



IssuesLetter

Consumer Choice Making It Work for All Customers

Retail customer choice sets customers free to choose their supplier of electricity from a range of competing, unregulated suppliers. Constructed and implemented right, choice could result in more and lower-cost energy options for all consumers. This Issuesletter considers the basic components needed to build effective and fair customer choice.

Two prerequisites must be met for choice to succeed. First, all customers need to have access to competitive suppliers on reasonable terms. If this does not occur, customers with limited choices may see their electricity costs rise. Second, vertical and horizontal market issues must be resolved so that the market is structured to support fair competition. Vertical market power is best addressed if the company owning the distribution wires has no corporate relationship or affiliation with a generation company. The solution to horizontal market power issues requires that no single generating company (or group of companies) manipulates market price.

Why is Customer Choice Desirable?

While most state regulatory commissions have yet to decide whether the industry should structure itself around retail competition, utility companies fully expect there will be competition. Thus a primary goal of utility managers has been to minimize shareholder risk. In their efforts to do this, many utilities have abandoned long-term resource planning and resisted making capital investments in energy efficiency and renewable energy. At the same time, the absence of retail customer choice prevents customers from having any outlet to exercise their own preferences for cleaner energy.

Until customer choice is in place, the only winners are high-cost utilities who continue to collect full stranded cost and larger customers who have successfully negotiated lower rates. Low-cost utilities are held back from competing for customers, and the market price for generation remains at regulated, rather than competitive, levels.

The best course of action for customers, regulators and the broader public interest is to complete the transition to full customer choice as quickly as possible and in a way that is efficient, equitable and environmentally sound.

Which Customers Should Have Choice First?

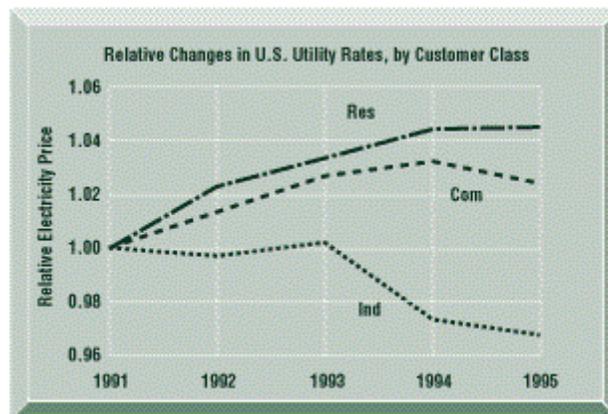
Two considerations guide the decision concerning which customers should have choice first: equity and administrative feasibility. Equity favors making choice available to customers of all sizes, at the same time, as soon as possible. Administrative feasibility

means markets are ready for customers to choose and the process of choosing is accessible and easy to implement.

Equity. Since large customers initially were the most vocal in seeking the right to exercise retail choice, much of the early consideration of retail competition focused on them (Michigan PSC Order April 1994, California Blue Book April 1994). Some argued that because a handful of large customers use a lot of electricity, they would be the best single group to test the waters of choice and give utilities a chance to work out the kinks. In reality, offering retail choice exclusively to large customers not only would be unfair but would likely harm the excluded customers.

Limiting the right to shop for electrical service to a few customers or customer classes gives the utility strong incentives to slash prices in the competitive market while raising prices of the captive customers who are prohibited from seeking alternatives. This practice of predatory pricing means captive customers are at great risk of becoming the unwitting underwriters of utility marketing efforts. Allowing only certain customers to exercise choice places a tremendous burden on utility regulators to constantly monitor the utility's pricing strategies for all cost categories in both competitive and monopoly markets to prevent cross-subsidization. Even if this task were feasible, as a practical matter, it is beyond the resources of most state commissions.

Predatory pricing injures competition. Subsidies from the monopoly customers can push rates low enough to drive out existing competitors and discourage new ones.



Source: Energy Information Administration, 1996.

A similar equity problem exists in cases where regulated utilities are permitted to use discounted rates and special contracts to retain large customers. These rates, when set at (or very slightly above) marginal costs, have allowed the largest customers to escape at least some of their share of strandable costs. And over the long run, despite initial arrangements that generally place a percentage of the strandable cost burden on shareholders, customers not receiving special rates have a good chance of paying not only their own share but much of the strandable costs of the larger customers as well.

Restricting choice to large customers may also harm the environment. Small customers have consistently shown a greater interest in purchasing electricity from renewable resources even when it has meant higher prices. Utility polling around the country of

small customers continually confirms this interest. If these customers cannot shop, renewables and other clean technologies will not be exploited to their full potential.

Administrative feasibility. The most equitable approach would have all customers entering the world of retail competition at once. This approach could also be the most chaotic if the systems needed to support competition competitors, a market, independent operation of the transmission and distribution systems, and metering and billing systems are not yet in place. Picking a realistic future date for a flash cut will help insure a truly competitive start. For example, Massachusetts, Vermont, New Hampshire, Rhode Island and New York plan retail customer choice for all customers in 1998, a year after the commencement of a competitive power exchange in January 1997. The selection of a 1998 starting date anticipates that it will take a year for the necessary market structures to be in place.

