PUBLIC SERVICE COMMISSION

OF MARYLAND

REPORT TO THE GOVERNOR AND MARYLAND GENERAL ASSEMBLY ON THE STATUS OF ELECTRIC RESTRUCTURING AND THE STRUCTURE, PROCUREMENT, AND TERMS OF STANDARD OFFER SERVICE

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INTRODUCTION

Section 7 of Senate Bill 1 of the 2006 Special Session ("SB 1") requires the Public Service Commission of Maryland ("Commission") to conduct an evidentiary proceeding to study. and evaluate the status of electric restructuring in the State of Maryland. SB 1 also requires the Commission to evaluate the different methods by which electric utilities should procure generation service to residential and small commercial customers. The Commission had previously established Case Nos. 9064 and 9063 in the spring of 2006 to evaluate similar issues. In Case No. 9064, the Commission was to examine the current procurement methods for provision of Standard Offer Service ("SOS") to residential and small commercial customers and changes, if any, to that procurement that could be accomplished in time for incorporation into the upcoming SOS bid cycle. Case No. 9063, in contrast, was an examination of the optimal electric industry structure going forward.

After incorporation of several additional issues into the two proceedings arising from enactment of SB 1, the Commission took testimony, held hearings, and received briefs from the parties. On November 8, 2006, the Commission issued Order No. 81102 in Case No. 9064 (See Appendix), setting forth an interim procurement regime for the immediate future. Order No. 81102 made some changes to the SOS procurement process covering SOS service through June of 2009. Utility implementation of this Order is underway, with the initial procurement of generation under the terms of Order No. 81102 to occur in January 2007.

As mentioned above, Case No. 9063 addresses a wider scope of issues than Case No. 9064 and a variety of potential methods for meeting the generation needs of residential customers. It will address longer-term matters. The Commission has concluded the evidentiary and hearing process in Case No. 9063, and is currently considering legal briefs filed by the parties in mid-December.

HISTORY

Maryland's Electric Customer Choice and Competition Act of 1999[1] (the *1999 Act")* established electric industry restructuring as the official policy of the State. Its chief objective was to remove the generation and pricing of electricity supply from the regulatory purview of the Commission. The State accomplished that goal by allowing Maryland's investor-owned public service electric companies to sell or transfer their generation assets to others. The electric public service companies became "wires" companies, providing the essential transmission and distribution line "links" between customers and the entities that provide the generation service (also known as electric supply service).

The *1999 Act* also allowed retail customers to select the electricity supply provider of their choice. It provided for licensing of competitive suppliers, and allowed the pricing of electricity supply to be determined by market forces.

So as to ensure that all customers would have a supplier of electricity, in the *1999 Act* the General Assembly made provision for the default electric supply service known as Standard Offer Service. This is the electric supply service available to all customers who, for whatever reason, do not have a competitive provider of generation services. The *1999 Act* further provided that SOS initially would be provided by the traditional electric public service companies in their respective utility service territories. That obligation, pursuant to the *1999 Act,* has been extended and, pursuant to SB 1, that obligation now rests firmly on electric public service companies within their traditional service territories.

The *1999 Act* also gave direction to the Commission for the procurement of SOS. That procurement is to be done competitively and at a market price that permits the recovery of the verifiable, prudently incurred costs to procure or produce the electricity, plus a reasonable return. See *PUC Article,* §§ 7-510(c)(3)(ii)(2), 7-510(c)(4). Under the law, the Commission was to oversee a competitive procurement to determine the market price of electricity. This method replaced the traditional ratemaking paradigm, in which utility rates were established through direct pncmg regulation by the

[1] Md. Ann. Code, *Public Utility Companies Article (PUC Article),* §§ 7-501 *et seq.*

Commission. The *1999 Act* also capped electricity rates for most Maryland residential customers at levels below those in existence in 1999. These rates would be in effect for a period lasting at least four years from the initial implementation date for each utility. These capped rates, the level and terms of which were accepted by the Commission in a series of settlement agreements, are often referred to in utility tariffs as "price-freeze service." The price freeze periods (in years) varied from company to company, ranging from four to eight years.

In order to fulfill the *1999 Act's* prov1s1ons pertaining to the competitive procurement of SOS, the Commission, on the basis of several settlement agreements approved in 2003, required the utilities to procure SOS generation on a competitive bid basis. The Commission established the competitive bid process in the confines of Case No. 8908.[2] Depending on the restructuring schedule for each utility, the contract lengths procured varied between one-, two-, and three-year contracts. The Case No. 8908 procurement process also separated the bidding over a three to four month period stretching from December of a given year into March of the following year, in order to minimize the chance of temporary price spikes due, for example, to weather abnormalities. One portion of a utility's SOS load, or "tranche," was bid in each of the months in that period.

SOS procurements for residential and commercial customers of Potomac Electric Power Company ("PEPCO") and Delmarva Power & Light Company ("DPL"), and commercial customers of Baltimore Gas and Electric Company ("BGE") and the Potoinac Edison Company d/b/a Allegheny Power ("AP")[3] were relatively uneventful during the 2003-2004 and 2004-2005 bid periods. However, as the utilities procured energy in late 2005 and early 2006 for delivery in the summer of 2006, prevailing wholesale electricity prices in the market were significantly higher than previous years. The likely source of these increased prices was a run up in natural gas prices following the catastrophic impacts of Hurricanes Rita and Katrina on the nation's oil and natural gas infrastructure. Natural gas fired electric power plants comprise a significant portion

[2] See In the Matter of the Commission's Inquiry into the Competitive Selection of Electricity Suppliers Standard Offer Service, Case No. 8908.

[3] AP' s residential customers are able to receive price freeze service through December 31, 2008, pursuant to the terms of that company's electric restructuring settlement agreement.

of the fleet of electric generators that serve customers in Maryland. In addition, stunning increases in demand for energy in developing nations and geopolitical conflicts in energy producing regions of the world placed dramatic upward price pressure on energy commodities.

The summer .of 2005 also revealed a significant increase in wholesale electric market prices in the Mid-Atlantic region due to increased electric demand, coupled with constraints in transmission infrastructure limiting the availability of lower cost generation available to serve that demand. As a result, locational marginal prices in the Mid-Atlantic reflected limitations on the transmission system's ability to import power from the Western areas of PJM.

Bids and prices for standard offer type services for 2006 ·in Maryland, the District of Columbia, Delaware, New Jersey and Pennsylvania all reflected similar price levels due to the increase in natural gas prices and transmission "congestion." SOS price increases occurring as a result of the competitive 200 -2006 procurements produced electric supply prices that resulted in "typical customer" bill impacts of a 35 percent to 72 percent increase in annual bills.[4] The reason for the broad range is the relative proportion of the load that was being procured. For BGE, since this was its first procurement following price freeze service, 100 percent of the SOS load was procured – resulting in a 72 percent bill increase for residential customers. PEPCO and DPL, by contrast, whose price freeze service ended in 2003, had previously procured roughly half of its power needs in prior years in multi-year contracts. Therefore, for PEPCO and DPL, the blending of lower priced multi-year contracts with higher priced contracts in the 2005-2006 procurement produced smaller increases in the 35 percent - 39 percent range for total bill impacts for a typical residential customer. However, as stated above, the wholesale market prices from the 2005-2006 procurement were similar for Maryland utilities and throughout the Mid-Atlantic region.

diven the. magnitude of the SOS price increases incurred in the 2005-2006 bid procurement period, the Commission investigated appropriate ways to mitigate the SOS increases in Case Nos. 9052 (for BGE) and 9058 (for DPL and PEPCO). Ultimately, pursuant to mandatory provisions in SB i, rates for BGE's residential customers

[4] Exclusive of deferrals mandated by SB I.

increased by 15 percent, with the remaining 57 percent cost increase scheduled for future implementation pursuant to various provisions of SB 1. Residential customers of PEPCO and DPL had the opportunity from SB 1 to join a voluntary rate increase deferral program, but few customers elected to do so.

STATUTORY CONSIDERATIONS

As summarized above, the *Electric Customer Choice and Competition Act of 1999* established competition for electricity supply as the State's policy. Since 1999, the Commission has been implementing that policy. Then, this past summer, the enactment of SB 1 amended certain aspects of the *1999 Act.* SB 1, among many other important provisions, imposed continuing obligations on investor-owned electric companies to provide SOS service (§ 7-510(c)(3)(ii)(2)), and provided new standards for SOS service and Commission consideration of new options for the provision of SOS service (§ 7-510(c)(4)(ii)). The latter section is paramount to the issues under consideration in Commission Case No. 9063, and so is set forth below:

> 7-510(c)(4)(ii)
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> 1. UNDER AN EXTENSION OF THE OBLIGATION TO PROVIDE STANDARD OFFER SERVICE IN ACCORDANCE WITH PARAGRAPH (3)(Il) OF THIS SUBSECTION, THE COMMISSION, BY REGULATION OR ORDER, AND IN A MANNER THAT IS DESIGNED TO OBTAIN THE BEST PRICE FOR RESIDENTIAL AND SMALL COMMERCIAL CUSTOMERS IN LIGHT OF MARKET CONDITIONS AT THE TIME OF PROCUREMENT AND THE NEED TO PROTECT THESE CUSTOMERS FROM EXCESSIVE PRICE INCREASES:
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> A. SHALL REQUIRE EACH INVESTOR-OWNED ELECTRIC COMPANY TO OBTAIN ITS ELECTRICITY SUPPLY FOR RESIDENTIAL AND SMALL COMMERCIAL CUSTOMERS PARTICIPATING IN STANDARD OFFER SERVICE THROUGH A COMPETITIVE PROCESS IN ACCORDANCE WITH THIS PARAGRAPH; AND
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> B. MAY REQUIRE OR ALLOW AN INVESTOR-OWNED ELECTRIC COMPANY TO PROCURE ELECTRICITY FOR THESE CUSTOMERS DIRECTLY FROM AN ELECTRICITY SUPPLIER THROUGH ONE OR MORE BILATERAL CONTRACTS OUTSIDE THE COMPETITIVE PROCESS.

