

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

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

Resource Insight, Inc.

NOVEMBER 2, 2007

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

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

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

6 A: Yes.

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

8 A: I am testifying on behalf of the Office of People's Counsel ("OPC").

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

10 A: On October 23, 2007, Mr. Walter P. Drabinski of Vantage Consulting filed
11 direct testimony in this proceeding on behalf of the Staff of the Commission.
12 Mr. Drabinski's testimony includes three public attachments and a
13 confidential briefing paper.¹ This supplemental reply testimony responds to
14 Mr. Drabinski's direct testimony, particularly with regard to the findings and
15 conclusions presented in the confidential briefing paper.²

16 **Q: Please describe the three attachments to Mr. Drabinski's testimony.**

17 A: Attachment 1 to Mr. Drabinski's testimony provides a conceptual overview
18 of active portfolio management, describing general policies and procedures
19 for managing short-term price volatility using standard financial instruments.
20 Attachment 2 compiles PJM spot-market price data for the past four years.

¹ Mr. Drabinski filed a heavily redacted version of the confidential briefing paper on October 26, 2007, and then filed a slightly less redacted version on November 1, 2007.

² However, I do not reveal any confidential information in my discussion of the confidential document. Moreover, I do not quote any text from the confidential document that is not also provided in the two redacted versions.

1 Using the data compiled in Attachment 2, Attachment 3 estimates what
2 residential SOS prices would have been over the last four years in Potomac
3 Electric Power Company's service territory with portfolios of varying mixes
4 of monthly forward contracts and spot-market transactions.

5 **Q: Do you have any general concerns regarding Mr. Drabinski's analyses in**
6 **these three attachments?**

7 A: I am concerned that Mr. Drabinski's perspective in these analyses is unduly
8 limited to the short term. This narrow focus on the short term leads Mr.
9 Drabinski to overlook long-term risks to consumers from the types of short-
10 term portfolio approaches that he describes in Attachment 1, and to
11 mischaracterize the current procurement approach as residing "at the far end
12 of the risk spectrum (less risk)."³ In fact, as I discussed in my direct
13 testimony, such short-term approaches, including the current procurement
14 approach, expose consumers to significant long-term risk from market re-
15 pricing of short-term wholesale contracts.

16 This narrow focus on the short-term also leads to a conceptualization of
17 portfolio management as a process that is: (1) focused primarily on managing
18 short-term price volatility; and (2) limited to short-term transactions and
19 trading of standard financial products, such as monthly forward contracts and
20 options.⁴ An active portfolio process focused on short-term risk management
21 not only exposes consumers to long-term risks, as noted above, but also

³ *Direct Testimony and Exhibits of Walter P. Drabinski*, Case No. 9117, October 23, 2007, Attachment 1, p. 5, fn. 4.

⁴ In other words, a focus on the short term leads to a procurement approach akin to that originally adopted and subsequently recognized as inadequate by Southern Maryland Electric Cooperative.

1 needlessly and perhaps inefficiently replicates the risk-management services
2 provided by full-requirements suppliers. As noted in testimony by several
3 other parties to this proceeding, there is no *a priori* reason to expect that
4 consumers would benefit from short-term trading relative to the current
5 procurement approach, since there is no expectation that the portfolio
6 manager could more efficiently manage short-term risk than full-
7 requirements suppliers.

8 I am also concerned by the fact that, due to time constraints, Mr.
9 Drabinski was able to evaluate only simple hedging strategies for his
10 simulation of portfolio management in Attachment 3. This simplified
11 approach produces misleading results, particularly that the so-called “100%
12 Hedge” portfolio produces greater short-term price volatility than purchasing
13 100% of load requirements in the spot market. In fact, a perfectly hedged
14 product – such as a fixed-price, full-requirements contract – would eliminate
15 all such price volatility during the term of the product.

16 Moreover, Mr. Drabinski’s simulation of portfolio management
17 provides no useful information regarding the impact of mixing in spot
18 purchases with full-requirements contracts, as proposed by Staff in this
19 proceeding. It would be reasonable to expect that the addition of spot
20 purchases would increase short-term price volatility compared to a pure full-
21 requirements portfolio. In contrast, Mr. Drabinski’s simulation yields the
22 opposite and counter-intuitive result.

