FirstEnergy

2800 Pottsville Pike
P.O. Box 16001
Reading, PA 19612-6001

610-929-3601

Bradley A. Bingaman, Esq.
(610) 921-6203
(610) 939-8655 (Fax)

June 1, 2010

VIA OVERNIGHT UNITED PARCEL SERVICE

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor
Harrisburg, PA 17120

Re: Implementation of Act 129 of October 15, 2008; Default Service Docket No. L-2009-2095604

Dear Secretary Chiavetta:

Enclosed for filing are an original and sixteen (16) copies of Comments of Metropolitan Edison Company, Pennsylvania Electric Company and Pennsylvania Power Company pursuant to the Commission's Proposed Rulemaking Order in the above-captioned docket.

Please date stamp the additional copy and return it to me in the enclosed, postage-prepaid envelope. Please contact me if you have any questions regarding this matter.

Very truly yours,

Bradley A. Bingaman

dlm
Enclosures

c: As Per Certificate of Service

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Implementation of Act 129 of October 15, 2008; Default Service	:	**Docket No. L-2009-2095604**

COMMENTS OF METROPOLITAN EDISON COMPANY, PENNSYLVANIA ELECTRIC COMPANY AND PENNSYLVANIA POWER COMPANY

I. INTRODUCTION

On May 10, 2007, the Pennsylvania Public Utility Commission ("Commission") issued a Final Rulemaking Order regarding default service, and the Commission's default service regulations became effective on September 15, 2007[1]. The Commission also issued a separate policy statement order on February 9, 2007[2], containing certain guidelines related to default service. The default service rules and policy statement were adopted as a result of the enactment of the Electric Generation Customer Choice and Competition Act of 1996[3] ("Competition Act") which deregulated the electric utility industry in Pennsylvania and provided customers with the opportunity to choose an electric generation supplier. Pursuant to the Competition Act, electric distribution companies ("EDCs") are responsible to acquire and deliver electricity to those customers who choose not to shop or buy their electricity from an alternate electricity generation supplier ("EGS"), or whose EGS fails to provide the promised electricity. The default service rules and policy statement addressed the important details associated with providing default service in accordance with the Competition Act.

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[1] 52 Pa. Code § 54.181 *et seq.*
[2] 52 Pa. Code § 69.1801 *et seq.*
[3] 66 Pa. C.S. § 2801 *et seq.*

Act 129 of 2008 ("Act 129") became effective on November 14, 2008. Among other things, Act 129 revised certain default service requirements originally set forth in the Competition Act. The proposed rulemaking order and amended policy statement subject to the current comment period were adopted by the Commission to make the Commission's existing default service rules and policy statement consistent with the provisions contained within Act 129. The Commission's Proposed Rulemaking Order was published in the *Pennsylvania Bulletin* on May 1, 2010[4] and comments were invited from interested parties within 30 days thereafter. The Commission's proposed amendments to its Policy Statement on Default Service and Retail Markets was also published in the *Pennsylvania Bulletin* on May 1, 2010, and invited comments within 30 days.

Metropolitan Edison Company ("Met-Ed"), Pennsylvania Electric Company ("Penelec") and Pennsylvania Power Company ("Penn Power") ("FirstEnergy" or "the Companies") appreciate the opportunity to comment on the proposed revisions to the default service rules and submit the following comments in response to the Commission's draft Proposed Rulemaking Order for the implementation of Act 129 regarding default service.[5]

II. COMMENTS

The Commission's proposed changes to the default service rules incorporate the language in Act 129. The Companies generally agree with this approach and the Commission's proposed changes to the rules and policy statement. The Companies commend the Commission for

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[4] 40 Pa.B. 2267.

[5] The Companies are not submitting Comments to the proposed amendments to the Policy Statement at Docket No. M-2009-2140580. The amendments to the proposed Policy Statement incorporate the language of Act 129 into relevant sections of the existing Policy Statement similar to the approach used to revise the proposed rules. Inasmuch as the Companies generally support the Commission's approach and changes to the Policy Statement and Rules as explained in the Comments herein, the Companies are not filing Comments in the Policy Statement proceeding.

adopting this approach and amending the rules and policy statement in a manner that provides flexibility for the Commission and EDCs to implement default service programs and procure default service energy.

In addition to inviting general comments on the proposed rulemaking, the Commission also raised additional issues through 16 specific questions to be addressed by interested parties in their Comments. The Companies' responses to these specific questions are set forth in detail below.