2.A. AS THE COMMISSION DIRECTS, THE COMPETITIVE PROCESS SHALL INCLUDE A SERIES OF COMPETITIVE WHOLESALE BIDS IN WHICH THE INVESTOR-OWNED ELECTRIC COMPANY SOLICITS BIDS TO SUPPLY ANTICIPATED STANDARD OFFER SERVICE LOAD FOR RESIDENTIAL AND SMALL COMMERCIAL CUSTOMERS AS PART OF A PORTFOLIO OF BLENDED WHOLESALE SUPPLY CONTRACTS OF SHORT, MEDIUM, OR LONG TERMS, AND OTHER APPROPRIATE ELECTRICITY PRODUCTS AND STRATEGIES, AS NEEDED TO MEET DEMAND IN A COST-EFFECTIVE MANNER.

B. THE COMPETITIVE PROCESS MAY INCLUDE DIFFERENT BIDDING STRUCTURES AND MECHANISMS FOR BASE LOAD, PEAK LOAD, AND VERY SHORT-TERM PROCUREMENT.

C. BY REGULATION OR ORDER, AS A PART OF THE COMPETITIVE PROCESS, THE COMMISSION SHALL REQUIRE OR ALLOW THE PROCUREMENT OF COST-EFFECTIVE ENERGY EFFICIENCY AND CONSERVATION MEASURES AND SERVICES WITH PROJECTED AND VERIFIABLE ENERGY SAVINGS TO OFFSET ANTICIPATED DEMAND TO BE SERVED BY STANDARD OFFER SERVICE, AND THE IMPOSITION OF OTHER COST-EFFECTIVE DEMAND-SIDE MANAGEMENT PROGRAMS.

3.A. IN ORDER TO PREVENT AN EXCESSIVE AMOUNT OF LOAD BEING EXPOSED TO UPWARD PRICE RISKS AND VOLATILITY, THE COMMISSION MAY STAGGER THE DATES FOR THE COMPETITIVE WHOLESALE AUCTIONS.

B. BY REGULATION OR ORDER, THE COMMISSION MAY ALLOW A DATE ON WHICH A COMPETITIVE WHOLESALE AUCTION TAKES PLACE TO BE ALTERED BASED ON CURRENT MARKET CONDITIONS.

4. BY REGULATION OR ORDER, THE COMMISSION MAY ALLOW AN INVESTOR-OWNED ELECTRIC COMPANY TO REFUSE TO ACCEPT SOME OR ALL OF THE BIDS MADE IN A COMPETITIVE WHOLESALE AUCTION IN ACCORDANCE WITH STANDARDS ADOPTED BY THE COMMISSION.

5. THE INVESTOR-OWNED ELECTRIC COMPANY SHALL PUBLICLY DISCLOSE THE NAMES OF ALL BIDDERS AND THE NAMES AND LOAD ALLOCATION OF ALL SUCCESSFUL BIDDERS 90 DAYS AFTER ALL CONTRACTS FOR SUPPLY ARE EXECUTED.

The parties to Case No. 9063 provided the Commission with their views on the best way(s) to implement the changes to SOS service mandated by SB 1. The remainder of this Report provides additional details on the two current Commission proceedings concerning SOS service (Case Nos. 9063 and 9064), summarizes the parties' positions and recommendations in Case No. 9063, and describes the status of Case No. 9063 and its anticipated remaining schedule.

THE OPTIMAL ELECTRIC INDUSTRY STRUCTURE - CASE NO. 9063

BACKGROUND

On May 10, 2006, following a petition filed by the Office of People's Counsel ("OPC"), the Commission initiated Case No. 9063. Citing the results of the 2005-2006 procurement and the relatively small number of residential customers obtaining their electricity supply from non-utility sources, OPC urged the Commission to conduct an investigation into the optimal structure of the electric industry in Maryland.[5] The Commission sought comments from interested stakeholders on OPC's request. The following parties responded to the Commission's solicitation for comments on OPC's request: PEPCO; DPL; Eastalco Aluminum Company ("Eastalco"); AP; Maryland Energy Administration ("MEA") and the Power Plant Research Program of the Maryland Department of Natural Resources ("PPRP"); Washington Gas Energy Services ("WGES"); South River Consulting, LLC ("South River"); BGE; Southern Maryland Electric Cooperative ("SMECO"); OPC; and the Retail Energy Suppliers Association ("RESA").

[5] Request of the Office of the People's Counsel for an Investigation into the Optimal Structure of the Electric Industry in Maryland, Docket No. 1, March 16, 2006 at 1-2. OPC amended its request on April 10, 2005, Docket No. 5.

Upon initiation of the proceeding, [6] additional intervenors filed for party status in the proceeding, including: the Apartment and Office Building Association of Metropolitan Washington ("AOBA"); FirstEnergy Corporation; Dominion Retail, Inc. ("Dominion"); the Maryland Industrial Group and United States Gypsum Co. ("MIG"); Commerce Energy, Inc. ("Commerce"); United States Department of Defense and other interested Federal Agencies ("DOD"); Sempra Energy ("Sempra"); the PJM Industrial Customer Coalition ("PICC"); Pepco Energy Services, Inc. ("PES"); the Maryland Public Interest Research Group, Public Citizen, Baltimore ACORN and Environment Maryland (collectively, "MPIRG"); ISG Sparrows Point, LLC ("ISG"); Consolidated Edison Energy, Inc. and Consolidated Edison Solutions, Inc.("ConEd"); Constellation Energy Commodities Group ("CECG"); Constellation New Energy, Inc. ("CNE"); Morgan Stanley Capital Group, Inc. ("Morgan Stanley"); Mirant Mid-Atlantic, LLC ("Mirant"); Coral Power, LLC ("Coral"); Conectiv Energy Supply, Inc. ("CESI"); National Energy Marketers Association ("NEMA"); and the Mayor and City Council of Baltimore ("Baltimore City").

OPC filed a motion seeking to begin evidentiary proceedings and consolidate this case with Case No. 9064. The case was held in abeyance until after the completion of the special session of the Maryland General Assembly and the passage of SB 1. After the passage of SB 1, both OPC and the Commission's Technical Staff ("Staff') filed motions to reopen this proceeding. On August 1, 2006, Staff filed a proposed issues list. After a prehearing conference held on August 2, 2006, the Commission adopted Staffs issues list on a non-exclusive basis, as well as a procedural schedule.

CASE NO. 9063 ISSUES

Based upon the requirements of various sections of SB 1 and the Commission's previously announced intentions for the proceeding, the issues list included the following issues: *

[6] On the same date, the Commission docketed *In the Matter of the Competitive Selection of Electricity Supplier/Standard Offer or Default Service for Investor-Owned Utility Small Commercial Customers; and for the Potomac Edison Company d/b/a/ Allegheny Power's, Delmarva Power and Light Company's and Potomac Electric Power Company's Residential Customers,* Case No. 9064, initially intended as a policy review regarding the provision of standard offer service for small commercial customers Statewide, and residential service for Pepco, DPL, and AP customers.

1. Purchase of SOS through competitive or negotiated contacts of various duration - SB 1 §7(b)(l);

2. Requiring or allowing Investor Owned Utilities ("IOUs") to purchase or lease generation - SB 1 §7(b)(2);

3. Procurement of energy efficiency and conservation measures at the time of the SOS bid for IOUs-SB 1 Section 7(b)(3);

4. Procurement of SOS through bilateral contracts between wholesale electricity suppliers and IOUs – SB 1 Section 7(b)(4);

5. Allowing opt-out aggregation of residential electric customer demand by local governments in the service territories of IOUs – SB 1 Section 7(b)(5);

6. Procurement process and criteria for evaluation of bids for energy and conservation resources – SB 1 Section 7(d)(2);

7. Evaluation of the benefits to small commercial customers of not offering SOS service – SB 1 Section 7(d)(3)(ii);

8. Definition of default service - SB 1 Section 7(c)(3)(iii)2; and

9. Implications of various bid processes including declining block auction, full requirements bidding, variable pricing per formula - SB 1 Section 7(c)(4).

