PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA
1333 H STREET N.W., 2nd FLOOR, WEST TOWER
WASHINGTON, D.C. 20005

ORDER ADOPTING WHOLESALE STANDARD OFFER SERVICE PROCESS

March 1, 2004

FORMAL CASE NO. 1017, IN THE MATTER OF THE DEVELOPMENT AND DESIGNATION OF STANDARD OFFER SERVICE IN THE DISTRICT OF COLUMBIA, ORDER NO. 13118

I. INTRODUCTION

1. By this Order, the Public Service Commission of the District of Columbia ("Commission") hereby adopts the wholesale Standard Offer Service ("SOS") model to govern the provision of SOS in the District of Columbia ("District") in conformance with the Retail Electric Competition and Consumer Protection Act of 1999 ("Act"), as amended.[1]

II. BACKGROUND

2. Pursuant to Section 34-1509(c) of the Act, the Commission was required to adopt regulations or issue orders establishing the terms and conditions for standard offer service and for the selection of an electricity supplier to provide SOS before January 2, 2004.[2]

3. On December 4, 2003, through Order No. 13005,[3] the Commission released for comment, draft wholesale SOS rules and regulations. In a companion Order issued on the same day, the Commission established a SOS Working Group and advised parties that they should consider the issues set forth in the December 4 Wholesale Order and the September 30, 2003 Order proposing retail rules.[4] It was the collective opinion of the

[1] *See* the Retail Electric Competition and Consumer Protection Act of 1999 ("Act"), D.C. Code, 2001 Ed. §§ 34-1501-1520. On January 6, 2004, the Council of the District of Columbia approved Bill 15-0439, "Electric Standard Offer Service Amendment Act of 2003," which gives the Commission the discretion to choose either wholesale or retail as the bidding model for the implementation of SOS.

[2] *See* Act at Section 109(c), D.C. Code, § 34-1509(c), as amended.

[3] *Formal Case No. 1017*, Order No. 13005, rel. December 4, 2003. ("December 4 Wholesale Order").

[4] *See Formal Case No. 1017*, Order No. 12932, rel. September 30, 2003. On December 18, 2003, PEPCO, as administrator of the SOS Working Group process, filed the Report of the Working Group. PEPCO maintains that the Working Group, which met on December 10, 2003, was comprised of all parties in this case. *Formal Case No. 1017*, Report of the Working Group at 1, filed December 18, 2003.

Commission that the formulation and establishment of a SOS Working Group would streamline and expedite the SOS process. The Commission further determined that a collaborative approach among parties on the various issues and comments would lead to a more comprehensive and reasoned set of SOS regulations in the District of Columbia.

4. On December 31, 2003, the Commission issued Order No. 13028 which adopted wholesale SOS rules and regulations.[5] On the same day, the Commission issued Order No. 13027, a companion order which adopted retail SOS rules and regulations.[6] On January 9, 2004, the Commission issued Order No. 13035 which sought comment on the preferred model for the implementation of SOS in the District.[7] On January 29, 2004, timely comments were filed by the parties.[8] PSEG Energy Resources & Trade LLC ("PSEG") filed late comments on January 30, 2004. In order to have a complete record upon which we will consider the preferred process for the implementation of SOS, we find good cause to grant the filing of these comments out of time. Parties are reminded, however, that filings made out of time must either be preceded by a request for extension or accompanied by a request for leave to file. On February 9, 2004, parties filed reply comments.[9]

5. Also, on January 29, 2004, parties filed Motions for Reconsideration of Order No. 13028.[10] On February 9, 2004, parties filed Responses to the Motions for Reconsideration.[11] The focus of this order is on the selection of a model for the implementation of SOS in the District. Therefore, to the extent parties raised particular issues about the implementation of SOS or about SOS Rules and Regulations adopted in Order No. 13028, those arguments will be addressed in future Commission Orders on Reconsideration.

5 *See Formal Case No. 1017,* Order No. 13028, rel. December 31, 2003.

6 *See Formal Case No. 1017,* Order No 13027, rel. December 31, 2003.

7 *See Formal Case No. 1017,* Order No. 13035, rel. January 9, 2004.

8 The following parties filed timely comments: Constellation Power Source, Inc. and Constellation New Energy, Inc. (collectively "Constellation"), the Office of the People's Counsel ('OPC"), J. Aron & Company ("J. Aron"), Potomac Electric Power Company ("PEPCO"), PEPCO Energy Services, Inc. ("PES"), Washington Gas Energy Services, Inc. ("WGES"), General Services Administration ("GSA"), Morgan Stanley Capital Group ("Morgan Stanley") and Mid-Atlantic Power Supply Association ("MAPSA").

9 The following parties filed Reply comments: Constellation, PEPCO, PES, WGES, and Morgan Stanley.

10 Motions for Reconsideration of Order No. 13028 were filed by MAPSA, PES, Morgan Stanley, Strategic Energy, LLC, PEPCO, OPC, and Constellation.

11 Responses to the Motions for Reconsideration of Order No. 13028 were filed by PES, Constellation, PEPCO, and OPC.

III. CHOICE OF MODEL

6. Pursuant to the Act and Order Nos. 11576[12] and 11796,[13] retail choice began in the District on January 1, 2001. Under the retail choice program, retail electric customers can select their provider of electric power from several retail power suppliers. Currently 11.53% of residential customers, 14.95% of small commercial customers and 25.12% of large commercial customers have availed themselves of the retail choice program.[14] The Act provides SOS for those customers: (1) who contract for electricity with an electricity supplier, but who fail to receive delivery of electricity under such contracts; (2) who cannot arrange to purchase electricity from an alternative electricity supplier; or (3) who do not choose an alternative electricity supplier.[15] Currently, PEPCO serves as the SOS provider. As discussed above, the Act requires that the SOS program begin on February 8, 2005.

7. The Commission is considering two approaches -- the retail model and the wholesale model -- to fulfill our statutory obligation to establish the terms and conditions for SOS and to select an electricity supplier to provide SOS. Under the wholesale approach, the incumbent utility, PEPCO, will provide generation in its role as the Provider of Last Resort. The Commission has adopted rules governing both the retail and wholesale SOS process and has solicited comments regarding the preferred model for the implementation of SOS in the District. The Commission has evaluated those comments and, for the reasons discussed below, has determined that the wholesale model will best meet the needs of the District.

8. A timeline implementing the designated Wholesale SOS process is attached to this order. The evolution of this timeline began with the timeline attached to Order No. 13005.[16] On December 18, 2003, both PEPCO and Morgan Stanley commented on the timeline issued December 4, 2003,[17] and thereafter, the Commission incorporated Morgan Stanley's comments into the attached timeline.

12 *See Formal Case 945, In the Matter of the Investigation into Electric Service Market Competition and Regulatory Practices, ("Formal Case 945")* Order No. 11576, rel. December 30, 1999.

13 *See Formal Case 945,* Order No. 11796, rel. September 18, 2000.

14 *See Formal Case No. 1017,* Comments of Potomac Electric Power Company at 2, filed January 29, 2004. ("PEPCO Comments").

15 *See Formal Case No. 1017,* Order Initiating Proceeding, Order No. 12655, rel. February 21, 2003.

16 *See Formal Case No. 1017,* Order Releasing Proposed Wholesale Standard Offer Service in the District of Columbia, Order No. 13055, at Attachment B, rel. December 4, 2003.

17 *See Formal Case No. 1017,* Comments of the Potomac Electric Power Company on Proposed Wholesale Standard Offer Service Rules and Regulations, at 1-3, filed December 18, 2003; *Formal Case No. 1017,* Comments of Morgan Stanley Capital Group, Inc. Regarding Standard Offer Service Issues and Proposed Draft Wholesale Rules and Regulations, at 3-5, Attachment 1, filed December 18, 2003.

A. Initial Comments In Support of the Wholesale Model

9. **Morgan Stanley** criticizes the retail SOS procurement process and asks the Commission to take into account the past failures of retail marketers in many states and the District.[18] Morgan Stanley comments that unlike the retail procurement process, the wholesale procurement process is both low risk and widely accepted.[19] Morgan Stanley further comments that the NERA/PSE&G Paper characterized the wholesale process as a straightforward bidding approach to acquiring some or all of the aggregate power supply.[20]

10. **Morgan Stanley** further asserts that the State of New Jersey met the local utilities' service obligation to retail consumers with sixteen (16) winning wholesale bidders selected to provide 18,000 MW of wholesale supply under 10- and 34-month contracts.[21] Morgan Stanley argues that the New Jersey procurement process has been heralded as one of the great successes of deregulation.[22] Morgan Stanley notes that the President of the New Jersey Board of Public Utilities stated that, among other things, wholesale bidding provides an effective mechanism for securing the best price possible for ratepayers.[23] Finally, Morgan Stanley cites the recent decision of the Maryland Public Service Commission to employ a wholesale procurement process for the provision of the electric generation supply for SOS.[24]

11. **Constellation** favors the wholesale model and comments that the wholesale rules proposed by the Commission have many similarities to the wholesale process adopted in the State of Maryland.[25] Constellation cites the success of the implementation of a wholesale procurement process in states such as New Jersey and

18 *See Formal Case No. 1017*, Comments of Morgan Stanley Capital Group, Inc. Supporting the Wholesale Standard Offer Service Model at 3, filed January 29, 2004. ("Morgan Stanley Comments").

