

FAILED EXPERIMENT:

**Deregulated Electric Market, Its Problems, and Why We Need the
Commonwealth Energy Procurement and Development Agency
(HB 1909)**

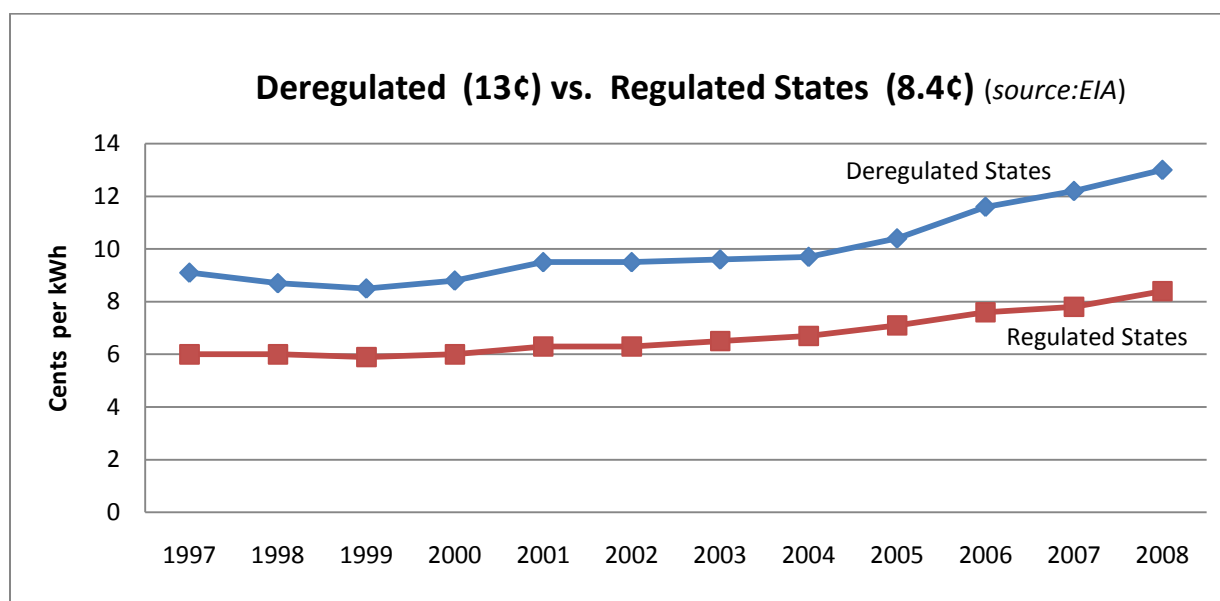


**A REPORT BY CHAIRMAN CAMILLE "BUD" GEORGE
HOUSE ENVIRONMENTAL RESOURCES AND ENERGY COMMITTEE**

DEREGULATION IN PENNSYLVANIA

In 1996 Pennsylvania enacted the Electricity Generation Customer Choice and Competition Act, which deregulated electricity generation. The premise was that customers should be able to choose their generation supplier and that competition among generators would lower prices. Generation costs comprise 60% to 80% of consumers' utility bills. The Act allowed the utilities to recover stranded costs and required that the rates be capped during this recovery period.

In 2005, the rate caps for the Pike County Light & Power Company expired. The result of the auction to provide supply to retail customers showed a shocking increase of 129% in generation rates and 79% in overall rates. The rate caps for most of the utilities (PPL, PECO, Allegheny, Met Ed, Penelec) expire in 2010 and 2011. Although the current severe down-turn in the economy may dampen the rise in post-rate cap prices, Pennsylvania must brace itself for significant rate hikes once the economy recovers. Efforts to extend the rate caps have failed.

