RETAIL ENERGY
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June / July 2003
Predicting Retail Energy Market Activity

Issue Spotlight:
Retailer Friendly Markets

What makes for successful retail electric markets? This month, REF queried three prominent energy experts to uncover their versions of retail utopia. Our panel—all from the retailer perspective — identified crucial market changes that would make their jobs smoother, if not downright fun. Balanced against the wish list is what it would take from a political perspective to turn ideal to reality.

The nation's experiment with retail electric competition is more than five years old and much experience and insight has been gained, some quite painfully. What has all this taught us about what makes an effective retail electric market? Or, more specifically, what has this taught our panel of

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INSIDE

Switching Trends: Hot and Cold

The march to frenzied competition in New Jersey draws closer as the largest customers move to market-based rates on August 1 though customers have not yet signed up in droves. Don't be fooled — expect serious activity akin to BGE and Texas non Price-to-Beat levels. In New England, Maine and Massachusetts markets are mediocre to skittish and precious little movement exists in neighboring states.

Harvesting Garden State Load

New Jersey is about to turn the corner of retail choice after an unpleasant ride for much of the past four years. While it never soared as high as neighboring PECO market, it crashed even lower. On the mass-market side, AES Power Direct, New Power, ECONnergy, and Green Mountain, among others, made forays, and none came out the better for it. The large C&I market saw a much larger rise, and a much greater fall. The kick-in-the-teeth while down came in a ruling for the final year of the four year transition period ending July 31, 2003, in which C&I customers could not opt into choice for an entire year.

But unless you have been living in a retail energy cave, you know big changes are occurring in New Jersey. The Basic Generation Service (BGS a/k/a default service) structure changes dramatically for the large customers, known as the Commercial and Industrial Energy Pricing class (CIEP).

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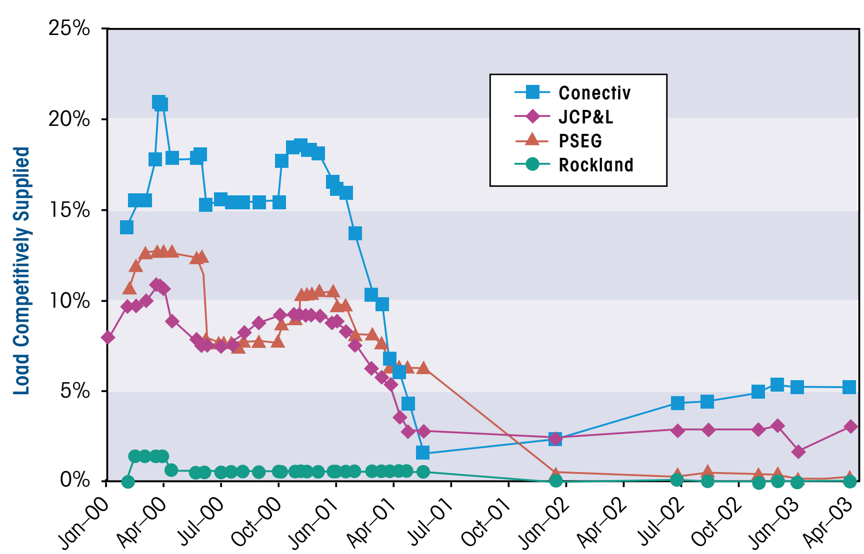
New Jersey Load Competitively Supplied, 2000–2003



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These 1,768 customers (generally over 1 MW and constituting roughly 2,500 MW of load) will have their energy prices based on:

- PJM locational marginal price
- Capacity price that was determined at auction (around $60 / MW-Day varying by territory or about $3.50 / MWh at 70 percent load factor)
- PJM ancillaries as an estimated fixed-charge to be trued-up
- Retail margin adder of $5 / MWh
- Transmission charges based on peak demand
- Default Supply Service Availability Charge of $0.15 MWh, which ensures (just what it says) default supply.

The rest of the customers — constituting over 15,000 MW — are in the Fixed Price (FP) class. This class also had an auction to supply their BGS, but did not have a retail adder for the first ten months of choice (but will for the next 24 months when they too will have a retail margin adder of $5 / MWh). This is another Garden State twist as the first year of post transition is only 10 months long so as to align New Jersey with PJM on annual capacity assignment.

For those paying attention, the CIEP structure looks similar to the BGE Schedule P, and the Texas non-Price-to-Beat (non-PTB) sectors, both of which have been big hits. But as Jon Gordon of Select Energy points out, the nearby New York markets also have few buffers between the hourly LMP and the large consumer, but much less retail load migration has occurred for this segment in New York than in either Texas or BGE.

The consensus is that the New Jersey CIEP market will more closely match the high switching activity in BGE and Texas (90+ percent), than, for example, ConEd with 39 percent of non-residential load switched because of:

- **Shock value.** The CIEP segment will go from the current cozy fixed price to the hourly pricing in one fell swoop.
- **Generation Availability.** There is enough capacity to provide lubrication for deal-making. This contrasts sharply with ConEd where the lack of excess generation and import capacity lead to classic Manhattan gridlock.
- **Competition.** Richard Rathvon, Vice President of Reliant Energy Solutions, made the most definitive statement. "The great design of the CIEP market has led to competition on every transaction. The market design is working as every CIEP customers is seeing multiple offers and a competitive price." Rathvon's statement is backed up by every retailer we spoke with (some who asked for anonymity) as all noted that the CIEP market had attracted serious competition.