19 *See* Morgan Stanley Comments at 4.

20 *See* Morgan Stanley Comments at 6.

21 *See* Morgan Stanley Comments at 7.

22 *See* Morgan Stanley Comments at 7.

23 *See* Morgan Stanley Comments at 7.

24 *See* Morgan Stanley Comments at 8.

25 *See Formal Case No. 1017*, Comments From Constellation Power Source, Inc. and Constellation NewEnergy, Inc. On the Preferred Standard Offer Service Model at 4, filed January 29, 2004. ("Constellation Comments") (citing the following provisions adopted by the Commission that mirror Maryland's regulations: shorter term pricing for large customers, seasonal rates, the use of a consultant to ensure the fairness of the bidding process, the use of 50 MW bidding blocks, the use of multiple tranches, a short bid acceptance and approval period and the flexibility to file rate adjustments with the Commission as a result of the regulations of PJM or the state).

Massachusetts.[26] Constellation further asserts that, nationwide there is a lack of experience with the retail model, citing Texas as the lone state in which a true retail bidding process has been implemented.[27] In Constellation's view, the Maine model functions more like a wholesale model, in that, the utility remains the entity in contractual privity with the retail consumers and the suppliers bid to serve percentages of the load. **WGES** and **OPC**, however, assert that Maine has adopted a true retail model. Constellation further cites the recent cancellation of the Rochester Gas & Electric ("RG&E") Single Retailer Model which, according to Constellation, put retail suppliers into the utility's role of billing and payment processing while maintaining RG&E's role as the Provider of Last Resort.[28]

12. **PES** comments that most jurisdictions have adopted a wholesale SOS model and due to the familiarity bidders have with the wholesale process, there will likely be greater participation in the SOS process in the District if a wholesale model is adopted.[29] PES also comments that at the time of the District's solicitation, bidders will have gained additional familiarity with the wholesale model as a result of Maryland's decision to adopt the wholesale process.[30] **J. Aron** also favors the wholesale model and cites the success of the wholesale model employed in New Jersey as a contributing factor in J. Aron's decision to support the wholesale approach.[31]

13. **PEPCO** favors the wholesale SOS model and comments that for the past four years PEPCO has been providing SOS in the District.[32] PEPCO further comments that its provision of SOS has worked well in conjunction with the development of the competitive electricity supply market.[33] PEPCO contends that consumers have become comfortable with PEPCO as the sole provider of SOS, and that retaining PEPCO as the sole SOS provider after February 7, 2005 will avoid the perception by some consumers that they have been switched to a different SOS provider without their consent.[34]

[26] *See* Constellation Comments at 5.

[27] *See* Constellation Comments at 8.

[28] *See* Constellation Comments at 8-9.

[29] *See Formal Case No. 1017*, Initial Comments of PEPCO Energy Services, Inc., at 2, filed January 29, 2004. ("PES Comments").

[30] *See* PES Comments at 2.

[31] *See* J. Aron Comments at 4

[32] *See* PEPCO Comments at 1-2.

[33] *See* PEPCO Comments at 2

[34] *See* PEPCO Comments at 3.

14. **PSEG** favors the wholesale model and comments that the wholesale model has a proven track record in the PJM market.[35] PSEG further comments that the wholesale process adopted by the State of New Jersey demonstrates that a properly designed wholesale bidding process will enhance wholesale competition while allowing for an active retail market.[36]

15. **MAPSA** supports the wholesale model and argues that the wholesale model recognizes the importance of achieving price parity between SOS and competitive retail supply.[37] MAPSA contends that the wholesale model proposed by the Commission more accurately reflects the costs of acquiring and serving retail customers in the prices paid for the service.[38] MAPSA further comments that the wholesale rules proposed by the Commission for the solicitation of SOS insure that the SOS price will reflect, as closely as possible, the costs associated with the provision of a retail electricity service.[39]

Comments Opposing the Wholesale Model

16. In contrast, **WGES** and **OPC** point to the experience in Maine as a basis for adopting a retail SOS model in the District. According to **WGES**, the Maine program has been successful, since its 2002 beginning, for multiple utilities and a population higher than that in the District.[40] **OPC** states that the retail SOS model adopted by the Commission has several common factors with the successful Maine program, including: (1) Commission-controlled bidding; (2) a two-phase bidding process; (3) bids for a fixed amount are set out in the RFP; (4) Commission-selected providers and terms; (5) services such as metering and billing would be provided by the transmission and distribution ("T&D") utility;[41] and (6) the T&D utility provides service in case of default.[42]

17. **WGES** states in its reply comments that it is significant that the Maine Public Utility Commission ("Maine PUC") has secured retail SOS providers to begin SOS service beginning March 1, 2004, and that the program has been successful.[43]

[35] *See Formal Case No. 1017*, Late-Filed Initial Comments of PSEG Energy Resources & Trade, LLC, at 5, filed January 30, 2004. ("PSEG Comments").

[36] *See* PSEG Comments at 5.

[37] *See Formal Case No. 1017*, Mid-Atlantic Power Supply Association's Initial Comments Regarding the Appropriate Model for the Implementation of Standard Offer Service in the District of Columbia, at 2, filed January 29, 2004. ("MAPSA Comments")

[38] *See* MAPSA Comments at 2-3.

[39] *See* MAPSA Comments at 2

[40] *See* WGES Comments at 5.

[41] In both the wholesale and retail model, PEPCO will serve as the T&D utility.

[42] *See* OPC Comments at 6.

[43] *See Formal Case 1017*, Reply Comments of WGES, at 2, 3, filed February 9, 2004. ("WGES Reply Comments")

WGES also notes that PEPCO has downplayed the success in the Maine and Texas retail SOS programs, and mistakenly referred to the Maryland SOS model that has, according to WGES, slowed down competition by keeping the utility SOS.[44]

18. In its Reply Comments, **WGES** rebuts PEPCO's argument that utility SOS should be continued because customers are more comfortable with PEPCO. WGES argues that there is no evidence to prove that this is the case, and proffers that customers are in search of savings and are aware of their competitive supplier options.[45] WGES further states that PEPCO's argument that the retail SOS model is comparable to government "slamming," is false, because customers are more sophisticated and understand the workings of the competitive supplier process.[46] WGES also points out that PEPCO's alleged solution to this slamming is to leave PEPCO in control of the lion's share of the market as a phantom competitor.[47] WGES notes that PEPCO is concerned that by adopting the retail SOS process the Commission will allow unregulated entities become SOS monopolies, but WGES also points out that by adopting the wholesale SOS model, PEPCO would effectively remain the SOS monopoly, thus going against the purpose of the Act – to break up monopoly power.[48]

19. **PEPCO** replies to WGES's assertions by stating that it is not the monopoly provider of electricity supply service in the District and that PEPCO has not been the monopoly provider since 2001.[49] PEPCO argues that it has fully supported deregulation in the District and Maryland and that it has been on the record in favor of competition since 1995.[50] PEPCO further observes that it is not aware of any attempts made by WGES or its affiliate, Washington Gas Light Company ("WGL"), to propose or amend laws to end the *de facto* role of WGL as the SOS provider of natural gas supply.[51]

Discussion

20. The Commission finds the arguments made by Morgan Stanley, Constellation, PSEG, PES, J. Aron, MAPSA and PEPCO persuasive and will adopt the wholesale model to implement SOS in the District.

[44] *See* WGES Reply Comments at 5.

[45] *See* WGES Reply Comments at 4-5.

[46] *See* WGES Reply Comments at 5.

[47] *See* WGES Reply Comments at 8.

[48] *See* WGES Reply Comments at 7-8.

[49] *See* PEPCO Reply Comments at 6.

[50] *See* PEPCO Reply Comments at 7.

[51] *See* PEPCO Reply Comments at 7.

21. The Commission's obligation is to implement the SOS model that is in the best interest of the District and its ratepayers. The Commission's focus is on implementing a process that is efficient, will result in the lowest priced, reliable electricity supply for the District, and that will not tax Commission resources unjustifiably. With these objectives in mind, the Commission finds that the wholesale SOS model meets the Commission's goals for several reasons. Namely, under the wholesale model, SOS supply will be procured through a solicitation process that is likely to produce more than sufficient bids and competitive wholesale pricing.[52]

22. Also, the majority of jurisdictions that have enacted retail choice generally have adopted a wholesale SOS model.[53] Most notably, the Commission recognizes the favorable results that New Jersey has had with the wholesale model. Thus, the wholesale model provides a broader base of experience in other jurisdictions from which the Commission can draw.[54] We also agree with PES that since potential bidders are familiar with the wholesale model, the adoption of this model should lead to greater participation in the competitive procurement process and the submission of bids that are more reflective of the wholesale market.[55]

23. Moreover, the existing SOS model is akin to wholesale model, where PEPCO serves as the SOS provider and procures generation from a wholesale generation provider. Using this wholesale model, our retail market has progressed toward competition. Based on PEPCO's recent market monitoring report, 12.5% of residential load and 51.2% of non-residential load have switched to competitive suppliers.

