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September 28, 2007

**<u>Via Hand Delivery and Electronic Mail</u>**
Honorable Kristi Izzo
Board of Public Utilities
Two Gateway Center
Newark, NJ 07101

Re: I/M/O the Provision of Basic Generation Service for
The Period Beginning June 1, 2008
BPU Dkt. No. ER07060379

Dear Secretary Izzo:

Enclosed for filing please find an original and ten copies of the Department of the Public Advocate, Division of Rate Counsel's Final Comments on the BGS process in the above-referenced matter.

These comments will also be circulated electronically through the electric list server used by the Board of Public Utilities for these types of communications.

We are enclosing one additional copy of the materials transmitted. Please stamp and date the copy as "filed" and return it to our courier. Thank you for your consideration and assistance.

Sincerely yours,

KIMBERLY K. HOLMES, ESQ.
ACTING DIRECTOR

By: *s/ Badrhn M. Ubushin*
Badrhn M. Ubushin
Assistant Deputy Public Advocate

c: President Jeanne M. Fox, (via hand delivery)
Commissioner Frederick F. Butler, (via hand delivery)
Commissioner Joseph L. Fiordaliso, (via hand delivery)
Commissioner Christine V. Bator, (via hand delivery)

**I/M/O the Provision of Basic Generation Service ("BGS")**
**For the Period Beginning June 1, 2008**
**BPU Docket No. ER07060379**
**Final Comments of the Department of the Public Advocate**
**Division of Rate Counsel**
**September 28, 2007**

The Department of the Public Advocate, Division of Rate Counsel ("Rate Counsel") respectfully submits these final comments to the Board of Public Utilities ("Board" or "BPU") in the above-captioned matter. In this proceeding, Rate Counsel filed initial comments dated August 24, 2007. The issues addressed in the initial comments were the following:

- Pay As Bid and Tick Down on Ties,
- Pass through of changes in transmission charges,
- Information concerning BGS-FP supply sources, and
- The BGS Portfolio.

All of these issues have been put before the Board in previous BGS proceedings. Rate Counsel put them before the BPU again this year because we believe that they are worthy of further consideration. The first three issues deal with specific features of the BGS-FP auction. The last is broader. It deals with the framework within which the electricity supply for BGS-FP customers, and indeed all energy supply issues for the State of New Jersey, should be considered. In addition, in response to the Board's request for "alternative BGS procurement proposals," Rate Counsel filed comments dated July 2, 2007.

In these final comments Rate Counsel will respond to comments made, and issues raised, by other parties in their initial comments and during the hearing held by the BPU on September 20, 2007. In these responses Rate Counsel will focus primarily but not exclusively on points related to those raised in its two sets of previously filed comments.

## RESPONSE TO INITIAL COMMENTS

Initial comments were filed by the Retail Energy Supply Association (RESA) and by Constellation Energy Commodities Group, Inc. and Constellation NewEnergy, Inc. (Constellation). The following issues were raised by RESA and Constellation in their comments:

- Lowering the threshold for BGS-CIEP service and for the Retail Margin.

- Procurement of supply for BGS-FP customers.

In the remainder of this section each of these issues will be addressed.

**Lowering the Threshold**

Customers who obtain their electricity through Basic Generation Service currently receive two types of service. Service with energy priced on an hourly basis is available as an option for all customers. It is also the only service available to "large customers," that is, those above a 1,000-kW threshold. RESA has proposed lowering the threshold substantially, making hourly pricing the only BGS option available to many smaller customers. It has also proposed lowering the threshold at which customers pay the retail margin, forcing them to pay an additional charge if they choose to remain on BGS. The effect of the RESA proposals would be to push customers who have chosen to remain on BGS-FP off that service. In support of this "pushing," RESA argues as follows:

> "As it is structured, BGS-FP creates a false price signal – and a false sense of complacency – that electricity costs are fixed for substantial periods of time. Hence, under the current BGS structure, most electricity customers in New Jersey lack a clear signal and a clear incentive to conserve energy, shift consumption patterns or explore energy-efficient or renewable alternatives."

