

Are Retail Markets Working? -- Part Deux

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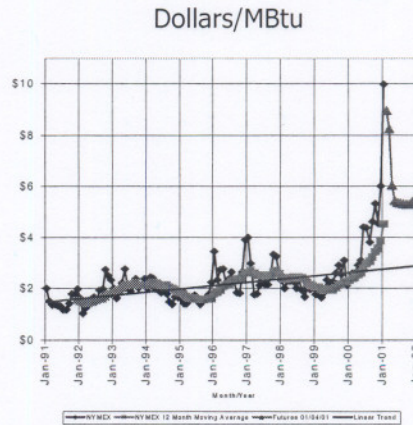
Niagara Mohawk
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Outline of Presentation

- Gas and electric price trends in New York
- Are markets working?
- Is retail competition working?
- Rethinking default service
- Where do we go from here?

NYMEX natural gas futures prices

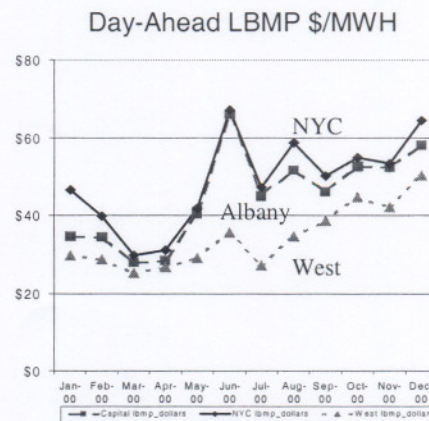
- Strong demand and lagging supply lead to high natural gas prices
- Coupled with unusually cold weather, gas bills double for some customers
- Gas prices also affect electricity prices



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High electric prices in New York cause some to question whether restructuring is working . . .

- New York wholesale prices downstate average \$65/MWH in June 2000
- Some customers' bills double for the month of July
- Some declare restructuring a failure; others ask "Can California happen here?"



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Prices are high due mostly to "normal" market forces

- Stronger economy downstate
- Supply outages (generation and transmission)
- Difficulties in adding new supply
 - lengthy siting process
 - lack of construction during transition
- High gas prices
- Congestion due to transmission constraints
- ISO issues
- Nevertheless, some suspect skulduggery and call for
 - market power investigations
 - wholesale price regulation

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Are retail markets working?

- Many think not:
 - Customers have seen price increases, not decreases, and
 - Few customers have switched suppliers
- Default service
 - defined broadly here as regulated commodity service available to virtually all customers
 - has correctly emerged as **the** single most important issue that will drive the development of retail competition

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Rethinking default service

- Until recently, the debate centered around *who* should provide this service
 - Identifying the candidates
 - one or more ESCos
 - assigning all ESCos a portion of the responsibility
 - “anyone but the utility”
 - How do we get there?
 - outsourcing
 - commodity supply
 - the retailing function as well (aka, “bidding out customers”)
 - complete structural separation (i.e., Atlanta Gas Light)
- The *product design* is the real design issue that will drive the evolution of the market

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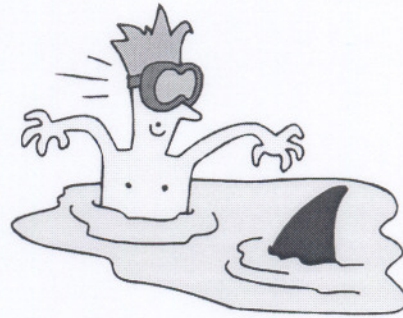
Rethinking default service

- Two basic product design options are used:
 - Passing through the wholesale spot market price of electricity, or
 - Fixed price service

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Option 1: Throw 'em in the pool (spot market pass through)

- Default customers are served by passing through the spot market price of energy
- Customers forced to face price risks
- The invisible hand will provide price hedges
- Customers choose whether to:



switch or swim

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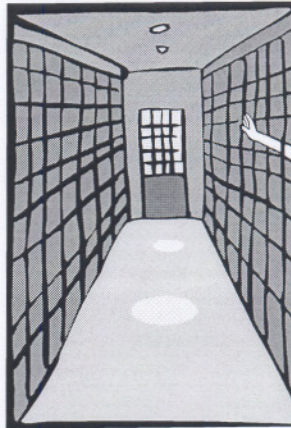
Passing through the wholesale spot market price . . .