24. The Commission finds persuasive PEPCO's argument that the model adopted in the State of Maine is not applicable to the District because more residential customers have switched to competitive suppliers in the District than in Maine.[56] The Commission has considered the arguments raised by OPC regarding the similarities of the Maine model and the retail model proposed by the Commission; however, we do not find those arguments to be compelling. It should be noted that the State of Maine and the District of Columbia are different in that: (1) Maine's retail prices are much higher than the District's; (2) Maine is involved with the New England Independent System Operator ("New England ISO"), whereas the District is involved with PJM – a smoothly functioning Regional Transmission Organization ("RTO") -- which is in a different phase

[52] *See* MAPSA Comments at 4.

[53] *See* PES Comments at 2. Only Maine and Texas have had experience with the retail model. Furthermore, as Constellation points out, the New York Public Service Commission recently ordered RG&E to cease its Single Retailer Model. Thus, even a program that seemed to be experimenting with certain aspects of a full retail SOS program has been recently cancelled. *See* Constellation Comments at 9.

[54] *See* J. Aron Comments at 9.

[55] *See* PES Comments at 2.

[56] *See* PEPCO Comments at 4. *See also* Standard Offer Study and Recommendations Regarding Service after March 1, 2005, (a study conducted by the Maine Public Utilities Commission which documents that more customer switching took place in the District than in Maine as of July, 2002) *available at* http://www.state.me.us/mpuc/.

of development than the New England ISO;[57] and (3) Maine's initial experiences with the retail SOS model were not very successful. In fact, Maine has used the wholesale model as a fall back when it has received insufficient or inadequate bids. Thus, the retail model has not been overly successful while the wholesale model has proven to be compatible with retail access.

25. Moreover, many of the common factors noted by OPC are also reflected under the proposed wholesale model. For example, (1) the Commission will approve the bidding process to be used and the results of that process; (2) services such as metering and billing will continue to be provided by PEPCO; and (3) PEPCO as the SOS provider will by definition be the default provider. Thus, for the reasons discussed above, we find that the wholesale SOS model is more likely to benefit District ratepayers than our proposed retail model.

26. The Commission is persuaded that it may not be the optimal entity to manage an SOS solicitation, as would be required under the retail model. As MAPSA points out, a competitive solicitation for SOS power supply is better suited for the incumbent utility than for the Commission.[58] In addition, we believe the wholesale model will require substantially fewer Commission resources than the retail model. Under the retail model, the Commission anticipates that its workload will increase substantially as a result of the additional obligations the Commission will be required to meet. Experience has shown however, that a competitive retail market can develop under the wholesale SOS construct. Therefore, the expenditure of significant additional Commission resources required by the implementation of the retail SOS model is not justified. Also, under the wholesale model, significant efficiencies can be attained through the implementation of commercial contracts. [59]

27. As discussed in more detail below, we find that the wholesale SOS model will produce lower consumer rates because it will attract significantly more bidders than the retail SOS process. [60] The wholesale model has a proven track record in the PJM

[57] In fact, the New England ISO has imported many Standardized Market Design ("SMD") features from PJM in the past few years.

[58] *See* MAPSA Comments at 4.

[59] We agree with PEPCO that the Commission would be responsible for the selection and management of the retail SOS providers' contracts, which would create an administrative workload for the Commission that would not be present under the wholesale model. The Commission would be forced to oversee the retail SOS provider through the limited rights granted by a commercial contract. *See* PEPCO Comments at 11.

[60] We agree with PSEG that the proposed retail bidding process incorporates substantial risk and uncertainty for bidders. For example, potential retail bidders would need to forecast administrative costs, such as billing, collection and uncollectible accounts. The higher level of risk and uncertainty associated with the retail SOS process would discourage participation by potential SOS providers and make the bidding process for SOS service less competitive. On the other hand, the proposed wholesale SOS process would allow bidders to compete primarily on the price of electric supply and thus would promote greater participation and enhance competition. See PSEG Comments at 3.

market.[61] Specifically, New Jersey has conducted its third auction and PJM is familiar with all the requirements and coordinations associated with wholesale model. These synergies are likely to produce a more robust competitive market for District consumers.

28. Similarly, because the wholesale SOS model is compatible with the current rate design, ratepayers will receive the benefits that come from preserving the existing rate structures. Likewise, the RFP process under the wholesale model has been fully vetted among many of the stakeholders active in the District of Columbia energy market.[62] The Commission also recognizes the close proximity the District has with the State of Maryland and, as such, expects bidders to have gained additional experience as a result of that State's recent decision to implement the wholesale SOS model. Thus, to the extent entities become familiar with the process in Maryland, we believe that District ratepayers will benefit by the increased participation in the District's process that is likely to come. For these reasons, we believe that the wholesale SOS model will achieve the same, and possibly a greater, level of economic efficiency as the retail SOS model.[63] In other words, the wholesale procurement process is both low risk and widely accepted.[64]

29. The Commission is further persuaded by the fact that under the wholesale approach, where PEPCO would retain the traditional customer care functions and risks (e.g., retail metering, billing and collections), wholesale SOS bidders will be free to compete directly on wholesale price. This should ultimately increase the number of qualified wholesale bidders and eliminate the wholesale bidders' potential exposure to retail costs and risks, thereby reducing their bid prices.[65] For this reason, we are also persuaded that the wholesale model will facilitate the establishment of transparent pricing for retail customers.[66]

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61 See PSEG Comments at 5.

62 *See Formal Case No. 1017,* Comprehensive Framework for the Provision of SOS Submitted on Behalf of Constellation, filed August 29, 2003. ("Constellation SOS Framework").

63 *See Formal Case No. 1017,* SOS Regulations and Responses to the Commission's Areas of Concern Submitted on Behalf of PEPCO, filed August 29, 2003.

64 Morgan Stanley cites a paper authored by the National Economic Research Associates ("NERA") and Public Service Electric & Gas ("PSE&G") which outlines the competitive bidding process used by the State of New Jersey to meet default service obligations. The NERA/PSE&G Paper concluded that the past failure of the retail approach, combined with the relatively limited number of parties either interested in, or capable of, providing SOS service, meant that the Board of Public Utility was inclined towards the lower-risk wholesale approach, especially for this first auction. In fact, because the electric distribution companies retained all of the retail metering, billing, and non-payment risks, this approach eliminated the bidders' potential exposure, thereby reducing their bids. Morgan Stanley further cited the decisions of the Maryland and Connecticut regulatory commissions in selecting the wholesale model for determining their SOS providers. *See* Morgan Stanley Comments at 6.

65 *See* Morgan Stanley Comments at 4.

66 We agree with PES that the proposed wholesale model will clearly establish each component of the final retail rate paid by the SOS customers. That is, the competitive procurement process will solicit the wholesale rate for the generation component. The Administrative Charge and margin to provide SOS by the Electric Company will be established by a regulatory proceeding, thus interested parties will know exactly how the retail rate was established. *See* PES Comments at 3.

30. We also find that the wholesale SOS model is consistent with certain existing regulatory provisions. Specifically, the proposed wholesale model preserves the transmission "deadband" benefits provided for in the PEPCO/Conectiv merger Settlement Agreement. Order No. 12395 approving the Settlement indicates as part of the Settlement Agreement that PEPCO has agreed to accept a "transmission deadband" which would adjust transmission and distribution rates so that the overall rates remain constant, unless transmission rates increase or decrease more than 10 percent. In the event that transmission rates established by the Federal Energy Regulatory Commission ("FERC") rise the full 10 percent contemplated in the Settlement Agreement, this feature alone would provide a benefit to District ratepayers of "up to $9.5 million." Under the wholesale SOS model, PEPCO will be required to follow the "deadband" provisions the Commission specified in the PEPCO/Conectiv merger order. Whereas, under the retail model, the SOS provider would not be required to maintain the "deadband" provisions, possibly depriving ratepayers of such benefits.

31. For these reasons, and those elaborated upon below, the Commission finds that the wholesale SOS model is best suited for the District of Columbia and will implement this model pursuant to the directives of the Act.

B. The Competitive Advantage of Each Model

32. Commenters in favor of the wholesale model argue that there are several risks associated with the retail SOS model that will drive up bid prices or discourage suppliers from participating in the process which will effectively dampen competition. **Morgan Stanley** comments that a wholesale model will encourage a competitive marketplace and ensure that SOS customers will pay the lowest prices for reliable service by creating a vibrant marketplace with numerous competitors.[67] Morgan Stanley also comments that the wholesale model will attract high credit-quality wholesale suppliers to compete for the SOS retail load.[68] Morgan Stanley argues that the wholesale approach allows wholesale bidders to compete directly based on wholesale price while the electric company retains the responsibility of traditional utility functions such as billing and collections. Morgan Stanley comments that wholesale bidders operate under PJM-based wholesale metering, accounting and scheduling, rather than the metering and accounting of the utility and retail customers.[69] Morgan Stanley further argues that wholesale suppliers do not rely on the volatile spot market but instead bid to win the auction with

[67] *See* Morgan Stanley Comments at 2; *see also* Comments of Morgan Stanley Capital Group Inc. Regarding Standard Offer Service Issues and Proposed Draft Wholesale Rules and Regulations, at 3, filed December 18, 2003.

