I/M/O the Provision of Basic Generation Service ("BGS") for the Period Beginning June 1, 2006
BPU Docket No. EO05040317

Final Comments of the Division of Ratepayer Advocate

September 13, 2005

The Division of the Ratepayer Advocate ("Ratepayer Advocate") is filing these final comments pursuant to the procedural schedule established by the Board of Public Utilities ("Board" or "BPU") in its May 5, 2005 Order.[1] These comments address issues raised by the Board in its May 5 Order as well as issues raised by various parties in their submissions to date. This submission builds on the initial comments filed by the Ratepayer Advocate on August 19 and the public comment made on behalf of the Ratepayer Advocate on September 7.

Revenues from the Retail Margin

The uncommitted portion of the Retail Margin revenues collected from customers over the past two years has grown to approximately $25 million. The Ratepayer Advocate recommends that all of these funds that are uncommitted be returned through a new Retail Margin Adjustment Clause (RMAC). The proposed RMAC would flow Retail Margin revenues back to the customers in the rate classes which provided them through a mills-per-kWh credit, set annually for each class.

It is not hard to see the appropriateness and equity of the Ratepayer Advocate's proposal. Imposition of the Retail Margin raises the price below which service from Third Party Suppliers (TPS) is economically attractive, from the cost of the applicable utility service to the cost of that service plus 5 mills per kWh. For those subject to the Retail Margin, BGS costs plus 4.9 mills becomes an economically attractive offer. Thus, both those taking BGS and those going to the market have their price for electricity raised by the operation of the Retail Margin. Therefore, Retail Margin revenues should be returned to all customers in those rate classes subject to the Retail Margin. This approach is consistent with the Board's statement, that Retail Margin revenues "are customer supplied funds that must be returned to customers." [2]

The Retail Margin provides an incentive for customers to obtain and retain competitive service from TPS. Retail competition is a means, not an end. The end is the provision of safe, reliable electric service to New Jersey ratepayers at the lowest reasonable price. The Ratepayer Advocate understands that energy prices may need to rise somewhat in the short run so that a competitive retail market has an opportunity to develop. However, in the long run, that market

[1] *I/M/O the Provision of Basic Generation Service for the Period Beginning June 1, 2006*, BPU Docket No. EO05040317, Decision and Order, May 5, 2005.

[2] I*/M/O the Provision of Basic Generation Service Pursuant to the Electric Discount and Energy Competition Act, N.J.S.A. 48:3-49 et seq.*, BPU Docket Nos. EX01110754, EO02070384, Decision and Order, December 18, 2002.

must be able to beat the price of BGS if retail competition is to provide lower prices over the long run for New Jersey energy consumers. With this point in mind, the Ratepayer Advocate suggests that the Board consider setting a date by which the Retail Margin will be abolished.

ACE Proposal: Profit from BGS

Atlantic City Electric Company ("ACE"), in its Company Specific Addendum, has proposed that the Retail Margin be extended to all rate classes and that ACE be allowed to retain a portion of the Retail Margin revenues, to compensate the Company's shareholders for risks claimed to be associated with the provision of BGS. The Ratepayer Advocate urges the Board to reject ACE's proposal.

There are basic conceptual problems with the ACE proposal. The provision of service by a distribution utility with a monopoly franchise, such as ACE, is paid for at cost. This includes the return ACE currently is permitted. That return is simply the cost of obtaining and retaining equity capital. ACE argues that, like an unregulated retail business, it should be allowed to earn a "margin," that is a mark-up on wholesale (i.e., BGS supply) costs. In response the Ratepayer Advocate notes that unregulated businesses do not provide a reasonable basis for comparison with a regulated utility. ACE also claims that there are risks associated with the provision of BGS. The risks identified by ACE arise from the possibility of a legislative or Board-approved disallowance of BGS cost recovery. As a matter of regulatory policy, ACE need not and should not be protected from or compensated for the risk of unfavorable regulatory or legislative decisions. In particular, ACE and its shareholders should not be provided additional revenue now, to compensate for the possibility that ACE may be denied recovery of imprudently or inappropriately incurred BGS-related costs in the future.

There is also a practical problem: ACE has not provided a reasonable basis for the specific charges it proposes or the revenues it expects to receive. The charges ACE has proposed are intended to compensate ACE for risks a regulated utility providing BGS service might incur. The only data on margins that ACE has provided are the margins earned by unregulated businesses which provide far different products and services. Further, the range of mark-ups cited by ACE is very wide. ACE offers no support for the specific margins it has proposed, assuming any mark-up is warranted. For example, there is nothing in ACE's submission which explains why its proposed residential margin of 1.0 mills is a better choice than .5 or some other "small" amount.

