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BAILEY CAVALIERI LLC
ATTORNEYS AT LAW

One Columbus 10 West Broad Street, Suite 2100 Columbus, Ohio 43215-3422
telephone 614.221.3155 facsimile 614.221.0479
www.baileycavalieri.com

direct dial: 614.229.3210
email: Dane.Stinson@BaileyCavalieri.com

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September 5, 2007

Via Hand Delivery

Ms. Renee Jenkins
Docketing Division
Public Utilities Commission of Ohio
13th Floor
180 East Broad Street
Columbus, OH 43215-3793

Re: *In the Matter of the Application of the Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company, for Approval of a Competitive Bidding Process for Standard Service Offer Electric Generation Supply, Accounting Modifications Associated with Reconciliation Mechanisms and Phase In, and Tariffs for Generation Service; Case Nos. 07-796-EL-ATA and 07-797-EL-AAM.*

Dear Ms. Jenkins:

Please find enclosed for filing in the above captioned matters the original and eleven (11) copies of the following pleadings: (1) *Motion to Intervene of Direct Energy Services, LLC* and (2) *Initial Comments of Direct Energy Services, LLC*. Please file the original and nine (9) copies of each pleading and date stamp and return the additional two copies.

Very truly yours,

BAILEY CAVALIERI LLC



Dane Stinson

Enclosures

cc: Counsel of Record

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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of the Ohio Edison)	
Company, The Cleveland Electric Illuminating)	
Company, and The Toledo Edison Company, for)	
Approval of a Competitive Bidding Process for)	Case No. 07-796-EL-ATA
Standard Service Offer Electric Generation Supply,)	Case No. 07-797-EL-AAM
Accounting Modifications Associated with)	
Reconciliation Mechanisms and Phase In, and)	
Tariffs for Generation Service.)	

**INITIAL COMMENTS
OF
DIRECT ENERGY SERVICES, LLC**

On July 10, 2007, Ohio Edison Company, The Cleveland Electric Illuminating Company, and The Toledo Edison Company (the "Companies") filed, pursuant to Section 4928.14, Ohio Rev. Code, and Chapter 4901:1-35, Ohio Admin. Code, an application for approval of a competitive bidding process. The Companies' proposed competitive bidding process is designed to procure electric supply beginning January 1, 2009, for the provision of standard service offer ("SSO") electric generation to the Companies' retail electric customers who do not purchase electric generation service from a competitive supplier.

By entry issued August 16, 2007, the Public Utilities Commission of Ohio ("Commission") directed that any interested person may file comments regarding the Companies' application and propose alternative methodologies to the application. Per the Commission, initial comments are to be filed by September 5, 2007. The Commission's staff is to file its comments by September 14, 2007, and replies are to be filed by October 5, 2007.

I. INTRODUCTION AND SUMMARY OF POSITION

The end of the Companies rate stabilization plans ("RSPs") and the Companies' application for approval of a competitive bidding process offers the Commission the unique opportunity to revisit the status of retail electric competition in Ohio and to develop a competitive supply procurement process that gives life to the pro-competitive policies of Ohio's electric restructuring law, Am. Sub. Senate Bill 3 ("SB 3").

Competitive energy markets can and do work. Direct Energy Services, LLC ("Direct Energy") and its corporate parent, Centrica plc, have substantial experience providing competitive energy supply across the globe. In Ohio, Direct Energy is a certified competitive retail natural gas supplier ("CRNGS") to over 200,000 thousand customers who have decided to take natural gas supply from a company other than the incumbent natural gas utility. Centrica is a leading provider of energy and energy-related services to over 32 million customers worldwide. Centrica has annual revenues of \$31 billion, \$24 billion in market capitalization, and over 30,000 employees. Direct Energy has over 5 million gas and electricity customers and more than 5,000 employees in North America. It operates in 13 U.S. states and the District of Columbia, and owns 1,260 megawatts of gas-fired generating capacity in Texas.

Given the right market structure, Direct Energy would like to enter the Ohio electric market. Indeed, Direct Energy is a certificated retail electric service ("CRES") supplier in Ohio. Although the Companies' proposal is a positive step toward the creation of a competitive retail market in Ohio, Direct Energy is concerned with various provisions contained in the proposal, which appear to be unjust, unreasonable and contrary to SB 3.

Direct Energy has found that the following market attributes are common to many competitive retail energy markets:

- A competitive procurement process for the provision of standard service offer electric generation that closely tracks price movements in the underlying wholesale market. Without such a competitive process, a competitive retail electric market is unlikely to ever develop in Ohio.
- Protections to ensure that SSO generation costs are not improperly shifted to shopping customers.
- Where retail energy competition has flourished, policy makers have been actively engaged in fostering its development. Key mechanisms used by policymakers to foster the development of retail electric competition include the creation of utility consolidated billing and purchase of receivables programs, the creation of market referral programs and the creation of dedicated teams focused on fostering the development of retail competition.