The Commission specifically permitted parties to address any other issues they considered appropriate.[7] Much of the testimony and proposals reflect the desire of all parties to fulfill the statutory goals of ensuring that SOS prices are stable and reflect the best cost possible. However, as described below, the parties have widely varying opinions on how best to achieve these objectives.

PROPOSED PROCUREMENT METHODS

There were five distinct procurement methods recommended in the direct testimony of parties in Case No. 9063. Four of the methods can be characterized as modifications to the current full requirements procurement method ("FRPM"), and share essential bidding characteristics with each other and the FRPM. One of these proposals, however, would use only very short-term contracts. The remaining proposal departs

[7] Notice of Procedural Schedule, Preliminary Issues List and Intervention Status with Provisional Service List. Case No. 9063, Docket No. 71, Aug. 3, 2006.

sharply from tlie FRPM. The Commission next describes the SOS procurement processes put forth in the proceeding, followed by summaries of the parties' positions on the proposals. This section of the Report will then conclude with a summary of the parties' positions expressed on each of the options set forth in§ 7-510(c)(4)(ii) of SB 1.

The procurement proposals can be summarized as follows:

- FRPM - Quarterly 25 percent Bidding (Staff);
- FRPM - Rolling 3-Year 33 percent Contracting (BGE, DPL, Pepco);
- FRPM - One-Year 100 percent Contracting (WGES);
- FRPM - Monthly 100 percent Bidding (RESA); and
- Managed SOS Portfolio (OPC).

FRPM - Quarterly 25 percent bidding - 1-year contracts

As to details of the proposals, Staff recommends a modification to the current FRPM such that bids for 25 percent of the SOS load occur in a 1-year contract, staggered four times per year. Thus, each quarterly bid would re-price 25 percent of the SOS load at prices obtained from competitive wholesale market bids. This method differs from the current approach in that it reprices the entire SOS load on a yearly basis, instead of having a mix of one-, two- and three-year contracts. Of course, it does so in a manner that gradually changes the prices over a 12-month period. Under this proposal, bids covering 25 percent of the SOS load would be conducted four times per year, at three-month intervals. A single bid would be conducted each period, with the bid results rolled into SOS rates on the power flow date.

FRPM - Rolling 3-year Contracting

BGE, DPL and Pepco, ("the Companies") have proposed using the existing FRPM with contracts having a duration of three years.[8] The Companies have proposed to establish an ongoing procurement schedule that would purchase 33 percent of the total SOS load each year. BGE has recommended that the purchase each year be split into two tranches, one each in October and February.[9] The Potomac Edison Company d/b/a Allegheny Power ("APS" or "AP") has advocated continued use of the full requirements

[8] PHI Witness Peter E. Schaub, Case No. 9063, Direct, pages 8-11.
[9] BGE Witness Mark D. Case, Case No. 9063 Direct, page 22-23.

process (including the mix of one, two and three year contracts) that is currently used by Maryland's utilities.[10]

FRPM - One Year 100 Percent Contracting

WGES continued to support the method proposed by WGES Witness Warren in Case No. 9064. Witness Warren recommends conducting the FRPM using one-year contracts that purchase 100 percent of the SOS load each year.[11]

FRPM - Monthly Bidding

Witness Charles S. Griffey, on behalf of the Retail Energy Suppliers Association ("RESA"), proposed that the existing method be revised to procure 100 percent of the load each month using contracts lasting for one month.[12] RESA's Witness described his SOS procurement method as based on a monthly auction that would reprice SOS each month. The distinguishing feature of this method is that SOS rates would change on a monthly basis rather than annually or quarterly.

Managed SOS Portfolio

OPC recommended abandonment of the existing FRPM in favor of a managed portfolio containing generation contracts and assets uwned by the respective electric distribution company in each service territory.[13] OPC recommended that the utilities be directed to evaluate a variety of contract terms and types over a long term planning horizon. OPC did not propose a specific procurement scheme but rather a process through which the utilities should analyze a variety of options.

POSITIONS **OF** THE PARTIES

MARYLAND ENERGY ADMINISTRATION/POWER PLANT RESEARCH PROGRAM

MEA witnesses Estomin and Kahal offered a thorough review of supply options the Commission may wish to consider, and presented a report they previously prepared

[10] APS Witness, Robert B. Reeping, Case No. 9063 Direct, page 20.
[11] WGES Witness, Harry A. Warren, Case No. 9063 Direct, page 10.
[12] RESA Witness Charles S. Griffey, Case No. 9063 Direct, page 10.
[13] OPC Witness Barbara R. Alexander, Case No. 9063 Direct, page 14.

for their client. [14] They urged caution m changing the State's SOS procurement framework. They also noted that the problems currently facing SOS customers include the relatively high level of wholesale electric prices in PJM markets in recent years, as well as the volatility of prices in those markets. [15] They cited in particular the increases in fuel costs discussed above, "congestion charges," [16] and the costs of environmental controls as the primary factors leading to higher electricity production costs, which are flowed through to customers via the competitive bid procurement process. They discussed methods of attenuating those problems.

They also provided a history of Maryland's electric industry and the trends that led to industry restructuring nationally and in the State. They noted that the price freeze components of Maryland's implementation of industry restructuring meant that the newly-licensed suppliers could not compete with the prices available from the utilities during the years of the price freeze periods. That initial stumbling block, combined with the relatively high costs of marketing to small volume customers, constrained the development of retail markets for small customers during the price freeze periods. [17]

Mr. Kahal and Mr. Estomin noted that the Case No. 8908 procurement process generally has worked well. [18] As a modification to that process they recommended consideration of laddered three-year contracts as an interim measure that could be implemented now. [19] They further observed that since the trends in energy prices are largely due to fuel costs and changing environmental controls, the recent volatility in electricity prices is likely to continue. [20]

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[14] MEA/PPRP Exh. 1 at 5.
[15] Id. at 6-7.
[16] Congestion charges impact areas that have insufficient generation or transmission assets to allow the delivery of otherwise available low cost power. They usually are assessed at times of peak demand, although they can also occur if key generation or transmission facilities are out of service. They arise out of the need to use higher cost oil or natural gas-fired generation when lower cost power, available on the market, is•4mable to be delivered to an area due to insufficient transmission line capacity. The central portion of Maryland, and the Eastern Shore, find themselves subjected to congestion charges more and more frequently. More generation and/or transmission capacity, or a lessening of demand for electricity, or some combination thereof, is needed in those parts of the State in order to ease the assessment of congestion charges. The Commission is working with its stakeholders, PJM, and federal and other state regulators on these issues.
[17] MEA Report, p. 21.
[18] Id. at 30.
[19] Rebuttal testimony at pp. 6-7.
[20] Id. at 37.

Observing that volatility of prices as well as increases are driving concerns, Messrs. Kahal and Estomin listed the various supply options available to the Commission under SB 1. Two significant options are utility ownership of generation and the ability to enter into long-term contracts. They explored both options at some length in their testimony and report

They noted that utility ownership of generation would require utilities to make very large investments. They said that since the utilities will need sufficient assurance of cost recovery in order to protect their credit ratings and access to capital on reasonable terms, assurances of cost recovery for those plants would become very important.[21] Messrs. Kahal and Estomin note that utility ownership and the need for cost recovery assurance would require either the elimination of retail choice,[22] or the imposition of a stranded cost recovery mechanism that would permit cost recovery regardless of whether customers shop.[23]

They also pointed out that even if new generating capacity is purchased, leased or constructed by the utilities, rates would be more stable but could not be returned to pre-deregulation levels. This is because new generation would be priced based on current costs instead of the embedded cost of facilities constructed years, and even decades, ago. In addition, higher fuel prices and environmental compliance costs would drive new regulated generation rates beyond pre-restructuring levels.[24] Specifically, they presented estimates of the cost of power from new coal-fired generation at roughly $60/MWh.[25] They also noted that meaningful utility ownership of plant would take many years to develop.

As to long-term supply contracts (e.g., contracts ranging in length from 15-20 years), the two witnesses noted that their impacts would be similar to utility ownership of generation facilities. They also described the difficulty in negotiating fixed price long-term contracts, saying that the owners of the generation would need ample headroom to

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[21] The Commission observes that one key aspect of the *1999 Act* was to shift cost responsibility for generating plants onto the owners of the plants and away from retail customers.

[22] In other words, the utility would use its own generation to provide service to a customer class, classes, or subsets thereof who, in order to ensure that enough customers would participate to bear the costs of that generation, would be prohibited from buying their electricity supply from anyone else.

[23] Id. at 9-11.

[24] Id. at 11-12.

[25] Id. at 12-13.

cover fuel and other variables in the out-years of the long-term contracts. They believe it more likely that the owners of generation instead would seek fuel cost or other pass-throughs as clauses in long-term contracts.

Mr. Kahal and Mr. Estomin also urged revisiting the use of energy efficiency and conservation programs in light of the fact that energy prices are now much higher than they were when previous energy efficiency and conservation programs were phased out.[26] They stated that the potential environmental benefits of programs that reduce electricity consumption are important. Additionally, they noted that there are many implementation issues associated with these programs. These implementation issues include funding, measuring program penetration and effectiveness, and the potential for adverse economic impacts, particularly for those customers not participating in the programs. In light of those issues, they recommended that additional work be done to examine the potential for these programs, funding methods, delivery systems, and the respective roles of the utilities, State agencies, and markets.

