STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

COMMONWEALTH EDISON COMPANY	)	
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	)	
Proposal to implement a competitive procurement process by establishing Rider CPP, Rider PPO-MVM, Rider TS-CPP and revising Rider PPO-MI	))))	**No. 05-0159**
	)	

REPLY BRIEF

OF

DIRECT ENERGY SERVICES, LLC

AND

U.S. ENERGY SAVINGS CORP.

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REPLY BRIEF OF
DIRECT ENERGY SERVICES, LLC
AND U.S. ENERGY SAVINGS CORP.

Direct Energy Services, LLC, ("DES") and U.S. Energy Savings Corp. ("USESC"), by their attorneys DLA Piper Rudnick Gray Cary US LLP, pursuant to Section 10-101 of the Public Utilities Act (the "Act") and Section 200.800 of the Rules of Practice of the Illinois Commerce Commission ("Commission"), hereby submit their Reply Brief with regard to the proposed change in tariffs ("Tariffs") to implement a competitive procurement process by establishing Rider CPP, Rider PPO-MVM, Rider TS-CPP, and by revising Rider PPO-MI pursuant to the filing made by Commonwealth Edison Company ("ComEd") with the Commission on February 25, 2005 and responding to the initial briefs filed by ComEd and Staff of the Commission ("Staff").

I. Executive Summary: Price Stability Under ComEd's Proposal Would Come At Too High Of A Price

Direct Energy and USESC have set forth a simple and straightforward modification to ComEd's procurement proposal:

> **First,** customers with over 1 MW annual peak demand would have a default rate that is hourly;
>
> **Second**, customers that have under 1 MW annual peak demand and usage greater than 15,000 kWh a year would receive a default price that results from a monthly auction; and
>
> **Third**, customers that use 15,000 kWh or less a year would receive a default price that results from a quarterly auction.

ComEd and Staff were the only parties to respond to provide any response to the Direct Energy and USESC proposal; each asserting that the Commission should focus on price stability rather than providing proper price signals or promoting the competitive market. (*See* ComEd Init. Br. at 101-04; Staff Init. Br. at 96-97.) As explained in the Initial Brief of Direct Energy and USESC, price stability under ComEd's proposal would come at too high of a price for consumers. ComEd's plan ensures that customers on ComEd's default service would not be able to appropriately respond to market prices, and almost certainly would overpay for the service that they receive. The Commission should not endorse a policy which undermines the development of the competitive market and which significantly risks locking in long-term contracts for default service that are well above the market price of electricity.

In order to advance the best interests of the citizens and businesses of Illinois by promoting the development of an effective and efficient market for retail electricity service, the Commission should direct ComEd to revise its auction proposal in line with the modifications proposed by Direct Energy and USESC. Accordingly, Direct Energy and USESC respectfully request that the Commission enter an Order in this proceeding amending ComEd's proposal consistent with the changes proposed by Direct Energy and USESC.

V. Auction Design Issues

A. General Effectiveness and Suitability

ComEd and Staff each assert that the Commission should reject the modifications proposed by Direct Energy and USESC based upon their proclaimed concern about price stability. As discussed in the Direct Energy and USESC Initial Brief at pages 12 to 15, and as further discussed below, ComEd and Staff's concern is overblown and misguided. Further, the criticism lodged by ComEd and Staff does not refute the testimony of Direct Energy Vice President James Steffes.

There Is No Dispute That Shorter-Term Contracts Yield Substantial Consumer Benefits

Based upon the positions outlined in the parties' initial briefs, it is clear that there are substantial consumer benefits associated with including shorter-term contracts in the auction process. Indeed, much can be gleaned by the fact that parties do not dispute much of the expert testimony sponsored by Direct Energy and USESC.

First, no party takes issue with the fact that contracts with durations of longer than one year are saddled with an elevated risk premium. (*See* DES/USESC Init. Br. at 13-14, DES/USESC Ex. 1.0 at lines 161-66.) Indeed, Staff seems to acknowledge as much, citing Staff witness Zuraski's concern about "potential risk premiums associated with long-term contracts" and his conclusion that "long-term contracts may entail an excessive risk premium." (Staff Init. Br. at 96 *quoting* Staff Ex. 12.0 Corrected.) It appears that residential and small business customers may pay approximately 10% higher default service prices under ComEd's proposal than they would under a model with shorter-term contracts. (*See* DES/USESC Init. Br. at 12.)

Second, no party takes issue with the fact that long-term contracts remove the impact of changes in market price driven by supply and demand, to the detriment of the competitive market.[1] (*See* DES/USESC Init. Br. at 15; DES/USESC Ex. 1.0 at lines 283-89.) Again, Staff cites the testimony of Staff witness Zuraski: "if there is a significant expected upward or downward trend in market prices, the longer-term contracts will induce uneconomic retail switching activity." (Staff Init. Br. at 96 *quoting* Staff Ex. 12.0 Corrected.)

Third, no party disagrees with the conclusion that a default service based on long-term contracts can contribute to a lack of demand-side reductions, and increased environmental harm due to increased energy consumption. (*See* DES/USESC Init. Br. at 13-14; DES/USESC Ex. 1.0 at lines 316-334.)