Although the Companies' proposal is a good initial step toward fostering greater retail electric competition in Ohio, Direct Energy is concerned with particular provisions in the proposal that distort market pricing signals for customers and those that improperly shift costs to customers who have chosen to shop.¹ Direct Energy requests that the Commission conduct a hearing on the Companies' application as required by Sections 4909.18 and 4928.14, Ohio Rev. Code, and Rule 4901:1-35, Ohio Admin. Code. Through hearing, the parties and the Commission will be able to test the Companies' application, which lacks sufficient support in the July 10, 2007 filing, to develop a competitive procurement process to reflect market prices as required by Section 4928.14, Ohio Rev. Code.

¹ Direct Energy notes that this filing contains its initial comments to the application, the details of which in certain instances lack significant supporting detail. Accordingly, Direct Energy reserves the right to supplement its positions as this proceeding progress, via reply comments to Staff's and other parties' comments, as well as through any subsequent hearing process.

II. COMMENTS

A. *Competitive Markets Can and Do Work.*

1. Other Jurisdictions' Experience with Competitive Electricity Markets.

Direct Energy has significant experience in providing North American customers with innovative electricity and natural gas products. Moreover, affiliates of Direct Energy compete in certain competitive European energy markets, specifically in the United Kingdom, Spain and Belgium. Importantly, in many of these markets, the Direct Energy affiliates focus on both business and residential customers. This broad geographic experience with competitive retail electric markets, coupled with a focus on all customer types, provides a unique perspective to comment on restructuring issues.

a. United Kingdom

In the United Kingdom, Centrica traces its roots back to the state-owned, vertically integrated natural gas monopoly. In the 1980s, the United Kingdom decided to privatize its state-owned monopoly, creating British Gas plc. In 1997, through a demerger of British Gas plc, Centrica and BG plc were formed. Centrica obtained the customer relationships (and the British Gas brand), the gas trading business, and certain natural gas production fields. British Gas plc's transportation and storage business (Transco), the Exploration and Production function, International Downstream, Research & Technology and Properties businesses remained with BG plc. In December 1999, BG plc completed a financial restructuring which resulted in the creation of a new parent company, BG Group plc. In 2000, BG Group demerged Transco as Lattice Group and Lattice was acquired by National Grid plc.

The United Kingdom is considered by many energy market observers to be one of the most competitive electricity and natural gas markets in the world. In the United Kingdom, there are no government price controls on retail prices for electric and gas. Price controls were lifted in April 2002. Retail prices are subject to normal competition law (anti-trust principles). The Secretary of State for Trade and Industry noted in a white paper presented to Parliament earlier this year that:

To date, the UK has benefited from one of the most competitive and reliable electricity markets in Europe with “cost-reflective” prices and few outages. Where outages have occurred, these have been the result of short-term network failures rather than shortages of electricity generation capacity.²

According to the United Kingdom’s Office of Gas and Electricity Markets (“OFGEM”) June 2007 Domestic Retail Electric Market Report, all segments of the UK energy market remain highly competitive. Some of the key findings from the June OFGEM report:

- vigorous price competition exists between the big six suppliers for all customers - the spread between prices has shrunk and the most expensive suppliers have been forced to become more competitive to stem customers losses
- Suppliers are innovating to retain and win customers - there has been rapid growth in: fixed and capped price deals that shield customers from rising wholesale prices; cheaper online deals; and green tariffs.
- Customer service is improving: suppliers are investing huge sums to improve their systems and 5 suppliers have cut the number of unresolved complaints.³

² See, *Meeting the Energy Challenge: A White Paper on Energy, May 2007, Department of Trade and Industry*, (<http://www.dti.gov.uk/energy/whitepaper/page39534.htm>) at 5.1.5.

³ See, OFGEM Domestic Retail Market Report June 2007, overview (<http://www.ofgem.gov.uk/Markets/RetMkts/Compet/Pages/Compet.aspx>).

An OFGEM analysis suggests that “competition between suppliers has saved all domestic customers more than £100 on average by protecting them from the full impact of rising wholesale prices over the last four years. Customers who did shop around saved even more - £279 on average. And customers who signed up for fixed price deals have made even greater savings.”⁴

b. Alberta, Canada

In Alberta, Canada, Direct Energy provides competitive services to business and residential customers in addition to regulated natural gas and electricity default service (through Direct Energy Regulated Services). Centrica acquired the default service role from the incumbent utility provider, ATCO, which remains the owner and operator of the distribution network.

Alberta commenced restructuring its electric market in 1998. The Alberta government credits restructuring as the reason Alberta was able to “dodge a short supply bullet.” According to an August 2006 Alberta Government fact sheet on electric restructuring:

Investors continue to invest in generating electricity in Alberta as they can compete to sell electricity at market prices. Over 4,000 megawatts (MW) has been added to Alberta’s electricity supply since 1998. Industry has also expressed interest in investing in another 4,800 MW of new power development in coming years, which will ensure we continue to meet our provinces growing demands.

In Alberta, seventeen electric marketers serve large commercial electric customers, six marketers serve small commercial electric customers and four marketers serve residential electric customers. These marketers have offered consumers a variety of prices and pricing options to customers, from long-term fixed price products, to innovative products that drop the price over

⁴ *Id at 1.*
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the life of the contract. Some marketers have also offered shorter term contracts, green products, customized pricing to fit the needs of larger customers, and home services options combined with traditional energy supply service.

