Energy Choice Matters

May 9, 2008

Merger and Organic Growth Increase Integrys Energy Services' Sales

Integrys Energy Services posted greater physical and forward sales of gas and electricity despite a high-priced environment that has customers opting for shorter-term deals, the competitive supplier reported during an earnings call.

Integrys Energy Services' income from continuing operations decreased $13.3 million for the quarter to $51.6 million, mostly from increased mark-to-market losses. The competitive unit also had higher operating and maintenance expenses from higher payroll, benefit costs, and consulting fees stemming from growth of the unit's business.

While the acquisition of Peoples Energy, only partially recorded in last year's quarter, accounted for much of the increase in physical sales, Integrys Energy Services saw organic growth in gas and power as well, executives reported.

Physical retail natural gas volumes grew to 107.6 bcf versus 91.5 bcf in the year-ago quarter. Organic retail natural gas sales growth was most pronounced in Illinois, Michigan, and Wisconsin.

Forward gas contracted values were 535.7 bcf versus 510.1 bcf a year ago.

Pre-tax realized natural gas margins increased to $42.7 million from $38.7 million for the first quarter of 2007, mostly due to the inclusion of Peoples Energy for a full quarter.

Physical retail electric volumes reached 3,953 million kWh compared with 2,439 million kWh in the prior year's quarter. Texas led organic growth, followed by organic and merger-related growth in Illinois.

Integrys Energy Services also saw growth in New England electric sales from an increased sales focus in the area.

Electric forward contracted volumes hit 96.3 million MWh versus 74.6 million MWh a year ago.

... Continued Page 6

CAPP Says Pilot Shows Need for Opt-Out Municipal Aggregation in Texas

The response from REPs to a pilot aggregation project among six Texas cities shows that legislators need to permit opt-out municipal aggregation, and that all Texans aren't benefiting from deregulation, the Cities Aggregation Power Project asserted.

Over 1,600 households in Cisco, Comanche, Dublin, Eastland, Hamilton and Snyder registered for the People's Electricity Program that sought to obtain lower rates through aggregation. The majority of those customers have never switched providers, CAPP said. The cities are either in Oncor, Texas New Mexico Power, or AEP Texas North.

CAPP reported the pilot was unable to find an "attractive" offer.

"Providers simply refused to take part in the program or saw no reason to offer rates lower than those already available," said Geoffrey Gay, legal counsel for CAPP.

Gay claimed that residential customers in the small towns, "have essentially been ignored."

CAPP argued REPs have "no incentive" to go into rural areas to aggressively pursue customers.

We did not receive a response for a request for comments from several REPs before press time.

CAPP noted that in some instances, the costs of acquiring new customers in small communities may not be cost-effective for REPs, which can often enroll more new accounts by focusing marketing efforts in larger cities.

CAPP claimed opt-out municipal aggregation would boost participation.

... Continued Page 6

Surges and Circuits
A weekly review of what's up and down in energy markets.
***Pushed to Monday due to voluminous news*

Popowsky Estimates Pa. Prices After Rate Caps

Although it's not possible to determine with certainty what power prices will be for Pennsylvania consumers when rate caps expire at the remaining utilities, Consumer Advocate Sonny Popowsky estimated the increase to range from 8% to 63%, in a letter to Gov. Ed Rendell, D.

Rendell pounced on the results to push the legislature to pass H.B. 2201. The law calls for default service to be bought via a, "competitive procurement plan designed to produce the lowest reasonable rates on a long-term basis and includes a portfolio of long-term, short-term and spot-market purchases."

The default rate for residential and small business customers would be a fixed rate that would change no more than annually, although utilities could offer other pricing plans. Utilities would have to offer voluntary phase-in plans as part of the expiration of rate caps.

Popowsky used PPL's average price of procured power (10.52¢) from three default service auctions held to date (another three remain) to estimate the rates at PPL and other utilities. Popowsky reasoned PECO and Met Ed would receive similar prices from procurements as PPL given their geography, while utilities further west, Penelec and Allegheny (West Penn), would have prices about 9% lower.

