



# IssuesLetter

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## **Setting Rates for Default Service: The Basics**

*January 1999*

**One of the most important issues** which any state moving to retail electric competition must face is setting the rates, terms, and conditions for default service -- the electric generation service which will be provided to customers who, for one reason or another are not signed up with a competitive generation provider. Early experience in California and Massachusetts shows that a significant majority of residential and small commercial consumers are likely to be default service customers. Early experience in Pennsylvania shows that the price of default generation service plays a crucial role in dictating whether competitive retail suppliers can enter and participate in the market.

Overlooking the careful design of default service is a serious mistake which can undermine the development of a competitive retail market. For example, suppose all customers who do not choose a supplier remain with the incumbent utility and pay for generation services at wholesale commodity prices. This is tantamount to awarding a large share of the retail market to the only seller customers have ever dealt with, at a price other retail competitors can't match. It is not likely to lead to vigorous competition in the small use commercial and residential markets.

There are three principal components crucial to any default rate policy -- setting the right price while minimizing overall costs, deciding who should provide default service, and the relationship of default service to developing clean energy resources. This Issuesletter will discuss each in turn.

### **What is Default Service?**

The concept of default service does not exist in ordinary competitive markets. Every consumer buying any other product chooses a retail supplier. There is no default provider of, for example, gasoline. Every consumer that buys gasoline chooses a *retail* supplier. Customers do not have the option of doing nothing, thereby having their cars filled by a default provider at a wholesale price.

Of course, electricity is not gasoline. For a several reasons - including the essential nature of electricity, the unique transition to competitive markets, the risk that some consumers will not have choices, and the political risk or "forcing" large numbers of consumers to choose a supplier - all default customers must have an uninterrupted supply of electricity at reasonable costs. Default service, sometimes called standard service or service of last resort, is designed to meet these market and political realities.

### **Rate Reductions and Default Service Rates**

A number of states have coupled the move to retail competition with an overall reduction in the rates charged for electric service. A properly crafted rate reduction can be entirely consistent with a well-designed default service policy if the price of default generation service is set at the retail market price. The rate reduction should be reflected in one (or more) of the rates for the non-competitive monopoly services. The critical element is that the price of retail generation service not be artificially depressed.

By its nature the price of default service is not set directly by the market; regulators will set the price for default service. When reviewing pricing options, the purpose served by default service, the effect that the price of default service will have on consumer behavior and on the development of a competitive retail electricity market need to be considered.

### **Pricing Default Service: California**

In California, customers who buy generation from a competitive provider receive credit on their bills based on the spot market price for electricity generation established at the Power Exchange (PX). The PX price is, in effect, the market price for short-term (hourly) wholesale power in California. Thus, customers who take default service pay the PX price for their generation. To date, few firms have been able to compete effectively, due at least in part to the fact that default service does not include the retailing, metering or billing costs that competitive providers would incur to serve customers. The few small California customers who have chosen new suppliers (competition began in April 1998) have largely done so for reasons other than price. For instance, a number are choosing electricity from "green" sources that are being sold at higher rates.

The California PUC is currently considering increasing the "PX credit" to include retailing costs such as marketing and customer service costs. The effect of such a change would be to raise the price of default service by a like amount.

The gasoline analogy teaches us that if regulators did not create a default service for electricity, the generation market would yield both a competitive *wholesale* price and a competitive *retail* price. If retailers incur more costs than wholesalers - which is typical in most consumer markets- the competitive retail price for electricity would be above wholesale price.

### **How Do Retail Generation Prices Differ from Wholesale Prices?**

There are real costs for non-utility sellers participating in the retail electricity market and they can be high. These retailing costs include marketing, customer service and communication, and required interaction with the distribution company. At least one major supplier has exited the residential market in California claiming that it cannot cover its retail costs when competing against a default wholesale price. Marketing costs need to be taken into consideration when determining the price for default service. This means that *retail*, not wholesale prices should be used to set the default price.

While there are many important implementation details and choices involved in setting the price for default generation service, regulators are faced with two main pricing policy

options: to price default service at the competitive wholesale price, as was done in Massachusetts and California, or the competitive retail price, as was done in Pennsylvania and is now being considered in California. The choice will greatly influence the extent and pace at which a retail market develops.

