

McCULLOUGH RESEARCH

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Date: April 7, 2008
To: McCullough Research Clients
From: Robert McCullough
Subject: Kaye Scholer's Redacted "Analysis of Possible Complaints Relating to Maryland's SOS Auctions"¹

It is disturbing to read the favorable analysis of a highly secretive electricity auction in 2005 that in itself was quite secretive. The Kaye Scholer analysis posted by the Maryland Public Service Commission on April 4, 2008 is deeply redacted: 124 black blocks strike virtually all data concerning the auction and a few of the later pages are effectively dominated by half-page tables that are fully redacted. Even the original title has been replaced by a title out of line with the remaining text.

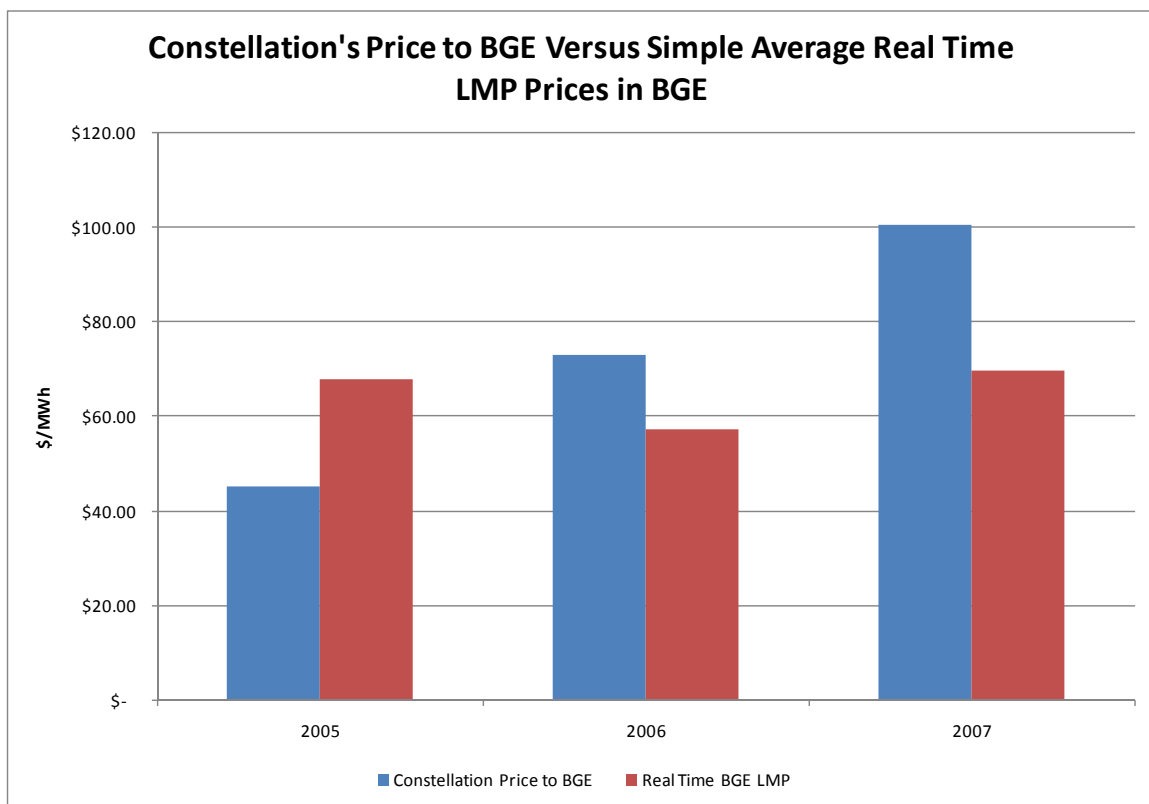
Given the lack of transparency, it is easier to discuss the issues that this analysis fails to address.

Why are the Maryland auction prices so high?

While all entries pertaining to costs and prices are redacted in the Kaye Scholer analysis, there is some irony in the fact that the Federal Energy Regulatory Commission's FERC Form 1 and its Electric Quarterly Reports (both documents are in the public domain) provide a fairly good picture of the data that the Kaye Scholer analysis to Maryland's regulators does not review. To gain a sense of the redacted data, it is helpful to compare the Kaye Scholer analysis to the FERC documents.