1. What is meant by "least cost to customers over time"?

Inasmuch as it is impossible to predict the future, the General Assembly could not have intended for the Commission to define and approve the perfect default service plan that, if viewed with the benefit of hindsight years later, would have yielded a lower price than all of the endless possible alternative default service plans. Instead, Act 129's standard that the prudent mix of contracts shall be designed to ensure the least cost to customers over time must be viewed from a procurement design perspective and recognize that procurements made through a highly competitive process should be expected to produce the least cost to customers by allowing the default service provider to select the alternative which is reasonably designed to produce the least cost to customers.

The Commission's existing default service rules (and the proposed revisions) which require a competitive process are, therefore, designed to produce the least cost to customers. The portion of the sentence regarding the requirement for "least cost to customers over time" cannot be read alone and should be considered as a part of the entire sentence regarding the default service provider's obligation. The statutory language sets forth the default service provider's ("DSP") obligation to provide adequate and reliable service to customers using a prudent mix of: (1) spot market purchases; (2) short-term contracts; and (3) long-term purchase contracts of more

than four and not more than 20 years designed to obtain the least cost, but not necessarily to simply obtain the least cost to customers. It is important to distinguish that the DSP is required to use a prudent mix as the first threshold for its default service supply. The prudent mix of procurements is approved by the Commission as part of the specific company's default service plan.

Least cost should not be the sole criteria for determining prudency of default service procurements. If that was the case, then it would be likely that all DSP procurements would be done on a spot market basis. While that approach may appear to some to yield a least cost approach, it also subjects default service customers to the risk of price spikes during high use periods. These price spikes subject customers to both high prices and price volatility, and given the unpredictability of spot market pricing, may well not result in the "least cost" after all. Similarly, DSP procurements that target only long-term contracts, while protecting from price spikes possibly related to spot-market purchases, may lower the risk, but would not yield the least cost. This is the reason why the prudent mix of procurements standard is very important when evaluating the definition of "least cost to customers over time."

2. What time frame should the Commission use when evaluating whether a DSP's procurement plan produces least cost to customers over time?

The Commission should simply use the time frame covered by the DSP's procurement plan in evaluating whether a DSP's procurement plan produces least cost to customers over time. To evaluate the DSP's procurement plan for the least cost over a longer time period would add complexity, risk, and the potential to add long term stranded costs back into the regulatory equation subjecting customers to increased costs.

3. **In order to comply with the requirement that the Commission ensure that default service is adequate and reliable, should the Commission's default service regulations incorporate provisions to ensure the construction of needed generation capacity in Pennsylvania?**

The Commission's default service regulations should not incorporate provisions to ensure the construction of needed generation capacity in Pennsylvania at this time. Given that the generation rate caps that have stymied retail competition in this state for over a decade either have not yet expired or have recently expired, it is premature to make any long term assumptions regarding the amount of load that will be served through default service, therefore making any long-term commitments to supply that load premature, and perhaps even imprudent at this time. Default service by its nature is a back-up plan that is designed by policy to assure reliable service for those customers that either have not or cannot contract for generation and transmission services from an EGS.

In 2007, PJM recognized the need to maintain adequate reserve margins in the wholesale markets and created a separate capacity market known as the Reliability Pricing Model. The Companies believe that the Commission should allow the PJM capacity market to operate for a complete economic cycle before drawing any conclusions regarding the need to either participate in the changing of the PJM capacity market design or by incorporating provisions within the default service rules to further encourage construction of needed generation capacity in Pennsylvania.

While the Commission may not require an EDC to commence construction or acquire an interest in a generation facility, the Commission may consider requiring long–term generation contracts to promote the construction of generation capacity in Pennsylvania. However, the Companies believe that such an approach would not be good public policy and do not recommend that approach. Incorporating provisions for the construction of additional generation

capacity through long-term generation contracts would be similar to the approval of non-utility generation contracts that were approved and entered into in the late 1980s and early 1990s. The experience from those contracts has clearly demonstrated that the utilities that were mandated to enter into such contracts have found those non-utility generation contracts to have been over-market, and they have cost customers significant additional amounts of money over time. Any additions of capacity in Pennsylvania should be solely market-based, where the owner of the new generation would bid on a portion of the default service obligation.

If the Commission concludes that there needs to be provisions in the default service rules to ensure the construction of generation capacity in Pennsylvania, for instance requiring long-term contracts to meet the AEPS mandates, the Commission should explore non-bypassable competitively neutral alternatives to including cost recovery of such generation in the bypassable default service rates of the EDCs. For example, at Met-Ed and Penelec, the NUG Rider and SPAEC Rider are both designed to recover the cost of generation from delivery service customers in a competitively neutral manner that would assure that all customers receive the benefit of as well as pay the costs associated with such long-term generation commitments.

