

Retail Competition in the U.S.: Is It Working?

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Outline of Presentation

- Few mass market customers are switching suppliers
- Does the lack of switching mean markets are working or failing?
- Alternative approaches are being adopted
- The emerging consensus: the design of default supply is the critical issue

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."

3

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

4

Most states are trying to achieve conflicting goals:

- Protect customers from “undue” price volatility during the transition
- Lower prices for all customers, not just those who switch
- Promote customer switching
- Create an efficient market
- These goals will dictate different designs for default service

5

Economics of Commodity Resellers

- Have to look at underlying economics to get a real sense of 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

6

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

7

Transaction costs are high relative to available margin for small customers

Back Office Costs (aka 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

8

Transaction costs

- Incumbent utilities have two cost advantages relative to ESCos in terms of transaction 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

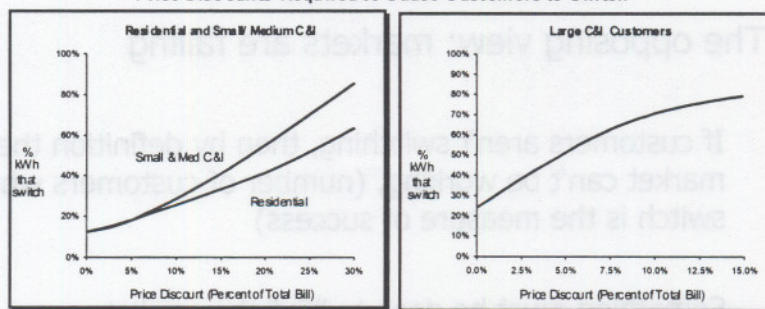
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Customers need a reason to switch ...

Confidential
DRAFT

- When value can't be offered in other ways, price discounts are needed to induce most customers to switch.

Price Discounts Required to Cause Customers to Switch



- Big customers switch for lower discounts
- Bill discounts are easier to produce for big customers (30-40% of bill is commodity)
- Only 20% of total bill is commodity for typical residential customer

Price is Confidential. Prepared for Confidential Use

10

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.
 - 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 they would derive isn't worth the price retailers need to charge to cover their costs.
 - Regulators shouldn't try to manage outcomes. They should let customers decide what is best for them.

11

If few customers switch, are markets failing? . . .

- 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

12

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)

13

If customers are forced to buy from commodity retailers, what will it cost?

- Assume the commodity is the spot market so we can focus on transaction costs
- Actual transaction costs will vary, depending 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%

14

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)

15

Confirming Economic Evidence is Emerging . . .

- ME recently conducted an auction and rejected bids for 2 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.)

16

The design of default supply is the critical issue

- We continue to believe that default supply should be based on the un-hedged 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)

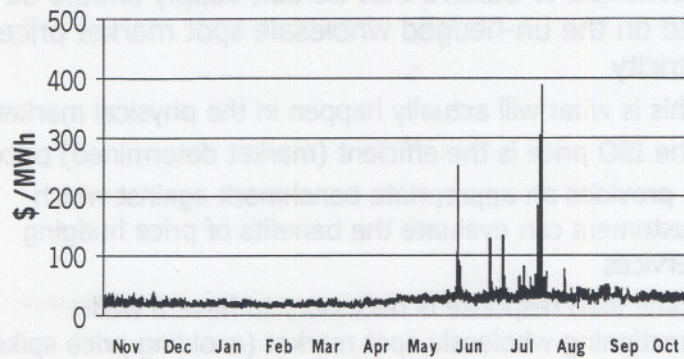
17

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?

