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Customer Choice: What will it Take to Do it Right?

by

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OUTLINE OF PRESENTATION

- What are the most important building blocks needed to effectively deregulate energy markets?
- What are the forces driving deregulation?
- What problems and pitfalls have occurred and how can they be avoided?
- Will customer choice "take off?"

BUILDING BLOCKS FOR EFFECTIVE DEREGULATION

- Above all else, be clear about your goals:
 - protect consumers from "undue" price volatility during the transition?
 - continue subsidies for universal service?
 - lower prices for all customers, not just those who switch?
 - promote customer switching?
 - create and efficient market?

- These goals will dictate different designs for default service and will yield conflicting results.
- A workably competitive wholesale market is necessary for retail competition to work:
 - a deep, liquid market (with many transactions);
 - visible, transparent prices;
 - sufficient number of independent suppliers to eliminate market power (at least 5-6);
 - transmission controlled by an independent entity;
 - transmission pricing must reflect congestion;
 - ISO must administer a market to procure reliability services efficiently and price congestion accurately.
- But retail choice is needed for effective wholesale competition too.

FORCES DRIVING DEREGULATION

- General resurgence of faith in markets and disillusionment with command-and-control regulation.
- The traditional system of regulated monopoly had become almost completely dysfunctional in New York:
 - Record levels of surplus combined to create all-time high electricity prices even though demand was flat;
 - Failure of nuclear power to live up to its potential;
 - Regulatory "fix" of mandated purchases from independent power purchases (IPPs) created an even worse problem;
 - Economic development problems created a real sense of urgency to do something.

WHAT PROBLEMS HAVE EMERGED?

- Setting up the institutional infrastructure to make wholesale competition work has been harder and more expensive than many of us thought it would be.
 - FERC Order 888/889 (which requires utilities to provide open access to their transmission system) has not been enough to create competitive wholesale markets.
 - Lack of clear FERC authority to order more sweeping changes.
 - Institutional heterogeneity (public v. private power).
 - Lack of consensus on transmission pricing.
 - Lack of agreement on which structure is optimal (functional unbundling, ISO, Transco, RTO, etc.).
 - Some states have neither the inclination nor the leverage to implement restructuring (negative

stranded costs).

- Few mass market customers are switching suppliers.
 - In many states where retail access has been enacted (California, Massachusetts, New York, etc.), fewer than 2% of customers have switched suppliers.
 - Even in Pennsylvania, where switching is being heavily subsidized, only 10-12% of customers have switched suppliers. (When customers switch commodity suppliers, they receive a credit that is 0.6 to 1.3 cents/kWh more than it actually costs the utility to serve them. This subsidy is called "headroom.")

WHY ARE SO FEW MASS MARKET CUSTOMERS SWITCHING SUPPLIERS?

- Wildly unrealistic expectations.
 - Circa 1994: "retail competition in electricity will spread much more rapidly than it did in natural gas."
- Problems in wholesale markets.
 - Immature wholesale markets make it difficult and expensive for some retailers to acquire commodity supplies.
- Conflicting public policy goals in designing transition plans.
- Underlying economics of commodity retailing.

ECONOMICS OF COMMODITY RETAILING FOR SMALL CUSTOMERS

- There are four widely recognized problems that make it difficult to profitably serve mass market (residential and small commercial) customers:
 - **Small Volumes:** an average residential customer consuming 1000 kWh per month would have a commodity bill = \$30/month (if commodity prices average 3 c/kWh).
 - **Thin margins:** margins are squeezed by default supply prices, but competition will also yield low margins (3-7% for other retail commodities); 5% of \$30 = \$1.50/month; gross profit on a single pack of cigarettes = \$1.00.
 - **High transaction costs.**
 - **Hard to offer value-added hedging services** when default supplies are already hedged.

HOW CAN VIRGINIA AVOID THESE PROBLEMS?

- Wholesale issues must be resolved due to VA law and FERC regulations.
 - Having VA utilities join an existing regional transmission organization (RTO) would minimize start-up costs and create a more efficient market (economics indicate large (multi-state) RTOs make sense).
- At the retail level:

- Be clear about the goals, then adjust your expectations accordingly.
- Don't simply "count heads" to measure success for mass market customers.
- Retailers should add to, not subtract from, the value created at the wholesale level.