4. If the Commission should adopt a provision to ensure the construction of needed generation capacity, how should the default service regulations be revised?

The Companies do not believe that there should be a provision included in the regulations to ensure construction of generation capacity. However, if the Commission adopts such a provision, the regulations should be revised to include the development of a competitively neutral mechanism that would allow the costs to be borne by all delivery service customers and not be exclusively borne by an unknown volume of default service load.

5. Which approach to supply procurement – a managed portfolio approach or full requirements approach - is more likely to produce the least cost to customers over time?

There has been no compelling evidence that shows that a managed portfolio of block and spot market purchases produces a lower cost to customers over time than does a portfolio of full requirements contracts purchased at different times with different terms. There is, however, clear evidence that shows that a managed portfolio approach shifts the volumetric risk associated with the supply of default service from suppliers to buyers of default service, and that shift places more price risk on default service customers leaving them more exposed to price volatility than does a laddered portfolio of full requirements contracts.

There is also no compelling evidence to support the concept that a "managed portfolio" approach that requires "timing the market" would produce the least cost to customers over time. Such a strategy of requiring EDCs to "time the market" is unlikely to produce the least cost over time, and will likely increase the cost to all customers by adding the costs of greater infrastructure and an increased number of necessary employees to engage in the managed portfolio activity on behalf of the EDC. It will also increase the cost to all customers resulting from expensive litigation regarding hindsight reviews inappropriately probing what the EDCs should have known the markets were going to do, when it is impossible for the EDCs (or anyone else for that matter) to accurately predict future market behavior or future market prices.

6. What is a "prudent mix" of spot, long-term, and short-term contracts?

There is not one definitive prudent mix of spot, long-term, and short-term contracts because a prudent mix must not only focus on producing low cost, but it must also comply with Act 129 requirements and include an acceptable amount of price risk. While the default service rules require a separate portfolio for each class, it would not be "prudent" to include spot, long-

term, and short-term contracts in a portfolio to serve each class. For instance, EDCs should not be required to enter into any long-term contracts for the industrial class because the generation procured will likely not be needed due to customer shopping, and, therefore will result in stranded costs. Over time, the same could be said for the Residential and Commercial class customers as well. Therefore, the "prudent mix" means that while spot, long-term, and short term contracts should be considered for each class, not all products are dictated to be used in a portfolio to serve a specific class. In fact, it may not be prudent to include a long-term product in a portfolio to serve any of the customer classes.

7. Does a "prudent mix" mean that the contracts are diversified and accumulated over time?

Yes. A "prudent mix" means that the purchases will be conducted during different time periods at varying lengths for potentially different products. It also means that consideration should be given to spot, short-term, and long-term products before recommending a specific procurement plan for each customer class.

8. Should there be qualified parameters on the prudent mix? For instance, should the regulations preclude a DSP from entering into all of its long-term contracts in one year?

There should not be exclusions or qualifying parameters surrounding a prudent mix. It is likely that what constitutes a "prudent mix" will change over time with changing technologies and market conditions; therefore, the Companies believe that flexibility should continue to be provided for in the regulations.

9. Should the DSP be restricted to entering into a certain percentage of contracts per year?

No. It may be that a prudent mix for the Commercial Class would consist of all one-year contracts purchased not more than 12 months prior to power flow. Hence, while such procurements may be made during the same 12 month period, they could still be procured on four to six different dates – assuring diversity relative to timing.

10. Should there be a requirement that on a total-DSP basis, the "prudent mix" means that some quantity of the total-DSP default service load must be served through spot market purchases, some quantity must be served through short-term contracts, and some quantity must be served through long-term contracts?

Given that customers can shop and leave default service at any time, a case can be made that a prudent mix should never include long-term contracts. Mandating today that a "prudent mix" requires some minimum quantity of long-term contracts diminishes the flexibility that Act 129 contemplated and provided for in interpreting "prudent mix". If in 2014, 95 percent of the residential load is shopping, would the default service rules benefit from a requirement that says at least 50 MW of long term contracts have to be included in the residential portfolio? The Companies believe that a "prudent mix" will evolve over time, and that a minimum quantity of spot, long-term contracts, and short-term contracts should not be prescribed at this time.

11. Should there be a requirement that some quantity of each rate class procurement group's load be served by spot market purchases, some quantity through short-term contracts, and some quantity through long-term contracts? In contrast, should a DSP be permitted to rely on only one or two of those product categories with the choice depending on what would be the prudent mix and would yield the least cost to customers over time for that specific DSP?

