

SUPREME COURT OF PENNSYLVANIA

No. 359 MAL 2020

NRG ENERGY, INC.

Petitioner,

v.

**PENNSYLVANIA PUBLIC UTILITY
COMMISSION**

Respondent.

**BRIEF OF AMICUS CURIAE THE R STREET
INSTITUTE IN SUPPORT OF THE PETITION**

Brief of Amicus Curiae in support of Petition for
Allowance of Appeal from the June 2, 2020 Order of the
Commonwealth Court at Docket No. 58 CD 2019,
affirming the December 20, 2018 Opinion and Order of
the Pennsylvania Public Utility Commission at Docket
No. R-2018-3000164

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STATEMENT OF INTEREST OF AMICI CURIAE

The R Street Institute is a nonprofit, nonpartisan, public-policy research organization with a mission to engage in policy research and outreach to promote free markets and limited, effective government. R Street has a long-standing interest in electricity competition because of the economic and environmental benefits it provides. R Street submitted an amicus brief before the Commonwealth Court in this case, and thus is eligible to submit an amicus brief in support of the petition for allowance of appeal per 210 Pa. Code Rule 531(b)(1).

Pennsylvania is a leader in consumer choice in electricity markets. Ensuring that competition in Pennsylvania is not undermined by cross-subsidization is a core principle of the Commonwealth's law as well as an important policy matter that must be resolved appropriately for Pennsylvania and other jurisdictions that have elected to pursue electricity market restructuring.

No one other than the amicus curiae or its counsel paid for the preparation of this amicus curiae brief or authored this brief, in whole or in part.

ARGUMENT

I. The Competition Act Requires the Public Utility Commission to Prevent Cross-Subsidies.

Central to this case is the Electricity Generation Consumer Choice and Competition Act (“Competition Act”), enacted by the Pennsylvania legislature in 1996. Prior to the Competition Act, Pennsylvania electricity operated under a monopoly utility model. Under this system, electric utilities were granted exclusive right to provide electric service in a given geographic region and were subject to extensive oversight and regulation by the Commonwealth’s Public Utility Commission (“Commission”). Electric rates were determined under a cost-of-service model, according to which a utility was allowed to charge what was necessary to recover its costs plus an additional amount to provide a return on and of its investment.

The Competition Act fundamentally restructured this system, giving residential and business customers in the Commonwealth the ability to choose their electric provider. Under the new system, incumbent electric utilities were required “to unbundle their rates and services and to provide open access over their transmission and distribution systems to allow competitive suppliers to generate and sell electricity directly to consumers in this Commonwealth.” 66 Pa. Cons. Stat. § 2802(14). In passing the Competition Act, Pennsylvania recognized that the

switch to competition was essential “to benefit all classes of customers and to protect this Commonwealth’s ability to compete in the national and international marketplace for industry and jobs.” *Id.* § 2802(7).

While the Competition Act made Pennsylvania’s electric system substantially more competitive, the Legislature also decided to keep certain parts of the electric system immune to competition. Setting forth the policy goals of the Competition Act, the Legislature asserted that “[i]t is in the public interest for the transmission and distribution of electricity to continue to be regulated as a natural monopoly subject to the jurisdiction and active supervision of the commission.” *Id.* § 2802(16). The Act also determined that “[e]lectric distribution companies should continue to be the provider of last resort in order to ensure the availability of universal electric service in this Commonwealth.” *Id.*

Some other states that have restructured their electric markets have determined to “quarantine the monopoly” in order to ensure competition functioned properly. *See* Michael Giberson & Lynn Kiesling, *The Need for Electricity Retail Market Reforms*, Regulation, Fall 2017, at 34, 37. This is not the path that Pennsylvania chose. Instead, the Commonwealth codified a policy in which the residual poles-and-wires company—sometimes called a “default provider”—would continue to provide energy-supply service, at least to customers who did not elect to choose a third-party provider. PECO Energy Company

(“PECO”) continues to operate both as a distribution utility and as an electric provider in the competitive sector providing a “default provider” electric service option for customers in its distribution area.

The Commonwealth’s policy choice to have a default provider comes with an obvious risk. The residual monopoly may seek to underprice its energy-supply offering, which is subject to competition, by shifting its costs onto the poles-and-wires service, which its monopoly customers cannot help but purchase and which is subject to guaranteed cost recovery.

If default provider rates do not reflect the actual costs of serving customers who do not choose a third-party supplier, then customers do not have a true choice. Instead, competitors that do not have a monopoly function to sop up costs must lay the full freight of overhead costs on the rates they would charge customers, making the default provider’s prices look more attractive by comparison. This results in a situation where “default service customers are misled about their retail market options and thus, frequently remain with their incumbent utility” even where they would not do so absent the subsidy. *See* Frank Lacey, *Default Service Pricing – The Flaw and the Fix*, 32 Electricity J. 3, 5 (2019). Such an outcome would be contrary to “the overarching goal of the [Competition] Act,” which “is competition.” *Coal. for Affordable Util. Servs. & Energy Efficiency in Pa. v. Pa. Pub. Util. Comm’n*, 120 A.3d 1087, 1101 (Pa. Cmmw. Ct. 2015).

