

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Proceeding on Motion of the Commission
as to the Rates, Charges, Rules and Regulations
of New York State Electric & Gas Corporation
for Electric Service.

CASE 05-E-1222

**DIRECT TESTIMONY OF L. LYNNE
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Dated: February 6, 2006

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INTRODUCTION

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- Q. Please state your names and business addresses.
- A. My name is L. Lynne Kiesling. My business address is 3228 Andersen Hall, 2001 Sheridan Road, Northwestern University, Evanston, IL 60208.
- My name is Andrew N. Kleit. My business address is 507 Walker Building, The Pennsylvania State University, University Park, PA 16802-5013.
- Q. Dr. Kiesling, please summarize your educational and professional background.
- A. I earned a bachelor's degree in economics from Miami University in 1987. I received a doctorate in economics from Northwestern University in 1993.
- From 1992 to 1997 I was an Assistant Professor of Economics at the College of William and Mary in Virginia. I taught classes in introductory microeconomics, European economic history, research and writing in economics, and history of economic thought. I also taught state and local public finance in the graduate Thomas Jefferson Program in Public Policy.
- From 1997 to 2000 I was a Manager at Pricewaterhouse Coopers LLP, specializing in economic analysis of international tax issues. From 2000 to

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1 2003 I was Director of Economic Policy at Reason Foundation, where I
2 authored or co-authored six policy analyses of electricity restructuring and
3 other energy policy issues, and several other articles and commentaries
4 relating to electricity restructuring in the U.S. and abroad.

5
6 Since 2000 I have been a Senior Lecturer of Economics at Northwestern
7 University. I have taught undergraduate courses in the economics of energy
8 markets, environmental economics, European economic history, and history
9 of economic thought. Since 2003 I have also been Director of the Center for
10 Applied Energy Research, International Foundation for Research in
11 Experimental Economics, and a Research Scholar at the Interdisciplinary
12 Center for Economic Science at George Mason University.

13
14 I also have extensive experience dealing with electricity restructuring issues in
15 a regulatory context. In addition to my policy-related writing and research, I
16 have participated in a Technical Conference at the Federal Energy Regulatory
17 Commission, and I have submitted testimony and public comments in both
18 federal and state proceedings. Much of my published research has addressed
19 questions of electricity market design and regulatory policy. My *curriculum*
20 *vitae* and a list of my publications are attached to this statement as Exhibit ____
21 (DEP-1).

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2 Q. Dr. Kleit, summarize your educational and professional background.

3

4 A. I earned a bachelor's degree in mathematics and political science from
5 Middlebury College in 1982. I received a doctorate in economics from Yale
6 University in 1987.

7

8 From 1987 to 1991 I was a staff economist at the Federal Trade Commission
9 in Washington, D.C., and I worked on a variety of antitrust and regulatory
10 issues. From 1989 to 1991 I was Economic Advisor to the Director, Bureau
11 of Competition at the FTC, where I advised the FTC's chief antitrust attorney
12 on the antitrust issues facing the agency. From 1991 to 1992 I was Senior
13 Economic Adviser to the Director for Investigation and Research, Consumer
14 and Corporate Affairs Canada, Ottawa/Hull, Canada. In this role I was
15 assigned to review all significant antitrust and regulatory matters for the chief
16 antitrust law enforcement officer of the Canadian government.

17

18 From 1992 to 1998 I was assistant and associate professor at Louisiana State
19 University in Baton Rouge. I taught classes in introductory (honors),
20 intermediate, and graduate microeconomics, undergraduate and graduate
21 industrial organization, and undergraduate environmental economics.

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Since 1998 I have been associate professor of energy, environmental and mineral economics, and professor of energy and environmental economics at the Pennsylvania State University in University Park. I have taught classes in energy and mineral economics, benefit-cost analysis and financial risk management.

I am the author of over 70 articles and the author or editor of 5 books, including publications in the Journal of Law and Economics, Review of Economics and Statistics, The Texas Law Review, Antitrust Bulletin, Journal of Regulatory Economics, Resources and Energy Economics, Energy Studies Review, and The Energy Journal. A great deal of this work has concerned electricity markets.

I also have extensive experience dealing with electricity market issues in a regulatory context. In 2002-4, I was a consultant for the Pennsylvania Office of the Attorney General on market power in electricity capacity markets. In December 2004, I spoke to FERC commissioners about barriers to entry in electricity markets, and in February 2005 I spoke in a FERC staff seminar about market definition in electricity markets. In 2005 I submitted comments to the FERC on behalf of Direct Energy with respect to the *Exelon/PSEG*

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1 merger. My *curriculum vitae* and a list of my publications are attached to this
2 statement as Exhibit ____ (DEP-2).

3

4 Q. What is the purpose of your testimony?

5

6 A. The purpose of our testimony is to:

7 (1) describe the benefits of competitive retail electricity markets for
8 consumers;

9 (2) explain why NYSEG's proposal is inconsistent with the Commission's
10 objective of promoting robust competitive retail electricity markets;
11 and

12 (3) recommend how NYSEG's proposal should be restructured to promote
13 the development of robust competitive retail electricity markets.

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EXECUTIVE SUMMARY

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Q. Please summarize your testimony.

A. The Commission is absolutely correct to advance competitive retail electricity markets as the right vehicle to deliver the best value to households and businesses in New York. In light of this goal, the Commission should reject the proposal by NYSEG as inconsistent with the need for an expeditious transition from regulation to competition. In fact, the proposals put forward by NYSEG in this proceeding would not foster a competitive retail electricity market for the following three reasons. First, NYSEG’s proposals relating to the structure of utility default service and delivery rates would not result in robust retail electricity markets. Second, NYSEG’s proposal would create complex rules for consumers and energy service companies (ESCOs), which would significantly raise the search costs for consumers and significantly raise the marketing and sales costs to ESCOs. This, in turn, would deter customers from exploring competitive solutions for their electricity needs and deter ESCOs from entering the market to serve these consumers. Finally, there is substantial reason to believe that NYSEG’s proposals would provide NYSEG with powerful financial incentives to retain, and even expand, its existing default supply business. For these reasons, the NYSEG proposal should be rejected.

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2 We suggest a simplified default retail access program with one delivery rate
3 and one default service rate for each customer class. We also explain why the
4 Commission must restructure NYSEG's program rules and financial
5 incentives comprehensively, or there is a significant risk that a robust
6 competitive retail electricity market will not develop.

7

8 Q. Please provide an overview of the structure of your testimony.

9

10 A. In Section I of our testimony, we explain why retail customers in NYSEG's
11 historic service area will be best served by the development of competitive
12 retail electricity markets. This section will also describe three basic
13 requirements for any retail access program to be effective in fostering the
14 development of robust competitive retail electricity markets. In Section II we
15 summarize NYSEG's retail access plan and explain why that plan is
16 inconsistent with each of these three fundamental requirements and, as a
17 result, is not likely to attain the Commission's policy objectives of providing
18 consumers with robust competitive retail electricity markets. Section III
19 contains our recommendations for a retail access plan for NYSEG. Finally, in
20 Section IV, we provide some concluding comments.

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1 Q. On whose behalf are you submitting this testimony?

2

3 A. We are submitting this testimony on behalf of Direct Energy Services, LLC
4 (“Direct Energy”). Direct Energy is a subsidiary of Centrica plc, a leading
5 provider of energy and other energy-related services to over 18 million
6 households worldwide, with annual revenues of \$31 billion, \$17 billion in
7 market capitalization, and over 38,000 employees. In North America, Direct
8 Energy has over 3 million gas and electricity customers. Recently, Direct
9 Energy announced plans to enter the New York retail energy markets to
10 supply natural gas and electricity to residential and business customers.¹

11

12 **I. The Competitive Process**

13

14 **A. The Benefits of Competition in Retail Electricity**

15

16 Q. Please explain why you believe that consumers in NYSEG’s service territory
17 will be best served by the development of competitive markets for retail
18 energy supply.

19

¹ *Restructuring Today*, January 26, 2006 at 1 (“Direct Energy is about to bite into the Big Apple. The firm has ‘people on the ground’ and is about to launch a multi-media campaign in the Empire State, Senior Vice President Badar Kahn told RT in an interview yesterday.”).

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1 A. Competition creates incentives for all market participants to allocate valuable
2 resources efficiently in the short run, and to elicit the mix of products and
3 services that best meets customer needs over time. Retail electricity
4 competition empowers customers to make choices that fit their budgets, their
5 lifestyles, and their ability/desire to bear price risk.

6
7 This relationship can be expressed in both theoretical and practical terms. The
8 Commission has articulated these benefits accurately and clearly. We agree
9 with the Commission’s August 24, 2004 Policy Statement that:

10 “[R]obust competition, where feasible, should be our long-range
11 vision. In the best of all worlds, all retail functions (except delivery)
12 now provided by utilities would be competitive. To that end, all
13 potentially competitive utility functions will be opened to competition,
14 and . . . regulated utilities should be replaced by ESCOs when markets
15 become workably competitive. In determining when markets are
16 becoming workably competitive, and are therefore prepared for more
17 aggressive migration strategies, we intend to consider a number of
18 factors”²

19
20 We also wish to point out that the Commission’s Policy Statement is fully
21 consistent with the policy of the United States government, as laid out in the
22 Energy Policy Act of 2005:

23 “It is the policy of the United States that time-based pricing and other
24 forms of demand response, whereby electricity customers are provided

² Case 00-M-0504 – *Proceeding on Motion of the Commission Regarding Provider of Last Resort Responsibilities, the Role of Utilities in Competitive Energy Markets and Fostering Development of Retail Competitive Opportunities*, Statement of Policy on Further Steps Toward Competition in Retail Energy Markets, slip op. at 17 (issued and effective August 24, 2004) (hereinafter “Statement of Policy”).

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1 with electricity price signals and the ability to benefit by responding to
2 them, shall be encouraged, the deployment of such technology and
3 devices that enable electricity customers to participate in such pricing
4 and demand response systems shall be facilitated, and unnecessary
5 barriers to demand response participation in energy, capacity and
6 ancillary service markets shall be eliminated.”³
7
8

9 Q. How will robust retail competition benefit consumers?

10

11 A. Competitive markets provide powerful incentives for all market participants to
12 act in ways that benefit consumers. The incentives for innovation and
13 efficiency that result from this process have been successful in powering our
14 Nation’s economy for over 200 years and have given American consumers a
15 standard of living that is the envy of the world.

16

17 In the short run, which is defined as the period when capital assets are fixed,
18 competitive markets reward suppliers for maximizing output from existing
19 facilities while at the same time deterring producers from operating
20 uneconomic facilities. These markets also provide consumers with accurate
21 signals of the true costs of producing the goods and services they are
22 interested in buying. These price signals permit consumers to take advantage
23 of low cost goods and services to the extent that they are available and to
24 protect themselves from excessive prices by switching to other substitutes

³ Section 1252(f) of the Energy Policy Act of 2005, Public Law No. 109-58.

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1 when market conditions cause any particular good or service to become
2 uneconomic. This process is frequently referred to as “static” efficiency.

3
4 In the long run, when investments in new capital assets are possible,
5 competitive markets provide even greater incentives for efficiency, while also
6 providing consumers with further protections from excessive prices. Unlike
7 franchised distribution utilities, competitive suppliers face the very harsh
8 reality that they will be forced out of business unless they can provide their
9 customers with the goods and services they want at prices that are competitive
10 with those offered by such suppliers’ rivals. Thus, competition rewards
11 businesses that excel at supplying customers with what they want at low cost,
12 while punishing those that do not.

13
14 Most of the value creation that arises from retail competition comes from new
15 investment and innovation to produce new products and services. As
16 technology changes over time, robust retail competition is the means through
17 which the product differentiation and cost reduction benefits of these new
18 technologies will be available for customers, and will simultaneously reflect
19 and shape their preferences.⁴ Moreover, while competitive markets reward

⁴ For an elaboration on this argument, see Stephen C. Littlechild, “Competition in Retail Electricity Supply,” Cambridge University Department of Applied Economics Working Paper 0227, 2002.

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1 successful competitors with higher profits, those higher profits also provide
2 other businesses with powerful incentives to invest their capital to compete
3 with those successful competitors. Over time, this new entry tends to reduce
4 prices and, hence, profits to normal levels, to the benefit of consumers
5 generally. This second type of efficiency is frequently referred to as
6 “dynamic” efficiency.

7

8 Q. Can traditional cost-based regulation provide the incentives required to
9 provide these sorts of benefits to NYSEG’s customers?

10

11 A. No. Economists and regulators have long understood that cost-based
12 regulation is at most a second-best alternative to robust competition.
13 Competition allows market prices to provide valuable signals that enable
14 producers and consumers to allocate resources. Price transparency and the
15 reflection of both customer preferences and production costs in prices greatly
16 enhance efficiency. On the other hand, cost of service ratemaking regulation
17 disconnects the prices individual customers pay from the marginal cost of
18 providing them electricity service.

19

20 Such regulated rates do not fluctuate to reflect changes in actual marginal
21 costs. Inefficient energy consumption and production is the logical

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1 consequence of this disconnect, which means that regulated rates do not
2 satisfy either static efficiency conditions or dynamic efficiency conditions that
3 induce optimal capital investment in the electricity system.