From that basis, Popowsky calculated the following prices increases for residential customers when rate caps expire:

PECO - 8%
PPL - 37%
Penelec - 50%
Met Ed -54%
Allegheny (West Penn) - 63%

At Allegheny, the rate increase won't occur all at once, with a 1.2¢ increase scheduled for 2009 and 2010, making the increase at the end of 2010 only 41%.

As percentages, the increases reflect the size of the current rates, Popowsky noted, and thus PECO, which has higher rates today, has a lower percent increase.

The total cost over current rates would be $1.55 billion annually, Popowsky estimated. At PPL, the average residential customer would pay $500/year, he noted.

Mirant's Muller Doubtful of New Capacity Keeping Pace with Demand

The "inexorable" march of declining reserve margins is going to raise consumer electricity prices, Mirant CEO Ed Muller told analysts on an earnings call.

He continues to see nothing happening in the marketplace that will realistically will create supply to meet rising demand. While the slowing economy and higher fuel prices may slow a rise in demand and power prices, over time Muller eventually sees higher prices from a lack of supply continuing for almost a decade. Adding new nuclear capacity is going to take longer than people think, Muller explained.

While he'd like to build new capacity in Maryland, the economics don't currently support it, as RPM is not providing revenue streams that justify adding capacity.

Muller does not know what Maryland policymakers will do in terms of the industry's structure, but suggested Mirant would be pleased to participate in a process where new capacity is built under contracts.

Given the state of the economy, Muller thinks the increase in power prices that will be felt under the Regional Greenhouse Gas Initiative ought to be a higher focus.

Hedging losses and lower sales in the Northeast caused by higher fuel prices increased Mirant's quarterly loss to $152 million compared with a loss of $52 million a year ago.

Excluding $303 million in hedging losses Mirant earned $158 million, up from adjusted earnings of $129 million a year ago.

Mid Atlantic realized gross margin rose to $264 million from $246 million in the year-ago quarter from higher capacity market revenue.

Realized gross margin in New England fell about one-third, from $90 million in the year-ago quarter to $61 million, from lower generation volumes at Mirant's plants due to higher fuel costs, particularly oil. Lower incremental realized value from hedges also contributed to the lower margin.

But the market's volatility in the first quarter backs the company's decision to hedge, Muller added.

Mirant will respond to Pacific Gas & Electric's RFO for 1,200 MW, Muller reported. Submissions are due in July.

World Energy Confirms Customers Delaying Procurements

World Energy Solutions saw a slowdown in customers using its online auction procurement service but expects "vigorous" buying activity when customers return to the market, executives reported on an earnings call.

Customers, particularly wholesale consumers, have sought to delay commodity purchases given spikes in fuel and energy prices, COO Philip Adams noted. Wholesale customers with one-to-three year positions can more easily delay their buying than retail customers whose contracts are typically 12-18 months. Accordingly, World Energy saw a bigger dip in wholesale customers using its procurement services.

But Adams expects the dip to be a temporary phenomenon, as prices will either go down and prompt customers into the market, or sustained high prices will convince customers that by delaying procurement there's little upside and only greater risk from further price spikes.

Volatile markets are good for World Energy's customer count in the long-term, Adams added, since customers shop more aggressively as prices rise.

World Energy recorded a net loss of $2.2 million for the quarter, compared with a $0.4 million loss a year ago, on higher operating expenses. Staff grew from 24 to 62 year-over-year.

Executives reported a healthy customer pipeline with its wholesale market client base growing to 20 from 2 in the prior year's quarter.

The firm's number of channel partners grew to 46, an increase of 14, year-over-year.

Executives touted its selection as the auction provider for the Regional Greenhouse Gas Initiative as creating a great cross-selling opportunity to suppliers regulated under the carbon cap.

Either Way, It's Time for Action in Maryland, Stakeholders Say

Stakeholders urged the Maryland PSC to bring greater certainty to the state's electric industry, including issuing a final order in several major cases such as its review of SOS (9117), but diverged on what policies the PSC should make permanent, in comments on the PSC's interim re-regulation report (Matters, 5/7/08).

Recommendations ranged from ending retail competition completely to new policies to lower barriers to retail choices, with most comments addressing the use of long-term contracts for SOS.