¹ http://www.psc.state.md.us/psc/aboutus/Scanjob_20080404_181221.pdf

Constellation Energy's charges to its affiliate, Baltimore Gas and Electric, have risen markedly from \$45.12/MWh in 2005² to \$72.91 in 2006³ and \$100.35/MWh in 2007.⁴ The rate of growth is 122% in just two years. By contrast, Locational Marginal Prices (LMP is PJM's acronym for prices) for BGE over the same period increased from \$67.92/MWh in 2005⁵ to \$69.79/MWh in 2007⁶, a growth rate of just 3% over the corresponding two years.



While it is tempting to simply compare LMPs with the prices paid by consumers, few apples-to-apples comparisons are available that do not require extensive calculations. Actual energy

² 2005 BGE Form 1, pages 326-327.

³ 2006 BGE Form 1, pages 326-327.

⁴ Weighted average from Constellation Energy's sales to BGE in 2007 EQRs: this value should be viewed as an approximation of the value to be reported in BGE's as yet unavailable 2007 Form 1.

⁵ PJM State of the Market 2006, Volume 2, page 74.

⁶ PJM State of the Market 2007, Volume 2, page 55.

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prices are a major component, but not the only component, of comparison between prices and auction results.

The Kaye Scholer redacted analysis touches very briefly on whether the components of such a comparison are themselves competitive:

Finally, we have considered the PJM market monitor's analysis and reports relating to the competitiveness of wholesale electricity markets in Maryland.⁷

This is an odd statement given that PJM's State of the Market 2007 report shows a lack of competitiveness in Maryland's markets. In energy, for example, the PJM report indicates a \$6.93/MWh markup over marginal costs for BGE.⁸ We would expect high markup over costs when suppliers have market power. This compares sharply with a value of \$1.95/MWh in 2006.⁹ This sharp increase in the difference between prices and marginal cost would be consistent with increasing market power in the energy market.

The significantly more controversial market known as the PJM capacity market does not pass the PJM market monitor's market power tests:

Market power remains a serious concern in the PJM Capacity Market based on market structure conditions in this market including high levels of supplier concentration, frequent occurrences of pivotal suppliers and extreme inelasticity of demand.¹⁰

These rapidly increasing auction prices require substantial explanation, yet even absent the redactions Kaye Scholer gives them relatively little attention.

⁷ Kaye Scholer redacted analysis, page 3.

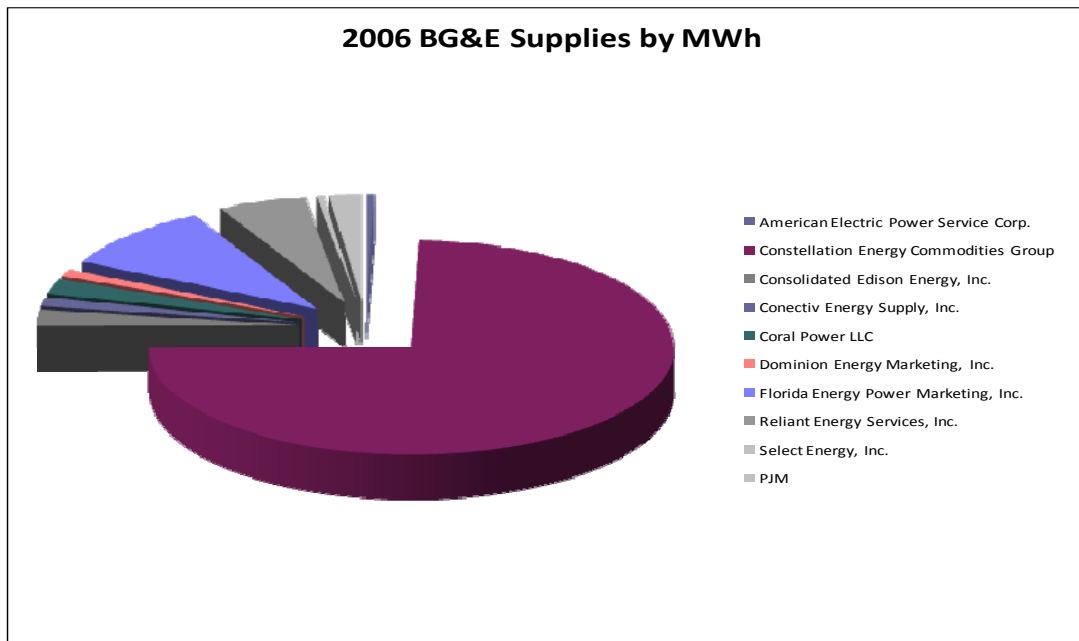
⁸ PJM State of the Market 2007, Volume 2, page 38.