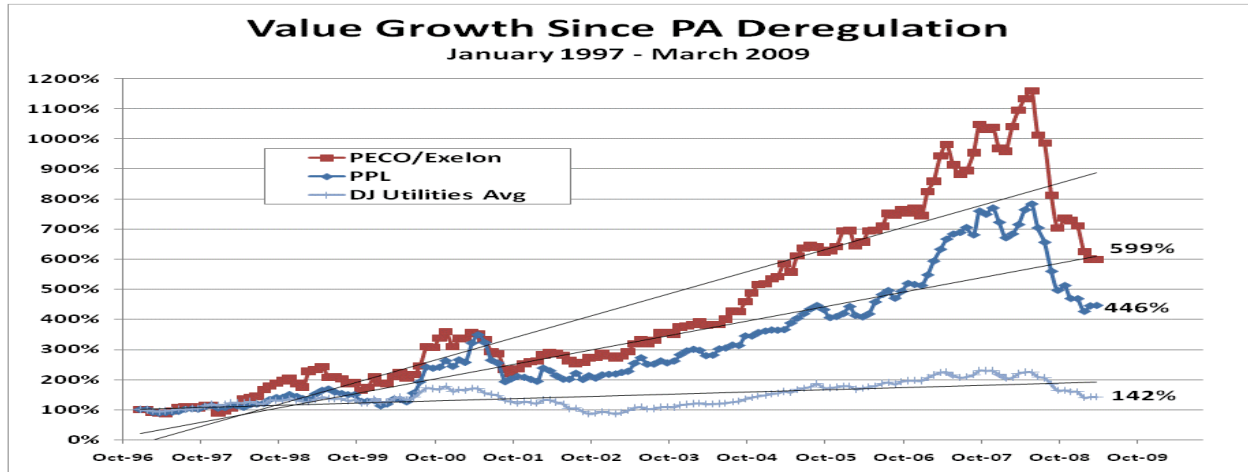


The last decade has shown that deregulation of the generation market has failed. Despite the promise of lower prices, the average rates for deregulated states are 54% higher than the rates for regulated states. A 1¢ per kWh increase in rates means \$5 million to \$10 million in annual operating costs for a Pennsylvania steel manufacturer; the impact on larger manufacturers may be even greater. A 1¢ increase also represents \$1.5 billion in costs to Pennsylvania consumers.

[Note: The wholesale market for power trades and auctions in Pennsylvania is operated by a not-for-profit entity called the PJM Interconnection, a Regional Transmission Organization that serves 12 states and the District of Columbia. PJM is regulated by the Federal Energy Regulatory Commission. Rates for transmission and distribution remain regulated.]

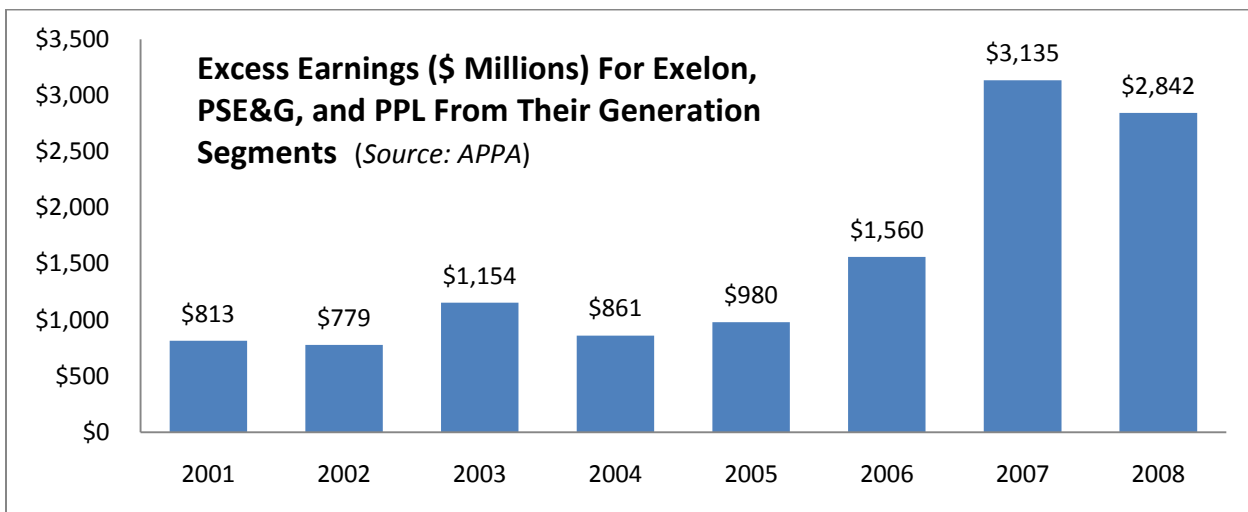
A WINDFALL FOR A FEW POWER COMPANIES

Not surprisingly, profits of the utilities with generation affiliates soared. PPL's stock value (taking into account stock splits and dividends) rose nearly 800% from 1998 to 2008; for PECO, nearly 1150%. In comparison, Dow Jones Avg. for Utilities increased about 225% for the period.