If default service is priced at the wholesale level, retail competition will probably be limited to niche markets. The default service provider will have a substantial, perhaps insurmountable, advantage in the market. The advantage will not stem from superior economic performance but from the administrative decision that gave one firm the competitive advantage of being named the default service provider. If by doing nothing, customers can receive default generation service at wholesale prices they are very unlikely to pay a higher, retail rate to another supplier.

If regulators set default prices at the retail level, competition will be more vigorous. But regulators will have to be very careful to assure that default providers are not overcompensated and that consumer interests are safeguarded.

Choosing to price default service above the competitive wholesale price does not necessarily translate into an increase in the total price paid by default customers nor should it result in a windfall to the default service provider. Because the default provider will not incur the same retail marketing costs that other retail suppliers incur, the premium charged to make the default price look like a fair retail market price can (and should) be flowed directly back to consumers. The relationship between default service pricing and recovery of allowed stranded costs and other fixed charges is such that higher default prices for generation services could be applied to offset stranded cost or other charges recovered by the distribution company. This approach would require periodic recalculation of distribution and stranded costs charges as customers migrate from the default provider to other suppliers. A simpler approach would be to directly credit the default retail premium back to customers in a separate line item on bills.

### **Who Should Provide Default Service?**

Default service can be provided in many ways. Three options are: 1) by the incumbent monopoly utility as a regulated offering, 2) as a form of access to the hourly wholesale market (e.g. in California, the standard service is based on the price charged by the power exchange or PX), and 3) via an auction where one or more firms are chosen to provide the service.

If the incumbent utility automatically becomes the default service provider, a number of potential problems arise. First, this approach guarantees that the incumbent will have a large, probably insurmountable, advantage. The incumbent begins with virtually a 100 percent market share. If the default service price is too low, it will be difficult for competitive providers to develop a significant market presence in the face of such market dominance. Second, the approach implies that the incumbent utility remains a vertically integrated firm which provides both monopoly (distribution) and competitive services (retail marketing and probably generation) to the same customers. (Previous Issuesletters by RAP describe the serious problems of having a vertically integrated firm provide both

competitive and monopoly services. See, [www.raonline.org](http://www.raonline.org)) Finally, the distribution company, because of its monopoly relationship with customers, will have marketing opportunities that are simply unavailable to other competitors.

Market-based solutions for the delivery of default service are preferable. These approaches rely on bidding mechanisms to pick one or more firms to supply default service at the lowest cost. One interesting bidding approach is the creation of Retail Marketing Areas (first proposed by Dr. Kenneth Rose of NRRI and now pending in Ohio restructuring legislation) where the winning bidder(s) would provide generation services to default service customers for a period of years. Subsequent auctions could choose the provider(s) for the next period. If the incumbent utility were not in the generation or retailing business, then the utility would, in most cases be able to administer the auction and choose the winning bidders, and the commission would play an oversight role. Alternatively, if the incumbent was one of the bidders, or would be competing directly with the firms who were bidding, commissions would need to take a much more direct role in bidding process. Commissions could either engage an independent firm to administer the bidding process or administer the bidding themselves.

Massachusetts, Nevada and Maine restructuring legislation require competitive processes to select generation service providers for non-choosers.

This market-based approach makes sense for three reasons. It relies on market forces, not administrative proceedings to find the best provider(s) of default service, provides competitive suppliers an additional opportunity to enter the market and helps insure that default service will be provided at the lowest, overall cost.

### **Structuring a Market Based Approach**

Where default service is bid out, care needs to be taken in structuring the auction to make sure retail costs are captured. Asking bidders to indicate the price they would charge default customers and to pick the lowest price bid is the wrong approach. Because the default provider would bear no retailing costs a simple auction in which default service went to the low price bidder would yield a price near the wholesale price of power. A better approach is to ask prospective bidders to indicate the payment they would be willing to make to be granted the right to provide default service to customers at a set price which includes retailing costs. For example, the minimum bid might be the short-term wholesale energy price plus a one cent allowance for retailing costs or alternatively, the average retail price charged by competitive suppliers. The firm willing to make the largest payment for this right to sell to customers at this administratively determined price would be chosen as the default service supplier. These two approaches would be equally effective in finding the lowest cost provider of default service and in minimizing the overall cost to electric customers of obtaining default service. But the second approach is also consistent with the goal of not artificially discouraging the development of a competitive retail market.

