

**SUPPLEMENT TO THE FINAL REPORT
OF THE
PUBLIC SERVICE COMMISSION OF MARYLAND
TO THE
MARYLAND GENERAL ASSEMBLY**

**OPTIONS FOR RE-REGULATION AND NEW GENERATION:
FINANCIAL RISK ANALYSIS OF RETURN TO RATE BASE
REGULATION**



MARCH 26, 2009

This will supplement the Public Service Commission’s (the “Commission”) Final Report entitled “Options For Re-Regulation and New Generation (the “Final Report”). The Final Report, which the Commission submitted to the Maryland General Assembly on December 10, 2008, contained the Commission’s discussion of and recommendations regarding “re-regulation” options. The Final Report was accompanied and supported by two consultants’ reports: the State Analysis and Survey on Restructuring and Reregulation and the Analysis of Options of Maryland’s Energy Future, both of which were prepared by Kaye Scholer LLP, Levitan & Associates, Inc. and Semcas Consulting Associates (collectively, “Consultants’ Reports”).¹ The Commission briefed the General Assembly on the results of the Consultants’ analyses and the Commission’s recommendations on December 16, 2008.

As directed by Senate Bill 400, the Consultants’ Reports and Final Report addressed the full range of potential “re-regulation” options.² In response to the General Assembly’s questions regarding the December 2007 Interim Report, and to evolving market and economic conditions, the Commission directed the Consultants in 2008 to analyze a possible return to rate base regulation. Specifically, the Commission directed the Consultants to model the potential economic cost or benefit to ratepayers if a fleet of electricity plants now owned by Mirant Corporation (“Mirant”) were returned to rate base regulation to serve the Potomac Electric Power Company (“Pepco”) load.³ The

¹ The Consultants’ Reports were dated December 1, 2008, which reflects the date they were provided in final form to the Commission.

² The Final Report addressed, and the Consultants’ Reports analyzed, a broad range of “re-regulation” options, including varying levels of Commission-directed new generation (either through utility-built plant or a long-term contract), demand side management strategies, renewable generation (both solar and wind), and a return to rate base regulation.

³ The Commission consciously framed the modeling exercise to avoid any analysis of generation assets owned by Constellation Energy Group (“Constellation”) because, at the time, the Commission had before it a proposed transaction between Constellation and MidAmerican Energy Holdings, Inc.

Consultants modeled a hypothetical return to rate base regulation under two scenarios: first, if Pepco itself reacquired and owned the plants; and second, if a hypothetical State power authority acquired and owned the plants for the benefit of the Pepco load.

Under each of the “full re-regulation” scenarios, the Consultants’ economic modeling identified potential ratepayer benefits over the twenty-year study period.⁴ In addition, the Consultants’ Reports identified and discussed several cost and risk factors that would bear on a decision to proceed (or not) with legislation effecting a return to rate base regulation. And after considering all of the issues, the Commission concluded in the Final Report that the costs and risks of implementing “full-re-regulation” left it unable to recommend that the General Assembly pursue legislation in that regard, notwithstanding the potential benefits:

We cannot, however, recommend that the General Assembly pursue full re-regulation – the magnitude and uncertainty of the benefits, relative to the high cost of achieving the outcome do not clearly warrant the return to rate base regulation. Moreover, there are a number of other potentially serious risk factors that could create unanticipated, adverse consequences for Maryland’s ratepayers.⁵

The Commission presented the findings of its consultants and its recommendations regarding re-regulation options to the Senate Finance Committee and House Economic Matters Committee on December 16, 2008. During the Senate briefing, several members of the Finance Committee asked the Commission to prepare and submit a quantitative analysis of the costs and risks associated with a return to full re-regulation

⁴ The potential benefits varied over the study period depending on a number of factors, including projections of future fuel prices. *See* Levitan Report at 167-87.

⁵ Final Report at 2.

so that the General Assembly could compare them to the quantitative analysis of potential benefits.

This Supplement represents the Commission's response to the Finance Committee's questions. In the wake of the December 16 briefing, the Commission directed its consultants to perform two tasks. *First*, the Consultants were directed to quantify, to the extent possible, the risk factors identified in the Final Reports and the Consultants' Reports and to quantify these both in terms of the *probability* that the risks would occur in the first place and in terms of the *potential economic impact* if they do. *Second*, the Consultants were directed to update their analysis of the potential economic benefits of a retrospective return to rate base regulation to reflect more up-to-date data and projections regarding fuel prices, energy usage and cost of capital, among other things. The Consultants completed their follow-up analyses on March 11, 2009, and submitted their Financial Risk Analysis of the Return to Rate Base Regulation prepared by Levitan & Associates, Inc. and Kaye Scholer LLP (the "Rate Base Report") to the Commission that day.

The Rate Base Report contains a comprehensive and detailed analysis, but at bottom concludes that *the risk-adjusted value of returning to full-rate base regulation through utility ownership is essentially zero*. This means that the risk of ratepayers incurring additional costs (above and beyond the price of reacquiring plants under eminent domain) upon a return to full-regulation is about the same as the risk of ratepayers seeing a benefit compared to the baseline case – or, put another way, that *it is as likely as not that the costs and risks of returning to rate base regulation would at least wash out any potential economic benefits*. The Rate Base Report utilizes a Monte Carlo

simulation analysis (utilizing 1,000 random scenarios) to identify the broad range of potential economic outcomes – for IOU ownership, the model revealed outcomes ranging from more than a negative \$4 billion dollars in economic impact to approximately \$6 billion in economic benefits. The simulations include two first-order risk factors (future greenhouse gas regulation and fossil fuel prices) and six second-order risk factors (capacity prices, transaction costs in reacquiring the plants, transition costs as the plants return to utility ownership, the IOU’s higher cost of equity, new capital expenditures flowing from stricter environmental regulations, and a possible extended unplanned outage), all of which were concerns the Commission identified in the Final Report.

The Rate Base Report supports the Commission’s recommendations in the Final Report. The potential economic benefits from a return to rate base regulation bring with them a meaningful potential for superseding costs and risks. The Commission was and remains reluctant to recommend that the General Assembly commit billions of ratepayer dollars to a strategy that offers at best a 50-50 chance of a positive economic outcome. Accordingly, the Commission reiterates its recommendation that the General Assembly focus on prospective options for incremental, ratepayer-focused “re-regulation” and, in any such legislation, allow the Commission to retain the authority and flexibility to respond to evolving economic conditions and ensure that new generation serves ratepayers’ interests.