Alternatively, a phase-in option like the one contemplated in the California PUC, December 1995 Order could be used to give choice to a proportion of all customer classes over a period of time. A simple phase-in might give 33 percent of each customer class retail choice in year one, another 33 percent choice in year two and grant it to all customers by the third year. Another phase-in strategy proposed by Pennsylvania Power and Light calls for a ramping-up period in which new customers enter the market on a monthly basis. The benefit of a phase-in is that markets have additional time to develop, and there is an opportunity to work out some of the problems that no amount of preplanning could anticipate.

How Can Policy Makers Insure Small Customers Have Choice?

Giving customers the option to choose is only useful only if there are a reasonable number of suppliers competing for their business. Regulators cannot require competitive suppliers to market to small customers, but they can make the entry of competitors easy and still maintain standards for consumer protection. Requiring that competitors comply with cumbersome regulatory requirements or incur other significant administrative costs will restrict entry. Existing suppliers will be favored. There will be fewer suppliers and less innovation.

Regulators can minimize administrative barriers to entry by implementing the following:

Reasonable access fees. Customers pay access fees to use the transmission and distribution systems for electricity delivery. Access fees will include any allowable strandable costs and the wires charge. If access fees are too high, they will swamp any potential generation savings. This will discourage entry of new competitors and slow the development of competitive markets.

Minimal certification requirements. Excessive certification requirements will reduce supplier interest. In New Hampshire's pilot choice program, the minimal certification requirements faced by the 30 competing suppliers included registration, identification of a local agent and affiliation with a NEPOOL member. Reasonable requirements might

include a minimal showing of financial feasibility and the disclosure of other basic customer information, such as fuel mix.

Access to customers versus protection of privacy. Regulated utilities by virtue of their legal monopoly status know a great deal about their customers, much of which customers fully expect to be kept private. Not only are names, address, credit histories and some medical problems known to the utility, but so are the details of electricity use, which is of value to competing suppliers. What information should be publicly available and what needs to be protected is a sensitive question. All suppliers need to identify and contact the pool of customers. Customer usage information may also prove to be key to creating a market. At a minimum, customer information made available to any generation company affiliated with the distribution company should be available on the same terms to all other competitors.

Sharing of non-choosers. If choice is granted to all customers, some will opt not to choose a supplier. Leaving all non-choosers with their existing company would create a market-share advantage for that company. To be fair to all suppliers, these customers could be assigned to all competitors based on the market share each supplier has captured from choosing customers. This was done by the Federal Communications Commission when opening interstate long distance markets to competition. Customers could then be served under a standard offer and be permitted to switch suppliers at least once without incurring additional costs.

Encourage aggregators. Public policy should welcome aggregators. Like local grocery, hardware or clothing stores, aggregators do not own the means of production. They buy from producers and resell. Retail aggregators can reduce transaction costs for small customers and put together innovative and/or highly customized packages in ways that current suppliers cannot.

There are several possible candidates for the role of aggregator. Municipalities in several states have already voiced their interest in becoming the retail seller for their communities. Other not-for-profit organizations, such as buying coops or for-profit businesses, could be aggregators as well.

Customer should not be required to buy from only a single aggregator, such as a municipality. Substituting one monopoly for another thwarts the very innovation and variety that competitive electric markets, driven by customer choice, promise.

Real-Time Meters

There have been proposals to prohibit customers from choosing to buy from competitive suppliers unless they invest in real-time meters. Real-time meters record the time that usage occurs as well as the amount of electricity used per month. They are significantly more expensive than the meters now used by most small customers.

Real-time meters should not be a prerequisite for customer choice. If sophisticated metering is not justified for a customer currently served by a regulated utility, it will not be justified simply because the customer has chosen a competing supplier.

The continued use of traditional meters, however, does raise some issues which must be resolved. Some of the most important of these revolve around the question of how to be sure suppliers and customers pay the time-sensitive costs for the energy they use. Norway has developed a system relying on average load profiles that both allows for the continued use of traditional meters and fairly allocates costs to consumers.

Unbundling

Typically, regulated rates for most customers, particularly smaller customers, combine all costs into a single kWh charge. Customer choice will work only if rates are unbundled so that customers can compare the costs of competitive services.

Generation will be a competitive service and needs to be priced separately. Knowing what different generation options cost will assist customers in making energy decisions by allowing them to shop knowledgeably.

Generation, however, may not be the only area where customers have choices. Unbundling could also occur in ancillary services (the miscellaneous services such as spinning reserve and voltage support which are needed for the reliable operation of the system). Even some distribution services such as metering could become competitive. Whenever individual services are provided competitively, the costs of those services need to be reported separately.