Finally, it is important to note that ACE's proposal extends the Retail Margin to residential and commercial customers, raising the cost of BGS-FP to them by about $13 million per year. There is no evidence that the amounts proposed will do what the Retail Margin was intended to do—move customers into the competitive retail market. In fact, there is no evidence, and no reason to think that residential or commercial retail supply would be available at the BGS-FP price plus 1.5 to 2.0 mills. Use of the Retail Margin in a situation where it is likely to fail in its intended purpose will weaken the public's support for the Board's ongoing efforts to develop a retail market.

Expansion of the CIEP Class

It has been suggested that the CIEP class be expanded to include all customers with a peak load share of 750 kW or above. Two arguments have been put forward to support this proposal: (1) CIEP service has proved to be an effective inducement for very large customers to take competitive retail service, so expansion will help develop the retail market, and (2) expanding CIEP service will increase demand responsiveness, and so help the electricity markets function better. The Ratepayer Advocate has considered these arguments and the evidence offered to support them. With each argument, there are serious problems.

Turning to the first argument, the Ratepayer Advocate notes that expansion of the CIEP class would make CIEP the only non-market alternative for smaller customers than those previously on CIEP service. In their statements to the Board on September 7, both PSE&G and JCP&L noted that, among those currently eligible for only CIEP service, a larger fraction of load than customers has shifted to TPS. This shows that, on average, it is the larger customers who shift from CIEP to TPS. Experience since the threshold for mandatory CIEP was lowered is consistent with this observation. In response to RAR-6, PSE&G provided data showing that while 63 percent of all CIEP eligible customers have gone to a TPS, only 34 percent of the CIEP customers added due to the reduction of the CIEP threshold in June 2005, have gone to TPS. All of this information suggests that lowering the threshold is becoming less effective as a means of moving customers to the market.

The second argument concerns the enhancement of demand responsiveness. When considering this argument, it is useful to note that hourly pricing is not the only, and may not be the best way to improve demand responsiveness. The Literature Search performed by the Rutgers' Center for Energy, Economic & Environmental Policy, ("CEEEP") and filed by the Retail Energy Supply Association made this point quite clearly. After listing rate design options ranging from simple, seasonal and time-of-use rates based on fixed to true hourly pricing, the CEEEP went on to state:

> "The above list represents a continuum from no to little signaling of wholesale prices to customers to real-time changes in prices that customers pay. In theory, each of these pricing options will result in different levels of demand response since each sends a different price signal to end use customers. However, CEEEP was unable to identify any studies or literature that analyzed the different levels of demand response that could be expected from implementation of these various pricing options available."
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> *Assessment of Customer Response to Real Time Pricing, Task 1: Literature Search 7* (Rutgers – The State University of New Jersey, Edward J. Bloustein School of Planning and Public Policy, Center for Energy, Economic & Environmental Policy, June 30, 2005).

The Ratepayer Advocate notes that the Board is currently exploring various time of use rate options and suggests that the Board keep an open mind as to whether such options may be preferable to hourly pricing for some customers over the long run.

The Ratepayer Advocate is concerned about adverse customer reactions if smaller customers are placed on mandatory CIEP service. As all the EDCs confirmed in their statements on September 7, there has been little voluntary switching to CIEP. One can only conclude that switching to CIEP is not an attractive option for customers currently eligible for FP service. This conclusion is confirmed by the customer comments made on September 7. The New Jersey Food Council (NJFC), speaking directly on behalf of smaller customers who might eventually face mandatory CIEP service, pointed out that the customers they represent can neither obtain service in the retail market at the cost of BGS plus the Retail Margin, nor do they have the ability to efficiently manage their load in response to hourly price signals. Thus, in NJFC's view, extension of CIEP to those they represent would create pure hardship. Even A&P, which generally favored hourly pricing in its comments on September 7, did not voluntarily switch any of its 116 New Jersey stores on FP to CIEP. In light of the statements by NJFC and A&P, the Ratepayer Advocate is concerned that shifting smaller customers to mandatory BGS-CIEP may result in increased customer dissatisfaction. Similar concerns were raised by PSE&G in its statement on September 7. PSE&G also noted that, in the face of current market volatility, this is a particularly poor time to force additional small customers onto mandatory CIEP service. The Ratepayer Advocate agrees with this point.

At this time, the evidence supporting expansion of the mandatory BGS-CIEP class is unconvincing. Expansion runs the risk of creating customer dissatisfaction with competition as a whole. There are useful things to be learned from on-going rate experiments, things which may affect the choice of limits for CIEP service. Voluntary switching ensures that customers who want CIEP service can have it. Accordingly, the Ratepayer Advocate urges the Board not to lower the BGS-CIEP threshold at this time.

