STATE OF NEW YORK

PUBLIC SERVICE COMMISSION

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| Proceeding on Motion of the Commission as to Policies, Practices and Procedures for Utility Commodity Supply Service to Residential and Small Commercial Industrial Customers | Case 06-M-1017 |

# INITIAL COMMENTS OF THE NEW YORK STATE CONSUMER PROTECTION BOARD

Teresa A. Santiago
Chairperson and Executive Director

Douglas W. Elfner
Director of Utility Intervention

David Prestemon
Intervenor Attorney

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Albany, New York

NYS CONSUMER PROTECTION BOARD
5 EMPIRE STATE PLAZA
SUITE 2101
ALBANY, NY 12223-1556
http://www.nysconsumer.gov

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By order issued August 28, 2006, the Public Service Commission asked interested parties to: (1) identify actions that should be taken to protect residential and small business customers who purchase commodity service from utilities against market price volatility and (2) address related issues including mechanisms for recovering utilities' commodity-related costs and for disclosing utility supply portfolio price information.[1] The PSC currently allows utilities broad discretion in their commodity price hedging practices, has expressed a preference to expose customers to spot market price volatility when competitive alternatives are freely available, and discourages utilities from entering into long-term contracts for supply to replace expiring "legacy hedges."[2]

Since its August 2004 Policy Statement was issued, however, it has become apparent that residential and small business customers continue to need protection

[1] Case 06-M-1017, Order Instituting Proceeding and Notice Soliciting Comments, August 28, 2006 ("August 2006 Order").

[2] Case 00-M-0504, Proceeding on Motion of the Commission Regarding Provider of Last Resort Responsibilities, the Role of Utilities in Competitive Energy Markets and Fostering Development of Retail Competitive Opportunities, Statement of Policy on Further Steps Toward Competition in Retail Energy Markets, August 24, 2004 ("August 2004 Policy Statement"), pp. 31 - 34.

from severe upward price swings. Electricity and natural gas commodity prices have become increasingly volatile and have spiked to all-time highs at times over the last two years. Consumers and the state's economy have suffered as a result.

In the meantime, competitively provided alternatives to utility pricing have not been sufficiently attractive to residential and small business consumers to promote the growth of retail access at the level that might have been expected a few years ago. Despite heightened awareness of energy prices by consumers, financial rewards to utilities based on migration to ESCOs, and continuation of PSC-endorsed programs that originally were conceived as "interim" or "temporary," the vast majority of residential and small business consumers still are not seeing any benefit in switching suppliers.

In these circumstances, the Consumer Protection Board recommends that the Commission require utilities to structure their commodity portfolios in a manner that provides significant price risk mitigation for smaller customers. Those portfolios should include a balance of spot market purchases, generally available physical and financial hedges, and term contracts up to three years in duration, without over-dependence on any one alternative. With the guidelines we suggest below, such portfolios will mitigate price risk for consumers without impinging upon the development of competitive alternatives.

**Issues 1 and 6[3] - Portfolio structuring and the use of longer-term strategies.**

Utilities should be required to maintain a diverse, balanced portfolio of physical and financial supply arrangements for residential and small commercial customers designed to mitigate forward price volatility, but they should be permitted to exercise

[3] As listed in the August 6, 2006, Order at pp. 6-7.

broad discretion in designing those portfolios. The relative values of various supply options are constantly shifting. What appears to be a good mix in one time period may look very risky in another. Mandating a specific portfolio structure is likely to force bad decisions as often as it produces good ones. On the other hand, permitting over-reliance on a single purchasing strategy defeats the risk mitigation value of a portfolio approach. Consequently, we recommend that the Commission adopt the three general guidelines discussed below.