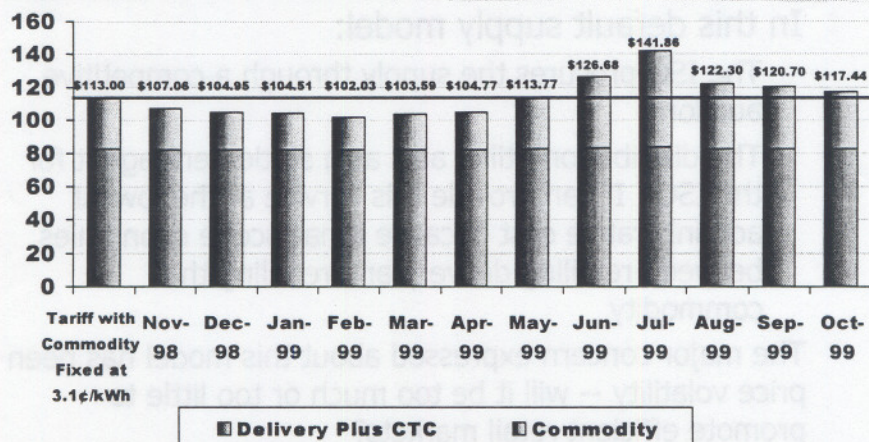
18

Niagara Mohawk Estimated Hourly Spot Market Prices, 11/1/98 thru 10/31/99



19

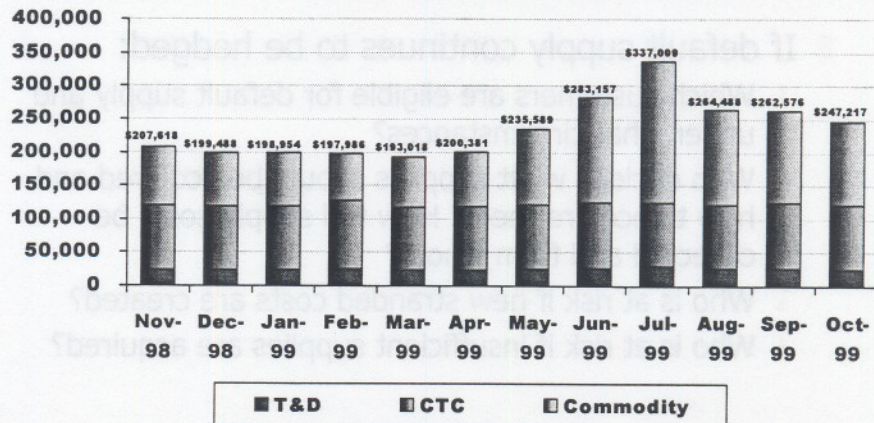
Niagara Mohawk Power Corporation Simulated Monthly Residential Electric Bills - 1000 kWh/month November 1998 - October 1999



NOTE: Monthly bills for November 1998 through October 1999 were estimated based on wholesale spot market prices weighted by the residential class average load shape and adjusted for voltage level.

20

**Niagara Mohawk Power Corporation
Simulated Monthly Electric Bills - Large Industrial
November 1998 - October 1999**



NOTE: Monthly bills for Nov. 1998 through Oct. 1999 were estimated based on a 7MW, 80% load factor customer on SC3A (TOU) rates. Commodity costs were based on wholesale spot market prices adjusted for voltage level.

21

Design of default supply is key to 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) price, it will:
 - interfere with the development of an efficient retail market and
 - pose many additional problems and risks

22

Design of default supply is key to retail markets . . .

- If default supply continues to be hedged:
 - 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?

23

Summary Observations

- We need rules about default supply because of the nature of the network
- Among the choices available to retail customers should be the option of buying wholesale at the low administrative costs utilities can offer
- It is not a good idea impose a structural change whose immediate impact will be to increase the cost of serving residential customers 10-20% without any market evidence that real value is being created

24

Summary Observations . . .

- Should billing be made competitive?
 - issues and problems are widely misunderstood
 - allowing ESCos to issue a combined commodity and delivery bill is **not** the same thing as outsourcing
 - customer preference for a single bill is a symptom of a much larger problem: sufficient value isn't being created to make it worth someone's while to write out another check
 - the extent to which moving retailing functions to the competitive sector can reduce cost duplication depends largely on whether delivery services are billed volumetrically

25

