High Voltage Cost Cutting – How Dealers Can Capitalize on Deregulation

Robert Kennedy doesn't pay attention to spot electricity prices and has never heard of NYMEX. But the Texas automotive executive is a whiz when it comes to spotting ways to reduce expenses. That's what has made him a pioneer in electricity deregulation.

Kennedy, chief financial officer of Gillman Auto Group, recently executed a contract we negotiated with a competitive electricity provider. It enables him to pool the load of Gillman's various dealerships and achieve savings of 10 to 15 percent.

Gillman Auto Group's largest dealership has an annual electricity bill of approximately $150,000 and the total group's electricity costs approach a million dollars per year. So savings can be substantial.

"At first, I had mixed feelings about electricity deregulation," said Kennedy. "Electricity had been working just fine forever and it seemed like they were trying to fix something that wasn't broken. My goal was to figure out how to capitalize on the change in order to save money."

Kennedy says his best decision along the way was to link up with an energy broker who could examine his company's needs, draw up a list of requirements and negotiate a contract with a competitive provider. As is standard practice, this personalized service didn't cost Kennedy or his company a penny. The provider funded the services of his energy broker.

"It has all worked great and billing has been extremely simple," said Kennedy.

Promises, Promises

Gillman Auto Group is one of more than a quarter million business and residential customers in Texas that have switched to what the state calls Competitive Retail Electric Providers since the beginning of 2002. The Public Utility Commission of Texas has been unabashedly enthusiastic in its implementation of the electricity restructuring legislation signed into law by then-Governor George W. Bush in 1999.

Of course, a lot has changed since that bill was signed.

For years, many of us have watched the evolution of the various maps found online that illustrate the spread of electricity competition. Through the middle and late 1990s, state after state took aggressive action to ensure their industrial, commercial and residential consumers were not left behind. Month in and month out, the U.S. map filled up with states setting a specific date for restructuring.

However, the introduction of open electricity markets was not without its problems. California, seen as a pioneer by those who didn't know better, drew up a re-regulated system that was guaranteed to collapse, which it did.

Today, if you look at those online maps, you'll see the effects of the "California contagion." The steady march toward competitive retail markets is being threatened by uncertainty about how to structure markets that adequately protect consumers while providing a financial incentive for providers to enter the market and compete.

However, an analysis of the status of electricity choice across the country provides plenty of evidence that this pullback does not signal the end of deregulation.

Seventeen states plus the District of Columbia continue to make positive strides toward encouraging consumer choice.

Lessons Learned

Far from ignoring the California experience, leaders in the states that are restructuring have learned valuable lessons about the best way to structure electricity markets. For instance, the importance of hedging against short-term price swings through long-term contracts was driven home by the failure of CalPX. So was the benefit of simplifying institutional requirements to encourage direct contracts between buyers and sellers.

California's troubles also underscored what already was known about the potential impact of inadequate generation and transmission capacity. More recently, we learned that certain energy suppliers could manipulate short-term prices to the detriment of consumers.

While state after state is quick to point out how their restructuring efforts differ from the Golden State, one California misstep is almost universal. The tendency of states to link a rate cut – or a rate freeze – to the transition to a competitive market is designed to protect consumers by establishing a safety net. This so called "price to beat" establishes a price ceiling to ensure that customers don't end up paying more for electricity as a result of restructuring.

Consumer protections are necessary, but setting an artificially low price to beat may present the biggest threat to competitive markets. By creating a disincentive for competitive providers to enter the market, regulators have created the widespread perception that no company is interested in competing for their business and that competition can't deliver the savings that were promised.

Texas is bucking this trend, however. While Texas regulators have established a price to beat, they review and revise it periodically and set it at a level high enough to encourage competitive providers to participate. This has paid off in a number of ways. First, it attracts the most financially stable competitors by enabling them to operate profitably. Second, it sends a signal to incumbent utilities that the state wants competition to succeed. Finally, it strengthens perceptions among business and residential customers that electricity choice can deliver on its promises by offering a range of options and the opportunity for savings.