[68] *See* Morgan Stanley Comments at 3.

[69] *See* Morgan Stanley Comments at 4.

the lowest price which will achieve price stability.[70] Morgan Stanley comments that competition lowers prices and ensures greater product diversity.[71]

33. **Morgan Stanley** also contends that the adoption of the wholesale model in the District would be consistent with the regulatory approach of the FERC which is committed to encouraging competitive wholesale power markets.[72] Morgan Stanley comments that a wholesale SOS procurement process relies on the benefits of a well-established wholesale marketplace.[73] Morgan Stanley further argues that the wholesale process avoids the uncertainties and risks of the retail process which are created by the relatively limited number of retail marketers either interested in or capable of procuring wholesale power and then providing retail service.[74] Morgan Stanley further comments that the small number of potential retail providers is likely a result of the increased risks associated with competitive retail service.[75]

34. **Constellation** favors a wholesale SOS procurement process as a reasoned and proven means of providing reasonably priced SOS to retail customers after the expiration of the rate cap.[76] Constellation further comments that the wholesale model promotes the continued development of competitive markets.[77]

35. **Constellation** comments that it is prudent in the transition to a competitive market to have PEPCO remain the SOS provider and secure the wholesale supply to meet its obligation pursuant to a competitive bid process.[78]

36. **PES** states that the bidders under the wholesale model will produce prices that are more reflective of market conditions which, in turn, will aid the development of a competitive retail electricity supply market.[79]

70 *See* Morgan Stanley Comments at 4.

71 *See* Morgan Stanley Comments at 5.

72 *See* Morgan Stanley Comments at 5.

73 *See* Morgan Stanley Comments at 5.

74 *See* Morgan Stanley Comments at 3.

75 *See* Morgan Stanley Comments at 4.

76 Pursuant to the Act, SOS must be provided by PEPCO at capped rates until January 1, 2005. The price cap includes generation, transmission, and distribution rates. *See Formal Case No. 1017*, Order No. 12655, at 2, rel. February 21, 2003.

77 *See* Constellation Comments at 2.

78 *See* Constellation Comments at 3.

79 *See* PES Comments at 2.

37. **MAPSA** argues that the wholesale model recognizes the importance of achieving price parity between SOS and competitive retail supply.[80] MAPSA argues that a true retail model reflects the costs of acquiring and serving retail customers in the prices paid for the service. MAPSA contends that the wholesale model proposed by the Commission achieves this end.[81] MAPSA further comments that the wholesale rules proposed by the Commission for the solicitation of SOS insures that the SOS price will reflect, as closely as possible, the costs associated with the provision of a retail electricity service.[82]

38. **PSEG** supports the wholesale model for implementing SOS in the District because a wholesale bidding process would stimulate supply competition from wholesale suppliers and, as a result, produce aggressive pricing for consumers.[83] PSEG argues that the retail model has a higher level of risk and uncertainty than the wholesale model because the retail model will require bidders to forecast their administrative costs. PSEG further comments that the increased certainty associated with the wholesale model will attract more bidders and therefore produce lower consumer rates.[84]

39. **J. Aron** favors the wholesale model and argues that the retail model will inject uncertainty, risk and cost for suppliers and, in turn, for consumers.[85]

40. Finally, **PSEG** comments that a wholesale model also would produce lower consumer rates because the administrative charge component of the rate would be based on actual costs instead of the projected costs associated with the retail model.[86]

41. In contrast, **WGES** highlights that retail competition in the District has proven that it benefits consumers; 13 percent of the District's residential load is served by competitive suppliers; and "nine to one" is the number of competitive suppliers that would be eligible to compete for retail SOS in the District (as compared to one wholesale supplier).[87]

80 *See* MAPSA Comments at 2.

81 *See* MAPSA Comments at 2-3.

82 *See* MAPSA Comments at 2.

83 *See* PSEG Comments at 2.

84 *See* PSEG Comments at 3.

85 *See Formal Case No. 1017*, Comments of J. Aron & Company on Adoption of Wholesale Rules and Regulations in Response to Questions Posed in Order No. 13035, at 3, filed January 29, 2004. ("J. Aron Comments").

86 *See* PSEG Comments at 4.

87 *See* WGES Comments at 5 (listing PES, WGES, Constellation NewEnergy, BGE Home Products and Services, Allegheny Energy Supply, Dominion Retail, FirstEnergy, Smart Energy.com, and Cook Inlet as eligible retail SOS providers).

42. **GSA, WGES,** and **OPC** argue that the Commission should not adopt the wholesale SOS model because doing so will make it increasingly difficult for effective competition to develop in the District.[88] These parties contend that competition will be stifled because the customers will not notice any difference in their service,[89] only one part of their service will be exposed to competitive forces,[90] and possible market entrants will be discouraged.[91] WGES comments that it does not support the wholesale SOS model as the primary SOS model, but welcomes it as a contingency plan.[92]

43. **GSA** states that the retail SOS model should be adopted because it would provide the only flexibility in the selection of SOS providers and it would best facilitate the development of competition in the District of Columbia.[93] The GSA notes that the retail model will best serve competition in the District, because it will allow customers to become accustomed to being served by an entity other than PEPCO, without detriment to reliable service. GSA also contends that customers will be more likely to seek out other third party suppliers, thus creating a more active competitive market.[94]

44. **WGES** states that the retail SOS model will be a better vehicle for promoting electric market competition in the District because it will encourage market entry of new retail suppliers and will assist in the evolution of competitive retail markets.[95] WGES further states that by choosing the retail SOS model, the Commission will be sending a message to potential market entrants that the Commission is "serious" about competition and providing benefits to the District's consumers.[96]

45. In its Reply Comments, **Morgan Stanley** argues that the Commission should reject arguments made by the GSA, WGES and OPC that the wholesale model does not promote a competitive market.[97] Morgan Stanley argues that competition under the wholesale model will likely be vigorous because of the size and diversity of the load and the backing from the Commission that the wholesale supplier will be paid thereby

88 *See* GSA Comments at 2; WGES Comments at 2; OPC Comments at 2.

89 *See* GSA Comments at 2.

90 *See* OPC Comments at 2.

91 *See* WGES Comments at 2.

92 *See* WGES Comments at 3.

93 *See* GSA Comments at 1.

94 *See* GSA Comments at 2.

95 *See* WGES Comments at 2.

96 *See* WGES Comments at 2

97 *See* Morgan Stanley Reply Comments at 13.

greatly reducing the risk of non-payment.[98] Morgan Stanley comments that the wholesale rules allow residential and small commercial customers to switch among SOS and competitive retail suppliers.[99] Morgan Stanley further contends competition is more likely under the wholesale model because retail consumers are more likely to switch when there is a secure, reliable reasonably priced back-stop supply that remains available.[100]

46. In its Reply Comments, **PEPCO** urges the Commission to reject WGES's claims that the only way to signify the Commission's commitment to competition is to select the retail model.[101] In response to WGES's assertion, PEPCO comments that many other jurisdictions have also adopted a wholesale model, so WGES is incorrect in stating that only a retail model will demonstrate a commitment to competition.[102] PEPCO also reiterates that the State of Maine and the District and are not similar because the percentage of customers and loads that have switched were much higher in the District than in Maine.[103]

47. **WGES** argues that the regulatory "bargain" underlying the Act calls for the SOS load to be fully exposed to the effects of retail competition, and that the Commission should first solicit retail SOS bids, and only in case of insufficient or inadequate bids should a wholesale SOS model be pursued.[104] WGES also rebuts PEPCO's argument that the Act's deadlines support a wholesale SOS model, by pointing out that a wholesale SOS model was contemplated only as a contingency plan in the Act, before amendment.[105] WGES also rebuts PEPCO's argument that the wholesale model provides "less market risk premium," and notes that nothing in the Act prevents the Commission from "refreshing" retail SOS bids to reflect current market conditions, as the start of service date approaches.[106]

48. In its Reply Comments, **WGES** states that the arguments raised by opponents of the retail SOS model are not compelling and are simply observations of facts. WGES contends that the following are obvious arguments in favor of the retail

98 *See* Morgan Stanley Reply Comments at 13.

99 *See* Morgan Stanley Reply Comments at 13.

100 *See* Morgan Stanley Reply Comments at 13.

101 *See Formal Case No. 1017*, Reply Comments of PEPCO, at 4, filed February 9, 2004. ("PEPCO Reply Comments").

102 *See* PEPCO Reply Comments at 4-5.

103 *See* PEPCO Reply Comments at 5-6.

104 *See* WGES Reply Comments at 3.

105 *See* WGES Reply Comments at 6.

