



NATIONAL GUIDELINES
FOR
DESIGNING AND PRICING
DEFAULT ENERGY
AND
RELATED SERVICES



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I Introduction

The **National Energy Marketers Association (NEM)** is a national, non-profit trade association representing a regionally diverse cross-section of both wholesale and retail marketers of natural gas and electricity. NEM also represents producers, generators, transporters, and marketers of energy-related information, services and technology throughout the United States.

NEM is committed to working with representatives of state and federal governments, large and small consumer groups and utilities to devise fair and effective ways to implement restructuring of natural gas and electricity markets. NEM and its members appear before state Public Utility Commissions, the Federal Energy Regulatory Commission and legislative bodies throughout the nation. NEM members urge lawmakers and regulators to implement:

- Laws and regulations that open markets for natural gas and electricity;
- Rates, tariffs and operating procedures that lower the cost of energy;
- Standards of conduct that protect consumers;
- Rules to permit competition based on price and quality of service; and
- Policies that encourage new technologies, including the integration of energy, telecommunications and Internet services.

II Background

Over the last two decades, a number of key industries vital to the U.S. economy have been successfully restructured by introducing competition as an alternative to regulated monopolies. As a result, these industries have experienced significant reductions in prices charged to consumers, along with gains in efficiency, innovation and productivity. In telecom, trucking and air travel, cost savings to consumers have averaged forty percent. Given the size and importance of the U.S. market for energy and related services, products and technologies, total benefits to consumers and the economy to be realized through vibrant retail competition are substantial. If the promise of

restructuring is to be fully realized, however, markets must be designed to foster competition.

In that regard, one of the most important issues confronted in the restructuring of U.S. energy markets is the design and pricing of what is referred to as “default service.” Default service, also known as standard offer or basic generation service, refers in the broadest sense to the service provided to those customers in a competitive market who are not receiving energy supply services from a competitive supplier for any number of reasons, including a simple failure on the part of the customer to select a supplier.¹ This paper explores the impact of default service design and pricing on the development of competitive markets.

Historically, utilities have been given a regulated return on capital invested in generation, transmission and distribution systems in exchange for an “obligation to serve” the public. This historic obligation has encompassed what is recognized in the context of a restructured utility industry to be two distinct commercial services: the supply of natural gas or electricity (referred to jointly throughout this paper as energy) and the transportation or distribution of that energy. NEM submits that in a restructured environment the obligation to serve should be converted into an obligation to deliver. That is, while the utility should and will continue to provide transportation or distribution service for all customers, it is not necessary or desirable to establish the utility, on a long-term basis at least, as the default provider of energy supply services.

It is not necessary for the utility to act as the default service provider because marketers have the ability and experience to supply these services to customers. Marketers have long been involved in developing and aggregating generation and natural gas supply, and providing utilities with energy as a commodity. Indeed, in many cases, marketers have supplied utilities with energy and related services on an outsourced basis for years, enabling those utilities to provide energy supply services. Neither is it necessary to establish the utilities as default service providers in order to allow those utilities the opportunity to compete for customers, or customers the opportunity to choose a familiar entity as their energy service provider. In a competitive environment, utilities can form competitive subsidiaries and customers can affirmatively choose those subsidiaries as their suppliers. However, in a market that has opened to competition, an assumption that customers who have not selected a competitive supplier have made an affirmative decision to receive service from the utility is unwarranted.

Retaining the utility as the default provider of energy supply services long term in a restructured environment will have a negative impact on the development of competitive markets. The structure and pricing of default service are critically important issues in determining whether consumers will receive the benefits of meaningful price competition. When states mandate the selection of incumbent utilities for all consumers who fail to make timely supplier elections and set a non-competitive price for default service, they create a significant barrier to new suppliers and perpetuate the same non-competitive energy services that restructuring is designed to replace. It is also vital that states not select winners and losers in a competitive market. Automatically presuming that an entity affiliated with the incumbent utility should act as the default supplier, in lieu of the utility itself, grants that entity an unfair competitive advantage and violates the important principle that all market participants should be treated in a competitively neutral fashion. In contrast, the representative assignment of default service customers to competitive suppliers or the award of default service to one or more suppliers through a bidding process, will result in increased market diffusion and an improved ability on the part of suppliers to spread costs and compete on the basis of price.