WILL CUSTOMER CHOICE "TAKE OFF?"

- It's clear that the development of retail markets for small customers will depend critically on the design of default supply.
- We believe default supply should be based on the unhedged wholesale spot market price of electricity.
 - This is what will actually happen in the physical market.
 - The ISO price is the efficient (market determined) price.
 - It provides an appropriate benchmark against which customers can evaluate the benefits of price hedging services.
 - Some load response is necessary to have a well-functioning wholesale spot market (avoiding price spikes and the need to resort to command and control measures to balance load and supply in real time markets).

DESIGN OF DEFAULT SUPPLY IS KEY TO RETAIL MARKETS

- In this default supply model:
 - The ISO procures the supply through a competitive auction.
 - The distribution utility acts as a settlement agent for the ISO. It can provide this service at the lowest administrative cost because it has scope economies between retailing delivery and retailing the commodity.
- The major concern expressed about this model has been price volatility - will it be too much or too little to promote efficient retail markets?
- Every other alternative model for default supply we can think of has many more problems. For example, if default supply continues to be offered at a relatively low, fixed (hedged) prices, it will:
 - interfere with the development of an efficient retail market and
 - pose many additional problems and risks.
- If default supply continues to be hedged, these questions will follow:
 - Which customers are eligible for default supply and under what circumstances?
 - who decides what supplies should be acquired and how to acquire them? How will supply costs be collected and from whom?
 - Who is at risk if new stranded costs are created?

- Who is at risk if insufficient supplies are acquired?

SUMMARY RECOMMENDATIONS

- Do create a competitive wholesale market.
- Do allow all customers access to un-hedged commodity service at the low administrative cost utilities can offer.
- Don't subsidize entry through excess back-out credits because:
 - It will force non-switching customers to pay more than they should have to (billions more in PA).
 - It will encourage uneconomic entry and simply postpone the day of reckoning if commodity retailers aren't creating real value.
- Don't force customers to buy from competitive retailers by "bidding out" default supply because it:
 - will easily raise the costs of serving the average residential customer by 10-20% (See Appendix, for details), and
 - is therefore bad public policy and bad customer policy.
- If you decided that default supply must be offered at a hedged price, you need to recognize that it will reduce customer incentives to switch.

APPENDIX

ECONOMICS OF COMMODITY RESELLERS

- Have to look at underlying economics to get a real sense what is happening and why.
- Overall problem: the price of default service in most states has been capped, making it hard for new entrants to add value through price hedging.
- Two features of commodity retailing are important:
 - cost and ability to hedge the commodity;
 - transaction costs (the focus of this appendix).

TRANSACTION COSTS ARE HIGH RELATIVE TO AVAILABLE MARGIN FOR SMALL CUSTOMERS

- Customer Account Management Services (CAMS)
 - billing
 - central payment processing

- collections
- call center
- meter reading and meter services
- Sales and Marketing Costs
 - general & administrative costs
 - distribution channel
 - offer (acquisition cost)
 - fulfillment

CUSTOMER ACCOUNT MANAGEMENT COSTS (CAMS)

- Incumbent utilities have two cost advantages relative to ESCos in terms of CAMS costs
 - Scope economies in billing, central payment, and collections processing due to the fact that they already provide these services for delivery (T&D) and can extend those functions to the commodity with negligible marginal cost.
 - As a default provider (commodity purchased through the spot market) there is no need to invest in customer acquisition, a key cost driver for new entrants.

IF FEW CUSTOMERS SWITCH, ARE MARKETS WORKING OR FAILING?

- One view: markets are working.
 - If there are no barriers to entry, and customers don't switch, then you have success by definition.
 - Regulators shouldn't try to manage outcomes. They should let customers decide what is best for them.
 - If default supply is the unhedged wholesale spot market price of electricity, and customers are not willing to buy from retailers, they are simply saying the value it would derive isn't worth the price retailers need to cover their costs.
- The opposing view: markets are failing.
 - If customers aren't switching, then by definition the market can't be working, (number of customers who switch is the measure of success).
 - Something must be done to "fix" the market.