- Has attractive economic features
 - a more efficient price
 - a good benchmark for evaluating price hedging
 - eliminates the need to restrict switching
 - some demand response is needed for well-functioning wholesale markets, and
- Works well for large customers, **but**
- Has one small disadvantage:
 - it might not be politically sustainable for small customers if prices become high and volatile

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Option 2: Throw 'em in the slammer (fixed price, restrict switching)

- Switching is restricted to prevent gaming
- Utility may bid out supply or “bid out” customers
- The visible hand provides price hedges
- Customers choose to:
**switch or
get slammed**



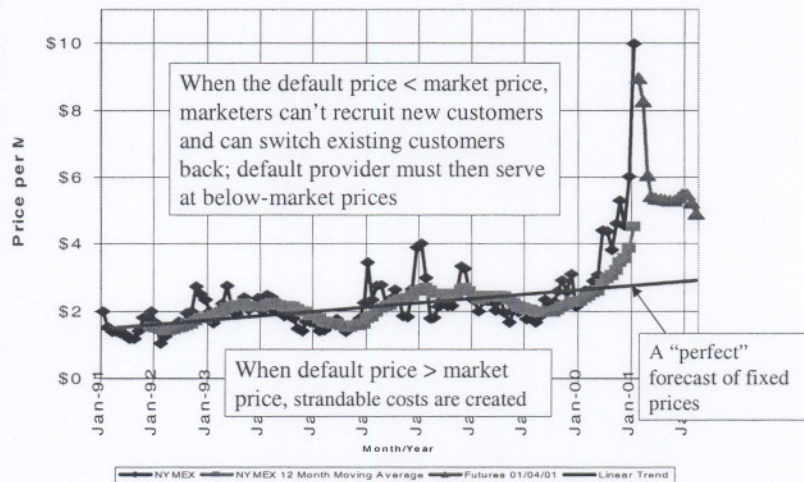
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Fixed price default service . . .

- When combined with unrestricted switching, functions as a free call option, allowing marketers to slam customers back onto utility service when the market price is above the regulated price, in turn leading to:
 - huge deferrals and cost-shifting among customers or
 - huge financial losses for the default provider
- Thus, either switching must be substantially restricted to control gaming, or
- The price of fixed price default service will be much higher

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Price levels vs. price volatility



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Price levels vs. volatility . . .

- Even a "perfect" forecast of average fixed prices creates arbitrage opportunities which have significant risks
- Forecasts are rarely perfect, so arbitrage opportunities (and market impacts) are even greater
- Prices can be volatile month-to-month, but average annual prices will be the same unless there is forecast error
 - Anecdotal evidence is that price volatility is a problem for some small customers, even when they average out over longer periods of time
 - Niagara Mohawk's fixed price gas service -- customers who signed up were unhappy that the market price was lower in hindsight

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Restrictions on switching

- Examples:
 - minimum terms (e.g., 12 months)
 - service distinctions:
 - standard offer service - regulated fixed price service for customers who don't switch
 - default service - priced at market, for customers who leave and come back to the utility and for new customers
- Minimum terms - don't completely solve arbitrage opportunities
- Service distinctions
 - Customers on default service can pay 20% higher total bills than their next door neighbors who have never switched
 - How do you adequately inform customers of the rules without discouraging switching?
 - What's a new customer? A new name on the account? Or a new premise?

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Where do we go from here?

- At present, problems in wholesale markets overshadow concerns about retail markets
- Achieving workably competitive markets is going to take longer than originally anticipated
 - a longer transition period may be needed for small customers
 - large customers can be moved to the market now, but the shift is difficult politically when prices are high
- I still believe markets are the right answer and that they can and are working for large customers
- For mass market customers, the picture is less clear as a result of market experience over the past year (even excluding events in California):

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Where do we go from here?

- Do the benefits of competition for mass market customers outweigh the costs?
 - potential benefits:
 - lower prices
 - better service options (i.e., price hedging)
 - nifty new as-yet-undefined service options
 - costs:
 - implementation costs (billing system conversions, electronic data interchange, etc.)
 - increased transaction costs (customer care, marketing and sales)
 - customer search and hassle costs (what the heck is hedging anyway?)

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Where do we go from here?

- If the benefits do outweigh the costs for mass market customers, how do we make competition work when there is a regulated commodity alternative?
 - Setting the default price equal or close to the market will work, but how much volatility is too much for small customers?
 - Is regulated fixed price commodity service fundamentally inconsistent with having well-functioning retail commodity markets?
- If we conclude that the benefits might not outweigh the costs for mass market customers, how do we deal with the perceptions that
 - if they don't have choice, they are being left behind?
 - if they have choice and don't choose, the market isn't working?

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