The MEA witnesses described several other modifications to the existing SOS procurement regime that they believe are worthy of study. They include opt-out aggregation,[27] restrictions on choice (prohibiting retail choice among residential and small commercial customers, as one example), the establishment of a State power authority,[28] and increased flexibility for utilities to enter into bilateral contracts with suppliers outside the confines of the competitive bid process.

UTILITIES

Four investor-owned utilities ("IOUs") - AP, BOE, DPL, and PEPCO - and the Southern Maryland Electric Cooperative ("SMECO") filed testimony in the proceeding.

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[26] Id. at 17.

[27] Aggregation means a pool of customers in a buying group for purposes trying. to obtain the best price for electricity supply for that group. "Opt-out" aggregation is usually used in the context of aggregation by a municipal'or another governmental body covering the customers residing within the governmental unit's boundaries. The specific phrase "opt-out" refers to a method of obtaining the largest number of participants within the pool – that is, directing membership in the pool by everyone within the political boundaries except and only to the extent that a potential member "opts-out" of the group.

[28] The witnesses describe how a State power authority might look at some length in their report. See pp. 50-52. Among other facets of this option are that it would require legislation enabling the authority to issue bonds, purchase or construct generation and transmission assets, and to operate those assets. Several states and the federal government have power authorities, entities that own or control generation or transmission assets for the ultimate use ofretail customers. The Tennessee Valley Authority might be the best known of these entities.

The IOUs uniformly supported the continuation of SOS procurement via wholesale bidding using the existing or somewhat-modified full requirements procurement model.

AP

AP took the position that the Commission should continue to develop policies that foster a competitive and efficient wholesale market, and that the local distribution utility should continue to be a provider of last resort to residential and small commercial customers.[29] AP recommends that SB 1 be implemented in a manner that promotes the participation of both wholesale and retail suppliers in the Maryland market.[30] AP witness Reeping noted that Federal policies and actions continue to promote the development of a competitive wholesale market.[31] Witness Reeping argued that the local distribution utilities are best positioned to provide SOS and be the providers of last resort, in light of their continued obligation to serve and their regulated status.[32] Mr. Reeping also discussed the various electricity procurement options permitted by SB 1, and notes that no one can successfully "time the energy market" all of the time.[33]

According to Mr. Reeping, the existing full requirements procurement process has generally worked well.[34] In his opinion, the utilities should not construct or lease new generation because this could be anti-competitive, as well as uneconomic for ratepayers. [35] Customers would need to guarantee rate recovery of utility generation investment, even if they choose a competitive alternative to SOS.[36]

Witness Reeping believes it may be feasible to create a bidding process for demand-side resources.[37] He has concerns about the possibility of municipal opt-out aggregation, although those concerns might be alleviated if the municipal aggregator became the provider of last resort.[38] In general, AP supports continuing the existing full requirements procurement process, and believes that a suitable blended portfolio of

[29] APExh:i'1 at 2.
[30] Id.
[31] Id. at 3-6.
[32] Id. at 6-9.
[33] Id. at 9-12.
[34] Id. at 13.
[35] Id. at 14.
[36] Id.
[37] Id. at 15.
[38] Id. at 16.

mixed-length contracts can be assembled through this process.[39] Mr. Reeping also suggests that default service could be considered synonymous with SOS, and that small commercial customers should continue to have access to SOS.[40]

BGE

BGE believes that the existing power procurement model has generally worked well.[41] In fact, the analysis of BGE witness Lesser indicated that prices are in fact lower under the current deregulated industry structure than they would be if rates had continued to be regulated under the former system.[42] BGE witness Case noted that even after the recent rate increases stemming from the 2006-2007 procurement, BGE customers' monthly bills are very similar to, and not necessarily higher than, those for other utility customers in this part of the country.[43] BGE witness Case argued that the optimal structure of the electric industry in Maryland is one based upon robust wholesale competition, retail competition for all customers, and demand-side measures promoted by the utilities.[44] According to witness Lesser, wholesale competition has increased generation plant efficiency and reduced costs.[45] BGE testified that retail markets in Maryland, especially for commercial and industrial customers, are robust and continue to develop.[46] The witnesses noted that although the market for residential customers in the BGE service territory is not as robust, price freeze service for those customers only recently ended, and BGE has been conducting a multi-media campaign in recent months to educate customers on their rights to choose a competing supplier.

BGE opposes having Maryland utilities enter into long-term power purchase agreements, which would undermine development of competitive retail markets and demand-side management initiatives.[47] BGE witness Case recommended that the

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[39] Id. at 19-20.
[40] Id. at 18-19.
[41] BGE E:idl. 4 at 2; BGE Exh. 3 at 9.
[42] BGE Exh. I at 36-7. MEA witnesses Kahal and Estomin disagreed with that analysis. Rebuttal, pp. 8-9.
[43] BGE Exh. 3 at 10.
[44] BGE Exh. 3 at 5.
[45] BGE Exh. I at 37. However, Dr. Lesser also stated that environmental initiatives such as Maryland's Healthy Air Act will make it more difficult to build coal-fired power plants in Maryland, which have lower fuel costs than those using natural gas. Lesser Direct, p. 19. Legislation such as the Healthy Air Act will also impact the operations and costs for existing baseload coal-fired generation. Id.
[46] BGE Exh. 3 at 6-9.
[47] Id. at 17-19.

existing procurements be modified to obtain "laddered" three-year contracts, procured in tranches at different times of the year, with each tranche covering a third of the SOS load.[48] A volumetric risk mechanism ("VRM") reprices the portion of load (at market rates) that returns to SOS after taking service from competitive supply. BGE recommended that . a VRM should be part of all mass-market SOS electricity procurements in order to reduce wholesale risk premiums. BGE also suggested that the Commission might consider implementing a descending clock auction, such as the one used in New Jersey.[49] The Commission should support utility-provided energy conservation and efficiency programs that are cost-effective, and BGE is actively considering additional energy conservation and efficiency initiatives.[50] BGE supports municipal opt-in aggregation, but believes that opt-out aggregation would be harmful over the long run to customers, wholesale suppliers, and retail suppliers.[51] This is because opt-out aggregation would introduce volumetric pricing risk to the provision of SOS, for which suppliers would have to be compensated, thereby increasing SOS prices. [52] The witnesses further described the increased risk and potential for higher costs that accompanies the use of long-term contracts, bilateral contracts, and utility-owned generation. [53]

PEPCO/DPL

Pepco/DPL ("PHI") witness Wathen recommended that small commercial customers, as well as residential customers, should have SOS available.[54] Witness Schaub proposed that electricity be procured through competitive bidding for staggered three-year contracts, with one third of the SOS load purchased each year.[55] PHI's experience with similar procurements in New Jersey and the District of Columbia

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[48] Id. at 22.

[49] Id. at 2 . In a descending clock auction, suppliers bid to supply generation at decreasing price levels, starting at a price level that the auction monitor believes will lead to offers of blocks of power that far exceed the amount needed to supply the load. The price is then decreased gradually, until the blocks of roower offered at a particular price level equal the amount of the load.
Id. at 26-7.

[51] Id. at 29-34.

[52] Case Direct, p. 29.

[53] Lesser Direct, pp. 47-51; Case Rebuttal, pp. 13-17; Lesser Rebuttal pp. 21-33.

[54] PEPCO/DPL Exh. 1 at 12.

[55] Pepco/DPL Exh. 3 at 2.

indicates that this procurement method can effectively limit the pnce volatility experienced by customers.[56] PHI did not support the use of negotiated contracts for SOS procurement, or the construction or lease of generating facilities by utilities.[57] PHI believes that market forces should determine where and when new capacity resources would be developed.[58] PHI also argued that utility ownership of generation needed to meet even a portion of its SOS load would shift certain risks now borne by generators onto SOS customers.[59] PHI could accept the use of contracts longer than three years in term, or through bilateral negotiations under certain conditions,[60] but opined that contracts longer than five or 10 years in length would raise volumetric risks.[61] Mr. Schaub illustrated this point by describing the adverse impacts on customers of an existing long-term contract that PEPCO has with a generator.[62]

PHI saw no compelling reason to change the basic Request for Proposals ("RFP") form of electricity procurement in Maryland. This recommendation comes in part because its experiences with other methods in other jurisdictions do not suggest that they produce better results.[63]

PHI believes that implementation of cost-effective energy efficiency and conservation measures could help lower electricity costs for Maryland customers.[64] Such measures should be developed and implemented by the utilities, subject to Commission approval.[65] The utilities should be entitled to recover any revenues lost through such programs, either according to a calculated amount, or as the result of revenue stabilization measures.[66] Witness Wathen also stated that PHI opposes municipal opt-out aggregation because it reduces Commission control over electricity supply and creates

