I/M/O Provision of Basic Generation Service ("BGS")

Pursuant to the Electric Discount and Energy Competition Act

N.J.S.A. Docket No. EO03050394

Final Comments of the Division of the Ratepayer Advocate

September 23, 2003

Introduction

On August 8, 2003, the Division of the Ratepayer Advocate (Ratepayer Advocate) filed initial comments in this matter. In those initial comments, the Ratepayer Advocate indicated that it would review the initial comments and proposals of other parties, conduct discovery, and provide the Board of Public Utilities (Board) with a final set of comments. The following comments respond to the initial comments of other parties, address the three proposals put forward by the Board Staff, and provide additional input on two of the issues addressed in the Ratepayer Advocate's initial comments. Finally, these comments respond to an issue of public disclosure under the Open Public Records Act (OPRA) as requested by Commissioner Carol J. Murphy at the public hearing held on September 10, 2003. However, the Ratepayer Advocate continues to urge the Board to adopt the entirety of the recommendations contained in our initial comments.

Initial Comments by Other Parties

Initial comments on the EDCs' BGS-FP auction proposal were filed by various electricity providers and their trade association, the Mid-Atlantic Power Supply Association (MAPSA), the large users who would be supplied through the BGS-CIEP auction, AARP and the Ratepayer Advocate. In responding to the initial comments of the other parties, the Ratepayer Advocate will focus on issues relevant to the BGS-FP auction and the rates applicable to customers supplied using the electricity obtained in the BGS-FP auction.

In their initial comments AARP suggests that the **goal** of the BGS-FP auction should be to provide **stable, affordable electric supply** to the residential and small non-residential customers who depend upon this auction to provide electricity, a necessity of modern life. To meet this goal, AARP recommends that the BGS-FP supply be provided using a **Portfolio of Resources** including long-term supply options. As set forth in our initial comments, the Ratepayer Advocate takes this same position. Here we will respond to those parties who argue against even three-year contracts, and for contracts limited to one year.

The suggestion to focus BGS-FP supply on one-year contracts appears in the comments of the Constellation Companies, Reliant Resources, Inc. and Strategic Energy, as well as those of

MAPSA. In contrast, J. Aron and Company (J. Aron), a current BGS supplier, supports the use of three-year contracts. The Ratepayer Advocate would direct the Board's attention to the reasons J. Aron gives for supporting the three-year term:

- Use of three-year contracts will provide stability of pricing to BGS-FP customers while electricity markets continue to develop and stabilize.

- The ability to recover BGS Suppliers' costs over a three-year period will attract more BGS bidders by reducing the long-term transactional cost of participation.

In the Ratepayer Advocate's view, the two reasons advanced by J. Aron for supporting three-year contracts also support opening up the auction to resources with a term longer than three years, as suggested by AARP and the Ratepayer Advocate. MAPSA, the suppliers who favor one-year contracts, and the New Jersey Large Energy Users Coalition (NJLEUC) are concerned primarily about the development of a market, not about the provision of stable, affordable electric service to those on BGS-FP. The Ratepayer Advocate also continues to urge that the Board modify the auction approach to one based on baseload, cycling, and peaking products, rather than tranches each of which represents a "slice-of-the-system."

Turning to a new matter, in its initial comments, the Ratepayer Advocate addressed the question whether contracts for BGS supply are wholesale or retail. This issue was also addressed in the initial comments of Morgan Stanley Capital Group (MSCG). MSCG advanced the following reasons supporting the recognition of the contracts as wholesale, not retail:

- (1) suppliers are not assigned certain retail customers, but instead simply fulfill a percentage of the EDC's load; (2) the suppliers do not have any contact with the retail customers; (3) rates are based on the EDC's tariff (there is no direct passthrough of the BGS Suppliers' cost to retail customers nor do retail customers pay the Suppliers directly); (4) the retail customers are not aware that an entity other than the EDC is serving its load; and (5) the retail customers cannot enforce the Agreements.

MSCG also pointed out that, in a letter opinion issued by the New Jersey Department of the Treasury, Division of Taxation (Division) earlier this year, the Division held that for tax purposes with respect to last year's BGS auction, the Division considers the EDC to be the retail vendor of the electric power to the BGS customer and the supplier to be making wholesale sales of electric power to the EDC.[1] The Ratepayer Advocate agrees with MSCG's reasoning and joins with MSCG in urging the Board to determine that the contracts are wholesale, not retail in nature.