106 *See* WGES Reply Comments at 6.

model: (1) the fact that the purpose of deregulation is to enhance competition in wholesale and retail markets; (2) FERC is advancing wholesale markets; (3) local public service commissions are regulating the development of retail markets; (4) the District's wholesale market is currently much more competitive than its retail market, although more than half the District's load is being supplied by competitive suppliers.[107] WGES also objects to arguments made by PEPCO, PES, J. Aron, Constellation and PSEG that PEPCO should continue its "strangle hold" on SOS supply, and argues that competition should be invigorated by creating a neutral retail SOS environment.[108]

49. **WGES** rebuts PEPCO's argument that utility SOS has stimulated the development of the competitive electric supply market in the District since January 2001, based on the statistics that PEPCO cites – that 54.51% of load in the District has switched to competitive suppliers. WGES argues that by examining the identical statistics, one could argue that utility SOS has prevented the competitive retail market from developing more aggressively.[109]

Discussion

50. The Commission finds the wholesale model to be more likely to increase competition and encourage bidder participation in the SOS process. In making this determination, the Commission finds persuasive the argument that under the retail model, bidders will likely include risk premiums in their bids to cover the unknown costs of billing, collections and customer care, effectively increasing costs to consumers. The Commission finds persuasive Morgan Stanley's argument that the traditional utility functions required of competitive suppliers under the retail model such as billing, collections, and customer care functions tend to increase retail prices and may decrease the number of bidders, in effect hampering competition. The Commission also finds compelling arguments made by PES that the limited experience competitive suppliers have with the retail model will cause those suppliers to submit bids that do not reflect the market, to insure that all of their costs, risks and margins are covered.

51. The Commission is persuaded by PES's argument that significant sums of money have already been spent on educating consumers about the implementation of retail choice and that the consumer education programs that have been implemented thus far including information about the wholesale model while the adoption of the retail model would require the undertaking of a new consumer outreach program.[110] The Commission also recognizes PEPCO's current success as the provider of SOS, where 12.5% of residential load and 51.2% of non-residential load has switched to competitive

[107] *See* WGES Reply Comments at 2.

[108] *See* WGES Reply Comments at 3.

[109] *See* WGES Reply Comments at 4.

[110] *See* PES Comments at 6.

suppliers, and expects that consumers will be more comfortable during the implementation of SOS with PEPCO as the default provider.[111]

52. In response to WGES's argument that there are nine (9) suppliers eligible to provide SOS, the Commission notes that currently only three (3) providers are providing service. The Commission also notes that due to changes in the electric industry following the collapse of Enron, the number of potential providers has diminished. The Commission also finds speculative arguments made by WGES, GSA and OPC that the wholesale model will stifle competition because customers will not notice any difference in their service; in fact, some SOS customers already have received service from third party suppliers. These parties have provided nothing to substantiate their claims that this trend will not continue and improve. Finally, under either SOS model in the District, generation is the only part of service exposed to competitive forces. As such, we find to be without merit the argument made by GSA, OPC and WGES that competition will be stifled under the wholesale model because only a single component of SOS service will be exposed to competitive forces.

C. Costs Associated with the Implementation of Each Model

53. **OPC** contends that implementing the wholesale SOS model would cost District ratepayers $130 million per year in higher rates without any specified benefits.[112] According to OPC, the $130 million costs to the ratepayers should be attributed to: administrative costs, which are not subject to competitive bidding; forward price contracts with above-market prices at time of delivery; and permitting PEPCO to add a margin to the administrative charge because there is no basis for allowing PEPCO a margin as it simply takes additional funds from customers.[113] OPC also argues that a retail SOS model is the best approach because competitive suppliers would minimize costs, including administrative costs, in the bidding process.[114] OPC also notes that the wholesale SOS model would be much more complex and difficult to regulate, administer and oversee than a retail SOS model.[115] According to OPC, the determination of the administrative charge, the multiple bidding rounds, and the frequent true-ups contribute to the complexity and difficulty surrounding the wholesale SOS model.[116] OPC also cites

[111] *See Formal Case No. 945, Phase II*, Interim Electric Choice Monthly Report Form of Potomac Electric Power Company, filed January 16, 2004.

[112] *See* OPC Comments at 1; *see also* OPC Comments, Affidavit of Karl Richard Pavlovic on Behalf of the Office of the People's Counsel, Attachment A, at 8-10.

[113] *See* OPC Comments at 9-11.

[114] *See* OPC Comments at 9.

[115] *See* OPC Comments at 2.

[116] *See* OPC Comments at 8.

the multiple cost elements of the administrative charge that would be subject to debate and disputes and misuse of incremental costs in the wholesale bidding process.[117]

54. **Morgan Stanley** criticizes assertions made in OPC's December 18, 2003 Comments opposing a wholesale procurement process and states that OPC's opposition is the result of OPC's misunderstanding of the nature of competition in wholesale markets.[118] Morgan Stanley comments that multiple bidders competing with each other will drive prices down.[119] Morgan Stanley also criticizes OPC's assertion that the wholesale supply cost component of retail rates is based on unhedged forward price contracts.[120] Morgan Stanley comments that OPC is incorrect and that wholesale bidders will hedge their Wholesale Full Requirements Supply Agreement ("WFRSA") in order to win the bid.[121] Finally, Morgan Stanley criticizes OPC's assertion that forward contract prices are often higher than spot prices.[122] Morgan Stanley characterizes the relationship between forward and spot markets as being a function of market fundamentals and also characterizes forward contracts such as the WFRSA as a hedged and prudent risk.[123]

55. **PES** also criticizes assertions made in OPC's December 18, 2003 Comments as unfounded.[124] Specifically, PES argues that OPC is incorrect in stating that retail rates under the wholesale model do not reflect the prudent hedging of forward contracts.[125] PES comments that both the utility and the wholesale supplier are appropriately hedged in the market through the use of the WFRSA.[126] PES further criticizes OPC's assertion that competitive suppliers will set their rates just under the SOS price therefore establishing high rates.[127] PES comments that competitive suppliers will compete not only against the SOS rate but against each other.[128] PES further

117 *See* OPC Comments at 8-9.

118 *See* Morgan Stanley Comments at 8-9 (stating that OPC believes that wholesale bid prices will increase because the Electric Utility will pass through in retail rates wholesale power costs derived from a wholesale SOS procurement process).

119 *See* Morgan Stanley Comments at 9.

120 *See* Morgan Stanley Comments at 9.

121 *See* Morgan Stanley Comments at 9.

122 *See* Morgan Stanley Comments at 9.

123 *See* Morgan Stanley Comments at 10.

124 *See* PES Comments at 4.

125 *See* PES Comments at 4.

126 *See* PES Comments at 4.

127 *See* PES Comments at 4.

128 *See* PES Comments at 4.

comments that a wholesale model will create market-sensitive rates and that there are no incentives for suppliers to cluster their bid offerings around the SOS rate.[129] PES criticizes OPC's assertions that there is no justification for providing a margin to the Electric Company and that an administrative charge will raise the retail price above the competitive market.[130] PES argues that the inclusion of a margin and administrative charge will bring the SOS rate closer to a rate that reflects the cost that a retail supplier would incur to provide retail electric service.[131]

56. **PEPCO** criticizes assertions made in OPC's December 18, 2003 Comments which include the allegation that there are additional costs attributable to the wholesale bidding model that are a result, in part, of the failure of PEPCO to hedge.[132] PEPCO argues that under the wholesale model it would buy power in the wholesale market at fixed prices as a hedge against its commitment to sell power at fixed prices to SOS customers.[133] PEPCO further argues that the forward contract, or WFRSA, is itself a hedge, so OPC's assertion that PEPCO would use "unhedged forward price contracts" displays OPC's misunderstanding of the WFRSA.[134] PEPCO further argues that while the forward market prices in PJM are sometimes higher than spot prices, to participate in the spot market, a power market participant would have to maintain an open position to consistently obtain daily prices; this is an extremely risky position that is unlikely to be taken by any participant.[135]

57. **PEPCO** further criticizes OPC's assertion that suppliers will price just under the SOS rates.[136] PEPCO argues that under the wholesale model, suppliers will submit bids based on three pricing components: wholesale costs plus administrative costs plus a margin.[137] PEPCO further argues that wholesale costs should be comparable for similarly creditworthy buyers and, as such, suppliers will be competing based on their

129 *See* PES Comments at 4-5.

130 *See* PES Comments at 4.

131 *See* PES Comments at 5.

132 *See* PEPCO Comments at 11.

133 *See* PEPCO Comments at 12.

134 *See* PEPCO Comments at 13.

135 *See* PEPCO Comments at 13-14.

136 *See* PEPCO Comments at 17.

