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Approaches to utility default service procurement – time to take a second look?

Regulators in several Northeast states are reviewing how their utilities procure power on behalf of default service customers in the wake of high electricity prices over the winters of 2013/14 and 2014/15. Regulators are asking whether a different procurement process could have insulated default service customers from market price volatility or mitigated the impact of commodity fuel prices on default service customer rates. However, we recommend that regulators and other policymakers take a careful look at the structure of the competitive markets in their jurisdictions to ensure:

1. There are clearly defined goals and objectives for the default service program;
2. The role for the utility in the marketplace is well defined and understood; and
3. The energy and capacity procurement processes of those utilities support program objectives and are consistent with the utilities role in the market.

Without clear objectives, it is difficult to evaluate the progress of market restructuring and impossible to define procurement rules that effectively balance the interests of all market constituencies. This is especially true given that the process must be executed across a wide range of potential market conditions.

Investor-owned utilities in the Northeast have divested or spun off their rate-regulated generation to comply with state policies on deregulation. These state policies enable, and sometimes motivate, customers to shop for power from alternative providers. Customers can also opt to take the “default” utility service, power that is procured by the utility from market-based resources through competitive procurements. These default procurements vary in form, timing, and frequency with some using simple RFP processes, and others using more sophisticated auction-based mechanisms.

New England states that have restructured their markets all use RFP processes; that is, the utility notifies potential suppliers that it is seeking all or a portion of its requirements and the suppliers bid to serve that requirement. Most RFPs allow bidders to submit one-time proposals, which may

be evaluated on predetermined price and non-price criteria. One drawback of these one-shot, sealed bid type RFP processes is that the bidders tend to submit bids based not only on how they value the supply, but also on how they think others may bid to serve the load. Some may be afraid of winning at a price lower than competitors' valuations of the market (known in auction theory as the "winner's curse"). Others may submit high price bids on products where they expect limited competition in an attempt to maximize their margins. The incentives in RFP processes to shade bids can lead directly to higher end-use generation costs for default service customers.

Utilities in several deregulated states in the Mid-Atlantic and Midwest regions of the US use auction-type mechanisms to procure power. In an auction, potential suppliers bid on standardized supply contracts in support of the default service load, typically on a fixed \$/MWh basis. The auction framework allows for different supply options. For example, products may vary by contract term or load may be broken out across customer or rate classes. Prior to each round of the auction, the price or prices are announced to bidders. Bidders submit the amount of each product they are willing to supply at the products' announced prices. If there is more supply than needed, the next round begins at a new, lower set of prices. Bidders are free to change the quantities bid and the products bid upon in response to the new prices and price relationships. This process continues until supply and demand are in balance for all offered products.

During an auction, bidders know they are bidding to supply under the same contract terms and conditions and at the same prices as other bidders. They are also given certain information on supply and demand conditions at each successive round. This structured flow of information prevents bidders from gaming the system and drives the final prices in the desired direction. Most importantly, it takes away any incentive to guess how others might bid in an effort to maximize supplier returns. Winners are the bidders willing to serve the load at the lowest price. With one-shot processes, that may not be the case.

Realized prices from RFPs and auctions can both be competitive. However, as more products are offered, the higher the probability that auctions yield better results. Through the iterative rounds, bidders can easily switch between products in response to the changing price dynamics. The iterative round structure lowers the probability that one or more products receive limited interest and clear at above-market prices. The ability to offer more products allows for enhanced flexibility in meeting program objectives and better tools to insulate customer rates from commodity price volatility.

As Northeast regulators consider whether their RFP default procurement process is accomplishing its objective, they should first address the following questions:

- What is the desired role of default service in the market? Is it simply a service of last resort or is it an additional competitive option for customers?
- Should all customer classes be allowed to choose?
- What are the acceptable tradeoffs between overall price levels and price volatility?
- Should all utilities be required to adopt an identical framework for procurements or should they have flexibility to tailor their products and process to the needs of customers in their service territory?

- How do you encourage competitive suppliers to enter the market while maintaining low prices for default service customers?
- How do you balance the interests of ratepayers, competitive suppliers, and utility shareholders in the market?
- Does the selected process interfere with other objectives like renewable energy or conservation?
- How does the selected process create or exacerbate potential subsidies across rate classes?
- Are subsidies acceptable if they lower the overall weighted average default service cost?
- How should regulators address potential rate differentials across utility service territories within the same state?
- How can you avoid rate shocks or discontinuities?
- What is the best process to identify low cost suppliers?

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