the practical guide to success under deregulation

Energy Competition Strategy Report™

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Texas' progress in electric choice ranks No. 1 in U.S.

The Center for the Advancement of Energy Markets (CAEM) recently ranked Texas No. 1 in the nation for its progress on energy restructuring. Pennsylvania dropped to the No. 2 spot and Maine followed in third place in CAEM's 2002 Retail Energy Deregulation (RED) Index.

How did Texas' 2001 score of 31 shoot up to 69 in 2002? And how does it compare to perennial winner, Pennsylvania, whose score of 67 didn't budge from 2001 to 2002?

The RED Index gives Texas high marks for protecting customers by requiring utility companies to separate their competitive and regulated businesses, for adopting statewide, uniform business practices, and for establishing a bilateral wholesale market.

Nat Treadway, RED Index project director, says that with only a two-point difference between Texas and Pennsylvania, Texas came out on top simply because it scored better on the attributes that CAEM likes than did Pennsylvania. **(See Figure 1.)** For instance, Texas wins attributes on uniform business practices (5), wholesale market model (9), stranded cost calculation (10), stranded cost implementation (11), and interconnection to the grid (19). Pennsylvania wins attributes on percent of eligible customers (2), default provider (14), default provider rates (16), network pricing (18), and regulatory convergence (20).

"CAEM likes Texas' bilateral wholesale market model, while Pennsylvania used both bilateral and pool arrangements," Treadway explains. "CAEM prefers Pennsylvania's 'any company' approach to default provider, while Texas uses 'affiliate assignment.' And CAEM likes Texas' consensus approach to business practices, while Pennsylvania scored less with a regional approach."

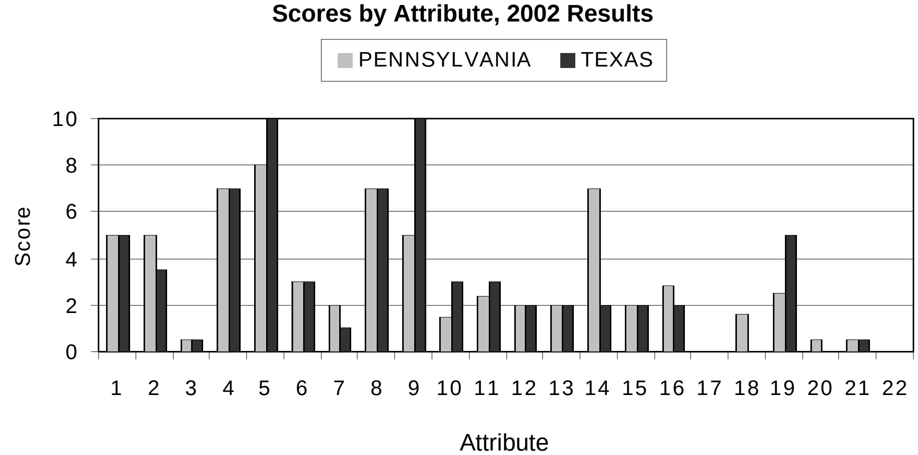
'Tweaking' to do

The Electric Reliability Council of Texas (ERCOT), which manages the electric grid for about 85% of the state, also handles a number of administrative and managerial aspects of customer choice, such as customer switching and billing. **Tom Noel**, ERCOT president and chief executive officer, attributes the No. 1 score to the fact that ERCOT is the first of 10 North American reliability councils "to actually have both a centralized retail and centralized wholesale system."

ECSR caught up with Noel recently and asked a few questions. Here's what he says:

• **What obstacles did ERCOT face and how did you overcome them?** "I don't want to be facetious, but we haven't overcome them all yet. Basically, we had to educate consumers to understand that with a separated wholesale and retail operation, buying electricity is no longer a one-

Figure 1: Comparison of RED Index Scores by Attribute, 2002 Results



Source: RED Index 2002 by the Center for the Advancement of Energy Markets.

stop shop.