Alberta has made a conscious decision to move away from long-term wholesale supply contracts for its regulated default service rate. In Alberta, the Regulated Rate Option, or RRO, provides a regulated electricity rate to all eligible customers. Consumers who have not chosen a competitive electricity retailer and are eligible, are automatically an RRO customer. The calculation of the RRO rate is approved by the Alberta Energy and Utilities Board (EUB). Anyone who consumes less than 250,000 kWh per year is eligible to take the Regulated Rate Option. The average household in Alberta uses approximately 7,600 kWh per year.

In late 2005, the provincial government enacted new Regulations that changed the way the RRO was to be calculated effective July 2006. The final rate consumers see on their bill is a blended price of the electricity procured under the price setting plan, and includes costs from their energy provider for procurement activities, risk compensation, a return on sales, and compensation for any consumer groups and independent advisors that were involved in the procurement decisions and rate determination. The RRO and procurement details are filed with the EUB each month and prices fluctuate on a monthly basis. The rate initially included a 20% portion of electricity that reflected month ahead market prices and 80% that reflected term pricing. On July 1, 2007, the portion of the RRO rate that that reflects month ahead pricing increased from 20% to 40%. Over the next 3 years, the RRO will include an increasingly larger

portion of month ahead pricing. This rate will be calculated as follows:

- July 1, 2008 – 40% long term / 60% month ahead pricing
- July 1, 2009 – 20% long term / 80% month ahead pricing
- July 1, 2010 – 100% month ahead pricing

c. Texas

In Texas, Centrica operates three different retail companies – Direct Energy, West Texas Utilities Retail Energy, LP (“WTU”), and CPL Retail Energy, LP (“CPL”).

Texas is a very competitive market. As of June 2006, Texas had over seventy-five registered retailers actively serving customers.⁵ As of September 15, 2006, 17 retailers were offering products throughout the state. These REPs were offering between 35 and 41 different products in various territories, including four REPs which were offering, between them, five different renewable energy options.⁶ Currently in Texas, only a little more than five years into retail competition, more than three million residential customers (almost 36% of all households) have switched to a competitive retailer.⁷ In 2006, competitive offers were lower than the Price to Beat in all five Texas service territories.⁸

⁵ See http://www.puc.state.tx.us/electric/reports/scope/2007/2007scope_elec.pdf, Report to the 80 Texas Legislature, *Scope of Competition in Electric Markets in Texas*, at 58.

⁶ See http://www.puc.state.tx.us/electric/reports/scope/2007/2007scope_elec.pdf, Report to the 80 Texas Legislature, *Scope of Competition in Electric Markets in Texas*, at 58.

⁷ See http://www.puc.state.tx.us/about/commissioners/hudson/present/pp/HRIC_021307.pdf Testimony of Public Utility Commission of Texas Chairman Paul Hudson before the Texas House Regulated Industries Committee, February 13, 2007.

⁸ *Id.* at 60.

d. New York

Direct Energy entered the New York competitive retail electric market in early 2006. The New York experience demonstrates the impact that policymakers can have in establishing a competitive retail energy market.

Early on, the New York Public Service Commission “sought the development of robust retail competition by supporting key initiatives, such as increased customer choice, lower barriers to market entry for energy service companies (“ESCOs”), a level playing field for all suppliers, effective dispute resolution protocols, essential consumer protections, innovative pricing and services, ease of customer migration among suppliers, and price/value comparisons.”⁹ In addition, the New York Commission established an Office of Retail Market Development and identified several best practices—including purchase of receivables and marketer referral programs—to promote competitive retail energy markets. As a result of New York’s efforts to foster retail energy competition, as of May 2006, there were seventy-three suppliers in New York with at least seven competitive suppliers serving residential electric customers and eight competitive suppliers serving residential natural gas customers in each major utility franchise area.

New York customers who switch suppliers do not appear to miss their former utility supplier. From a 2006 New York Public Service Commission Staff report:

In April 2005, Orange and Rockland Utilities, Inc., the utility with the highest percentage of customer migration, reported that for calendar year 2004 only about 1.5% of all retail access customers switched back to the utility for their energy commodity supply. Orange and Rockland reported

⁹ See, New York State, Department of Public Service, Staff Report on the State of Competitive Energy Markets: Progress to Date and Future Opportunities (March 2006) at 28.

much higher percentages of retail access customers who switched commodity suppliers to another ESCO; 6.7% of electric and 3.7% of natural gas retail access customers, respectively.¹⁰

e. Illinois

Direct Energy entered Illinois' competitive retail electric market in 2006. Recent switching statistics from Commonwealth Edison Company ("ComEd"), the state's largest investor owned utility, indicate that a significant number of ComEd's non-residential customers are taking advantage of electric offers from competitive retail electric suppliers.