(Source: IECPA)

According to a study by the American Public Power Association, from 2001 to 2008, the return on equity by the generation segments of Exelon, PSE&G and PPL in the PJM territory (the wholesale market covering Pennsylvania) exceeded the return on equity by the regulated generation companies by a total of 12.1 billion dollars. Of those \$12 billion, about \$6 billion were generated between 2007 to 2008 by those three companies' generators. The \$12.1 billion in excess earnings translate to about \$20 billion in cost (accounting for tax) to consumers and represent millions of dollars in compensation to the company executives.



THE FLAWED MARKET

Deregulation has been bad for consumers, and no regulated states are following the path of deregulation. The wholesale market governing Pennsylvania is dominated by a few large utilities and Wall Street traders. Poorly regulated by the federal government, the market uses pricing schemes that shock the conscience. For example, in a pricing scheme called "single market clearing price," the price is set by the *highest* price bid by the most expensive--typically natural gas--generation that is necessary to meet the demand. This means that the least efficient generating unit sets the price, and all other generating units get paid the price that the least efficient unit bid, rather than their actual bids. Although 93% of power in Pennsylvania comes from cheap coal and nuclear generation, natural gas sets the clearing price for all generation 25% of the time, resulting in a windfall for nuclear and coal-fired generating facilities.

"For example, assume that the system load is 10,000 MW, and 9,999 MW of low cost nuclear or coal-fired generation is offered at 2.5 cents per kWh. If 1 MW of gas-fired generation is needed to meet the full load of 10,000 at a bid price of 10 cents per kWh, then all bids would be paid the 10 cents even though 99.9% of the generation offered was bid at 2.5 cents." --PUC Vice Chair Tyrone Christy

This may be fair for a new power plant with high recovery costs, but it is highway robbery when it comes to the formerly regulated large utilities that now own plants that have already been paid for by ratepayers and bought by the utility affiliate for pennies on the dollar; under deregulation, Three Mile Island Unit 1, now worth about \$1.5 billion, was bought by a utility affiliate for a net price of \$25 million.

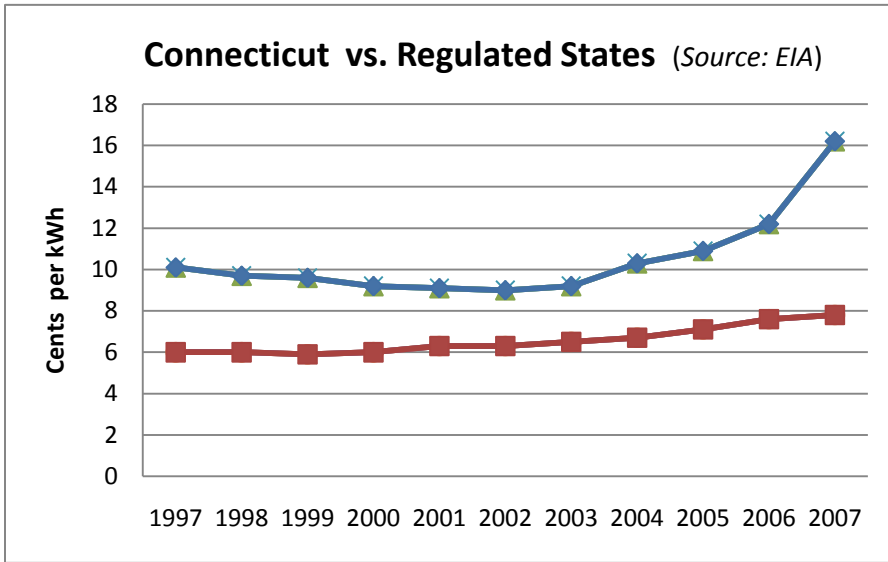
And what about the enormous capacity payments, called Reliability Pricing Model (RPM), imposed by PJM that are supposed to incentivize new base-load generation to ease congestion and to lower market prices, but failed to do so. PJM admits this failure to spur new baseload generation, but it claims that the failure is due to insufficient incentives, not the flawed scheme of RPM.