There is no evidence from Maryland's experience, or from other states around the country, that retail electric choice is benefiting small customers, the Office of People's Counsel declared in urging lawmakers to drop legislative language mandating the promotion of competition.

OPC dismissed the Texas experience since offers there are "predominantly" for monthly prices, OPC claimed.

"These markets do not appear to provide any true savings to customers, but only the opportunity to gamble on whether one offer turns out to be better than another," OPC charged.

OPC wants the PSC to direct the IOUs to submit long-term procurement plans covering 15 to 20 years.

The consumer advocate suggested that residential power procurements should include contracts or regulated power plants that are assigned to a wider group of ratepayers than just residential customers because of their benefits in ensuring reliability or moderating price volatility.

OPC submitted a report by its consultants showing that a portfolio approach including energy efficiency and renewables would be more advantageous, in terms of price and risk, than either the current SOS or a spot market approach.

But generators, retailers and distribution utilities raised a host of concerns regarding long-term contracts or regulated generation, and questioned whether they would even produce lower prices.

As the PSC interim report noted, transmission projects are the most cost-effective outcome to the state's supply problem, the Retail Energy Supply Association pointed out. Yet signing long-term contracts would deprive customers of the cheaper power available from the grid projects when they're completed, letting other states in PJM reap cheaper power prices while Maryland consumers lock-in a higher rate. RESA cautioned against even shorter-term bilateral contracts as costing up to $1.7 billion in excessive costs, based on one of the report's scenarios.

Long-term contracts would not likely produce lower prices, Baltimore Gas & Electric explained, because no merchant generator would enter a contract without indexing the variable portion of cost, e.g. fuel. Customers would thus pay all fixed costs of generation plus the prevailing fuel cost in hopes the margins will cover the fixed costs - a big risk for consumers.

BGE suggested laddering SOS over three years with two procurements annually.

Customers bear all of the risk of poor choices where a regulatory process, rather than the market, chooses winners and losers with respect to new technologies, environmental attributes, and even location of new infrastructure, Constellation Energy pointed out.

However, Constellation did find long-term commitments appropriate in some instances - such as a long-term supply arrangement to support new nuclear reactor design.

Competition wasn't pursued for "academic reasons," PPL reminded, but because of real failures in regulatory policies that led to large prices differences between neighboring utilities and plant cost overruns. Regulation failed to produce reasonable costs in the 1980s and early 1990s, PPL added.

PPL pointed to the higher cost of proposed, long-term offshore wind contracts in Delaware as belying the claim that such long-term contracts could reduce prices. The Delaware proposal, since abated, would have cost up to an extra $22/month for residential customers, PPL noted. California also regretted signing $43 billion in long-term contracts at $70/MWh when spot prices fell to $30/MWh, PPL observed.

Thus, long-term contracts carry a high risk for customers with little guarantee they'd actually produce lower prices, PPL concluded.

The PJM Power Providers Group (P3) argued that Maryland's situation is not a question of "waiting for the market to work" since the market already is. P3 pointed to 10,000 MW added by the RPM auctions held to date, with another 55,000 MW active in the PJM queue. While not all of that total will be built, P3 stressed that the numbers should not be dismissed.

Several market participants noted long-term contracts would be at odds with goals for energy efficiency and demand response because of static pricing. RESA, citing Maryland Energy Administration data, reported that electric use per residential customer increased by 15% from 1998-2004 when rate caps were in place in Maryland. In Texas, where prices weren't capped, use per residential customer decreased by 3% over the same period.

Allegheny Energy "continues to strongly support" the competitive market and current SOS procurement process, indicating that using the wholesale market procures power at the lowest available cost, promotes transparency and provides price signals for investment.

Still, Allegheny supports using long-term contracts "at competitive market prices," but only where full cost recovery is guaranteed and utilities are protected from prudence reviews and stranded costs. Long-term purchases should not increase cost of remaining load that is still bid, Allegheny cautioned.

Effective competition is a "viable alternative" to re-regulation, Pepco and Delmarva argued.