According to information ComEd filed with the Illinois Commerce Commission, as of last month (July 2007):

- 10.9 % of ComEd's small non-residential customers (0 kW to 100 kW) were taking service from a retail electric supplier.
- 52.8 % of ComEd's medium non-residential customers (100 kW to 400 kW) were taking service from a retail electric supplier.
- 83.9% of ComEd's large non-residential customers (400 kW to 1,000 kW) were taking service from a retail electric supplier.
- 93.5% of ComEd's very non-residential customers (over 1,000 kW) were taking service from a retail electric supplier.

While residential customers have yet to see the benefits of retail electric competition, Illinois has recently taken significant steps to knock down barriers that have kept retail electric suppliers out of the residential market. For example, Illinois has created an Office of Retail Market development that will be located within the Illinois Commerce Commisison and that will have as its goal the promotion of retail electric competition. In addition, the Illinois General Assembly recently sent the Governor a wide-ranging market improvement bill that will ultimately lead to utility consolidated billing and purchase of receivables programs, and the

¹⁰ *Id.* at 39.
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creation of marketer referral programs to encourage customers to try competitive electric supply. See Senate Bill 1299.

To be sure, Illinois recently abandoned its own experiment with a descending clock reverse auction competitive procurement process. It is instructive to note, however, that even with the new Illinois Power Authority, Illinois did not abandon the use of a competitive procurement process to procure power. It is also worth noting that the dramatic rate increases experienced by some Illinois residents were due in large part to rate design issues coupled with rates that were significantly cut and then frozen for 10 years. According to a report by Illinois Commerce Commission Staff shortly after the auction concluded:

For ComEd, which serves about 70% of residential consumers in Illinois, residential rates for customers without electric space heating will increase by 21% in January 2007, as compared to current rates. However, compared to where they were in 1997 (prior to enactment of the Restructuring Act), rates will actually be 3% less. Furthermore, in purchasing power terms (adjusting for inflation), the 2007 rates will be 22% lower than in 1997.¹¹

2. Significant Lessons Can Be Learned From Experience In Other Jurisdictions.

Experience in the U.S., U.K. and Canadian markets has provided valuable insights that should help guide the Commission in the instant proceeding. At least three lessons can be learned from these markets: **First**, retail energy competition can benefit all consumers (including residential consumers), and those benefits include downward pressure on price, increased conservation incentives, enhanced customer service, improved environmental management and new, innovative products. **Second**, retail energy competition requires that consumers be able to choose from a number of suppliers offering a variety of products. **Third**, retail energy

competition requires that default service pricing be properly structured; customers must see a default price that reflects the market, otherwise consumers cannot make informed and thoughtful decisions.

3. **The Indicia of a Successful Competitive Retail Market are Embodied in Ohio Law and Must be Implemented.**

The Ohio General Assembly codified the state's policy regarding competitive retail electric service in SB 3. As part of its policy, the General Assembly pledged to foster retail competition by ensuring a "diversity of electricity supplies and suppliers, by giving consumers effective choices over the selection of those supplies and suppliers." Section 4928.02(C), Ohio Rev. Code. Moreover, the General Assembly provided the roadmap to achieve its goal by requiring the electric distribution utilities, after their market development periods, to provide consumers with a *market-based* standard service offer (Section 4928.14(A), Ohio Rev. Code), as well as an option to purchase competitive retail electric service the price of which is determined through a competitive bidding process. Section 4928.14(B), Ohio Rev. Code. The General Assembly further provided that the competitive bidding option may be used as the market-based standard offer. *Id.* Thus, the General assembly recognized that the ability to choose from a number of suppliers offering a variety of products and the ability of customers to have a default price that reflects the market were essential to achieve its goal of a fully competitive electric retail market in the state.

The Commission is well aware of Ohio's struggles to create the competitive retail markets envisioned by SB 3. Indeed, at the conclusion of the market development period

¹¹ See, The September 2006 Illinois Auction Post-Auction Prepared by the Staff of the Illinois Commerce Commission with the assistance of Boston Pacific Company, Inc. (December 6, 2006).

(December 31, 2005 for the Companies), the Commission deemed that competitive markets were not sufficiently developed, and approved the Companies' RSP to shield customers from potential rate increases that market prices could bring. During the RSP, customers in the Companies' service territories had no competitive option, save for those served through governmental aggregation programs.

With their RSP set to expire on December 31, 2008, the Companies have filed with the Commission this application which requests that the competitive bid option serve as the market-based standard service offer under Section 4928.14, Ohio Rev. Code. The Commission has a unique opportunity to put in place a competitive bid process that will enable Ohioans to receive the benefits of a competitive retail electric market that were envisioned by SB 3. To do so, the Commission must (1) ensure an appropriate structure for default rates that promotes the development of the competitive market; and (2) make sure that SSO generation costs are not improperly shifted to shopping customers.

B. Certain Aspects of the Companies' Proposal Would Not Result in Market-Reflective Pricing and Would Serve as a Barrier to the Development of a Competitive Retail Electric Market in Ohio.