III Default Service Design

In the long term, all consumers in restructured energy markets should be served by competitive energy service providers at prices that are set by the market, and it is desirable to get to that end state as quickly as possible, following the opening of the market. An example of an approach that holds promise for accomplishing a quick transition to a fully competitive market is to assign customers to competitive providers after a limited period of time. Utilizing this approach, customers who have not selected a competitive supplier during a specified enrollment period are assigned to reliable suppliers based on the market shares of those suppliers. Although there may be some regulatory restrictions and requirements, the price and non-price attributes of the default service offer under this model are determined by individual suppliers and reflect efficient and true market conditions.

This process proved successful in accomplishing a quick transition in the long-distance telephone market in the mid-1980's. A similar program has been used in the Atlanta Gas Light service territory for natural gas. There are several benefits to such an approach. First, by allowing a

period of choice prior to assignment, customers are engaged and, as shown in the Atlanta Gas Light program, many customers will choose competitive suppliers. A designated period for choice also provides customers with a powerful incentive to become educated on the process of choosing an energy supplier. In addition, such an approach ensures competitive neutrality among all the competitors in a given marketplace and allows consumers to enjoy the benefits of meaningful choice.

NEM believes that the assignment alternative to default service holds promise for customers and the competitive market. We also recognize that other methods will be considered. Regulatory bodies may not be prepared to implement such an approach at the opening of the market and will evaluate other alternatives to satisfying their own state's unique set of circumstances regarding default service. Other options for approaching default service fall into four general models and may be used in varying combinations and permutations, preferably for a brief interim period of time before all customers make the transition to a competitive market.

- **Utility Retains Default Customers:** From a default service customer's perspective, competition has changed nothing. Customers continue to deal with the utility for all aspects of service. As indicated above, this approach is not a long term solution. When it is employed on a transitional basis, Commissions should insure that the transition plan:
 - **Maximizes appropriate incentives for customers to choose competitive suppliers** by allocating retail costs appropriately between the distribution rate and the energy supply service (i.e., default service) rate, thereby preventing customers from paying the retail cost component twice.
 - **Minimizes incentives for utilities to retain default service customers** by ensuring that revenues in excess of commodity costs benefit all customers via lower stranded costs or distribution rates.
 - **Educates consumers on the benefits of competitive energy supply service options**, including the potential for: innovative product offerings, flexible pricing, billing and delivery options, and cleaner and renewable energy resources; multiple supply and purchase alternatives; and lower costs as the result of competitive price pressure among suppliers.

- **Default Customers Transferred to Another Supplier.** Under this approach, default service is granted to an entity other than the utility, such as an affiliate or the buyer of the utility's generation assets. An automatic non-competitive transfer of customers to any other single entity (affiliated or unaffiliated) grants a substantial and unfair competitive advantage to one market participant and violates the concept of competitive neutrality. In addition, automatic transfer to a utility affiliate offers few, if any, advantages to the competitive market over leaving customers with the incumbent utility itself.

(Please refer to NEM's Uniform Code of Conduct for Regulated and Unregulated Suppliers of Energy and Related Services and Technologies, National Guidelines for Restructuring the Electric Generation, Transmission and Distribution Industries and National Guidelines for Unbundling and Restructuring the Natural Gas Distribution Function for further guidance on this issue.)

