COMMENTS OF DIRECT ENERGY SERVICES, LLC ON HOUSE BILL 5819, AN ACT CONCERNING ENERGY RELIEF AND ASSISTANCE

ENERGY AND TECHNOLOGY COMMITTEE

March 7, 2008

Direct Energy Services, LLC ("Direct Energy"), a licensed competitive supplier of electricity and natural gas in Connecticut, hereby provides its comments opposing HB 5819, An Act Concerning Energy Relief and Assistance. Rather than provide the relief and assistance implied by the title, the Act would put Connecticut citizens and ratepayers at risk of higher electric prices and reduced reliability, and at significant financial risk from the state's direct participation in the wholesale power markets.

The Act essentially takes two bad ideas and combines them into one law. The first is the concept of a state power authority, in this instance to be called the "Connecticut Energy Authority." The goal and objectives of the Authority would include to:

> 1) procure least-cost supply-side and demand-side resources through competitive procurement processes to meet the electricity needs of all retail customers who elect service by said authority; (2) construct and operate generation facilities; and (3) sell electricity at cost to distribution companies and to municipal electric utilities and cooperatives.

Implicit in these goals and objectives is the apparent belief that a state-owned and operated entity can deliver lower-priced and more reliable electric service than the existing system of competitive wholesale and retail markets. There is no support for this belief. In fact, while opponents of competitive frequently make the claim that Connecticut has the highest rates of any state in the country, the highest rates for any service territory in the continental United States frequently belong to those of the Long Island Power Authority, and agency with the same laudable mission as the Connecticut Authority would have but which was not able to deliver on its promises of superior performance.

The perils of creating a state authority to perform the many complex functions of electricity generation and procurement have been well-documented in a paper recently released by PJM Power Providers' Group. The report summarized those perils as follows:

- ***Power authorities are riskier*** – from both a reliability and financial perspective, power authorities are riskier. As described earlier in a 1999 GAO report on the BPA, federally run hydropower plants are generally less reliable in generating electricity than are nonfederal hydropower plants. As the report noted:

> "These plants could not always obtain funding for maintenance and repairs when needed, and, as a result, the agencies postponed maintenance until the money was available. These delays caused frequent, extended outages and inconsistent plant performance."

From a financial perspective, the risk of failing to perform by a power authority falls upon the taxpayers, not shareholders as is the case with a private company. As illustrated by the 2004 New York State Comptroller's Office Audit, the planning and major operating losses of the power authority caused significant costs to the state.

- ***Power authorities are less financially stable*** – the organizational structure and lack of proper cost control incentives tend to make power authorities less financially stable. As the GAO Report on the TVA pointed out, an investor-owned utility can use equity financing but power authorities must rely upon debt to finance capital, with greater fixed costs leading to higher rates. A 2001 NYPA study pointed out the lack of incentives for NYPA to control waste and inefficiency. The report concluded:

  > "This audit is a red flag that NYPA is not managing these enormous public assets based on sound business practices."

- ***Power authorities do not guarantee lower costs*** – there is no guarantee that any organizational structure can provide low costs. Historically this has applied to power authorities as well. The earlier quoted GAO study found that BPA wholesale prices doubled in the period 1972-2001 while costs from other sources of power fell. As described earlier, NYPA recently built several large plant projects using inaccurate construction costs and future revenue estimates that resulted in net losses. This type of management and lack of planning will not deliver lower costs to consumers.[1]

A Connecticut authority would not be exempt from these potential problems. It certainly would not be exempt from the basic financial requirements of conducting business in the wholesale power markets. The credit requirements alone would be a huge additional burden for the State. For example, simply to schedule the delivery of power to a significant number of Connecticut residents through the ISO New England grid would require the State to post what would almost certainly be hundreds of millions of dollars of security with ISO New England, which requires a form of credit significantly more liquid than

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[1] "Big Risk, Small Reward: Why States Should Say No to Power Authorities," prepared by the PJM Power Providers' Group, March 3, 2008. A copy of the full report will be made available upon request.

the full faith and credit of the State. The counterparties to the kinds of power contracts the legislation envisions the Authority executing would also require the posting of highly-liquid credit. These obligations alone would be a significant financial commitment for the state and would have to be met before one kilowatt-hour flowed to customers of the Authority. Allowing the Authority to transfer title to the power it acquires to electric distribution companies might mitigate these credit requirements somewhat, but creating an Authority to enter into power contracts worth billions of dollars and then having that Authority simply "transfer title" to that power to a private entity would be an extraordinary misuse of public funds.

