

**STATE OF MARYLAND**  
**BEFORE THE PUBLIC SERVICE COMMISSION**

**In the Matter of the Optimal Structure of the )**  
**Electric Industry of Maryland )**

**Case No. 9063**

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

Resource Insight, Inc.

**NOVEMBER 16, 2006**

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 submitted direct and rebuttal**  
6 **testimony in this proceeding?**

7 A: Yes.

8 **Q: What is the purpose of your surrebuttal testimony?**

9 A: The purpose of this surrebuttal testimony is to respond to the rebuttal testimony  
10 of: (1) Phillip VanderHeyden, on behalf of Commission Staff; and (2) Dr.  
11 Jonathan Lesser, on behalf of Baltimore Gas and Electric (“BGE”).

12 People’s Counsel is also sponsoring surrebuttal testimony from Ms.  
13 Barbara Alexander.

14 **II. VanderHeyden Rebuttal**

15 **Q: What is Staff’s proposal with regard to the procurement of resources to**  
16 **serve residential SOS load?**

17 A: Staff proposes a modification to the current procurement process, whereby  
18 utilities procure one-year contracts through a quarterly bidding process. Mr.  
19 VanderHeyden supports this approach over other parties’ proposals primarily on  
20 the basis of his claim that SOS prices under Staff’s approach will more closely  
21 track market prices (as set by competitive retail price offers) than SOS prices  
22 under other parties’ proposals.

1 **Q: What is the basis for Mr. VanderHeyden's assertion that Staff's proposal**  
2 **minimizes the divergence between SOS prices and retail price offers?**

3 A: Mr. VanderHeyden presents a comparison of hypothetical market prices and  
4 SOS prices under two procurement approaches: (1) Staff's proposal for  
5 quarterly bidding of one-year contracts; and (2) BGE's and Pepco Holdings,  
6 Inc.'s ("PEPCo") proposal for annual bidding of three-year contracts. Mr.  
7 VanderHeyden concludes from this analysis that SOS prices under Staff's  
8 proposal will more closely track retail price offers than SOS prices under the  
9 approach proposed by BGE and PEPCo.

10 **Q: Is Mr. VanderHeyden's analysis a reasonable basis for adopting Staff's**  
11 **proposed approach?**

12 A: No. This analysis stacks the deck in favor of Staff's proposal by assuming that  
13 competitive retail offers will be for one-year products, and that such retail offers  
14 will be re-priced on a quarterly basis. In other words, this analysis assumes that  
15 the terms and pricing of retail offers will be nearly identical to those of the SOS  
16 contracts procured under Staff's approach. It is no wonder then that Mr.  
17 VanderHeyden finds that SOS prices under Staff's proposal closely tracks retail  
18 price offers.

19 **Q: Would you expect a strong correlation between retail price offers and SOS**  
20 **prices under Staff's proposal?**

21 A: Not necessarily. Retailers may be offering a different market product than the  
22 annual contract procured under Staff's proposal. If so, then market-pricing  
23 dynamics for these two products may be very different. There is no reason to  
24 expect that pricing of an annual SOS contract would track that for, say, a two-  
25 year retail offer for full-requirements service, since the underlying wholesale  
26 market prices for these two different products are unlikely to be strongly

1 correlated. In addition, retail pricing may be updated significantly more  
2 frequently than on the quarterly basis adopted in Staff's approach, further  
3 widening the divergence between SOS prices under Staff's approach and retail  
4 prices.

5 Exhibit JFW-S1 illustrates the potential for divergence between retail price  
6 offers and SOS prices under Staff's approach. Exhibit JFW-S1 graphs two data  
7 series. First, it shows actual price offers by Washington Gas Energy Services  
8 ("WGES") for residential customers in PEPCo's service territory between  
9 March 26 and September 6 of this year.<sup>1</sup> Second, Exhibit JFW-S1 shows a  
10 simulation of SOS prices during this same period under Staff's proposed  
11 procurement scheme (i.e., quarterly procurement of annual contracts), assuming  
12 that annual SOS contracts are priced at PJM on-peak monthly forward prices  
13 prevailing at the time of procurement.<sup>2</sup>

14 As indicated in Exhibit JFW-S1, SOS prices under Staff's approach would  
15 not have tracked very closely with changes in WGES' retail price offers over  
16 the sample period. In fact, simulated SOS prices rose steadily over this period,  
17 while retail prices dropped precipitously and then increased before leveling out.