137 *See* PEPCO Comments at 17.

own costs and margin expectations.[138] PEPCO asserts that suppliers will be motivated to lower their prices to more effectively compete with one another.[139]

58. **J. Aron** criticizes an assertion made in OPC's December 18, 2003 Comments that forward contract prices are often higher than spot prices.[140] J. Aron comments that spots prices can and do fluctuate above and below forward prices.[141] J. Aron further states that retail suppliers typically do not want to assume commodity price risk without hedging; therefore their bids reflect the forward price of the commodity.[142] J. Aron criticizes OPC's assertion that competitive suppliers will submit bids just under the SOS rates and argues that SOS bids will reflect the market.[143]

59. In its Reply Comments, **PES** reasserts arguments made in its Initial Comments that rebutted OPC's assertion that the wholesale model will cost District ratepayers an additional $130 million. Specifically, PES argues that the wholesale model provides for greater price transparency which contradicts OPC's assertion that administrative costs can be more clearly delineated in the retail model.[144] PES also comments that the wholesale model does, in fact, provide an environment in which both the utility and the competitive supplier will be hedged.[145]

60. **Constellation** argues, in its Reply Comments, that OPC's recommendation to rely on the spot market was employed in the State of California with disastrous results.[146] Constellation further argues that consumers that want price certainty forego the opportunity of lower spot market prices but avoid the risk of higher spot market prices.[147] Constellation also attacks OPC's assumption of a uniform margin. Constellation argues that the profit margin is an element that is to be determined in a

[138] *See* PEPCO Comments at 18.

[139] *See* PEPCO Comments at 18.

[140] *See* J. Aron Comments at 5.

[141] *See* J. Aron Comments at 5 (citing the spot and forward market prices in the Western United States during the period of late 2000 and early 2001).

[142] *See* J. Aron Comments at 5-6.

[143] *See* J. Aron Comments at 7.

[144] *See Formal Case No. 1017,* Reply Comments of PEPCO Energy Services, Inc., at 2, filed February 9, 2004. ("PES Reply Comments").

[145] PES Reply Comments at 2.

[146] *See Formal Case No. 1017,* Reply Comments of Constellation Power Source, Inc. and Constellation NewEnergy on the Preferred Standard Offer Service Model, at 4, filed February 9, 2004. ("Constellation Reply Comments").

[147] *See* Constellation Reply Comments at 4.

separate proceeding on the Administrative Charge; therefore, it is not certain that PEPCO's profit margin will be 4 mills.[148] Constellation further argues that if the retail market is competitive, then competitive retail suppliers will likely reduce their margins to remain competitive.[149] Constellation also argues that OPC is inaccurate in its assertion that the retail model will minimize administrative charges.[150] Constellation recommends that the Commission adopt a Maryland-style SOS that would provide refunds to customers for the difference between the fully embedded retail costs and the incremental charges.[151] Constellation states that the argument of WGES and OPC that the retail model is less complicated to administer is flawed because the simplification comes at a higher price to consumers due in part to the uncertainty regarding the determination of the accounts receivable rate.[152] Constellation argues that the goal of retail competition in the District is best served by the wholesale model which provides accurate market pricing for retail services.[153]

61. **Morgan Stanley** reasserts arguments made in its Initial Comments in response to OPC's opposition to the wholesale model. In its Reply Comments, Morgan Stanley specifically argues that forward prices are at times below spot prices and, more importantly, forward contracts mitigate the risk of contracting based on volatile spot market prices.[154] Morgan Stanley further argues that forward contracts are a hedge, thus the wholesale SOS model requires hedging of market risk to benefit retail customers.[155] Specifically, Morgan Stanley argues that forward contracts are a hedge and mitigate market risk to the benefit of retail consumers.[156] Morgan Stanley criticizes OPC's assertion that the margin portion of the Administrative Charge will unjustly transfer revenues to PEPCO and comments that the Administrative Charge will be determined during a separate administrative proceeding.[157]

148 *See* Constellation Reply Comments at 5, (the figure 4 mills is derived from OPC's Comments at Affidavit of Karl Pavlovic at 9 which estimates a 1 mill per Kwh for the incremental charge subtracted from PEPCO's Commission-approved administrative charge of 5 mills for hourly priced service).

149 *See* Constellation Reply Comments at 5-6.

150 *See* Constellation Reply Comments at 6.

151 *See* Constellation Reply Comments at 6.

152 *See* Constellation Reply Comments at 7. The accounts receivable referred to by Constellation in its Comments are supplier accounts receivable, see WGES Comments at 3.

153 *See* Constellation Reply Comments at 8.

154 *See Formal Case No. 1017*, Reply Comments of Morgan Stanley Capital Group, Inc. Supporting the Wholesale Standard Offer Service Model, at 3, filed February 9, 2004. ("Morgan Stanley Reply Comments").

155 *See* Morgan Stanley Reply Comments at 5.

156 *See* Morgan Stanley Reply Comments at 5.

157 *See* Morgan Stanley Reply Comments at 8.

62. In its Reply Comments, **PEPCO** criticizes OPC's witness Dr. Pavlovic and comments that Exhibit 4 to Dr. Pavlovic's testimony is unsupported and incorrect because it examines only the first price for each month instead of an average price.[158] PEPCO submits an analysis similar to that offered by OPC, which shows instances in which the spot market price was higher than the forward market price.[159] PEPCO also reasserts arguments made in its initial comments including rebutting assertions made by Dr. Pavlovic.[160] PEPCO reiterates its commitment to hedge and notes that OPC's statement that the spot market is always lower than the forward market is flawed.[161] PEPCO further incorporates by reference its criticism of OPC's assertion that suppliers will price just under the SOS rates.[162]

Discussion

63. The Commission will address OPC's contention that the wholesale model will cost District ratepayers an additional $130 million. Specifically, in its December 18, 2003 comments and the accompanying affidavit of Dr. Karl R. Pavlovic on the draft wholesale SOS rules, OPC indicated that District ratepayers would pay approximately $130 million more per year under the wholesale SOS model described in the proposed regulations attached to Order No. 13005 than they would pay under the retail SOS model proposed in the initial regulations attached to Order No. 12932.[163]

64. OPC also assumes that the wholesale model will result in higher costs to consumers for four reasons: (1) under the wholesale model the retail rates will not reflect the benefits of prudent hedging of forward contracts; (2) competitive suppliers will set their rates just under the SOS price and thus establish high rates for all District customers; (3) there is no justification for providing a margin to the Electric Company for providing SOS; and (4) the margin portion of the Administrative Charge will raise the retail price above the competitive market level.

65. OPC's January 29, 2004 Comments assume that there are at least three components to the additional costs imposed by implementation of wholesale SOS. First, because administrative costs are not subject to bidding, bidders do not compete to keep the costs as low as possible. Therefore, under wholesale SOS, administrative costs will not be as close to marginal cost as is the case under retail SOS. OPC argues that while it is impossible to quantify the exact effect of this factor, there is no question that this will

158 *See* PEPCO Reply Comments at 8.

159 *See* PEPCO Reply Comments at 10, Exh. 1.

160 *See* PEPCO Reply Comments at 12.

161 *See* PEPCO Reply Comments at 12.

162 *See* PEPCO Reply Comments at 18.

163 *See Formal Case No. 1017*, Application for Reconsideration of Order No. 13028 of the Office of the People's Counsel, at 2, filed January 29, 2004.

have a negative effect on the rates that retail SOS customers will have to pay. OPC argues that this drawback is an inherent flaw in the wholesale SOS model.

66. OPC further stated that the fact that the Administrative Charge would be set administratively rather than through a bidding process means that retail customers will be subject to a higher administrative charge under wholesale SOS, even if the Commission does not permit a margin to be artificially added to that charge. OPC uses as its underlying assumption 4 mills as the margin portion of the Administrative Charge and concludes that $23 million per year would be unjustly transferred from SOS customers to PEPCO as a result of this margin.

67. OPC asserts that two other aspects of the administrative costs, however, are quantifiable. First, the retail SOS rates that would result from the Wholesale SOS Rules would be based on forward price contracts. OPC argues that market prices at the time of delivery, however, will almost invariably be lower than forward prices, and these lower prices can be realized via prudent hedging of the forward contracts. The Wholesale SOS rules, however, do not require PEPCO to hedge the forward contracts. More significantly, the Wholesale SOS Rules do not require PEPCO, if it does hedge the contracts (which it almost certainly will), to pass the benefits through to retail SOS customers. OPC contends that retail SOS customers under the Wholesale SOS Rules will therefore pay more than the market price, because the retail rates will not reflect the benefits of prudent hedging of the forward contracts. Given the current SOS load in the District, OPC has estimated that these payments by SOS customers will be approximately $45.9 million on an annual basis.

68. In addition, OPC assumes that because competitive suppliers will price just under the SOS price, the increase in prices due to this lack of hedging will raise the retail market price for electricity in the District above the competitive market level, extracting monopoly rents from non-SOS retail customers as well as from SOS customers. OPC estimates that the non-SOS retail customer forward price payment would be approximately $41.0 million over the competitive market price on an annual basis.

69. Additionally, just as with the forward price payment, OPC assumes that the margin portion of the Administrative Charge will raise the retail price above the competitive market level, increasing payments by non-SOS customers. Given the current non-SOS load in the District, OPC estimates that the effect would be to increase payments by non-SOS retail customers by approximately $20.5 million on an annual basis. Thus, without a requirement to prudently hedge and assuming a margin set at a level of 4 mills, electricity customers in the District, SOS and non-SOS, will be forced to overpay by at least $130 million per year.[164]

[164] *Adding* the four numbers and rounding results is roughly $130 million. 20.5M+23M+45.9M+41M = 130.4M.

