



Growing Competitive Electricity

Why Texas Must End the Price to Beat

by **Robert J. Michaels, Senior Fellow, Texas Public Policy Foundation**

Background

In Texas and elsewhere, electricity's future will be one of competitors vying to serve individual residences and businesses. For over half of the population, competition is becoming an alternative to service by regulated monopoly utilities. In the past, utilities produced and distributed power under an obligation to serve all customers in their assigned territories. Prior to the 1970s, most large utilities were self-sufficient, charging regulated rates that covered their costs and gave investors a reasonable return. (Some cities and rural areas were served by municipal systems or cooperatives.) Beginning in that decade, new laws and technologies allowed the emergence of wholesale or bulk power markets where utilities might purchase power for less than the cost of producing it themselves. Alongside utilities, a new industry of independently owned generators and marketers developed as another source of power for utilities to distribute.

However, the development of these markets was hindered by some of the new laws. For instance, the 1978 Power Plant and Industrial Fuel Use Act forbade the use of natural gas as a primary boiler fuel in new power plants and required all existing gas-fired plants to convert to an alternate fuel by 1990. This caused extensive market disruptions in those states that relied heavily on gas-fired generation, such as Texas (93 percent), Oklahoma (99 percent), and Louisiana (87 percent).

Why the Price to Beat Should Terminate

- The PTB is very different from a "regulated" price.
- The PTB distorts market prices and adds unnecessary uncertainty.
- Political factors can affect the PTB in ways that are inefficient and impede competition.
- There is an asymmetry between increases and decreases in a provider's PTB.
- Keeping the PTB or modifying it will dash the expectations of almost all market participants.

By 2004, the Federal Energy Regulatory Commission [FERC] had succeeded in putting about two-thirds of the nation's electricity system under the control of regional organizations. They operated the transmission systems of all the utilities in their areas to efficiently coordinate power flows in a nondiscriminatory manner.

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With the stage set, wholesale markets began to grow. By 2004, non-utility generators (including owners of some plants divested by utilities) owned 44 percent of the nation's capacity and produced 37 percent of its power.¹ Wholesale buyers also multiplied as new laws required transmission owners to move power from economical sources to small municipal utilities and cooperatives who were formerly without many choices. Only the actual consumers of power were still excluded from markets. State regulators would have to determine the market access, if any, that these "retail" customers could enjoy. Industrial users (some larger than municipal utilities) pressed for rights to seek their own suppliers, as did some advocates for commercial and residential customers.² California was the first to explore retail competition, and opened its grid in 1998. Illogical and inconsistent rules brought its markets to collapse, but other states' experiences were more favorable. Over 500,000 Pennsylvania customers are currently served by competitive providers, and by one estimate they have saved \$5 billion since markets opened in 2000. Currently, 20 states allow retail customers some form of access to competitive suppliers.³

Texas and Senate Bill 7

Regulation came late to Texas, and markets came early. It became the last state to regulate retail rates when the Public Utility Regulatory Act (PURA) of 1975 created the Public Utility Commission of Texas (PUCT).⁴ In the 1990s the Electricity Reliability Council of Texas (ERCOT) transformed itself from an association of utilities into a regional transmission operator. Large enough to produce power reliably and efficiently, the ERCOT area is exempt from federal regulation of rates and requirements for access to transmission because it is linked only weakly with interstate grids. Texas successfully deregulated wholesale power in 1997, requiring ERCOT transmission owners to offer nondiscriminatory access to their lines. A 1997 revision of PURA laid a foundation for retail competition, saying the public interest required that "electric services and their prices should be determined by customer choices and the normal forces of competition."⁵ In 1999, the legislature passed Senate Bill (SB) 7, which required the start of customer choice by Jan. 1, 2002.

SB 7 radically reshaped the state's utilities by changing the rules for procurement and sale of their power

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supplies. They had to unbundle their operations into three distinct components—production, transmission, and retail. Some utilities chose to form independent companies for this, while others chose to keep these operations related through the use of a holding company. Users would deal with new organizations known as Retail Electricity Providers (REPs). They were responsible for arranging power supplies to serve customers who had chosen them, using generation that they owned or had contracted for. Utilities could also own affiliated REPs. They too had to assemble their own power supplies, but regulation would no longer guarantee their financial health.

The Price to Beat and Market Performance

At the outset of choice, REPs affiliated with established utilities would serve almost everyone, but the PUCT and legislature wanted to see the quick entry of new suppliers and encourage consumers to explore their new alternatives. They expected (correctly, as it happened) large commercial and industrial customers to have enough at stake to strike supply deals without being prodded. As for residential and small commercial customers, there were questions about both sides of the market—would any REPs (other than utility affiliates) want to serve them, and would households be motivated to learn about their new choices? SB 7 instituted a "Price to Beat" (PTB) per kilowatt-hour (kwh) for these customers. A utility's PTB was based on its 1999 costs, discounted by 6 percent.⁶ Utility-affiliated REPs were required to charge the PTB, while unaffiliated REPs were free to set their own prices. One of the primary purposes of the PTB was to temporarily provide "headroom" for the unaffiliated REPs to earn a profit in order to encourage both unaffiliated REPs and consumers to participate, and thus foster the formation of competitive markets. The PTB was set at a level high enough for this to occur, and affiliated REPs were not allowed to charge less (or more) than the PTB.