In their application, the Companies have included several provisions designed to "smooth out potentially volatile market prices." Application at 3. These include (1) procuring long-term laddered supply contracts (from one to three years in length) for both of its CBP proposals (load and slice of system) (Application at 12, 15-16, Exhibits A-1 at 1 and A-2 at 2); (2) proposing the slice of system alternative to maintain benefits to customers that historically have been served under below average rates (Application at 17); and offering a residential rate phase-in of up to three years (Application at 32). Each of these provisions distorts the market-based pricing

mandated by Section 4928.14, Ohio Rev. Code.

Direct Energy is concerned that unless measures adopted to mitigate price volatility are carefully designed, such measures will act as a barrier to SB 3's overarching goal of developing fully competitive markets for competitive electric retail service. Market fluctuation is not a new concept to American consumers, as they see prices go up and down for almost every good and service they buy – for instance, gasoline, airline tickets, mortgage rates, and food. In those environments, competition is a welcome means to ensure downward price pressures, scarcity management and the development of innovative products. Although Direct Energy appreciates the need to balance the competing interests of sending meaningful price signals with mitigating price volatility, the Companies' proposal goes too far. The proper purpose of the SSO is to signal to consumers through the default service rate that energy markets do fluctuate, not to create artificial price signals by over-insulating consumers from the market. The Companies do not present any analysis on what level of price fluctuations are problematic for consumers, which should be an issue for the parties and the Commission to test in the hearing process.

1. Long Term Contracts

The Companies appear to believe that long-term supply contracts (*i.e.*, contracts exceeding one year) are necessary to mitigate price volatility. In their application, the Companies provide the Commission with the option of selecting two competing competitive bid processes. One would solicit bids on a load class basis (suppliers would bid for each load class separately), and the other would solicit bids based upon a "slice of system" approach (suppliers would bid on tranches of total SSO customer load). Under each alternative, the Companies would solicit long-

term laddered contracts with durations of one to three years and blend the supplies to establish a retail price. Application, Exhibits A-1 at 1 and A-2 at 1. A competitive bid process based upon long-termed laddered contracts would be unjust and unreasonable as they would (1) send the wrong pricing signals to consumers, (2) result in a higher SSO price, and (3) discourage movement to a competitive retail market.

a. Long-Term Contracts Send the Wrong Price Signals.

An SSO price based upon blended long-term supply contracts would provide customers with price signals that become stale over time and bear little relationship to actual energy market conditions. Stale pricing signals will present a significant barrier to new entry that will inhibit competition; competitors will find it difficult to offer customers alternative products on a sustainable basis; and customers will not be able to select from the market the services that meet their individual needs, contrary to Section 4928.02(C), Ohio Rev. Code.

Moreover, over time, a succession of fixed-price long-term contracts will exhibit price volatility that does not differ significantly from the underlying volatility of the market on which the contracts are based.

b. Long-Term Contracts Result in a Higher SSO Price.

Although the Companies contend that long term contracts will “smooth” price volatility, such contracts are likely to lead to a higher SSO than if shorter contract terms were used. Because of their long terms, such contracts are saddled with an elevated risk premium. Thus, consumers may pay higher default service prices than they would under a model with shorter contracts. Suppliers to the auction will face: (1) customer migration risk, (2) price risk, (3)

counter party risk, (4) operational risk, and (5) regulatory risk. It appears inevitable that each of these risks would be greater in a long-term contract than in a shorter (monthly) contract. These risks will undoubtedly be priced into a supplier's risk premium, increasing the overall expense to consumers under the Companies' proposal. The Companies' use of overlapping, multi-year, full requirements wholesale supply contracts would lock out the Companies' consumers from potential costs savings associated with a portfolio comprised entirely of shorter-term (for example, monthly) wholesale supply contracts.

c. Long-Term Contracts Discourage Movement to a Competitive Retail Market.

Long-term wholesale contracts discourage movement toward a competitive retail electric market. Depending on the direction of the wholesale market, long-term wholesale supply contracts can provide wholesale suppliers with attractive long-term revenue streams. Thus, if the Commission were to approve long-term contracts, it could be creating a constituency to advocate against customer choice, because wholesale suppliers who win the long-term contracts could be incented to discourage customer switching. Because the wholesale suppliers would be inclined to want to minimize any financial risk incurred as a result of customers moving off of rates tied to suppliers' long-term contracts, these suppliers might actually be motivated to work against any education program that encourages consumers to make the best possible energy decisions, including leaving default service for a competitive retail offer. In fact, the winning wholesale suppliers likely could discourage any movement at all toward a competitive retail electric market

d. The SSO Price Should be Based Upon Market Reflective Pricing.

The Companies' proposal, based on long-term, wholesale supply contracts, ignores the benefits of market-reflective default pricing, which Direct Energy asks the Commission to consider. Market-reflective pricing merely means that the SSO price would adjust on a timely basis with movements in the underlying wholesale market. In this vein, the Commission should consider a process whereby supply is contracted over a shorter time, and the SSO price is set using a monthly auction process, *e.g.*, the SSO could provide monthly billing to customers based on one-month forward power purchase agreements. Under this proposal, the utility would contract for full requirements service for its default service customers for the delivery month 45 days before delivery would begin. This would provide customers with transparent, market-based monthly prices, since these competitive wholesale auctions would be held very close to the time of actual delivery. The proposal also allows customers a 45 day window to evaluate the default service price before it becomes effective. This time frame will provide an adequate opportunity for customers to compare the new default service price to other offers available from other CRES suppliers and to make the economic decisions that are best for them.