4
5 Moreover, cost of service ratemaking regulation requires the Commission to
6 make inherently subjective decisions concerning capital asset decisions, cost
7 allocation and cost functionalization that are unlikely to lead to economically
8 efficient outcomes. Cost of service ratemaking regulation cannot possibly
9 capture the rich and complex web of information required to move toward
10 “efficient” pricing for electricity supply arrangements in either the short run or
11 the long run.

12
13 Additionally, the administrative process to implement cost of service
14 ratemaking regulation – including this testimony – imposes substantial cost on
15 the Commission, the utility and other parties. Avoiding these types of costs in
16 the future should be an important goal of the Commission. This point is
17 particularly true in light of the previously noted fact that even when all of
18 these costs are incurred, cost of service ratemaking regulation is inherently
19 incapable of providing producers and consumers with the incentives required
20 to achieve an efficient outcome in either the static or the dynamic sense.

21

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1 Q Can you provide any concrete examples of the benefits consumers have
2 received as a result of a shift from regulation to competition?

3

4 A. Yes. What telephone customer in 1970 (about the time of the beginning of
5 restructuring in telephone competition) would have been able to articulate a
6 preference for mobile cellular internet access? Competition provided the
7 driving force that motivated entrepreneurs to make the investments required to
8 create new value for customers in ways that consumers had never imagined.

9

10 Thinking about retail electricity competition this way reinforces the point that
11 competition and markets are not solely about lowest possible price, but are
12 best thought about more broadly as a process for creating the greatest possible
13 value for consumers. Many telecommunications customers today pay higher
14 bills than under regulation, but get much more for their money.

15

16 Similarly, many people spend more per year on airline tickets than they did in
17 the 1970s, but fly more and get more value from the service.

18

19 Q. Can you provide any specific examples of how competitive retail electricity
20 markets can benefit consumers in NYSEG's service territory?

21

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1 A. While we believe that the greatest benefits to consumers from competitive
2 retail markets will come in ways that cannot be foreseen at this time, the
3 foreseeable benefits of such competition are also substantial. In electric
4 power, one of the most important dimensions upon which customers have
5 different preferences that could be met by competitive ESCOs offering
6 different products is price risk. Customers have varying degrees to which
7 they are willing to bear price risk, depending on their income, the share of
8 electricity cost in their budget, their facility with enabling technology, as well
9 as other factors. Product differentiation that enables customers to choose how
10 much price risk to accept is a likely outcome of retail competition that benefits
11 customers.

12
13 Choosing the level of price risk to accept is something customers must do
14 daily in even the most basic economic decisions. Some customers will be
15 interested in a contract in which they can choose to bear some price risk.
16 Other customers may prefer a fixed-price contract, where they bear no short-
17 term price risk. Retail competition enhances the variety of alternatives open to
18 customers. Offering consumers multiple, competitive choices would make
19 consumers better off by allowing them to choose the product that best fits
20 their needs and by bolstering overall system reliability, as price would provide

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1 incentives to reduce demand and increase output in the right places and at the
2 right time.

3
4 Critics of this “Portfolio of Contract Choices” vision worry that customers
5 may be confused over their options. This concern is misplaced. Successful
6 retail providers will offer product attributes that consumers want to purchase
7 and marketing and education materials that support those choices. For
8 instance, if consumers are highly concerned about price volatility, they could
9 choose fixed priced contracts that insure against price risk. If consumers are
10 interested in green power, they could purchase renewable products.
11 Consumers who may be interested in keeping their electricity bills equal over
12 time could choose to pay their accounts through levelized billing. Some
13 consumers may even choose to face variable prices, with higher prices during
14 peak hours and the lowest possible price during off peak hours; this choice is
15 likely to reduce consumption in those peak hours with higher prices. The
16 effects of shifting demand away from peak would reduce their use in those
17 hours, and the overall effect on prices in *all* hours could lead to lower
18 electricity bills for all customers, including those who do not shift their usage.

19

20 Q. Do you have any examples where competitive markets are working for larger
21 customers?

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1

2 A. According to data published on the Commission's own website, as of
3 December of 2005 fully three-quarters of the load of New York State's
4 industrial and commercial customers (generally those customers with
5 demands over 2 MW) is now being served by competitive ESCOs.

6

7 Additionally, as shown in the following table, the experience in other states
8 demonstrates that competitive markets currently exist for large commercial
9 customers on hourly pricing.

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Switching Levels In Other States

Region/State/Utility	Size Threshold for Customers on Hourly Priced Service	Number of Customers Switched	Load Switched	# of Marketers Actively Seeking Customers
ERCOT	Above 1 MW	All customers are on deregulated rates regardless of provider. As of December 31, 2005, 2,580 customers (72.7%) were with providers other than the incumbent.	7,123 MW (73.4%)	More than 15 ⁵
Maryland	Above 600 kW	1,106 (78.6%) http://www.psc.state.md.us/psc/electric/enrollmentrpt.htm	2,487 MW (87.4%)	16 ⁶
Duquesne Light, PA	Above 300 kW	785 (92%)		8 ⁷
New Jersey	1,250 kW	1,267 (64.68%)	2,530 (83.9%) – end of December	At least 12 ⁸

Based on the Commission's own experience, as well as the experience in other states, the Commission may wish (at some point in the not too distant future) to consider relieving utilities of their obligation to provide default service to large electric customers.

⁵ Switching data provided by ERCOT. http://www.ercot.com/mktinfo/retail/trans_rpt/Number_Premises_Switched_EOM_2005_12.ppt

Marketer information supplied by Texas PUC and cross checked against EIA 861 database. <http://www.powertochoose.org/business/compareoffers.asp>

⁶ Maryland switching data and supplier information provided by the MD PSC and reflects end of December 2005. <http://www.psc.state.md.us/psc/electric/enrollmentrpt.htm>

⁷ Switching data from Duquesne Light Company Fourth Compliance Filing, Docket Number 00032071, Exhibit B. Supplier number from Kevin Moody, Pennsylvania council.

⁸ Switching data and active supplier list provided by the New Jersey BPU at the following sites http://www.bgs-auction.com/documents/CIEP_Switching_1205.xls and <http://www.bpu.state.nj.us/home/supplierlist.shtml>.

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1 Q. What about small retail electric consumers?

2

3 A. Experience in electricity markets in Texas, and in other countries like England
4 and Norway, demonstrates that there is strong demand for competitive retail
5 electricity supply and that consumers are interested in getting a product that
6 meets their needs.

7

8 Q. Will competitive retail electricity markets benefit even those that do not
9 choose an ESCO?

10

11 A. Even customers who do not choose a competitive ESCO benefit from the
12 decisions of others who do, because even though wholesale and retail markets
13 are jurisdictionally split for regulatory purposes, wholesale and retail markets
14 are inextricably economically intertwined. While wholesale electricity
15 markets already exist in New York and surrounding regions, they cannot
16 evolve fully without valuable customer preference information being
17 transmitted into them through market-responsive pricing, including time of
18 use pricing for some customers. Retail competition, in which a variety of
19 suppliers compete through an assortment of products and services and manage
20 the specific needs of their customers, is the best way to facilitate this
21 evolution. Without retail price and product choice signals, wholesale

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1 generation, pricing, and investment decisions are likely to be less efficient
2 because they are unlikely to match customer values with costs, except by
3 accident. Value creation in the electricity industry derives from the value that
4 customers place on the products and services available to them, not from the
5 cost of the assets used to provide those services. Communicating information
6 about that value from retail markets into wholesale markets via retail
7 competition and demand participation in wholesale markets is crucial to a
8 healthy industry that benefits customers.

9

10 Customer choice and demand response can also reduce society's overall costs
11 in the other ways. Investment in generation and transmission assets is
12 determined by the level of peak demand. The more extensive market-based
13 pricing programs becomes, the longer the time will become between costly
14 and unpopular transmission and generation investments. Unfortunately, as we
15 have learned, cost of service ratemaking regulation, which is based solely on
16 cost recovery and profit as a rate of return on assets, will not create the right
17 incentives to minimize total costs.

18

19 Market-based pricing, by integrating wholesale and retail markets, will allow
20 consumer demand response. In the short-term, this capability will be a
21 powerful reliability tool as customers curtail use when they recognize higher

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1 prices, rather than simply continuing to consume under the “false” price signal
2 of regulated, fixed, average rates. Hence, market-based pricing leads to lower
3 long-run average cost because of avoided investment. Customer load
4 reduction can also provide long-term reliability benefits, by reducing the
5 likelihood of transmission bottlenecks and insufficient generation leading to
6 blackouts.⁹

7

8 Q. Are you suggesting that the Commission should mandate time of use pricing
9 for small customers?

10

11 A. No. Because both the costs and benefits of installing time of use meters on
12 residential accounts remains in flux, we believe the Commission should
13 permit competition and market forces to determine whether the benefits of
14 time-of-use metering justify its costs.

15

16 **B. Designing Retail Rates to Promote Robust Competition**

17 Q. What should the utility’s role be in competitive retail electric markets?

18

⁹ Eric Hirst, “Reliability Benefits of Price-Responsive Demand,” *IEEE Power Engineering Review* 22, (November 2002), pp. 16-21; Stephen Rassenti, Vernon Smith, and Bart Wilson, “Controlling Market Power and Price Spikes in Electricity Markets: Demand-Side Bidding.” *Proceedings of the National Academy of Science* 100 (2003): pp. 2998-3003.

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1 A. The Commission’s ultimate vision is for commodity services to be provided
2 by ESCOs and for the utilities to focus on providing unbundled “wires and
3 pipes” delivery services. It is our understanding that the Commission has
4 determined that in the near term, utilities should continue to provide default
5 commodity service as competitive markets develop. At some point in the
6 future, however, the Commission has made clear that utilities should exit the
7 commodity sales function and concentrate instead on providing the unbundled
8 “wires and pipes” delivery services and related services required to support
9 robust competitive retail electricity markets.

10

11 Q. When will markets be sufficiently robust to permit utilities to exit the
12 commodity function?

13

14 A. Defining when markets are “competitive” is often difficult. A competitive
15 market generally leads to prices equal to average production costs in the long
16 run, and the process by which that outcome is achieved is one of rivalry.
17 There are several different ways to evaluate the degree of competitiveness in a
18 market.

19

20 The first approach simply looks at the number of firms in a market. This view
21 is based on the argument that a large number of firms indicates competition,

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1 while only one firm (a monopoly) indicates no competition. One problem
2 with this approach is that there is no theoretical economic basis on which to
3 determine how many firms a market needs to achieve a competitive outcome.
4 In some markets, competitive outcomes occur with only two firms; other
5 markets with two firms may result in collusion and monopoly-level prices.
6 Furthermore, the definition of the relevant market makes it even more difficult
7 to determine how many competing firms there are in a given market. One
8 reason why markets with two firms can yield competitive outcomes is that in
9 such markets, those two firms have significant rivalry. Thus when looking at
10 the number of competing firms in a market, the important factor to consider is
11 not just the number of competitors, but the degree to which they exhibit
12 rivalry. One way to measure rivalry in a market is changes in market share
13 over time.

14
15 A second approach relies on the direct measurement of the difference between
16 prices and average cost. In competitive markets, long run prices should equal
17 average costs, and firms competing in the market earn normal rates of return;
18 in the absence of competition, prices exceed average costs and firms earn
19 supranormal profits. There are serious problems with this approach. One
20 problem is that the normal rate of return result applies only in the “long run”
21 and we simply do not know how long the economic concept of the long run is

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1 in terms of actual time. Short run profits do happen in competitive markets all
2 the time (as do short run losses) and their existence at any point in time is
3 absolutely no evidence of collusion or a lack of competition. A second
4 problem is that calculating profit margins requires detailed knowledge of the
5 costs (and risks) facing the firm that may be difficult to obtain.

6
7 A third approach is to evaluate how open a market is to new competitors. Are
8 there entry barriers that prevent new firms from competing with the firms
9 already in the market? If a market has only one firm, but faces potential
10 competition from new entrants (i.e., it is “contestable”), it may still charge a
11 competitive price in order to deter those entrants. Looking at the
12 contestability of the market focuses on the kind of dynamic, rivalrous
13 interactions that lead to long-run competitive outcomes. If for example we
14 had a contestable market in which only one firm or a small group of colluding
15 firms were charging high monopoly-like prices, we would expect new entrants
16 to come in and compete away the high prices. Thus the crucial evaluation to
17 perform here to measure the competitiveness of a market is to estimate
18 existing entry barriers. This evaluation will provide information about the
19 degree of competitiveness of a market that is superior to looking at the
20 number of firms or the market shares, although those data will also be useful

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1 because they can indicate changes over time that are consistent with rivalry
2 and contestability.

3

4 Q. This analysis suggests that utilities will ultimately be required to exit the
5 commodity function. What is the rationale for this policy?