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[56] Id.
[57] Id. at 13:i1s.
[58] Id. at 14.
[59] Schaub rebuttal pp. 6-7.
[60] Id. at 9-11, 21.
[61] Schaub Direct, pp. 10-11.
[62] Schaub rebuttal, p. 12.
[63] Id. at 22-29.
[64] Pepco/DPL Exh. 1 at 3.
[65] Id. at 4-5.
[66] Id. at 8-9.

risks for wholesale suppliers.[67] The result is likely to be higher prices for all SOS customers.[68]

PHI also contended that any move to introduce bid rejection concepts into the SOS bid procurement process would destroy the SOS procurement market.[69] It advised that any bid rejections should remain within the purview of the Commission, and exercised only for demonstrated serious flaws or lack of integrity in any particular bid cycle.[70]

SMECO

SMECO witness Cox noted that as a cooperative utility, the procurement provisions of SB 1 do not apply to SMECO. She offered her testimony to provide the Commission with information on what SMECO believes has been a successful alternative method of procuring SOS supply.[71] Given the differences between a cooperative and an investor-owned utility, SMECO made no recommendation that the Commission adopt SMECO's procurement approach for the investor-owned utilities.[72]

Witness Cox described SMECO's managed portfolio as containing a variety of products purchased on markets, through brokers, and via bilateral negotiations. [73] In partnership with ACES Power Management, SMECO carefully assesses its power needs and market conditions to determine which products to purchase. [74] SMECO seeks to provide its members with reliable power at the lowest possible price, in a manner that roughly tracks market prices, but limits customers' exposure to substantial price spikes.[75] SMECO witness Cox believes the Cooperative has succeeded in reducing price volatility

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[67] Id. at 10-11.
[68] Id. at 11.
[69] Id. at 38.
[10] Id. „
[71] SMECO Exh. 1 at 4-5. Staff concurs that the provisions of SB 1 do n t appear to apply to SMECO. Staffs position with respect to the merits and hazards of SMECO's procurement method is a matter of public record in the docket of Case 8985, *In the Matter of the Provision of Standard Offer Service by Southern Maryland Electric Cooperative, Inc.*, and has not changed. Staff is not at this time recommending any changes to SMECO's procurement model. Tr. at 479.
[72] SMECO Exh. 1 at 6.
[73] Id. at 7.
[74] Id. at 7-17.
[75] Id. at 9.

for its members.[76] SMECO can support demand side management spending, but stated that any such spending must be done in a cost-effective manner.[77]

OFFICE OF **THE** PEOPLE'S COUNSEL

OPC witness Alexander believes the Commission should take prompt steps to implement the policies enunciated in SB 1, including implementation of procurement options likely to provide benefits to customers.[78] Witness Alexander stated that the Commission should use the aggregated power of the residential class to obtain the best possible SOS bargain on their behalf.[79] According to witness Alexander, the purpose of SOS is to assure stable, reasonable, and affordable rates for customers who are not served by a competitive supplier.[80] Long term affordability can only be assured by examining var10us supply options available over a longer-term planning period such as 10-15 years.[81] Witness Alexander believes that individual customers lack bargaining power relative to competitive electricity suppliers.[82] Since she believes that experience in other jurisdictions suggests that suppliers cannot be relied upon to meet their contractual obligations, there must always be a default supplier with an obligation to serve and to provide that service at "a reasonable and stable price."[83]

Ms. Alexander interpreted the SB 1 requirement that the Commission consider market conditions at the time of procurement to mean that SOS providers should get the best deal available for their customers, given that there are a variety of market prices for a given product or service.[84] SOS prices should reflect only actual and documented prices of providing the service, which should be a blended price for all of the products included in the supply portfolio. [85] According to Ms. Alexander, residential customers have a documented preference for price stability and would be willing to pay a small premium to obtain it.[86] OPC's witness noted that no sustainable or robust retail competitive market

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[76] Id. at 17-18.
[77] SMECO'•Exh. 2, at 8,
[78] OPC Exh. 10 at 3.
[79] Id.
[80] Id. at 4.
[81] Id.
[82] Id.
[83] Id.
[84] Id. at 5.
[85] Id.
[s6] Id.

has developed for residential customers.[87] Witness Alexander believes that SB 1 makes SOS a permanent service for residential and small commercial customers and that default service accordingly has no application for these customers.[88] Ms. Alexander recommended that the Commission require the utilities to begin, as soon as possible, a procurement planning process that would consider all of the procurement options permitted under SB 1, over a 10-15 year planning period.[89]

OPC witness Wallach described the existing SOS procurement process, and notes that Pepco's rates appear to have increased more slowly over the last three years than would have been the case had Pepco used only one-year contracts.[90] However, he also stated that the existing approach has exposed customers to unreasonable price increases.[91] Witness Wallach attributes these increases to developments in PJM's spot markets, including increasing commodity prices, reliance on natural gas as the marginal fuel,· increased congestion costs, and the implementation of "scarcity-pricing rules."[92] These developments have increased the risks for wholesale suppliers providing full requirements service.[93] According to Mr. Wallach, broadening the SOS supply portfolio to include at least some longer-term products would move SOS prices from volatile marginal prices towards more stable cost-based prices.[94] He recommended that a SOS portfolio strategy not be limited to just one type and duration of supply product.[95]

RETAIL SUPPLIERS

RESA

RESA witness Griffey believes that the existing SOS procurement framework will not lead to sustainable retail competition, because it provides customers with price signals that "become stale over time."[96] This in turn results in retail competition that is

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s1 Id.
[88] Id. at 47.
[89] Id. at 42.
[90] OPC Exh. 14 at 4.
[91] Id. at 5.
[92] Id. at 6
[93] Id. at 9.
[94] Id. at 10.
[95] Id. at 12.
[96] RESA Exh. I at 3-4.

intermittent at best.[97] According to Witness Griffey, SOS pricing should be market responsive. He therefore proposed that SOS be re-priced monthly based on the results of a monthly auction process.[98]

RESA opposes allowing the utilities to purchase electricity through long-term contracts, whether they are negotiated or bid.[99] Mr. Griffey also opposed permitting utilities to purchase or lease generation because that approach would reestablish the risks that existed for customers and utilities prior to deregulation, as well as the possibility of stranded costs.[100]

According to Witness Griffey, to the extent that energy efficiency goals are not met through the retail energy market, procurement of energy conservation and efficiency measures should be done in a compe itively neutral manner. [101] He does not object to opt-in municipal aggregation, but is concerned that opt-out aggregation would simply replace one regulated monopoly with another. [102] Mr. Griffey believes default service should come into existence after a set end date for SOS. Default service would then be viewed as a backstop service which customers may use while they seek and choose "another competitive retailer." [103] Finally, Mr. Griffey does not believe that altering the form of bidding would make it better suited to the development of a competitive market, if the result is a relatively long-term contract. [104] He stated that a variable price bid based on a monthly index, however, might have similar results to the monthly bidding proposed by RESA. [105]

WGES

WOES witness Warren pointed out that the results of the 2006-2007 procurement did not represent a failure of competition policy, but stemmed instead from large increases in fuel prices.[106] Witness Warren further noted that notwithstanding the

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[97] Id. at 4- .
[98] Id. at 7, 10.
[99] Id. at 14-15, 18.
[100] Id. at 15-16.
[101] Id, at 17.
[102] Id. at 18.
[103] Id. at 21.
[104] Id. at 22.
[105] Id.
[106] WGES Exh. I at 3.

passage of SB 1, "the over-arching policy of the 1999 [Electric Customer Choice and Competition] Act remains the creation of robust, competitive retail electricity supply markets for all the electricity consuming businesses and residents in Maryland."[107] He testified that SOS should be procured through a transparent process that provides the SOS provider and customers with access to the wholesale electricity markets.[108] According to witness Warren, the current process should continue to be used, but contracts should be limited to no more than one year.[109] The Commission may limit price volatility through the use of rate stabilization plans anq budget billing.11° To the extent that the Commission mandates procurement of energy conservation and efficiency measures, the benefits should be available to all distribution customers, regardless of whether they are on SOS or take service from a competitive supplier.[111] Mr. Warren supports municipal aggregation, but does not differentiate between opt-out and opt-in versions.[112] Finally, he believes that a default service is not the same as an SOS service that meets statutory requirements, but is a backstop service to be used after there is no longer a need for SOS.[113]

CNE

CNE witness Harvill argued that working retail energy markets are the best way to deliver benefits to electricity consumers, and that customers do best when they have access to both a market-priced SOS and all the options available from retail suppliers.[114] He testified that successful retail electricity markets require regulatory certainty, and SOS prices that reflect the full costs of providing the service.[115] Witness Harvill did not recommend a specific term for SOS contracts, but suggested that they should reflect a balance between reflecting spot market prices, and some level of price stability.[116] In determining whether markets are competitive, the Commission should use several

[107] Id. at 5f,
[108] Id. at 9.
[109] Id. at 10.
[110] Id. at 11.
[111] Id. at 14.
[112] Id. at 14-15.
[113] WGES Exh. 2 at 7.
[114] CNE Exh. 1 at 5-6.
[115] Id. at 7-8.
[116] Id. at 8-9.

