

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Default Service and Retail Electric Markets	:	Docket No. M-00072009
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Advance Notice of Final Rulemaking Order In Re: Rulemaking Re: Electric Distribution Companies' Obligation to Serve Retail Customers at the Conclusion of the Transition Period Pursuant to 66 Pa.C.S. § 2807(e)(2)	:	Docket No. L-00040169
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**REPLY COMMENTS OF
MORGAN STANLEY CAPITAL GROUP INC.**

I. INTRODUCTION

On February 9, 2007, the Pennsylvania Public Utility Commission (the "Commission") entered the orders regarding the Proposed Policy Statement on Default Service and Retail Electric Markets (the "Policy Statement")¹ and the Advance Notice of Final Rulemaking (the "ANFRO"),² which, among other things, create a framework for Default Service Providers ("DSPs") to acquire power for default service. On March 2, 2007, twenty-seven interested participants filed comments with the Commission regarding the Policy Statement and twenty-six interested parties filed comments with the Commission regarding the ANFRO (together, the "Comments"). Morgan Stanley Capital Group Inc. ("MSCG") hereby submits these reply comments in response to certain Comments.

¹ *Proposed Policy Statement In Re: Default Service and Retail Electric Markets*, Commission Docket No. M-00072009 (entered Feb. 9, 2007) (the "Proposed Policy Order").

² *Advance Notice of Final Rulemaking Order In Re: Rulemaking Re: Electric Distribution Companies' Obligation to Serve Retail Customers at the Conclusion of the Transition Period Pursuant to 66 Pa.C.S. § 2807(e)(2)*, Commission Docket No. L-00040169 (entered Feb. 9, 2007).

II. SPECIFIC RESPONSES TO THE COMMENTS

Issue 1: DSPs Should Have the Flexibility To Unbundle Default Supply Into Separate Component Products

MSCG agrees with the comments of the Office of Consumer Advocate (the “OCA”) and UGI Utilities, Inc., to the extent they advocate for DSPs to have the flexibility to procure separately the component parts of default supply. Rather than rely solely on a single form of load following product, DSPs would be able to contract for a basket of different products, including energy, capacity, ancillary services, demand response and renewables, with different durations and sources, to diversify its supply. The DSPs should have the flexibility to separately contract for demand response products, renewable energy products and related products at the proper wholesale price. While the Proposed Rules and ANFRO advocate DSP flexibility,³ they tend to favor load-following products over separate procurements for component products.⁴ Accordingly, the Commission should clarify that DSPs may procure default supply in component parts, rather than solely rely on load following products.

MSCG disagrees with the comments of Allegheny, which advocate that DSPs should be restricted to “plain vanilla” products, and that only retail providers should be allowed to take advantage of “differentiated, specialized products and services.”⁵ For DSPs to offer appropriate services, they must be given the flexibility to contract with wholesale suppliers for the full array of products and services that wholesale suppliers can provide. Artificial constraints on the types of products and services that DSPs can utilize will necessarily decouple the price of wholesale

³ “[W]e have concluded that each DSP should craft an approach best suited to its own service territory.” Proposed Policy Order, 4.

⁴ ANFRO § 69.1807(c), for example, limits competitive bid solicitations to tranches of load within each customer class.

⁵ Allegheny Power Comments, 4.

power and related products from the cost of default supply. Accordingly, the Commission should not restrict DSPs to procuring standardized products.

Issue 2: Default Service Should Be Procured Through Bilateral Contracts or a Standard Procurement Process

MSCG agrees with the comments of Duquesne Light Company and the OCA that advocate allowing DSPs to retain flexibility over the process for procuring default supply, so long as such procurement processes espouse the principals of transparency, consistency and fairness. These procurements could be stylized as a formal request for proposals, a wholesale auction or an arms-length bilateral contract. The Commission, however, should limit this flexibility by requiring certain standard concepts to be included in any procurement to ensure that such procurement is transparent, fair and competitive. Although not an exhaustive list, the Commission should require the following industry-standard principles up-front now for inclusion in any solicitation, regardless of the product type or solicitation method, so that all potential suppliers, the DSPs, regulators and other stakeholders are certain as to the rules *prior* to the solicitation, thus ensuring a transparent, fair and competitive process:

- *Parameters of Product:* Responsibilities should be clearly defined in the agreement that governs the product to be provided. For example, bidders should not be responsible for changes to transmission-related costs and taxes. The timing and scale of increases in such costs are determined through an administrative, not market process. Such cost changes cannot be estimated or modeled accurately or hedged by suppliers. If bidders are responsible for administratively determined cost changes, which cannot be hedged, they inevitably will include in their bids an inherently inaccurate estimation of cost increases as well as a premium to address the regulatory risk of such increases. Thus, consumers will be obligated to pay for winning bidders' *estimated prediction* of such costs, rather than the actual, administratively determined cost.
- *Bilateral Credit Provisions:* The inclusion of reasonable, industry-standard bilateral credit terms (such as those credit and margin terms in the EEI Master Agreement) will increase the bidders' ability to participate fully in Pennsylvania default service procurements. Many suppliers, including financial institutions such as MSCG, have internal treasury requirements limiting credit exposure to a particular counterparty. Adopting bilateral credit provisions helps to address the risk to suppliers of potential

insolvency of the utility and thus increases the likelihood that a supplier will participate or participate fully in the default service procurement. The most straightforward solution is to include industry standard credit provisions in the agreement that require both the utilities and the suppliers to supply credit support to each other if certain credit rating events or mark-to-market margining levels are realized.

- In addition to bilateral credit provisions, the agreement should provide that in the event that a utility is downgraded to below investment grade, the utility will: (1) at the request of the supplier, transfer all cash collateral being held pursuant to the agreement to an independent collateral agent; and (2) accelerate payments to suppliers so that the billing period is shortened from each calendar month to each calendar half-month. Although this does not address fully the risk to suppliers of a utility bankruptcy, it does help address the security of collateral and some cash flow issues, should the utility become insolvent.⁶
- As part of the application and bidder qualification process, we recommend that the DSPs provide a procedure for parties to submit alternative forms of financial security for review and acceptance, such as parent company guarantees and letters of credit.
- *Two-way Termination:* The standardized agreement should include a “two way” default payment structure that allows netting of settlement amounts. Netting of settlement amounts allows each party to set-off the amount that the defaulting and non-defaulting parties owe each other. This benefits both parties’ creditworthiness by limiting each party’s exposure to the other. Two-way settlement provisions are the standard in the industry as well as in other commodity industries.⁷ Without two-way termination payments, one party may actually have an incentive to cause the other party to default, in order to avoid the obligation to make a termination payment while avoiding the negative ramifications associated with being the defaulting party. Two-way termination payment provisions would thus provide the appropriate incentive to both parties to the agreement to honor its terms.
- *Notional Quantity:* In the case of load-following agreements, in the event an agreement is terminated early, the agreement should set forth explicit calculation methods to determine any termination payment that is due. Specifically, the remaining volume should be based on the previous years’ data, adjusted for known changes to load.⁸ Such

⁶ See, e.g., ComEd CPP-A, Section 6.8.b, and Section 9.1.

⁷ See EEI Agreement § 5.3.

⁸ See, e.g., ComEd CPP-A, Section 5.4.a “Settlement Amount.”

After the Non-Defaulting Party has provided the notice specified in Section 5.2(ii), the Non-Defaulting Party shall calculate, in a commercially reasonable manner and consistently with the calculation of Damages in this Agreement, a Settlement Amount under this Agreement. For the purposes of such determination, the quantities of CPP-A Supply provided for under this Agreement for the period following the Early Termination Date through the Natural Termination Date shall be deemed to be those quantities that would have been delivered on an hourly basis had this Agreement been in effect during the previous calendar year adjusted for such CPP-A Load changes as may have occurred since the previous calendar year.

language is included in nearly all states' standard offer contracts. This language creates a notional quantity, allowing parties utilizing mark-to-market accounting to treat the agreement as a derivative without impacting the ability of counterparties to use accrual accounting if desired. Continued inclusion of this language ensures that a diverse group of suppliers using different accounting methods can participate in default service procurements.

- *Governing Law and Jury Trial Waiver:* The agreement should provide that the law governing interpretation of the agreement is New York law, a well-developed and widely accepted body of contract and commercial law. The agreement also should include a jury trial waiver provision. The EEI Master Agreement sets forth a commonly used industry standard provision containing these principals.⁹ Using the EEI Master Agreement standard provision will reduce the legal uncertainty and risk related to the agreement.

Issue 3: DSP Supply Contracts With Affiliates

Although MSCG agrees that DSPs should be able to negotiate bilateral contracts for the provision of default supply (along with other methods of procurement, including auctions and RFPs, that would have a form of contract applicable to all bidders agreed to prior to the solicitation) as long as they contain the standard provisions discussed in our response to Issue 2 above, the Commission should not permit the DSP to do so with its affiliates. Duquesne Light Company's and Industrial Energy Consumers of Pennsylvania's comments in favor of allowing a DSP to bilaterally contract with its affiliates for default supply, without engaging in an objective and competitive solicitation process, will, if implemented, greatly diminish suppliers' interest overall in providing default supply.