Beyond Select and Reliant, the most often cited competitors include Amerada Hess, Constellation NewEnergy, First Energy, Pepco Energy Services, Sempra, and Strategic Energy Ltd (SEL). Less mentioned were ConEd Solution, SJI Industries, and Tractebel. Interestingly, more than one noted the reticence of home team First Energy, while Hess and Pepco were singled out as having some of the most aggressive pricing.

July 11th is the big day, as it marks the last day that customers can switch and ensure not being charged the LMP prior to post transition on August 1st. So why aren't customers yet signing up in droves? Insight and speculation includes:

- Customers hoping that prices come down before signing on the dotted line. Certainly the recent one day ten percent drop in short-term gas prices gives them hope.
- Related, some customers are considering taking on the LMP volatility over August, thinking that cooler September weather may bring lower offers. Curiously, this also includes taking on the $5 / MWh retail adder. If they want to play this game, they might get a better short-term deal with a retailer rather than the BGS.
- Long lead-times. Reliant Energy Solutions's Rathvon related that customer education did not really start until May, and many companies need time to digest before signing a contract. He also noted that in balance the brokers and consultants are providing value by speeding up the customer education process.
- Retailers having difficulty processing the logjam of RFPs and pricing requests. One retailer ventured that some consultants to these companies may be doing a disservice to their clients when

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XENERGY Retail Energy foresight

For 27 years, XENERGY has met the challenges of the dynamic energy marketplace. We provide an unmatched combination of proprietary market knowledge, actionable research, and exceptional implementation services. Since industry restructuring took hold in 1995, XENERGY has been an innovative force helping to shape the marketplace. With over 150 professionals and 20 leading restructuring experts, XENERGY's consulting expertise is extensive, yet focused solely on the changing energy marketplace. Our highly successful track record of completing complex assignments under tight time frames has established XENERGY as a leading provider of strategic information and consulting. As an industry leader, XENERGY is committed to innovative solutions that enable our clients' success.

Managing Editor
Tom Michelman

Editor
Susan Weber

Contributors
Chris Dyson
Ryan Barry
Taff Tschamler

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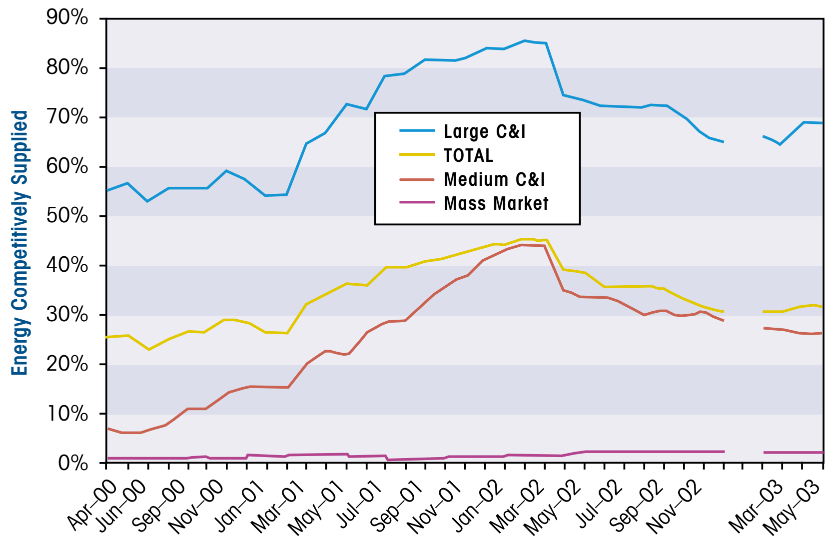
they make special requests on the RFPs between now and August, as retailers will not have time to handle them appropriately. This may delay contract initiation and leave those customers to the vagaries of the late summer spot pricing.

The deals being consummated are generally for 10, 22, or 34 months. Case in point is Reliant Energy Solutions' notable win serving Chemistry Council of New Jersey members with terms ranging from 10 months to 24 months, up to 300 MW load. Statewide, we hear of deals in a variety of flavors: fixed price, indexed, block-index mixed, fixed with a band-width, with the simple full requirements fixed price product as the most requested by customers. One retailer noted that customers were shying away from any bandwidths. This, she says, is in contrast to what customers would accept in the market four years ago. She went on to say that there might be some implicit band-widths their competitors have written into the contract language that allow the retailer to walk away, which some customers may not understand.

Not one of the retailers we spoke with was targeting the Fixed Price market and expected to see very little activity there. Phrases to describe the FP market included "a tag-along for multi-account CIEP customers" who wanted all the accounts on the Fixed Price regime, "niche", "little or no margin", "not worth investing in", "stumbled over some accounts." This is not the sound of competitors beating down the door.