- **Default Service Awarded Based on Revenue Bids.** This option puts the responsibility on the Commission to set the default service price. Suppliers then bid a dollar amount for the right to serve default customers at the price established by the commission. This revenue bid amount is then available to reduce stranded costs or offer other benefits to all distribution customers. While there are a number of benefits to this approach, an inherent problem with this option is the difficulty and risk of forecasting prices into the future. From a competitive market perspective, the greatest risk is that the price will be set too low, presenting substantial risk to potential default service providers and limiting opportunities for the competitive market to offer pricing benefits to customers. If this approach is utilized, it is important that these dynamics are considered and that Commissions provide themselves with opportunities to reset the default service price (and rebid the service) periodically.
- **Default Service Awarded Based on Price Bids.** This approach can represent significant progress toward establishing default service charges that reflect the competitive market for energy supply services. If it is utilized, however, it is important to ensure that the default service provider is responsible, to the maximum extent, possible for all of the retail functions and costs that impact competitive suppliers. Since a default service provider can avoid certain costs (such

as marketing costs) and enjoy certain advantages (such as instant economies of scale), it is important to neutralize these advantages in order to allow a competitive market to flourish.

IV Default Service Pricing

If any combination of the models described above are employed, a regulatory body must implement and manage rules regarding the price of default service. The pricing of default service is critically important to the development of a new competitive market because the default service price serves as the "price to compare" - the target against which consumers judge all competitive offers. Default service must be priced at retail rates for each customer class. If the default service price is subsidized or set artificially low, i.e., if it does not reflect the true costs of providing retail generation service, true competition on the basis of price and quality of service will not be possible. Competitive suppliers will be challenged to cover their costs and offer products that provide value to customers. If the incumbent utility acting as the default service supplier is permitted to subsidize retail energy services by passing through wholesale price signals and embedding the retail costs of energy-related services in its distribution rate, a competitive marketplace cannot occur. Indeed, permitting utilities to maintain default service and offer false price signals in the process, not only distorts energy price signals, but also establishes a significant barrier to effective price competition by forcing customers, who switch to competitive suppliers, to pay twice for retail energy services. Under these circumstances, fewer customers will choose competitive energy service providers, the utility's market share will be maintained, consumers will not benefit to the degree they should, and competitive markets simply will not develop.

There are four basic models that have been tried or considered for the pricing of default service. They are described below, beginning with the most competitive method and ending with the least competitive.

- **Wholesale Prices Adjusted to Reflect Retail Service Costs** — This approach starts with either a periodic rate or an index rate to determine a wholesale price and then includes the additional costs of providing retail energy services. The costs of providing retail natural gas service include pipeline capacity charges, no-notice service, city-gate delivery requirements, and

related-commodity charges. For the electric industry the costs associated with retail services include transmission charges, scheduling and control area services, losses and pool operating expenses. For both industries, retail energy services typically include the costs of risk management premiums, load shape costs, commodity acquisition and portfolio management, working capital, and taxes, as well as costs for administrative and general expenses, metering, billing, collections, bad debt, information exchange, compliance with consumer protection regulations, and customer care.

- **Periodic Rate** — A periodic rate is a pricing mechanism that relies on regulators, auctions or market mechanisms to set prices (either wholesale or retail) annually or at some other interval that allows for changes in market conditions. This is the approach taken in Arizona, Nevada, and Maine.
- **Fixed Rate** — Under a fixed rate mechanism the default service rate schedule is administratively determined for some period of years. The rate, which usually escalates over time, may be based on the embedded cost of utility generation, a speculative forecast of wholesale or retail prices over time, stranded cost recovery considerations and other factors. This is the approach taken in Massachusetts, Rhode Island, New Jersey and initially in Pennsylvania. Initial default service rates established in several utility service territories in Pennsylvania have helped to develop a competitive market in that state to date because the pricing structure has more realistically reflected the costs of providing retail services. However, escalating wholesale power costs are now presenting a challenge to suppliers competing with fixed default service prices. In contrast, default service rates in Massachusetts and Rhode Island were initially set at unrealistically low levels, thereby precluding any significant competitive activity in those states.
- **Index Rate** — The index rate relies on the wholesale marketplace to set the price of default service. Customers generally pay a monthly or billing period average of the spot market price. As applied in markets like California, customers do not avoid the overall higher costs associated with being served by a monopoly, because the retail service component remains embedded within the distribution rate.