Tips for Businesses

Many businesses that have the opportunity to switch electricity providers become paralyzed by how complicated the decision can get. Even something that should be simple, such as coming up with apples to apples comparisons of what competitive providers can deliver, can take on a life of its own.

Frankly, that's why brokers such as CHOICE! Energy exist – to act as an expert partner who can assess the unique needs of a business and shape an agreement with one or more providers who can meet those needs at the lowest possible price.

Most businesses are far more sophisticated today about energy matters than they were three or five years ago. However, it takes a real commitment of time and personnel to track and capitalize on all the subtleties of a deregulated market. Price, while an important consideration, is not the only one. Others include:

- **Creditworthiness of the supplier** – Nobody has a crystal ball, but a little due diligence into a competitive provider's financial condition can save lots of headaches down the road. One thing we've all learned over the course of the past year is how unpredictable the financial stability of energy suppliers can be. Even the most powerful multibillion-dollar companies aren't necessarily financially stable when subjected to Wall Street's intense scrutiny and tightening credit.

One solution is to keep an eye on emerging trends. For instance, the current environment has facilitated the emergence of a new class of energy providers that are well funded and not affiliated with utilities. Many of these new participants are also privately held and, consequently, not subject to Wall Street's microscope.

- **Ability to perform –** Believe it or not, we know of several examples of companies that have switched to a competitive provider and did not receive a bill for eight or nine months. Just as frustrating have been those instances when a company has agreed on a contract but was unable to actually have their account switched.

We recommend asking for references and checking to make sure a provider has a history of switching customers in a timely manner and accurately billing their accounts. Negotiation of a contract is only part of the process. Just as critical as the price and contract terms is the provider's ability to perform.

- **Risk management capabilities –** Larger and more sophisticated end users with a load greater than 1 megawatt often understand the importance of hedging their financial risk, but are often unclear how to do so. The result is that either they take undue and unwarranted risk or they shy away from futures and derivatives investments that could improve their financial position while preventing substantial losses. The assistance of an independent third party, such as a broker or consultant, can be invaluable in such an assessment.

At the least, larger end users should understand – or should engage a partner that understands – the fundamentals of energy financial instruments and how to use hedging tools such as futures, over-the-counter options, forwards, swaps and spreads. A good initial step would be to read “Energy Risk Management: Hedging Strategies and Instruments for the International Energy Markets,” by Peter C. Fusaro. It is an excellent primer.

As Fusaro notes, “Some factors for a company to consider in deciding whether to use risk management tools include profit margins, credit exposure, cash flow requirements, debt service obligations, project economics and planning requirements.” While these strategies can help your company maximize the savings made possible by competition, they are not for the faint of heart and should always have the support of upper management.

Nearly five years after California became the first state to restructure its electricity market, the industry is far from realizing the full potential of customer choice. Despite scandals that have ruined companies and careers, there are numerous bright spots that illustrate the promise of choice.

We’ve learned that competitive electric markets can thrive, even in this time of turmoil for the industry. To do so, they require government support – we’ve seen how even subtle government interference can kill a market. They need integrity – we’ve seen how fraud can undermine public acceptance of choice. They need creativity, as illustrated in Cleveland where an opt-out program has helped an aggregator to sign up 350,000 residential customers. They also need to win the trust of early adopters, such as Robert Kennedy, the Texas automotive executive who is big on finding new ways to cut costs.

And, perhaps most important, competitive retail markets need time to prove themselves.

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Javier Loya is the president and CEO of Houston-based CHOICE! Energy L.P. (www.choiceenergy.com). CHOICE! is an institutional energy brokerage specializing in natural gas and electricity. The company provides clients – including multinational corporations, institutional banks, oil companies, natural gas and electrical power marketers, and utilities – with a single comprehensive source for market liquidity, price discovery and intelligence.