[1] A copy of the letter is contained in the response to RAR-MSCG-1 and NJEDC-MSCG-2.

The Ratepayer Advocate also agrees with NJLEUC's proposals concerning certain aspects of the Board's December 18, 2002 Order on BGS.[2] NJLEUC recommends that the Board "direct Staff to immediately convene the Metering Working Group to (1) assess each EDC's advanced metering and information system capabilities, and (2) determine the nature and extent of the technology improvements necessary for each EDC to implement real time metering and open protocol data exchange. The Board should also establish an expedited timetable for the implementation of these enhanced capabilities …." (NJLEUC initial comments, pages 11-12) Accomplishing these objectives will help the Board decide if, how and when to expand the CIEP class in the future and should assist large commercial and industrial customers who wish to join the CIEP class to do so. NJLEUC also regrets that the CIEP Education Task Force has yet to meet. The Board directed the creation of the CIEP Education Task Force "to develop recommendations for the Board on educating CIEP customers on hourly pricing, the mechanics thereof and their possible alternatives." (December 18, 2002 Order, pages 17-18) The Ratepayer Advocate recommends that this Task Force should be convened as soon as possible to help the large commercial and industrial customers to understand better how they may benefit from electric supply competition.

Finally, the Ratepayer Advocate notes that, in its initial comments, AARP opposed PSE&G's proposal to eliminate the block rate for residential usage less than 600 kWh per month. The Ratepayer Advocate joins in this opposition, for the reasons provided on page 7 of AARP's initial comments: this change would both reduce the incentive for energy conservation and harm seniors and low-income customers with low usage.

The Staff Proposals

In the course of discussions of the arrangements for the BGS auction, Board Staff put forward three proposals (Staff Proposals):

1. Purchase roughly 5 percent of the required one-year tranches through the PJM spot market.

2. Use NUG generation to serve one-year tranches of BGS-FP load for Conectiv, JCP&L, and PSE&G.

3. Fund new or expanded load management efforts through the auction process.

The complete text of the Staff Proposals, as received by the Ratepayer Advocate, is attached to these comments. In response to the Staff Proposals, the Ratepayer Advocate has three comments:

- Taken as a whole, the Staff Proposals introduce a Portfolio Approach for the supply of BGS-FP. Unfortunately, Staff does not include the longer-term resources that are essential for a balanced portfolio.

[2] *I/M/O The Provision Of Basic Generation Service Pursuant To The Electric Discount And Energy Competition Act, N.J.S.A. 48:3-49 et seq.*, BPU Docket Nos. EX01110754 and EO02070384, Decision and Order, December 18, 2002.

- Staff proposes to include spot market purchases and NUG generation, in an effort to lower costs for BGS-FP. However, Staff has provided little data to show that inclusion of these resources will lower costs.

- Staff notes that demand-side programs are "under utilized and could deliver substantially greater savings." However, Staff's proposal to expand the use of demand-side resources is very limited.

In the remainder of this section, the Ratepayer Advocate will expand on each of these comments.

As AARP and the Ratepayer Advocate both noted in their initial comments, it is appropriate to rely on a portfolio of resources to provide BGS-FP. Thus, the Ratepayer Advocate was gratified when Board Staff proposed to go beyond the auction and provide BGS-FP using a portfolio of resources. However, the Ratepayer Advocate is concerned that there is no opportunity to test whether the use of longer-term resources - such as contracts for longer than three years - could reduce the cost of BGS-FP supply. Long-term contracts are routinely used in the electric utility industry to obtain energy supplies. For example, as reported in the *Electric Utility Week* issue of September 8, 2003 (copy attached), Hydro Quebec Distribution just entered into 20-year term contracts worth US $8 billion. Long-term contracts for a portion of a plant's output provide generation owners with a means to "lock in" a minimum level of revenue. With this revenue in place, they can then "play the market," searching for opportunities to sell the remaining output at higher prices. Such long-term contracts may provide an opportunity to lower BGS supply costs. Thus, the Ratepayer Advocate suggests that there be an opportunity to consider including longer-term contracts in the portfolio for BGS-FP supply. Whether any longer-term contracts are, in fact, included would depend on the terms (and particularly the **price**) at which such longer-term contracts are available.