V

Approaches to Default Service An Assessment

In natural gas, competitive markets are well developed for larger industrial and commercial customers. In those cases no default service is needed or provided for large, transportation customers. A number of large, small volume, gas transportation programs exist, particularly in Georgia, Illinois, Ohio, and New York; however, those programs are relatively new. Restructured electricity markets are also in the early stages of development. Nevertheless, several states have developed default service and pricing approaches that provide both negative and positive experiences and can offer guidance on the issue of how to structure default service to support competitive retail markets. Customer migration, i.e., the number of customers choosing a competitive supplier, is a key indicator of retail market activity.

Early evidence suggests that in those markets where default service pricing reflects the true costs of providing retail services rather than hiding these costs in distribution rates, markets are developing quickly, while markets that have subsidized or artificially low default service prices relative to retail costs are developing much more slowly. For example, in Massachusetts and, to a significant extent, in California, where default service prices at the start of competition were set at or below the wholesale cost of power (with other costs of providing generation service buried in the utility's distribution rates), few competitive suppliers are active and after almost two years of competition, only .5% of customers in Massachusetts and 1.9% of customers in California have switched to competitive suppliers. In contrast, in Pennsylvania, where "shopping credits" (i.e., the prices to compare) in several of the largest utility service territories are more reflective of true retail costs, competitive suppliers are able to cover the costs of providing service and offer savings to customers. There many suppliers are active in the market and 10% of customers have switched after just one year of competition. The impact of competitively priced retail shopping credits is also apparent when customer migration rates are compared across utility service territories in Pennsylvania. In the PECO service territory, where the spread between the retail price for default service (shopping credit) and wholesale cost for power is greatest, the customer migration rate is approximately 16%, compared with migration rates for Allegheny Power and PP&L, where the

retail-wholesale spread is much smaller, of about 1.9% and 3.6%, respectively.

It is also clear that the default service award structure has been important in the early stages of development of competitive, small volume, retail gas markets. Currently, the Atlanta Gas Light Choice Program, which requires all customers to either choose a supplier or be assigned one (as did the long-distance telephone program in the mid-1980s), has provided strong encouragement for customers to choose a supplier. It has also provided strong encouragement for suppliers to compete in the market, since they acquire a share of non-choosing customers based on their relative share of the market. As a result of this competitive assignment policy, as well as a market-driven retail-wholesale price spread, approximately 80% of customers chose a competitive gas supplier during the nine-month enrollment period.

While large volume, gas transportation markets are well developed in many states and the number of smaller volume programs is on the increase, examination of both the utility's rate structure and terms of transportation service should be reviewed for proper cost allocation components. The success of those programs will continue to be based on the utility's pricing policies and the structure of the open access programs.

VI

Principles to Guide the Design of Default Service

NEM does not believe that there is one right approach to restructuring energy markets or one right design for default service. We do believe, however, that the goals of restructuring are achieved by the advancement of competitive retail markets, and that the constructs of default service and pricing are critical to that advancement. Furthermore, we believe it is now possible to identify some principles to guide the design of default service and pricing mechanisms to support development of a competitive market at the earliest possible date. Those principles are described below:

- **Design Default Service to Maximize Customer Choice and Minimize Default Service Customers.** As noted above, suppliers are attracted to markets where they can compete successfully with default service on the basis of price. Customers, of course, are also much more likely to select a competitive supplier

when there are many suppliers in the market advertising and offering a variety of products and services for sale. This is the basis for a robust, competitive market. Competitive retail default service prices and the distribution of default service customers to multiple competitive suppliers encourage customer migration.

