

STATE OF MARYLAND
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of the Commission's)
Investigation of Investor-Owned)
Electric Companies' Standard Offer)
Service for Residential and Small)
Commercial Customers in Maryland)

Case No. 9117

REPLY TESTIMONY OF
JONATHAN WALLACH
ON BEHALF OF
THE OFFICE OF PEOPLE'S COUNSEL

Resource Insight, Inc.

SEPTEMBER 28, 2007

TABLE OF CONTENTS

I.	Introduction.....	1
II.	Impact of Portfolio Planning and Procurement	3
	A. Portfolio Efficiency	4
	B. Price Divergence.....	7
	C. Stranded Costs	13
III.	Alternative Procurement Proposals	17

TABLE OF EXHIBITS

Exhibit JFW-R1	<i>Percentage of PEPCo Residential Customers Served by Competitive Electric Suppliers</i>
Exhibit JFW-R2	<i>PEPCo Residential Generation Rate: Actual vs. Hypothetical Quarterly Procurement</i>

1 **I. Introduction**

2 **Q: Please state your name, occupation, and business address.**

3 A: I am Jonathan F. Wallach. I am Vice President of Resource Insight, Inc., 5
4 Water Street, Arlington, Massachusetts.

5 **Q: Are you the same Jonathan F. Wallach that filed direct testimony in this**
6 **proceeding?**

7 A: Yes.

8 **Q: On whose behalf are you testifying?**

9 A: I am testifying on behalf of the Office of People's Counsel.

10 **Q: What is the purpose of your reply testimony?**

11 A: On September 14, 2007, a number of parties to this proceeding submitted
12 direct testimony asserting that implementation of a portfolio management
13 program for residential Standard Offer Service ("SOS") load would harm
14 consumers and competitive markets. This reply testimony addresses these
15 claims.

16 In addition, in response to the Commission's questions on program
17 design in Order No. 81563, a number of parties proposed alternatives to the
18 current procurement scheme for residential SOS load. This reply testimony
19 responds to those proposals.

20 The Office of People's Counsel is also sponsoring reply testimony by
21 Roger Colton and by Harold Muncy.

22 **Q: How should the Commission judge the merits of parties' proposals?**

23 A: Such proposals should be judged according to two standards that arise from
24 the fact that residential SOS is, by statute, a permanent, regulated service.

1 First, since residential SOS is a regulated service, procurement proposals
2 should be evaluated on the extent to which the outcomes serve not the
3 proponents' narrow commercial interests, but the broader public interest.
4 Where private and public interests conflict, the interests of ratepayers should
5 prevail.

6 Second, since residential SOS is a permanent service, proposals should
7 be judged on the extent to which they ensure that consumers affirmatively
8 benefit from taking Standard Offer Service. Proposals that seek to promote
9 the transition to "competitive" retail markets – that diminish the concrete
10 benefits from taking residential SOS in order to achieve theoretical benefits
11 from competitive service – should be rejected as contrary to statutory
12 requirements for a permanent service that serves the public interest.

13 **Q: Should the Commission judge a proposal on the basis of whether it**
14 **promotes customer migration to competitive retail supply?**

15 A: Not if such incentives come at the cost of diminished benefits from SOS.
16 Maryland consumers have had the opportunity to choose for over seven
17 years, and that choice has been consistently and overwhelmingly to remain
18 on regulated SOS.¹ That decision to stick with SOS apparently has not
19 wavered, even when such alleged barriers as rate caps, cost subsidies, or
20 supplier fees were eliminated. At this point, it seems clear that consumers
21 have stayed with the regulated option because it best serves their interest, not

¹ Apparently, regulated service has also become the preferred option for state regulators. A September 20, 2007 press release by RKS Research and Consulting reports that "A new nationwide survey confirms a dramatic reversal of support among state utility regulators for deregulated energy markets. In fact, one third of regulators in currently competitive states say they are now seriously considering re-regulating utilities in their jurisdictions, according to this survey." The press release is posted on-line at: <http://www.rksresearch.com/changecourse.html>.

1 because there have been barriers to choosing the competitive alternative. The
2 Commission should reject any proposal that would force consumers to
3 choose otherwise.

4 **II. Impact of Portfolio Planning and Procurement**

5 **Q: Please summarize parties' direct testimony in this proceeding with**
6 **regard to integrated portfolio planning and procurement for the**
7 **purposes of serving residential SOS load.**

8 A: The testimony of a number of parties to this proceeding is that portfolio
9 planning and procurement is harmful to consumers and the competitive retail
10 supply market. Specifically, parties claim that portfolio procurement would:
11 (1) inefficiently substitute for the current procurement approach or for the
12 competitive retail market; (2) yield prices that diverge from "market" prices;
13 and (3) create stranded costs.

14 **Q: In general, do these parties accurately characterize the impact of**
15 **integrated portfolio procurement?**

16 A: No. As I discuss specifically below, these claims regarding the harm from
17 portfolio management are for the most part unsubstantiated and inaccurate.