6 A. In theory, the Commission might permit utilities to compete on an unregulated
7 basis with other suppliers of commodity services even after the development
8 of competitive retail markets. In practice, however, there are several good
9 reasons for the Commission not to allow this. First, as the Federal Energy
10 Regulatory Commission (“FERC”) recognized in its Order No. 888, utilities
11 that control the delivery facilities required to establish markets for commodity
12 services and are also allowed to compete in those markets themselves have
13 both the incentive and the opportunity to discriminate in favor of their own
14 commodity services and against other providers of similar services:

15

16 “[O]wners, controllers and operators of monopoly transmission
17 facilities that also own power generation facilities have the
18 incentive to engage, and have engaged, in unduly
19 discriminatory practices in the provision of transmission
20 services by denying to third parties transmission services that
21 are comparable to the transmission services that they are
22 providing, or are capable of providing, for their own power
23 sales and purchases. These practices drive up the price of
24 electricity and hurt consumers. Furthermore, the incentive to

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1 engage in such practices is increasing significantly as
2 competitive pressures grow in the industry.¹⁰”
3

4 Second, to the extent that a utility combines both regulated and unregulated
5 activities in a single entity, the difficulties inherent in cost of service
6 ratemaking regulation will be greatly enhanced by the further need to
7 apportion revenues and expenses between regulated and unregulated activities
8 without the guidance provided by competition and market forces. Utilities
9 will have both the incentive and the ability to seek to persuade the
10 Commission and/or the courts to permit them to recover a portion of their
11 costs of supplying commodity services from their captive delivery service
12 customers. If this occurs, those delivery service customers will be
13 inappropriately overcharged. This combination would obscure the
14 transparency of commodity pricing, and therefore runs contrary to the
15 Commission’s ultimate objective of achieving competitive retail electricity
16 markets.

17
18 Third, to the extent that a utility is successful in recovering a portion of the
19 costs of its competitive commodity services from consumers of its regulated
20 delivery services, that utility will have an inappropriate advantage over

¹⁰ *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Order No. 888 61 FR 21,540, 21,566 (May 10, 1996)

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1 competing suppliers of commodity services, who generally will not be able to
2 recover any of their costs from consumers of regulated delivery services. This
3 inappropriate competitive advantage will interfere with the proper operation
4 of competition and market forces and could permit the utility to continue to
5 supply commodity services even if its true costs of providing such service
6 would render its service non-competitive if offered on a stand-alone basis.
7 While this result would be incompatible with the proper operation of
8 competitive markets at any time, it is particularly troublesome during the
9 transition from regulation to robust competition, since other potential
10 suppliers of the unregulated service may be deterred from making the
11 investments required to enter those unregulated markets if they believe that
12 the incumbent utility will be able to use this cost savings to reduce prices for
13 unregulated services below market levels.

14
15 Once competitive retail electricity markets emerge, all of these concerns can
16 be avoided by adopting a simple rule requiring utilities to exit the commodity
17 sales function. While it is also possible for the Commission to adopt broad
18 rules prohibiting discrimination and cost-shifting, the costs of establishing and
19 enforcing these rules are likely to be very high as long as utilities have strong
20 financial incentives to engage in such prohibited conduct. Thus, such
21 “behavioral” remedies have important deficiencies when compared to

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1 “structural” or “financial” remedies that would eliminate the incentives that
2 give rise to the conduct that the Commission wishes to deter the utility from
3 taking.

4
5 Q. Please explain the difference among “behavioral”, “financial”, and
6 “structural” remedies.

7 A. Behavioral remedies involve the establishment of rules prohibiting conduct
8 deemed to be inappropriate, which may be coupled (explicitly or implicitly)
9 with penalties for non-compliance, that are enforced by governmental action.
10 Structural remedies involve changing the market in ways that eliminate
11 incentives to engage in inappropriate conduct. As we see from antitrust
12 matters in general and the *Microsoft* case (*U.S. v. Microsoft*, 253 F.3d 34
13 (2001)), in particular, “behavioral” remedies are inherently problematic.^{11,12}
14 A review of the remedies issue in the *Microsoft* case is helpful in
15 understanding the challenges inherent in any behavioral remedy.

16

¹¹ See Lopatka and Page, Devising a Microsoft Remedy That Serves Consumers, 9 Geo. Mason L. Rev. 691 (2001). For other discussions of this problem in the antitrust context, see, for example, Elzinga, The Antimerger Law: Pyrrhic Victories?, Journal of Law & Economics 12 43 (1969), and Coate and Kleit, The Art of the Deal: The Merger Settlement Process at the Federal Trade Commission, Southern Economics Journal. 70 977 (2004).

¹² We note that neither the authors of this testimony nor Direct Energy take any position here about the underlying merits of the antitrust complaints against Microsoft.

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1 In simplified terms, Microsoft was alleged to have “biased” its software in
2 order to favor Microsoft’s web browser “Internet Explorer.” The court
3 ultimately accepted this allegation, but found it very difficult to construct
4 effective relief for this problem.

5
6 It would have been possible, for example, to separate corporate control of
7 Microsoft’s operating system from corporate control of its software programs,
8 in what would constitute a “structural” remedy. It was generally believed,
9 however, that there were important cost advantages from vertical integration
10 in this industry. Thus, structural vertical separation was not seen as viable. In
11 the case of retail restructuring in the electric power industry, progress toward
12 competition has occurred, among other reasons, because, as discussed below,
13 there are no apparent advantages associated with vertical integration between
14 electricity delivery and commodity service. Thus, the factors that preclude the
15 use of a structural remedy in the Microsoft case do not exist in NYSEG’s
16 current situation.

17
18 Conceptually, it would have been possible to give Microsoft financial
19 incentives to encourage customers to use its rivals’ software. We will refer to
20 such a remedy as a “financial remedy.” Such a remedy, however, would face
21 two problems. First, it was not clear that an antitrust court would be in a

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1 position to supervise the imposition of such incentives. Second, it was by no
2 means clear that rivals' software was or would be preferable to Microsoft's.
3 Once again the parallel situation does not arise in this matter for two reasons.
4 First, unlike the Court in the Microsoft matter, the Commission has a
5 fundamental duty to engage in continuing oversight of NYSEG. Second, the
6 Commission has determined in the course of that oversight that all distribution
7 utilities, including NYSEG, should ultimately exit the commodity function..

8
9 This situation left the antitrust court in the Microsoft case with only
10 behavioral remedies. A behavioral remedy instructs the relevant firm to
11 behave in a manner consistent with what the regulatory authority desires, such
12 as "write software that does not discriminate against Microsoft's rivals."
13 Behavioral remedies rely on low enforcement costs and information costs to
14 ensure that the firm adheres to the conduct guidelines. We suggest, however,
15 that the costs of enforcement and information are rarely low enough to make
16 behavioral remedies effective protections for consumers and potential
17 competitors. Behavioral remedies in the presence of high information and
18 enforcement costs give the regulated firm latitude to engage in conduct that
19 stifles competition by perpetuating entry barriers.

20

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1 Any effort to engage in behavioral remedies faces informational and
2 enforcement challenges that are now well-presented in the economic
3 literature. In particular, such remedies are difficult because the relevant firm
4 has better information about its own costs than the regulator, and is able to
5 move faster in various dimensions than the regulator. This information
6 asymmetry increases the challenge, and the cost, of enforcing regulatory
7 remedies, because the firm may be able to continue to behave in ways
8 inconsistent with the regulator’s desired outcome, and the regulator and the
9 customer may be unable to monitor the firm’s behavior. Thus behavioral
10 remedies can result in unintended, potentially negative, outcomes. In
11 addition, the regulated firm is able to take advantage of any uncertainties (or,
12 in economic jargon, “contractual incompleteness”) in any behavioral order
13 from a regulatory authority; given the difficulty of specifying completely all
14 possible outcomes *ex ante*, the firm may end up with discretion that would
15 allow it to reduce or eliminate any benefits consumers might gain through a
16 behavioral remedy.¹³

17
18 Thus, we suggest that the Commission should avoid behavioral remedies in
19 favor of structural and financial remedies, when such remedies are feasible.

¹³ Laffont and Tirole, *A Theory of Incentives in Procurement and Regulation*. Cambridge, Massachusetts: MIT Press (1993), p. 13.

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1 In this matter, such remedies are both available and consistent with
2 Commission policy.

3

4 Q. Would the structural approach of requiring the utility to exit the commodity
5 sales function reduce the administrative costs both to the Commission and to
6 parties involved in New York retail electricity markets?

7

8 A. Yes. To do otherwise, and to allow the incumbent utility to compete at retail,
9 would create long-term responsibilities for the Commission. What may be an
10 appropriate cost accounting of regulated costs today may not be appropriate
11 tomorrow. With a dynamic electricity industry, the rules needed to regulate
12 such a relationship may well change over time, and change quickly. This, in
13 turn, increases the threat to a viable retail electricity market from
14 inappropriate subsidy through regulation.

15

16 Thus, allowing the incumbent utility to provide retail service in a fully
17 competitive retail electricity market imposes a continuing burden on the
18 Commission. It requires continued regulatory oversight to referee between
19 the incumbent utility and ESCOs when disputes and other conflicts occur,
20 which they undoubtedly will. Unfortunately, in such a context the incumbent
21 utility, with its regulatory advocates supported by the utility's rate base, would

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1 have an important advantage with respect to other retail providers, whose
2 regulatory activities must be funded directly from the firms' commercial
3 activities.

4
5 Moreover, the administrative burdens on the Commission may be further
6 increased if the utility encounters financial difficulties as a result of its
7 commitments to provide commodity service (particularly fixed-price
8 commodity service) that jeopardize its ability to continue to provide regulated
9 delivery services for which there are few effective substitutes. As occurred in
10 the infamous Savings and Loan collapse,¹⁴ utilities may have incentives to
11 take inappropriate risks in the knowledge that much of their downside risk is
12 covered by regulation. In these circumstances, the Commission may find
13 itself under political pressure to aid the utilities financial situation in the
14 interest of promoting service reliability. In this regard, it is instructive to note
15 that as recently as 2002, NYSEG itself proposed that the Commission should
16 compensate it for historic losses on commodity sales incurred by its gas
17 operations.¹⁵

¹⁴ See, for example, Cebenoyan, Cooperman, and Register, Firm Efficiency and the Regulatory Closure of S&Ls: An Empirical Investigation 75:3 The Review of Economics and Statistics, (2003) 540.

¹⁵ CASE 01-G-1668 - *Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Gas Service*, Order Establishing Rates, slip op. at 3 (issued and effective November 20, 2002) ("Second, NYSEG sought to recover losses

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1

2 Q. How do you respond to the contention that competition and consumer choice
3 will be harmed if utilities are prevented from competing as suppliers of
4 commodity services?

5

6 A. This contention is based on the erroneous assumption that utilities and their
7 ESCO affiliates are each independent businesses that compete with each other
8 as well as with other suppliers of commodity services. In reality, however, all
9 competition between utilities and their ESCO affiliates has already been
10 eliminated by the fact that each of these entities is a wholly-owned subsidiary
11 of a common ultimate parent entity. The United States Supreme Court has
12 recognized that such affiliates are in fact a single integrated “enterprise” and,
13 consequently, cannot be found guilty of conspiracy with each other to restrain
14 competition.¹⁶ Because all competition has already been eliminated between a
15 utility and its ESCO affiliates by virtue of their common ownership, excluding
16 utilities from markets that are also served by their ESCO affiliates will not
17 harm competition by reducing the number of independent firms competing to
18 serve that market. Instead, such a requirement will promote competition by

resulting from below-cost commodity sales to its customers, which the company has estimated as \$36.9 million for the year ending September 30, 2002, the final scheduled year of the 1998 plan.”).

¹⁶ *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 770 (1984) (“[T]he coordinated activity of a parent and its wholly-owned subsidiary must be viewed as that of a single enterprise for purposes of section 1 of the Sherman Act.”).

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1 ensuring that no competitor is able to engage in cross-subsidization at the
2 expense of captive utility ratepayers.

3
4 The only other way that competition could be harmed by limiting utilities to
5 the delivery function would be if those utilities had some unique competitive
6 advantage in providing commodity services that could not be readily
7 transferred to its affiliates and, consequently, would be lost if the utility were
8 precluded from providing such commodity services to consumers. As
9 previously noted, however, there does not appear to be any evidence that
10 suggest that any cost advantages are available through vertical integration
11 between distribution and retail services. We are unaware of any evidence that
12 utilities have any such unique, non-transferable competitive advantage with
13 respect to retail commodity sales. Although the Commission has required
14 New York utilities to provide unbundled retail delivery services for more than
15 five years, to the best of our knowledge no utility has ever claimed that the
16 separation of its commodity and delivery functions has increased its total costs
17 of service by eliminating economies of integration between these two
18 functions. As a result, there is no reason to believe that utilities in New York
19 have any unique cost advantage over other suppliers of commodity services.

20

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1 Q. Would achieving the Commission goal preclude the use of the utilities' brand
2 names?

3

4 A. Not at all. Utilities would still be free to compete with their brand names
5 through their non-regulated affiliated ESCOs, as they do now. Thus, if they
6 desire, residential consumers will still be able to obtain commodity services
7 from this familiar source.

8

9 Q. What principles should the Commission follow when designing retail rates
10 during the transition from regulation to competition?

11 A. In order to move forward on the transition from regulation to the robust
12 competitive markets envisioned by the Commission in its Statement of Policy,
13 the Commission should follow three fundamental principles in setting
14 NYSEG's retail rates:

15 1. Utilities should be required to establish a single delivery rate to apply
16 to all deliveries for all customers in any rate class, without regard to
17 the source from which that customer obtains its commodity supply;

18 2. Utilities should provide each customer with a single, transparent
19 "default" commodity service offering; and

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1 3. Utilities should be precluded from adopting rate designs that provide
2 them with incentives to deter their customers from switching to
3 competitive commodity suppliers.