- **Establish a Competitive Process for Acquiring Default Service Customers.** No one market participant should be granted an unfair competitive advantage in the provision of default service to customers. State-mandated selection or non-competitive transfers of customers at subsidized energy prices should be avoided at all costs. The opportunity to serve default service customers through a competitive process provides a public service in a manner that does not impose barriers to meaningful competition or distort the operation of competitive price signals.
- **Design Default Service Pricing Mechanisms that Reflect Retail Prices and Do Not Produce Artificial or Cross-Subsidized Price Signals.** All suppliers providing generation and gas commodity service to customers at retail, including default service and competitive suppliers, incur costs to do so in addition to the wholesale cost of the energy commodity. These costs include: for natural gas, no notice service, pipeline capacity charges, city-gate delivery requirements, and related-commodity charges; for electricity, transmission charges, scheduling and control area services, and distribution system line losses; for both electricity and gas, a share of pool operating expenses, risk management premiums, load shape costs, commodity acquisition and portfolio management, working capital, taxes, administrative and general expenses, the costs of metering, billing, collections, bad debt, information exchange, compliance with consumer protection regulations, and customer care. Default service pricing mechanisms that hide the true costs of providing retail energy services, showing instead the wholesale power costs alone as the "price to compare," do not benefit default service customers, who are getting a false price signal and are still paying the other costs to provide generation or gas sales service in the distribution component of the bill. They do, however, penalize customers who switch to competitive suppliers since those customers are paying for the retail costs of energy supply services twice. They also have a devastating effect on the competitive market, since competitive suppliers are unable to

compete effectively on the basis of price with the subsidized default service option.

- **Price Default Service Separately for Each Customer Class.** The costs to provide default service varies by customer group. Properly designed default service prices should reflect these real price differences to encourage competition for all customer classes.
- **Design Default Service Pricing Mechanisms to Account for Changing Market Conditions.** While it is early in the development of competitive markets to have much concrete experience with this, there is a huge inherent risk for the retail market in a “price to compare” that does not change over time in response to changes in the wholesale markets. Such set prices put tremendous pressure on retail suppliers during periods of wholesale price volatility, and provide opportunity and motivation for generation owners, comprised largely of utilities, to “game” the wholesale market for competitive advantage. Default service pricing mechanisms that allow prices to change over time in response to wholesale market conditions better reflect real competitive markets, provide more accurate price signals, and help level the competitive retail playing field.
- **Design Specific Programs to Address Low-Income Needs; Do Not Try to Utilize Default Service for this Purpose.** Often, concerns that low-income individuals will be unwelcome in the competitive market drives, explicitly or implicitly, the design and pricing of default service. This approach serves neither low income customers nor the development of a competitive market well. Specific programs should be designed to serve low-income needs and to facilitate the targeting of public benefits funds. Such programs might include aggregation of low-income customers to access lower prices in the competitive market, perhaps with subsidies or guarantees of payment that would ensure the lowest-cost supply for these customers.
- **Utilize Default Service Only as a Transition Mechanism.** Default service can be a useful mecha-

nism for insuring a smooth transition to competitive markets. However, it is not needed on a permanent basis. To the extent that there are, or are perceived to be, long-term needs for some of the functions filled by default service providers today, such as providing a mechanism to supply and bill customers who have been dropped by their current supplier for some brief interim period, those needs should be addressed directly or default service should be redefined and circumscribed to address just those needs (i.e., a true provider of last resort function).

VII Conclusion

Because of the importance of default service design and pricing to the development of competitive retail energy markets, NEM urges Commissions and legislators to carefully consider the issues raised in this paper in crafting their restructuring plans. Where settlements and/or transition plans are already in place, that attempt to balance the interests of market participants, there may be less flexibility to accommodate these concerns during the transition period. Opportunities for modifying default service plans without disrupting existing settlements, however, should be explored, where necessary to enhance the competitiveness of the market. In addition, in most states, Commissions still have to determine what provisions should be made for default or POLR service after the transition period. At that stage Commissions have another important opportunity to redesign default service into a limited (and competitive) POLR service and to allow the competitive market to better serve the energy needs of consumers.

VIII Endnotes

i The term “provider of last resort service” or “POLR service” is sometimes also used as a synonym for default service. Usually and more appropriately, however, this term is used to describe a much narrower set of responsibilities, such as, providing service on an emergency, interim basis when a customer has lost or been dropped by his/her supplier.