metrics, including: switching trends; number of retailers and market concentration; diversity of product offerings; availability of information to customers; and customer satisfaction. [117] Mr. Harvill urged the Commission to continue its efforts to foster competitive markets. [118]

WHOLESALE SUPPLIERS

CECG

CECG witness Schnitzer believes that a full requirements product obtained through a competitive procurement is superior to either the development of new generation with rate-based cost recovery, or a managed portfolio approach. [119] Both of these approaches could undermine wholesale competition and inhibit market investment in new capacity. [120] The issue of whether there is adequate generating capacity in the region should remain under the auspices of the Regional Transmission Organization, i.e., the PJM Interconnection. [121] Witness Schnitzer stated that a fixed-price full requirements procurement delivers the price stability desired by smaller customers. [122] Finally, Mr. Schnitzer opposed opt-out municipal aggregation. According to the witness, opt-out aggregation could noticeably increase the price of SOS for non-aggregated customers because it would increase switching risks for wholesale SOS suppliers. [123]

CESI

CESI witness Gabbard believes that monthly SOS auctions in Maryland would likely lead to less wholesale supplier participation than the existing process. [124] If the load to be bid is for amounts of load that are too small, or for time periods that are too short, wholesale suppliers may use their limited resources to participate in more substantial procurements elsewhere. [125] In contrast, bidding on three-year contracts is attractive to wholesale suppliers because there are limited opportunities to bid on such

[117] Id. at 12.
[118] Id. at 14.
[119] CECG Exh. 1 at 2.
[120] Id.
[121] Id. at 6.
[122] Id. at 8.
[123] Id. at 15.
[124] CESI Exh. I at 2-3.
[12s] Id.

procurements. [126] Witness Gabbard disagreed with arguments that monthly bidding would limit migration and regulatory risks for wholesale suppliers.[127] Finally, witness Gabbard argued that three-year pricing might be different from the pricing customers would see with monthly bidding, but it is no less accurate.[128]

COMMERCIAL AND INDUSTRIAL CUSTOMERS

AOBA

AOBA witness Oliver addressed the following utility-provided SOS supply alternatives: 1) purchase electricity through negotiated contracts; 2) purchase, lease or construct generation; or 3) bid for the purchase of energy efficiency and conservation measures. Witness Oliver stated that these options would require the use of an integrated resources planning model with a re-regulated electricity supply service, as well as reasonably predictable customer load. [129] He testified that absent a competitive bidding process or well-developed integrated resource plan, it is hard to judge the reasonableness of negotiated terms. [130] Mr. Oliver stated that bids for energy conservation and efficiency measures are not feasible as long as alternative suppliers are free to compete with utility SOS.[131] Neither the utilities nor their customers should be at risk for the recovery of the costs of such measures. [132] Mr. Oliver did not see any evidence to support a contention that small commercial customers would benefit from the elimination of SOS.[133] He suggested that to facilitate competition for small commercial customers, and improve the transparency of competitive electricity pricing, the Commission could require retail suppliers to quote prices based on a standardized set of terms and conditions. [134] Finally, Mr. Oliver suggests that default service be priced in a manner that appropriately reflects the uncertain costs of providing the service, while still having prices known at least 45

[126] Id. at 4.
[127] Id. at 6-7.
[128] Id. at 7-8.
[129] AOBA Exh. 1 at 5-6.
[130] Id. at 6.
[131] Id. at 7.
[132] Id. at 8.
[133] Id. at 9-10.
[134] Id. at 11.

days prior to the month in which they will be effective.[135] Hourly price service should not be the only default service offer d to a customer.[136]

THE TECHNICAL STAFF OF THE PUBLIC SERVICE COMMISSION

Staff witness Sillin noted that the SOS power procurements that have occurred in Maryland have been. competitive and in compliance with the process required by the Commission's orders in Case No. 8908.13[7] He noted that energy is by far the largest component of wholesale power costs, and that fuel prices therefore have a significant impact on the price of wholesale power. [138] Witness Sillin described a number of alternative options for SOS power procurement, including declining clock auctions, double auctions, direct contracting, and procuring generation facilities. [139] He also described the specific SOS procurement methods, results and overall restructuring status in neighboring jurisdictions. [140] Next, Mr. Sillin described developments that could tend to change the procurement results in Maryland, either increasing or decreasing prices.[141]

In his Rebuttal Testimony, Witness Sillin identified six criteria that the Commission should use in evaluating procurement proposals: 1) reliability of service should be maintained; 2) the procurement process should be transparent; 3) the procurement method should result in prices that mirror or closely approximate electricity market conditions; 4) the SOS procurement method should not be administratively burdensome or costly; 5) price shock should be avoided if at all possible; and 6) the power procurement method selected should be competitively neutral. [142] Analyzing the parties' proposals using these criteria, he concluded that the Staff proposal made by Witness VanderHeyden best meets the stated criteria. [143] Mr. Sillin also offered Staffs vision of a default service, which is a service that could be made available in lieu of SOS,

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[135] Id. at 12-15.
[136] Id. at 15.
[137] StaffEJ<h. 5 at 7. Case 8908 is *Re Competitive Selection of Electricity Supplier/Standard Offer Service,* 94 Md. P.S.C. 113 (2003); *Re Competitive Selection of Electricity Supplier/Standard Offer Service,* 94 Md. P.S.C. 200 (2003); *Re Competitive Selection of Electricity Supplier/Standard Offer Service, Phase II,* 94 Md. P.S.C. 286 (2003).
[138] StaffExh. 5 at 9.
[139] Id. at 10-12.
[140] Id. at 12-26.
[141] Id. at 26-31.
[142] StaffExh. 6 at 4-6.
[143] Id. at 27.

after the retail market is judged fully competitive. [144] Such a service should be consistent with the default service already offered to large customers, ideally based on the hourly PJM LMPs (locational marginai prices). [145]

Staff witness VanderHeyden offered a specific SOS procurement strategy in order to balance SB 1's goals of low cost and low volatility for SOS rates. He recommended that the Commission move towards more ubiquitous time-of-use pricing as a means of implementing the SB 1 mandate regarding energy efficiency and conservation programs. [146] Witness VanderHeyden recommended against allowing the rejection of bids that have been duly submitted within the requirements of a procurement process approved by the Commission. [147] He suggested that the Commission continue to procure electricity through a full requirements bid process unless and until another method has been found to be superior. [148]

Mr. VanderHeyden's procurement approach suggested that the Commission •, mitigate price volatility and avoid price shock by creating a quarterly layered bid structure in which wholesale suppliers bid to supply power under one-year contracts. Staff's recommendation uses bids at four separate occasions during the course of a year, with each bid covering 25 percent of the SOS load. [149] Witness VanderHeyden also proposed that the Commission direct interested stakeholders to develop an "electricity road map" by which Maryland would transition from the existing SOS model to a fully competitive retail electricity market, in which all customers would receive service from a competitive supplier, or via a basic default service. [150]

Staff witness Icart addressed the issues of energy conservation and efficiency measures, and the use of long-term contracts to procure electricity. Mr. !cart concluded that there might be benefits to be gained from the solicitation of energy efficiency and conservation measures. [151] Mr. !cart reviewed five tests that have been used to determine if demand-side programs are cost effective, and noted that the Commission has primarily

[144] Id. at 24-25.
[145] Id. at 25.
[146] StaffExh. 7 at 4.
[147] Id. at 6.
[148] Id. at 10.
[149] Id. at 16-17.
[150] Id. at 13.
[151] StaffExh. 9 at 2.

relied on the Total Resource Cost test for this purpose. [152] He also reviewed past efficiency and demand response programs in Maryland, as well as programs developed in other jurisdictions. [153] Mr. Icart urged the Commission to ensure that any demand side initiatives will have results that are measurable and verifiable. [154] Finally, with respect to long term contracts, Mr. Icart took note of the history of long-term power purchase agreements entered into pursuant to federal law in Maryland, and noted that to date, they have been extremely costly to Maryland ratepayers. [155]

SUMMARY OF PARTIES' POSITIONS ON SECTION 7-510(c)(4)(ii) SOS OPTIONS

Case No. 9063 provided an opportunity for energy industry participants and other interested parties to recommend to the Commission an optimal structure for Maryland's electric industry structure going forward. As noted above, the parties to the case also provided critiques of and recommendations for changes to the provision of SOS. The following section provides an overview of the various methods authorized by SB 1 and the features of each option highlighted by parties in the case.

COMPETITIVE CONTRACTING

Section 7-510(c)(4)(ii)(l)A. requires investor owned utilities to obtain supply through a competitive process. For Maryland's investor-owned utilities, competitive procurement is currently implemented by the full requirements procurement method ("FRPM"), using competitive bidding to procure all SOS supply needs. As described above, SMECO, a non-profit cooperative, uses a managed portfolio procurement process that mixes spot purchases, contracts of multiple lengths, and a variety of hedging tools. Both methods would appear to comply with the competitive process requirements of SB 1 despite their different approaches.