The Competition Act, anticipating this danger, provided that the “commission shall require that restructuring of the electric utility industry be implemented in a manner that does not unreasonably discriminate against one customer class to the benefit of another.” 66 Pa. Cons. Stat. § 2804(7). Indeed, the act specifically imposed an affirmative duty on the PUC to examine “all default service rates shall be reviewed by the commission to ensure that the costs of providing service to each customer class are not subsidized by any other class.” *Id.* § 2807(e)(7). The PUC’s own regulations also recognize this duty, providing that a local utility’s “default service costs may not be recovered through the distribution rate.” 52 Pa. Code. § 54.187(e).

II. The Public Utilities Commission Erred in Allowing Allocation of All Indirect Costs to Distribution Services in Contradiction of the Competition Act

In this case, PECO has attempted to shift costs into the monopoly rates it charges to all electric customers through an inaccurate accounting of indirect costs. Any business providing electricity service has to incur certain indirect costs, such as costs for overhead, billing, and customer service. Such customer-service and administrative costs have traditionally been recognized as distinct from costs for distribution and should be allocated differently. *See Nat’l Ass’n of Regulated Util. Comm’rs, Electricity Utility Cost Allocation Manual* 20–22 (Jan. 1992).

The effect here is substantial. Testimony presented to the Commission suggests that allowing allocation of all administrative and customer service costs to residential distribution service is the equivalent of a subsidy of 1.25 cents per kilowatt hour to residential customers of the default provider's competitive business. Direct Testimony of Chris Peterson on Behalf of NRG Energy Company, Pa. Pub. Util. Comm'n v. Phila. Energy Co., No. R-2018-3000164 (June 26, 2018).

Completely allocating the costs of these services to distribution services (and thus paid for by all electric customers, including those who do not use the utility as their default service provider), means that PECO's default service can deliver retail electricity services at a lower cost than it would be able to if it was a stand-alone provider. If this is allowed, the default provider gains an unfair advantage.

The impact of this distortion is costly to electric consumers. One recent research study found that:

The indirect costs incurred to provide service to default service customers amount to billions of dollars annually and are being paid by distribution customers. This distorts significantly the retail energy markets, providing the incumbent default service provider with a pricing advantage that allows them to maintain market dominance in the residential and small commercial customer segments.

Lacey, *supra*, at 5.

PECO is underpricing a service offering that is subject to competition and shifting the unaccounted-for costs to rates that all customers must pay.

Undoubtedly this is more convenient to PECO, which faces neither a risk of losing customers to competitors nor of under-recovering the costs of offering energy supply service to Pennsylvanians. But the Competition Act does not permit the Commission to countenance it.

How to properly allocate administrative and customer-service costs between distribution and retail electric services is not a simple question. But that does not mean that there are no wrong answers. The Commission acted arbitrarily in not attempting to develop a reasonable allocation determination and instead allowed a 100 percent allocation that is not reasonable and not supported by any evidence in the record..

III. The Commonwealth Court Erred in Permitting the Public Utilities Commission to Deviate from the Competition Act.

In order to achieve the purposes of the Competition Act, courts and regulators must vigilantly police the boundaries between the competitive and non-competitive sectors of the electricity system. As noted in *Lloyd v. Pa. Pub. Util. Comm'n*, 904 A.2d 1010 (Pa. Cmmw. Ct. 2006), the Commission should not allow “one class of customers to subsidize the cost of service for another class of customers over an extended period of time.” *Id.* at 1020.

The Commonwealth Court's decision below did not adhere to these requirements. The Commonwealth Court briefly dismisses concerns over the Competition Act by saying that "the Commission has repeatedly reviewed PECO's default and distribution cost allocations and found them to be reasonable and lawful." Op. at 25. Yet it is precisely the question at issue whether the Commission's conclusions here were erroneous. The mere fact that the Commission reached a certain conclusion does not settle the matter. The Commonwealth Court does not attempt to explain how it could be reasonable to allocate zero percent of PECO's indirect costs to its default service. The Commission's decision in this regard is clearly erroneous, and the Commonwealth Court erred in affirming it.

The Commonwealth Court does cite two pieces of testimony in support of the Commission's decision. First, the Court cites testimony to the effect that PECO's conduct is not anti-competitive because "PECO cannot make a profit from its default service." Op. at 26. Second, the Court argues that all residential customers benefit from the availability of PECO's "safety net" of a default service option even if they do not use it. But even accepting these assertions as true, this overlooks the broader market effects of having a default option with artificially low prices. Regardless of the effect of the allocation on PECO, electric consumers themselves are harmed by the suppression of price competition induced by the

default service's subsidized rates. And whether or not consumers as a whole actually do benefit from having the default service available as an option, the Competition Act does not allow the Commission to subsidize that option by making all customers pay part of its indirect costs through charges to the distribution side business. 52 Pa. Code. § 54.187(e). The damage from the Commission's decision goes beyond any benefit that unfairly accrues to PECO itself. The Commission's decision undermines the very competitive system that was the purpose of the Competition Act.

CONCLUSION

For the foregoing reasons, amicus curiae supports the Petition to allowance of appeal of the Commonwealth Court's decision below.

Respectfully submitted

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CERTIFICATE OF COMPLIANCE WITH WORD LIMIT

I certify that this brief complies with the word count limits in 210 Pa.
Code Rule 531(b) because it contains 1859 words.

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July 2, 2020

**CERTIFICATE OF COMPLIANCE WITH PUBLIC ACCESS POLICY OF
THE UNIFIED JUDICIAL SYSTEM OF PENNSYLVANIA**

I certify that this filing complies with the provisions of the *Public Access Policy of the Unified Judicial System of Pennsylvania: Case Records of the Appellate and Trial Courts* that require filing confidential information and documents differently than non-confidential information and documents.

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