UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Conference on Competition In Wholesale Energy Markets — Docket No. AD07-7-000

Comments of Daniel Allegretti,
Vice President and Director of Wholesale Energy Policy
Constellation Energy Group

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My name is Daniel Allegretti, Vice President and Director of Wholesale Energy Policy with Constellation Energy Group. Thank you for the opportunity to speak here today and give you our perspective on this important issue. To put my remarks in context, let me give you a very brief introduction to Constellation. In addition to BGE, an electric and gas utility in central Maryland, Constellation owns approximately 8,700 megawatts of generation and serves 35,000 megawatts of wholesale and retail customers' peak load nationwide. Constellation Energy Commodities Group is the largest wholesale supplier of power, while Constellation NewEnergy is the largest competitive retail supplier, focusing on commercial and industrial customers around the country. As you can see, we serve significantly more load than we own generation, making well-functioning markets critical to our business model. Our business is customer-focused; in addition to participating in various wholesale procurement processes, we work with customers to design and offer a variety of energy products to meet their needs over varying contract terms.

The topic today is “improving opportunities for long-term contracting in organized markets.” I think it is critical to start with one fundamental fact: The goal of a well-functioning wholesale market is to provide information to buyers and sellers to allow them to make rational economic decisions. There is nothing inherent in the structure of today’s organized markets that permits parties to enter into short-term transactions but somehow impedes or prohibits them from making longer-term arrangements, nor should there be. It is not the goal of the market, nor should it be a goal of regulators, to promote arbitrary contract lengths. Rather, clear market signals should provide buyers and sellers the information needed to assess risks and make the best decisions. Let me explain.

Organized Markets

Organized markets, as you well know, consist of the highly visible spot markets (real-time and day-ahead) as well as the over the counter (OTC) or bi-lateral markets. Buyers and sellers in the organized regional markets all have the option of transacting in the daily markets or through forward contracts of various terms. To forego an opportunity to transact in the daily market and instead reach agreement on terms and price in a forward contract, necessarily entails an assessment of the probable outcomes in the daily market for some period in the future. It is, therefore, no surprise that regions with well-designed and well administered spot markets also have the most robust forward bi-lateral markets. Buyers and sellers who want to transact bilaterally must have confidence in the functioning of the daily market and be able to form their independent views about future price outcomes in order to reach agreement on a forward contract price. The most important features of an organized market that will facilitate this desirable type of long-term contracting are:

- **Price Formation**. Where daily prices accurately reflect actual supply and demand conditions, buyers and sellers will feel more confident in taking a future position. Where spot prices are distorted through the imposition of out of market compensation to generators and the use of uplifts or where aggressive mitigation measures and price caps are deemed necessary, then long-term contracting will be more difficult.
- **Price Integrity**. This goes both to the concept of price finality in daily markets as well as the protection of contract integrity in bilateral markets. Assuring just and reasonable rates through proper market design is the goal here. After the fact determinations and modifications to prices will impede the development of the bilateral market by creating uncertainty of outcome for both buyers and sellers.
- **Liquidity**. Buyers and sellers have greater confidence in their expectations where there is real depth to the daily markets. Trading hubs, larger scale and scope RTOs, ease and transparency of transactions across seams, and a high degree of operational competence will all serve to promote more bilateral contracting as well as trading in the daily markets.

For both buyers and sellers, contracts of various terms are desirable risk management tools in organized markets. It is instructive to consider reasons why parties may opt not to enter long-term contracts or prefer daily markets over forward contractual relationships of various lengths. Forward contracts can provide greater price certainty but they may require other economic trade-offs. In the end, it is incumbent on policy makers and regulators at all levels to ensure that market constructs do not prevent parties from accurately assessing these economic trade-offs in making their contracting decisions between short-term markets and longer-term commitments.

Fundamentally, contracts involve agreement among the parties on term (length), volume (quantity) and price, each of which implicates various risks the parties must assess and value. One example is credit. Contracting parties are faced with a trade-off between the cost of a financial default times the probability it will occur versus the direct cost of a financial guaranty to insure against it. Because the probability of default increases over time due to the uncertainty of each party's future economic circumstance, the default or credit costs are greater the longer the term of the transaction. This is not an impediment to an otherwise economic transaction but rather the manifestation of an underlying cost which is part of the economics of the transaction itself. Quantity is another term that manifests a greater cost in longer dated transactions. A seller can supply a fixed quantity but the buyer may have real uncertainty as to its own future demand and will want to embed that risk in the price. Alternatively, the seller could offer a load following product, in which case the cost is merely shifted to the seller; but the uncertainty, and hence the underlying cost of that uncertainty, remains and must be reflected in the price somehow.

The costs associated with managing these risks represent the trade-offs that must be made in a forward agreement whose terms are certain but which must fit somehow within an uncertain and changing economic future. Conflicting opinions about how to value these risks may lead parties to prefer shorter-term transactions. Valuing these costs and risks may lead some parties to participate in daily markets rather than enter longer-term contracts, or to opt for shorter rather than longer-term contracts. These costs should not, however, be considered as *impediments* to desirable long-term contracts. They are merely the natural economic trade-offs which are inherent in such transactions.

Perception and Expectations

The perception of inadequate long-term contracting opportunities may indeed be a matter of different expectations. Differing perceptions about depreciated embedded costs or long-run marginal costs do affect parties' views about whether price formation within the market design is efficient or optimal, but are not determinative of whether or not it makes sense to enter into a forward contract. Once again, the critical perception for both the seller and the buyer must be the opportunity cost of transacting instead in the shorter-term market. As long as the risk trade-offs associated with contracting forward are perceived as costlier than the alternative of the expected outcome in the spot market, the parties will choose not to contract forward. The point is not that the opportunities to contract forward are inadequate but rather that the opportunities to transact shorter-term are more attractive. This is simply buyers and sellers making rational decisions in the marketplace. This is not to say, however, that there are no opportunities for improving the contracting climate for parties in both the daily and forward markets. Increasing the efficiency and stability of the organized markets will allow parties to form clearer and more consistent expectations about the daily market, thereby enhancing their ability to contract forward on the basis of those expectations.

Recommendations

- Improve price formation by encouraging RTOs to adopt market mechanisms and designs that rely upon commodity prices, and minimize out of market compensation mechanisms such as uplift charges or reliability must-run contracts. Provide consistent guidance on the appropriate measure and mechanisms for addressing market power and avoiding the need for market intervention and price capping.
- Improve price integrity by providing continued affirmation of the Commission's adherence to the filed rate doctrine, as was done in the Commission's recent dismissal of the CARE complaints. Sending a clear message to the market as to how the Commission will view and respect the market-based rates embedded in bilateral agreements can help

restore confidence in the integrity and enforceability of such agreements, thereby promoting their use.

- Promote greater liquidity by encouraging RTOs to facilitate trading transactions across the seams between markets and to bring their operational practices and information systems up to the highest possible standards.
- Finally, the Commission can promote long-term contracting opportunities by lending stability to the organized markets. Regulatory uncertainty is another important cost of long-term agreements. Not allowing the perfect to be the enemy of the good and bringing some stability to market design, especially as regards to the definition of the underlying products, will go a long way.