---

<sup>1</sup> These price offers are provided in Attachment 1 to WGES response to OPC Data Request 2, Item No. 2. (This data response was attached to my rebuttal testimony.) Between March 26 and September 6 of this year, WGES offered only one product to PEPCo residential customers; this product had a contract term that ended in June of 2008. Exhibit JFW-R2 shows price offers for non-time-of-use residential customers.

<sup>2</sup> As I noted in my direct and rebuttal testimony, contract prices for full-requirements service will reflect costs other than for on-peak forwards. However, changes in on-peak forward prices are primary drivers of movements in such contract prices. Thus, annual forward prices provide a reasonable indication of movements in annual SOS contract prices and of the correlation between annual SOS prices and retail price offers.

1 **III. Lesser Rebuttal**

2 **Q: Please provide your overall impression of Dr. Lesser's rebuttal testimony.**

3 A: Dr. Lesser's rebuttal testimony leaves the impression that he either misread or  
4 misunderstood much of my direct testimony regarding the current SOS  
5 procurement process and alternatives to the current process. Dr. Lesser faults me  
6 for making statements that never appear in my testimony; he likewise disputes  
7 findings or recommendations that I never made.

8 More troubling are Dr. Lesser's repeated mischaracterizations of my  
9 testimony, as well as that of Ms. Barbara Alexander, through selective quotation  
10 or by simply ignoring those portions of our testimony that inconveniently  
11 contradict his unfounded allegations.

12 Ultimately, Dr. Lesser's rebuttal testimony comes across not as a reasoned  
13 argument in support of his client's portfolio proposal, but as a diatribe against  
14 the hobgoblins of past regulatory practice. A simplistic theology of "markets  
15 good; regulation bad" may provide a soothing nostrum for perceived problems  
16 of the past. However, it offers little of practical value to the Commission as it  
17 moves forward with the task of complying with the Legislature's mandate for  
18 reasonable and reasonably stable SOS prices.

19 **Q: Why do you believe that Dr. Lesser misread or misunderstood your direct**  
20 **testimony?**

21 A: It seems logical to conclude that Dr. Lesser misread or misunderstood much of  
22 my testimony, since his rebuttal testimony repeatedly attributes statements or  
23 positions to me that never appear in my direct testimony. Specifically:

- 24 • Dr. Lesser says of my direct testimony: "... despite his calling for LDCs to  
25 engage in 'active portfolio management,' which he never defines in his

1 testimony....”<sup>3</sup> Nowhere in my direct testimony do I call for LDCs to  
2 pursue “active portfolio management.” In fact, nowhere in my testimony  
3 do I use the phrase “active portfolio management,” which would explain  
4 why I never define that term.

5 • Dr. Lesser refers to “the approach Mr. Wallach recommends for selecting  
6 resource portfolios.”<sup>4</sup> My direct testimony does not include any  
7 recommendation regarding an approach for assembling resource portfolios.

8 • Dr. Lesser states that: “Mr. Wallach ... fails to define what he means by  
9 ‘least-cost’ ....”<sup>5</sup> Nowhere in my testimony do I use the phrase “least-cost,”  
10 which would explain why I never define that term.

11 • Dr. Lesser states that: “But to assert, as Mr. Wallach does, that the price of  
12 long-term contracts will always be below expected market prices....”<sup>6</sup> My  
13 direct testimony does not claim that such contracts will always be priced  
14 below market. Instead, I state that such contracts might be priced below  
15 market (a possibility acknowledged by Dr. Lesser), and discuss how this  
16 outcome depends on the allocation of risks between buyers and sellers.