Going forward are two big rule-making issues. One is the potential expansion of the CIEP for the second year post-transition. The range of suggestions include seeing how the dust settles on this round and not expanding the customer class at all, as well as pushing down the CIEP sector to 500 kW (approximately the size of a big box store). The second are municipal aggregation rules. After a change in legislation, New Jersey does have municipal opt-out aggregation (a potential savior of the FP market), but the details still have to be worked out. And the rules are important as their interpretation was what squashed any hope of municipal opt-in aggregation in 1999.

Maine Load Competitively Supplied 2000–2003



New England Roundup

In New England there have been two highlight markets, Massachusetts and Maine, and lately these have been mediocre to skittish. The other markets have been very weak sisters. Before going through the markets, it is important to understand a few wholesale realities. New England is currently replete with generation. This means capacity prices are low, and wholesale clearing prices are primarily a function of natural gas fuel costs, and heat rates. ISO–NE consumers now pay one of eight zonal charges. Load pockets in southwest Connecticut and Northeast Massachusetts impede a free flow of power and prices.

Connecticut has had little switching, though it has increased some lately. A low Standard Offer and very little wiggle room to increase the competitive portion of the bill have impeded the Connecticut market, and its future is very unclear. Jon Gordon, Manager -Market Analysis of Connecticut based Select Energy, tells *REF* that the DPUC's interpretation of the recent legislation that extends the standard offer period three years will make all the difference. Gordon states that the legislation seems to allow for a fuel adjustment to the extent that supply bids are higher than the 10 percent rate increase now allowed by law. But there are outstanding questions on whether such increases could be applied to the competitive generation portion of the bill, and how potential stranded costs could eat into potential headroom. Gordon is hopeful for a positive outcome, and as one other player put it: there is too much uncertainty for an outsider to make an investment in the Connecticut market until the dust settles. Mike Hachey, Director of Power Marketing of Transcanada, one of the few retailers serving customers in Connecticut, felt that the legislative intent was for default rates to be reset to current prices. The alternative, Hachey stated, is to hide the cost of procurement, which he felt did not make sense.

Rhode Island is not going anywhere soon. Most customers are on the Standard Offer and are not likely to be wooed to the perceived risk of competitive supply and potential Last

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Switching Trends •
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Resort Service. And conversely retailers are not likely to make major efforts of wooing.

New Hampshire is dominated by PSNH. Margins are underwater, and with PSNH still holding onto their generation, and the legislature rue to allow for real prices to be shown to end-use customers, nothing much is happening in the Granite State.

Vermont is not open, and no one sees any reason why it will be in the foreseeable future.

Maine has plateaued at the 30-35 percent range of competitively supplied load. Rich Silkman of Competitive Energy Services, the dominant broker in Maine, says there is nothing magical about this market. "What is important to customers is short-term savings and long-term price stability."

Maine switching has simply been a function of how and when prices get set. In 2001 prices by bid were set at the peak of the market and switching spiked. One year-ago, prices were set during a trough, and switching declined. Only slightly exaggerating, Silkman stated, "The only thing that matters is how the regulators set default prices." So coming up, Maine is moving to a six-month bid process for their medium and large commercial and industrial load.

That brings us to **Massachusetts**, which has had a precipitous drop in the switch rates (see figure on page 7). The drop appears to be a confluence of a number of factors, the most important being the run-up in natural gas prices, which drove-up the prices retailers could offer customers above the default rates. Combine this with uncertainty over the implementation of zonal pricing, and the large number of customers coming off the HEFA five-year aggregation deal (what a great deal it turned out to be for those customers) and the size of the switch rate drop is not so surprising.

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Current Switch Rates

Current Cumulative Switch Rates by Percent of Total Load Served by Competitive Suppliers