Generators owned by or affiliated with the six largest Pennsylvania utilities were paid over 3.5 billion dollars in capacity payments for years 2008 – 2010 as *incentives* to build new generation, but only 277 MW of low-cost baseload generation (nuclear, hydro, coal) are being built.

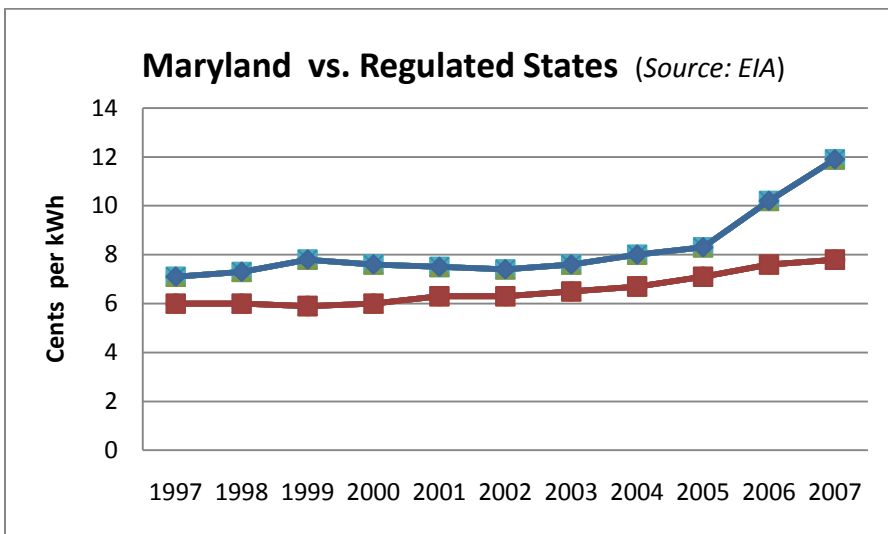
The capacity prices have risen from \$5.73 to \$111.93 per MW under the RPM scheme, which also correlates to the sharp increase in excess earnings by the power companies. These overpayments are outrageous, given that Pennsylvania produces more power than it needs, yet imports electricity from other states because its generators export 33% of the total output to other states.

WHAT AWAITS PENNSYLVANIA AFTER THE RATE CAPS: A Look at Our Neighbors

Other states with deregulated generation experienced great price shocks after the rate caps expired. Due to the severe recession, the rates in Pennsylvania may not immediately increase as drastically as feared upon expiration of the rate caps, but they will increase drastically--40% to 100% or more--once the economy recovers.



In 2006 generation rates in Connecticut increased by 25% to 72%. The Attorney General stated: "The conclusion is inescapable that electric deregulation has failed...." The governor called for a new Department of Energy that will take over policy making authority from the Department of Public Utility Control.



After the rate cap expiration in 2006, BG&E proposed a 72% rate increase for its customers in Maryland. Later that year, the governor lost re-election, and the board of public service commission overseeing the utilities was entirely replaced. Maryland is currently reviewing options for re-regulation.

In Delaware, rates increased 59% for residents after the rate caps expired. Occidental Chemical closed a major chlor-alkali facility in Delaware in November 2005, citing high electricity costs as the primary factor. Delaware is reviewing options to address the problem. New Jersey and New York have rates that are about 63% and 80%, respectively, higher than the average rates in the regulated states.

PENNSYLVANIA BUSINESSES AND JOBS ARE AT RISK

In the near future, Pennsylvania will face rate hikes that will shock the economy across all sectors, from our elderly citizens with fixed incomes and low-income residents to large manufacturers who provide desperately needed jobs.