4
5 Q. Please explain why you believe that utilities should be required to adopt a
6 single delivery rate for all customers in any rate class, without regard to the
7 source from which that customer obtains its commodity supply.

8
9 A. The basic rationale for this rule is simple. The source of any consumer's
10 commodity supply does not affect the costs to the distribution utility of
11 delivering electricity to that consumer. Thus, the price of that delivery should
12 not be a function of that consumer's retail choice.

13
14 In addition, a single delivery rate makes it easy for consumers to compare
15 competing offers for commodity service on an apples-to-apples basis. This
16 consistency is particularly important in the case of small customers
17 (residential and small commercial), who generally lack the access to expert
18 industry consultants required to analyze complex utility offerings.

19
20 Further, in order for consumers to act on the incentives for economic
21 efficiency provided by the competitive market processes described above, it is

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1 vitally important that those price signals be transmitted accurately to
2 consumers. To the extent that a utility is allowed to apply a different delivery
3 rate to its own commodity service than it applies to commodity service
4 provided by ESCOs, these market mechanisms will be distorted.

5
6 Q. Please explain why you recommend that utilities be limited to providing each
7 customer with a single “default” commodity service offering.

8
9 A. During the transition from regulation to competition, it is our understanding
10 that the Commission has determined to allow the utilities to continue to
11 provide commodity supply.¹⁷ This transitional role allows the Commission to
12 know that all consumers will have an electricity supply option while the
13 Commission analyzes whether or not the competitive retail electricity markets
14 have developed to the point where they alone are capable of meeting
15 consumer needs.

16
17 But if the Commission is to succeed in its goal of fostering a robust
18 competitive electricity market, it is vital that the Commission limit the role of

¹⁷ Statement of Policy, at pp 17-18 (“To that end, all potentially competitive utility functions will be opened to competition, and, subject to the requirements of the Public Service Law and Transportation Corporation Law, regulated utilities should be replaced by ESCOs when markets become workably competitive.”) (footnote omitted).

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1 utilities as suppliers of commodity services to the minimum extent possible.
2 Given this constraint, the utility should be limited to offering a single,
3 transparent default service offering to any customer.

4

5 Q. What do you mean when you say that the utility default commodity service
6 rate should be transparent?

7

8 A. Transparency means that the utility default service price must be based either
9 on an established public index or on prices actually paid by the utility to
10 purchase wholesale commodity services on a forward basis. The problems
11 that inevitably arise when forecasts or market quotes are substituted for actual
12 transaction prices are described later in our testimony. The utility default
13 commodity service should be fully transparent to promote competition and
14 customer choice.

15

16 Q. Should utility default service rates be fixed, and if so, for what time period?

17

18 A. Given that New York is working through its transition to a competitive retail
19 electricity market, it is not unreasonable for the utility default service rate to
20 protect small customers from short-term spot changes in energy prices. But
21 the proper utility default service rate must also recognize that price signals are

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1 critical for well-functioning markets and that consumers can respond to price
2 signals. Given these goals, we recommend that NYSEG establish monthly
3 fixed prices for small customer default commodity service. Monthly fixed
4 price default service ensures that small customers will encounter no
5 unnecessary obstacles to switching at any time during the year. In order for
6 the transition to robust competition to occur, ESCOs must have an on-going
7 opportunity to market their products to consumers and consumers must be free
8 to switch to a competitive ESCO without any unreasonable restrictions, such
9 as exit fees or enrollment periods. Restrictions on small customer switching
10 are not necessary under a monthly fixed price default service regime, as the
11 utility knows that it will not be harmed financially if a consumer switches at
12 the next billing cycle because the utility will not have any committed forward
13 obligations; in other words, this default service model ensures that the utility
14 will not be left “holding the bag.”

15

16 Q. In your view, would this provide small customers with adequate protection
17 from market price fluctuations?

18

19 A. Yes. As experience from other markets demonstrates, small customers would
20 have several competing options from ESCOs to manage their price risk.
21 Moreover, small customers desiring more (or less) protection from market

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1 price fluctuations would be free to contract for such service from ESCOs.
2 Small customers desiring to avoid fluctuations in the level of their bills would
3 also have the ability to elect budget billing.

4
5 Moreover, this monthly pricing would also tend to reduce the overall prices
6 paid by small customers choosing to stay with the NYSEG default service rate
7 by eliminating the need to pay any premium to NYSEG to cover the risk of
8 committing to supply those customers at a fixed price for two years. This
9 pricing would also provide consumers the assurance that the cost of shaping
10 energy supplies to their class load curve would be determined by competitive
11 markets rather than by the provisions of NYSEG's tariff.

12
13 Q. Earlier you mentioned that electricity consumers, even households, do
14 respond to price signals. What evidence do you have to validate this issue?

15
16 A. Many studies confirm that residential customers will in fact respond to price
17 signals for their electricity service.

18
19 In September 2004, the Government Accountability Office (GAO) issued a
20 study demonstrating that active demand participation does exist, through both
21 market-based retail pricing and reliability-driven programs, and is crucial for

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1 enhancing the efficiency of electric power markets, as well as for improving
2 reliability.¹⁸ The report surveys the extensive literature on the costs and
3 benefits of double-sided markets where supply and demand can actively
4 participate in the market. For example, it highlights the \$1.5 million in
5 savings to consumers under the New York ISO’s demand bidding program in
6 the summer of 2001 alone, as well as savings of from \$38 to 58 million to
7 both customers and utilities in 2001 due to other NYISO demand-based
8 reliability programs.

9

10 This study also provides extensive background information on retail pricing
11 plans for small customers that shown demand response programs to be very
12 popular and successful, including one conducted by Gulf Power of Florida.
13 For example, one residential Gulf Power customer saved \$600, more than
14 one-third of his annual power bill, by responding to price signals and shifting
15 activities to off-peak hours.¹⁹ The GAO study also highlighted and analyzed
16 the three main obstacles to achieving the benefits of retail choice: state
17 regulations protecting customers from price fluctuations, the lack of installed
18 enabling technology, and a lack of customer awareness of the benefits of retail
19 choice.

¹⁸ “Electricity Markets: Customers Could Benefit from Demand Programs, but Challenges Remain,” GAO-04-844; available at <http://www.gao.gov/cgi-bin/getrpt?GAO-04-844>.

¹⁹ Ibid., p. 24.

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In discussing the urge to protect customers from price volatility, the report notes that:

“The appeal of seeming to insulate retail consumers from wholesale market fluctuations may be compelling, but most experts agree that the lack of significant demand response can actually lead to higher and more volatile prices.²⁰”

A set of recent studies from Rutgers University provides additional evidence for the value of active demand and dynamic pricing.²¹ These studies surveyed existing literature on demand response and found evidence that customers of all sizes do respond to dynamic prices. In particular, one study evaluates the effect of dynamic pricing on wholesale power prices in the PJM wholesale market. They found that even a small increase in the amount of power on real-time contracts reduces peak wholesale prices by more than it increases off-peak wholesale prices, leading to an overall reduction in average wholesale prices for the entire market.

Further evidence supporting the idea that residential customers desire retail electric choice and dynamic pricing comes from recent demonstrations of residential demand response from Illinois and California. The Energy Smart

²⁰ GAO, *ibid.*, p. 19.
²¹ “Assessment of Customer Response to Real-Time Pricing, Task 1: Literature Search”, June 2005, and “Assessment of Customer Response to Real-Time Pricing, Task 2: Wholesale Market Modeling of New Jersey and PJM,” September, 2005, Center for Energy, Economic, and Environmental Policy, Edward J. Bloustein School of Planning and Public Policy, Rutgers University.

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1 Pricing Plan (ESPP) in Illinois relies on a simple 24-hour advance notification
2 (by phone, email, or website) of price changes, and installation of a simple
3 interval meter.²² ESPP is the largest residential hourly pricing project in the
4 U.S., with 750 participating households in 2003 and over 1,000 households in
5 2004. In the first year of the program (2003), customers saved an average of
6 19.6 percent on their energy bills. They generally joined the program
7 expecting to save \$10/month on average, and were not disappointed. Their
8 cumulative savings over the two years has been 11 percent, exceeding their
9 stated expectations of 10 percent savings. Surveys also indicate that the
10 participants found the price information timely, and that with this small
11 inducement to save money on their energy bill by making small behavioral
12 modifications, they actually became more aware of their energy use overall,
13 not only their use in the hours that had higher prices. Participants also said
14 that their personal contributions toward reduced energy use and improving the
15 environment by participating in this plan were important to them.

16

²² Further information about the ESPP is available at <http://www.energycooperative.org/energy-smart-pricing-plan.php>. Summary reports on the 2003 and 2004 results of the project are available at <http://www.energycooperative.org/reports.php>.

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1 Although 2003 and 2004 were both mild summers, participants did respond in
2 the few hours that prices rose.²³ Most customers responded by increasing the
3 temperature on their air conditioners or shifting their laundry time to off-peak
4 hours. The econometric analysis of the results showed a price elasticity of
5 demand²⁴ in those hours, at the margin, of -0.042 in 2003 and -0.08 percent in
6 2004. In other words, when price rose by 100 percent, participants reduced
7 their electricity use by 4.2 percent and 8.0 percent, respectively.²⁵ For
8 residential electricity customers this is a healthy response, particularly given
9 the lack of severe weather conditions. These reductions in use are reductions
10 at the margin, a margin that can often see prices go up by more than 100
11 percent in peak hours on hot days. Although the elasticity number may sound
12 low, because it represents demand reductions at the margin and at the right
13 time, it implies that price variability can take strain off of the system and
14 contribute to grid stability and service reliability in those hours. It also
15 demonstrates that residential customers can and will change their behavior in
16 response to price signals, and the survey results indicate that they like being
17 able to do so. This result, in turn, implies there is great potential to allowing a

²³ In Northern Illinois, 2004 was the coolest summer since 1992, and the fourth coolest summer in 25 years, with daytime temperatures never exceeding 90 degrees. Evaluation of the 2004 Energy-Smart Pricing Plan, Final Report. Summit Blue Consulting, March 2005, pp. 16-17.

²⁴ Price elasticity of demand is a normalized measure of the responsiveness of quantity demanded to price, where such elasticity equals (the change in quantity divided by the change in price) times (market price divided by market quantity).

²⁵ Because Summer 2004 was so cool, customers had fewer high-price episodes to which to respond. When the episodes occurred, though, they did respond.

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1 market where firms can respond dynamically to consumer demand by offering
2 variable rate programs.

3

4 Q. Are there other studies that support your belief that consumers will respond to
5 these price signals?

6

7 A. Yes. The California Public Utility Commission and the California Energy
8 Commission recently completed a dynamic pricing pilot that tested different
9 rate structures with and without the installation of enabling metering
10 technology.²⁶ This project divided 2,500 households and small businesses
11 into several treatment groups. Overall, the pilot's results suggest a potential
12 statewide average reduction in peak-period energy use of 13.1 percent. This
13 result is consistent with those observed in Gulf Power's variable pricing
14 program and in the Energy Smart Pricing Plan in northern Illinois. A 13
15 percent reduction in energy use from these small customers in peak hours can
16 mean the difference between normal operations and a blackout. Furthermore,
17 in the California pilot small customers cut their energy use precisely when the
18 risks of such failures are highest – on critical days during the hottest summer
19 months.

20

²⁶ The final report on the Statewide Pricing Pilot is available at http://www.energy.ca.gov/demandresponse/documents/group3_final_reports/2005-03-24_SPP_FINAL_REP.PDF.

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1 The largest reduction in residential and small commercial peak use came from
2 the participants on the CPP (critical peak pricing) plan with variable peak
3 periods. Customers on that pricing plan and with the smart, enabling
4 technologies (controllable thermostats) reduced their peak-period energy use
5 by 27 percent, more than double the effect of the other participants. The study
6 indicates that customer access to the enabling technology, combined with
7 pricing that reflects time-varying cost differentials, created the opportunity for
8 them to change their behavior. And they did so, to a larger extent than is
9 commonly believed possible for residential and small commercial customers.
10 Furthermore, in a survey of participating households, 91 percent of those
11 households said that based on their experience, dynamic pricing should be
12 offered to all customers for them to choose.

13

14 Q. Are the benefits of these price signals limited to those consumers who are
15 willing to adjust their consumption patterns?

16

17 A. No. Customer response to price changes benefits not only those who respond,
18 but also other customers and the system as a whole. Reducing peak use
19 reduces wholesale market prices and long-run investment requirements that
20 affect all customers, not only those who choose to see price changes. This

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1 widespread consequence of customers having the right to say “no” is the most
2 powerful tool for public interest that comes out of demand response.