State / LDC	Residential	Commercial	Industrial	Total	Report Date
AZ	0.0	0.0	0.0	0.0	06/10/2003
CA	0.6	1.2* / 14.0#	35.4	13.1	04/30/2003
CT	1.6	0.4		1.5	Mixed
CL&P	2.1	0.6		2.0	04/05/2003
UI	0.0	0.0		0.0	04/08/2003
DC / Pepco	14.2	48.7		41.8	04/03/2003
DE	n/a	n/a		n/a	06/06/2003
DEC	n/a	n/a		n/a	06/06/2003
DP&L	0.0	8.0		5.8	06/06/2003
IL	0.0	26.3	57.6	29.7	04/30/2003
AmerenCIPS	0.0	37.0	30.1	21.2	04/30/2003
AmerenUE	0.0	0.2	0.0	0.0	04/30/2003
CILCO	0.0	0.0	0.0	0.0	04/30/2003
ComEd	0.0	33.8	63.1	34.4	04/30/2003
IP	0.0	14.8	57.5	31.8	04/30/2003
MidAmerican	0.0	8.6	3.6	4.0	04/30/2003
MA	2.3	9.5* / 12.8#	27.5	14.9	04/30/2003
Fitchburg	0.0	0.6* / 2.8#	16.7	7.9	04/30/2003
NGrid	0.7	6.6* / 13.5#	33.7	15.7	04/30/2003
NSTAR	4.7	14.0* / 13.2#	23.6	15.2	04/30/2003
WMECo	0.7	6.6* / 8.8#	18.2	9.4	04/30/2003
MD	4.6	26.9		16.2	04/25/2003
Allegheny	0.0	0.0		0.0	04/25/2003
BG&E	0.0	29.2		14.6	04/25/2003
Conectiv	0.0	9.0		4.2	04/25/2003
Pepco	16.8	39.3		28.3	04/25/2003
ME	1.7	25.7	68.1	31.0	05/31/2003
BHE	0.2	27.0	36.0	17.0	05/31/2003
CMP	0.1	25.0	77.0	34.0	05/31/2003
MPS	34.0	68.0	100.0	60.0	05/31/2003
MI	n/a	n/a	n/a	9.7	03/31/2003
Consumers	n/a	n/a	n/a	6.1	03/31/2003
DTE	n/a	n/a	n/a	11.6	03/31/2003
NJ	0.0	0.0		1.6	Mixed
Conectiv	0.0	0.0		5.2	02/28/2003
GPU	0.0	0.0		3.1	01/31/2003
PSEG	0.0	0.0		0.3	02/28/2003
Rockland	0.0	0.0		0.0	02/28/2003
NY	5.6	33.6		22.5	03/31/2003
CHG&E	0.1	24.3		14.2	03/31/2003
ConEd	5.8	38.8		28.6	03/31/2003
LIPA	0.3	2.3		1.3	03/31/2003
NYSEG	6.2	38.9		22.6	03/31/2003
NMPC	6.0	38.1		25.0	03/31/2003
O&R	26.7	35.5		32.2	03/31/2003
RG&E	13.0	51.7		34.7	03/31/2003
OH	13.5	24.1	13.6	16.0	12/31/2002
Allegheny	0.0	0.0	0.0	0.0	12/31/2002
AEP	0.0	3.4	0.0	1.0	12/31/2002
Cinergy	4.8	22.2	26.1	17.8	04/18/2003
DP&L	0.0	8.7	27.7	9.9	12/31/2002
FirstEnergy	35.7	44.3	21.1	31.5	12/31/2002

*Small Commercial #Large Commercial n/a= Not Available n/o=Not Open

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Current Cumulative Switch Rates by Percent of Total Load Served by Competitive Suppliers (continued from page 4)

State / LDC	Residential	Commercial	Industrial	Total	Report Date
OR	n/o	0.0		0.0	05/01/2003
PacifiCorp	n/o	0.0		0.0	05/01/2003
PGE	n/o	0.0		0.0	05/01/2003
PA	4.9	13.3	12.1	9.5	04/01/2003
Allegheny	0.1	0.0	0.0	0.1	04/01/2003
Duquesne	24.7	33.0	26.1	29.4	04/01/2003
GPU	0.3	2.5	31.6	7.6	04/01/2003
PECO	8.1	12.2	5.9	8.6	04/01/2003
Penn Power	0.3	0.2	0.0	0.2	04/01/2003
PPL	0.2	10.2	9.8	4.9	04/01/2003
RI	n/a	n/a	n/a	10.4	04/01/2003
TX	11.6	47.6		31.6	04/30/2003
AEP–CPL	14.1	53.8	n/a	41.0	06/02/2003
AEP–WTU	16.1	50.0	n/a	41.0	06/02/2003
HL&P	10.8	54.8	n/a	34.0	06/02/2003
Oncor	11.8	44.3	n/a	28.0	06/02/2003
TNMP	7.2	34.2	n/a	46.0	06/02/2003

*Small Commercial #Large Commercial n/a= Not Available n/o= Not Open

Notes on Reported Cumulative Switch Rates

State	Comment/Disclaimer
ALL	Switching refers to a customer receiving retail electric commodity from an organization other than a customer's traditional Local Distribution Company (LDC). "Switchers" include customers who either choose to purchase retail commodity from an unregulated affiliate of their LDC, or from suppliers not affiliated with their LDC (or in the case of Illinois those who choose to take the PPO from the host distribution company). When customers switch back to energy commodity services offered by the host LDC or another retail supplier, this is referred to as "churning."
CA	Small commercial is defined as <20 kW, medium commercial as 20–500 kW, and industrial >500 kW.
MA	Massachusetts reports switching for small commercial and medium commercial customer classes separately. "Small commercial" represents commercial and industrial rate classes averaging <3 MWh/month; "medium commercial" represents commercial and industrial rate classes averaging 3–120 MWh/ month; and "industrial customers" represent commercial and industrial rate classes averaging >120 MWh/month.
ME	Maine reports percent load switching at the distribution company, but not at the statewide level. Therefore, percentages at the statewide level are estimates. Residential switching is defined as residential and small commercial standard offer classes that do not incur demand charges. Accounts in the commercial customer class (medium nonresidential in Maine parlance) are defined as standard offer rate classes with a maximum demand <=500 kW, and the industrial customer classes (large nonresidential in Maine parlance) are defined as standard offer rate classes with a maximum demand >500 kW.
PA	Statewide percentages computed by *REF*.
TX	Change in reporting, Industrial category does not include Non-PTB customers. As of December 2002, 91.5% of Non-PTB customers were being served by competitive contracts. 25.9% of street lighting is being supplied by a non-affiliated energy supplier. Commercial is defined as Non-PTB customers receiving secondary transmission service.

