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Retail Competition: Should Markets Be Bifurcated
Between Core and Non-Core Customers?

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Thank you for inviting me to speak here this morning. The topic of energy competition stimulates almost as much debate these days as debates over the Red Sox, Yankees rivalry. The biggest difference between these two debates, as I see it, is that there are good arguments to be made on both sides in terms to what extent should policy makers continue to foster competitive energy markets; while in baseball there is clearly no doubt as to the dominance of the Yankees.

With that, I would like to get right to the heart of the New York Public Service Commission's position on competitive energy markets by stating simply that: as long as we have confidence that the wholesale market in New York is competitive, and properly mitigated where it is not deemed workably competitive, we see no reason to bifurcate the market. In other words, we believe that the day-ahead and real-time wholesale prices in New York are "just and reasonable" for all customer classes.

To carry my baseball analogy a little further, just because the Red Sox come in second place year after year, does not mean they give up. To their credit, they continue to put out a competitive team despite the hardships and heartbreak. Likewise, just because smaller customers are not yet fully realizing the benefits of retail competition, does not mean we should stop trying. There are safeguards in place, and to the extent that small customers are not being hurt by our efforts to foster more competitive markets, it is well worth the effort to continue down the path.

It is clear that issues of stranded costs, cost shifting among customers, and market incentives for the construction of new power plants must continue to be addressed as the wholesale and retail markets develop. We believe that we have satisfactorily addressed these issues and have charted a reasonable course to proceed with competition for all customer classes, recognizing that course corrections might be required in the future.

This does not mean that we have not accounted for differences in customers' ability to shop for power, to control their demand or consumption, or to attract marketers to serve them. We simply have not seen the dysfunction or disadvantage in the markets

serving any customer class to the degree that would require the withdrawal of competitive options.

To put the New York Commission's perspective into context, the transition toward more competitive electricity markets in New York State began in the early 90's – a time of increasing retail prices and decreasing "wholesale" prices. At that time, large customers attempted to bypass utility commodity purchases because they were drawn to low wholesale prices or cogeneration proposals that could lower their costs. At the same time, smaller customers, in the form of municipalization, studied bypass options in an interest to lower costs. By 1993, the Commission first allowed large customers who could demonstrate a willingness and ability to either install their own generations or leave the state due to energy costs to negotiate a discounted rate, or Flex rate.

In 1996, the Commission issued its vision statement, which called for expanded consideration of competitive opportunities beyond large customers. The Commission asked utilities to file a plan including; but not limited to,:

- retail choice for all customer classes;
- divestiture of generation assets; and
- recovery of stranded costs

Between 1997 and 1999 the Commission approved the restructuring plans of individual utilities, with modifications. The restructuring orders reflected differing approaches in different utility territories in terms of:

- Timing of retail choice;
- Backout credit designs and amounts;
- Role of the utility; and
- Portfolio design for smaller customers and larger customers

The approach taken by New York differs from that of most other states in that we approached restructuring administratively as opposed to legislatively. This allowed for different concepts to be tested with different utilities based on customer needs, market

realities, and utility circumstances. An unfortunate consequence of this approach was that it did not provide consistency for ESCOs interested in operating in more than one utility market. As would be expected, we have seen a tremendous variety in results from each utility. The two areas where we insisted on consistency were reliability and service quality, which for all delivery customer classes remained the same or improved.

To generalize a little about the experience in New York State, we have found that larger customers are more interested in shopping for commodity where their local utility offered only a pass through of market prices. Smaller customers were generally provided a portfolio of long-term contracts, shorter term hedges and spot market purchases. In areas where spot market prices constituted a higher percentage of the utility's portfolio, there was more interest in marketers and more migration. In areas with utility fixed price offerings, migration was generally slower. However, many factors, besides default service design, contribute to migration rates.

For example, the design approved by the Commission for Con Edison included:

- Back out credit rates of 1 mill per kilowatt hour for large customers and 2 mills for small customers;
- A one-time customer incentive for migration to an ESCO was adopted; and
- Sales tax advantages for customers choosing marketers.