ALTERNATIVE APPROACHES TO RESTRUCTURING RETAIL MARKETS

- Eliminate barriers, then let markets work (CA, MA, NY etc. are close to this approach).
- Subsidize entry by establishing back out credits higher than the utility's cost of providing the commodity

(PA, NJ, etc.).

- Bid out the right to serve customers (customers may or may not be allowed to "opt out") (ME, CT, PA, NJ, etc.).
- Completely separate the wires function from the retailing function (TX).

IF CUSTOMERS ARE FORCED TO BUY FROM COMMODITY RETAILERS, WHAT WILL IT CONCERN?

- Assume the commodity is the spot market so we can focus on transaction costs.
- Actual transaction costs will vary, depending on the firm's scale of operations, sales and marketing costs and customer switching rates.
- A conservative estimate is \$50-\$100 per mass market customer per year assuming market maturity. If average monthly consumption is (1000 kWh/month) and total average residential prices are:
 - 7 c/kWh, total bill would increase by 6 to 12%
 - 5 c/kWh, total bill would increase by 8 to 17%

WHY ISN'T THE ANSWER TO JUST INCREASE THE UTILITY BACK-OUT CREDIT?

- New entrants argue that back-out credits should cover their retail transactions costs.
- If ESCos bill for both delivery and commodity, some costs may be saved, but others are increased, and the bulk of the costs can't be eliminated.
 - So long as delivery services are billed on a volumetric, per customer basis, the utility must maintain systems and databases to support "retail-level" billing.
 - This is true, even if the ESCo has primary contact with customer and even if utility is not the default provider.
 - Utilities don't have incentive costs (delivery is a monopoly service).

CONFIRMING ECONOMIC EVIDENCE IS EMERGING

- Maine recently conducted an auction and rejected bids for 2 out of the 3 utilities because they were "too high."
- GPU recently conducted an auction for their first block of customers; nobody submitted a bid to serve them.
- In Pennsylvania, people are beginning to realize that non-switching customers will pay billions of dollars more than they should have to due to the subsidized shopping credits.
- Texas utilities are proceeding with restructuring and investing tens of millions of dollars in duplicate customer care systems (call center, billing, collections, payment processing, etc.).

FIVE MISPERCEPTIONS MAY BE DRIVING RETAIL RESTRUCTURING

- The fundamental economics of commodity retailing are not disputed. Why then do many states remain intent on "forcing" competition at the retail level?

- **Misperception No. 1:** Residential customers should get price reductions as large as industrial customers.
 - Reality: price reductions won't be as large because of the underlying costs to serve and because residential customers in some states are subsidized (served at prices below cost).
 - **Misperception No. 2:** Residential customers won't benefit unless a large number of retailers show up to compete to serve them.
 - In reality, residential customers in New York will benefit from:
 - eliminating the old system of regulated monopoly over generation and the continued price increases that would have resulted, and
 - having direct access to the benefits of a vigorously competitive wholesale spot market.
 - Retailers will have to add value in other ways. If they can't, entry isn't efficient or desirable.
 - **Misperception No. 3:** "Forcing" competition at the retail level is still worth it, even if the benefits can't be identified. (Ex: service innovation in telecommunications).
 - Analogies to telecommunications are grossly exaggerated (a better analogy would be natural gas).
 - Having the utility provide default supply through the spot market will not pose a barrier to innovation.
 - The only way to make sure the cost increases are worth the benefits is to let customers decide for themselves.
 - **Misperception No. 4:** High transaction costs are evidence of market barriers - problems sufficiently large that they would threaten efficient competition and therefore justify market intervention.
 - High *relative* transaction costs are a result of:
 - customer inertia - a result of customer search and hassle costs, and
 - low margins on small volumes.
 - Market intervention is not warranted to offset normal costs of doing business.
 - **Misperception No. 5: The objective is to create many competitors, not competition.**
 - Larry Ruff argues that retailers should add to, not subtract from the value that is being created by competitive wholesale markets.
 - We should have learned our lesson from our PURPA experience; subsidies created many new entrants but at an enormous cost to consumers.
 - Consumers should be able to decide whether the costs of services retailers can offer are worth the benefits customers derive from them.
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