18 Generally, these objections appear to stem from a misunderstanding of
19 the nature of risk and the role and impact of resource diversification in the
20 risk-management process. For example, some parties raise the concern that
21 the cost of a long-term contract could exceed spot-market prices over the life
22 of the contract, i.e., that the contract costs could be stranded. This concern is
23 largely misplaced: a diversified portfolio might include a long-term contract,
24 even one that is *expected* to be more costly than spot prices (e.g., a contract
25 for new renewable generation), as insurance against the harm from an

1 *unexpected* long-term upswing in spot prices.² In other words, the portfolio
2 might be diversified away from sole reliance on spot purchases to reduce
3 overall portfolio risk, i.e., the risk of unexpected outcomes, even though such
4 diversification increases the portfolio's expected costs.³

5 **A. *Portfolio Efficiency***

6 **Q: Why do some parties believe that a portfolio-management program**
7 **would be an inefficient substitute for the current procurement**
8 **approach?**

9 A: A number of parties assert that the current approach and the portfolio-
10 management alternative both employ active portfolio management, with the
11 only difference being that the wholesale supplier of full-requirements service
12 manages the portfolio under the current approach, whereas the utility would
13 manage the portfolio under a portfolio approach. From this perspective, these
14 parties further argue that a portfolio assembled by a utility manager would
15 likely be more costly or riskier to consumers than one procured by a
16 competitive wholesale supplier. According to Michael M. Schnitzer,
17 testifying on behalf of Constellation Energy Commodities Group and
18 Constellation New Energy:

² The insurance value in this instance depends on the extent to which long-term contract prices are uncorrelated with spot prices. Diversification in this example would also reduce the expected short-term volatility in portfolio costs.

³ As I discussed in my direct testimony, portfolio diversification may also advance reliability, environmental, or other public-policy goals.

1 A full requirements supplier must manage and price certain financial
2 risks: principally energy prices, load growth, weather variation and
3 customer switching. While it is certainly possible for an EDC to take on
4 and manage these risks, it is unlikely that it could do a better job than the
5 broad universe of wholesale suppliers competing with one another.⁴

6 **Q: Is this a valid argument?**

7 A: No, since it overlooks the fact that the current approach leaves consumers
8 exposed to long-term risks that can be effectively and efficiently managed
9 through portfolio diversification.

10 It may in fact be the case that the risk premium paid by consumers
11 under the current approach represents an efficient trade-off for the risks
12 assumed by a wholesale supplier over the two-year term of its fixed-price
13 full-requirements contract.⁵ Even so, that risk premium represents
14 compensation for risk allocation between consumers and suppliers solely
15 during the two-year term of the contract. Consumers bear full price risk when
16 the contract expires, and so suppliers have no incentive to manage their
17 portfolios to mitigate such long-term risks.⁶

⁴ *Direct Testimony of Michael M. Schnitzer*, Case No. 9117, September 14, 2007, pp. 7-8.

⁵ However, testimony in this proceeding by a Frank C. Graves for PEPCo Holdings, Inc. (“PHI”) indicates that this premium may exceed efficient levels.

⁶ Rolling procurement of two-year contracts may dampen the immediate impact of unexpected price swings. However, consumers continue to be exposed to such outcomes in the long term. Testifying on behalf of PHI, Mr. Graves stated: “Even with laddering of contracts, there will be residual market price movements that are intrinsic to contracting over short (few years) horizons. (*Direct Testimony of Frank C. Graves*, Case No. 9117, September 14, 2007, p. 23.)

1 **Q: Why do some parties believe that a portfolio-management program**
2 **would be an inefficient substitute for the competitive retail market?**

3 A: According to Charles S. Griffey, testifying on behalf of the Retail Energy
4 Supply Association (“RESA”), *any* regulated service is necessarily less
5 efficient than the competitive alternative:

6 The primary flaw of a mandated managed portfolio design is the belief
7 that an administratively mandated approach to electricity procurement
8 on behalf of a hypothesized homogenous group of customers can
9 improve upon market outcomes.... In an efficient market, one cannot
10 improve upon market outcomes without advantaged information....
11 Also easily dismissed, because customers have heterogeneous needs, is
12 the result that a litigated, centrally managed proceeding will result in the
13 correct choice for each customer’s optimal level of risk.⁷

14 By Mr. Griffey’s argument, a regulated portfolio approach must be
15 inefficient, because it seeks the optimal risk-return trade-off for the “average”
16 customer, and therefore is unlikely to provide the optimal trade-off for each
17 individual customer taking regulated service. Moreover, according to Mr.
18 Griffey, a regulated approach is unlikely to achieve the optimal trade-off
19 even for the average customer, since “[i]f an entity has no incentive, due to
20 lack of reward opportunities, to obtain the best outcome for its customers it
21 inherently will not strive to do so.”⁸

22 In other words, Mr. Griffey sees no role for a regulated service in
23 providing a “best price” for consumers, since “only competition can lead to
24 such a situation because only the customer can choose the best price for
25 himself.”⁹

⁷ *Direct Testimony of Charles S. Griffey*, Case No. 9117, September 14, 2007, p. 6.

⁸ *Id.*, p. 7.

⁹ *Id.*, p. 14.

1 **Q: Is there any merit to Mr. Griffey's critique of a regulated portfolio**
2 **program?**

3 A: Only in an idealized world of perfect and atomistic competition, where retail
4 markets offer, and consumers freely and rationally choose, the optimal
5 portfolios that maximize individual consumers' welfare. In which case, there
6 would be no need for any type of regulated service.