17 • Dr. Lesser refers to the “vague and simplistic scenario planning suggested  
18 by Mr. Wallach.”<sup>7</sup> My direct testimony does not contain any discussion  
19 regarding scenario planning, whether “vague and simplistic” or otherwise.

20 Dr. Lesser most clearly misses the mark when he faults me for using a  
21 simulation of PEPCo’s generation rates to “prove that the mixed-duration

---

<sup>3</sup> *Rebuttal Testimony of Jonathan A. Lesser*, Case No. 9063, November 3, 2006, p. 15.

<sup>4</sup> *Id.*, p. 17.

<sup>5</sup> *Id.*, p. 18.

<sup>6</sup> *Id.*, p. 24. Emphasis in original.

<sup>7</sup> *Id.*, p. 33.

1 portfolio leads to lower retail prices.”<sup>8</sup> The purpose of that simulation was not to  
2 “prove” anything of that sort, but simply to illustrate the correlation between gas  
3 prices and prices for the mixed-duration contracts that make up PEPCo’s  
4 residential SOS portfolio.<sup>9</sup> To do so, I compared PEPCo’s actual average annual  
5 retail generation prices against a simulation of such prices assuming that all  
6 contracts procured by PEPCo over the last three years were priced at Henry Hub  
7 forward prices prevailing at the time of contract award. In other words, I  
8 simulated pricing for the varying-term contracts actually procured by PEPCo,  
9 not for some other portfolio that “leads to lower retail rates” than PEPCo’s.

10 **Q: Please discuss Dr. Lesser’s mischaracterization of your direct testimony.**

11 A: In a number of places in his rebuttal testimony, Dr. Lesser selectively quotes or  
12 misrepresents a report to the Ohio Consumers’ Counsel (“OCC Report”) that I  
13 attached to my direct testimony, in order to manufacture inconsistencies  
14 between that report and my direct testimony. For example, Dr. Lesser discusses  
15 how the OCC Report describes several noteworthy aspects of Maryland’s  
16 current procurement process, and then goes on to state that: “... given what Mr.  
17 Wallach said in his own report from June 2006, it is not clear why his testimony  
18 recommends just the opposite in October 2006.”<sup>10</sup>

19 In fact, there is no inconsistency between my direct testimony and the  
20 OCC report regarding the problems with Maryland’s current procurement

---

<sup>8</sup> *Id.*, p. 20.

<sup>9</sup> In fact, earlier in my direct testimony, I offered evidence that PEPCo’s procurement of a portfolio of varying-term contracts offered benefits relative to procurement of just one-year contracts.

<sup>10</sup> Lesser rebuttal, p. 23. Emphasis in original.

1 process and potential alternative procurement strategies. As stated in the OCC  
2 report:

3 A number of retail-choice states have begun to diversify their SSO  
4 procurements slightly, such as acquiring power in multiple solicitations  
5 within a year and purchasing supplies for overlapping periods. This kind of  
6 diversification, however, addresses only the timing of the procurement,  
7 which still depends on one kind of purchased product – all-requirements,  
8 fixed-price contracts with similar terms and lengths – and ultimately on  
9 wholesale markets driven by one fuel price. The cost and risks of SSO  
10 procurement from the short-term market are no longer minor problems and  
11 cannot be ignored. For the wholesale *and* retail power markets to work for  
12 all customers, significant changes in SSO planning and procurement are  
13 needed.<sup>11</sup>

14 At other times, Dr. Lesser simply ignores portions of my direct testimony  
15 that contradict his mischaracterizations. For example, Dr. Lesser claims that I  
16 fail to recognize the trade-off between risk and return.<sup>12</sup> Yet, as I stated quite  
17 explicitly in my direct testimony (p. 11):

18 Direct investment is the clearest example of this relationship between risk  
19 allocation and price. For example, ownership or control of a baseload asset  
20 implies that the output of that asset will be priced at cost, rather than at a  
21 spot- or forward-market price established by a more expensive marginal  
22 resource. However, this benefit comes at the cost of increased risk.  
23 Investors assume risks associated with the finance and construction of a  
24 generating facility, as well as the fuel, maintenance, outage, and other risks  
25 associated with plant operation. Ultimately, investors assume the risk that  
26 the investment will not be economically beneficial over the life of the asset.