Bottom Line Predictions

Reported and Predicted Cumulative Switch Rates for Selected Markets by Load

<table>
<tr><th>State/Market</th><th>Time Period (End of)</th><th>Residential</th><th>Commercial</th><th>Industrial</th></tr>
<tr><td>IL – ComEd</td><td>Apr – 2003 (current)</td><td>0</td><td>34</td><td>70</td></tr>
<tr><td></td><td>Q3 – 2003</td><td>1</td><td>36</td><td>72</td></tr>
<tr><td></td><td>Q1 – 2004</td><td>1</td><td>38</td><td>73</td></tr>
<tr><td>ME – CMP</td><td>May – 2003 (current)</td><td>0</td><td>25</td><td>77</td></tr>
<tr><td></td><td>Q3 – 2003</td><td>0</td><td>29</td><td>80</td></tr>
<tr><td></td><td>Q1 – 2004</td><td>0</td><td>30</td><td>82</td></tr>
<tr><td>NJ</td><td>Feb – 2003</td><td colspan="3">2</td></tr>
<tr><td></td><td>Q3 – 2003</td><td colspan="3">12</td></tr>
<tr><td></td><td>Q1 – 2004</td><td colspan="3">14</td></tr>
<tr><td>PA – PECO</td><td>Mar – 2003 (current)</td><td>8</td><td>12</td><td>6</td></tr>
<tr><td></td><td>Q3 – 2003</td><td>7</td><td>20</td><td>8</td></tr>
<tr><td></td><td>Q1 – 2004</td><td>28</td><td>18</td><td>9</td></tr>
<tr><td>TX – ERCOT</td><td>Apr – 2003 (current)</td><td>12</td><td colspan="2">48</td></tr>
<tr><td></td><td>Q3 – 2003</td><td>16</td><td colspan="2">51</td></tr>
<tr><td></td><td>Q1 – 2004</td><td>22</td><td colspan="2">54</td></tr>
</table>

IL — ComEd

- Not much new C&I switching activity is expected in the coming months due to the end of the springtime switching period, the increased use of long-term contracts due to more long-term certainty concerning CTC levels, and shopping saturation levels for some industrial classes.
- Beginning on July 1 Illinois marketers will finally be able to enroll customers using an electronic signature. This might encourage a small amount of residential shopping activity, although past residential bundled rate reductions still make it very difficult for mass marketers to offer any savings.

Maine – CMP

- Maine is going in the right direction with its six month instead of annual bid, and the potential of monthly tracking of prices for the medium and large users.
- The sixth month bids should marginally improve things for this sector, though there is little to be optimistic about for mass-market sector. One green retail offer ain't going to do much of anything quickly.

New Jersey

- A tale of two non-residential markets:
  - The Commercial and Industrial Energy Pricing (CIEP) segment will kick some butt, though it may take a month or three past the August opening to get most of the load moved to competition.
  - The FP market will see a slight increase riding on the coat tails of their CIEP brethren. In all, it is 2500 MW max that will migrate.
- Residential switching in larger numbers is not in foreseeable future. Let's see some opt-out aggregation rules promulgated before hanging our hat on that one.

Pennsylvania – PECO

- Ugh. An indication of the Pennsylvania doldrums was that one retailer salesman was moved from the Pennsylvania to the New Jersey office for the duration, and was glad to leave the quiet behind.
- The PECO residential Market Share Threshold (MST) did not consummate as no retailer could make an offer beating the 6.06 cent / kWh price-to-compare. The silver lining is that 100,000 customers that were to be auctioned off will now be added to the planned part two of the residential MST so retailers will bid on 375,000 customers. The bidding did come at a bad time, but that does not preclude the fall bid coming at a bad time either, but hope springs eternal. The commercial MST will be kicking-in soon.

Texas –ERCOT

- Reliant put in the latest PTB Fuel Factor Adjustment, its second and last for the year. If approved, the natural gas prices associated with the fuel factor will be:
  - First Choice TNMP $5.958 / MMBtu
  - Mutual Energy CPL / WTU $5.123 / MMBtu
  - TXU $5.31 / MMBtu
  - Reliant $6.10 / MMBtu
- At the end of June gas broke sharply lower with a 12 Month Strip, dropping 30 cents in to $5.4525 / MMBtu.
- Only the commodity gods know where prices will go from here, but for Reliant and First Choice, one could imagine locking in forwards and then selling hard.
- Harry Potter is not the only one in the Phoenix club, as Texas Commercial Energy announced new deals. Heck, when things like that happen, it looks good.

