

Default Service: Issues and Options

Theresa Flaim, Ph.D.

Vice President, Strategic Planning

Niagara Mohawk

Harvard Electricity Policy Group

May 25, 1999

Outline of Presentation*

- What goals are we trying to accomplish?
- What is default service?
- Who should be eligible for it?
- Who should provide it?
- What will it cost?
- Who should pay for it?

*The views expressed are those of the author. They are not necessarily endorsed by Niagara Mohawk.

What are the goals?

- Potential goals include:
 - protect consumers from “undue” price volatility during the transition
 - continue subsidies for universal service
 - promote customer switching
 - create an efficient market
- Different goals will dictate different designs for default service

What are the goals? - cont'd

- I believe the most important goal is to create an efficient, workably competitive market:
 - Produce services customers want (customers decide)
 - Services are produced at minimum cost
 - Producers bet with their own money (can't use OPM for nuclear plants or IPP contracts)

What is default service?

- It includes two functions:
 - physical supply
 - financial responsibility
- Product design options:
 - **Unhedged Service** (wholesale spot market prices)
 - | is the efficient price signal (the market determined price of serving load at a given point in time and space)
 - | it ensures that the level of hedging that customers buy is efficient (customers have to decide what they want and how much they are willing to pay for it)

What is default service?

■ Product design options (cont'd):

■ Hedged Service

- | offers customers a product similar to the service they are used to, and
- | protects customers from price volatility, but
- | will be inefficient (someone else has to decide the type and cost of hedging services) and
- | will reduce customer incentives to switch and make it harder for new entrants to offer value-adding services

Who should be eligible for default service?

- Customers who choose but whose suppliers fail or terminate them (Backstop supplier)
- Customers who do not select another supplier (couch potatoes) (Default supplier)
- Customers with special needs such as low income customers, high-credit risk customers, etc.
- Any customer who wants it

Who should provide default service?

- Nobody?
 - probably not feasible politically or legally
- Independent System Operator (ISO)?
 - will always be the physical provider
- Local distribution company (LDC)?
 - has the legal obligation in some states
- One or more ESCos who win the right to provide the default service through an auction?
- All ESCos who are assigned the obligation to provide default service as a requirement?

What will it cost?

■ When default service is hedged

- It must be regulated (somehow “unregulated” default service seems an oxymoron)
- Utilities and regulators must figure out what is the “right” amount of hedged supplies, the “right” cost, who should pay how much for what, how you collect new stranded costs when you oversubscribe, etc.
 - The failure of the old system to do this very well is one of the prime motivators for deregulation
 - Nevertheless, these tasks must be done if default service is a hedged service