70. The Commission finds OPC's arguments lack merit. For example, the statement made by OPC's witness Dr. Pavlovic that, "market prices at the time of delivery, will almost invariably be lower than forward prices, and these lower prices can be realized via prudent hedging of the forward contracts"[165] is incorrect. The spot market fluctuates dramatically from day to day, and, as such, there are times when spot prices are either lower or higher than forward prices. In fact, the Commission has found in exhibits submitted by Dr. Pavlovic instances where the spot prices are higher than forward prices.[166] Both spot prices and forward prices are determined by supply and demand. Spot prices are determined by real time supply and demand and forward prices are determined by expected supply and demand. The purpose of hedging is generally to seek stability in prices but a party's position based on a hedged outcome will not necessarily be better than its position based on an unhedged outcome. In this regard, hedging can be more appropriately compared to an insurance policy than to a pre-paid discount. Whether the decision to hedge results in reduced costs depends on an after-the-fact analysis. What is certain, however, is the measure of price stability experienced as a result of the hedge.

71. We are also persuaded by Constellation's argument and find that OPC's approach would place District ratepayers at risk due to an over reliance on the spot market.[167] This was the approach attempted in California, with disastrous results. It is the Commission's desire to avoid price spikes similar to those experienced in California during the Western energy crisis.

72. Thus, we find that OPC's arguments are contradictory. On one hand, OPC argues for hedging, and on the other hand it says market prices will always be lower, suggesting that reliance on the market is the way to go. This type of inconsistency cannot be the basis of our regulatory policy going forward.

73. We also agree with PEPCO that entering into forward contracts is a way of hedging and that the phrase "unhedged forward price contract" is an oxymoron. We also agree with J. Aron that PEPCO and the retail suppliers typically do not want to assume commodity price risk without hedging.

74. It is not clear why OPC has not assumed any incremental costs for suppliers yet still assumes that the margin over the incremental costs will be 4 mills/kWh for competitive suppliers. Based on OPC's Exhibit 5,[168] the $130 million was derived by

165 *See Formal Case No. 1017*, December 18, 2003 Comments of OPC at Affidavit of Karl Pavlovic, at 8.

166 *See Formal Case No 1017*, December 18, 2003 Comments of OPC at Exhibit 4, at 4, "Weighted Average Daily on Peak/Peak" Column, May 2003 (indicating there are some instances of forward prices that were lower than spot prices).

167 *See* Constellation Reply Comments at 4.

168 *See Formal Case No. 1017*, Application for Reconsideration of Order No. 13028 of the Office of the People's Counsel, at Exhibit 5, filed January 29, 2004.

adding two components: (1) a forward premium of $87 million and (2) a margin of $43 million. However, neither component can be supported.

75. First, OPC's assumptions do not have any foundation and are not verified. Specifically, OPC offers nothing to support either the 4 mills as a reasonable margin or 8 mills as a reasonable forward premium regarding the margin. It is not likely that PEPCO (as the SOS provider) and the alternative competitive suppliers would incur exactly the same administrative charge and same profit margin. Different firms have different business risks and differing profit margins. Thus, the assumption of a uniform margin of 4 mills/kWh in OPC's calculation for both PEPCO and the alternative suppliers cannot be supported. OPC, itself, has indicated that PEPCO does not have any business risk and thus, no margin should be given to PEPCO.

76. Without explaining its inconsistency, OPC also states that PEPCO as the SOS provider will bear absolutely no business risk for the expenses it will incur in procuring wholesale supply. Thus, PEPCO will have no financial incentive to ensure that the wholesale procurement is in fact competitive. Although that seems to be OPC's belief, OPC nevertheless assigns the same margin – 4 mills – to PEPCO and to the retail suppliers. [169]

77. We agree with PEPCO that OPC's assessment of a 4-mill margin is excessively high. Moreover, looking to the Maryland Settlement Agreement for comparative purposes, we see that Maryland provides a margin for residential customers at roughly 1.5 mills, the margin for small commercial customers at roughly 2 mills and the margin for other commercial customers at roughly 2-3 mills.[170] The established margins in Maryland are significantly lower than OPC's assumption. Thus, we are further unpersuaded by OPC's assertion that the wholesale model will result in excessive cost to ratepayers.

78. The Commission also finds persuasive PES's argument that the wholesale model facilitates the establishment of the transparent pricing by establishing each component of the final retail rate paid by the SOS customers. As noted above, the wholesale rate for generation will be established in the competitive procurement process. We also note that the administrative charge including a margin, if the Commission so approves a margin, will be determined and approved by the Commission in a regulatory proceeding.[171] For all of these reasons, we are persuaded that the wholesale model does not create unjustified additional costs.

[169] We note that in its reply comments OPC is silent and does not defend the forward premium.

[170] *See Case No* 8908, Testimony in Support of Settlement Agreement of Calvin L. Timmerman on Behalf of the Staff of the Public Service Commission of Maryland, at Exhibits CLT-4 *et seq.*, filed November 22, 2002 (MD PSC).

[171] *See* PES Comments at 3.

D. Commission Oversight of the SOS Process

79. **Morgan Stanley** comments that the Commission's oversight of the bid process and approval of retail SOS rates will ensure that the wholesale procurement process is fair, prudent and results in appropriate retail SOS prices.[172] PEPCO also comments that despite OPC's arguments to the contrary, it is confident that the Commission is fully capable of monitoring, assessing and correcting any unfair practices in the conduct of the wholesale bidding model.[173] J. Aron also notes that OPC is incorrect when it states that, unlike the retail SOS model, the wholesale SOS model does not provide the necessary Commission oversight to ensure fairness in the process.[174]

80. **OPC** states that because a large portion of the rate is set administratively, this requires active regulatory oversight on this process, which the Commission-adopted wholesale rules do not provide.[175] In its critique of the lack of regulatory oversight, OPC points out that the Commission would rely too heavily on an outside consultant, who would monitor the procurement process, and could possibly end up regulating the process entirely outside of the public eye.[176] Further, OPC notes that the wholesale rules do not provide for periodic formal reviews, leaving an unacceptable regulatory gap, and leaving the public and the OPC without an understanding of what took place during the procurement process.[177]

81. In its Reply Comments, **Morgan Stanley** argues that the Commission should reject as unfounded OPC's claim that the Wholesale Rules provide inadequate oversight.[178] Morgan Stanley argues that contrary to OPC's assertion, under the Wholesale Rules, the Commission will retain oversight over PEPCO's procurement costs, rate of return, bid process and Administrative Charge.[179]

82. In its Reply Comments, **WGES** notes that it does not address OPC's cost calculations, but notes that PEPCO goes to great lengths to discredit them, despite the fact that PEPCO would benefit if, in fact, OPC's comments are valid.[180] WGES states

172 *See* Morgan Stanley Comments at 3.

173 *See* PEPCO Comments at 20.

174 *See* J. Aron Comments at 7.

175 *See* OPC Comments at 13.

176 *See* OPC Comments at 14-15.

177 *See* OPC Comments at 16.

178 *See* Morgan Stanley Reply Comments at 12

179 *See* Morgan Stanley Reply Comments at 12.

180 *See* WGES Reply Comments at 6, *see also* summary of PEPCO's Comments rebutting OPC's cost calculation at ¶¶ 54, 55, and 60 *supra*.

that all suppliers, both retail and wholesale, must hedge their risks attendant to forward SOS contracts, but WGES cautions that PEPCO overstates the hypothetical case where District suppliers would be "unhedged," because both PEPCO and retail suppliers would hedge their risks.[181]

Discussion

83. The Commission finds that OPC's assertions that the proposed wholesale rules do not provide active regulatory oversight to be unfounded. As evidence of the Commission's ongoing commitment to provide effective regulatory oversight, the wholesale rules contain numerous provisions which authorize the Commission to actively oversee most facets of the SOS process. For example, Rule 2951.2 of the Wholesale Rules provides for a policy review after the initial year of wholesale SOS and subsequently as the Commission deems necessary. To provide additional regulatory oversight, Rule 2951.2 was revised to state that the Commission will conduct reviews of the SOS procurement process as needed. Rules 2952.3 and 2952.4 provide for the Commission's review of the bid solicitation process. Rule 2953.2 provides for the Commission review and approval of the winning bidder. Also, pursuant to Rules 2953.4 and 2953.5, the Commission will hold a proceeding to determine the appropriate Administrative Charge to be assessed for the service provided by the Electric Company in implementing SOS.