RESA's argument is wrong, and the Board's approval of this recommendation would be a disservice to the current BGS-FP customers.

The RESA argument is wrong because it seems to assume that hourly energy prices are the only "correct" price signal, and it does not take into account the varied levels and structure of the charges that BGS-FP customers face. In 2002, the BGS-FP procurement produced an average price of 5.228¢ per kWh. In 2007, the average price was 9.942¢ per kWh. That is an increase of over 90 percent in just five years. This increase, as it makes its way through to the BGS-FP rates, will provide a strong incentive for BGS-FP customers to invest in energy efficiency. Further, the BGS-FP rates are, by design, seasonal. The higher summer charges provide an incentive for customers to be particularly careful with their electricity usage during the high-cost summer months.

In addition, Rate Counsel believes that the BPU, in various pending proceedings, is currently exploring better ways to encourage energy conservation, demand response and renewable energy than just pushing smaller customers onto hourly electric prices. There is an ongoing demand response working group, and the parties in current dockets are examining the future of the Clean Energy Program's energy efficiency and renewable energy initiatives. As all parties to this case must be well aware, the BPU is heavily involved in formulating the new Energy Master Plan for New Jersey that will also address solutions for these issues that are not as simplistic as expanding the BGS-CIEP tariffs.

The RESA argument also appears to be aimed more at creating business opportunities for RESA members rather than improving BGS-FP service from the customers' perspective. Adopting RESA's recommendations would only serve to force customers without the wherewithal to deal effectively with hourly prices onto the hourly price structure simply to provide third party suppliers with the opportunity to "save" them from this dilemma toward which RESA urges the BPU to push them.[1] Were the RESA recommendations accepted, some customers currently receiving BGS-FP service would be forced to choose between the hourly energy prices on BGS-CIEP service and service from suppliers such as Direct Energy LLC, a member of RESA which sent a letter supporting the RESA comments. What services do suppliers such as Direct Energy offer these customers? Under "Business Electricity Plans" the Direct Energy web site provides the following description:

> "With the volatility in electricity prices over the last few years, Direct Energy has created fixed rate programs to help you protect your business from uncertainty. No tiered pricing. No rate adjustments. No added stress. Direct Energy can help you **lock in your price today, for the next five years**, and help you put your money back into your business." (Emphasis added.)

Apparently, RESA's concern about the "false sense of complacency" provided by stable electricity prices vanishes if the stability is provided by a third party supplier instead of BGS-FP service.

**Procurement of Supply for BGS-FP Customers**

Both RESA and Constellation offered comments related to the procurement of the resources required to provide BGS-FP service. In the case of RESA, there is a proposal to substantially shorten the term of the contracts procured through the BGS-FP auction, moving to annual and then quarterly contracts, to replace the system of laddered, three-year contracts currently in use. RESA characterizes this change as a step toward real-time pricing. To support these proposals, RESA argues that the small customers who take BGS-FP service should be exposed to greater price volatility. The comments made earlier concerning the CIEP threshold apply here as well. RESA's argument is again both wrong and self-serving.

There is no need to make the changes RESA suggests. The rapid increase in the BGS-FP costs and the seasonal rates which BGS-FP customers face provide appropriate price signals without creating price volatility. However, stable BGS-FP pricing does not provide the business opportunities for RESA members such as Direct Energy that acceptance of the RESA proposals would create. If the RESA proposal to serve BGS-FP customers using annual and then quarterly contracts is accepted, auction price increases such as the 55 percent jump between 2005 and 2006, will likely create substantial volatility in BGS-FP rates. With that in mind, consider the "service" Direct Energy offers to residential customers on its web site:

> "As one of the largest integrated retailers in North America, we have the ability to protect what you pay for electricity. So **you don't have to worry about the volatility of energy prices**." (Emphasis added.)