If the second approach is taken, then the payment from the winning bidder(s) could be

used to reduce the wires charges or the CTC which the monopoly distribution company would otherwise charge customers, or it could simply be credited back to customers on their monthly bills. So long as the default premium is given entirely over to electricity customers, they will be largely indifferent to the fact that the default provider is charging above wholesale market prices for generation service.

## **What Should Default Service Include?**

Default service ought to take customer preferences into account. In the monopoly utility environment, Integrated Resource Planning or some similar planning process provided consumers with an opportunity to influence resource selection. In a competitive market environment, some customers will choose their resource mix directly. But the fact that most small-use consumers will not choose to shop among suppliers need not preclude the opportunity for these customers to express preferences as to what resources should be included in the default service.

Customers have repeatedly said in one state poll after another that they want cleaner, greener resources to be used for generating their electricity. It makes sense that the default service reflect these preferences. Otherwise, the default rate becomes a race to the bottom - the dirtiest resources at the lowest prices. If green resources are included in the default service, customers who want a resource mix that is "greener" than the default will shop for it, as will customers who want lower cost and are willing to accept less "green" to get it.

### **Pricing Default Service: Pennsylvania**

In Pennsylvania, default service is provided by the incumbent utility, although at least 20 percent will be subject to bid by 2001 . To encourage customers to shop around, the Pennsylvania PUC deliberately set the default service rate (which they call the "shopping credit") above anticipated market prices. The result is that customers who choose a competitive supplier pay a lower rate. It is not clear how well this approach will work in practice. There is evidence that actual retail market prices will be higher than expected which could thwart the PUC's attempt to encourage customers to switch.

The level of the shopping credit for some Pennsylvania utilities (credits vary by utility) is generally consistent with the approach taken in this Issuesletter, but the treatment of the surplus profit from a higher default service rate is not credited back to customers. According to Commission statements, the combination of the tariffed rate and the shopping credit were set in an attempt to provide the utility with its full revenue requirement based on the assumption that all customers would opt to take service from a competitive supplier. If this is true, and if some customers do not switch suppliers (a virtual certainty), the utility will be over earning and customers will be paying more than they should for electricity.

Pennsylvania has designed renewable resource requirements into the default service. Maine requires all providers to be 30% invested in renewable resources, reflecting the large supply of renewable facilities already developed in that state. Massachusetts, Rhode Island and California support the development of renewable resources through public goods charges that are paid by all customers, including default customers.

## **The Long Term Role of Default Service**

The long term nature of default service is hard to predict. Vigorous retail competition, if it develops, could push retailing costs down to the point where retail prices become nearly identical to wholesale prices.

On the other hand, the policy measures discussed in this Issuesletter do not guarantee success. For example, a single small state, acting on its own, may not have a large enough market to attract several competitive providers. More troubling still is the possibility that retailing costs could turn out to be so high that retail marketing should remain a natural monopoly indefinitely, at least for smaller customers. If either example holds, then default service is likely to become even more important. The pricing issues surrounding default service will become less critical since the goal of encouraging a competitive market will become moot. But simultaneously, the need to adopt a strong competitive framework such as periodic bidding for the right to be the default provider becomes even more important. This bidding framework will become the only mechanism whereby small customers can tap into the competitive generation market.

Where the range of possible outcomes is this wide, the need to maintain flexibility and periodically revisit the issue is obvious. The policies discussed here allow for evolution as the retail market emerges - or fails to emerge - for smaller customers.

## **Conclusion**

A well-developed, default service policy needs to protect smaller customers and it needs to encourage (or at least not discourage) development of a competitive retail market for these same customers in the longer term. To achieve these goals, default service should not be priced at wholesale prices. In fact, failure to reflect retail costs in the default price will severely stifle development of a retail market.

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