27 Finally, and most troubling, Dr. Lesser falsely ascribes positions or intent  
28 to me or Ms. Alexander. The starkest example of this is when Dr. Lesser cites a  
29 reference in Ms. Alexander’s testimony to the phrase “robust scenarios”,  
30 fabricates out of whole cloth what Ms. Alexander’s means by use of that phrase

---

<sup>11</sup> *Integrated Portfolio Management in a Restructured Supply Market*, A Report to the Ohio Office of Consumers’ Counsel, June 30, 2006, p. 9. Emphasis in original.

<sup>12</sup> Lesser rebuttal, p. 16.



1 (i.e., that robustness does not include consideration of uncertainty), and then  
2 concludes on the basis of that fabricated definition that Ms. Alexander and I  
3 “have little understanding of the analytics of uncertainty.”<sup>13</sup>

4 **Q: What is the basis for Dr. Lesser’s vehement opposition to People’s**  
5 **Counsel’s proposals in this proceeding?**

6 A: Dr. Lesser’s opposition appears to originate with a fundamental aversion to  
7 government regulation. As he puts it in his rebuttal testimony: “But as  
8 experience has demonstrated, government intervention in markets is almost  
9 always problematic.”<sup>14</sup>

10 In this particular case, Dr. Lesser apparently views regulatory approval of  
11 any substantive modification to the current procurement process as a threat to  
12 the competitiveness of the wholesale spot market. According to Dr. Lesser:

13 If ... there is a requirement that buyers purchase all or the majority of their  
14 supplies on the basis of bilateral contracts, then the market discipline  
15 provided by a workably competitive wholesale spot market may be  
16 eroded.<sup>15</sup>

17 Expanding on arguments in the direct testimony of BGE witness Mark  
18 Case, Dr. Lesser contends that excessive reliance on bilateral contracts will  
19 substantially reduce the amount of generation traded in the spot market, severely  
20 eroding the value of spot-market prices as a competitive benchmark for contract  
21 pricing and hedge valuation, and as a revenue source for merchant generation.

---

<sup>13</sup> *Id.*, p. 29.

<sup>14</sup> *Id.*, p. 7.

<sup>15</sup> *Id.*, p. 11. Emphasis in original.

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

2 A: No. As I discussed in my rebuttal testimony, this argument is premised on a  
3 misunderstanding of the People's Counsel's proposals in this proceeding. Ms.  
4 Alexander's direct testimony recommends that utilities undertake a planning  
5 process that considers and evaluates the full range of resource options available  
6 in the wholesale markets, including short-term full-requirements contracts, and  
7 then assembles a portfolio that complies with the mandates of SB1. Ms.  
8 Alexander does not recommend that the Commission require that bilateral  
9 contracts, or any other product, constitute the bulk or any other pre-determined  
10 portion of the portfolio.

11 Moreover, regardless of the extent of the reliance on bilateral contracts, it  
12 is not reasonable to presume, as Dr. Lesser does, that Commission-approved  
13 utility procurement of bilateral contracts will have a different impact on  
14 wholesale spot or forward markets than bilateral contracting by other wholesale-  
15 market participants. Portfolio procurement entails utilities acting like other  
16 buyers in competitive markets, procuring the mix of resources that serves their  
17 customers' interests, in this case their interest in paying reasonable and stable  
18 SOS prices. Contrary to Dr. Lesser's dark view of the dead hand of regulation,  
19 Commission approval of utilities' procurement strategies does not transform  
20 what is a normal feature of wholesale market dynamics into a threat to those  
21 very dynamics.

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

23 A: Yes.

Staff SOS Proxy Price vs. WGES Retail Price Offer