Finally, no party disagrees that if market prices decline substantially during the term of the default service contracts and consumers do not have competitive options, it could yield the worst of all possible scenarios: consumers locked into high rates with no real competitive option. (*See* DES/USESC Init. Br. at 12; DES/USESC Ex. 1.0 at lines 291-303.)

In short, no party has taken issue with the testimony of Direct Energy and U.S. Energy Savings Corp. that there are substantial benefits associated with an auction process that incorporates shorter-term contracts. Indeed, although Staff recommends that the Commission adopt ComEd's proposal, Staff makes the case for a revised process, relying upon shorter-term contracts, particularly for the first auction.[2] (*See* Staff Init. Br. at 96.)

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[1] Direct Energy and USESC also explained that ComEd seems to be requesting Illinois consumers to pay twice for volatility management, both through long-term default contracts and through PJM's proposed Reliability Pricing Model. (*See* DES/USESC Ex. 2.0 at lines 228-37.)

[2] Staff quotes the following passage from the testimony of Staff witness Zuraski: "[A]s with any new process, the possibility of discovering problems or errors is higher for the initial implementation of the auction and will diminish over the course of subsequent auctions as problems are discovered and remedied on a going-forward basis. However, the length of time that is required before any remedial measures can take effect generally will be tied to the length of the supply contracts. In this regard, it may make more sense to test the waters with shorter-term contracts until all the problems with the auction (if any) have been identified and, if possible, eliminated or ameliorated." (Staff Init. Br. at 96 *quoting* ICC Staff Ex. 12.0 Corrected.)

Nevertheless, ComEd and Staff suggest that the Commission should forgo these benefits due to an unsubstantiated concern about price stability. The Commission should put this concern in proper perspective, and understand that the DES/USESC proposal would not expose customers to unmanageable price variability.

The Concern Regarding
Price Stability Has Been Overstated

Although Direct Energy and USESC appreciate the need to balance the competing interests of mitigating price variability and sending meaningful price signals, the ComEd proposal goes too far in focusing upon price stability and fails to provide market sensitive pricing. Both ComEd and Staff assert that the Direct Energy and USESC proposal is inconsistent with the goal of achieving price stability. (*See* ComEd Init. Br. at 103; Staff Init. Br. at 97.) However, the Commission can achieve significant consumer benefits by endorsing modest revisions to ComEd's proposal.

As an initial matter, the Commission should note that in terms of the frequency of price adjustments, the modifications proposed by Direct Energy and USESC are not substantial. The following table illustrates the similarities:

Table 1: Comparison of ComEd and DES/USESC Proposals

	ComEd Definition	DE/USESC Definition	ComEd Product	DE/USESC Product
Largest Customers	Over 3 MW	Over 1 MW	Hourly Pricing	Hourly Pricing
Medium-sized Business	400 kW – 3 MW	More than 15,000 kWh annually and less than 1 MW	Semi-annual pricing based on Annual product	Monthly pricing based on Monthly product
Small Business And Residential	Less than 400 kW	Less than 15,000 kWh annually	Semi-annual Pricing based on Blended multi-year product	Quarterly pricing based on Quarterly product

For the largest customers, ComEd agrees with Direct Energy and USESC that it is appropriate to offer such customers solely an hourly product. The only difference is in determining where the defining line for the “largest” customers is drawn: ComEd has not justified treating a 1-3 MW customer different than an over 3 MW customer. Indeed, ComEd’s original proposal included the 1-3 MW customers in its “Very Large Load” customer grouping with other customers over 3 MW. (*See* ComEd Ex. 7.0 at lines 927-33.)

For many of the medium-sized business customers with demands of less than 1 MW, Direct Energy and USESC suggest that their price be adjusted monthly rather than semi-annually as ComEd has proposed. That is, ComEd now proposes that business customers with demands greater than 400 kW be included in its annual auction product, with prices adjusted via a regulatory construct to reflect seasonality. Direct Energy and USESC recommend that business customers with demands of less than 1 MW and with usage of more than 15,000 kWh[3] annually be included in a monthly auction, allowing the market to reflect changing market conditions throughout the year.

Finally, for the residential and small business customers, rather than have a regulatory construct reflect seasonality by translating multi-year contracts on a semi-annual basis as suggested by ComEd, Direct Energy and USESC's recommended quarterly adjustments in price based upon quarterly auctions.

Aside from determining the frequency with which the prices should change, the Commission must determine what inputs it should direct ComEd to include in calculating those price adjustments. Again, the sole concern raised regarding the use of the shorter-term contracts was that some customers would have less stable pricing. However, Direct Energy and USESC have demonstrated that the price variability associated with their proposed modified auction structure is manageable and that consumers likely would pay less.