Switching Trends •

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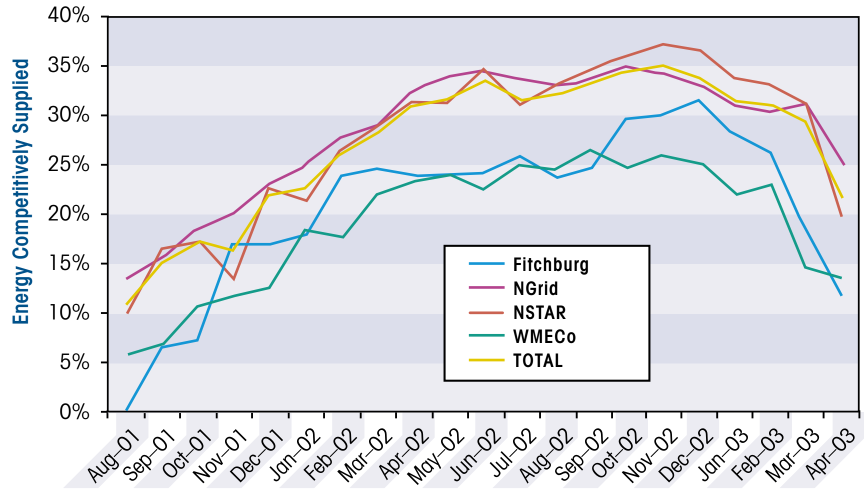
It does not look like switch rates will bounce back as quickly. HEFA chose Select Energy as their new preferred provider, but as Select's Gordon points out, his company must still go out and sign-up the individual customers. In addition, margins are still quite tight in the NSTAR market. While NGrid went out to bid during the brunt of gas price spikes, NSTAR apparently straddled the spike, procuring 50 percent of their obligation by early 2003, and procuring the rest after the NGrid solicitation and gas prices had subsided some. This would be a major window of opportunity for the NGrid market, except as pointed out, this market has been picked over pretty well.

In the longer term Massachusetts is looking pretty appealing. The DTE has a pending rule-making on how frequently default supply and prices should get set for the large customers. The inclination appears to be quarterly, if not monthly procurement. This would correlate default prices closer to market prices, something that many retailers have worked toward for a long time. Second, the second default service ruling 02-40-B means that post-transition default service costs will include:

- Procurement-related wholesale costs "(1) the design and implementation of the competitive bidding process, including the evaluation of supplier bids and contract negotiations; and (2) the ongoing administration and execution of contracts with suppliers, including accounting activities necessary to track payments made to suppliers."
- Direct retail costs. "(1) unrecovered bad debt, (2) complying with the Department's default service regulatory requirements, including required communications with its default service customers, and (3) compliance with RPS."

Massachusetts Non-Residential Customer Migration



Spotlight •

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assembled energy experts — Craig Goodman, President of the National Energy Marketers Association; Phil O'Connor, Vice President of Constellation NewEnergy, and Bill Kinneary, President of Total Gas and Electric — about retail utopia?

This month's Spotlight identifies the key features of a retailer-friendly market and discusses the political strategy that will be needed to make the retailer-friendly market a reality. It should be noted that policy utopia for retailers could be anything but for other market players — regulators, utilities, retailers, and customers — who all hold differing views on policy perfection. This issue, we focus squarely on retailer needs and do not attempt to balance viewpoints.

Wish List: Creating Retailer-Friendly Markets

√ Market-based utility pricing
√ Unbundling the utility bill
√ Fairly allocating payments from a single bill
√ Long-term certainty on stranded cost charges

Retailer Wish List

Market-Based Utility Pricing

Send price signals to the consumer or you will never see the real benefits of restructuring, say our energy experts. In support of market based pricing in New Jersey for large customers, but also speaking to the company's broader view of retail utopia, Constellation NewEnergy notes in a September 2002 Comment filing:

NewEnergy and others have stated repeatedly that ultimately the success of the competitive retail market will be a function of our ability to establish Basic Generation Service (BGS) default rates that accurately track, on a current basis, the cost of electric supply to end-use customers of all rate classes.

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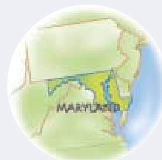
Market Based Rates, by State

Illinois

ComEd is allowed to pull its Rate 6L default service after December 2006 (although some of these rate class customers became ineligible in June 2003). Rate 6L is ComEd's capped-rate default service for customers 1 MW or larger.

Maryland



Baltimore Gas and Electric's Schedule P customers (1,500 kW and greater) were forced to either find competitive supply or pay a market passthrough as of July 2002.

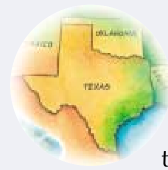
New Jersey

Commercial and Industrial Energy Pricing (CIEP) customers move off fixed price to the hourly pricing as of July 31 (see Switching Trends article on page 1 for more detail).

New York

Most New York utilities have market-based default service rates.

Texas



Non-Price-to-Beat customers (> 1 MW load) are not subject to regulated rates since market opening on January 1, 2002. The utility affiliate may decide what type of offer to make.

For Craig Goodman, president of the National Energy Marketer's Association (NEMA), these real time price signals should include load-shifting, distributed generation, and greater energy efficiency as well as the resulting environmental benefits. Goodman called the decisions by states such as Illinois, Maryland, New Jersey, New York and Texas to expose large commercial and industrial customers to market-based default rates as "necessary first steps." The adjacent sidebar shows states and utility territories that have moved customers off fixed default rates to market based pricing, all shining examples of electric choice without a safety net.

Our energy experts dissented on exposing smaller customers to market-based rates. Philip O'Connor, Vice President of Constellation NewEnergy, claimed that most retail electric mass markets were simply not mature enough. "In most places it's pretty clear that we haven't yet reached the point where the transactional costs of enrolling and serving the residential or small commercial customers are low enough for anybody but the local utility to serve these customers," he said.