When considering the Ratepayer Advocate's proposal concerning long-term contracts, it is important to note the proposal is only to provide an **opportunity to consider** longer-term contracts as components of a BGS supply portfolio. Unlike the situation that gave rise to NUGs, there would be **no obligation** to enter into long-term contracts. Nor would there be any obligation, when contracting, to set the contract price at "avoided cost" as was done with NUGs. Rather, long-term contracts would only be accepted if they offered an opportunity to advance the goal of providing safe, stable, affordable electric supply to the many customers who depend on BGS-FP. The opportunity to consider longer-term contracts (i.e., 3+ years) is supported by both the Natural Resources Defense Council (NRDC) and AARP. (See pages 62 and 97 of the transcript of the September 10, 2003 public hearing.)

The Ratepayer Advocate supports the effort by Board Staff to reduce costs to ratepayers through the use of spot market and NUG resources to supply BGS. However, the savings anticipated by Staff rest on the historic experience that auction prices have, on average, been above spot market prices. As many parties pointed out at the public hearing, there is no certainty that this will continue. Absent such evidence, the Ratepayer Advocate cannot determine with certainty whether Staff Proposals 1 and 2 will save or cost ratepayers money in the future. For this reason, the Ratepayer Advocate would modify these proposals as follows. The Board should

consider obtaining some BGS load from the spot market only if it also decides to allow bidders to make bids for contracts of durations longer than three years, as the Ratepayer Advocate recommends. Doing both would help balance the supply risks by more largely diversifying the lengths of the contracts considered. If the Board should decide to obtain some BGS load from the spot market, then a smaller percentage than 5 percent should be included. This would allow the Board to examine the usefulness of that effort, while decreasing the possible negative effects on BGS rates, if the spot market prices spike when the purchases are made.

The Ratepayer Advocate applauds the Board Staff proposal that, beginning in June 2004, certain load management programs would be funded through BGS rates instead of the Societal Benefits Clause (SBC). The Ratepayer Advocate agrees that the number of customers in the appliance cycling programs should be increased as Staff recommends, and that Rockland Electric Company should develop such a program. However, the Ratepayer Advocate believes that the program participation for Conectiv, PSE&G and JCP&L should be increased by 33 percent by June 2004, instead of only 10 percent. The Ratepayer Advocate also suggests that 33 percent annual growth should be required for each of the next three years.[3]

The Ratepayer Advocate agrees that there is a direct connection between the load management cycling programs and the cost of BGS supplies. Expanded cost-efficient load management programs can **reduce the cost** of BGS supplies by reducing the peak period demands that need to be met for customers in both the FP auction and the CIEP auction for large commercial and industrial customers. Therefore, the Ratepayer Advocate also supports Staff's proposal that both FP customers and CIEP customers pay for the load management programs through BGS rates. Finally, the Ratepayer Advocate supports the Staff proposal that, in the future, the Clean Energy Council and the utilities work to integrate existing load management programs into BGS and to create new programs, and that the parties consider whether such programs could deliver greater benefits if transferred to suppliers or other market participants.

As the utilities noted in their comments at the public hearing, moving the funding of certain load management programs from the SBC to the BGS creates a "free rider" issue. The Ratepayer Advocate acknowledges that issue. Looking ahead, the Ratepayer Advocate recommends the Board investigate the means to address the impact of that issue. However, as the NRDC, AARP and the Ratepayer Advocate all pointed out at the public hearing, such programs are a natural, cost-effective component that the portfolio for BGS should contain. Given the cost of the appliance cycling programs at issue, currently $7.9 million annually, this move will have minimal effect on the charges associated with the roughly $5.2 billion BGS procurement. Even if the programs expand, as the Ratepayer Advocate recommends, and Rockland Electric Company also institutes such a program, the rate effect on the $5.2 billion BGS costs would not justify leaving these programs out of BGS. Including these programs under BGS will allow the programs to be sized more appropriately. Thus, on balance, despite the free riders, the proposed change is beneficial. If the Board believes the issue of which customers pay for the appliance cycling programs is of sufficient concern, that issue could also be taken up with the Clean Energy Council when it discusses load management and BGS with the parties, as Staff recommends.

