

## U.S. power industry facing long, difficult journey to competition Shangri-La

KATHLEEN DAVIS, ASSOCIATE EDITOR

The writing is on the wall: Texas is the hands-down deregulation leader. No one is disputing that. In fact, consultants XENERGY recently sent out a release declaring Texas the "king of retail electric competition" in the U.S.

However, being at the top of the pile doesn't necessarily make you perfect.

"I make a joke when I give speeches that Texas is first in its class, but that it's a pretty stupid class," stated Ken Malloy, CEO of the Center for the Advancement of Energy Markets (CAEM), a Washington, D.C.-based, non-profit think tank specializing in policies for an effective transition between the monopoly and choice models.

"If my son came home from school today and said, 'Dad, I got the best mark in the class, but it was only a 69,' I'd have mixed feelings: impressed because, potentially—among a bunch of stupid people—he was the smartest, but also disappointed because it wasn't a higher grade," he added, pointing out that this is where Texas currently sits: at a 69 on CAEM's Retail Energy Deregulation (RED) Index 100-point scale.

"Texas is really trying to make it work," stated Tom Michelman, senior professional with XENERGY and one of the contacts for the "Texas is king" statement that XENERGY recently released. "That's one thing that really sets the state apart. People there really believe in competition; they have bought in to the concept that an open market is best in the long run."

"And they are doing everything they can to push it forward," he added.

### Pass or fail?

CAEM's RED Index measures the progress states have made in moving from the monopoly model of public utility regulation to the competitive model. The index is based on 22 attributes that CAEM has identified as the foundation for an effective transition to competition.

Texas was at the top of the U.S. list at 69. Pennsylvania, Maine and New York also garnered passing grades (60 or above), but no one could touch England, which came in at 83.

"There's a quantum difference between Texas and England," Malloy stated. "But not even England is perfect. No one is. I can identify three or four things that even England could do to move up into the 90s."

Malloy pointed out, however, that the U.S. shouldn't panic over the numbers just yet. England's been at it for more than 10 years, with more than one version, and they are only now reaching into the 80s on the RED Index.

Besides, Malloy finds great potential in the Lone Star state.

"Texas is the best among a bunch of mediocre implementations," Malloy said. "And, it's a good starting point, but, clearly, they've got to push—as I believe they are—to refine and move up the scale."

"At this point, I'd clarify and say Texas will be the king," added Michelman. "They aren't there yet. They are still going through a few growing pains, but by the end of 2002 they are likely to have more load than any other state switched. But, they are still having technical problems, a few glitches."

"This certainly doesn't knock them out of the game, however," he added.

Malloy agreed. He believes that Texas will move into the 80s over the next three to four years. Currently, England's switching numbers have pulled them above the pack. And the Texas model is so new that those numbers are still very minuscule.

Malloy runs a comparison of the English and Texas models, which have similarities in the area of default service. Most states' default services simply provide that the utilities continue to serve remaining customers at a "price to beat rate" of one kind or another. CAEM labels this at a minus 10 on the attribute that measures it on the RED Index, which is one way that states at the bottom of the scale like Nebraska and Louisiana can end up in negative numbers.

Texas and England, on the other hand, transferred all residential and commercial customers to a retailer immediately. Malloy labeled the English model superior because most of the corporate entities that the customers were transferred to were not utility affiliates. The same cannot be said for Texas.

"I think this makes Texas' model a little less desirable than England's model because, again, that affiliate relationship creates a barrier to a competitive market," Malloy added.

In fact, there are two barriers at work with affiliates in Texas: a consumer-based one and a regulatory one. First, consumers will, most often, stick to a name they are familiar with and pass on other options.

Malloy said, "Even I—wearing my consumer hat one day while looking as gas marketers—thought about switching to an affiliate because I was swayed by the 'brand name.' It was like being struck by a two-by-four in the head. I thought, 'My God, I'm an expert in this field, and even I'm being lured into the seduction.'"

"That affiliate relationship, as a marketing strategy, is insidious."

The second problem with Texas has to do with the regulation of these affiliates. CAEM likes the rigid rules governing them, but finds that they don't often go far enough. Even with the 40 percent rule that Texas has (that the affiliate must get rid of 40 percent of their assigned customers within three or four years), the affiliate can still retain 60 percent, and, therefore, market dominance.

"I'm impressed overall with Texas and ERCOT," Michelman stated. "Overall, they seem to be doing things right, putting a lot of thought into the problems that do arise, learning from other ISOs."

"If they haven't managed to do things perfect the first time, that's not the end of the world, as long as they are committed to seeing it through," he added.

Malloy points to Georgia's foray into gas deregulation as the perfect model to work from in order to quickly transition to retail competition.

"Georgia did something that is so breathtaking and under-reported," Malloy said. "But, it's also very controversial."

