the energy at retail to end-use customers) must purchase "capacity" (and "ancillary services," which are not relevant to this discussion) as well as energy. The purpose of the capacity market is to help assure that plants are built in a timely manner to avoid shortages. In December 2006, the Federal Energy Regulatory Commission approved a new capacity model for the PJM area – the "Reliability Pricing Model" (RPM) – to provide greater incentives for building generation. This model is working, as RPM auctions conducted to date have resulted in greater demand response, plants brought out of retirement, uprates at existing plants, and new generation. All told, RPM has resulted in 16,000 additional megawatts of capacity. PJM press release, "PJM Capacity Auction Results: Power Supplies Up, Prices Down." May 15, 2008.

- Creating an additional state bureaucracy – a state power authority – to purchase or supply electricity will not lead to lower electricity prices. Electricity prices are rising because of increases in underlying costs, and the creation of such an agency will not reduce these costs. Moreover, the activities of such an agency may place risks upon captive customers or taxpayers that are currently, and more appropriately, placed upon investors in a competitive market.
- Authorizing the Public Utility Commission to modify wholesale power contracts between generators and utilities whenever cheaper power becomes available violates federal law, because such contracts are subject to federal jurisdiction, and the federal courts have emphasized the importance of maintaining the integrity of these contracts.<sup>4</sup> Authorizing the modification of these contracts would also be poor public policy because it would discourage generators from selling to utilities and would lead to higher, not lower, prices.
- Imposing a new state tax on generators will increase the cost of producing electricity, will discourage generators from investing in Pennsylvania, and will be a factor in decisions by generators whether to retire marginal plants. Such a tax will lead to fewer jobs and higher electricity prices in Pennsylvania.
- Extending retail price caps or precluding utilities from recovering some portion of the cost of buying electricity in the wholesale market would be unlawful and poor public policy. States may not require utilities to supply electricity to customers and then refuse to allow them to recover the cost of procuring electricity in federally regulated wholesale markets.<sup>5</sup> Moreover, such a policy would damage the credit rating of utilities, discourage generators from contracting with utilities (forcing the utilities to rely more heavily on purchases in the spot market), and lead to higher electricity prices to customers.

In conclusion, electricity prices are rising because of increases in underlying production costs, not because of competition or any flaws in wholesale markets. Policies that will help customers make the transition to paying market prices are appropriate. Policies that are based upon a rationale that markets have failed will cause greater problems – more expensive, less reliable electricity – in the future.

Thank you for allowing me to testify, and I would be happy to answer questions.

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<sup>4</sup> See, *Morgan Stanley Capital Group, Inc. v. Public Utility District of Snohomish County*, 128 S.Ct. 2733 (2008).

<sup>5</sup> See, *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 106 S.Ct. 2349 (1986).