3

4 Q. Please explain your third principle for the development of utility rates.

5

6 A. We believe that if the Commission is to be successful in completing the
7 transition from regulation to robust competition, it must rely on incentives
8 rather than on traditional “command and control” regulation of utility
9 behavior. As previously noted, any effort to engage in such “behavioral”
10 remedies when utilities are provided with financial incentives to behave in
11 ways that conflict with those behavioral standards faces informational and
12 enforcement challenges that are now well-presented and understood in the
13 economic literature. Accordingly, the Commission should avoid behavioral
14 remedies whenever possible. Rather it should use both structural and financial
15 remedies, whenever possible. In this case, such remedies are both available
16 and consistent with Commission policy.

17

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1 **II. Analysis of the NYSEG Proposal**

2 **A. Summary of NYSEG’s “Voice Your Choice” Program**

3 Q. Please summarize the retail access provisions of NYSEG’s proposed plan.

4 A. NYSEG proposes to retain its existing “Voice Your Choice” retail access
5 program, with minor changes. Under this program, NYSEG proposes to
6 establish three consecutive two-year commodity periods. Each of these
7 commodity periods would be preceded by an “open season” during which
8 customers could switch freely between fixed price service from NYSEG,
9 variable priced service from NYSEG, and service from an ESCO. These open
10 seasons would be from October 1 to December 31, 2006, from October 1, to
11 December 31, 2008, and from October 1, to December 31, 2010. Any election
12 made during one of these open seasons would affect the customer’s service
13 options during the twenty-four month period immediately following the
14 closing of the open season in question (the commodity period).

15
16 Customers wishing to receive commodity service from NYSEG would have
17 two options: a Variable Price Option (VPO) and a Fixed Price Option (FPO).
18 The VPO would have a fixed delivery charge, a floating non-bypassable wire
19 charge (NBWC) and a floating commodity charge based on actual wholesale
20 prices in the day-ahead and real-time spot markets operated by the New York
21 Independent System Operator, Inc. (NYISO). The FPO would have the same

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1 fixed delivery charge found in the VPO, but the NBWC for this service would
2 be fixed for the two year commodity period, as would the commodity charge.

3
4 The fixed NBWC would be established on a forecast basis for the commodity
5 period. To the extent that this fixed NBWC failed to recover NYSEG's full
6 transition costs, that revenue shortfall would be deferred for future recovery.

7
8 NYSEG would establish the commodity charge for the FPO for the upcoming
9 commodity period on the first day of each open season (that is, on October 1
10 of 2006, 2008 and 2010). This charge would be calculated by NYSEG on the
11 basis of the average of the prices for the previous 20 trading days for forward
12 contracts for fixed price commodity service for the upcoming twenty-four
13 month commodity period available to NYSEG from energy brokers and on-
14 line exchanges. This index price would then be adjusted for on-peak and off-
15 peak usage. Forward prices for installed capacity would be forecast on a
16 similar basis and then expressed on a \$/MWH basis so that they may be added
17 to NYSEG's projected forward energy price to establish a total commodity
18 cost figure on a \$/MWH basis.

19
20 This total commodity cost would be adjusted to reflect differences in the load
21 characteristics of each of NYSEG's rate classes and then multiplied by 135

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1 percent to determine the total fixed commodity price component of the FPO
2 rate for each rate class to be in effect for the upcoming twenty-four month
3 commodity period. In approving this rate setting methodology in 2002, the
4 Commission noted that “[s]omething over half this premium is intended to
5 cover actual out of pocket costs with the remainder intended to compensate
6 NYSEG for the risks of offering fixed price services.”²⁷

7
8 Customers that do not affirmatively select a rate option during any open
9 season would continue to receive service under their current rate option. New
10 Large Customers that fail to make an election would be assigned to NYSEG’s
11 VPO, while new Small Customers would be assigned to NYSEG’s FPO. Any
12 customer that initially elects to receive service under the FPO and any Small
13 Customer assigned to the FPO by default would have a further four month
14 “grace period” from January 1 through April 30 of the first year of any
15 commodity period to switch to ESCO service without additional charge.

16
17 Customers who want to purchase commodity service from an ESCO would
18 also have two options under NYSEG’s proposal. Customers that elect ESCO
19 service under NYSEG’s ESCO Price Option (EPO) would pay a fixed

²⁷ Case 01-E-0359 – *Petition of New York State Electric & Gas Corporation for Approval of its Electric Price Protection Plan*, Order Adopting Provisions of Joint Proposal With Modifications, slip op. at 4 (issued and effective February 27, 2002).

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1 delivery charge and a floating NBWC, which would be equal to the fixed
2 delivery charge and floating NBSC under NYSEG's VPO. Customers served
3 under the VPO could switch to the EPO (or from the EPO to the VPO) at any
4 time without incurring any penalty from NYSEG. Customers taking service
5 under NYSEG's FPO could only switch to the EPO during the two open
6 seasons or during the three month grace period following each of these open
7 seasons.

8
9 Customers wishing to convert from FPO service to ESCO service outside of
10 any open season or grace period would be required to take service under
11 NYSEG's ESCO Option with Supply Adjustment (EOSA) rather than under
12 the EPO. Delivery rates under the EOSA rate would be equal to the rates for
13 bundled service under the FPO, with a back-out credit equal to NYSEG's
14 actual avoided costs of energy and capacity purchased in NYISO spot
15 markets. As a result, customers served on the EOSA would pay the fixed
16 delivery charge established in the FPO, the fixed NBWC established in the
17 FPO, and the difference between NYSEG's commodity charges established in
18 the FPO (including the premium noted above) and actual spot market prices.
19 The EOSA rate would also be made available as an option to all customers
20 taking service under NYSEG's EPO on October 1, 2006.

21

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1 Customers wishing to convert from either the VPO or the EPO to the FPO
2 outside of an open season would be allowed to do so. However, the
3 commodity rate charged to customers switching to the FPO in such
4 circumstances would be the lesser of: (1) the FPO commodity rate previously
5 established for that commodity period; or (2) such higher fixed commodity
6 rate as NYSEG may establish to reflect market conditions at the time the
7 customer makes that switch.

8

9 Q. In your view, is the EOSA rate a fully unbundled rate?

10

11 A. No. The EOSA rate includes what might be described as a break-up fee to be
12 paid to NYSEG for termination of service under the FPO. This “break-up”
13 fee is calculated by subtracting NYSEG’s actual spot market prices for the
14 customer’s actual energy usage (without any markup) from the fixed price
15 charge established in the VPO (*which would include NYSEG’s risk premium*
16 *for providing a two-year fixed price*). Remarkably, this “break-up” fee
17 applies even to those customers who elect to take service under the EOSA rate
18 without ever taking service under the FPO rate.

19

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1 **B. Evaluating the NYSEG Default Service Price.**

2

3 Q. Does NYSEG’s proposal comply with the three recommendations for retail
4 access programs discussed in your testimony?

5

6 A. No. In fact, NYSEG’s proposal is inconsistent with each of those
7 requirements.

8

9 Q. Please explain why NYSEG’s proposal is inconsistent with your
10 recommendation that utilities be required to establish a single delivery rate to
11 apply to all deliveries without regard to the source of the customer’s
12 commodity service.

13

14 A. Rather than propose a single delivery rate to apply to commodity supplies
15 from all sources, NYSEG provides a confusing array of four different delivery
16 rates: the Variable Price Option, the Fixed Price Option, the ESCO Price
17 Option and the ESCO Option with Supply Adjustment. This structure adds
18 unnecessary complexity to the difficulties consumers already face in
19 attempting to understand the risks and the opportunities presented by
20 developing retail markets.

21

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1 Any facet that makes retail choice more complicated increases the “search
2 costs” to customers of switching. Choosing a design with high embedded
3 customer search and switching costs creates an entry barrier for other retailers.
4 By making it more expensive to switch, in terms of the effort customers may
5 make, NYSEG’s complicated retail access proposal encourages customers to
6 stay with their incumbent utility. This barrier restricts such customers from
7 benefiting from retail electricity competition.²⁸

8

9 Q. Is this the only problem with NYSEG’s proposed delivery rates?

10 A. No it is not. NYSEG’s proposal actually provides different mechanisms for
11 the recovery of NYSEG’s stranded costs depending on which of these
12 delivery options the customer selects.

13

14 Q. Please explain why this is inappropriate.

15 A. Stranded costs represent those above-market generation-related obligations
16 incurred by NYSEG in the past. They are based in no way on any customer’s
17 forward-looking retail access choices. The Commission should be careful to
18 ensure that it is very clear to consumers that their stranded cost payments will
19 remain the same regardless of whether they take their commodity service from

²⁸ See, for example, Klemperer, Competition When Consumers Have Switching Costs: An Overview with Applications to Industrial Organization, Macroeconomics, and International Trade, 62:4 *Review of Economic Studies* 515 (1995).

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1 the utility or from the ESCO, since any difference in stranded cost recovery
2 levels will act as a barrier to competition.

3
4 In this light, the Non-Bypassable Wires Charge (“NBWC”) which NYSEG
5 proposes to use to recover its stranded costs is plainly inappropriate. NYSEG
6 proposes that customers who choose ESCO service under the EPO should be
7 subject to a floating NBWC, while customers who take default service from
8 NYSEG under its FPO would receive a fixed NBWC.²⁹ There is simply no
9 reason why the NBWC applicable to customers electing service under the
10 EPO should be different from the NBWC applicable to customers taking
11 default service from NYSEG.

12
13 This proposal clearly violates the principle of transparency. Any customers
14 who seek to switch from NYSEG to an ESCO must evaluate the relative costs
15 of a fixed versus variable payments for stranded costs. This may not be a
16 simple calculation. Indeed, it is not simple even to describe this calculation.
17 To the extent that consumer are unable or unwilling to perform this difficult
18 calculation, they are likely to continue to take default service on the
19 assumption that the Commission will protect them from overcharges under
20 that rate option.

²⁹ This is a simplification. With the EOSA provisions, the choice becomes even more complex.

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1

2 Conceptually, ESCOs could offer retail customers a fixed price, and hold the
3 risk themselves of paying the floating NBWC (though marketing such a
4 project would require additional effort, constituting a further barrier to entry).

5 In this scenario, however, the floating NBWC rate can be seen as an
6 unnecessary method of transferring risk to competing ESCOs, constituting yet
7 another barrier to competition in this market.

8

9 Q. Is NYSEG proposing to offer a single default commodity service?

10

11 A. No. NYSEG is proposing to offer two different commodity service offerings.
12 Moreover, each of these commodity offerings has both a different commodity
13 rate (fixed versus variable) and a different delivery rate due (fixed versus
14 floating NBWC). As previously noted, however, the only reasons for the
15 utility to offer a default service are to ensure that all consumers have supply
16 service during the transition to competition. Thus, there is no justification for
17 permitting NYSEG to offer more than one form of commodity service to any
18 particular customer.

19

20 The presence of additional utility options increases consumer search costs,
21 thereby erecting an unnecessary barrier to the transition to robustly

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1 competitive markets for the reasons discussed above. Indeed, if small
2 customers are willing to search for something different than the default
3 service rate, that willingness implies a confidence in retail markets that
4 eliminates any need for a “safety net”.

5

6 Q: Why do you view NYSEG’s proposed multiple options to customers as
7 anticompetitive, when you view such options by ESCOs are pro-competitive.

8

9 A: Any offering by the incumbent distribution utility poses a host of problems for
10 the regulator and for competition in general, as discussed above. Thus, any
11 such offerings should be limited to default service, and should be provided
12 only in a form consistent with the rationale for default service. Should
13 NYSEG’s parent, Energy East, Inc., desire to offer customers multiple
14 options, it would be free to do so through its non-regulated affiliates, NYSEG
15 Solutions and Energetix.

16

17 Q. Is NYSEG’s fixed commodity pricing proposal for default service
18 transparent?

19

20 A. No. The pricing provisions of NYSEG’s Fixed Price Option have a large
21 number of serious flaws. One important flaw is its opaque determination of

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1 the default service rate, which makes it hard for customers to compare options
2 across retailers. In addition, the NYSEG approach can be expected to
3 inappropriately inflate the “calculated” price of power above the actual market
4 price.

5
6 Q. Please explain.

7
8 A. As discussed above, NYSEG proposes to make its fixed price default service
9 rate the function of a survey of prices from electricity traders and broker
10 exchanges. This approach provides NYSEG with a great deal of discretion and
11 is not easily observable. The core problem is that NYSEG’s fixed energy price
12 would be based on (i) traders chosen by NYSEG, and (ii) prices “available” to
13 NYSEG. NYSEG would thus be given the opportunity to choose the trading
14 parties whose prices reflect NYSEG’s preferences.

15
16 Moreover, prices “available” to NYSEG are not the same as market prices.
17 As an examination of the “order book” for any widely traded stock makes
18 clear,³⁰ available prices include both those near the market price and those far
19 away from the market price. (Such order books are now easily available from
20 Yahoo.com.)

³⁰ See Harris, *Trading and Exchanges* (2003) 109-110 for a discussion of order books.

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1

2 To illustrate the different between prices offered, and market prices, we have
 3 printed below a copy of the order book for Energy East, NYSEG's parent
 4 company, for January 23, 2006 (acquired from Yahoo.com).