Of course, as discussed earlier in this report, improvements to the FRPM that could be< implemented in time for the bid procurements for the upcoming SOS provision year were the subject of Case No. 9064. The Commission seeks to improve price

[152] Id. at 13.
[153] Id. at 4-8, 18-24.
[154] Staff Exh. I0 at 7.
[155] Id. at 9-12; Exh. EI-2.

stability while retaining the benefits of competitive bidding by moving to twice-yearly bidding and two-year contracts (pending any additional changes arising out of Case No. 9063). In this manner, Maryland ratepayers retain the fully transparent nature of the same competitive bidding auctions used by governments, corporations and individuals for a wide variety of goods and services in the American economy.

The Commission includes a brief summary of Case No. 9064 as an appendix to this report. It is available in its entirety, as is the testimony of the parties in Case No. 9063, using the Case Search feature on the Commission's web page (http://www.psc.state.md.us).

The FRPM works by breaking the total amount of customer load (by rate class) into smaller blocks (e.g., 50 megawatts). Wholesale suppliers bid on a price and number of blocks for which they will provide all of the power supply requirements, e.g., energy, capacity, line losses, blackstart, ancillary services, etc. The provision is "turnkey," and also adjusts to changes in demand arising from customer conservation, switching or new enrollments.

The length of power contracts is a key issue in SB 1 and Case No. 9063. Parties have proposed the FRPM in Case No. 9063 with variations using contracts on the order of one month up to three years. The annual frequency of procurement and percentage of load in each bid are equally important issues as contract length. The contract length impacts both the price of the contract as well as the time-period over which SOS rates are permitted to fluctuate. Short contract periods allow SOS to more closely reflect wholesale market conditions. Longer terms slow down the effect of wholesale energy price changes on SOS rates.

Although it benefits from being competitive, transparent and has the reliability of a proven method, the FRPM is the approach that generated widespread public concern in 2006 due to the increase in wholesale energy prices. Although much of the press promoted the idea that the Commission had "approved" the SOS price increases, the fact of the matter is that the price increases were the result of the wholesale market conditions existing at the time. The Commission was obligated by previous orders and restructuring legislation to conduct a wholesale bid and accept the results as long as the process by which the power was procured was competitive. To fail to do so might have resulted in a

situation where utilities had no option but to purchase spot market electricity to supply SOS load, at higher and more volatile prices.

In spite of the problems of recent history, the FRPM is a method that was developed by a broad coalition of stakeholders and has been adjusted for efficiency by the Case No. 8908 Procurement Improvement Process working group. Constellation witness Schnitzer pointed out that by using the FRPM, customers that do not switch still gain the benefit of competitive procurement at the wholesale level.

Several parties pointed out that the FRPM places the majority of supply risk on the wholesale suppliers because they provide the service at a fixed price and must respond to changes in load. Utilities do not assume risks for wholesale market price changes or fluctuations in customer usage. Any price premiums associated with supply risk are priced into the contract costs at the time of bid. By procuring competitively, wholesalers cannot overprice in exchange for supply risk or other costs, without risking the loss of sales revenue.

Concerns have also been raised that the success of the FRPM depends on the robustness of competition in the wholesale market and also that wholesale prices run higher than the cost of baseload generation due to reliance on natural gas as a marginal fuel. Another concern is that market prices are unattractive because of their variability. Thus, ultimately, concerns have been expressed that the FRPM can lead to volatile and unnecessarily high prices.

The Commission's decision in Case No. 9064 addresses at least some of the volatility issues set forth above. Many parties to Case No. 9063 also proposed addressing these concerns through a mix of different (longer or shorter) contract terms and through staggered procurements. OPC proposed competitive procurements using contracts of very long lengths and many other methods, as set forth not only above, but also in the discussions that follow on the other SOS procurement options contained in SB 1.

UTILITY OWNERSHIP OF GENERATION

Since 2000, investor-owned utilities have not owned generation, and have provided SOS by contracting for electricity. They divested themselves of generation ownership pursuant to the *1999 Act.* Provisions in SB 1, supported by some parties, direct the Commission to study whether it would be beneficial for these distribution

companies to acquire part of their SOS supply requirements by re-investing in generation plants. Re-entry of utilities into the generation function requires either purchase or construction of generation assets by the regulated distribution companies. Proponents of this approach recommend it because it breaks (at least partially) the link between wholesale power costs, the market price for the marginal fuel (natural gas and/or oil) and the rates for SOS paid by residential and small commercial customers.

MEA has estimated that the timeframe for realization of benefits to customers from this option is on the order of six years or more. The cycle for new supply development would have to incorporate planning, siting, licensing and construction. Power plants, particularly large coal-fired or nuclear baseload plants, and their attendant transmission line connections have proven to be notoriously difficult to site in populated areas. Utility generation, if pursued, would likely encounter public opposition similar to that experienced by other recent projects in energy related infrastructure, such as ', liquefied natural gas facilities or high-voltage transmission lines.

Testimony in Case No. 9063 suggests that funding (at acceptable interest rates, if at all) of utility generation may require some limitations on customer choice. As described by MEA witness Kahal, in order to secure financing on the order of billions of dollars, (as needed to construct baseload coal-fired generation of 500MW or higher), certain customers would have to be subject to monopoly generation service. Without mandatory retention of customers, utilities could be subject to un-recovered, "stranded" generation costs. Financiers of such projects would be likely to extract interest rate premiums to cover those risks if, indeed, they would be willing to lend money at all under those circumstances.

MEA's witnesses stressed that utility-owned generation would not result in a return to pre-restructuring price levels, as increased fuel, environmental compliance and new construction costs may result in significant increases over previous utility costs. Mr. Kahal also noted that the cost of purchasing generation assets provides no advantage over construction. Recent sales have priced older generation at the price of newly built capacity. While discussing price comparisons between utility generation and wholesale competitive procurement, MEA witnesses acknowledged that they could not determine with precision if the prices would be better or worse. MEA's witness states that "it is

likely that costs under a utility asset ownership scenario would be in the range of recent historical market prices." Mr. Kahal was able to state that in the case of utility owned generation taking a significant portion of a utility's portfolio, prices would be more stable than market-based prices.

The Commission Staff suggested a means to benefit from utility owned generation without also losing the benefits of competitive retail electricity. Under Staff's plan, utility generation would be funded by non-bypassable charges paid by all customers. The generation output would be resold into the competitive market as a price hedge, rather than being a component of the SOS portfolio. In this manner, SOS prices would remain market-based, while all customers would receive a credit when the market prices exceeded the cost of utility (or State-owned) generation.

Constellation provided testimony that utility ownership or, as described below, long-term contracting, could reduce the competitiveness of the wholesale market. If competitive suppliers were to suspect that their generation projects would be shut out of significant portions of SOS load by utility ownership, it would discourage investment in new projects. Its witnesses observed that utility ownership and operation of generation, and long-term supply contracts, have the effect of transferring risks away from suppliers and onto customers. They also noted that using such tools for even a portion of SOS load supply creates a utility SOS price "disjointed" from competitive wholesale pricing, with the potential to disrupt the operation of those markets.

PEPCO witness Schaub provided similar testimony. He discussed at length the risks of long-term contracts and utility ownership of generation, including fuel costs, premiums for counter-party defaults, credit rating agencies' treatment of long-term obligations as debt on company balance sheets, among many others. He further described in some detail the point that utility ownership of generation alters the load patterns that would remain to be covered by competitive procurements, thereby shifting additional risks onto the suppliers of that generation and increasing their costs. Mr. Schaub could not quantify whether the benefits of utility ownership would offset the costs and increased risks on other aspects of SOS supply.

LEAST COST PLANNING / ENERGY EFFICIENCY

No party in Case No. 9063 proposed a specific means to acquire energy efficiency programs integral with the procurement of SOS. There was a general concern from parties to accurately target potential efficiency measures, so that the results would be both cost effective and result in quantifiable energy savings. MEA addressed the potential benefits and concerns regarding the use of energy efficiency programs to reduce energy supply costs. Witness Kahal pointed out the programs in use in other states and noted that funding and cost recovery of efficiency programs remains a significant obstacle. He mentioned some states that require energy efficiency to be considered as part of infrastructure planning, e.g., for generation and transmission lines. The MEA witnesses made several points regarding the concerns of properly aligning program costs with the benefits on a customer class basis, and accounting for the total benefits of such programs which may accrue slowly yet accumulate over time.

The PSC Technical Staff recommended that time-of-use ("TOU") pricing be used to encourage energy efficiency, citing a recent Edison Electric Institute report linking on-peak pricing to reductions in overall system costs including reliability. Such an approach would require utilities to administratively determine TOU rates if the SOS bid process did not develop them directly. Both PEPCO and BGE currently have some residential customers on TOU rate schedules.

As mentioned earlier, AOBA witness Oliver suggested that energy efficiency programs would only be effective in a monopoly-generation environment. He found that it would be difficult to integrate such programs into the procurement process.

BGE stated that it is looking at new energy efficiency programs for possible implementation. Mr. Case described the conditions under which new programs might be possible, including a long-term commitment, stable and long-term funding, and appropriate incentives to the utilities for providing the programs.