Without the proper oversight and protections against favoritism that can be implemented in a solicitation process (either through a request for proposals or auction or other competitive structure), DSP affiliates may use their relationship with the DSP to provide default supply at

⁹ "10.6 Governing Law. THIS AGREEMENT AND THE RIGHTS AND DUTIES OF THE PARTIES HEREUNDER SHALL BE GOVERNED BY AND CONSTRUED, ENFORCED AND PERFORMED IN ACCORDANCE WITH THE LAWS OF THE STATE OF NEW YORK, WITHOUT REGARD TO PRINCIPALS OF CONFLICTS OF LAW. EACH PARTY WAIVES ITS RESPECTIVE RIGHT TO ANY JURY TRIAL WITH RESPECT TO ANY LITIGATION ARISING UNDER OR IN CONNECTION WITH THIS AGREEMENT." EEI Master Agreement, Edison Electric Institute § 10.6 (April 25, 2000).

rates above the proper wholesale price. To the extent there is a compelling need for bilateral negotiations between a DSP affiliate and a DSP, the DSP should go to the Commission prior to negotiations, explain why a competitive solicitation would not be an adequate procurement method to acquire the particular product and allow interested parties to comment on the DSPs request if they so desire. This will afford the Commission an opportunity to create adequate safeguards to protect the integrity and transparency of bilateral negotiations between affiliates where, if ever, there are significant reasons to have bilateral negotiations in lieu of a solicitation-stylized procurement. Accordingly, the Commission should continue to prohibit DSPs from acquiring default supply from their affiliates through bilateral negotiations without further formal Commission action.

Issue 4: Release of Confidential Information

MSCG supports the comments of Constellation, which request the Commission to clarify that the names of winning bidders in a procurement process will not be released any earlier than ninety days after the supply contracts are executed between the winning bidders and the DSPs, and supports the comments of Consolidated Edison Solutions, Inc., which encourage the Commission to maintain confidentiality about specific supplier bids and awards.¹⁰ To release the winning bidders' names any earlier will harm bidders' ability to acquire their supplies effectively and competitively in the wholesale markets. Even after bidders are notified by the Commission of their status as winning bidders, such winning bidders continue to hedge their portfolios and layer in supply through transactions in the wholesale markets.

¹⁰ See Consolidated Edison Solutions, Inc. Comments, 3.

MSCG disagrees with the comments of the Office of Small Business Advocate, which argue that statutory advocates should be given access to bids and bid methodology, regardless of confidentiality issues.¹¹ It is not clear what level of protection, if any, would be provided to such clearly confidential and commercially sensitive information. MSCG opposes the release of any information relating to bidding strategy or any other commercially sensitive information. Such information is the core business expertise that makes firms successful, and releasing it is tantamount to giving a firm's competitors all of its strategies for "how it's done" (e.g. Coke giving Pepsi its secret formula). In a highly competitive energy market place, the release of such information will significantly discourage bidder participation and dampen competition. Furthermore, the requests for commercially sensitive information may not stop there. "Statutory advocates" might then ask for highly proprietary hedging strategies associated with the risk management of a supplier's portfolio. Suppliers manage a portfolio of risks, including supply obligations, purchases and physical and financial hedges. Therefore, no one obligation such as a default product is matched with a particular purchase or hedge. Moreover, such information is irrelevant to the Commission's task at hand – to ensure the procurement was fair and the results are competitive.

Issue 5: Automatic or Retroactive Application of Changes to Commission Policy or Regulations.

MSCG supports the comments of Constellation, which request the Commission to clarify that: (1) while policies with respect to default service, and their implementation, may be modified by the Commission at a later time, such modifications will not disrupt the sanctity of contracts already executed between suppliers and DSPs; and (2) contract prices paid to suppliers

¹¹ See Office of Small Business Advocate Comments, 7-8.

will not be retroactively adjusted. Any possibility of retroactive modification to the price or terms of contracts entered into between suppliers and DSPs will present an unacceptable risk to potential bidders, thereby greatly decreasing participation and competition in any procurement. MSCG urges the Commission to state explicitly that any future modifications to the Policy Statement or rules governing default service supply will not retroactively modify such contracts or prices.

V. CONCLUSION

MSCG encourages the Commission to consider and adopt our suggested recommendations herein. Our proposals ultimately will help to ensure supplier participation, the likelihood of lower wholesale bids, and thus the lower costs to consumers of default service. MSCG looks forward to continued involvement in this process and appreciates the opportunity to submit these reply comments.

Respectfully,



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