COMPETITIVE RETAIL ELECTRICITY: THE OTHER e-COMMERCE

Harvard Electricity Policy Group
22nd Plenary Session
John F. Kennedy School of Government
Cambridge, Massachusetts
May 22-23, 2000
Philip R. O’Connor, Ph.D.
NewEnergy Midwest LLC
Chicago, IL  poconnor@newenergy.com
COMPETITIVE RETAIL ELECTRICITY: THE OTHER E-COMMERCE

Harvard Electricity Policy Group
25th Plenary Session
John F. Kennedy School of Government
Cambridge, Massachusetts
May 25-27, 2000
Philip R. O'Connor, Ph.D.
NewEnergy Midwest LLC
Chicago, IL postmaster@newenergy.com
NewEnergy is:

- An AES Company (largest global IPP);
- The largest multi-state competitive retail electricity provider (2000 MW of demand);
- Operating in all current open access states;
- Positioned as the key player after the local utility and its affiliate;
- A leader in the policy & rules debates;
- Committed to a socially responsible electric industry that is centered on the customer.

**WHAT WENT WRONG WITH THE MONOPOLY MODEL?**

- Implementing national nuclear policy drove sunk costs past sustainable levels.
- New technologies arose from change in other industries (gas, airlines, telecom, rail).
- The old top-down model proved unnatural in a bottom-up, digital world.
- The political consensus underlying classic regulation gradually unraveled.
- Only competition can provide new capacity.
NETWORK INDUSTRY ERAS: REGULATION & DE-REGULATION

- In the regulatory era the focus is on wide deployment of the network and scaling up of the basic technology.
- In the de-regulatory era the focus is on innovative use of the network to link buyers and sellers and to encourage add-on technologies and services.
- The goal in both eras is efficiency.

WHY ARE WE MAKING THIS TRIP?

- Diverse models are replacing a single "legitimate model" -- vertical monopoly.
- Monopoly is being reduced to essentials.
- Customer choice and price elasticity will play central roles in the planning equation.
- Regulation is being replaced by markets.
- Actual risk/reward profiles of various industry segments are being sorted out.
- Innovation is being re-invigorated.
ROLES OF THE RETAIL MARKETER

- Multiple retailing models play varied roles:
  - taking price risk that utilities are no longer willing to take on and that many customers are not ready to take on;
  - guiding customers in exercising choice;
  - identifying inefficiencies in wholesale markets, legacy systems and traditional rate design;
  - keeping utilities and regulators focused.
- Marketers are the key motivators and innovators in the early stages of access.

BARRIERS TO COMPETITIVE MARKETER ENTRY

- A focus solely on near-term marginal savings obscures the value of innovation.
- Standard offer (basic electric service) options tend toward under-pricing and continued cross-class subsidies.
- 100% stranded cost recovery limits shopping credits and deters customers from seeking innovative options and deters marketers from committing resources.
STANDARD OFFERS:
THE LAST TEMPTATION

- Standard offer service
  - tempts us to hang on to the past;
  - as a “safety net” stunts the growth of the market by creating a governmental threat to investments by new entrants in the market;
  - enforces a “split personality” in the utility;
  - tends to keep regulators as price setters and tempts new distorted prices and cross-subsidies;
  - creates the possibility of new stranded costs.

THE NATURE OF SHOPPING CREDITS & COMPETITION

- Shopping credits can:
  - be the lubricant to ease the transition to access;
  - represent a fair discount to 100% stranded cost recovery given the certainty being provided to utilities compared to rickety old regulation;
  - create competition among marketers to deliver the greatest share of the credit to customers;
  - lure marketers into service innovation;
  - is consistent with the way we opened up gas & telecom to competition.
JOSKOW IS RIGHT TO FOCUS ON INNOVATION

- If the goal is to do the same old thing more cheaply, we could stay with monopoly.
- Innovative use of the network is the key feature of the de-regulatory era.
- Focusing on innovation makes the case for competition in as many areas as possible, such as metering, billing, & handling.
- Innovation is rooted in more sophisticated collection & use of information.

JOSKOW'S MARKETER THESIS: ASSUME A CAN OPENER

- A transition based on zero shopping credits and a "basic service" option is flawed:
  - assumes well functioning wholesale markets;
  - assumes that 100% stranded cost recovery, an unprecedented level for any network industry;
  - assumes that marketers will innovate services while shut out of producing near-term savings;
  - assumes too little opportunity for savings beyond stated retail-related costs;
  - assumes rapid deployment of smart metering.
NewEnergy Customer Profile
Average Cost Savings by Rate Class

NewEnergy Savings Profile
Customer Demand Class 100kW-400kW
DEFAULT SERVICE: HANGING ON BY THE FINGERNAILS

- Default service may have its place but care must be taken not to lock utilities either into a preferred or a disadvantageous position.
- Marketers can bid for volunteer customers.
- Utilities can “auction” customers.
- Customers can choose between competing arms of the utility during “open enrollment”
- The important task is to reduce transaction costs for home & commercial switching.

REDUCING TRANSACTION COSTS FOR SMALL USERS

- Re-evaluate current consumer rules to:
  - eliminate the idea that competitive electricity will be a replication of the monopoly model;
  - maximize opportunities for Internet marketing, switching, billing and meter reading;
  - encourage pre-paid power to reduce bad debt;
  - place as much as possible of the electric revenue stream into the competitive market.
- It’s no longer all about the utility.
CUSTOMER LETHARGY: WHAT'S THE HURDLE RATE?
- Savings must be sufficient for customers to leave a system they know but dislike.
- NewEnergy's Illinois experience shows an inverse relationship between customer size and the savings % needed for switching.
- Starting point for savings is the shopping credit as a discount to stranded costs.
- Once having made the switch for savings customers are prepared for innovations.

LET'S NOT CONFUSE THE TRANSITION WITH THE FUTURE
- The debate should not be over how the electric business will look years from now.
- The focus should be on reasonable methods to open the network for innovative models.
- Problems attributed to "de-reg" are more likely the result of the slow pace of de-reg.
- The slow pace limits the flow of price signals between wholesale & retail levels.
- Marketers are the can openers of the future.