BGS-FP Supply Contract Duration

One-third of the electricity required for BGS-FP service is currently procured each year in the form of three-year contracts. This minimizes the exposure of small customers taking BGS-FP service to abrupt shifts in the market price of electricity. To see the importance of protection from such shifts, the Board need only consider the events of the last year, in New Jersey and elsewhere.

In New Jersey, when last year's BGS-FP auction prices increased by about 20 percent, the impact on customers was limited because the increase only affected one-third of the FP supply. In other jurisdictions which rely on short-term supply arrangements, the impact of abrupt increases in the cost of electricity was far different. In Maine, where supply is procured on a six-month basis, rate hikes of 22 to 27 percent will be seen by customers of the two largest utilities in the state. In Rhode Island, customers taking Last Resort Service supplied via short-term contracts, will see increases of 41 percent between September 2005 and February 2006.

Today BGS-FP costs reflect an average of three sets of contracts: 2003 contracts averaging about 5.6¢ per kWh, 2004 contracts averaging 5.6¢, and 2005 contracts averaging 6.7¢. Assuming current market conditions continue, the 2006 auction will replace 5.6¢ contracts from 2003 with contracts likely costing 6.7¢ or more. At 6.7¢, the resulting increase would be over 6 percent. As this shows, use of three-year contracts does not shield small customers from changes in the market. It simply shields them from massive abrupt changes they are ill equipped to handle.

It is the Ratepayer Advocate's position that the approach taken by the Board is appropriate, and indeed necessary to provide reasonable price stability to the small customers taking BGS-FP service. The Ratepayer Advocate urges the continued use of hedging, such as that provided by the use of "rolling" sets of three-year contracts, in the procurement of BGS-FP supply.

Bidding Arrangements

In its initial proposals, the New Jersey Large Energy Users Coalition (NJLEUC) pointed out that PSE&G may have the ability to "game" the BGS-FP and BGS-CIEP auctions. The NJLEUC asked the Board to require each qualified BGS bidder to disclose to the Board and its auction consultant, on a confidential basis, the source(s) of power to be bid into the auction; and to authorize the Board to take appropriate remedial action if the disclosures reveal that a supplier, in the dual capacity as qualified bidder and common supplier to other qualified bidders, may adversely affect competition or exercise market power to artificially inflate auction prices. In its September 7 comments, NJLEUC noted that testimony by Frank Cassidy on behalf of PSEG Power in the pending merger proceeding shows that PSE&G, through its subsidiaries, has controlled up to 75 percent of the auction through direct participation by PSEG affiliates and sales to other auction winners.

The difficulties that may be associated with the disclosure of bidders' sources of supply are apparent to the Ratepayer Advocate. However, the Ratepayer Advocate urges the Board to take the NJLEUC comments into account when it considers the level of market power impacts and costs which might be associated with the merger.

Pass-Through of Transmission Rate Increases

Current Board policy allows the automatic pass-through of transmission rate increases to BGS customers. However, the Board has expressed an intent to re-examine this policy. The Ratepayer Advocate would like to express its concern that the current "pass-through" policy will have an adverse effect on the development of retail competition in New Jersey.

Retail electricity suppliers are affected by changes in transmission charges which current Board policy allows wholesale suppliers to pass through to BGS customers. This creates an advantage for wholesale suppliers, allowing them to avoid a risk that retail suppliers must accept. The current policy makes it harder for retail suppliers to compete with BGS service, and so is likely to adversely affect the development of the retail market. If the Board were to change its policy and require the BGS suppliers to accept the transmission rate risk, this would allow retail suppliers to offer competitive fixed price service which includes the cost of transmission rate

related risks, or to offer lower priced service on which the customer accepts the transmission rate risk. This change would help retail suppliers attract customers, and so would foster the development of the retail market.

The Ratepayer Advocate recognizes that, if the pass through of transmission rate increases to BGS customers was eliminated, BGS suppliers would likely add a risk premium to their bids, raising BGS costs. However, BGS customers would avoid the risk of substantial, abrupt increases in costs such as those that accompanied the implementation of the Seams Elimination Cost Adjustment (SECA) in the Midwest. It is the Ratepayer Advocate's position that, as with BGS-FP supply costs, having BGS customers pay for a hedge against substantial abrupt, unexpected price changes is reasonable.

It is the Ratepayer Advocate's view that the current policy of passing through transmission cost changes to BGS customers is harmful to the development of a retail market in New Jersey. The Ratepayer Advocate suggests that the anti-competitive effects are removed if all suppliers—BGS-FP, BGS-CIEP, and TPS—face the same risks associated with transmission rate charges. This can best be accomplished by eliminating any pass-through of such charges by any BGS suppliers.