5

6

7

8

9

**Order Book
 2:24 PM, Energy East (EAS),
 January 23, 2006, 2:34PM**

Bid Orders		Sell Orders	
Price	Order Size	Price	Order Size
24.63	400	24.72	200
23.83	1000	24.73	400
23.8	1000	25.57	1000
23	80	25.62	1000
16.07	100	32.89	100

10

11 The order book lists the offers to buy and sell that exist at a particular time,
 12 here 2:34 PM on January 23. On this day, Yahoo.com reports that the market
 13 price for Energy East ranged from \$24.50 to \$24.82 dollars per share. As the
 14 order book indicates, however, a large number of offers existed well "away"
 15 from the market. Thus, on the sell side (the side most relevant here), there was
 16 a relatively large number of offers available well above the trading price for
 17 Energy East. In particular, there was an offer outstanding to sell Energy East
 18 stock at \$32.89 per share, approximately 33 percent above the market price.

19

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1 Using NYSEG’s proposed approach, the \$32.89 sell order is a “market offer”
2 and represents a price that could be used in computing an average price. Yet
3 this price in no way represents the “market price” that any sophisticated
4 purchaser of Energy East stock could be expected to pay, as this price was
5 well away from the price of any market transaction in such stock.

6

7 Q. Are there any other problems with NYSEG’s proposal to use “offered” prices
8 to calculate its expected costs?

9

10 A. Yes, NYSEG’s methodology offers a further opportunity to overstate the
11 acquisition price of power. NYSEG proposes to make projections of the price
12 of power two years into the future at certain fixed purchase dates. It is well
13 understood in commodity markets, however, that the further out in time
14 contract purchases are, the thinner the relevant market becomes. As a market
15 becomes thinner, it becomes less “liquid,” in that the number of active buyers
16 and sellers declines abruptly. Less liquid markets are more subject to market
17 impacts, where the price of the market moves against the parties attempting to
18 make a large purchase (or sale) of the relevant contract. Therefore, the impact
19 of large purchases of electricity on market prices can become significant as

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1 the length of the relevant contract increases.³¹ In this context, it means that as
2 NYSEG “searches” for power up to two years into the future, the prices it is
3 likely to record become further and further away from the true expected
4 economic cost of such power.

5
6 This lack of liquidity can lead to locking in prices for retail customers that are
7 unlikely to reflect market conditions two years hence, when delivery occurs.
8 Such actions could impose a price risk premium on customers that they do not
9 realize, and that they might not be willing to pay if the choice were
10 transparent. Thus, NYSEG’s proposal to acquire a large amount of power
11 through two-year forward and/or futures contracts may generate serious
12 “liquidity impacts,” increasing the price of power which NYSEG is allowed to
13 impose on its small customers.

14
15 Q. Can you illustrate the extent to which liquidity decreases the further into the
16 future one extends a fixed price agreement?

17
18 A. As Professor Stulz points out,³² one measure of market liquidity is the market
19 “open interest.” Open interest is the amount of contracts outstanding in a
20 market at any given point in time. Unfortunately, power for the NYSEG area

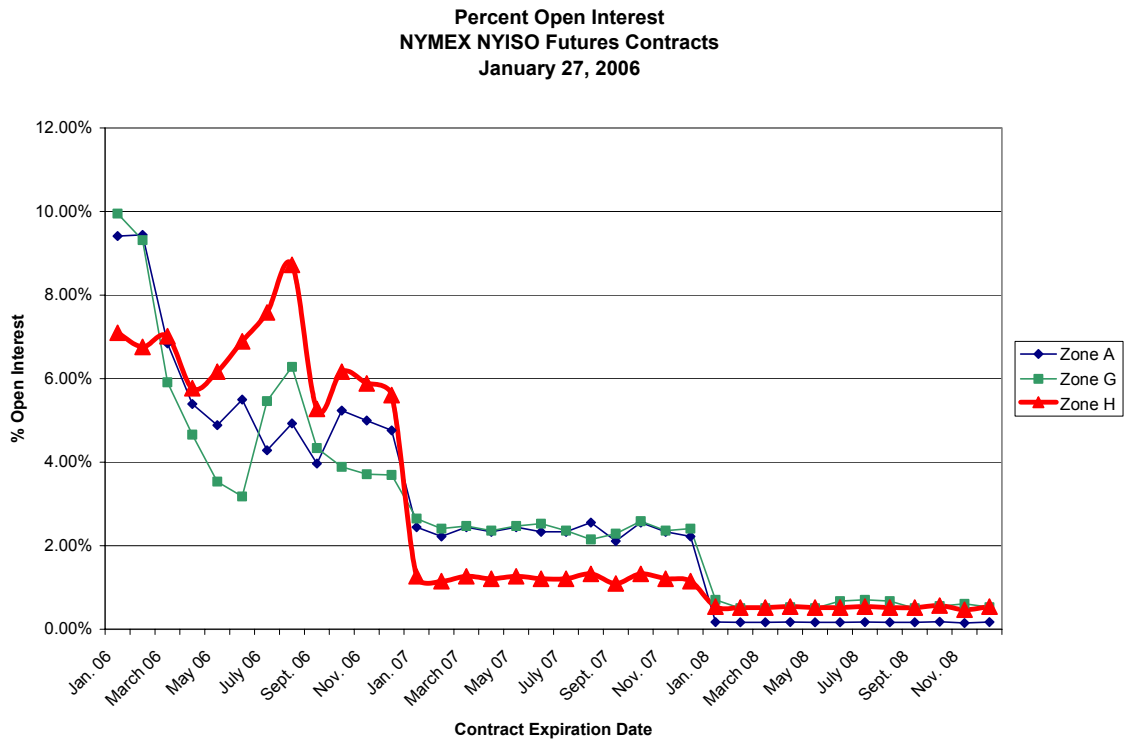
³¹ The discussion here is taken from Stulz, Risk Management and Derivatives (2003) p.195.

³² Stulz, *supra*.

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1 is not traded on an exchange, so no direct information is available on NYSEG
 2 liquidity across contract length. It is possible, however, to examine market
 3 data on three NYISO area products (Zone A, G, and H) traded on the
 4 NYMEX exchange, with data available from NYMEX.³³

5



6

7

8 The figure above indicates the percentage open interest, as a function of the
 9 total open interest, on each of the NYISO products for January 27, 2006,

10

across contract length. As the figure makes clear, the level of open interest

11

falls dramatically for each of the three contracts once the relevant expiration

³³ NYMEX ACCESS Report on Futures, January 27, 2006, available from NYMEX website, www.nymex.com.

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1 date becomes one year distant. For Zone A contracts, the average open
 2 interest as a percentage of total open interest for contracts less than one year
 3 old is 5.80 percent. For the second year of Zone A contracts, this falls to 2.36
 4 percent. Similar results apply for Zone G, where the average percentage
 5 outstanding contracts falls from 5.33 percent in the first year to 2.42 percent in
 6 the second year. The results are even more striking for Zone H, where the
 7 average percent outstanding contracts falls from 6.58 percent in the first year
 8 to 1.23 percent in the second year.

9
 10 **Average Percent of Open Interest**
 11 **By Date of Futures Contract**
 12 **January 27, 2006**
 13

Expiration Date of Contract	NYISO Zone A Futures	NYISO Zone G Futures	NYISO Zone H Futures
0 to 11 months out	5.80%	5.33%	6.58%
12 to 23 months out	2.36%	2.42%	1.23%
24 to 36 months out	0.17%	0.58%	0.53%

14 These data clearly suggest that the “order searching” of power envisaged by
 15 NYSEG of forward energy during the second year have a far greater
 16 likelihood of affecting “estimated” prices than would “searching” for forward
 17 energy contracts for the first year. This, in turn, implies that NYSEG’s
 18 proposal to “search” for contracts two years out may have the potential for
 19

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1 further harmful price impacts on small default consumers. Furthermore,
2 since power for NYSEG’s system is not traded on an established exchange,
3 such searches are likely to be in less liquid markets than the organized
4 markets for NYISO Zone A, G, and H power.

5
6 This lack of liquidity can lead to locking in prices that are unlikely to reflect
7 market conditions two years hence, when delivery occurs. Such a move could
8 impose a price risk premium on customers that they do not realize, and that
9 they might not be willing to pay if the choice were transparent. Thus,
10 NYSEG’s proposal to acquire a large amount of its power through two-year
11 forward and/or futures markets may generate serious liquidity impacts,
12 increasing the cost of power purchased for small customers.

13
14 NYSEG therefore proposes a method for determining a default service price
15 that gives it a great deal of discretion, and cannot easily be monitored by the
16 Commission, or used by customers to evaluate competing options. It also has
17 the ability to estimate prices that are well above those that occur in the market,
18 or would occur absent any “liquidity effect” created by NYSEG’s “searches”
19 for power contracts. We therefore urge the Commission to reject this
20 approach.

21

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1 Q. Does NYSEG's proposed default service strike an appropriate balance
2 between providing consumers with a reasonable degree of protection from
3 short term fluctuations in market prices and avoiding the imposition of undue
4 limits on customer switching options?

5
6 A. No it does not. NYSEG's plan proposes that ESCOs only be able to convert
7 customers taking service under NYSEG's default Fixed Price Option to ESCO
8 service at the delivery rates established in its ESCO Price Option during brief
9 windows in 2006, 2008 and 2010. NYSEG makes no provision in its proposal
10 for customers served under its default option to receive unbundled retail
11 delivery service under the ESCO Price Option in the remaining six years in its
12 rate plan.

13
14 This limited enrollment window would serve to create excessive marketing
15 costs for ESCOs. Any firm that wishes to sell its products on a market must
16 be able to obtain the attention of potential customers. Potential customers,
17 however, may not be as attentive to commercial opportunities at all times of
18 the year. Thus, limiting the enrollment window (which is a very unusual
19 government regulation) would increase the marketing costs of ESCOs and
20 therefore act as a barrier to entry in the retail electricity market in the NYSEG
21 service territory. Such a barrier to entry would be exacerbated by the complex

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1 manner in which NYSEG proposes to calculate its default service rate.
2 Further, such a limited open season would be further restricted by the ESCOs
3 not knowing what the relevant price to beat would be.

4
5 The limited enrollment period proposed by NYSEG would thus create
6 unwarranted entry barriers for ESCOs, and is therefore contrary to
7 Commission policy. We note that it appears that limited enrollment windows
8 similar to those proposed by NYSEG exist in no other restructured state.³⁴
9 Thus, there is no obvious need for such an important restriction on ESCO
10 marketing. We note that, if default service is structured appropriately,
11 NYSEG's commodity risk would be greatly reduced, and real choices will be
12 available at all times, not during some utility pre-defined window.

13
14 Q. Is it true that customers taking service under NYSEG's FPO are free to
15 convert to ESCO service at any time?

16
17 A. Yes in theory. However, customers converting to ESCO service outside of the
18 brief windows discussed above must take delivery service under NYSEG's
19 EOSA offering. Under this offering, the customer must continue to pay

³⁴ Illinois Commerce Commission Case Nos. 05-0160, 05-0161, and 05-0162 (Consol.), *KEMA Analysis of Competitive Procurement Mechanisms*, Direct Testimony of Direct Energy Services, LLC and U.S. Energy Savings Corp., Exhibit 1.1, submitted June 15, 2005.

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1 NYSEG's fixed price of commodity service, but receives a "backout" credit
2 equal to the actual market price of the commodity service they receive. This
3 pricing structure has two specific elements that would serve to deter ESCOs
4 from serving such customers. First, it is complex and therefore likely
5 confusing. Second as previously noted, it requires customers to pay a NYSEG
6 what is in essence a "break-up" fee equal to the difference between the fixed
7 commodity price in the VPO (which would include the 35 percent mark-up)
8 and actual spot market prices (which could be expected to include only a bit
9 over half of this 35 percent mark-up). Remarkably, this break-up fee applies
10 even if the customer never took service from NYSEG under the FPO.

11

12 Q. Does NYSEG's proposal reward the utility for keeping customers on utility
13 default service?

14

15 A. Yes. NYSEG's proposal appears to provide the utility with substantial
16 financial rewards for keeping customers on its default Fixed Price Option.

17

18 Q. Please explain your answer.

19

20 A. As previously noted, NYSEG's default Fixed Price Option starts with a
21 pricing mechanism that is inherently non-transparent and likely to overstate its

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1 actual costs. To that, NYSEG is allowed to add a “premium” of 35 percent, of
2 which apparently up to half is designed to compensate NYSEG for the “risks”
3 of that fixed price offering. Significantly, NYSEG has offered no cost study
4 justifying this risk premium in this proceeding. Nor was this risk premium
5 established by the operation of market forces in a robustly competitive market,
6 since this premium is not the result of an actual Request For Proposals
7 conducted and accepted by NYSEG. Accordingly, there is no basis on which
8 the Commission can conclude that this premium represents a fair price for
9 consumers to pay for the risks actually assumed by NYSEG.

10

11 Q. Is there any reason to believe that these rates overcompensate NYSEG for the
12 risks involved?

13

14 A. In the absence of a properly structured rationale for such rates, it is impossible
15 to state for certain whether these rates overcompensate NYSEG for the risks
16 involved. Several factors do, however, suggest that it is likely that NYSEG is
17 being overcompensated.

18

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1 Q. Please describe these factors.