1. No more than 60% of a utility's supply requirements for smaller customers should be met with spot market purchases. The August 2004 Policy Statement provides limited guidance in this area, stating only that portfolios including zero or 100% spot purchases would be unacceptable.[4] Either of these extremes reflects a passive approach to price risk management that is unlikely to be in consumers' interest. As found in a recent study conducted on behalf of the National Association of Regulatory Utility Commissioners, "a narrow, passive approach to portfolio management may expose retail customers to rates that are higher or more volatile, than a comprehensive, active approach."[5] It went on to suggest that:

> recent developments in the competitive wholesale electricity markets create greater opportunities but also greater pitfalls. A passive or inactive utility is more likely to suffer from the pitfalls than benefit from the new opportunities….Utilities, even in states with restructured electricity industries, may need to take another look at how and why to manage resource portfolios.[6]

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4 Policy Statement, p. 33.

5 Energy Portfolio Management: Tools & Resources for State Public Utility Commissions, prepared by Synapse Energy Economics, Prepared for Consideration of NARUC, October 2006. p. 6.

6 Id., p. 39.

Small customers, both residential and commercial, have clearly demonstrated that they are price risk averse by opting overwhelmingly for fixed price commodity services in those territories where they have been available. The Commission, itself, has repeatedly recognized this demand for stability and has viewed it as an opportunity to be exploited by competitive marketers.[7] Given this very basic desire of customers to limit their exposure to price volatility, it simply makes no sense to suggest that a utility can meet its obligation to serve the public interest by relying virtually entirely on spot purchases and making no effort at all to mitigate price risk.

Utilities have historically undertaken measures to reduce the volatility of their commodity prices. The operation of traditional gas adjustment and fuel adjustment clauses, for example, significantly dampens short-term price swings. In the absence of adequate guidance on acceptable portfolio management, utilities may have an incentive to increase the price and/or volatility of the commodity service they provide, particularly when they receive financial rewards based on the number of customers that migrate to ESCOs. Con Edison's current rate plans have such provisions,[8] and provide the Company a powerful incentive to make its commodity service less palatable to consumers. Artificially degrading utility service in order to make the offerings of unregulated providers appear more attractive is not an acceptable means of promoting the development of retail competition. It is also not necessary.

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7 Policy Statement, p. 31.

8 Case 04-E-0572, Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Consolidated Edison Company of New York, Inc. for Electric Service, Order Adopting Three-Year Rate Plan, "Joint Proposal," March 24, 2005, , pp. 29 – 31; Case 03-G-1671, Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Consolidated Edison Company of New York, Inc. for Gas Service, Order Adopting the Terms of a Joint Proposal, September 27, 2004, Joint Proposal, pp. 29 – 30.

Unregulated suppliers have a major advantage over utilities. They can make money by lowering their commodity costs below those of their competitors. Utilities cannot. The obligation of utilities is to act prudently. Once they have structured a portfolio that brings their costs within the "zone of prudence," they have little to gain, and much to lose, by taking additional risks.

Competitive suppliers, by contrast, have an incentive to maintain a continuous presence in the market and to trade and re-trade their positions in an effort to obtain the lowest possible weighted average cost of supplies. As long as utilities and competitive suppliers have comparable purchasing and hedging options, the competitive entities should be able to offer the most attractive prices to consumers without any artificial worsening of utility offerings. Our recommendations assure that such comparability will be maintained.

Overall, the PSC should provide more guidance to utilities regarding acceptable supply portfolios, particularly utilities with a financial incentive to migrate customers to ESCOs.

2. <u>The physical and financial arrangements utilized should be ones that are normally readily available to all market participants</u>. Advantageous legacy contracts included in the commodity price charged by utilities present an impediment to competition because they cannot be replicated, even by an entirely competent competitor. In most cases, this is because the underlying capital costs were recovered long ago from ratepayers. Forward contracts, futures, swaps, options and similar physical and financial supply arrangements present no such problem. They are readily

available on comparable terms to all market participants and utilities should be permitted to use them freely in structuring their portfolios.

3. Contracts intended to mitigate price risk which have a fixed, capped or collared price, or combinations of physical contracts and financial instruments producing the same result, should be limited to terms of three years or less. The other important aspect of utility service that cannot be replicated by competitive entities is the assurance of recovery of prudently incurred costs. The state's interest in protecting the financial health of its utilities generally requires that they be shielded from the adverse financial consequences of purchasing decisions that were reasonable at the time they were made. Competitive entities get no such protection. With utilities, ratepayers bear the risk involved in purchasing decisions. Competitive suppliers may or may not be able to pass that risk to their customers. Consequently, it is far less risky for a utility to include a long-term, fixed-price contract in its portfolio than it is for an unregulated supplier.