A monthly priced SSO has several benefits all of which serve the public interest. First, while prices will vary, they will vary upward and downward; monthly priced SSO provides symmetry because price decreases and increases occur quickly.¹² Second, such market reflective pricing empowers customers who choose to remain on SSO with a better ex ante price signal which allows them to manage electricity buying decisions for their respective homes and

¹² Such upward and downward movement is similar to what Ohio's natural gas customers experience on a monthly basis.

businesses in the most economic manner. With more accurate price signals, retail consumers have more accurate information upon which to base their consumption decisions. Third, even for customers who switch from the SSO product, having the transparency of a monthly price signal in the market will inform customers about underlying changes in the electricity market over time. Fourth, keeping the time between the auction date and the delivery date short will minimize many of the risks of supplying default service. Finally, monthly priced SSO will allow for competitive entry by avoiding the disconnect between SSO and market prices that can occur over the duration of long-term contracts. Customers that remain on SSO will be provided a market priced service but, more importantly, customers will have the ability to choose from a variety of longer term fixed priced products from competitive retailers when the design of the SSO product is not a barrier to competition.

e. The Proposed Reconciliation Mechanism Skews Market Pricing Signals to Consumers.

In their application, the Companies have proposed a reconciliation mechanism. Application at 19. The mechanism is intended to recover, *inter alia*, the total amount of SSO supply costs, which the Companies refer to as the SSO revenue requirements. Any over- or under-recovery of the revenue requirement would be reconciled quarterly on the customers' bills. Exhibit C-1 at 5. The risks and rewards of providing SSO should be appropriately priced to compensate for the risk involved in providing the service. Although the application is unclear, it appears that the risks of providing SSO, including the risk of customer migration, could be recovered through the reconciliation charge. It is critical that the SSO price reflect these risks without reliance on the ability to reconcile revenues to costs. The reconciliation charge (or true

up) to recover SSO revenue requirement would skew the market price signals to customers, confuse customers, and impede shopping. Indeed, the Companies recognize that the reconciliation mechanism may prove unduly burdensome to SSO customers and expressly reserve the right change the mechanism with Commission approval. Application at 20. Direct Energy urges the Commission not to venture down this slippery slope.

2. The “Slice of System” Competitive Bid Process

In their application, the Companies provide the Commission with the option of selecting two competing competitive bid processes. One would solicit bids on a load class basis (suppliers would bid for each load class separately), and the other would solicit bids based upon a “slice of system” approach (suppliers would bid on tranches of total SSO customer load.) Under the “slice of system” approach, class-specific rates would be developed through an allocation methodology. The stated benefit of this option is to provide greater flexibility in establishing specific generation rates for different customer classes, so as to continue to provide benefits to customers that historically have been served under below average rates. Application at 17.

CRES providers must provide supply at market rates. For many consumers, the market-based SSO created by this application will serve as their initial price to compare in determining their choice of a CRES supplier. Because the “slice of system” alternative is designed to permit distortions to class-specific rates,¹³ it would distort price signals to consumers, and discriminate against the offerings of CRES suppliers. As such, the “slice of system” alternative as proposed is

¹³ The avoidable charges for the “slice of system” alternative would be equal to the lower of the blended competitive bid price multiplied by the supplier seasonal billing factor adjusted for average distribution line losses and applicable taxes, or the customer’s SSO generation charge created through the allocations process. See Application at ¶ 43.

unjust, unreasonable, and unlawful, and must be rejected.

3. The Residential Rate Phase-In

The Companies' application proposes that, if residential rates increase 15% or more as of January 1, 2009, SSO generation rates may be phased-in over a period of up to three years. Application at 32. Specifically, the Companies propose that they be authorized to defer the expense associated with the difference between phased-in SSO generation charge revenues and the SSO supply costs for the phase-in period, with appropriate carrying costs. Although the application is not entirely clear, if phased-in rates were available only to SSO customer, the phase-in would distort pricing signals and impede the ability of CRES providers to compete for SSO customers. Indeed, the price freezes and rate caps available to residential consumers during the market development period can be cited as a main reason that competitive markets have not fully materialized in Ohio. Any rate mitigation or phase-in mechanism approved in this proceeding must be implemented in a competitively neutral fashion.

C. The Companies' Proposal Places Unjust and Unreasonable Costs on Shoppers.

In addition to the increased risk premiums that long term contracts will impose upon all customers, the Companies' proposal also shifts SSO generation costs to shoppers. Such cost shifting is unjust and unreasonable and requires the Commission to examine the application in the context of a hearing. Specifically, the Companies' proposed Revenue Variance Rider seeks to shift responsibility to shoppers for the following SSO generation costs:

1. **Cleveland Electric Illuminating Company's Special Contract Customers.** The Companies' application proposes to continue special contracts in place for certain customers of Cleveland Electric Illuminating Company ("CEI"), and also proposes to recover 50% of the difference between the SSO generation charge

and the generation portion of the special contract rate through the Revenue Variance Rider. Application at ¶ 37; Sample Tariff, Exhibit D-1, Original Sheet 85.