7 However, in the real world of market barriers, seemingly irrational
8 behavior, transaction costs, and imperfect competition, regulation steps in to
9 serve the public interest where retail markets fall short of the mark. A
10 regulated portfolio service, by design, seeks the optimal risk-return trade-off
11 for the *average* customer, because it must serve *all* customers that apparently
12 have not found their individually optimal portfolios in the retail market. Rate
13 regulation of that portfolio service provides the incentive for portfolio
14 managers to assemble and manage the portfolio that minimizes costs and
15 risks to those customers that choose the regulated alternative.

16 In other words, a regulated portfolio service provides an additional
17 choice for consumers to maximize their welfare. It is ironic that Mr. Griffey
18 would deny consumers that choice in order to promote retail competition.

19 ***B. Price Divergence***

20 **Q: Please summarize parties' comments with regard to the divergence**
21 **between portfolio pricing and market pricing.**

22 A: A number of parties assert that managed-portfolio prices, particularly for
23 those portfolios that include longer-term contracts, are more likely to diverge
24 from "market" prices than prices produced by procurement approaches that
25 rely solely on short-term contracts. These parties further contend that such
26 price divergence constitutes a barrier to entry by competitive retail suppliers.

1 For example, Reliant Energy witness Stacy Dochoda asserts that:

2 As long as the SOS price [is] based on long term contracts, Reliant
3 believes that a robust, sustainable retail market will not evolve. Such a
4 SOS service may create windows of competition but it is not designed to
5 reflect current market prices making it difficult for retailers to remain in
6 the market for any extended period of time.¹⁰

7 **Q: What do these parties mean when they refer to “market prices”?**

8 A: Remarkably, the parties that have raised concerns about price divergence in
9 this proceeding, as well as in Case Nos. 9099 and 9063, have not bothered to
10 explain which “market prices” they are referring to in these instances.

11 As this Commission heard in Case No. 9099, there are a number of
12 markets for electricity products, each of which has unique prices and price
13 terms, including:¹¹

- 14 • Day-ahead and real-time hourly spot markets.
- 15 • Over-the-counter daily, weekly, or monthly forward markets for on-
16 peak, off-peak, or round-the-clock physical or financial products.
- 17 • NYMEX monthly forward markets for on- and off-peak physical or
18 financial products.
- 19 • Bilateral markets for monthly to multi-year fixed-block, load-following,
20 unit-contingent, or slice-of-system contracts.

21 However, as best as I can discern from their testimony, these parties are
22 not referring to any of these markets, or, in fact, to any particular organized
23 market. Instead, these parties appear to define “market prices” in circular

¹⁰ *Direct Testimony of Stacey Dochoda*, Case No. 9117, September 14, 2007, p. 15. By “long term contracts,” Ms. Dochoda is referring to the two-year contracts procured under the current approach.

¹¹ These are markets for energy products. Prices for full-requirements service would also reflect market prices for capacity, ancillary services, and renewable-energy credits.

1 fashion as the current price offers by competitive retail suppliers for any
2 product offered by those suppliers.

3 **Q: According to these parties, what drives the divergence between longer-**
4 **term contract prices and prevailing retail price offers?**

5 A: Although not stated explicitly, these parties appear to believe that the extent
6 of price divergence depends on how often SOS contracts are re-priced
7 through the procurement process. According to this logic, competitive retail
8 prices change frequently, reflecting changes in underlying wholesale market
9 prices for the product being offered (e.g., a one-year contract for full-
10 requirements service.)¹² In contrast, the price of a longer-term SOS contract
11 is set once at the time of procurement, reflecting underlying wholesale
12 market prices at that point in time, and fixed for the duration of the
13 contract.¹³ Thus, price divergence is driven by the fact that underlying
14 wholesale market prices can and will vary considerably over time.

15 Following this line of reasoning, the shorter the term of the SOS
16 contract, the lower the risk of price divergence. Since, for example, monthly
17 SOS contracts have to be procured on a monthly basis, SOS would be re-
18 priced each month, more closely tracking changes in the wholesale market
19 prices underlying retail price offers.

¹² As I showed in Exhibit JFW-3 of my direct testimony in this proceeding, clearing prices for a 12-month strip of PJM forward contracts can vary 2%-3% *per day*. As I showed in Exhibit JFW-2, clearing prices for the 12-month strip covering calendar-year 2008 increased about 18% over a 6-month period, and then declined by that same amount over the following three months.

¹³ Although fixed for the term of the contract, prices for a multi-year SOS contract can vary by year and by season within each year.

1 **Q: Have these parties offered any evidence to support this alleged**
2 **divergence between longer-term contract prices and prevailing price**
3 **offers?**

4 A: No.

5 **Q: Would you expect a strong correlation between prices for shorter-term**
6 **contracts, such as monthly or quarterly contracts, and prevailing price**
7 **offers?**

8 A: No. A monthly or quarterly contract is a different market product, with
9 different market pricing dynamics, than those being offered by retail
10 suppliers. There is no reason to expect that pricing of a shorter-term SOS
11 contract would track that for a significantly longer-term retail offer for full-
12 requirements service, since the underlying wholesale market prices for these
13 two different products are unlikely to be strongly correlated.