23 **Q: What types of portfolio approaches should the Commission be**
24 **analyzing?**

25 A: As discussed in my direct testimony, consumers could potentially benefit
26 from procurement of products with longer terms than would be available

1 from full-requirements suppliers at a reasonable price.⁵ The Commission
2 should therefore be analyzing the long-term costs and risks of diversified
3 portfolios that mix short-, medium-, and long-term products. This analysis
4 would explicitly incorporate forecast uncertainty in the simulation of
5 portfolio costs and performance, modeling key inputs as probabilistic
6 variables with probability distributions based on historical data.

7 In addition, this type of analysis could be used to evaluate the long-term
8 implications of Staff's short-term proposal to mix spot purchases with two-
9 year full-requirements contracts.

10 **Q: Why should a short-term proposal such as Staff's be evaluated over a**
11 **long-term planning horizon?**

12 A: Because the short-term nature of the SOS products procured under such
13 proposals give rise to continuing risk over a long-term horizon. For example,
14 under the current approach and Staff's proposed modification, consumers are
15 fully exposed to market-price risk every two years, when existing full-
16 requirements contracts expire and new ones are procured at prevailing market
17 prices.

18 **Q: Please describe Mr. Drabinski's briefing paper.**

19 A: In response to testimony filed in this proceeding by Mr. Frank C. Graves on
20 behalf of PEPCo Holdings, Inc., Mr. Drabinski conducted an analysis of
21 *apparent* risk premiums in winning SOS price offers for the last four years'
22 solicitations for residential SOS supply. Similar to Mr. Graves' analysis, Mr.
23 Drabinski estimated the prevailing market price for a full-requirements

⁵ It is this ability to diversify the portfolio with longer-term products that distinguishes long-term portfolio management from, and adds value relative to, the portfolio-management service embedded in full-requirements service.

1 product at the time of each solicitation. Mr. Drabinski then calculated the
2 ratio of winning SOS price offers to estimated market price to derive the
3 apparent premium over market price embedded in each winning offer.

4 Based on the pattern over time of apparent risk premiums – in
5 particular, the increase in apparent risk premiums in the 2006 solicitation –
6 Mr. Drabinski finds that:

7 Our analysis therefore differs from Mr. Graves’ work in our conclusions
8 on the importance of these two risk factors (load shape uncertainty and
9 the risk of switching). This also leads us to the conclusion that
10 transferring load shape risk to customers and forbidding switching will
11 not produce significant savings in the form of reduced risk premiums.⁶

12 Instead, Mr. Drabinski finds that “[v]olatility is likely the primary
13 contributor to our estimate of the premium.”⁷

14 **Q: Is it reasonable to conclude that apparent risk premiums are due to**
15 **price volatility, not normal load uncertainty or migration risk?**

16 A: No, simply because price risk does not exist in isolation from normal load or
17 migration risk. If there were no uncertainty with regard to the magnitude of
18 load in any hour, such as uncertainty due to weather conditions, then an SOS
19 supplier could buy forward just what she needed to serve her load obligation
20 in every hour, and thereby lock in the price for serving that obligation in
21 every hour. Similarly, if there were no risk of customer migration, then there
22 would be no risk to that supplier of having to sell excess supply (i.e., excess
23 created by migration to competitive supply) at a price below what she paid
24 for that supply, or of having to buy additional supply (i.e., due to load

⁶ “Briefing Paper: Risk Premiums in Maryland SOS Prices”, attachment to Drabinski Direct, p. 6.

⁷ *Id.*, p. 1.

1 returning to SOS) at a higher price than the fixed price the supplier is
2 contractually obligated to charge that returning load.