2. **Street Lighting and Traffic Lighting.** The Companies' application proposed a special rate for street lighting and traffic lighting in all areas except municipalities served through opt-out governmental aggregation. It proposes to recover the difference between the special rate and the SSO generation charge through the Revenue Variance Rider. Application at 35-36; Sample Tariff, Exhibit D-1, Original Sheet 85.
3. **The Residential Rate Phase-In of up to Three Years.** The Companies' application also proposes that, if residential rates are increased 15% or more as of January 1, 2009, the increase in the SSO generation charge may be phased-in over a period of up to three years.¹⁴ The deferred purchased power expense would be included in each Company's proposed Revenue Variance Rider and would be non-bypassable. Application at ¶ 78; Sample Tariff, Exhibit D-1, Original Sheet 85.

Requiring all customers to subsidize generation service to select customers is unjust, unreasonable and unlawful. Moreover, because the non-bypassable charge also will be applied to customers who choose to shop, the charge will distort pricing signals and discriminate against CRES providers. At a minimum, the charge must be avoidable to those who shop.

D. The Availability of Up to Seventy-Five Percent of the Companies' Load to a Single Supplier.

The Companies' application provides that no single supplier may provide more than 75% of the SSO supply for any class in the load class alternative or 75% of the system load under the "slice of system" alternative. One of the fundamental policies of this state in enacting competitive retail electric service is to ensure a diversity of electric supplies and suppliers. Section 4928.02(C), Ohio Rev. Code. By making up to 75% of the Companies' load available to

a single supplier, the Companies are violating the statute and the spirit of SB 3. The maximum load available to a single supplier should be subject to further comment at hearing.

E. The Limitation of Renewable Energy Credits to Sources from within PJM or MISO.

To encourage the use and development of renewable generation sources, the Companies propose to reserve or set aside one tranche which must be supplied 100% from renewable generation sources. The application provides that the winning bidder for the tranche must surrender to the Companies one renewable energy credit ("REC") for every megawatt hour actually delivered to the Companies. However, only RECs from sources within the MISO or PJM RTOs may be used to fulfill this obligation. Application at ¶ 63. The Companies' proposal fails to take into consideration the national, if not global, nature of climate change. The Companies' proposal is unjust and unreasonable and, moreover, imposes an unlawful restraint on interstate commerce.

F. The Commission Should Consider Other Measures to Foster Competition in this State.

This proceeding, and the end of the Companies' RSP, presents the Commission with the unique opportunity to implement other programs to carry out the pro-competitive policies of SB 3. These include (1) establishing a Market Referral Program, (2) creating an Office of Retail Market Development, and (3) implementing a purchase of receivables program as has been done for CRNGS suppliers.

¹⁴ As stated previously, the application is not entirely clear, but appears to apply the phase in only to SSO generation customers. A competitively neutral phase-in that would be made available to all residential customers, including shoppers, could be acceptable to Direct Energy.

1. Office of Retail Market Development

The Commission should join other states in establishing an Office of Retail Market Development. The Office would be charged with the duty to serve as a liaison to the Commission to address competitive issues that arise between CRES suppliers and the electric distribution utilities ("EDU"), and to create, implement and oversee incentive programs to foster competition in the state and the policies of Section 4928.02, Ohio Rev. Code.

2. Market Referral Program

The Commission should join other states that have recognized the value of market referral programs.¹⁵ Indeed, the establishment of a market referral program specifically to increase the number of Ohioans taking service from CRES suppliers is consistent with Section 4928.02(C), Ohio Rev. Code. Under the program, the EDU would provide customers who are establishing new electric service a choice of offers from participating CRES suppliers. A customer who expressed a preference would be enrolled with the supplier of the customer's choosing. If no preference were given, the customer would be provided the opportunity to enroll with a supplier selected randomly on a rotating basis.

3. Purchase of Receivables

To foster competition in Ohio's natural gas market, the Commission has ordered natural gas local distribution companies to purchase the receivables of competitive providers without a discount. See *In the Matter of the Joint Application of The East Ohio Gas Company*

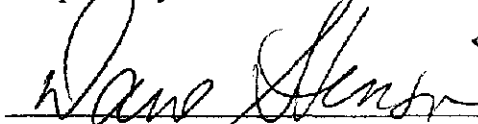
¹⁵ New York, as referenced earlier, has well established market referral programs. Illinois has established an Office of Retail Market Development and the Illinois legislature recently passed legislation to encourage the development of market referral programs in Illinois. See Senate Bill 1299.

d.b.a. Dominion East Ohio, Columbia Gas of Ohio Inc., Vectren Energy Delivery of Ohio, Northeast Ohio Natural Gas Corp., and Oxford Natural Gas Company for Approval of an Adjustment Mechanism to Recover Uncollectible Expenses, Case No. 03-1127 (Finding and Order, December 17, 2003). Indeed, the Commission subsequently ordered Duke Energy-Ohio to purchase the receivables of CRNGS and CRES supplier (See, *In the Matter of Cinergy Corp. and Duke Energy for a Change in Control of CG&E*, Case No. 05-732-EL-MER (Order, December 21, 2005), at 17-19), but on rehearing reversed its order as to CRES suppliers as beyond the scope of the proceeding. *Id.*, (Entry on Rehearing, February 6, 2006) at 21-22. Direct Energy submits that the Commission consider this issue in the context of this proceeding as well.