⁹ PJM State of the Market 2006, Volume 2, page 61.

¹⁰ PJM State of the Market 2007, Volume 1, page 3.

Why does Constellation dominate the bidding?

While the dominance of Constellation Energy is addressed, the scale of its dominance is redacted. Again, FERC Form 1's can supply some of the redacted data (note that BGE's FERC Form 1 is not yet available, so we have no estimate for 2007). In 2005, Constellation Energy Commodities Group provided almost 82% of BGE's purchases. In 2006 it was 74% of total purchases:



There are three reasons that these high levels of concentration are troublesome:

1. BGE and Constellation are affiliates.
2. Logically, rapidly increasing auction prices should attract successful competitors.
3. Substantial effort has been expended to keep data on the auction unavailable – even an unsuccessful attempt to have FERC remove auction data from its records.

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The U.S. Department of Justice indicates that a Herfindahl-Hirschman index above 1,800 indicates a very concentrated market.¹¹ Any market where values reach as high as 3,943 would therefore appear worrisome. HHI values for the Maryland auctions were 3,786 in 2003/2004, 1,958 in 2004/2005, 3,943 in 2005/2006, and 2,853 in 2006/2007.¹²

The Kaye Scholer redacted analysis criticizes our use of HHI in analyzing the results of an auction in Illinois rather than calculating the HHI on the initial bid amounts:

Although the Illinois AG used HHIs based on the second market definition, only the first definition reasonably reflects the level of competition for SOS supply. The competition occurs when qualified bidders submit their bids for proposed SOS blocks, and the HHI based on those market shares more accurately reflects the degree of competition.¹³

While this may be regarded as an abstruse debate between experts, the Kaye Scholer criticism misses the point. The seemingly endless Rocky sequels are interesting because one underdog keeps winning against many challengers. In Maryland, Constellation faces many contenders, but always retains the championship in the end.

Why does Kaye Scholer believe that the arguments that helped to pave the way for a \$1 billion settlement for Illinois consumers were in error?

Throughout the Kaye Scholer redacted analysis the implicit comparison to the Illinois Attorney General's ultimately successful challenge of a wholesale electricity auction held in 2006 is apparent. Kaye Scholer mentions the Illinois experience no less than thirty times – often critically.

¹¹ <http://www.usdoj.gov/atr/public/testimony/hhi.htm>

¹² Kaye Scholer redacted analysis, Appendix A.

¹³ Kaye Scholer redacted analysis, page 10.

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The heart of the debate is whether or not the risk adjustment required to bring open market prices up to auction prices is correct. In Illinois, the margin between market prices and the auction was on the level of 40%. A substantial debate about the methodology and level of the risk adjustment appears in the affidavits submitted by Illinois parties to FERC largely because the risk premium adjustment is not well understood and has little agreement between experts.

In general, delivery risk adjustments for retail contracts have been quite low. The market experience has been nowhere near the large adjustments needed to make the differential “go away” in auctions such as those in Illinois and Maryland.

Market participants have few guides on how to calculate such adjustments. In the real world, such margins are the result of real transactions, not a theoretical calculation undertaken after the fact. The Kaye Scholer redacted analysis is silent on the methodology used to calculate the risk premium. We note that the actual value of the adjustment has been redacted as well. While in most cases the redactions have been dictated by the high levels of secrecy agreed to by Maryland’s regulators, an after-the-fact risk premium analysis is a theoretical exercise and need not be confidential.

Thorstein Veblen, the great American economist, once drily remarked that theories constrain the underlying facts. The Kaye Scholer redacted analysis seemingly implies that the settlement in Illinois should not have taken place. Since the settlement did, in fact, take place, the unstated risk premium methodology would appear to be of doubtful application in both Illinois and Maryland.