

**STATE OF NEW JERSEY
BEFORE THE BOARD OF PUBLIC UTILITIES**

In the Matter of the Provision of)
Basic Generation Service Pursuant to) **Docket No. EX-1050303**
The Electric Discount and Energy)
Competition Act)

**ORAL SUMMARY TESTIMONY OF
PAUL L. CHERNICK
ON BEHALF OF
THE DIVISION OF RATEPAYER ADVOCATE**

Resource Insight, Inc.

October 3, 2001

Good morning, Commissioner Murphy.

Thank you for the opportunity to provide this summary of the Ratepayer Advocate's technical concerns raised by the proposal of the four New Jersey Electric Distribution Companies (EDCs) for acquiring BGS supply for the fourth year of the transition to competition.

The basic theme running through my direct testimony, which was filed on August 29, 2001, is that of the risks it poses for ratepayers. The EDCs have proposed an approach to acquiring BGS supply that exposes the ratepayers to tremendous risks. Let's just look at a few of the risky aspects of the proposal:

- All the state's electric supply eggs would be in one basket. All 20,000 MW of BGS supply would be acquired in one auction on one day. If any event or circumstance increases the price of that auction—an indication that markets will be tighter in 2002–03, a FERC order creating new uncertainties in market rules, an uptick in gas futures, an attack on Mideast oil facilities or an American refinery, a flaw in the auction design, exercise of market power—it will increase the costs of *all* of the state's BGS supply for the entire 2002–03 supply year.
- The scale of this auction is enormous, representing about a third of the capacity in the PJM market and roughly \$5 billion.

- The proposed auction method has never been used to purchase anything. It has been used only for sales of licenses and entitlements. Purchases of a real commodity, such as electricity, are very different from sales of licenses; while buyers of licenses need only have money, the bidders in the BGS auction will need to have access to generation, which is in limited supply in the 2002–03 period. There is no experience with the Simultaneous Multi-Round Clock Auction approach in circumstances similar to the proposed BGS auction.
- The proposed auction would involve two levels of the market in generation services. If all went well, generation owners would compete to provide energy and capacity to marketers, and the marketers would compete to more efficiently bundle generation services, manage their risks, and provide the lowest bids in the auction. Unfortunately, the EDCs have not provided any information on the extent of competition the Board might expect at either market level; among generation owners or among the marketers who will actually be bidding in the auction.
- The generation market is quite tight in 2002, with only about 10% more uncommitted generation—that is, generation not already committed to serving other customers—available in PJM than would be acquired in the auction. The EDCs estimate that they need excess interest of 26% to 60% to have a successful auction, and past successful Simultaneous Multi-Round Auctions generally had bidding ratios of 150% or more.

- The tight market in uncommitted generation appears to be dominated by a few generation owners, particularly PSEG Power and Reliant Resources, who may be able to control bid prices by controlling the prices they charge the marketers, including their affiliates. Reliant's market power will be increased by its pending acquisition of Orion.
- Given the shortage of generation capacity, multiple marketers will have their bids backed up by commitments from the same generation. The auction rules do not prohibit this behavior, and the EDCs expect it. As a result, the Board and its agent will not know how much real independent interest has been expressed when the first bids come in, and may find that the auction collapses soon after the Board loses the power to restrict the scope of the auction.
- While the Board's agent would know which marketers are bidding, how many slices of supply they bid on, and how those bids change during the auction, the generation market underlying the auction will be composed of bilateral contracts, and will be entirely hidden.
- To the extent that the auction fails to attract sufficient bidding interest, the EDCs propose that the Board commit itself in advance to acquiring all the remaining BGS supply from the PJM spot markets. Utilities would be prohibited from acquiring any power through bilateral contracts. Electric energy spot market prices are volatile, and most purchasers avoid buying from them except for balancing. The requirement that the California utilities purchase their BGS supply on the spot markets contributed to the crisis in the California energy markets. While the EDCs' stated intent is to punish marketers for failing to bid, and force them into the auction, the effect may be to punish ratepayers.

- The EDCs recognize that excess reliance on the spot markets is undesirable, and suggest that the Board determine the maximum level of acceptable spot purchases. All the remaining purchases would be from the auction, no matter how weak the interest or how high the prices.
- At a recent informal conference meeting with the Ratepayer Advocate, the EDCs' consultant suggested that the EDCs could hedge their spot-market purchases with financial contracts, such as options, while refusing to sign contracts with generators for physical delivery of electricity. Since the same marketers who refused to bid in the auction may be selling the options that the EDCs would be buying, this suggestion seems incompatible with the EDCs' proposal that the Board prohibit bilateral contracts outside the auction. The Board should not limit its options for mitigating risk of BGS supply requirements through bilateral contracts of any type.
- Finally, the EDCs have failed to provide any mechanism for establishing a benchmark market price, to determine whether the auction prices are reasonable. I fail to see why anyone would start an auction for \$5 billion of power without any idea of what it should cost if the market is working properly.

I would be happy to answer any questions you might have.