14 **Q: What does the experience with residential retail choice in Maryland**
15 **indicate with regard to the impact of this alleged divergence on**
16 **competitive entry?**

17 A: Experience over the last seven years does not support the contention that the
18 alleged price divergence has been a barrier to competitive entry and the
19 development of retail markets. In fact, trends in residential-customer
20 migration appear to support the opposite conclusion.

21 Exhibit JFW-R1 shows monthly switching statistics for Potomac
22 Electric Power Company (“PEPCo”) residential customers from the start of
23 retail choice in 2000 through August of this year. If, as Ms. Dochoda
24 contends, the alleged price divergence hinders competitive entry, then one
25 would expect to see increased migration to competitive supply whenever
26 there was a significant re-pricing of residential SOS, since such re-pricing

1 should decrease price divergence. Thus, one would expect increased
2 migration after July of 2004, when PEPCo SOS switched from capped to
3 market-based rates, and after June of the following three years, when SOS
4 rates were re-priced to reflect procurement of new contracts in those years.

5 Instead, as indicated in Exhibit JFW-R1, the only period of increased
6 switching was in the first two years of retail choice, when residential SOS
7 was priced at capped rates. After reaching a peak of almost 16% in mid-
8 2003, residential migration has steadily declined through all re-pricing
9 periods.

10 **Q: Would evidence of this alleged price divergence be a valid basis for**
11 **excluding longer-term resources from a managed SOS portfolio?**

12 A: No. Even if there was price divergence between long-term contracts and
13 prevailing price offers, any such difference would be muted in a diversified
14 portfolio that mixes spot, short-, medium-, and long-term products.

15 More importantly, price divergence is not a reasonable basis for
16 violating the statutory mandate to procure a diversified portfolio that
17 minimizes SOS costs and risks. Imposing artificial and arbitrary constraints
18 on portfolio diversification solely for the purpose of forcing portfolio prices
19 to mimic retail offers would be contrary to the public interest.¹⁴

¹⁴ A portfolio that matched retail offers would probably also be contrary to the retail-suppliers' interests, since it would frustrate suppliers' attempts to differentiate their products from SOS on the basis of price. In fact, testimony by retail suppliers in this proceeding gives the impression that their interests are best served by maximizing the volatility and uncertainty of SOS prices relative to retail price offers. For example, proposals to implement quarterly procurement would eliminate the volatility-mitigation benefits of two-year laddering under the current approach. In other words, under the quarterly procurement approach, 100% of SOS would be re-priced each and every quarter.

1 **Q: Would quarterly procurement of SOS contracts expose residential**
2 **consumers to excessive price volatility?**

3 A: Yes. In fact, quarterly procurement would likely have produced more volatile
4 prices than those resulting from the procurement approach used for the last
5 four years.

6 Exhibit JFW-R2 illustrates how much more volatile prices would have
7 been under a quarterly procurement approach compared to actual prices.
8 Exhibit JFW-R2 graphs two data series. First, it shows actual retail
9 generation prices for PEPCo's residential SOS load from the start of market-
10 based pricing on July 1, 2004 to August of this year. Second, Exhibit JFW-
11 R2 shows a simulation of quarterly retail generation prices during this same
12 period under a quarterly procurement scheme, assuming that SOS contracts
13 for delivery in any quarter (e.g., June through August) are procured the
14 month prior to the start of that quarter (e.g., May.) Prices for the quarterly
15 contracts include cost estimates for all components of full-requirements
16 service, including:

- 17 • baseload energy at the PJM Western Hub;
- 18 • balancing energy for following the residential load shape;
- 19 • congestion, net of revenues from Auction Revenue Rights;
- 20 • capacity;
- 21 • ancillary services;
- 22 • Renewable Portfolio Standards requirements;
- 23 • losses;
- 24 • transaction costs and risk; and
- 25 • the Administrative Charge.

26 As indicated in Exhibit JFW-R2, quarterly generation prices for
27 PEPCo's residential SOS customers would have been substantially more

1 volatile than actual prices.¹⁵ Furthermore, the average price over the analysis
2 period under quarterly procurement is about 11% higher than the average
3 actual price.¹⁶

4 **C. *Stranded Costs***

5 **Q: What concerns do parties raise concerning stranded costs?**

6 A: Some parties express the concern that the costs of a longer-term contract or
7 generation investment may eventually be stranded, i.e., that the cost of the
8 contract may exceed the contract's market value. According to Mr. Frank
9 Lacey, testifying on behalf of Direct Energy Services: "The most significant
10 risk is that under a managed portfolio procurement approach, customers
11 could likely face a significant stranded cost risk."¹⁷

12 In essence, the concern is that utilities may enter into a longer-term
13 contract or investment commitment based on expectations about future
14 market-price trends, only to find that market prices fall below expected
15 levels. According to Mr. Robert B. Reeping, testifying on behalf of the
16 Potomac Edison Company:

¹⁵ More specifically, prices under the quarterly procurement would have been more volatile from quarter to quarter. On the other hand, the volatility of average annual prices from year to year would have been comparable between the two procurement scenarios. In other words, either short-term procurement approach would needlessly expose consumers to excessive annual price risk.

¹⁶ I was unable to calculate the total cost differential between these two procurement scenarios, because I did not have time to collect monthly data for PEPCo residential sales.

¹⁷ *Direct Testimony of Frank Lacey*, Case No. 9117, September 14, 2007, p. 27.