[3] Attached is a schedule of the current participation figures in the appliance cycling programs.

Improving the BGS-FP Auction Rules

In its initial comments, the Ratepayer Advocate identified two concerns with the rules proposed for the BGS-FP auction:

- In the course of the auction, product prices do not always "tick down" (i.e., decrease), even when all current bidders for a product might willingly accept lower prices.

- All winning suppliers are paid the "market clearing price," even when some of them had indicated a willingness to accept lower prices.

To alleviate these concerns, the Ratepayer Advocate proposed two changes in the BGS-FP auction rules proposed by the EDCs. First, during the course of the auction, prices should "tick down on ties." Second, winning bidders should be paid the lowest price they willingly indicated they would accept for each tranche won. This section of the Ratepayer Advocate's final comments further explains and supports these important changes to the proposed BGS-FP auction rules.

In the BGS-FP auction, suppliers bid for the opportunity to supply tranches, i.e., fractions of BGS-FP supply requirements each EDC is seeking to meet, through one- or three-year contracts. In the auction, one- or three-year contracts with each EDC are separate "products." Under the proposed rules, the price for tranches of a product will only "tick down" (i.e., decline) if the number of tranches bid for that product exceeds the number of tranches desired. Thus, for example, if 10 tranches of JCP&L-1 (one-year contract supply for JCP&L) are desired, and 11 are bid, the price will tick down. However, if only 10 are bid, the price will remain unchanged.

The Ratepayer Advocate's first concern focuses on such "ties." When a tie occurs, bidders may be willing to accept a lower price. However, because prices do not "tick down on ties" under the rules proposed by the EDCs, this possibility may never be tested.

The problem here is similar in some ways to that described by J. Aron in its public hearing comments: the EDCs' proposed auction rules simply miss an opportunity to obtain supply at a lower price. (See J. Aron comments on page 147, lines 1 to 15, of the hearing transcript.) The Ratepayer Advocate suggests that the rules be changed so that, when ties occur, prices do tick down until the tie is broken (i.e., there are less willing bidders at the current price than there are tranches desired). Thus, in the example involving JCP&L-1, the prices would tick down until there were 9 or less tranches bid. At that point, bidders would be retained to fill the desired number of tranches and the price decline would cease until additional bidders increased the number of bids at the current price to 10 or more. At that point, the price would tick down again.

In response to the Ratepayer Advocate's proposal that prices "tick down on ties," there might be concern that this could cause bidders to raise the minimum price at which they would freely agree to supply tranches. In response to this concern, the Ratepayer Advocate would direct

attention to the basis for supplier offers, as described in Strategic Energy's response to discovery request RAR-Strategic-1. That response in its entirety reads as follows:

> Generation market suppliers build their offers around a forecast of their long-run costs and achievable profits. These costs and profit factors include: fuel, taxes, insurance, depreciation, and return of and on equity. Long-term forecasts of many of these factors prompt the generation supplier to anticipate and cover the uncertainty of future market conditions. These uncertainties are provided for through a risk premium. Additionally, many generation providers will anticipate a gradual rise in market prices over time and in an effort to avoid losing out on these opportunities, will add a premium.

As this response makes clear, offers are based on a supplier's **anticipated costs,** achievable profits and the price offered in the auction. Whether the auction "ticks down on ties" has no effect on the suppliers' costs, and so should not affect the suppliers' bids.

To fully appreciate the Ratepayer Advocate's point, consider the situation of a supplier who bids to supply one of the 10 desired tranches of JCP&L-1 at 4.90¢. Suppose that, based on that supplier's own assessment, there is still a profit to be made at a bid of 4.85¢. That supplier would not forego the opportunity for that profit simply because the decrease in price from 4.90¢ to 4.85¢ might reflect a "tick down on ties". Suppliers will pursue profitable opportunities to bid, even when the rules require prices to tick down on ties.

The Ratepayer Advocate's second concern deals with the way in which the prices paid to winning bidders are set. The concern is easily illustrated. Assume that when the auction ends, there are bids for all 10 desired tranches of JCP&L-1. Assume that 9 of the bids were for 4.85¢ and that one was a retained bid at 4.90¢. Under the current rules, **all** of the winning bidders would be paid 4.90¢. As the discovery response cited above shows, each of the 9 bids of 4.85¢ likely includes an "anticipated profit". Thus, paying the "market clearing price," 4.90¢, to all winning bidders, overcompensates 9 of the 10 winners. To avoid this situation, the Ratepayer Advocate recommends that winning bidders be paid the lowest price they freely indicated they would accept for each tranche they won.