However, should the PSC pursue re-regulation, it should be limited to residential and small commercial customers, the Pepco utilities suggested. Additionally, the PSC would need to ensure that there would be no stranded costs either by eliminating customer choice, or by imposing a non-bypassable surcharge on all customers.

But the Maryland Energy Group, representing industrials, argued that the costs of long-term contracting or utility-built generation for small customers should not be socialized over all customer classes via non-bypassable distribution charges.

Industrials also cautioned against putting too many eggs in the demand response basket, since an over-reliance on demand resources could cause needed supply investment to be bypassed, exacerbating potential shortfalls and raising prices. Utility load response programs need to be cost effective, the group added.

Washing Gas Energy Services also noted that once a decision is made to cure reliability problems with non-market solutions, the reliance on such solutions will be perpetuated, since it will drive merchant solutions from the market, thus leaving only non-market alternatives for any subsequent power needs.

AARP reminded the PSC of its statutory obligation to procure SOS at the "lowest cost with the least volatility" and "best price" in light of market conditions, and the need to protect customers from excessive price increases. Such a policy cannot be obtained without evaluating a variety of contract terms and contract types for SOS over a longer-term planning horizon such as 10-15 years, AARP claimed.

Direct Energy noted the interim report contained little on retail competition, and urged the PSC to pursue polices that would eliminate barriers to greater mass market choices. Suggestions included requiring customers to affirmatively choose a commodity provider when initiating new service and quick implementation of new payment processing rules.

Direct further pushed opt-out municipal aggregation with a sunset date of 2015, or at least approval of its low-income aggregation proposal in Case 9117.

The two-year static SOS product needs to be abandoned so the state can achieve its environmental goals through prices that prompt demand response, Direct added. Smart meters would facilitate load response, but a proper pricing structure could achieve demand response in the absence of smart meters, Direct noted.

Global Competition, Entry Barriers Hindering New Generation, Dynegy's Williamson Says

Mark-to-market loses of $284 million resulted in Dynegy posting a $152 million loss in the first quarter, compared with a $14 million profit a year ago.

CEO Bruce Williamson, though, touted the IPP's position as he sees a sustained period of higher power prices from global competition and rising barriers to entry. New generation development is virtually nonexistent, Williamson claimed, because of environmental regulations, rising construction costs and unstable capital markets. Demand is still growing and Williamson does not expect the economic slowdown to significantly decrease demand.

Electric forward curves do not yet fully reflect the anticipated market implied heat rate expansion, Dynegy noted. While forward heat rates are somewhat compressed due to rising natural gas prices, Dynegy expects them to expand as supply and demand further tighten.

Dynegy reported slightly higher volumes in the Midwest, but sales were hurt by outages. In the Northeast, lower spark spreads led to lower volumes.

Briefly:

PUCT to Brush Up on Entergy Transition to Competition

The PUCT is to hold a "refresher" meeting regarding Entergy's transition to competition plan (33687) towards the end of the summer (possibly at the end of an open meeting) to allow Commissioners to get back up to speed on the docket which had been abated as SPP performed various integration studies (Matters, 4/30/08). The record won't be re-opened and there won't be new testimony; Commissioners will review and ask questions about the current record and progress to date. SPP expects to complete its study in the November to December timeframe, and the PUCT yesterday directed ERCOT to update its integration study to provide a meaningful comparison as to which power region Entergy should join. Chairman Barry Smitherman was anxious that the studies be finished before next year's legislative session, since Entergy's participation in retail choice is always a topic there.

PSC Staff, O&R Throw Water on RESA MHP Suggestion

RESA's request for Orange and Rockland to lower its mandatory hourly pricing threshold to 500 kW as part of a rate case joint proposal (Matters, 5/5/08) should be denied because no party offered testimony on the issue, New York PSC staff and O&R argued in reply comments (07-E-0949). O&R also cautioned against changing MHP, which would necessitate new meters for certain customers, before the Commission develops an advanced metering policy to ensure consistency and avoid stranded costs.