84. As originally enacted, the Act required that the Commission complete the competitive selection of the SOS provider no later than July 1, 2004.[182] However, on January 6, 2004, the Council of the District of Columbia approved Bill 15-0439, the "Electric Standard Offer Service Amendment Act of 2003," which, among other things, gives the Commission the discretion to choose either (or both) the wholesale or retail process as the bidding model for the implementation of SOS.[183] In Section 2 of the Amendment, Section 109(d)(1) of the Act was amended to reflect the fact that the July 2, 2004 deadline for selecting an SOS provider(s) applies only to the selection of a retail electricity supplier(s) by the Commission, if the Commission chooses to conduct such a process.[184] "If competitive bid procedures for the selection of a retail electricity supplier or suppliers to provide [SOS] are conducted by the Commission, the competitive selection of retail electricity supplier or suppliers to provide [SOS] shall occur before July 2, 2004."[185] No similar language was included regarding the implementation of wholesale SOS in the Amendment.

181 *See* WGES Reply Comments at 7.

182 *See* the Retail Electric Competition and Consumer Protection Act of 1999 ("Act"), at § 109(d)(1), D.C. Code, 2001 Ed. § 34-1509(d)(1).

183 *See* the Electric Standard Offer Service Amendment Act of 2003 ("Amendment"), D.C. Code, 2004 Ed. §§ 34-1501, 34-1509.

184 *See* Amendment at § 2, D.C. Code, 2004 Ed. § 34-1509(d)(1).

185 *Id.*

85. Before the Act was amended, in recognition of the July 1, 2004 statutory deadline for selecting an SOS provider(s), the Commission issued Order No. 13005 on December 4, 2003, asking parties to, among other things, comment on retail and wholesale SOS bidding timelines.[186] In response to this order, the parties filed comments and PEPCO and Morgan Stanley submitted comments on the proposed wholesale SOS timeline.[187]

86. PEPCO comments that the proposed timeline would generally be appropriate for carrying out the wholesale SOS process, but proposed two changes to the timeline.[188] First, PEPCO suggests that the Commission approve the proposed documents, such as the *pro forma* WFRSA, by June 1, 2004 instead of by May 1, 2004.[189] According to PEPCO, this would allow the Commission and the parties necessary time to review and comment on the documents.[190] PEPCO also notes that the publishing of retail prices should take place before the suggested December 7, 2004 date, to provide consumers with price information well in advance of the new SOS supply.[191]

87. In its comments, Morgan Stanley notes that it supports the proposed timeline, subject to a few changes and additions.[192] Morgan Stanley highlights that it also supports PEPCO's suggested changes, as outlined at the December 10, 2003 technical conference, where PEPCO requested that the activation of the RFP website occur on June 1, 2004; that the pre-bid conference be postponed until late June 2004; and that retail prices be posted by November 19, 2004.[193] Morgan Stanley also proposes that the beginning date, of January 5, 2004, for the Working Group to convene, and a list of documents to be created by the Working Group, be included in the wholesale timeline.[194] Documents that would be produced by the Working Group include a Request for Proposals for SOS bidders; a *pro forma* WFRSA; a Form of Guarantee; a Market Monitor Function Process; a Bid Evaluation Process; and a Bidder Qualification/Application Process.[195] Morgan Stanley also suggests that the Commission approve, after a comment period, the Working Group's documents on or before May 15, 2004, and in the event

186 *See Formal Case No. 1017*, Order Releasing Proposed Wholesale Standard Offer Service in the District of Columbia, Order No. 13005, at 1, Attachment B, rel. December 4, 2003.

187 *See Formal Case No. 1017*, Comments of the Potomac Electric Power Company on Proposed Wholesale Standard Offer Service Rules and Regulations, at 1-3, filed December 18, 2003 ("PEPCO December Comments"); *Formal Case No. 1017*, Comments of Morgan Stanley Capital Group, Inc. Regarding Standard Offer Service Issues and Proposed Draft Wholesale Rules and Regulations, at 3-5, Attachment 1, filed December 18, 2003 ("Morgan Stanley December Comments").

188 PEPCO December Comments at 2.

189 PEPCO December Comments at 2.

190 PEPCO December Comments at 2.

191 PEPCO December Comments at 2-3.

192 Morgan Stanley December Comments at 3-5, Attachment 1 (Morgan Stanley's proposed timeline).

193 Morgan Stanley December Comments at 4.

194 Morgan Stanley December Comments at 4.

195 Morgan Stanley December Comments at 4-5.

consensus documents are not created, the Commission should review alternative proposals before April 11, 2004 and finalize any alternatives, after a comment period, by May 15, 2004.[196] Finally, Morgan Stanley proposes that the wholesale SOS implementation timeline should include a period for submitting alternate provisions of the *pro forma* WFRSA due on August 18, 2004 to allow the Electric Company sufficient time to review the proposed provisions.[197]

88. Upon reviewing PEPCO's and Morgan Stanley's comments, the Commission finds that adoption of Morgan Stanley's proposed wholesale SOS implementation timeline provides the Commission with a reasonable framework for implementing the wholesale SOS process. The Commission also recognizes PEPCO's suggestions and has included these in the wholesale SOS implementation timeline. Therefore, with a slight modification to the initial date, the Morgan Stanley wholesale SOS timeline is adopted as the timeline framework, modified as appropriate to allow the Commission to meet its statutory requirements. The wholesale SOS implementation timeline is attached to this order.

IV. CONCLUSION

89. The Commission directs the SOS Working Group[198] to develop, by consensus, the list of documents outlined in the attached timeline by April 1, 2004, for submission to the Commission. If the Working Group cannot reach a consensus by April 1, 2004, then the Commission directs the Working Group to proffer alternative versions of the documents for the Commission to examine, by April 11, 2004. If no consensus document is submitted, the Commission will consider the alternatives and choose a version that is in the best interest of the District's ratepayers.

THEREFORE, IT IS ORDERED THAT:

90. The Wholesale Standard Offer Service process is **ADOPTED.**

A TRUE COPY:

BY DIRECTION OF THE COMMISSION:

Sanford M. Speight

CHIEF CLERK

SANFORD M. SPEIGHT
ACTING COMMISSION SECRETARY

[196] Morgan Stanley December Comments at 5.

[197] Morgan Stanley December Comments at 5.

[198] The Commission notes that Constellation requested that the Working Group include a member of the Commission Staff, but the Commission has determined that such an assignment would place too great a strain on the Commission's resources necessary to carry out its statutory duties.

SOS Implementation Timeline

Activity	Date
Working Group formed for creation of documents	March 1, 2004
Working Group meets to develop consensus documents - RFP for SOS Bidders - *Pro Forma* WFRSA - Form of Guarantee - Market Monitor Function Process - Bid Evaluation Process - Bidder Qualification/Application Process	March 1, 2004 - April 1, 2004
Working Group submits consensus documents to Commission (or Parties provide individual proposals)	April 1, 2004
Parties provide individual proposals for non-consensus documents (if necessary)	April 11, 2004
Commission comment/review process	April 1, 2004- May 14, 2004
Commission approves final documents	May 14, 2004
Consultant to be hired by the Electric Company	Late May, 2004
RFP Website goes active with due diligence information	June 1, 2004
Solicitation for Expressions of Internet	June 1, 2004
Pre-Bid Conference	Late June, 2004
Credit Application and financial information due	August 18, 2004
Alternative Provisions to *Pro Forma* WFRSA due	**August 18, 2004**
Alternative Letter of Credit Form(s) due, if applicable	August 18, 2004
Alternative Form of Performance Assurance due, if applicable	August 18, 2004
PJM and FERC qualifications due	August 25, 2004
Issue applicants' eligibility status	September 1, 2004
1st tranche price proposals due with Binding Bid Agreement	September 20, 2004
1st tranche bid assurance collateral due	September 20, 2004
Award 1st tranche bids	September 21, 2004
Execute 1st tranche WFRSAs and transactions	September 22, 2004
Execute Guaranty Agreement, if applicable	September 22, 2004
Approve 1st change transactions	September 24, 2004
Issue any revisions to 2nd tranche bid block targets	September 27, 2004
2nd tranche price proposals due with Binding Bid Agreement	October 4, 2004
2nd tranche bid assurance collateral due	October 4, 1004
Award 2nd tranche bids	October 5, 2004
Execute 2nd tranche WFRSAs and transactions	October 6, 2004
Execute Guaranty Agreement, if applicable	October 6, 2004
Approve 2nd tranche transactions	October 8, 2004

Activity	Date
Issue any revisions to 3rd tranche bid block targets	October 11, 2004
3rd tranche price proposals due with Binding Bid Agreement	October 18, 2004
3rd tranche bid assurance collateral due	October 18, 2004
Award 3rd tranche bids	October 19, 2004
Execute 3rd tranche WFRSAs and transactions	October 20, 2004
Execute Guaranty Agreement, if applicable	October 20, 2004
Approve 3rd tranche transactions	October 22, 2004
If necessary, issue 4th tranche bid block targets	October 25, 2004
4th tranche price proposals due with Binding Bid Agreement	November 1, 2004
4th tranche bid assurance collateral due	November 1, 2004
Award 4th tranche bids	November 2, 2004
Execute 4th tranche WFRSAs and transmissions	November 3, 2004
Execute Guaranty Agreement, if applicable	November 3, 2004
Approve 4th tranche transactions	November 5, 2004
Post retail prices	November 19, 2004
Contract delivery period begins	February 8, 2005