1 ... [W]hile some longer term contracts may be attractive and necessary
2 to smooth price changes, we also want to be cognizant as to not lock
3 customers into long term deals (greater than 5 years, such as up to 30
4 years) that may become uneconomic. An example of such a
5 phenomenon is PURPA from the late 1970s and 1980s, with contract
6 terms of 30 plus years and payment streams that in most cases have been
7 above the market price for power from the inception of the contract.¹⁸

8 Mr. Schnitzer raises an additional concern that long-term commitments
9 will engender a “death spiral”, where above-market costs lead to customer
10 migration, which in turn further increases prices to remaining SOS
11 customers:

12 Under retail competition, the risks associated with long term
13 commitments are amplified. If an EDC makes long term commitments
14 and then wholesale prices fall, the SOS rates will be above prevailing
15 wholesale market prices, and retail customers will have an incentive to
16 leave the SOS service, leaving the EDC to recover the cost of its
17 commitments from only its remaining customers.¹⁹

18 **Q: Is the potential for stranded costs a significant concern?**

19 A: This concern is not significant enough to exclude longer-term contracts or
20 generation assets from the menu of resource options to be evaluated as part
21 of the portfolio-planning process.

22 Three considerations temper such concerns. First, a longer-term contract
23 or investment will be one of several resources in a much-larger, diversified
24 resource portfolio. This diversification hedges the risk of any one contract or
25 investment becoming stranded, and increases the likelihood that the portfolio
26 as a whole will be economic over the long term.²⁰

¹⁸ *Direct Testimony of Robert B. Reeping*, Case No. 9117, September 14, 2007, p. 7.

¹⁹ Schnitzer Direct, p. 9.

²⁰ The Commission should also consider the fact that the prices for long-term contracts included in a diversified portfolio would be set by competitive forces, not by regulation, as was

1 Second, a narrow focus on the risk of stranded costs fails to capture the
2 insurance value of a longer-term contract or investment. Whether or not a
3 contract is ultimately economic over its term, it can provide a long-term
4 hedge against market-price risk, providing insurance against the harm of
5 unanticipated price volatility.

6 Finally, any concern about another round of stranded costs in Maryland
7 needs to be weighed against the likelihood that, contrary to some parties'
8 expectations in 1998, there may not actually have been a first round of
9 stranded costs in this State. One indication of this possibility is provided by
10 the 1998 testimony of my colleague Paul Chernick on behalf of OPC in Case
11 No. 8794 regarding Baltimore Gas and Electric's ("BGE") stranded costs.²¹
12 Based on an independent forecast of market prices, Mr. Chernick found that
13 the market value of BGE's generation portfolio exceeded the portfolio's
14 expected costs. In other words, based on his market-price forecast, Mr.
15 Chernick found that BGE's portfolio produced stranded benefits, not
16 stranded costs. It now turns out that market prices in PJM in the nine years
17 since Mr. Chernick's analysis have been substantially higher than were
18 forecasted by Mr. Chernick for this same period of time. Thus, the
19 experience in PJM over the past nine years indicates that Mr. Chernick may

the case under PURPA. In other words, portfolio diversification will not lead utilities to "repeat the mistakes of PURPA." (Reeping Direct, p. 7)

²¹ Another indication that BGE's generation assets were never stranded is the fact that Constellation Energy appears to have profited handsomely from the sale of the output of those assets into the wholesale market. See *Affidavit of Edward Bodmer*, attachment to *Comments of the American Public Power Association*, FERC Docket Nos. RM07-19-000 and AD07-7-000, September 14, 2007 (as corrected September 24, 2007). This document is posted on-line at: http://www.appanet.org/files/PDFs/APPA_Cmts_AD07-7_9-14-07%20%5Bas%20filed%5D.pdf.

1 have in fact underestimated the market value of BGE's assets and thus the
2 true magnitude of stranded benefits.²²

3 **Q: Is there much risk of the type of “death spiral” that Mr. Schnitzer**
4 **describes?**

5 A: Mr. Schnitzer correctly observes that retail choice increases the risks
6 associated with the provision of residential SOS supply. However, there are
7 two reasons why reliance on long-term contracts or assets is unlikely to lead
8 to a “death spiral.” First, as noted above, such long-term commitments will
9 be part of a diversified portfolio, thereby reducing the risk of an extended
10 period of above-market portfolio prices. Second, as has been the experience
11 in Maryland over the last seven years, residential migration in response to
12 high SOS prices or large price increases is unlikely to be substantial enough
13 to trigger a death spiral.

14 In other words, as I discussed in my direct testimony in this proceeding,
15 retail choice increases migration risk for a diversified portfolio, but does not
16 pose an insurmountable barrier to implementation of a diversified portfolio
17 program.

18 **Q: Does this mean that continuation of retail choice will have no impact on**
19 **portfolio performance?**

20 A: No. Retail choice introduces risk – migration risk, regulatory risk, and
21 legislative risk – that would likely degrade portfolio performance, and could
22 materially affect the composition of a long-term resource portfolio.
23 Elimination of those risks might improve the performance of a portfolio-
24 management program (and perhaps that of other procurement approaches.)

²² Mr. Chernick's underestimate of actual market prices would be offset by any underestimate of actual prices for fuel burned by BGE's assets.

