Is Energy Competition like Pornography?:
Will We Know Success When We See It?

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www.caem.org
Discovering consumer, business, and environmental advantage in energy markets transformed by technology and competition
Six Years Ago
Restructuring was Problematic
Something Missing
Think Tank on Energy Restructuring

Mission=AID
Analyzer Key Issues
Inform Policymakers
Defend Real Competition

Character
Independent
Market-Oriented
Non-Profit-501(c)(3)
Change Agency, Think Tank
Not a lobbying group, trade association, or consulting firm

Canadian Affiliate
October 2001
Thinking About Success

- Ashley Brown’s proposal
- The difficulty of defining obscenity was memorably summarized by Justice Stewart in a concurring opinion when he said:

I know it when I see it.
Framework for thinking about success

1. What Problem Are We Trying To Solve?
2. What Definitions Have Others Given?
3. Evaluating These Definitions
4. My Proposed Definition Of Success
5. Measuring Success
6. Texas Compared To Georgia
Defining Success Depends on the Problem

What was wrong with the 100 years of success in electricity?

1. Volatile Energy Prices
   - Friedman’s point about oil prices and pencils
2. Average cost pricing—poor price signals
3. Incentives to build rather than conserve—AJ effect
4. Inefficiency of monopolists
5. Blunted innovation incentives
6. Cumbersome process for price changes
7. Creeping Mandates: Social Policy

High prices per se are NOT the problem

In fact, low prices are also a problem
What’s it all about, Alfie? Competitive Network Policy

**Traditional**
- Command-and-Control
- Monopoly Utilities
- Bundled Services
- Cost-Plus Pricing
- Silo-Based Products
- Fragmented
- Parochial
- State Focused
- Regulatory Driven

**Emerging**
- Market Based
- Customer Choice
- Unbundling/Access
- Performance Based
- Convergence
- Consolidated
- Regional/Global
- Federal Focused
- Antitrust Driven

So How Has It Gone To Date?
Why competitive energy markets?

1. Freedom/Choice
   - The central tension of the 20th Century was over central planning versus markets/capitalism; wars have been fought to preserve/enhance freedom
   - Completely apart from other benefits, there is a philosophical principle that freedom and choice should be preferred over coercion and monopoly

2. Rational Economic Decisions
   - The price of pencils is affected by world oil prices
   - Command and Control prices are irrational in volatile markets
   - “Right Prices” not lower prices
   - Average prices may be lower but some consumers, for some purposes, at certain times may pay more

3. Innovation in products and services
   - Consumers: are increasingly affluent, computer savvy, lead more complex lives, have more options, are very busy
   - We want flowing content services for our homes and businesses consistent with our lifestyle choices
Why competitive energy markets?

4. Technology Deployment
   - Regulation retards effective technological deployment; markets enhance it

5. Environment
   - Green products
   - Efficient use of resources
   - Conservation and efficiency
   - More flexible in response to new environmental rules

6. Homeland Security
   - Smaller, more flexible generation
   - Better responsiveness

7. Global Competitiveness
Possible Definitions of Success

1. Lower Prices
2. Economic Efficiency
3. Choice: an option other than the monopoly utility
4. Customers Served by Competitive Suppliers
5. Policy Attributes: RED Index
6. Market Structure, Attributes, and Functions
7. Competitive Wholesale markets
8. Compare Energy Networks to Other Networks
9. Market Determined Prices
10. DOJ Competitive Markets Test
11. Meeting Customer Demands
12. National Standardization—No state is an island
13. Integrated Flowing Content
1. Lower Prices

- Principle argument of advocates of competition
- Several Dimensions
  - Prices lower than they were when reform initiated
  - Prices lower than they otherwise would have been
  - Prices lower than comparable jurisdiction
  - Prices lower for all customers in all periods
- Poor definition
- CAEM Paper for Georgia Commission
2. Economic Efficiency

- Maximizing Consumer Welfare
- Allocative Efficiency
- Productive Efficiency
- Ultimately the correct test
- Rejected because it is too theoretical and not sufficiently simple to observe and measure
3. Customer Option