[1] It is certainly no offense for RESA to advocate for its members' self-interest, and Rate Counsel supports the right of all parties to legitimately seek to enhance utility services in New Jersey even when that improvement also improves their bottom line. However, no party would argue against the idea that EDECA's main thrust is to improve the quality of utility services from the customers' perspective and to lower gas and electric prices in New Jersey.

Under the guise of concern about efficient pricing, RESA urges the BPU to create volatility, so that RESA members such as Direct Energy can sell services that remove it.

Constellation's comments are quite different from those of RESA. With respect to the issue of contract term for the products procured through the BGS-FP auction, Constellation's position is that the Board has established a rational and balanced approach by allowing rolling three-year contract terms. It urges the Board to maintain this structure. (See page 5 of the BGS Proposal filed by Constellation on July 2, 2007). Constellation's procurement-related comments focus on Rate Counsel's proposal for a BGS Portfolio. Unfortunately, Constellation mis-characterizes the proposal. Rather than replacing the current BGS procurement process as Constellation states, Rate Counsel proposed to make the contracts obtained through the BGS-FP auction part of a portfolio of resources used to provide BGS-FP services.

Constellation's attempt to cling to the status quo—three-year contracts provided by wholesale suppliers such as itself the only source of resources to serve BGS-FP customers—does not accommodate the Board's own efforts. As the BPU has recognized, the resources used to provide BGS-FP service should include demand-side options. Further, as discussion by NERA and other parties at the September 20 hearing confirmed, it may be possible to procure contracts for longer than three years to serve BGS-FP customers. (See the remarks on page 44 of the hearing transcript.) BGS-FP auction results for 2003 and 2004—the years when contracts for both one and three years were procured—show that the additional cost of three-year compared to one-year contracts was very modest. Thus, the possibility of procuring longer-term contracts, even the five-year contracts discussed by NERA and others at the September 20 hearing, could provide substantial gains in stability without a significant price premium.

It is Rate Counsel's position that resources such as demand-side options and supply contracts with a term of more than three years should be considered as part of a mix of resources used to serve BGS-FP customers. Constellation would rule out even the additional resources that the Board itself sees as desirable. Such an overly negative and restrictive position should be rejected. Rate Counsel suggests that, if resources beyond those produced by the BGS-FP auction are to be added, the process of selecting and arranging for such additions should have professional management. Rather than trying to build pre-selected products—demand response, five-year or longer supply contracts, etc.—into the BGS-FP auction, professionals familiar with the electricity markets should identify the best products and opportunities, and suggest the most appropriate means for adding them to a BGS portfolio.

## ISSUES RAISED AT HEARING

On September 20, 2007 the Board held a "Legislative-Type Hearing" at which various issues related to BGS service were discussed. In addition to presentations by the EDCs and their consultants from NERA and by the Public Advocate, comments were offered by three representatives of the energy suppliers—RESA and two of its member organizations, Intelligent Energy and Constellation. During the course of the hearing, President Fox asked a number of those making presentations to address the following issues:

- Are there any options for the BPU to address New Jersey's need for additional generating capacity?
- Are there examples that show how a BGS Portfolio Manager might function?
- Should customers who leave BGS-FP service for the market be able to return at will?
- Should those who provide BGS-FP service be required to provide information on their sources of supply?
- Is adoption of pay-as-bid and tick-down-on-ties likely to raise or to lower the price paid for service obtained through the BGS-FP auction?

Discussion of these issues took up much of the September 20 hearing. In the remainder of these comments Rate Counsel will address each of these issues to provide information requested at the hearing and to respond to points made by other parties at the hearing.

**Capacity Additions**

As President Fox indicated, there is a need for New Jersey to add electric generating capacity. Adoption of the BGS portfolio approach and the use of a professional manager for the BGS portfolio would together substantially improve the Board's ability to address the issue of capacity addition.