1 **III. Alternative Procurement Proposals**

2 **Q: Please summarize parties' proposals for procuring wholesale supply to**
3 **serve residential and small-commercial SOS load.**

4 A: Parties have proposed a wide range of procurement schemes for serving
5 residential and small-commercial SOS load, including:

- 6 • Procurement and active management of a fully diversified portfolio of
7 contracts and assets of varying types and terms.²³ (PHI; Maryland
8 Energy Administration [“MEA”])
- 9 • Procurement and active management of a portfolio of contracts with
10 terms of three years or less. (PSC Staff; Washington Gas Energy
11 Services)
- 12 • Continuation of the current procurement approach, or close variants
13 thereof. (BGE; Constellation Energy Commodities Group; Potomac
14 Edison)
- 15 • Procurement of monthly or quarterly full-requirements contracts.
16 (RESA; Direct Energy Services)

17 In addition, Reliant Energy proposes a scheme for setting retail SOS
18 prices based on an index of PJM forward prices. According to Ms. Dochoda,
19 this pricing scheme can be applied to any procurement approach.

20 In summary, other than PHI and MEA, these procurement proposals
21 exclude consideration of longer-term products as a portfolio option. For
22 example, PSC Staff witness John Nelson “Skip” Trimble proposes
23 implementation of an active portfolio management program, but recommends

²³ PHI's proposal is contingent on elimination of retail choice for residential and small-commercial customers. Absent elimination, PHI proposes continuation of the current procurement approach.

1 that portfolio resources be limited to products with terms of three years or
2 less (except under “exceptional” circumstances.)²⁴

3 **Q: Do these parties provide a reasonable basis for eliminating longer-term**
4 **products as a resource option?**

5 A: No. With the few exceptions discussed below, these proposals lack any
6 analytical basis for excluding longer-term products from consideration as a
7 portfolio option. Instead, in most cases, this exclusion appears to be based on
8 speculation regarding the potential harm from including longer-term products
9 in an SOS portfolio.

10 To its credit, BGE acknowledges that its proposal lacks analytical
11 support and that any such proposal should be evaluated in terms of expected
12 costs, cost risk, and the trade-off between expected cost and risk:

13 Given this limited experience, BGE submits that additional analysis may
14 be beneficial before reaching final conclusions about the optimal
15 approach. In this regard, BGE is prepared to hire consultants to
16 undertake quantitative analyses of various risk – reward tradeoffs in
17 fashioning alternative constructs, but with just one month to prepare
18 testimony, it was not feasible to conduct such analyses in this time
19 frame.²⁵

20 **Q: What types of analyses did parties rely on to support limitation of a**
21 **resource portfolio to short-term products.**

22 A: Three parties offered hindsight analyses of one form or another to support
23 procurement of full-requirements contracts with terms of two year (as under
24 the current procurement mechanism) or less: RESA, Direct Energy, and

²⁴ *Direct Testimony of South River Consulting, LLC*, Case No. 9117, September 14, 2007, p. 22.

²⁵ *Testimony of William B. Pino*, Case No. 9117, September 14, 2007, p. 5.

1 PHI.²⁶ In general, these analyses attempt to simulate what SOS prices (or
2 price changes) would have been over the past few years under alternatives to
3 the current procurement mechanism.

4 In support of RESA's proposal for quarterly procurement, Mr. Griffey
5 analyzed NYMEX gas future prices over a variety of terms as a proxy for
6 SOS prices under various procurement schemes. Based on this analysis, Mr.
7 Griffey finds that:

8 A common misconception is that a portfolio should include long-term
9 contracts in order to avoid the price volatility that advocates of a
10 mandated approach argue would result from monthly contracts.
11 However, this is not true. For example, using data for natural gas futures
12 on the NYMEX since 1991 comparing the volatility standard deviation
13 of those gas prices for monthly, quarterly, and a laddered 2-year term
14 shows basically no difference between those approaches. In fact, the
15 standard deviation of all those terms for natural gas futures is about
16 60%.²⁷

17 Mr. Guy Sharfman, testifying on behalf of Direct Energy, compared
18 BGE's SOS rates against an estimate of what rates would have been under a
19 hypothetical monthly or quarterly procurement scheme. Mr. Sharfman found
20 that both costs and price volatility would have been less under the
21 hypothetical schemes than experienced under the 8908/9064 approach. Based
22 on these findings, Mr. Sharfman's co-witness Mr. Lacey concludes that "the
23 'best price' will be achieved by moving to shorter term procurement

²⁶ As noted above, PHI's analysis was intended to support continuation of the current procurement scheme in the event that retail choice is not eliminated. Also, BGE offered an analysis of spot-market prices to illustrate the volatility impact of incorporating spot purchases in a resource portfolio.

²⁷ Griffey Direct, p. 15.

1 increments.”²⁸ Specifically, Mr. Lacey recommends implementation of
2 quarterly procurement.