- Seems to be most states’ definition of success
- Success is making sure that customers have the option of buying from a supplier other than the traditional utility
- Variant: Success is based on the % of customers served by a competitive supplier
- Dominant model
4. Customer choosing a competitive supplier

- One often used measure of success is the percentage of customers who have actually switched from the utility to a competitive supplier.
- Texas/UK monopoly switching
  - How does this count?
- Some object because a decision to remain with utility is a “choice”
- This definition is in the ballpark but is too narrow a definition
5. Policy Attributes

What are the necessary set of policies that government must implement to achieve effective reform?

- RED Index
- Helpful tool but not the right definition of success
- 95 on RED Index but last attribute is a killer
6. Market Structure

- Does it look like a duck and quack like a duck?
- What are the functional characteristics of competitive markets?
  - All customers buying from non-affiliated suppliers
  - Number of Marketers
  - Marketer Mobility
  - Concentration of Marketers
  - Product Differentiation
  - Service Differentiation
  - Customer Satisfaction
  - Efficient Investment in necessary infrastructure
  - Retail Prices aligning with wholesale prices
  - Other attributes
7. Wholesale Markets

- Success is robust competitive wholesale markets not necessarily competitive retail markets
- This is close to the natural gas model
  - Competitive wholesale markets
  - Little residential and commercial retail competition
  - Significant large commercial and industrial competition
- Good start but is too narrow a definition
  - Ignores potential benefits of retail competition to mass market
  - Some, however, debate whether there are benefits to mass market from retail competition
8. Compare to Other Networks

- One way to look at success of electric restructuring is to look at other “network” restructurings and to compare
- Plexus Industries: Industries that are carry out conduit or logistical functions necessary to giving a commodity value
- Natural Gas is best analogy
- Telecom is next best
- Surprisingly large number of such industries
  - Rivers, highways, airports, cable, movie theaters, Window operating system, airwaves
- There is a common set of principles for Plexus Industries
- How closely does electric adhere to such principles
- This is a helpful way to evaluate policy in electric industry but is not in the final analysis the right test of success
9. Market Determined Prices

- Customers should see prices that to some degree respond to market forces.
- New Jersey Bidding
- This is largely a variation of wholesale competition and ignores potential benefits of full retail competition for mass market.
10. Competitive Markets

- DOJ Antitrust Guidelines
  - HHI of 1000 is competitive
  - HHI of 1000 to 1800 moderately concentrated
  - HHI over 1800 is a problem market
  - Price Increase of 5% in relevant market

- DOJ Oil Pipeline Report
  - Traditional Guidelines apply to markets becoming less competitive not more competitive
  - Direction of concentration is important
  - When you are starting from a very concentrated market of 10,000 and going to a 4000, that is a move in the right direction
  - Trying to “improve” a 4000 market by regulation may be counterproductive

- Helpful tool but not very useful in evaluating success of electric markets
11. Meet Customer Demands

- Customers haven’t clamored for choice so why impose it on them
  - Customers don’t want choice
- Be Careful
- Many innovations created consumer demand instead of responded to it
- Rogers, Diffusion of Innovation
- S Curve of Diffusion
- With change there is often little acceptance until a point of inflection when change and acceptance is rapid
- Not a good definition of success
12. National Standardization

- Success is only possible with national standardization of a model of competition
- Some go so far as to advocate preemption of state regulation of electric utilities
- Gas Industry Standards Board shows that standardization is a necessary condition for network industries
- If we are defining the end state of success rather than evaluating a single instance of success, than standardization has to be part of the mix
13. Integrated Flowing Content

- Some argue that it is wrong to focus exclusively on electric as the definition of success for a flowing content commodity.
- Analogy of buying a car; consumers do not want to buy a body, a muffler, brakes and a motor from different suppliers and to put together the car.
- Restructuring of network industries where the commodity flows directly into or out of the home or business should be the goal.
- Mass market customers want to purchase a set of services that are necessary for their comfort, convenience, and effective use of the home or business.
- Success, then, is defined by the degree to which a single middle man can combine packages that meet all the flowing content needs of the home owner or business person.
My Definition of Success