"We've handled well over 1 million transactions -- where people have either switched suppliers or moved in or out of different premises. With 5.5 million 'easy IDs' -- homes, refineries, or chemical plants -- and with more than a million having changed partners, that's pretty noteworthy. I hasten to point out that many of those people went to an affiliate REP [retail energy provider], not necessarily a totally new provider [competitive REP].

• **How would you characterize your progress?** "There have been some customer disappointments. Under the old system and in best conditions, you could get hooked up in a day. Because there are more people involved now, even if we followed the system as it was designed, we can't do it in a day. Instead we've developed a 'work around,' where the utility can hook up a customer very quickly and do the paperwork after hookup. That [new procedure] has created some billing problems that we're still trying to sort through. However, billing problems are less than 5% of the total."

• **Did you have any surprises?** "We knew there would be congestion, but thought it would be relatively modest. Our rules allowed us to uplift congestion costs, at the same rate, to the entire market. That turned out to be a bad idea. Some people did some economically inefficient things, which created congestion, because they paid no penalty, or at least they paid in proportion to the amount of market they controlled. After about a month of that, we decided to go another way: We set up a trigger point that if we passed it, we'd move to direct assignment of congestion costs. On February 15, we passed the trigger point, and now if you create congestion you pay for it. That keeps the game a whole lot more honest."

• **Do you have suggestions or recommendations for others?** We tried to learn from everybody out there -- from California, Australia, New Zealand, and the U.K. We did it as well as we absolutely know how to do it. Yet, we still find there were things we didn't think of. But whoever comes behind us, they'll see our way and make adjustments to it. To some extent we're pioneers.

"There's still some fine-tuning and tweaking as we go along," Noel concludes.

More insights into Texas choice

A day after finishing his panel -- "Retail at the Brink: Has Texas Found the Holy Grail?" -- at the Western State Regulators Conference, CAEM Chief Executive Officer **Ken Malloy** says he's "very primed for Texas."

Why? Malloy says that he asked the panelists, "Three years from now will Texas be working well enough to inspire confidence in retail?" They basically said you'll see that within a year to 18 months. "I tend to be an optimist. But what stunned me was how confident they all were that we'd see results in Texas in a soon-enough period that people will have to reevaluate the obituary that's written for retail competition."

One element of Texas' restructuring plan is somewhat worrisome, Malloy explains. Although the C&I market (customers who use more than one megawatt) is wide open to competition, the residential market is quite different. Malloy explains: "On Day 1, all residential customers were transferred from the utility to its affiliate retail electric provider (REP). The REP must charge the consumer a regulated price for five years, which is not capped and floats with market conditions.

"In addition, the affiliate REP must get rid of 40% of those customers within two years or pay a fine ($150 per customer) for the customers they didn't lose," he continues. "However, that 40% is offset by any customers they get in another service territory. For example, if Reliant aggressively markets in another utility service territory and attracts 10% of that utility's customers plus loses 30% of their customers, they hit the 40%."

Malloy believes that rule promotes enthusiasm for the REP to get rid of some of the residential customers in its service territory. It also promotes enthusiasm for that REP to go into other utility service territories and market aggressively to residential customers.

One concern, expressed by one of the roundtable panelists, was that on Day 1 the affiliate REPs had 100% of the customers, without any acquisition costs. And that's a "tremendous advantage" over all other competitive marketers, Malloy contends. "Yes, they're under some pressure to get rid of 40% of their customers," Malloy says, "But the fact is that on Day 1 they paid zero acquisition costs for 100% customers. That's a great beginning, but there's a dark side to it, too. The concern is whether it gave the affiliate REP too big a market head start over the other suppliers.

"Under the old system, utilities have no incentive to encourage marketers to come in to win customers. Here [in Texas] there's an incentive to cooperate with the marketers, and I think that's what's going to make the difference," Malloy concludes.