The decision to build and operate any generating facility, even a peaking unit, involves a long-term commitment of a substantial amount of capital. Long-term contracts for the output of a new unit can make it easier to justify commitment of a developer's internally generated funds, and to obtain debt or equity investments by others. Long-term contracts both ensure that a new unit will have a minimal cash flow and make it possible to estimate that cash flow with some accuracy. Even if the sale of a plant's output is likely, making the price clearer and more stable can provide benefits, such as facilitating use lower cost debt in place of higher-cost equity.

As the preceding discussion shows, long-term contracts such as those included as part of a BGS portfolio could be used to enhance the attractiveness of siting new generating facilities in New Jersey. However, developing such arrangements is best left to professionals who are knowledgeable about the relevant electricity markets as well as myriad other technical concerns. The same can be said for any long-term contracting. It is for precisely this reason that Rate Counsel has stressed the need for a BGS portfolio to have **professional management** which operates under the direction and control of the BPU. If such management is in place, the BPU can work with it to address issues such as capacity acquisition, as the core issue—stable, reasonable prices for BGS-FP service—is being addressed.

**Examples of Portfolio Management**

The professional Portfolio Manager recommended by Rate Counsel would work as an agent, helping to assemble the portfolio of resources to provide BGS-FP service. There are many examples of agents working to assemble the resources required to supply specific groups of electricity consumers. Many of these agents are set up as power authorities. For example, Illinois recently established a power authority which acts as an agent, dealing with procurement of power to serve retail customers. In Ontario such a power authority has been in operation since 2005. The Ontario authority has engaged in the following activities:

- Procured new clean and renewable energy supplies including via a Standard Offer Program for sources generating less than 10 MW;

- Engaged in conservation efforts such as product rebates, building retrofits, and appliance recycling as well as coordinating industrial demand response efforts;

- Procured new fossil-fuel electricity generation to meet reliability needs where the market failed to provide sufficient supply.

There are also power authorities which act as agents for limited groups of customers. For example, Oklahoma and Michigan have, for decades, had municipal power authorities which assemble portfolios of resources to provide power to retail level municipal power systems in the state. The organizations just described are referred to as "power authorities," rather than "Portfolio Managers." However, they act as agents, providing essentially the same services as a BGS Portfolio Manager might provide in New Jersey.

**Migration Risk**

Those taking BGS-FP service are free currently to move to the market and then to return to BGS-FP service if they wish to do so. Suppliers bidding into the BGS-FP auction presumably take this "migration risk" into account when they decide on the price at which they will bid to provide BGS-FP service. Migration risk could be reduced by regulating the movement of customers on and off BGS-FP service. At the September 20 hearing President Fox asked whether and to what extent such cost reductions should be pursued by the Board.

Rate Counsel recommends that the Board exercise care and restraint in establishing any limitations on movement on and off BGS-FP service. There are two basic considerations that support the position taken by Rate Counsel:

1. To date very few of those who are eligible for BGS-FP service have chosen to try the market. Among those who in the future might be tempted to try the market to get a better price, any limitation on their return to BGS-FP service could have a "chilling effect."

2. There has been no indication of the likely magnitude or the “dollar value” of migration risk as yet. Until such information is available, there is no reasonable way to assess the magnitude of the gain from removing such risk.

The first consideration above suggests that, in general, care should be exercised in addressing migration risk. The second consideration shows that the information required to act is not available at this time. Thus, Rate Counsel recommends that no action be taken, but that the BPU continue to monitor the situation.

**Transparency**

Customers taking BGS-FP service face two different but related types of risks:

- **Physical Supply.** Some of the generating units which provide their electricity could fail or need to be shut down, leaving them without the generation required to meet their needs.

- **Financial Arrangements.** A party in the chain of transactions involved in purchasing their electricity, or a contractual agreement in that chain, could fail, interrupting access to the generating units used to provide the service.