Rates and charges for regulated monopoly services may also need to be disaggregated. For example, transmission services are often provided under rate structures which bear little relationship to costs. In fact, transmission costs often vary dramatically according to the direction of the power flow and the particular hours in which the service is needed. If a transmission line is already heavily loaded by power flowing from north to south, new transactions which increase the north to south flow will be quite expensive to transmit. On the other hand, a new flow from south to north would impose no costs and could actually reduce overall costs. Transmission charges which reflect these factors are important if customers are to make economically rational decisions.

In deciding what costs to unbundle, the trick is to find a balance that keeps customers well informed but does not drown them in details.

Customer Protection Issues

Consumer education. Most retail customers, especially residential and commercial customers, are probably not aware that electric industry restructuring is underway and that they may soon have both the opportunity and responsibility to select their own electricity service provider. The potential for public confusion, annoyance and even fraud cannot be overlooked. Because of this, a public education effort should be dedicated to preparing all members of the purchasing public for retail customer choice. This effort, which should begin at least six to twelve months prior to the introduction of choice, needs to explain what services will be competitive, how to choose or change suppliers and where customers can direct questions and complaints.

Competing retailers will market to customers using a variety of product and service information. Retailers, however, may not be the best source to inform customers about the *transition* to choice and describe how the new markets will work. A government agency could either conduct this fundamental consumer education or direct the monopoly distribution to deliver it.

Disclosure of key information. Competitive markets depend on informed consumers. For customer choice to have any chance of delivering the expected benefits, customers will require reliable, comparable information on the price, the risk of price changes and the environmental characteristics of the power being sold. (This was the subject of RAP's October 1996 *Issuesletter*.)

Standard offer. A concern of all customers, but particularly small customers, is that competition could result in dramatic price increases. The likelihood of this occurring is enhanced if market power issues are not resolved. One way to address this issue, at least initially, is to require all suppliers to extend a long-term, standard offer with stable rates to protect small customers from price increases and price volatility.

The insurance industry serves as a model. While insurers compete among each other, all are required to offer one or more standard policy. The price of the standard policies vary from insurer to insurer in the same way the price of a standard offer of electricity will vary from supplier to supplier.

Protections for customers. Most commissions have rules in place that govern disconnections, outline standards for billing and collection practices, set acceptable service quality standards, protect privacy and perhaps provide subsidized rates for customers with limited ability to pay. In a competitive world, these protections will need to apply uniformly to all retail sellers. For example, all suppliers might be required to serve a share of high-risk customers.

Some new issues, familiar to those involved in telecommunications regulation, also arise. For example, if the distribution monopoly also serves as a billing agent for competitive generation firms, do partial payments by customers get credited to the distribution bill or the generation bill first? Most would agree customers should not be denied distribution service for failing to pay a generation bill.

Conclusion

A number of preparatory steps are needed for customer choice to produce a variety of competitively-priced energy alternatives for all customers. Market power issues must be resolved, and a fair and feasible system must be put into place that makes sure choice is extended to all customers. Unnecessary roadblocks need to be ferreted out, and a basic set of customer protections must be retained and applied to all suppliers.

Why Standardized Information?

The usefulness of information depends on customer knowledge. Telling consumers an appliance uses 100 kilowatt hours per year is only useful if the consumer already knows

what a kilowatt hour is, and how much it costs. On the other hand, telling consumers that an appliance uses \$50 per year @ 7¢ per kWh and that similar appliances use between \$40 to \$60 per year provides consumers useful information for comparison shopping. Likewise, comparisons of food prices were impossible until grocers started displaying each product's unit price as x cents per ounce.

The need for standardized customer information will be especially important for electricity markets. Shopping for electricity will be a new experience for residential and commercial customers. This inexperience, together with the fact the product is totally intangible, means the prospect for misleading claims and customer confusion is very high.

While most state regulatory commissions have yet to decide whether the industry should structure itself around retail competition, utility companies fully expect it. A primary goal of utility managers has been to minimize shareholder risk. In their efforts to do this, utilities have abandoned long-term planning and avoided making long-term capital investments. This has meant reduced investments in energy efficiency and renewable energy. At the same time, the absence of actual retail customer choice prevents customers from having any outlet to exercise their own preferences for cleaner energy.

Until actual customer choice is in place, the only winners are high-cost utilities who continue to collect full stranded cost. Low-cost utilities are held back from competing for customers, and the market price for generation remains at regulated, rather than competitive, levels. The best course of action for customers, regulators and the broader public interest will be to complete the transition to full customer choice as quickly as possible and in a way that is efficient, equitable and environmentally sound.

The Regulatory Assistance Project

177 Water Street
Gardiner, Maine 04345-2149
Tel (207) 582-1135
Fax (207) 582-1176

50 State Street
Montpelier, Vermont 05602
Tel (802) 223-8199
Fax (802) 223-8172

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