The March Toward Competitive Markets Continues

Jo Wyatt doesn't pay attention to spot electricity prices and has never heard of NYMEX. But the Houston real estate property manager is a whiz when it comes to spotting ways to reduce expenses. That's what has made her a pioneer in electricity deregulation.

Wyatt, vice president of property management for Houston-based Moody Rambin Interests, recently executed a unique contract we negotiated with a competitive electricity provider. It enables her to pool the load of the various suburban office buildings she manages and achieve average savings of 12 percent.

But what makes the agreement unique is Wyatt has retained the ability to move buildings in and out of the pool as she pleases with no questions asked. Currently, 20 of Moody Rambin's 31 properties are in the pool, but Wyatt anticipates adding more in the months ahead.

"Our company is similar to a lot of businesses – we dragged our feet at first," said Wyatt. "We saw that electricity choice might offer opportunities for savings, but we wanted to make sure the savings didn't come at the expense of reliability. It all seemed very complicated to someone like me who was used to paying a monthly electric bill without really studying it closely."

Wyatt says her best decision along the way was to link up with an energy broker who could examine her 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 Wyatt or her company a penny. The provider funded the services of her energy broker.

Promises, Promises

Moody Rambin 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.

But, as we all know, a not so funny thing happened on the way to open electricity markets. California, seen as a pioneer by those who didn't know better, drew up a reregulated 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 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. Far from it.

Restructuring at the End of 2002

According to the Electricity Information Administration, six states have put their restructuring efforts on hold. These include Arkansas, Montana, Nevada, New Mexico, Oklahoma and West Virginia. Of course, a seventh state, California, is the first and only state to have suspended direct retail access after having implemented it. At last report, a total of 26 states have no plans to pursue restructuring their electricity markets.

If the story ended there, I suppose an observer could write an obituary of electricity restructuring as an enormous disappointment that not only failed to live up to the promises of lower costs and greater efficiencies, but also was rife with scandal and nearly crippled the California economy.

But the story doesn't end there. Seventeen other states – including the second, third and fifth most populous states in the nation – as well as the District of Columbia thankfully have not been deterred by the constant drumbeat of sour news coming from the West Coast. Wisely, they are allowing their competitive markets to take shape and, in the process, millions of American businesses and homes are experiencing the freedom to choose and the benefits of open markets.

The "Early 18" as we call them, include Arizona, Connecticut, Delaware, the District of Columbia, Illinois, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Oregon (retail access limited to nonresidential customers), Pennsylvania, Rhode Island, Texas, and Virginia.

While these state-by-state experiments are reporting varying levels of success, there are definite signs that competitive markets are gaining traction.

For instance, in the Commonwealth Edison service area of Illinois, 50 percent of customers with demand greater than one megawatt have made the decision to switch. In Northern Ohio, more than 51 percent of customers in the Cleveland Electric Illuminating Company service area – including 56 percent of all residential customers – have switched. The District of Columbia's Public Service Commission reports that 60 percent

of the nonresidential customer demand has switched from the standard offer made by PEPCO.

Matt Buttler, spokesman for the Ohio Public Utilities Commission, points to two primary factors that have contributed to the surprisingly high switching rate in the Cleveland area. "First, our legislation accommodated governmental aggregation, which enabled the formation of the Northeast Ohio Public Energy Council (NOPEC)," said Buttler. "Additionally, prices in the Cleveland area were pretty high, so there was a greater opportunity for competitive providers to step in and deliver significant savings and still make a decent margin."

NOPEC, made up of more than 100 member communities, has pooled the demand of nearly 350,000 residential customers in the Cleveland area and is one of the most successful examples of aggregation in America. NOPEC officials explain that they've succeeded in part because customers in their jurisdiction were automatically switched unless they opted out.

"Customer inertia – the difficulty of motivating customers to take action to switch providers – is one of the biggest hurdles facing the competitive market," said Joe Dirk, NOPEC's spokesman. "We've been successful in part because we flipped it around and said if you don't want to participate in our pool, please notify us."

Green Mountain Energy Company is supplying NOPEC's electricity at a discount of six percent compared to the incumbent utility's price to beat.

The adoption of electricity choice has been slow and, in some cases, painful. However, these examples indicate that when the circumstances are right, businesses – and even residential consumers – will choose a competitive electric provider over their incumbent utility.

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 how easy it was for certain energy suppliers to 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. And third, 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 – particularly those with trading operations. 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 squeeze on these trading operations has facilitated the emergence of a new class of energy providers that are well funded, not affiliated with utilities, don’t have heavily

leveraged trading operations and – because many are privately held – are 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 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 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 ABCs 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 seven years after California became the first state to restructure its electricity market, the industry is far from realizing the full potential of customer choice. However, 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 Jo Wyatt, the Houston property manager who is big on finding new ways to cut costs.

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

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