There are various ways in which the BPU’s oversight of BGS-FP service is designed to minimize these risks, and to deal with them should they arise. However, under current arrangements, the BPU lacks information on the ultimate source of the electricity used to supply BGS-FP service and on the chain of financial transactions that support that supply. In discussions at the hearing, it was suggested that those, such as Rate Counsel, who support collection of this information, need first to imagine what the information collected will show, and then on the basis of that insight, explain exactly what use will be made of it. Rate Counsel submits that this view is simply wrong-headed.

Today BGS-FP supply—the lifeline that most New Jersey electricity consumers depend upon moment to moment—is a “black box.” To the extent that it is possible to do so, the Board has the responsibility to open that box, look inside, and assess what it finds. It is not Rate Counsel’s responsibility to foresee the results of this exercise. It is the responsibility of those who oppose it, to explain why it should not even be attempted. This is a burden that they have not, and in Rate Counsel’s view cannot, meet. The issue is not whether the BPU should address physical supply and financial arrangements. The issue is what are the **reasonable steps** to take in that direction? In order for there to be a productive discussion of the reasonable steps rather than another round of claims that getting any useful information is impossible, the Board needs to send a clear signal that it is committed to addressing the issues of physical supply and financial arrangements in a meaningful fashion. Now is the time to send that signal.

**Pay As Bid and Tick Down on Ties**

This year, as in the past, Rate Counsel has recommended that the Board adopt a Pay as Bid procedure wherein winning bidders in the BGS-FP auction are paid the lowest price they freely agreed to accept, not the highest price to be paid for the product on which they bid. Rate Counsel has also recommended that if the number of tranches bid exactly equals the number of tranches desired, the price for that product continues to “tick down” until there is a drop in the number of tranches bid. With these changes, the BGS-FP auction will produce equitable results from the perspective of all parties, particularly the customers who must ultimately pay the price that the auction produces.

It is a matter of simple arithmetic that, if Pay As Bid and Tick Down on Ties do not affect the pattern of supplier bids, then adopting them would lower the cost of the electricity obtained from the BGS-FP auction or leave it unchanged. However, some parties claim that their adoption will affect the pattern of bids. At the September 20 hearing Mr. Robinson of PSE&G described what these parties assume will occur as follows:

> “If you change the rules and allow - - the bidders will be paid their final bid, they will have a tendency of not wanting to win but win with the lowest bid because somebody else would have won with the higher bid. So instead of bidding very close to 8.95, they will bid very much closer to 9 because they don’t want to be that lowest bid that wins and that change in behavior would negate any advantage.” (Transcript at page 53)

Rate Counsel asks the BPU to consider carefully whether Mr. Robinson’s description of supplier behavior is plausible.

Mr. Robinson begins with a supplier who, under the current auction rules, is willing to accept close to 8.95¢ per kWh to supply one or more tranches of BGS-FP service. Presumably the supplier would only be willing to accept that price if it felt that, at close to 8.95¢ per kWh, it could cover its costs and likely earn a bit of profit. Mr. Robinson claims that a rule change which pays others a bit more for supplying the same service is likely to cause the supplier to reject a price it would previously have accepted and instead raise its required price to close to 9¢ per kWh, thus increasing its likelihood of not being selected. Does the Board believe that hard-headed business people who have expended significant time, energy, and money to participate in the BGS-FP auction will decrease their chances of winning at a price at which they could earn a profit, simply and solely because others may be paid a bit more? That is exactly what the opponents of Pay As Bid and Tick Down on Ties believe, as the following comments by Mr. Robinson makes all too clear:

> “You could be a winner, but **your boss wouldn’t like you** because you had won with the lowest bid.” (Transcript page 54, emphasis added.)

Rate Counsel takes the position that bidders and their bosses will prefer winning the opportunity to make a profitable sale with the lowest bid to risking the loss of a profitable opportunity by raising bids unnecessarily. Consistent with this position, Rate Counsel urges adoption of Pay As Bid and Tick Down on Ties.

Respectfully submitted,

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