- Retail choice exercised for all customers
  - Default Options Create Distortions
  - Default Options Create Disincentives for Marketers
- No marketers affiliated with network provider
- Market Structure Attributes for commodity
  mirror structure of competitive markets
- National (international) standards for energy
  networks including distribution companies
- Flowing Content Integration that revolutionizes
  the product and service model
Measuring Progress: RED Index

Indices—Simplify Complex Situations
- Thermometer of 104
- Economic Indicators: DOW over 11,000; Price to Earnings Ration of 25; CPI at 3.5%; Federal Reserve Price Cuts of .5%
- Hurricane Mitch was a Category 5 on Saffir-Simpson Hurricane Intensity Scale.

RED=Retail Energy Deregulation
- 22 Key Issues that Determine the Quality of Access
- Scale from 0 to 100—Negative Numbers Possible
- Survey of State Commissions

Comprehensive New Methodology
- Not a measure of success of retail
- Measures policies that are necessary conditions for success
- Coverage extended to Canada, Australia, New Zealand, and Great Britain
- Update of Electric and first time gas index in 2005
- RED Index Advisory Committee
Texas Takes over First in US
Even before debacle, California barely in top 20

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Red Index Averages by NARUC Region

- MACRUC: 45.8
- WSPSC: 9.3
- MACRUC: 12.7
- NECPUC: 35.8
- SEARUC: 3.4
- WSPSC: 9.3

RED Index Average Score by NARUC Region
US National Red Index Score

US Index

Measuring Success: Studies

- PJM Study: $3.2 billion in benefits in 2002
- Natural Gas Study: $600 billion in benefits
- Default Study: Large customers need to be vanguard and policy should incentivize switching
- Reserve Margin Study: Pending
- DISCO of the Future: Scenario Analysis
- All these studies can be found on CAEM.ORG
My Candidate for Success

Georgia Gas Model
- Date certain for customers to choose
- Passive Customers assigned to marketers based on success
- Rush of marketers: over 20
- Got consumers attention: 80% switched
- Black eye because of marketer billing and AGL rate increase
Evaluation of Georgia

- 5 years experience with 100%
- Multiple marketers
- Some concentration—top 4 have 80% market
- Top Marketer is an affiliate of AGL
- Changing Marketer Profile
- Product Differentiation: Georgia Website
- First two years of implementation were horrendous
- Billing and Bankruptcy
- Last three years much better operationally
- Complaints down
- Retail prices reflect wholesale gas prices
- First Wave of price increases—blamed on deregulation
- Price Cap Rule
- Second Wave of Price Increases
- Consumers now understand that GA prices will be affected by wholesale prices
Evaluation of Texas Electric

- **Best Electric Model**
  - Standardized for all discos
  - Separated commodity function from network functions
  - Unified regulatory scheme (PUC jurisdiction over ERCOT)

- **Problems**
  - Monopoly Assignment
  - Not all customers have meaningful access
  - Mass Market still very concentrated
  - Little opportunity for flowing content integration
Shameless Plug Slide

- Take a Leadership Position
  - Board Member
  - IDEAS Foundation
  - Strategy Committee
  - Convention and Awards Committee

- Join a Project
  - Default Phase II: Mass Market
  - RED Index Advisory Committee

- Outreach
  - Speeches
  - Media Contact

- Financial Support

- Contact:
  - CAEM.ORG
  - Ken Malloy, kmalloy@caem.org or 703-250-1580
Marx: Politics is the art of looking for trouble, finding it everywhere, diagnosing it incorrectly, and applying the wrong remedies.
Pioneers get all the arrows, but we get the best campsites.
A successful person is one who can lay a firm foundation with the bricks that others throw at him or her.

David Brinkley
First they ignore you.  
Then they laugh at you.  
Then they fight you.  
Then you win.  
Gandhi