The Georgia legislature gave retail gas customers roughly a year to switch to a competitive supplier. If the customer didn't switch within the year, he was assigned to a competitive supplier. According to Malloy, Georgia created an incentive for a lot of marketers to come in because they knew that all of the customers would be mandated into the competitive market, so there was a guaranteed large market.

Malloy also pointed out that Georgia's model kept consumers from being passive

below what its marginal cost is, there's a problem. It distorts resources. It distorts customers' consumption patterns," he stated. "Sure, I'd love to get a Mercedes for \$5,000, but that doesn't mean that the government forcing that price down to me is the best thing for society."

Malloy believes that organization is the key to putting retail electric competition on the right track. He also suggests that states make commercial and industrial customers switch first, before moving on to residential.

But, he said the first and foremost problem is solving current dilemmas—the little things keeping leaders like Texas in the "low pass" range. "Frankly, in all honesty, we haven't worked out the kinks yet," he added. And he's worried that the key players in this equation are too distracted right now.

"We could weather Calif. We could weather price volatility. Initially, I even thought we could even weather Enron," Malloy stated. "What is concerning me now, is that companies who favored competitive markets are so caught up in all the aftermath of Enron, that their eye is no longer on the ball the way it once was."

However, he does envision a working model on track and symbolic to the industry in five to 10 years, with 20 years a round number for getting unopened states moving. Understanding that this seems like forever to most people, Malloy points out that the telecom and gas industries have both taken decades to get to the places they are right now.

Michelman estimated that most states currently working at competition will have real working markets in a decade. He feels that 40 percent of states will have overall competition, 30 percent will have competition for commercial and industrial customers and the remaining 30 percent will continue to "hold their foot against the door" in matters of retail electric competition.

"In some areas, you're going to have holdouts for a long, long time: 20 years, even 30," he added.

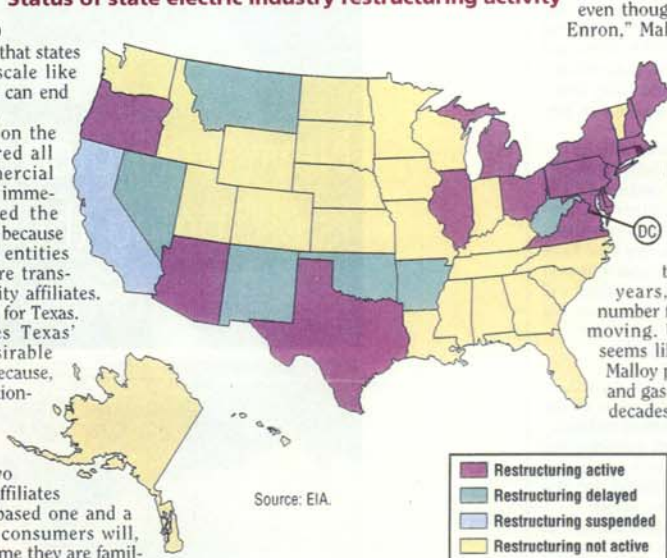
However, Michelman, like Malloy, can't see the whole industry going backward on the issue, no matter how much the consumer may wish it to be so. "[Deregulation] is out of the bottle; there's no amount of shoving that will stuff it back in at this point. It will certainly evolve as it goes along, but it's not going to become extinct."

"Yes, it's going to take a long time, and it's not going to be pretty. And it's going to be difficult, hard work. And, frankly, we need a more objective, long-haul view of restructuring. It's not going to happen tomorrow. It's not going to be smooth. It's not going to be simple. It's not going to be clean. It's not going to be uncontroversial," he said.

"There's no question to me, however, that my children and grandchildren will someday be able to choose a competitive electric supplier wherever they end up in the U.S.," he added. "That's inevitable." **ELP**

Malloy can be reached via e-mail at [kmalloy@caem.org](mailto:kmalloy@caem.org). Michelman can be reached at [tmichelman@xenergy.com](mailto:tmichelman@xenergy.com) or at 781-273-5700.

### Status of state electric industry restructuring activity



about retail choice. In fact, when the year was up, 80 percent had switched.

"80 percent," Malloy reiterated. "Think about that. When we talk about electric switching, we get excited when someone gets above five."

### The future

Malloy is resigned that the states that have yet to enact retail competition regulation will not do so for a number of years. He does believe, however, that the states that have moved forward will continue to make refinements. But to really rev up deregulation in the U.S., there's going to have to be a shining example to point to.

"We're going to need a Texas or a PJM to be more aggressive in implementing a competitive model, and then for results to happen. Benefits will have to be demonstrated as well," he said.

"There are bright parts of competition in the U.S., like Texas," Michelman added. "But, along with those, there are also many places that are absolutely stagnant. It's not uniform in any way, shape or form."

Malloy believes there may be continued resistance to retail competition in states with traditionally low power prices—where competition is currently stagnant, as Michelman pointed out—because prices may increase. Malloy, however, doesn't see this as a horrible reaction.

"Prices increasing, from an economic perspective, is a good thing. If those customers are getting energy priced today