3 Finally, Mr. Graves, on behalf of PHI, compared SOS prices for all of
4 the customer classes and for all of the PHI utilities against two hypothetical
5 portfolios: (1) a 70/30 mix of baseload forward contracts and utility-owned
6 gas-fired peaking generation; and (2) a portfolio of utility-owned coal-fired
7 baseload, gas-fired intermediate, and gas-fired peaking generation. Mr.
8 Graves finds that these two hypothetical scenarios would have produced
9 prices that exceed actual SOS rates in some years and are lower in some
10 years. While recognizing the diversification benefits of long-term contracts
11 or assets, Mr. Graves also claims that the risks of stranded costs outweigh
12 such benefits. These findings lead Mr. J. Mack Wathen, also testifying on
13 behalf of PHI, to conclude that:

14 ... [I]f the Commission recommends to the General Assembly that retail
15 choice should continue, then the process currently in place is the best
16 process. This is demonstrated in the study prepared for PHI by the
17 Brattle Group which shows that there is no measurable long-run benefit
18 to any other process over the competitive procurement process
19 developed in Maryland. If, however, the Commission recommends that
20 retail choice be eliminated for residential and small commercial
21 customers, then it appears that portfolio management may produce the
22 best price with the least amount of volatility.²⁹

²⁸ Lacey Direct, p. 17.

²⁹ *Direct Testimony of J. Mack Wathen*, Case No. 9117, September 14, 2007, p. 4.

1 **Q: Do any of these analyses provide information relevant to the evaluation**
2 **of portfolio performance over an uncertain planning horizon?**

3 A: No. These analyses use perfect hindsight to estimate costs associated with
4 known events; none of these analyses attempt to forecast costs or risks for an
5 unknown and uncertain future.

6 **Q: Does Mr. Griffey's analysis support RESA's proposal to limit the**
7 **portfolio to solely quarterly full-requirements contracts?**

8 A: No. In fact, it supports the contrary conclusion that, as I found in my direct
9 testimony, sole reliance on short-term contracts –whether monthly, quarterly,
10 or laddered two-year contracts – needlessly exposes consumers to excessive
11 gas-driven price volatility. As Mr. Griffey's analysis forcefully illustrates,
12 price volatility is comparably excessive for all types of short-term products.
13 That is one reason why I recommend in my direct testimony that utilities
14 procure a diversified mix of short-, medium, and long-term products.

15 **Q: Does Mr. Sharfman's analysis provide a reasonable basis for Direct**
16 **Energy's proposal to implement quarterly procurement of SOS**
17 **contracts?**

18 A: No. Mr. Sharfman's analysis is flawed in a number of respects. First, Mr.
19 Sharfman inexplicably derives an independent estimate of BGE's generation
20 rate, rather than use the actual tariffed rate. This results in an over-estimate of
21 both residential SOS price levels and volatility.³⁰ Second, Mr. Sharfman
22 apparently overstates SOS price levels relative to prices for his hypothetical
23 procurement scenarios by including the Administrative Charge and a risk

³⁰ Mr. Sharfman's estimation procedure results in residential SOS rates that vary each month, when actual rates are fixed for each summer and non-summer season.

1 premium in the former, but not in the latter.³¹ Third, the analysis overstates
2 SOS volatility by including data for six months prior to the lifting of price
3 caps in July of 2006. In other words, Mr. Sharfman includes in his estimate
4 of SOS price volatility the 120% increase in generation rates between June
5 and July of 2006, even though this increase was due to the transition from
6 capped Price Freeze Service (“PFS”) rates to market-based SOS rates, and
7 not due to volatility in the pricing of the full-requirements contracts
8 themselves.³²

9 Correcting for these errors dramatically alters the bottom-line results of
10 Mr. Sharfman’s analysis. Mr. Sharfman found that between January of 2006
11 and October of 2007 prices under a quarterly procurement program would
12 have been less volatile than actual SOS prices. Specifically, as reported in
13 Exhibit DES-5, he found an average volatility of 29% for SOS prices and
14 19% for prices under his hypothetical quarterly procurement.

15 However, limiting the analysis to the relevant time frame (after lifting
16 of the rate caps), and correcting for the other errors discussed above, reverses
17 Mr. Sharfman’s finding regarding relative volatility. With these corrections,
18 the average volatility for actual SOS prices declines to less than 6%, while

³¹ The risk premium is embedded in the tariffed rate. Mr. Sharfman did not include any premium for risk in his estimate of the generation rate for the hypothetical quarterly procurement scenario.

³² In fact, Mr. Sharfman inconsistently includes data from January to June of 2006 in his estimate of price volatility, but not in his estimate of costs. Including this data in his cost calculation would have wiped out the cost advantage Mr. Sharfman finds for his hypothetical procurement approaches. Indeed, Mr. Sharfman’s analysis might have shown a significant cost advantage for the actual PFS / SOS case, if it had included data all the way back to July of 2000 when capped rates first went into effect.

1 the average volatility for hypothetical quarterly prices increases slightly to
2 20%.

3 These corrections also significantly reduce the cost difference between
4 these two procurement approaches. As reported in Exhibit DES-4, Mr.
5 Sharfman found that from July of 2006 through September of 2007 the cost
6 of BGE's SOS program would have exceeded that for a hypothetical
7 quarterly procurement program by \$277 million. Correcting for the errors
8 discussed above reduces this cost advantage by about 43% to \$157 million.
9 While this corrected estimate still represents a 10% cost premium for the
10 current approach, that premium may reflect an economically efficient level of
11 compensation to wholesale suppliers to achieve the relatively low volatility
12 in SOS prices, given the risks associated with providing fixed-price full-
13 requirements service in a retail-choice environment.