Once the economy recovers, Pennsylvania must brace for post-cap rate hikes of 30% to 100% for residential customers, 40% to 120% for commercial customers, and 50% to 140% for industrial customers. Even with the recession and the historically low fuel costs, PPL's auctions for the year 2010 have shown an ominous 30% increase in rates.

In particular, electricity costs represent a significant portion of operating costs for many Pennsylvania manufacturers, as much as 70% in some cases. Pennsylvania Public Utility Commission Vice Chairman Christy testified that Signature Aluminum closed its plant in western Pennsylvania due in part to rising electricity costs and that AK Steel in Butler is reconsidering its expansion plan.

Alcoa closed its Maryland plant with 600 employees paying an average annual wage of \$55,000, solely due to electric rate increases. It is now deeply concerned about the impact of the increased rates in Pennsylvania for its Lancaster plant.

BOTTOM LINE: The current market structure endangers Pennsylvania businesses and jobs.

In July 2009, Pennsylvania lost about 500 factory jobs that came with the Carlisle Tire & Wheel to Tennessee, or more specifically, to the attractive electric rates offered by the Tennessee Valley Authority. Tennessee's offer trumped a \$6.9 million package in tax credits, loans and grants from Governor Rendell. Governor Rendell's spokesman said, "We don't have that same ability to offer [the attractive power costs that] Tennessee does".

Allegheny Power, along with 17 other generation companies in the deregulated state of Maryland, told the Alcoa plant in Maryland that it has to pay 350% more than the global average for electricity.

"We have facilities in 19 states around the country, and Pennsylvania has the highest power rates...." *Douglas Kittenbrink, Executive Vice President, Allegheny Technologies, in a press conference to announce its cancellation of its planned capital investments in Pennsylvania*

"Competition has not lowered U.S. industrial electricity prices" *Jay Apt, Carnegie Mellon Electricity Industry Center.*

A SOLUTION: HB 1909

THE COMMONWEALTH ENERGY PROCUREMENT AND DEVELOPMENT AGENCY

Because the wholesale market is under the federal jurisdiction, states' options are limited, but an independent public power agency can greatly mitigate some of the market flaws.

SINGLE MISSION:

To procure low-cost power for those Pennsylvania citizens who choose not to shop for power and for businesses that choose the Agency as the supplier.

TASKS:

1. Procure Electricity: The Agency would buy default supply for residents and businesses using a portfolio procurement approach; such an approach has allowed the Illinois Power Agency and the rural cooperatives in Pennsylvania to buy power cheaper than what the utilities offer.

2. Assist Private Development: The Agency could lower rates by helping to develop new plants through entering into long-term purchase agreements with private plant developers. Today the utilities refuse to enter into long-term contracts that are necessary for these developers to finance their construction because their generation affiliates make exorbitant profits from the short-term wholesale market and do not want competition in generation; in other words, abuse of market power.

3. Build or Acquire Generation: The agency could acquire or construct baseload generation, taking advantage of Pennsylvania's rich indigenous resources, and sell power to customers on a cost basis. The Agency could offer cheaper rates to manufacturers and businesses to attract and retain jobs in Pennsylvania. The construction would be financed by revenue bonds that would be backed solely by the Agency's revenue streams and assets. They

would not be backed by tax pledges or the full faith and credit of the Commonwealth.

OPERATION:

The Agency would be run by a five-member board, consisting of representatives from AARP, industrial energy users, farmers, the office of consumer advocate, and the office of small business advocate. The board would hire staff and consultants with expertise in energy procurement and development to accomplish its mission. The Agency would be financed by rebates from large generators formerly owned by the utilities based on the overpayments they continue to receive at the market.

IN COMPARISON:

1. Illinois Power Agency. After post-cap rate hikes stirred public outrage, Illinois sued the power companies for rebates and, as part of the settlement, established a non-profit public power procurement agency with the power to build new generation. Thus far, it has exercised only its power to procure supply from the wholesale market using a portfolio procurement approach. With only one staff and a team of consultants, IPA recently held an auction at which it procured power supply for all residential customers at rates that were 7.5% lower than the prior rates.