All parties commenting on the issue agreed with the broad concept that energy efficiency programs should be encouraged. There was disagreement as to what entity should bring these products to market, how the cost effectiveness of the programs should be measured, and how the programs should be funded.

LONG-TERM CONTAACTS

Procurement of energy via long-term, e.g., 15-20 year, contracts has been offered as a means to stabilize prices and reduce costs by disconnecting the price of SOS from variations in wholesale prices that are reflected in short-term full-requirements contracts. OPC in particular has suggested that long-term contracting would create an incentive for private construction of new plants by creating the level of revenue certainty necessary to attract large capital investment.

Because the commitment would be long-term in nature, long-term contracting shares most of the same concerns over stranded utility costs as utility ownership. For example, utilities would have to assume production risk and their customers. might need to either return to monopoly generation service or to guarantee revenue in some fashion, such as via stranded cost payments. MEA also noted that long-term contracts might be unavailable without fuel escalation clauses, as but one example. Thus, a prevalent view of the witnesses is that the benefits of long-term contracts have a downside that must be considered when evaluating procurement options.

Parities have noted that SOS procurement that avoids the use of the wholesale market is likely to lose some of the benefits found in the PJM markets because of a smaller pool of suppliers. As Constellation Witness Schnitzer mentions, the PJM structure does not include physical barriers to entry. As a re.sult, additional suppliers, who participate financially, compete against generation owners with physical assets. Constellation notes that there are many more strong financial participants than there are generation owners. As a result, the field of bidders is larger, resulting in greater competition.

There was no support on the record in Case No. 9063 for the option of having a non-competitive negotiation between a utility and a supplier. That is, all parties agreed that procurements within the confines of the competitive market are superior to closed, private negotiations.

OPT-OUT MUNICIPAL AGGREGATION

As noted earlier, opt-out municipal aggregation is a power supply scenario where a city or town becomes the default supplier for its residents. The use of the term "opt-out" refers to the transfer of customers from utility provided SOS to another supplier

designated by the local government. Under this scenario, a customer could choose not to join the municipal group, but must do so affirmatively. In other words, inaction on the part of the customer would indicate consent to switch power suppliers and acceptance of the terms and conditions of service approved by the local government. Under "opt-in" aggregation, by contrast, a buyer's group can be established to pool customers wishing to "opt in" to the group. That is, customers still have a choice, but the customers are not automatically enrolled in the aggregation group unless they elect" to join.

Unlike opt-in aggregation, opt-out aggregation issues affect SOS procurement and retail competition in several ways. As noted by utilities and wholesale suppliers, the problem of opt-out aggregation is that it could significantly reduce the SOS contract load in an unexpected and dramatic fashion. This is so because, under opt-out aggregation, a dramatic number of customers (i.e., virtually everyone in the community) will be served by a new supplier some time during the SOS contract term. This loss[156] of load or "volumetric risk" is a concern for wholesale suppliers who must make advance commitments to procure generation resources to meet supply obligations during an SOS contract period. Wholesale suppliers who entered into contracts for the provision of SOS supply could find, during the course of a contract period, a sudden and significant mismatch between their obligation to provide a certain amount of generation and the amount of generation needed. The cost to cover such risks may be substantial, according to several witnesses to the proceeding.

While opt-out aggregation poses risks to the pricing of SOS supply, conversely it may have a positive benefit for retail choice development. The Commission has previously expressed a willingness to approve an appropriately designed opt-out pilot program that addresses some of the above-referenced risks. Some retailers, like WGES, believe municipal aggregation may be attractive because they see energy retailers as potential sources for municipal supply. Others also found the approach to be acceptable, if steps were taken to minimize the impact on SOS contract risk by synchronizing the

[156] Although concerns about SOS suppliers losing load is often discussed in relation to this issue, it bears mentioning that the reverse scenario is equally concerning. If a municipality ceases its opt out program or if the municipal supplier defaults, there could be a sudden increase in the SOS suppliers' obligations. If the wholesale cost of power is increasing, this additional load burden could present a economic risk to the SOS supplier, whose obligation to serve default load and pricing levels were fixed in a prior procurement.

date of aggregation startup with the end of an SOS contract period. If that can be done, providers of SOS service would be bidding on a smaller number of generation blocks, rather than running the risk of losing much of their customer load base in the middle of a contract.

STATUS OF PROCEEDING AND SCHEDULE FOR FINAL ORDER

After parties filed two rounds of testimony, the Commission held public evidentiary hearings on this matter on November 16 and 17, 2006. Parties in the Case filed post-hearing briefs on December 8, 2006. This report summarizes the presentations made to the Commission. The Commission will be considering the testimony and other evidence, and the arguments and recommendations contained in the briefs, as it prepares an order that contains its findings and conclusions. The Commission expects to render a decision in Case No. 9063 in 2007.

CONCLUSION

The Commission has asked for, and received, recommendations on the future of Maryland's electric industry from a broad range of interested parties including: consumer advocates, government agencies, electric utilities, energy retailers, wholesale energy suppliers, industrial and commercial customers and local governments The record in this case is enormous; however, the Commission has the advantages of both time and experience in making its decision.

The decision in Case No. 9064 has addressed the current SOS power procurement cycle; in fact, the 2007 SOS bid cycle is already underway. Therefore, decisions made in Case No. 9063 will not impact procurement procedures until the end of 2007. The prices resulting from any changes made by the Commission in Case No. 9063 would not affect residential and small commercial ratepayers until June 2008.

This schedule provides time to consider all of the options presented in this case. However, stakeholders may need time over the next year to identify implementation issues or resolve technical challenges that may arise. Maryland's implementation of the *1999 Act* has benefited from a cooperative approach by all stakeholders, beginning with Commission-organized working groups to study electric restructuring issues in the late 1990's and continuing with settlement talks and working group processes in the first half

of this decade. The ongoing processes, such as SOS procurement improvement process discussions led by Commission Staff, would benefit from a stable regulatory environment, where all parties continue to have the opportunity to participate and make their views known.

The volume of testimony and evidence in the case speak to the level of interest that Maryland's electricity market has attracted both locally and nationally. As with previous industry changes, the Commission and the State have had numerous parties willing and able to provide policy advice and implementation expertise. Collaborative processes have a successful history in Commission proceedings. The Commission looks forward to resolving the issues pertaining to the optimal electric industry structure and its requisite technical details in a manner which best meets the policy directives of the General Assembly and the needs of the public.

Appendix- **PSC** No. **Order** 81102 **in** Case **No.** 9064

Case No. 9064 addressed several issues regarding the provision of Standard Offer Service ("SOS") using the full requirements procurement method that has been the approach used in M'!.fYland since the beginning of electric restructuring in 2000. Case No. 9064 does not address changes to the SOS procurement process going forward or the longer-term requirements of SB 1 pertaining to the consideration of alternatives to the pres.ent procurement approach. The Commission in its order in Case No. 9063 will address the longer-term issues.

Accordingly, Case No. 9064 provided the Commission and the parties with the opportunity to address considerations raised in SB 1 that could be implemented in the short amount of time available prior to the start of the procurement process for power flows that will occur in the summer of 2007. It also provided the vehicle to consider changes specific to the full requirements procurement approach in light of recommendations from the Case No. 8908 Procurement Improvement Process and necessary scheduling and other changes for the upcoming bid year.

Section 7(d)(3)1 of SB 1 required the Commission to adopt a uniform definition of small commercial customer as part of its review of restructuring. The Commission included the definition of small commercial customer, as it pertains to the procurement of SOS in a manner similar to residential customers as part of the issues considered in Case 9064. The Commission found Pepco's current definition of "small commercial", i.e., customers with demand less than 25 kilowatts (or the equivalent amount of energy usage) to be an appropriate definition for Statewide use.

Order No. 81102, issued in Case No. 9064 on November 8th of this year, incorporated thirteen numbered directives to which the companies 2007 bid procurement plans needed to comply. The ordered items are as follow:

1) •, Utilities must filed compliance tariffs with SOS contract terms of no more than 2-year length with appropriate transition contracts beginning in 2007;

2) Authorization for utilities to file administratively (instead of bid-based) determined time-of-use rates;

3) The definition of small commercial customer;

4) Approval of the 2006 PIP report bid schedule, subject to Case No. 9064 modifications;

5) A revised bid-day schedule;

6) Prohibition of rejection (by a utility) for bids valid under the Commission's approved procedure;

7) Incorporation of the Price Anomaly Threshold mechanism into Type I SOS;

8) Approval of the 2006 PIP report data provision modifications;

9) Approval of modifications to notional language in the FSA;

10) Incorporation in residential SOS of a volumetric risk mitigation mechanism;

11) Exclusion of Allegheny Power's residential SOS from the procurement modifications at this time;

12) Confirmation of current procedures for residential and Type I SOS; and

13) Denial of all motions not otherwise granted.

The Commission recently approved the bid procurement plans filed by the companies pursuant to Order No. 81102 for the upcoming SOS period at an Administrative Meeting. It should be noted that the Office of People's Counsel has requested rehearing of Order No. 81102, so the Commission will consider whether to alter aspects of that order pursuant to the rehearing request.