3 In other words, price risk arises primarily not from price uncertainty in
4 isolation, but from the correlation between price and load (either load-shape ,
5 load-growth, or migration-related) uncertainty.⁸

6 **Q: What is the basis for Mr. Drabinski’s assertion that load uncertainty is
7 not a major contributor to the apparent risk premium?**

8 A: Mr. Drabinski notes that suppliers will seek to hedge risks such as volume
9 uncertainty, and therefore that “concerns for load uncertainties, and
10 suppliers’ mark-up of their prices as a result, may well be overstated.”⁹

11 In making this argument, Mr. Drabinski appears to be misinterpreting
12 the results of his analysis of the apparent risk premium. Mr. Drabinski’s
13 analysis does not measure bidders’ *actual* mark-ups to their direct costs,
14 where, as Mr. Drabinski notes, direct costs might include costs to hedge load
15 uncertainty. Instead, the analysis measures *apparent* premiums on an
16 estimate of market costs that assumes no hedging of load uncertainty.¹⁰ This
17 apparent premium would therefore capture any actual costs to suppliers to
18 hedge load uncertainty, and would thus reflect a bidder’s premium over
19 unhedged market cost associated with hedging of load uncertainty.

⁸ There may be a small amount of pure price risk due to the fact that, even in the absence of load- or migration-related uncertainty, suppliers might not lock into supply until the contracts are approved by the Commission two days after bidding. If so, suppliers bear the risk of price movement in that two-day interim.

⁹ “Briefing Paper: Risk Premiums in Maryland SOS Prices”, p. 6.

¹⁰ However, this estimate of market cost includes an estimate of the cost to serve *expected* load variation.

1 **Q: What is the basis for Mr. Drabinski’s claim that migration risk is not a**
2 **major contributor to the apparent risk premium?**

3 A: Mr. Drabinski accurately notes that residential migration has been
4 insignificant in the past, and thus concludes that informed bidders are
5 unlikely to price in significant migration risk in their price offers:

6 We similarly believe that concerns for customer switching are also
7 overstated. There is no history that supports such a concern. Also, the
8 timeframes are relatively short – a year or two. It is not clear that any
9 event could occur in this timeframe that would result in massive
10 switching. Finally, if BGE’s recent hikes have not led to switching, it is
11 difficult to imagine what will.¹¹

12 There is no doubt that residential customers have consistently chosen to
13 remain on regulated supply service during the last four years, even when
14 faced with the substantial price increases of 2006. Given this experience, it is
15 likely that informed bidders no longer perceive a significant migration risk
16 associated with serving residential load. However, bidders’ perception of that
17 risk has probably changed with each year’s solicitation, depending on: (1)
18 their assessments of the likelihood that retail suppliers could price
19 competitively against SOS prices in the upcoming solicitation; and (2) actual
20 customer responses to competitive pricing in prior solicitations.

21 In fact, bidders’ changing perception of migration risk could explain
22 Mr. Drabinski’s finding that apparent risk premiums spiked “... in 2006, a
23 direct result of the Katrina-induced volatility.”¹² This spike in apparent
24 premiums may have been the result of bidders’ perception of a significantly
25 increased risk of customer migration to competitive retail supply. In turn, this
26 perception of increased migration risk may have been driven by two

¹¹ “Briefing Paper: Risk Premiums in Maryland SOS Prices”, p. 6.

¹² *Id.*, p. 3.

1 considerations. First, from the perspective of bidders at that time, the
2 Katrina-related spike in market prices for SOS was unlikely to be sustainable,
3 providing significant headroom for competitive retail suppliers to offer
4 discounted pricing once market prices declined.¹³ Second, the SOS price
5 increase was expected to be an order of magnitude larger than experienced in
6 the prior two years' solicitations. With no experience regarding migration
7 response to price increases of this magnitude, it is unlikely that bidders
8 would have simply assumed that migration rates would continue to be as low
9 as experienced in prior years.¹⁴

10 **Q: Does this conclude your supplemental reply testimony?**

11 A: Yes.

¹³ This perception proved accurate, as forward prices dropped substantially after the 2006 solicitations.

¹⁴ By this reasoning, bidders should have reduced their assessments of migration risk in subsequent solicitations, once it became apparent that residential migration rates did not materially increase after the 2006 price increases. Mr. Drabinski's finding of a drop in apparent risk premiums after 2006 appears to confirm the reasonableness of this argument.