O'Connor pointed out that the history of competition in network industries shows that it proceeds from the larger customers down towards the smaller customers. He did believe that bundled smaller customers would soon be paying a form of a market price, but it would not be an immediate market passthrough. Instead O'Connor thought that it would be a rate based on the multi-year forward contracts that the utility has been able to obtain in the wholesale market.

> *"Having the ability to buy what you want, from whom you want…is the best, most efficient, and lowest-cost form of consumer protection available."*
>
> *— Craig Goodman, President of the National Energy Marketers Association*

Goodman conceded that "during the transition period there is going to be a distinction between what are called 'core' and 'non-core' customers." During this period, safety nets will likely be kept in place for the core customers — which include residential and small commercial end users. However, Goodman dismissed the contention by some that smaller customers were not ready to shop. "I think consumers are smart," he said. "I think that they can make educated decisions."

He also argued that a truly competitive market was a form of consumer protection. "I truly believe," said Goodman, "that having the ability to buy what you want, from whom you want, in the amount you want, when you want it, is the best, most efficient, and lowest-cost form of consumer protection available."

Bill Kinneary, CEO of Total Gas and Electric, which competes in the mass markets in New York, New Jersey and Maryland, believes that smaller customers should be exposed to market-based rates as soon as possible. He compared the healthy switching activity in New York, where mass market customers are exposed to market-based rates, to the stagnant situation in New Jersey where smaller customers are still paying fixed rates.

Unbundle the Utility Bill

In some bundled utility rates, Goodman has found as many as 28 different competitive products services, technologies, and information services for which consumers are being charged monopoly prices." He contended that consumers are "buying stuff they don't even know they are buying. They are paying money for metering services they don't even know — that they are not even getting half the time."

Goodman said that there would have to be a two-step process to fix this problem. First, consumers must be

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> *If consumers really knew what was behind that utility bill, there would be a strong grass roots movement for more price competition.*
>
> *— Craig Goodman, President of the National Energy Marketers Association*

given itemized bills which identify the fully-allocated embedded costs of each of the products and services that they currently buy from the utility. Second, consumers must be allowed to shop for these unbundled products and services. "Anything that you can do to encourage consumers to shop for competitive services rather than pay monopoly prices is a service to consumers and a service to the economy," said Goodman.

O'Connor described the unbundling process in Illinois as having been "contentious and messy in various ways" but he argued that the ultimate outcome was a good one. He noted that it allowed retailers who wanted to compete for services such as metering "to do so based on embedded costs as opposed to some sort of calculation of incremental costs where there is an infinitesimal savings, if any, for the customer."

Kinneary, who was formerly Rate Manager for Brooklyn Union Gas before taking the helm of Total, is very familiar with the hidden charges in utility bundled rates. For example, he pointed out that many utilities have charges built into their rates for bad debt. When retail competition started and many marketers began taking on a big part of this nonpayment risk, most utilities did not reduce their delivery service charges and increase their commodity charges proportionately. "That's wrong and it makes no sense to me," he said.

Allocating Payments from A Single Bill

In restructured energy markets, billing comes in three flavors: 1) dual bill (supplier and utility separately bill the customer); 2) utility-consolidated (supplier charges listed on single utility bill); and 3) supplier consolidated (utility charges listed on single supplier bill). There are benefits to all three options, but in option two, suppliers want their money (and rightly so) and sometimes have a hard time collecting what they consider is fair.

Total's Kinneary considers the equitable allocation of payments from a consolidated invoice to be the most important issue for mass marketers, and will not compete again in New York utility service territories which do not fairly allocate payments from a single bill. "If a customer has a $200 bill and only pays $100, the utility gets $100 and I get nothing," he said.

> *Total Gas & Electric will not compete again in New York utility service territories which do not fairly allocate payments from a single bill.*
>
> *Bill Kinneary, CEO, Total Gas & Electric.*

Kinneary noted that the utility is even made whole for current charges before the marketer is even paid for past arrearages (note that New York announced on June 18th that it will be requiring proration of payments between the utility and marketers in September of this year — a very positive step).

Kinneary noted that the utilities do not share customer payment histories and while there are commercial sources for checking customer credit histories, these can be prohibitively expensive. This inability to cost-effectively pre-screen for bad payers, along with the utility-first payment allocation method, can saddle retailers with levels of bad debt that can make it impossible for them to offer savings.

Long-Term Certainty on Stranded Costs

"Purging uncertainty from retail markets is a key issue. The most important uncertainty has to do with stranded cost charges of various kinds that get in the way of multi-year arrangements," said NewEnergy's O'Connor.

O'Connor contrasted the different ways that Illinois and Michigan have dealt with this issue. In Illinois stakeholders and regulators were able to agree on an arrangement that allows for a multi-year calculation of stranded cost charges. "This permitted customers and providers to enter into arrangements longer than a year with the certainty as to what those transition charges would be during the course of those contracts," he said.

