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Retail Rollercoaster

FAST AND SLOW BUT FORWARD

Richard Schlesinger | July 14, 2011

THE COMPETITIVE RETAIL ENERGY MARKET is either speeding toward record growth or rolling down a winding road, headed toward a stop sign. How you see it depends in part on whom you talk to. "Retail electric services is an emerging high-growth industry," says Craig Goodman, president of the National Energy Marketers Association. "The short version is, there are no new deregulatory efforts going on at the present time," says H. Sterling Burnett, Senior Fellow at the National Center for Policy Analysis.

Actually, they're both right. Where deregulation has worked, it's worked spectacularly well, with customers exercising choice - migrating - in very large numbers. Where it's been botched - think California in 2001 - it's been such a disaster as to discourage other states from even addressing the issue. But in the last couple of years, more states have embraced deregulation, albeit cautiously, and where the rules have been clear and where restructuring has met certain criteria, it's been markedly successful. The consensus now is that the move to deregulate the retail market will ultimately prevail over the forces that would keep things as they always were; the only question is about timing.

A recent study by KEMA, the Dutch-based international energy consulting firm, reported that total retail energy volume sales increased 19 percent in 2010 over sales in 2009. The firm expects retail sales to post a 30 percent increase in 2011. Volume increases are driven by a number of factors, but increased marketing by retailers, more robust competition and policy changes are key. While the numbers are impressive, those increases are from a small base. Competition among energy suppliers is available in only 20 states, according to a survey by the Retail Energy Supply Association. While 88 percent of Americans say having a choice of retail energy suppliers is a good thing, fewer than 50 percent are aware such a choice is available, even in those states where it is.

Deregulation got off to a slow start and was essentially derailed by the California experience. Between April and December of 2000, the wholesale price of electricity in California exploded by 800 percent. That was the result of a perfect storm, including a drought, a heat wave, a sudden

increase in demand, historic delays in approving new plants and, perhaps most seriously, market manipulation that was made possible by the market design produced by partial deregulation, with Enron one of the chief villains. California mandated divestiture of installed capacity by incumbent utilities, which remained responsible for distribution, and mandated that utilities buy back power from independent producers on a newly created day-ahead basis that precluded entering into longer-term contracts to hedge price volatility. Most disastrously, California deregulated wholesale prices but capped retail prices. With the utilities essentially captive customers, the new independent marketers had no incentive to compete on price. In fact, they withheld supply and actually shut down plants to constrain supply.

Another significant problem, according to H. Sterling Burnett, senior fellow at the National Center for Policy Analysis, was that proponents of deregulation oversold its promise to lower retail prices and basically ignored other benefits, such as offering customers a choice of green energy and various billing options. As in California, many states only partially deregulated the power industry; where caps on retail prices remained in effect, the results were particularly disappointing.

Deregulation on the retail level depends on deregulation of the wholesale market. In the Western mountain region, Florida and the Southeast there is no competitive wholesale market, and until those wholesale markets become competitive, retail competition is difficult if not impossible. That pretty much limits deregulation to areas covered by ISO New England, the Midwest Independent Transmission System Operator, the PJM Interconnection in the East, and ISOs in California and Texas.

If the elimination of rate caps and a liquid deregulated wholesale market are essential for successful retail deregulation, perhaps the greatest impetus for success is having a purchase of receivables program (POR) in place. Without such an agreement, an alternative supplier has only two choices: run credit checks on every customer who wishes to migrate and reject those who fall below a certain credit threshold, a costly procedure that could eliminate a large pool of prospective customers, or accept anyone who chooses to switch and risk acquiring customers who default. Those customers then return to the original utility and the alternative supplier is left either swallowing the unpaid bill or initiating costly court procedures. A POR makes it much easier for a supplier to accept all customers. If a customer of a supplier defaults, the original utility buys back the receivables at a discount. "If you want vibrant retail competition, you need to have POR," says Young Kim, principal consultant to KEMA.

Kim credits expanded POR in Pennsylvania, along with the elimination of rate caps, as the greatest factor in Pennsylvania's now vibrant retail market. He also says it opened the Cincinnati territory for Duke and the Chicago area for ComEd in Illinois as well as the Maryland market. Legislation is pending to introduce POR in Massachusetts, and he thinks it's been key in New York. "If retailers don't have to worry about bad debt, they become agnostic to which type of

customer they can accept. In places with POR, we've seen a huge increase in migration," Kim says.

Goodman agrees: "POR was one of the key factors that made Pennsylvania attractive to suppliers. POR is always a game changer. It's the single biggest impetus in a state that is developing a retail market program." He points out, however, that the discount rate - the rate at which a utility buys the receivables - must be reasonable. "If the rate exceeds 2 or 3 percent, you're probably not going to have a successful retail program," he says.

Where price caps have been eliminated and generation infrastructure has been separated from transmission, as in Texas, competition has been strong. In Texas, 43 percent of residential customers have migrated; when the fact that not all residents can migrate is taken into account - municipally owned utilities, for example, are exempt from competition - the number is all the more impressive. Some states, including Michigan and California, have so-called shopping caps that limit how many customers can switch. The idea is to phase in competition gradually by limiting it to, say, 10 percent of total sales from the prior year. According to Kim, the day the cap in California was opened for enrollment it was totally filled within 24 hours.

Uncertainties remain. If Dodd-Frank makes hedging against sudden spikes in fuel prices too difficult or too costly, the wholesale market could shrink, severely constraining retail competition. And if states regulate fuel sources too strictly, the result could distort the market or make it too complex for all but the largest retailers to bother with. But as retail customers learn of the benefits of a competitive energy market, either through increased education by organizations such as the National Energy Marketers Association, or simply by word of mouth, and as customers move from deregulated states like Texas to states that remain regulated, demand will undoubtedly increase. And as retail customers demand it, it's hard to imagine that legislators and regulatory bodies will not respond and open new territories to competition.