Smitherman Ponders Automatic Approval for Current CCN Holders in CREZ TSP Selection

PUCT Chairman Barry Smitherman wanted more time before voting on a selection criteria for Transmission Service Providers (TSPs) for Competitive Renewable Energy Zones to consider the idea of automatically qualifying current CCN holders on financial measures (Matters, 5/2/08, 2/5/08). Accordingly, the Commission deferred action on the project

(34560). Transmission builders with a current CCN wouldn't jeopardize their core business by pursuing CREZ grid building without proper financial backing, the Chairman reasoned. Smitherman also doesn't put a lot of stock in credit ratings given today's market climate, so doubted certain financial metrics would be overly useful. Commissioner Julie Parsley still thought some specific guidance would be appropriate to steer applicants on the types of things the Commission would consider as evidence of financial competence in the qualification process.

PUCT Choice Guide Tops National Competition

The PUCT's Official Guide to Electric Choice won first place in the Brochure/Booklet category from the National Association of Government Communicators, beating thousands of local, state and federal government publications (Matters, 3/27/08).

PUCT Consolidates Entergy CCN Dockets

The PUCT consolidated two dockets concerning Entergy Gulf States' separation into Entergy Texas, 35183 and 35519. One of the dockets was opened as a protest by Texas Industrial Energy Consumers over Entergy Gulf States not seeking PUCT approval to transfer its CCN to Entergy Texas (35183), while the other was Entergy's subsequent request to do so (Matters, 2/5/08). Docket 35183 was closed and all filings should now be made in 35519.

PPL EnergyPlus Signs Pa. Colleges

PPL EnergyPlus won contracts totaling 1.3 bcf to supply natural gas to the Pennsylvania State System of Higher Education beginning in June. The pacts vary in length from 10 months to 3 years.

ISO-NE Issues Power Watch

ISO New England issued a Power Watch yesterday for Boston and northeast Massachusetts and called on demand response due to a transmission outage and unplanned outage at one power plant. The watch was issued at 2 p.m. and afternoon use was normal at around 16,000 MW. The watch was lifted late yesterday.

Integrys Earnings ... from 1

Pre-tax realized retail electric margins increased by $19.1 million from a $1.8 million negative margin in the first quarter of 2007, to a $17.3 million positive margin in the first quarter of 2008.

Integrys Energy Services President Mark Radtke was "pleased" with Integrys Energy Services' continued success in growing its forward book, especially in a rising price environment. Rising prices tend to reduce customers' enthusiasm for long-term price commitments, he noted, and Integrys Energy Services has seen a greater preference for monthly contracts.

At the end of March last year, Integrys Energy Services' average retail natural gas contract had 11.5 months remaining, while at the end of March this year, the average term is down 17% to 9.6 months. Integrys Energy Services has seen a similar trend on the electricity side, with the average term in Integrys Energy Services' largest market, Illinois, down 65% versus last year's quarter.

Radtke, though, is not particularly alarmed by the shorter contracting, and expects it to increase when prices stabilize or decline.

"Whether or not prices remain high, we generally don't expect customers to stay away from longer term contracts indefinitely," Radtke said.

Integrys Energy Services' organizational integration of Peoples Energy and the associated platforms are in place, and systems and process integration is substantially complete.

However, Integrys Energy Services is still working through a number of operational issues that have impacted its ability to bill some customers on a timely basis.

Virtually all of the Peoples Energy contracts have been moved to Integrys Energy Services. Integrys Energy Services has begun contract renewal of those customers, many of whom have contracts coming due in the second quarter.

While Integrys Energy Services is seeing bad debt rise from higher default rates among its retail customers, it has been able to remediate the bad debt issues and employ tools including credit insurance to reduce adverse financial exposure.

The marketer continues to add to its sales force dedicated to wholesale deals and is working on building out its natural gas capability and adding originators that focus on serving the producer market.

Integrys Energy Services anticipates launching a new product to environmentally aware customers late in the second quarter, part of its new green unit.

CAPP Aggregation ... from 1

However, it isn't clear, and CAPP does not claim in a news release, that participation was a problem, or that CAPP expects an opt-out pool to result in lower offers from REPs. CAPP's press contact referred us to its two attorneys for such specific questions, but a response was not received by press time.