2. Connecticut Electric Authority. Following similar post-cap rate hikes and public outrage, the Connecticut House of Representatives overwhelmingly passed a measure establishing a state power authority with broad powers.

MYTHS AND FACTS

"...consumers in states with markets administered by RTOs [deregulated markets] continue to pay higher electric rates than consumers living in non-RTO [regulated] states. Fossil fuel costs, in particular natural gas costs, do not explain the differential between electricity prices in RTO and non-RTO states." 2008 report by McCullough Research

A presentation for PPL investors bluntly showed that its capacity profits could be increased by decreasing its capacity reserve margin. In short, generators have every incentive to create a congested market and to increase prices in order to reap higher capacity payments.

MYTH: Higher prices are due to the rise in fuel costs.

FACT: Fuel costs are not responsible for high prices.

The rise in fuel costs does not explain the higher costs, as there are several instances where natural gas costs and wholesale electricity prices have shown trends in opposite directions. Rather, these high prices are explained by the interplay between high fuel costs and the single market clearing price methodology, as discussed earlier. If the fuel price increases were the sole reason for higher prices, then the parent corporations of the generators could not make so much profit.

MYTH: The market would lower prices.

FACT: The evidence proves that the generation market with its flaws inflates, not reduces, price; moreover, ratepayers still pay for the risks.

Post-deregulation electric rates have been consistently much higher--54%--than the rates in regulated states. This demonstrates the point that while private companies are better at making *profits*, that does not necessarily translate into cost-savings for consumers. The benefits from any efficiency gains that generators may have made under deregulation have not flowed back to consumers, but rather to shareholders. Furthermore, ratepayers still bear the risks under deregulation because the generators build risk premiums into their rates.

MYTH: The Agency lacks the technical expertise.

FACT: The Agency would acquire the necessary expertise through its consultants.

Consultants would provide the Agency with prudent advice on the procurement decisions based on statistical analysis and the risk parameters establish by the Agency. The rural cooperatives in Pennsylvania, Duquesne, Citizens' and Wellsboro, UGI, as well as the Illinois Power Agency, successfully use the available outside resources and advice to maximize the benefit for their consumers.

MYTHS AND FACTS

Currently, no large utilities procure default supply using an actively managed portfolio approach to get the most savings, an approach successfully used by the rural electric cooperatives, utilities like Duquesne, and the Illinois Power Agency. Such an approach allows these entities to exploit favorable market conditions by buying blocks of power at different times, using a mix of short-term contracts, long-term contracts, and spot market purchases. Under that approach, power supply for one month or season would rarely be purchased all at once.

"The [market] resembles that of an oligopoly, where there are only a few firms supplying all or most of the output, than a truly competitive marketplace."
-Rose and Meeusen Report

MYTH: The Agency would eliminate customer choice.

FACT: The Agency supports customer choice.

The Agency's procured supply would not be imposed on unwilling customers. The Agency would procure power only for default service customers who do not shop for power and are given POLR (providers of last resort) supply by their utility companies and for those businesses willing to take supply on negotiated terms and conditions from the Agency. Large utilities in turn have abdicated their duties to provide low-cost power to POLR customers and, rather than actively-managing the costs for ratepayers through a portfolio management approach, they have contracted this obligation to third-party contractors who add another layer of profit to the cost of generation. Customers will still have the opportunity to shop with competitive suppliers.

MYTH: The Agency would negatively impact competition.

FACT: The Agency would promote competition within the wholesale market that currently lacks true competition.

About 87% of low-cost baseload generation (nuclear, coal, hydro) is owned by five companies, which own about 75% of all generation. Four of those companies (PPL, Exelon, FirstEnergy and Allegheny) own electric distribution companies in Pennsylvania. In short, these utility companies often buy power from themselves through their affiliates, undercutting any meaningful competition. These companies also own substantial transmission assets and are influential members of PJM that governs the wholesale market, deciding where and when to site new generation. By fostering new private generation development, the Agency would cure the abuse of market power by the incumbent utilities that refuse to enter into long term contracts with these developers. If supply is still inadequate to relieve congestion and produce competitive rates, then the Agency could build or acquire generation through its revenue bonds. New generation would mean true competition, lower prices and less congestion.

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