Moreover, the bill appears to be based on the assumption that a state entity that builds power plants or acquires the rights to the output of power facilities and sells that power on a "cost-of-service" basis will provide customers with lower prices and less volatility than they experience now. This is a flawed premise in several respects. First, measures that would reduce volatility also would tend to result in higher prices over time. The only way to reduce volatility is to transfer the risk of price fluctuations to another entity, for which that entity will always extract a premium. For this reason, and the additional reason that rate "stability" sends exactly the wrong price signal to customers at a time when the state and the country need to move aggressively toward energy efficiency, demand response, and conservation. Second, the "cost-of-service" regime is the very one that resulted in the high prices that led Connecticut and other states to restructure in the first instance. Many decades of cost-of-service regulation led to the $4 billion in stranded costs that still constitute about 8 percent of every customer's bill. This is an experiment that has already been done and need not be repeated: a state authority or vertically-integrated utility will not, over time, deliver better results than can be delivered through a robust competitive market.

The second broad concept contained in the bill is increased reliance on various long-term and bilateral contracts and other arrangements for standard service supply. There are many objections to this approach, not the least of which is that Public Act 07-242 directed the Department of Public Utility Control to study this issue and report back to the Legislature on it. Direct Energy and many other stakeholders participated extensively in this proceeding, and we believe it would be prudent to await the DPUC's report before acting further on measures that could, like the Energy Authority concept, expose ratepayers to an extraordinary level of financial risk, plus the risk of further stranded costs.

Moving standard service procurement away from the current system of all requirements RFPs and toward a more managed portfolio approach by including bilateral contracts and other disaggregated elements of all requirements service would take the Connecticut market in exactly the wrong direction from where it should be going. The percentage of load served by standard service is decreasing rapidly, meaning that long-term obligations entered into on behalf of those customers would have to be paid for by a smaller and smaller group of customers. If prices moved in a direction that made those contracts uneconomic, Connecticut ratepayers could be left with another round of stranded costs, perhaps even before the existing stranded costs have been fully paid for. It would be unwise to take standard service procurement in a direction that is premised on the need to keep customers from switching away when it is apparent that they are doing so every day.

While the idea that there may be "good deals" to be had in what may be a rising cost environment is an alluring one, there is no evidence that the kind of highly regulated approach to energy procurement called for by the Act could deliver these results. At the end of the day, rather than relying on the proven method of robust competition at both the retail and wholesale levels to drive prices as low as they can be under the circumstances, the Act would have a handful of regulators and utility employees attempt to beat the market through a series of discrete purchasing decisions, each one of which would be gambling tens or hundreds of millions of ratepayer dollars on the outcome. However well-intentioned the regulators and utility employees might be, there is no evidence that they would consistently do so, and there is considerable evidence from the vertically-integrated era that they would not.

Finally, as discussed above with respect to the Energy Authority, a return to what were the same tools employed by vertically-integrated utilities before restructuring would also take Connecticut in the wrong direction with respect to energy efficiency, demand response, and conservation. Procuring power in a manner designed to mute price fluctuations in an attempt to elevate "stability" over all other policy considerations will make it extraordinarily difficult to get customers to change their behavior, other than through highly prescriptive programs that are likely to be unpopular and less effective than products and services driven by innovation and the need to provide strong value and a good customer experience.

Thank you for the opportunity to provide these comments.

Chris Kallaher
Director, Government & Regulatory Affairs
Direct Energy Services, LLC
162 Cypress Street
Brookline, MA 02445
(617) 879-0668 (voice)
(617) 879-0661 (fax)
(617) 549-3002 (cell)
chris.kallaher@directenergy.com
www.directenergy.com