The representatives of the auction manager, National Energy Research Associates, Inc. (NERA), made several comments on the pay-as-bid proposal that should addressed here. Dr. Chantale LaCasse believed that pay-as-bid would "require that information be withheld from bidders which will lead to bidder risk and which can undo the benefits of the auction format" and is "less likely to result in prices that will directly reflect differences in cost in serving the various territories." (Transcript page 10) These comments are incorrect for the following reasons.

Pay-as-bid does not withhold information from bidders and would not be a secret from them. The bidders should be notified before the auction begins that winning bidders will be paid the price they freely bid, not a clearing price, so that this information will not be withheld. Bidders would still receive all the other information they have received in previous auctions and no additional information would be withheld from them. Pay-as-bid actually would result in prices that will more directly reflect differences in the cost of serving the various territories than

a clearing price approach. The reason for this is that winning bidders will receive the price they freely bid and that bid price will certainly reflect the bidder's direct costs. A clearing price pays winning bidders **more** than they freely bid, so a clearing price is more likely to distort the BGS prices in the various territories.

Also, Dr. LaCasse stated that, "Auction theory does not support the contention that a pay-as-bid auction will result in lower prices for New Jersey customers." (Transcript page 10) Dr. LaCasse's comments here are also incorrect. The Ratepayer Advocate has already pointed out in our initial comments filed August 8, 2003 that there certainly is literature showing that a pay-as-bid or "discriminatory" auction results in lower prices for a buyer than the clearing price approach. Rather than repeat those comments here, the Ratepayer Advocate refers the Board and the parties to pages 10-11 of our initial comments for the discussion and the citation to the literature to this effect.

In considering the Ratepayer Advocate's proposals, it is important to distinguish the BGS-FP auction from other markets, such as the PJM energy markets, in which all bidders are paid the market clearing price. The differences between PJM and BGS-FP are numerous and include the following:

- In PJM, bids are for energy, not for "full requirements service."
- PJM is an ongoing market. BGS is an annual auction.

The Ratepayer Advocate notes that, in the past, opportunities for improvements in the auction rules and procedures have been noted and made. For example, in response to comments by J. Aron and others, there was an agreement to fine tune the BGS-FP auction process so that prices ratchet down differently than in the past. (See pages 147 to 148 of the public hearing transcript.) What is proposed by the Ratepayer Advocate here is a similar "fine tuning" of the BGS-FP auction procedures.

The two changes to the BGS-FP auction rules proposed by the Ratepayer Advocate are independent: either could be made with or without the other. While the Ratepayer Advocate believes that both changes should be made, implementation of the second change, i.e., pay-as-bid, is urged particularly strongly. Implementation of the second change would involve no change in the rules governing the operation of the auction itself. Prices would tick down and winners would be selected exactly as proposed by the EDCs. The literature cited in the Ratepayer Advocate's initial comments suggests that, in general, use of a pay-as-bid approach can reduce the cost of procurement through an auction. Roughly 90 billion kWh are being procured through the BGS auction. A reduction of even .01¢ per kWh in the average cost of the electricity procured through the auction translates into a saving of $9 million per year. Implementation of the Ratepayer Advocate's second suggestion could save New Jersey ratepayers millions of dollars per year in electricity costs without changing the proposed auction arrangements or forcing any supplier to accept prices below those it freely agreed to accept.

Confidential Information

In our initial comments (page 8), the Ratepayer Advocate recommended that the Board require all winning bidders to reveal on a confidential basis the cost of their power supplies. This data requirement would extend back to the costs of the power supplies that the bidders will rely upon and should be provided on a confidential basis available only to the Board, Board Staff, a Board consultant, the Ratepayer Advocate and the Ratepayer Advocate's consultant(s). As stated more fully in our initial comments, the Board would use that data to determine the reasonableness of the auction.