At the same time, limiting utilities to only spot and short-term purchases and hedges will minimize their ability to dampen price volatility. A reasonable level of longer term arrangements is an essential element of a balanced portfolio for any supplier. Therefore, we recommend that hedged components of utility supply portfolios for purposes of mitigating customer bill volatility, extend no farther than three years into the future.[9]

Subject to these limitations, utility price risk management efforts will not distort market price signals to consumers, and will be more likely to promote development of retail competition than to impede it.

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[9] Contracts for public policy purposes such as system reliability, mitigation of market power and environmental considerations, could be of longer duration.

**<u>Issue No. 2</u> – What is the appropriate balance between efforts to mitigate customer exposure to price volatility and to send those customers accurate price signals?**

If utility supply portfolios were structured in the manner we recommend above, the residual price volatility in those portfolios would still send accurate price signals to consumers. There is no rational justification for equating price signal accuracy with spot market prices. No competitive supplier that hopes to acquire and retain customers is going to rely entirely on unhedged spot purchases to meet its contractual obligations. As long as those suppliers can structure supply portfolios comparable to those that are included in the commodity price charged by utilities, consumers will have an accurate picture of what the competitive market has to offer.

**<u>Issue No. 4</u> – Should electric utility hedging costs, and the values achieved with reference to spot market prices, be recovered in commodity charges or delivery charges?**

"Legacy hedges" result from past utility practices or decisions for which it has been decided that all, or certain classes, of ratepayers are financially responsible. The benefit or detriment of these past arrangements in relation to current market prices is completely independent of customer commodity purchasing decisions. Consequently, the values associated with them should be passed to the responsible rate classes through charges that are independent of those commodity choices. The inclusion by NYSEG of the benefit of hydroelectric output and its Nine Mile nuclear contract, and the cost of its NUG contracts, in the non-bypassable wires charge, for example, is an appropriate method of dealing with such legacy transactions.

For current supply portfolio management efforts, all costs incurred, and the prices actually realized by a utility should be passed to customers through the commodity charge.[10] This is the cost of the supply portfolio that includes measures aimed at reducing price risk. Comparison of that cost to the daily, or hourly, spot market price is completely pointless. Customers are paying for insurance against price spikes, and if they feel that insurance is too costly, they can choose an alternative supplier. Moving the "cost of insurance" form the commodity charge to the delivery charge would impair, rather than improve, price transparency and comparability.

**Issue No. 7 – What utility supply portfolio information should be revealed by utilities to promote price transparency, and how?**

It is very difficult to comprehend how having detailed information about the structure of a utility's supply portfolio could be useful to consumers in making purchasing decisions, or to competitive suppliers in making marketing decisions. It is also hard to understand how revealing that information would be detrimental to a utility or its ratepayers. Absent some concrete examples of the benefits or harm that would result from such disclosures, we find it difficult to express any opinion as to what should be mandated. We do believe, however, as we stated in the ESCO Price Reporting proceeding recently concluded, that requiring utilities to present current and forecast retail price information in a manner that facilitates comparison with competitive lternatives would be of great assistance to consumers in reaching well-informed supply decisions.[11]

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10 Supply contracts for public policy purposes such as system reliability, market power mitigation and environmental considerations should be recovered in delivery rates since they benefit all customers.

11 Case 06-M-0647, In the Matter of Energy Service Company Price Reporting Requirements, Comments of the New York State Consumer Protection Board, July 25, 2006.

## CONCLUSION

The recommendations we make herein will assure that utility supply portfolios will provide needed price risk mitigation for residential and small commercial customers without impeding the development of competitive markets. We urge their adoption.

Respectfully submitted,

Teresa A. Santiago
Chairperson and Executive Director

Douglas W. Elfner
Director of Utility Intervention

David Prestemon
Utility Intervenor Attorney

Dated: November 17, 2006
Albany, New York