2

3 A. To begin with, the available evidence suggests that NYSEG's earnings under
4 its current rate plan, when adjusted to include these commodity revenues,
5 have been extremely high when compared to most other utilities regulated by
6 the Commission. For example, in response to Multiple Intervenors discovery
7 request MI-1, NYSEG reported actual return on equity for electric utility
8 operations in 2001 through 2004 as shown in the first five rows of the table
9 below:

10

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NYSEG's Annual Earned Return on Common Equity for its Electric Utility Operations for 2001-2004 (\$ million)³⁵				
	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
(Average) Base Rate	1,595	1,595	1,619	1,619
(Average) Common Equity Ratio	<u>36.17%</u>	<u>45.18%</u>	<u>46.04%</u>	<u>47.68%</u>
(Average) Common Equity Supporting Rate Base	577	721	745	777
Net Income per Books	<u>197.2</u>	<u>109.9</u>	<u>112.0</u>	<u>120.2</u>
Percentage Return on Equity	<u>34.2%</u>	<u>15.3%</u>	<u>15.0%</u>	<u>15.5%</u>
DEP Estimate of Additional Net Income on Commodity Service	-	Unknown	25.0/40.0/48.5	Unknown
DEP Estimate of Total Income	197.2	Unknown	137.0/152.0/160.5	Unknown
DEP Estimate of Percentage Return on Equity	<u>34.2%</u>	Unknown	<u>18.4%/20.4%/21.5%</u>	Unknown

1

2

3

It is our understanding that returns for calendar years 2002 through 2004 are

4

returns on delivery operations only, whereas the 34.2 percent return which

5

NYSEG achieved in 2001 also included revenues from commodity services.

6

Thus, to understand NYSEG's profits, including those on commodity service,

³⁵ Several of the terms in this table may require explanation. Numbers are "averaged" to take account for the fact that the rate base fluctuates across any calendar year. The equity rate base differs from the total rate base, in that much of the rate base is financed through means other than equity investments, such as bonds. The Percentage Return on Equity is calculated by divided the Net Income by the Common Equity Base. The information in rows 1 through 5 was taken form NYSEG's response to MI-1. The information in rows 6 through 8 of this table was calculated by the Direct Energy Panel (DEP) as explained in this testimony. We have placed the initials DEP in the caption of rows 6 through 8 to avoid any possible confusion as to the portion of this table that reflects our calculations.

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1 commodity service profits must be including. Unfortunately, information on
2 NYSEG's profits on commodity service appears to be limited.

3
4 In approving NYSEG's last multi-year settlement, the commodity service
5 provisions of which were virtually identical to NYSEG's proposal in this case,
6 the Commission noted that NYSEG has estimated annual profits from
7 commodity service alone at between \$25 million and \$40 million in 2003.³⁶

8 Assuming NYSEG's own projections were accurate, NYSEG's total return on
9 equity in 2003 would have been between 18.4 and 20.4 percent.

10

11 Q. Is there any reason to believe that NYSEG actually achieved this level of
12 return?

13

14 A. Although we have been unable to obtain a clear statement of NYSEG's
15 earnings on commodity service in 2003, several facts reported in NYSEG's
16 testimony in this case suggest that NYSEG's actual earnings in 2003 may
17 have been over 20 percent.

18

19 Q. Please explain.

³⁶ Case 01-E-0359 – *Petition of New York State Electric & Gas Corporation for Approval of its Electric Price Protection Plan*, Order Adopting Provisions of Joint Proposal with Modifications, slip op at 5 n. (issued and effective February 27, 2002).

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1

2 A. NYSEG Exhibit ____ (DWS-1) indicates that for an unspecified period during
3 2003 and 2004, NYSEG retained 5 percent of its total commodity revenues as
4 earnings and that NYSEG returned 4 percent of commodity remains to
5 ratepayers. Thus, the ratio of NYSEG's earnings on commodity service to the
6 revenues NYSEG returned to ratepayers from such service in this period was
7 5 to 4.

8

9 In Exhibit ____ (RRP-4), NYSEG reports that it returned a total of \$38.8
10 million to customers in 2003. If NYSEG's actual profits on commodity
11 service in 2003 were 5/4ths of that amount, or \$ 48.5 million, then its actual
12 overall return on equity in that year would have been 21.5 percent. These
13 rates of return are well over double the allowed rates of return established by
14 the Commission in recent years for NYSEG (10.5 percent)³⁷ and other New
15 York electric and gas utilities, including Niagara Mohawk Power Corporation
16 (8.58 percent)³⁸ and Central Hudson Gas & Electric Corporation (7.48
17 percent).³⁹

³⁷ Case 00-G-0670 – *Petition of New York State Electric & Gas Corporation for Approval for the Exercise of Gas Franchises in the Towns of Varick and Romulus, Seneca County*, Order Amending Certificate of Public Convenience and Necessity (issued and effective October 22, 2004).

³⁸ Case 05-E-0264 – *Joint Petition of Niagara Mohawk Power Corporation and Rochester Gas & Electric Corporation to Amend its Certificate of Public Convenience and Necessity*, Order Amending Certificates of Public Convenience and Necessity and Approving Limited Franchise (issued and effective May 20, 2005).

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1

2 Q. Are there any other reasons why you believe that NYSEG is earning higher
3 than competitive returns under the current rate plan?

4

5 A. Yes. NYSEG has made clear that it strongly desires to remain in the
6 commodity supply business, to compete as the utility, and to renew its existing
7 rate plan for an additional six years. It is unlikely that NYSEG would be
8 pressing vigorously for these structures if it believed that its earnings from the
9 provision of commodity service failed to compensate it for the risks involved.

10

11 Q. If NYSEG's commodity service commodity prices are in fact inflated, would
12 this not benefit ESCOs by making it easier for them to compete with NYSEG?

13

14 A. Under a properly structured retail access plan, higher utility commodity
15 service rates would indeed enhance the competitive position of ESCOs. In the
16 case of NYSEG's service offerings, however, we believe that the barriers to
17 entry described above are sufficiently high to offset the benefits to ESCOs of
18 higher prices for utility default service. As a result, consumers in NYSEG's
19 service territory are overcharged, less innovation occurs, fewer other

³⁹ Case 05-G-0290 – *Petition of Central Hudson Gas & Electric Corporation for Approval for the Exercise of a Gas Franchise in the Town of New Baltimore, Greene County*, Order Granting Certificate of Public Convenience and Necessity (issued and effective May 20, 2005).

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1 consumer benefits arise, and the transition to competition is needlessly
2 delayed.

3

4 Q. Are you aware of any other facts that would support the conclusion that the
5 benefits to ESCOs of higher utility commodity service rates are offset by the
6 barriers to entry created by NYSEG's retail access plan?

7

8 A. Yes. Our review of customer migration data provided on the Commission's
9 web site reveals that despite the apparent competitive advantage provided to
10 ESCOs by NYSEG's high commodity rates for default service, residential
11 customer migration on NYSEG's system remains near the state average and
12 well below the state leader:

13

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**New York Retail Electricity Migration
Percent Customer Migration
October 2005
Source: NYPSC Website**

Firm	Residential		Small/Medium Commercial and Industrial		Large C&I's		Total	
	Accts.	Mwhs	Accts.	Mwhs	Accts.	Mwhs	Accts.	Mwhs
Central Hudson	0.8%	0.9%	2.7%	13.9%	49.2%	80.1%	1.1%	27.8%
Con Edison	3.8%	4.8%	13.2%	40.1%	75.4%	83.9%	5.2%	38.8%
NYSEG	6.8%	9.6%	23.4%	50.2%	52.1%	83.6%	9.1%	42.0%
Niagara Mohawk	6.0%	7.9%	23.2%	50.2%	52.1%	83.6%	9.1%	42.0%
O & R	30.5%	32.9%	32.3%	43.5%	17.9%	26.8%	30.7%	34.8%
RGE	17.0%	23.5%	38.7%	56.9%	62.1%	68.6%	19.4%	50.5%
State-wide	6.3%	8.5%	17.9%	44.5%	56.0%	75.8%	7.9%	39.9%

6
7
8 Q. What other conclusions do you draw from these data?

9
10 A. Several themes emerge from these data. First, much progress has occurred in
11 New York State in creating retail competition for retail customers. The vast
12 majority of industrial customers have now switched to competitive suppliers.

13
14 Progress, however, has not been as broad for residential customers. The
15 percentage of residential customers switching to competitive suppliers is quite

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1 small for several of the utilities regulated by the Commission, including
2 NYSEG. As of October of last year, only 6.3 percent of NYSEG's residential
3 customers had migrated to competitive firms. We note, however, the
4 important advances made in Orange and Rockland's historic service area,
5 where 30.5 percent of residential accounts have migrated. We suggest that the
6 Orange and Rockland experience provides further evidence that retail
7 competition for residential customers is viable and can serve as an important
8 guidepost for Commission policy, so long as utilities are provided with
9 incentives to foster rather than to oppose the conversion of their customers to
10 competitive commodity suppliers.

11

12 The experience in Texas is also instructive. As of January 2006, nearly 1.8
13 million retail customers were taking service from a non-affiliated provider,⁴⁰
14 and a total of 2.3 million switch requests had been processed by the Electric
15 Reliability Council of Texas.⁴¹

16

⁴⁰ See, http://www.ercot.com/mktinfo/retail/trans_rpt/Number_Premises_Switched_EOM_2005_

⁴¹ See, http://www.ercot.com/mktinfo/retail/trans_rpt/Switch_Status_Trend_Data.xls

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1 **III. Our Proposals**

2 Q. Please describe how you believe the Commission should approach the process
3 of designing NYSEG's retail access programs.

4

5 A. Given that NYSEG's proposals are counter-productive to the Commission's
6 goal of fostering a robust competitive retail market, it will be necessary for the
7 Commission to give NYSEG precise directions and incentives to achieve the
8 Commission's goals in this area. In this section, we outline our suggestions
9 with respect to retail competition. Each of these proposals is fully consistent
10 with the Commission's goals of reaching toward full competition in small
11 retail customer market. Each of our proposals is also made with consideration
12 for each proposal's likely effectiveness, as outlined by the previous discussion
13 of remedies in the *Microsoft* case.

14

15 As discussed above, the Commission had made important steps toward robust
16 retail competition. We suggest building upon those steps whenever possible.
17 In particular, the Commission has the benefit of looking at the retail access
18 plans of several utilities that it regulates. It should seek to use in the NYSEG
19 proceeding, as much as possible, what has worked in other territories in other
20 territories.

21

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1 In this manner, the Commission can observe not only what is feasible in terms
2 of the level of retail migration, but also what types of programs are effective
3 in inducing viable retail competition. In that sense, the progress made by
4 Orange and Rockland is highly useful. We suggest that it is reasonable, at a
5 minimum, for all New York utilities in the next two years to reach the retail
6 migration levels for residential customers achieved by O&R: 30.5 percent of
7 customer accounts.⁴² Over a six year period (the length of NYSEG's
8 proposal) the Commission should require utilities to have migration levels
9 such that the "long-run" can be reached, and that historic utilities can exit the
10 business of providing commodity service to retail customers.

11

12 **A. Delivery Rates**

13 Q. How should NYSEG's delivery rates be designed?

14

15 A. As previously noted, NYSEG should be required to establish a single delivery
16 rate that would apply to all commodity service provided to a particular rate
17 class or group, regardless of the source from which any particular customer
18 obtains its commodity service. The establishment of such a simple,
19 understandable delivery rate is an important first step towards reducing the
20 search costs for those customers who are considering but have not yet made

⁴² NY PSC Electric Retail Access Migration Reports, October 2005.

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1 the transition from the utility's default commodity supply to competitive
2 commodity supply.

3

4 Q. Should NYSEG's stranded costs be recovered through a fixed or a floating
5 NBWC?

6

7 A. A fixed NBWC is preferable because it would make the price comparison
8 across competitors more transparent and less confusing for customers. Thus,
9 the fixed NBWC which NYSEG proposes for its FPO and EOSA rates should
10 be adopted as the stranded cost recovery mechanism for NYSEG's fully
11 unbundled retail delivery charges. All consumers, whether shopping or
12 remaining on default service, should pay these non-discriminatory NBWC
13 rates.

14

15 **B. Utility Commodity Service Offerings**

16

17 Q. How should NYSEG's commodity service offerings be structured?

18

19 A. As stated above, there is no rationale for allowing the incumbent utility to
20 offer more than one form of standard offer service to any customer. Further,
21 any offerings allowed by the incumbent utility must be consistent with the

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1 Commission’s long-term “structural” goal of having the utility exit the retail
2 electricity supply market. Hence, NYSEG should not be allowed to offer
3 multiple default service options. We note that there would be no restrictions
4 on how the firm’s competitive affiliates (in this case NYSEG Solutions and
5 Energetix) develop and price their competitive offerings.

6

7 **C. Rates for Default Commodity Service**

8

9 Q. How should NYSEG’s rates for default commodity service be structured?

10 A. As discussed above, NYSEG has an extremely opaque pricing formula for the
11 fixed price default service it offers to small customers. This opacity can
12 create confusion among small customers comparing retail alternatives, and
13 thus can serve as an entry barrier. We propose a simpler rule: NYSEG should
14 make its price to small customers an explicit, transparent function of its actual
15 acquisition price of electricity. In addition, NYSEG should report to the
16 Commission and to ESCOs the terms and conditions of its wholesale
17 electricity supply contracts.