14 **Q: Please describe Reliant Energy's proposal for indexing retail SOS prices**
15 **to forward prices.**

16 A: According to Ms. Dochoda, Reliant Energy proposes to index SOS prices to
17 PJM forward prices, with prices changing every six months. Under this
18 proposal, index pricing would commence six months after reaching a
19 threshold of 5% migration to competitive retail supply in a utility's service
20 territory. Six months after achieving the threshold, and every six months
21 thereafter, the SOS price would be set at the product of: (1) the SOS price
22 for the prior six-month period; and (2) the ratio of the current PJM forward
23 price to the PJM forward price prevailing six months ago.

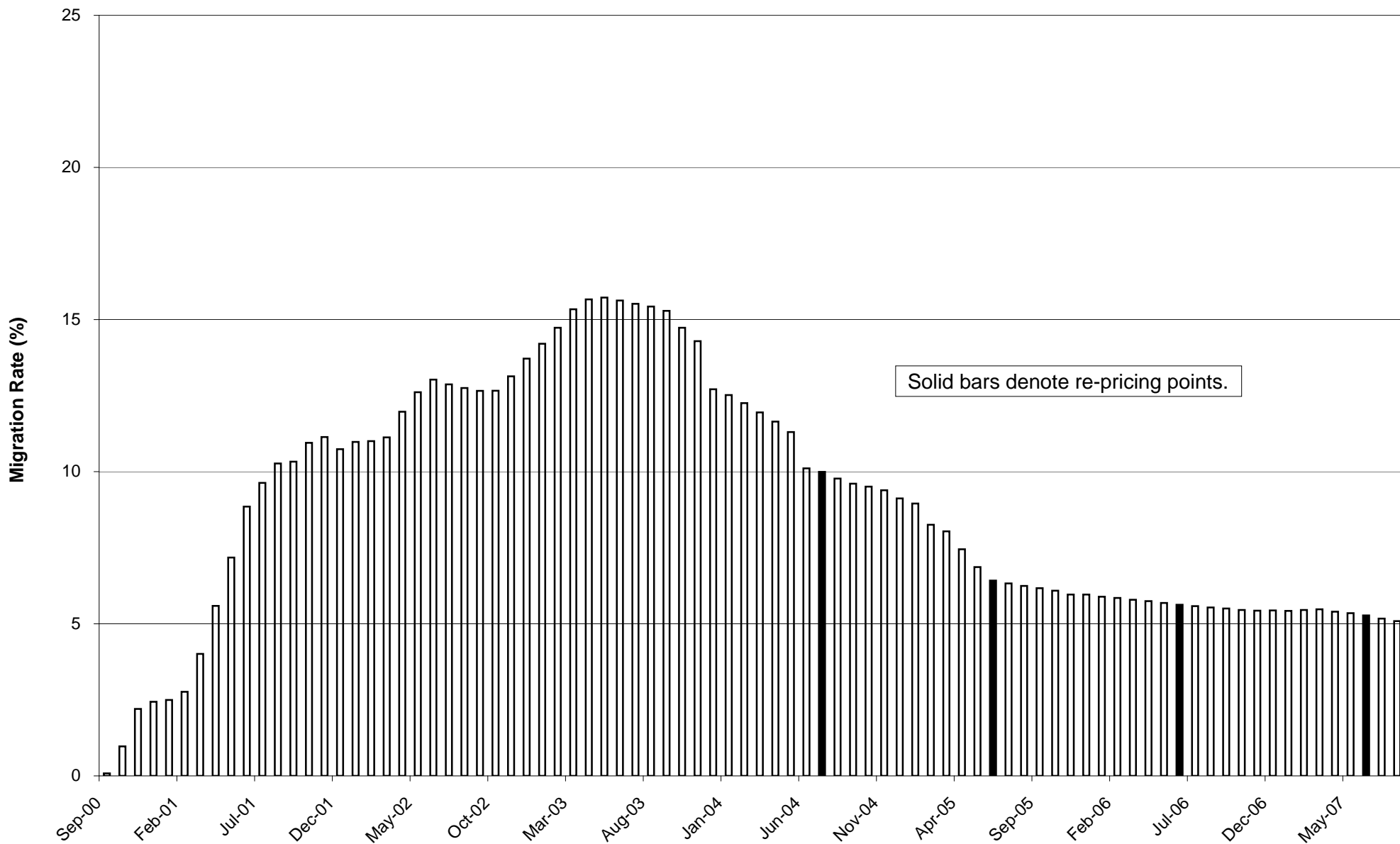
1 **Q: Is Reliant Energy’s proposal for biannual price changes an**
2 **improvement on the current pricing mechanism?**

3 A: That does not appear to be the case. The current procurement mechanism
4 already provides for re-pricing twice a year: on June 1 and October 1 at the
5 start of the summer and non-summer seasons, respectively. It is not clear to
6 me how layering biannual index pricing on top of the current biannual
7 pricing mechanism would create more “market-responsive” SOS pricing.

8 **Q: Does this conclude your testimony?**

9 A: Yes.

Percentage of PEPCo Residential Customers Served by Competitive Electric Suppliers



Solid bars denote re-pricing points.

PEPCo Residential Generation Rate Actual vs. Hypothetical Quarterly Procurement