III. CONCLUSION

For the foregoing reasons, Direct Energy requests that the Commission conduct a hearing and modify the Companies' application consistent with these comments, and those submitted in Direct Energy's reply comments.

Respectfully submitted,



Dane Stinson, Esq.

BAILEY CAVALIERI LLC

10 West Broad Street, Suite 2100

Columbus, Ohio 43215

(614) 221-3155 (telephone)

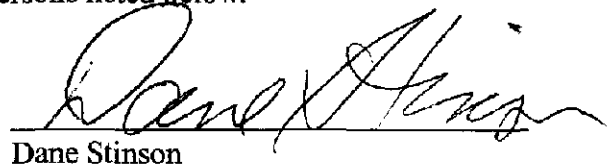
(614) 221-0479 (fax)

Dane.Stinson@BaileyCavalieri.com

Attorney for Direct Energy Services, LLC

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and accurate copy of the foregoing *Initial Comments of Direct Energy Services, LLC* was served by regular United States mail, postage prepaid, this 5th day of September, 2007 on the persons listed below.



Dane Stinson

James Burk
Kathy Kolich
FirstEnergy Corp.
76 South Main Street
Akron, Ohio 44308

Mark Whitt
Jones Day
325 John H. McConnel Blvd.
Suite 600
P.O. Box 165017
Columbus, Ohio 43216-5017

Janine L. Midgen-Ostrander
Jeffrey L. Small
Office of the Ohio Consumers' Counsel
10 West Broad Street, Suite 1800
Columbus, OH 43215-3485

David F. Boehm
Michael L. Kurtz
Boehm, Kurtz & Lowry
36 East Seventh St., Suite 1510
Cincinnati, OH 45202

David C. Rinebolt
Ohio Partners for Affordable Energy
337 South Main St., 4th Fl., Suite 5
P.O. Box 1793
Findlay, OH 45839-1793

Thomas J. O'Brien
Bricker & Eckler LLP
100 South Third Street
Columbus, OH 43215-4291

M. Howard Petricoff
Stephen M. Howard
Vorys, Sater, Seymour & Pease LLP
52 East Gay Street
P.O. Box 1008
Columbus, OH 43216-1008

Samuel C. Randazzo
McNees Wallace & Nurick LLC
21 East State St., 17th Fl.
Columbus, OH 43215

Stephen L. Huntoon
Senior Attorney
FPL Energy Power Marketing, Inc.
801 Pennsylvania Avenue, N.W.
Suite 220
Washington, D.C. 20004

William M. Ondrey Gruber
2714 Leighton Road
Shaker Heights, Ohio 44120

Joseph P. Meissner
The Legal Aid Society of Cleveland
1223 West 6th Street
Columbus, Ohio 44113

Marvin I. Resnik
AEP Service Corporation
1 Riverside Plaza
Columbus, Ohio 43215

Trent A. Dougherty
The Ohio Environmental Council
1207 Grandview Avenue, Suite 201
Columbus, Ohio 43212

Rick C. Giannantonio
FirstEnergy Service Company
76 South Main Street
Akron, Ohio 44308

Glenn Krassen
Bricker & Eckler LLP
1375 East Ninth Street, Suite 1500
Cleveland, Ohio 44114-1718

Richard T. Stuebi
The Cleveland Foundation
1422 Euclid Avenue, Suite 1300
Cleveland, Ohio 44115

Leslie A. Kovacik
Kerry Bruce
420 Madison Avenue, Suite 100
Toledo, Ohio 43604-1219

Lance M. Keiffer
Assistant Prosecuting Attorney
711 Adams Street, 2nd Floor
Toledo, Ohio 43624-1680

Richard L. Sites
General Counsel
Ohio Hospital Association
155 East Broad Street, 15th Floor
Columbus, Ohio 43215-3620

Sheilah H. McAdams
Marsh & McAdams
204 West Wayne Street
Maumee, Ohio 43537

Brian J. Ballenger
Ballenger & Moore
3401 Woodville Road, Suite C
Toledo, Ohio 43619

Paul S. Goldbert
6800 West Central Avenue
Toledo, Ohio 43617-1135

James E. Moan
4930 Holland-Sylvania Road
Sylvania, Ohio 43560

Peter D. Gwyn
110 West Second Street
Perrysburg, Ohio 43551

Paul Skaff
Leatherman, Witzler, Dombey & Hart
353 Elm Street
Perrysburg, Ohio 43551

Thomas R. Hayes
3315 Centennial Road, Suite A-2
Sylvania, Ohio 43560

Barth E. Royer
Bell & Royer Co., LPA
33 South Grant Avenue
Columbus, Ohio 43215