In particular, Direct Energy and USESC presented a detailed analysis of how a residential customer in New Jersey would have fared using a monthly default rate rather than the blended rate that was generated through the New Jersey Basic Generation Service ("BGS") wholesale auction. (*See* DES / USESC Ex. 1.0 at 452-75.) Looking at 2004 data, the analysis concluded that residential customers would have saved $6 million over the course of the year, even assuming that there was no demand-side response to the price signals.[4] (*See id.*) Moreover,

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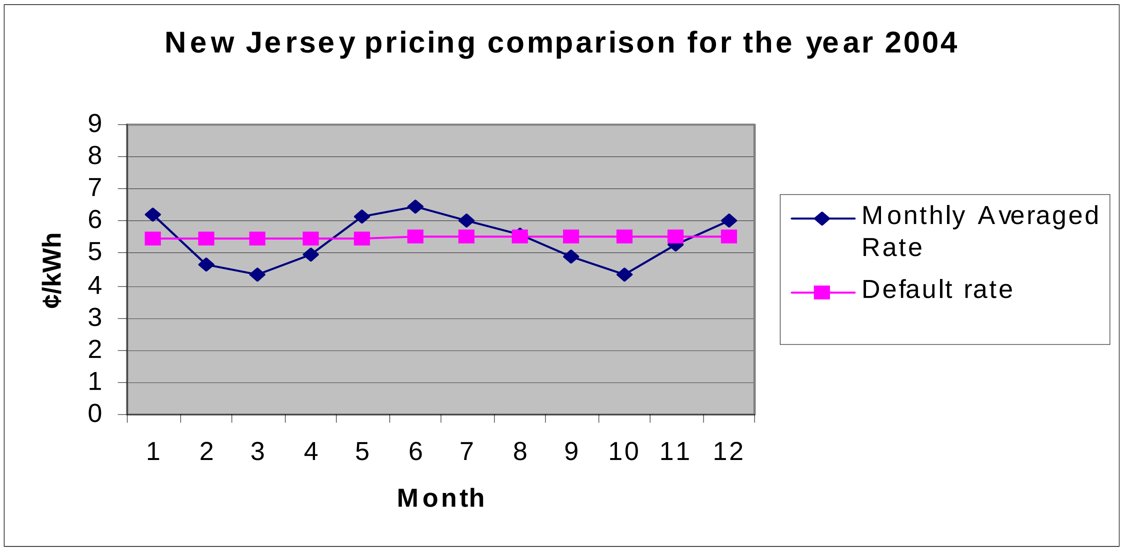
[3] Direct Energy and USESC have established the 15,000 kWh defining line to comport with the definition of "small commercial retail customer" in the Public Utilities Act. (220 ILCS 5/16-102.)

[4] Direct Energy and USESC presented a similar analysis using data for the periods 2001 through 2004, comparing a monthly pricing model against the tariffed service of ComEd's affiliate PECO, and concluded that residential customers would have experienced a savings of 9.4% under the monthly price, even assuming no demand-side response. (*See* DES / USESC Ex. 2.0 (Revised) at lines 164-68.)

while prices would have fluctuated from month-to-month, the price movements were not substantial, and were the result of seasonality in the underlying wholesale market. (*See id.*)

Mr. Steffes presented the following graphic illustration of the results of his analysis:

Table 2



(*Id.* at lines 469-71.) As Mr. Steffes concluded, "using a monthly pricing model not only creates demand side management and environmental benefits, it also does not expose customers to undue fluctuations in price." (*Id.* at lines 473-75.)

Finally, Direct Energy and USESC pointed to numerous examples of customers in Illinois and throughout North America capably managing their response to monthly energy pricing. (*See id.* at lines 486–550.) No party challenged the detailed examples of customers managing monthly and quarterly electric pricing in New York, Texas and Alberta, Canada; likewise no party disputed that Illinois consumers already successfully manage monthly pricing for natural gas. (*See id.*)

By ordering the modifications to ComEd's procurement proposal in line with the proposal set forth by Direct Energy and USESC, the Commission can appropriately set the stage for significant and substantial competition that would benefit all Illinois retail customers without exposing customers to unmanageable price volatility.

<u>CONCLUSION</u>: The Commission Should Order Modifications To Promote The Development Of The Competitive Market

As one door closes, the Commission must open the next door. The Commission should take the opportunity to establish a fully competitive retail electric market that benefits all Illinois consumers. The Commission should be wary of locking residential and small business customers into a series of long-term wholesale supply contracts that would have the unintended effect of denying those customers the advantages associated with a competitive retail electric market. Direct Energy and USESC have put forth straight-forward modifications to ComEd's procurement proposal that would enhance the development of a robust competitive retail electric market, to benefit all Illinois consumers.

Direct Energy and USESC respectfully request that the Commission enter an Order directing ComEd to modify the products and customer groupings included in its procurement proposal as follows:

1. For customers with an annual peak demand over 1 MW, establish an hourly default rate.

2. For customers with an annual peak demand under 1 MW and usage greater than 15,000 kWh per year, establish a default price based on a monthly auction.

3. Customers consuming 15,000 kWh or less per year, establish a default price based upon a quarterly auction.

Without exposing customers to unmanageable price volatility, the Direct Energy and USESC proposal would yield just and reasonable default rates for electric service that better reflect the true cost of producing electricity. As a result, default service consumers would receive more timely and accurate price signals that encourage more efficient energy use and energy efficiency improvements.

Respectfully submitted,

DIRECT ENERGY SERVICES, LLC
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