18

19 The simplest way to adopt this would be to change NYSEG’s proposed
20 mechanism for determining its small customer default service rate. As
21 discussed above, NYSEG proposes establishing such a price based on offers

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1 for two-year contracts. We propose instead that this default service rate be
2 based on *one-month* forward contracts *actually purchased by NYSEG*. Using
3 one-month contracts will have the advantage of allowing continuous open
4 enrollments for small customers in ESCOs. It will also eliminate the need for
5 small customers to pay any risk premium to NYSEG, thereby potentially
6 reducing rates and avoiding the creation of incentives for NYSEG to remain in
7 the commodity function. Using actually purchased contracts will also avoid
8 the problem discussed above of evaluating “offered” contracts. In addition,
9 this approach would also reduce the “market liquidity” effects of “searching”
10 for long-term contracts, which have the potential of further increasing prices
11 to small customers.

12
13 Q. Please explain why monthly fixed price arrangements are sufficient to
14 adequately protect small default service customers from market volatility.

15
16 A. First, while hourly spot prices for electricity do exhibit significant market
17 volatility, a monthly fixed price arrangement is able to smooth out any
18 extreme price impacts during any one hour during a given month. Put another
19 way, while in any month there may be high prices in some hours, there are
20 also many hours that have low prices. Given that a forward contract
21 represents the expected value of all future prices during a specific timeframe,

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1 a monthly price will include some higher priced hours and some lower priced
2 hours, in effect blending away the most excessive volatility. Therefore, one-
3 month contracts will to a great extent protect small customers against severe
4 electricity price fluctuations found only in the hourly market. Of course, such
5 forward contract prices will reflect the expected seasonality of wholesale
6 electricity prices; but this price signal is important for keeping retail markets
7 and wholesale markets related.

8
9 Allowing default service rates to fluctuate monthly, however, does not imply
10 that small customer bills will necessarily also fluctuate simultaneously. Small
11 customers will have many options to mitigate this bill variability. If they
12 choose to stay on default service, they will have access to levelized billing,
13 which will allow them to balance their payments across time. If they choose
14 an ESCO, they will have access to fixed price options. Hence, under this
15 proposal, default service will support the Commission's goals and help further
16 the transition to robust retail electricity competition.

17

18 Q. How should NYSEG recover the costs of such agreements?

19

20 A. To ensure that NYSEG is fully compensated for the costs it incurs in
21 providing default service to small customers, the default service price should

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1 also be defined such that it allows for NYSEG to receive full payment for any
2 cost fluctuations. We would anticipate that the one-month forward contracts
3 into which NYSEG would enter would reflect the full costs of service and
4 thus would greatly eliminate any price risk NYSEG would face.

5
6 These default service prices should be established continuously, so that
7 ESCOs and customers always know the “price to beat,” and so that small
8 customers can switch to an ESCO at any time across the year. In addition, the
9 default service price for each month should be made available to consumers
10 and ESCOs some time (perhaps 10 to 15 days) before the beginning of the
11 relevant month, to allow consumers and ESCOs to make appropriate decisions
12 about their choices.

13
14 We note that there is precedent for limited time horizons for default service to
15 small customers in New York. Some New York utility customers have
16 already been exposed to monthly default service pricing. Consolidated
17 Edison’s Market Supply Charge (“MSC”) was, until May of 2005, estimated
18 on a monthly basis. It is now estimated for three-month periods. The MSC is
19 comprised of the market cost of energy and capacity based on NYISO market
20 prices; ancillary service charges; NYPA Transmission Adjustment Charge;
21 and certain other transmission-related charges and credits. Estimated MSC

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1 amounts recovered in rates on a calendar month basis are reconciled to actual
2 market supply costs on a calendar month basis.^{43,44}

3

4 Q. How have other states approached the issue of estimating futures costs of
5 power for default service contracts for small customers?

6

7 A. Among the restructured states and the District of Columbia, only New York
8 uses an estimate of the future price of power in its default service parameter.⁴⁵
9 All other restructured states use (1) utility bilateral purchasing and self-supply
10 (e.g., Michigan) or (2) wholesale supply auctions (e.g., New Jersey) or a (3)
11 Request for Proposal (RFP) mechanism (e.g., Massachusetts). The experience
12 in other states shows that these supply mechanisms can be administered on a
13 periodic basis, under rules supplied by the Commission. Thus, the
14 Commission may also wish to consider these mechanisms for supplying the
15 commodity component of default service to NYSEG's customers.

⁴³ Tariff for Consolidated Edison Company of New York, Inc., P.S.C. No. 9 – Electricity, Sixth Revised Leaf No. 159, Effective April 1, 2005.

⁴⁴ One method of estimating the market price has been presented by a Commission staff panel in the pending Central Hudson matter. The panel is recommending using the NYMEX Clearpoint futures curve for NYISO Zone G as the basis for forecasting these electric commodity costs/revenues. See In the Matter of Central Hudson Gas & Electric, Corporation, Case 05-E-0934 & 05-G-0935, November 2005, Prepared Testimony of Unbundling Panel at 18.

Unfortunately, at this time there does not exist a futures market for electricity in the NYISO zones that comprise most of NYSEG's service territory. The Commission could use a liquid zone and simply recognize that the suppliers will need to add or subtract a basis premium. Should such market arise, we would suggest that the Commission consider using those prices in the default service price calculation.

⁴⁵ See KEMA Report, *supra*.

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1

2 Q. How should NYSEG's default commodity rate for its large commercial and
3 industrial customers be designed?

4

5 A. Here too, NYSEG should only be allowed to offer one form of default
6 commodity service for the reasons noted above. For these larger and more
7 sophisticated customers, we agree with NYSEG's proposal that default
8 commodity service rates should be based on NYISO spot market prices.

9

10 Q. What other features should the Commission include in NYSEG's rate plan?

11

12 A. Yes. As our critique of the NYSEG proposal makes clear, there should be
13 open enrollment for customers throughout the year. To restrict enrollment
14 would simply create unnecessary barriers to entry for ESCOs, and lower the
15 amount of competition that consumers would face.

16

17

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1 **D. Creating Incentives for NYSEG to Encourage Migration**

2

3 Q. What actions should the Commission take to provide NYSEG with incentives
4 to encourage the migration of its customers to competitive suppliers of
5 commodity service?

6

7 A. Customer migration is the natural consequence of a retail market design that
8 enables rivalry, and therefore promotes competition. NYSEG appears to have
9 strong incentives to discourage migration, based on the profit margin it earns
10 on its existing default service supply arrangements. Given these incentives,
11 and the natural limits on any form of behavioral regulatory policy, we
12 recommend that the Commission comprehensively restructure NYSEG's
13 incentives to ensure that they do not reward NYSEG for delaying retail
14 migration. In terms of the discussion of the *Microsoft* case above, this
15 proposal can viewed as a financial remedy. We suggest that structure of such
16 incentives take the following form:

17 i. Determine the Commission's goals (per year) for retail migration. We
18 suggest setting goals similar to residential retail access percentages
19 attained by for Orange and Rockland.

20

21 ii Determine how much money NYSEG is currently earning per default
22 service customer.

23

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1 iii. Deprive NYSEG of this profit amount for every customer they are
2 short on their migration targets, and reward NYSEG for making its
3 targets.
4

5 The Commission has engaged in similar incentive programs before. In the
6 recent Central Hudson retail plan, for example, the Commission set out a
7 policy of rewarding Central Hudson for reaching the Commission's retail
8 migration goals.⁴⁶ Thus precedent exists for the Commission giving historic
9 utilities the incentives to induce retail migration.

10
11 Without such restructuring of NYSEG's current incentives, it may become
12 difficult to create the retail electricity market that will naturally achieve a level
13 of migration in NYSEG's service territory proportionate to other properly
14 structured markets. As discussed above, it is very difficult for any regulator,
15 including the Commission, to engage in effective behavioral remedies against
16 the desires of the regulated utility. An appropriately designed incentive
17 structure, such as the one described above, would help ameliorate the
18 problem.

⁴⁶ See Central Hudson Retail Plan, CASE 05-M-0332, In the Matter of Central Hudson Gas & Electric Corporation's Plan to Foster the Development of Retail Energy Markets, at 13, June 1, 2005.

⁴⁸ Case 05-M-0858 – *In the Matter of State-Wide Energy Services Company Referral Programs*; Case 05-M-0332 – *In the Matter of Central Hudson Gas & Electric Corporation's Plan to Foster the Development of Retail Energy Markets*, Order Adopting ESCO Referral Program Guidelines and Approving and ESCO Referral Program Subject to Modifications, December 22, 2005.

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1 **E. The Commission’s ESCO Referral Program**

2 Q. What other steps should the Commission take to promote the transition from
3 regulation to competition?

4 A. In a recent ruling, the Commission has ordered each utility in its territory to
5 set up an ESCO referral program.⁴⁸ Under the Commission plan, utilities
6 responding to any inquiry from a customer would encourage these customers
7 to use an ESCO for their gas and/or electricity supply. Customers who agree
8 to participate in the program may either choose a specific ESCO, or they may
9 be assigned to an ESCO. If the customer does not express a preference for a
10 particular ESCO, they will be randomly assigned to a supplier from a list of
11 approved ESCOs. Participating ESCOs are required to offer all customers the
12 introductory discount for the introductory period established by that utility's
13 program. Customers may withdraw from the program during the introductory
14 period upon notice. Customers shall be limited to one introductory offer.
15 Additionally, under the Commission plan, utilities will have a choice of
16 adopting one of two options (the “Service Option” and the “Contract Option”
17 for establishing contracts with customers during the introductory period and
18 post-introductory period). This model is based on the successful ESCO
19 referral program established by Orange and Rockland.

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1 Under the ESCO Service Option, the utility enrolls the customer for the
2 introductory period. Within 5 days of notice of enrollment, the ESCO will
3 send the customer a contract for the post-introductory period. If the customer
4 does not affirmatively agree to the contract the customer will automatically
5 revert to the utility at the end of the introductory period.

6 Under the ESCO Contract Option, the utility enrolls the customer for the
7 introductory period. Within 5 days of notice of enrollment, the ESCO will
8 send the customer a contract covering both the introductory and post-
9 introductory periods. The ESCO contract will take effect unless rescinded by
10 the customer within 3 days of receipt. The ESCO contract must conform with
11 a list of requirements, which includes a month-to-month contract term and no
12 cancellation fees.

13
14 We support the establishment of an ESCO referral program for NYSEG
15 customers. We note, however, that the success of ESCO referral programs at
16 other utilities in New York State has been based in large part on the desire of
17 the relevant utility to make such programs work. In this sense, the ESCO
18 referral program can be thought of a behavioral remedy. If, in contrast, the
19 utility does not market its ESCO referral program, or does not arrange for
20 such a program to run smoothly, the success of such referral plans may be

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1 seriously jeopardized. Thus, no ESCO referral program is likely to be
2 effective in NYSEG's service territory unless the NYSEG's incentives are
3 properly restructured. At a minimum, the Commission should require NYSEG
4 to implement the ESCO Service Option.

5

6 **IV. Conclusion**

7 Q. Do you have any concluding remarks?

8

9 A. Yes. In New York, there has been tremendous success in inducing industrial
10 customers to migrate to ESCOs, allowing them to benefit from freedom of
11 choice through diverse product and service offerings. Unfortunately, much
12 work needs to be done with small customers.

13

14 We note that the Commission is now in the middle of the difficult, yet socially
15 rewarding task of creating fully competitive retail electricity markets. Such a
16 process will naturally take time. It is also highly possible that an incumbent
17 utility may attempt to slow down or manipulate the process in order to
18 maximize its own profits. We therefore suggest that the Commission use
19 what learning it has available to it, from other utilities in New York, as well as
20 from the experiences in other states, to ensure that any retail access program
21 ultimately adopted in this proceeding does not provide NYSEG with financial

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1 incentives to remain in the commodity function for a longer period than is
2 absolutely necessary.

3
4 Retail competition promises to bring large benefits to electricity customers in
5 New York. The Commission has been a leader in the retail access effort, and
6 has proposed economically sound principles for meeting this goal. The
7 NYSEG proposal, if implemented, will not properly structure the retail
8 electricity market and therefore will not meet the Commission's goals. In
9 contrast, we suggest that the Commission adopt our proposals so that true
10 competition occurs in NYSEG's historic service area.

11
12 The NYSEG proposal is deficient in many areas. It would serve to make
13 competitive terms less transparent, increasing the costs of switching and
14 therefore deterring competition. It would do this through difficult to
15 understand and evaluate mechanisms for setting NYSEG's retail price. It
16 would do this through difficult to understand NBWC payments for customers
17 who choose a provider other than NYSEG and through an extremely limited
18 window of opportunity for customers to switch away from NYSEG.
19 NYSEG's proposal to offer multiple default service options is in conflict with
20 the only rationales that the Commission has articulated for retail service from
21 historic utilities.

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In contrast, we have set out a list of proposals that would be fully consistent with the Commission’s vision of retail competition. We propose that the NYSEG default service rate be based on monthly fixed prices. We propose that consumers in NYSEG’s territory have the ability to benefit from competitive forces. Perhaps most importantly of all, we propose that NYSEG be given the proper economic incentives to reach the Commission’s retail access goals.