As a result, nearly 70% of large time-of-use customers in Con Ed's territory have migrated to ESCOs, representing nearly 80% of the load for that customer class. For smaller, residential customers we have seen only about 3% of these customers migrate to ESCOs, representing 4% of the residential load. The success in migrating larger customers is largely attributable to the sales tax differential which produces meaningful savings for these customers. On the other hand, commodity costs for residential customers represent a less significant percentage of their overall cost of living. This also reflects the fact that the margin for small customers is not really sufficient to make it worth the acquisition cost of the ESCO's, unless acquisition can be accomplished on a larger scale.

In Niagara Mohawk's territory in upstate New York, the largest customers paid spot market prices and longer-term hedges were reserved for other customer classes. These hedges will be removed through time, based on decreasing levels of demand. Back-out rates in this territory were 4 mills for large customers and 2 mills for small customers.

The results to date show that nearly 60% of the largest time-of-use customers migrated to ESCOs for commodity, representing 55% of the load in that customer class. Meanwhile, nearly 6% of residential customers migrated to ESCOs, representing 7% of the residential load.

In Orange & Rockland's territory outside of New York City, there was no back out credit, but the utility did offer the purchase of accounts receivables to eliminate the uncollectible risk for marketers, and the company has a philosophy that supports competition. At the same time, O&R had virtually no long-term contracts and passed through market prices to all customer classes, leading to higher price volatility. Wholesale electric price spikes were passed on to customers, sending a signal for them to manage consumption and/or look for a cheaper or less volatile product through the market. Also, O&R implemented a program known as "Switch and Save." Under this initiative, customers that contacted the utility expressing concern about their bills were encouraged to investigate competitive options, with a number of marketers agreeing to discount prices for the first several months.

O&R's approach has yielded significantly different results. About 24% of the largest time-of-use customers have migrated to ESCOs, representing nearly 50% of the load for that class of customers. On the other hand, 37% of small commercial customers and a little more than 30% of O&R's residential customers have opted for ESCO commodity service, representing more than 37% of the residential load in that territory. They have achieved similar results on the gas side and have a relatively low churn rate combined with high customer satisfaction levels.

The Commission and the market participants learned from these different approaches. First, we recognized that marketers needed consistent, uniform business rules for the exchange of customer information and revenues, and standardization and automation, through electronic data interchange. Second, the Commission sought to examine the ultimate role of the distribution utility as well as other barriers to retail market growth for small usage customers in a proceeding initiated in 2000.

Unfortunately, before a decision could be rendered in that case, wholesale markets in other parts of the country collapsed; accounting and financing scandals emerged among the largest new providers of retail service, and natural gas price increases and weakening demand undermined the financial position of most of the new independent generation owners. To compound things further, the attacks of September 11 and the August 14 blackout diverted the nation's, and especially New York's, attention to security and reliability concerns.

However, in January of this year, I revived the "competitive markets" proceeding and the Commission made key policy decisions in August 2004 in the following areas:

- Its vision of the end state, which includes utilities becoming primarily transmission and distribution providers over time;
- Unbundling of utility costs to assign them to competitive and noncompetitive functions; and
- Customer migration strategies that may include auctions, purchase of accounts receivable, and a transition of default commodity service toward a pass through of short term market prices for all customer classes, starting with the largest customers. Ultimately, we see ESCOs providing hedges. Utilities that enter into long-term contracts to retain market share will do so at their own risk.

We anticipate that, through individual rate cases that will reflect these goals, smaller customers will take greater control over their energy purchases, and the market will bring greater variety in product and service packages, including fixed rates, energy

efficiency, distributed generation and bundled electric, gas, water and telecommunications packages, to all customer classes. Arriving at this state will, no doubt, require advances in technology and further automation through real time load control techniques and smart grid applications, but we are patient and believe that customers will not be harmed by trying out competitive options during the transition.

In conclusion, New York will continue to support further development of both wholesale and retail markets. We strive to create a fertile ground for investment in generation, transmission, energy efficiency, and demand side management through our wholesale and retail market designs. We don't believe that the current state of the financial markets with respect to large scale investments will preclude merchant funding forever, but we are willing to examine the benefits of customer funding for such investments for public policy purposes. Ultimately, we believe that competitive markets will best provide New Yorkers with the ability to react to changing market conditions, stricter environmental policies and the dynamic politics of energy.

To summarize it all in one sentence: I am confident that the smaller customers will ultimately begin to reap the benefits of competitive wholesale and retail markets long before the Red Sox ever win another World Series. Therefore, we intend to continue our efforts to transition the electricity markets toward a more competitive environment for small and large customers alike.