A DSP should be permitted to rely on only one or two of those product categories if one or two of those product categories create a prudent mix and yield the least cost to customers over time.

12. Should the DSP be required to hedge its positions with futures including natural gas futures because of the link between prices of natural gas and the prices of electricity?

No. There are many ways of hedging the future cost of default service for a class. For instance, forward contracts at a fixed price work very well regardless of whether they are full requirements or block contracts. There are also financial products available that are not tied to natural gas. While there are times when hedging an electric position with futures including natural gas futures makes sense, creating a regulatory mandate to use one market method over another is unlikely to result in a prudent mix that results in the lowest cost to customers over time. It is not clear that there always exists a direct link between prices of natural gas and the price of electricity. There could be other circumstances which may cause a deviation from that correlation between the two indices. While it may be advantageous for a DSP to hedge positions as part of its default service procurement plan, it should not be mandated by regulation.

13. Is the "prudent mix" standard a different standard for each different customer class?

If the prudent mix standard is determined to require a minimum quantity of spot purchases, long-term purchases, and short-term purchases, then the prudent mix standard must be judged across all customer classes, rather than measured only for a specific customer class. However, if the prudent mix standard is determined to be a proper consideration and use of each of the different products based on the volumetric risk associated with the class, then the standard should be tied to the customer class.

14. What will be the effects of bankruptcies of wholesale suppliers to default service suppliers on the short and long term contracts?

The potential for wholesale suppliers to breach under-market contracts as a result of bankruptcy dictates that supplier master agreements must protect the EDCs and, more importantly, their default service customers by establishing appropriate credit requirements upfront in order to minimize counterparty risk while not being so overly burdensome to cause unreasonable risk premiums to appear in default service prices.

15. Does Act 129 allow for an after-the–fact review of the "cost reasonableness standard" in those cases where the approved default service plan gives the EDC substantial discretion regarding when to make purchases and how much electricity to buy in each purchase?

No, once the default service plan is approved by the Commission, which includes the approval of each specific procurement, and the inclusion of a spot market component is also approved, there should not be any after-the-fact "cost reasonableness standard" review. The Commission has approved each component of the plan, so to have a hindsight review would improperly take advantage of information that was not available at the time of the procurements. Such an unfair and unlawful review in the gathering of facts could prejudice the perceived "cost reasonableness" of the default service procurement that has already taken place. Furthermore, pursuant to 66 Pa. C.S. § 2807(e)(3.8), the Commission may only disallow costs for non-compliance with the approved plan, fraud, collusion, or market manipulation.

16. How should the requirements that "this section shall apply" to the purchase of AECs be implemented. Section 2807(e)(3.5) states that "…the provisions of this section shall apply to any type of energy purchased by a default service provider to provide electric generation supply service, including energy or alternative energy portfolio standards credits required to be purchased, etc."

The above language requires that the procurement of AECs must comply with the same procedures that govern the purchase of energy for default service. Therefore, incorporating the AECs within the products being procured for default service would be consistent with the requirement that "this section shall apply" to the purchase of AECs. Likewise, long-term or short-term purchases of AECs should be procured through an auction or request-for-proposal process, and spot purchases of AECs should be acquired via bilateral agreements through the broker market.

IV. CONCLUSION

The Companies appreciate the opportunity to comment on the Commission's Proposed Rulemaking Order regarding default service in Pennsylvania.

Respectfully submitted,

Dated: June 1, 2010

Bradley A. Bingaman
Attorney No. 90443
FirstEnergy Service Company
2800 Pottsville Pike
P.O. Box 16001
Reading, PA
(610) 921-6203
bbingaman@firstenergycorp.com

Counsel for:
Metropolitan Edison Company,
Pennsylvania Electric Company and
Pennsylvania Power Company

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Implementation of Act 129 of October 15, 2008; Default Service	:	**Docket No. L-2009-2095604**

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true and correct copy of the foregoing document upon the individuals listed below, in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant).

Service by overnight United Parcel Service, as follows:

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor
Harrisburg, PA 17120

Service by electronic mail, as follows:

Elizabeth Barnes, Assistant Counsel
Law Bureau
ebarnes@state.pa.us

Dated: June 1, 2010

Bradley A. Bingaman
Attorney No. 90443
FirstEnergy Service Company
2800 Pottsville Pike
P.O. Box 16001
Reading, Pennsylvania 19612-6001
(610) 921-6203
bbingaman@firstenergycorp.com