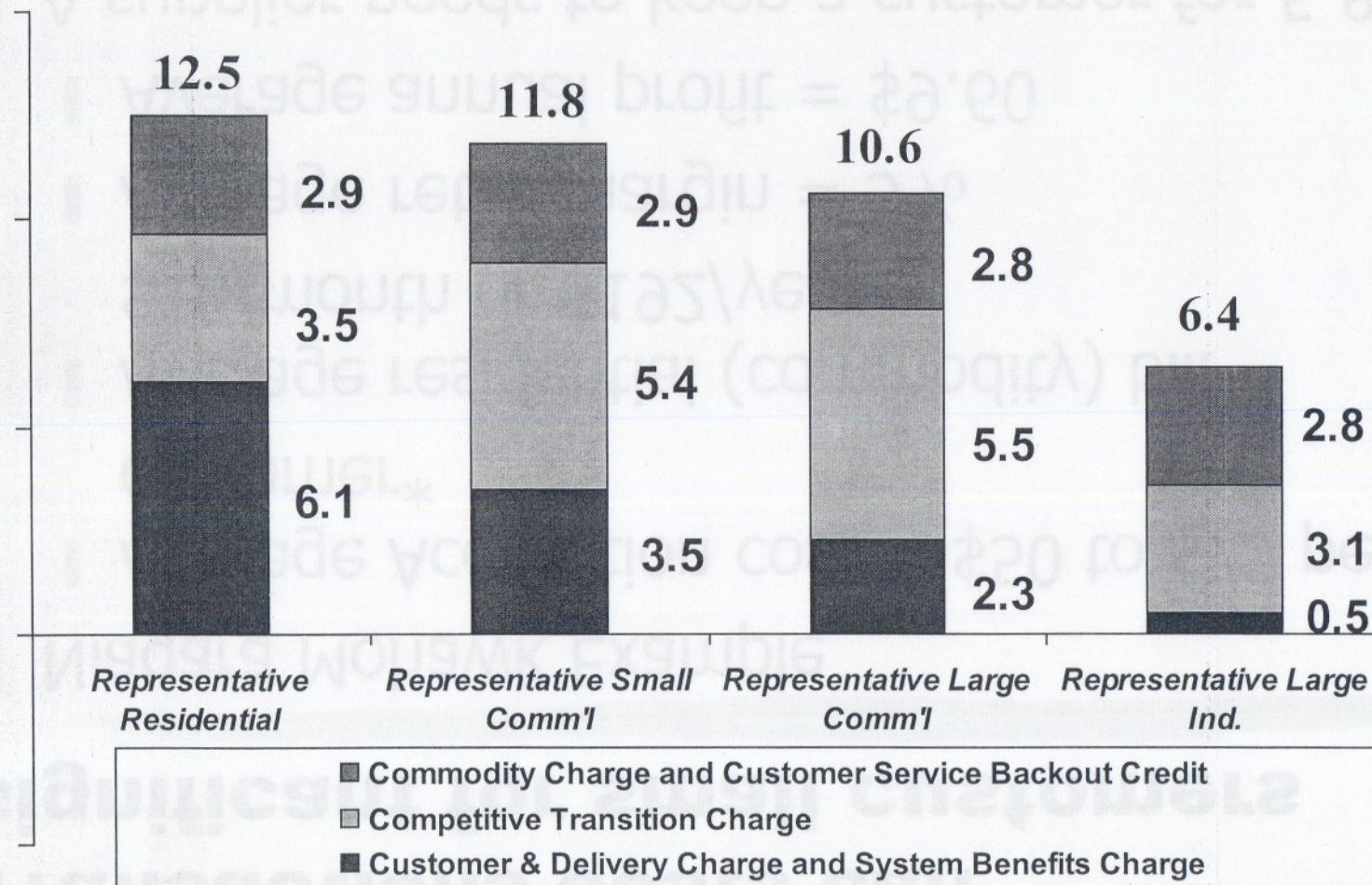
What will it cost?

■ When default service is the unhedged (spot market) price of energy

- Cost of the commodity will be the same for all providers (ISO, LDC or ESCo)
- Transactions costs of providing that access will vary by provider
 - | Only the LDC has scope economies between delivery and commodity services
 - | Every other provider will have to build duplicate capabilities and incur sales and marketing costs
 - | Therefore, the LDC can provide default access at the lowest administrative cost

Niagara Mohawk Average Unbundled Electricity Prices for 1999

cents/kWh



Year 1 of PowerChoice gab 5/7/99

Transactions costs can be significant for small customers

- Niagara Mohawk Example
 - Average Acquisition cost = \$50 to \$75 per customer*
 - Average residential (commodity) bill = \$16/month or \$192/year
 - Average retail margin = 5%
 - Average annual profit = \$9.60
- A supplier needs to keep a customer for 5-8 years to recover the acquisition costs

* Assumes average customer switches suppliers every two years.

Transactions costs can significant for small customers

- Average telecommunications customer changes suppliers every two years
- If switching rates for electricity are the same, suppliers would have to recover the \$50-75 from each residential customer -- a 25 to 40% increase in the \$192 annual commodity bill
- A forced ballot could increase costs substantially for small customers

Who should pay for default service?

- In most cases, the customer taking the service should pay for the cost of that service
- For special needs (such as low income) customers, the question of who pays can be separated from the other design questions, provided that there is a tax mechanism to support cross subsidies

Summary: A Straw Dog Proposal

- Highest priority should be to create a workably competitive market
- Default service should be
 - the unhedged wholesale spot market price
 - made available to all customers who want it
 - at minimum administrative cost (access provided by the LDC at a cost which reflects scope economies in transactions costs)

A Straw Dog Proposal

- This model will provide the best (most efficient) target for ESCos to compete against by offering value-adding services
- Transactions costs can be substantial for low-volume users; therefore it is critical that we not add costs before we are sure there are offsetting benefits
- Customers are the best judges of whether the benefits justify the prices they must pay