At the September 10, 2003 public hearing, Commissioner Murphy asked the Ratepayer Advocate to indicate in our reply comments the section of the Open Public Records Act[4] that would permit the Board and the Ratepayer Advocate to keep this data confidential. (Transcript pages 55-56)

N.J.S.A. 47:1A-1.1 states that:

> A government record shall not include the following information which is deemed to be confidential for the purposes of P.L. 1963, c. 73 (C.47:1A-1 et seq.) as amended and supplemented:…
>
> trade secrets and proprietary commercial or financial information obtained from any source...;
>
> information which, if disclosed, would give an advantage to competitors or bidders….

The above-quoted sections exempt these types of information from the definition of "government records" and give the Board and the Ratepayer Advocate clear justification to keep the cost of power supply data confidential and not release it. The Board already maintains confidentiality for other information from the auction process, including some information provided by bidders, and the cost of power supply data would similarly be kept confidential as well by the Board and the Ratepayer Advocate.[5]

The Ratepayer Advocate has also previously requested to receive an unredacted copy of the report from the Board's consultant, Charles River Associates, concerning the previous BGS auctions. The Board has yet to approve this request. The Ratepayer Advocate is continuing that

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[4] N.J.S.A. 47:1A-1 et seq.

[5] For example, the Board ruled that the following information be kept confidential -- (1) the logic processes and algorithms the auction manager uses to come up with volume adjustments and determinations, minimum and maximum starting prices, as well as final starting prices, etc.; (2) starting prices; (3) indicative offers, i.e., the number of tranches that a qualified bidder is willing to supply at the maximum starting price and the number of tranches a qualified bidder is willing to supply at the minimum starting price; (4) the prices set by the auction manager for each round of the auction; (5) individual bids; and (6) certain bidder information from the application forms to become a qualified bidder in the auction, such as financial and credit requirements. *I/M/O the Provision of Basic Generation Service Pursuant To The Electric Discount And Energy Competition Act, N.J.S.A. 48:3-49 et seq.,* BPU Docket Nos. EX01110754 and EO02070384, Decision and Order, December 3, 2002.

request and also requests an unredacted copy of the Board consultant's report concerning the upcoming BGS auction. The unredacted version of the report undoubtedly contains information the Board considered vital to deciding the reasonableness and effectiveness of the previous auctions. That same information would also be vital to the Ratepayer Advocate in reviewing the BGS auctions. The Ratepayer Advocate is the statutory party required by the State Legislature to review changes in utility rates and services and make recommendations to the Board on behalf of utility customers. Those duties cannot be carried out completely when vital information is withheld.

As the Board has noted in an order concerning the February 2002 BGS auction, the Ratepayer Advocate received the auction manager's confidential analysis of that auction. *I/M/O the Provision of Basic Generation Service Pursuant To The Electric Discount And Energy Competition Act, N.J.S.A. 48:3-49 et seq., Basic Generation Service ("BGS") Auction Results,* BPU Docket Nos. EX01050303, EO01100654, EO01100655, EO01100656 and EO01100657, Decision and Order, February 15, 2002, page 2. Although the Board's consultant's report contained "a similar confidential analysis", the Ratepayer Advocate did not receive that confidential report. *Id.* Similarly, in last year's BGS auction, the Ratepayer Advocate received the auction manager's confidential analysis of that auction, but not the confidential analysis of the Board's consultant. *I/M/O the Provision of Basic Generation Service Pursuant To The Electric Discount And Energy Competition Act, N.J.S.A. 48:3-49 et seq., Basic Generation Service ("BGS") Auction Results,* BPU Docket No. EX01110754, Decision and Order, February 6, 2003, page 3. Since the Ratepayer Advocate has received the confidential analysis of the auction manager concerning previous auctions, it makes sense to receive the confidential analysis of the Board's consultant as well concerning previous and upcoming auctions.

Numerous other matters before the Board require that the Ratepayer Advocate receive confidential information to complete our review. In those matters, the routine procedure is for the Ratepayer Advocate to sign a confidentiality agreement when the party providing the information justifies receiving confidential treatment for the information. The Board can also issue a protective order if it sees fit. That same procedure should be used in the BGS auction review proceedings and no party has put forth reasons to deviate from that routine procedure. Accordingly, the Ratepayer Advocate renews its request to receive an unredacted copy of the Board's consultant's report on previous and upcoming BGS auctions.