In Michigan, however, even though there currently are no stranded cost charges, the prospect that they will be reintroduced next year has made retailers reluctant to offer long-term contracts. O'Connor pointed out that this was a situation where retailers would be willing to accept some sort of stranded cost charge in exchange for long-term certainty. He is reasonably optimistic that Michigan regulators are finally beginning to realize that "this kind of uncertainty is really not good for anybody."

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> *The most important uncertainty [to be purged from retail markets is] stranded cost charges of various kinds that get in the way of multi-year arrangements.*
>
> *Philip O'Connor, Vice President, Constellation NewEnergy*

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Turning Wish List to Reality

REF also asked the three retail experts what political strategies would be needed to get their ideal market features adopted. The following describes the various strategies they advocate for lobbying utilities, state regulators, and federal officials. It also summarizes their assessments for the likely success of these efforts.

Get the Utilities on Board

All of our experts believed that a key part of any political strategy was getting utilities to realize that it was in their own best interests to make retail competition work. One approach is to show utilities how retailers can help them reduce their supply risks. "What utilities are trying to do," said O'Connor, "is to set reasonable boundaries and parameters for themselves which reduce their risk and put them in a better position as wire companies to deliver consistent earnings at a fair level." Goodman noted that marketers can help the utilities accomplish this by taking the risks and costs off their system.

Kinneary pointed to the ability of retail electric competition to discourage fuel switching as another selling point for utilities. "Orange and Rockland realizes that in the Northeast — the competition is not the marketers, it's propane and heating oil," he said. "And to the extent that they can beat heating oil and propane, why not have a marketer in there helping to get a better price?"

Work with Regulators

All the retail experts agreed that most of the market reforms will have to be accomplished at the state level. "Our entire organization has been premised on the fact that these things are going to have to be worked out at the state level," said Goodman. "We have no choice because that is where all the utilities are regulated. At the end of the day, the PUCs need to have tariff filings that allow competition or they don't allow competition," he said. "That's the reality of the situation."

Kinneary and O'Connor said that state regulators were well intentioned but needed to learn more about retailers' experience. "What we have found," said O'Connor, "is that where the commissioners already believe that competitive markets bring benefits, then it's a question of careful education so that they will weigh in on the side of reasonable policies." Of course, providing concrete examples of market successes and failures can help retailers make their case. Kinneary believes that the success of the O & R market has helped convince New York regulators to support a more equitable allocation of single bill payments.

Fill the Enron Vacuum

Before its much-publicized demise, Enron was an active campaigner for retailer interests and filling that vacuum has not been easy. "NEMA and its members have picked up a lot of the advocacy as there really is no one else out there to do this job at the grass roots level," said Goodman. "We do not have the resources of Enron or the utilities or their associations, so our workload has probably quintupled."

Looking Ahead

Formidable challenges of market reform aside, all of our experts are reasonably optimistic. Successful case studies can also make it easier for retailers to make their case. "Orange and Rockland is the example that we needed for a long time," said Kinneary. He sang the praises of O & R's "Switch and Save" program in which the utility actively encourages customers to switch, and most customers trust their utility. When dealing with skeptical utilities or regulators, he tells them: "Don't say these things can't work, they do work. Look at Orange and Rockland."

More Retailer Wish List Items

√ Performance-based utility rates
√ Continued ability to conduct telemarketing
√ Provider-of-Last-Resort certainty
√ FERC's Standard Market Design

Turning Retailer Wish List to Reality

√ Get the utilities on board
√ Work with regulators
√ Fill the Enron vacuum

The Last Word.

A regular REF feature is "The Last Word" in which industry veterans stick their necks out and make predictions concerning retail energy markets. If you want to try for 15 seconds of fame, send your pithy prediction (the more specific the better) to foresight@xenergy.com.

In 3 years, two-thirds of the C&I load in the U.S. will have competitive options available. Market and policy makers are getting over the California debacle and competitive choice for commercial and industrial customers will again begin expanding to more states and markets.
(Editor's Note: currently about half C&I load has choice)

—Philip O'Connor, Vice President, Constellation NewEnergy

Look for mass market resurgence across all New York utility territories in 2004. The New York Public Service Commission's decision to provide marketers with pro-rated payment from the utility consolidated bill is the single step it will take to open up both gas and electric markets in the state.

—Bill Kinneary, President, Total Gas & Electric

By 2013 robust competition will follow from a successful effort to get government employees out of fixing prices. What the public has not realized yet in the some 21 states open to choice is that prices are set by state government employees who choose a low price for the incumbent supplier so that no one wants to waste money marketing in that arena.

—George Spencer, Editor, *Restructuring Today*

The next capacity crisis that occurs in states that have been deregulated will demonstrate the value of competitive markets. There will be a number of large players who have contracted forward for their electricity supply and contracted around any capacity constraints. The rest of the population will face substantial capacity issues.

—Rich Silkman, Competitive Energy Services

The retail market design in New Jersey for large C&I customers — if the NJ BPU expands it to other C&I customers as currently envisioned — will create a vibrant competitive retail market by the end of 2004. This newly competitive market will provide these C&I customers choice, innovative products and cost efficiencies, which will ultimately benefit New Jersey's economy.

—Anonymous retailer

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3 Burlington Woods
Burlington, MA 01803
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