Two other aspects of the Texas approach are worth noting, which offer insights into the success potential of other markets:

• **One regulatory authority.** Both ERCOT and all players in Texas are regulated by one regulatory authority, the Public Utility Commission of Texas (PUCT), Malloy points out. In states where FERC regulates the RTO and the state regulates retail distribution companies, often there's tension. "The PUCT, frankly, has done a spectacular job in integrating the wholesale and retail market to make sure it works effectively together," Malloy states. "There's horizontal and vertical integration that you don't see in any other state.

"The downside to that, some say, is that Texas is irrelevant to the rest of the country, because no other jurisdiction can replicate the Texas model," Malloy continues. "To their credit, the other panelists said that it certainly differentiates Texas, but it points out how much more difficult to achieve retail competition will be in other states. However, if this model [Texas] is successful, it will point to the need for much closer cooperation between the states and Feds and also the states on a horizontal level."

• **Switching.** "In all other states, each distribution company is responsible for switching customers," Malloy points out. In Texas, however, ERCOT has that authority, which brings some good news and bad news. On the good side, Malloy says, there's one standard, one authority, and one organization with an incentive to do it right. On the bad side, many, many more customers have to be switched by one entity. "ERCOT admits they're not where they want to be in terms of systems problems. While they've made tremendous progress, they're not quite there," Malloy says. ✸

Competition moves ahead, but at a slower pace

According to **Ken Malloy**, president and CEO of the Center for the Advancement of Energy Markets (CAEM), the most "significant factoid" in CAEM's 2002 Retail Energy Deregulation (RED) Index was that the national average moved from 15 in 2001 to 17 in 2002.

The RED Index answers the question: "How are we doing with the transition to retail energy competition?" It measures a state's or country's restructuring progress based on 22 attributes, which are "market characteristics that determine the nature of competition and regulation in retail energy markets."

In the last three years, the average was nine in 2000, 15 in 2001, and 17 in 2002.

"While the trajectory slowed down, the point is we saw forward progress," Malloy reports. "And in the year we've just come through, that surprised me. I was prepared for actual retrenchment in retail competition. The movement toward retail competition has clearly suffered major setbacks, but there was still some progress made last year -- even in what is regarded as the worst year we have seen."

But, is the worst over? Malloy frankly tells *ECSR,* "I realize I underestimated the impact of Enron -- thinking it was a single company and we'd move on. But when you look at the stock reevaluations of the last month or so, the worst is not over. We didn't realize that many of the things Enron was doing were as pervasive as they were within the industry and that it would shatter Wall Street's confidence in companies that were in similar market positions. So it really wasn't a single company undergoing a major setback. It was more a whole set of practices within an industry that were suffering the setback and that would reverberate very powerfully through the industry."

It is interesting to note, Malloy comments, that those participating in the recent Western State Regulators Conference seem to mirror what's happening in the rest of the country.

"Those who were always skeptical of [energy restructuring] now have evidence of double-digit price increases, which, they believe, are a result of dysfunctional markets," Malloy comments. "They're willing to concede mistakes were made in how those markets were put together, so they regard it as an unfair test of competition. But their solution is 'until we know what we're doing, we shouldn't be doing this.'

Those who once were mildly inclined toward favoring competition, Malloy reports, now have shut down into a wait-and-see mode.

He cites what he terms "an excellent point" made by one conference attendee. "A couple of years ago we were looking at California, Pennsylvania, and other states moving forward with restructuring," Malloy says, repeating the attendee's comment. "'Now, you sit on a panel with six other people and the best you can do is say wait another 18 months for Texas and then we'll show you that retail competition can work.'

"The fact is we haven't shown in definite fashion that it's working anywhere the way competition advocates said it would five or six years ago. That was a good point. And that was coming from a commissioner who was inclined to favor competition, but felt that we're in a very hard, uphill battle now.

"Frankly, this has to be a time when the competitive movement licks its wounds and develops a more cohesive strategy," Malloy adds. "There's no real document that represents the strategy of the advocates for competition. It's a tough time that calls for extraordinary leadership in the competitive movement."

Editor's note: For more information about or to order the 2002 RED Index, go to www.caem.org.

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