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An affiliated REP could petition for an increased PTB when fuel costs increased, as will be discussed below. The law, however, gave the PUCT no powers to adjust it downward if fuel prices fell. Thus the PTB had two possible functions. First, if competition for small customers never materialized it would limit an affiliated REP's prices. Second, when retail access began ERCOT had a very high generation reserve margin of 35 percent. With gas prices low and PTBs relatively high, a number of new REPs could probably find power supplies that they could profitably resell at less than the PTB.

The new markets were largely successful. Industrial and large commercial customers had no price to beat, but hardly needed one. One month after choice began, 42 percent of large industrial load (primary voltage) and 12.5 percent of lower voltage commercial loads had found new REPs. By March 2006, those figures were 69.1 percent and 66.4 percent.⁷ Figure I shows the growth in supplier switching for the different classes of users since the opening of choice. These

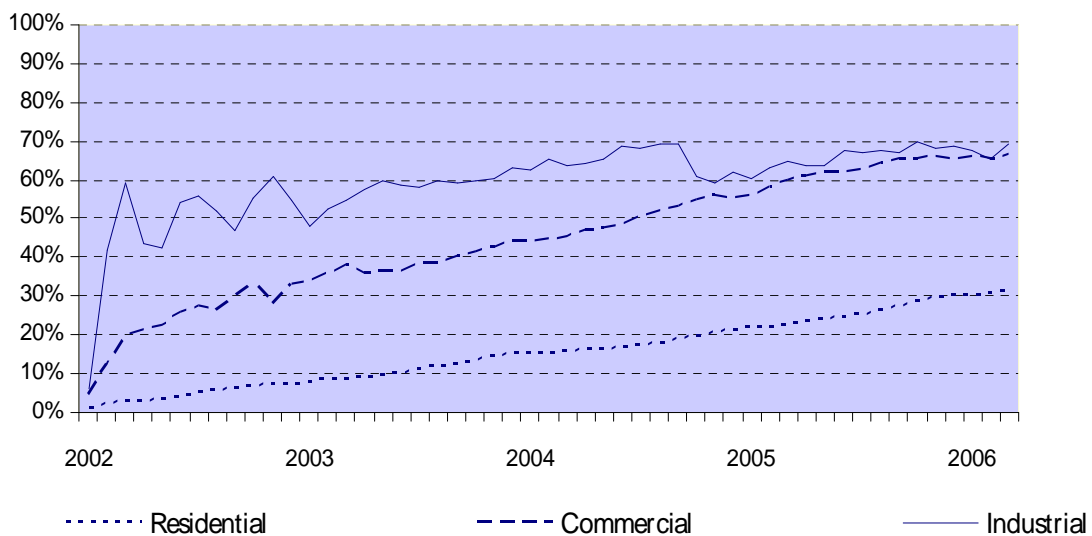
are net changes that also reflect some movement from new providers back to utility-affiliated REPs. Most residential customers now have more suppliers to choose from and more offerings on average from each of them. In December 2004, residential customers in Houston could choose from 11 suppliers selling under 12 different rate plans.⁸ Today they can choose from 26 plans offered by 14 suppliers.⁹ Except for two plans that offer renewable energy, all of them charge less than default server Reliant Energy's PTB per kwh. Table 1 shows similar growth in options for other residential users in ERCOT.

Table 1
Number of LSEs and Plans Available in Utility Territories: May 2006

Utility Area	# Providers	# Plans
AEP Central	15	24
AEP West Texas	13	22
Reliant Energy	14	26
Texas-New Mexico Power	12	23
TXU	14	29

Source: Public Utility Commission of Texas, <http://www.powertochoose.org/yourchoice/compareoffers.asp>. Tabulations for Corpus Christi (AEP Central), San Angelo (AEP West), Houston (Reliant), Lewisville (TNMP), and Fort Worth (TXU).

Figure 1
Percentage of Electric Loads Switched: January 2002-March 2006



The evidence shows that competition and retail choice are working in Texas. Because they are, the Price to Beat should not be extended beyond its scheduled Jan. 1, 2007 expiration.

Why the Price to Beat Should Terminate

The evidence shows that competition and retail choice are working in Texas. Because they are, the PTB should not be extended beyond its scheduled Jan. 1, 2007 expiration. Even if it had actually been necessary at the outset (and it probably was not), extension is poor economic policy. Much of the promise of competition will be lost if unaffiliated REPs remain protected from price competition by affiliated ones, and if the affiliated REPs never have to pass a fully competitive market test. Suggestions to extend it and give the PUCT powers to revise it downward are anti-competitive, and despite their superficial appeal they are anti-consumer in the long run. There are four basic reasons to abandon PTB and never look back:

1. *The PTB is very different from a “regulated” price.* Unlike a traditional regulated rate, the PTB is indexed from a starting point (1999) and was designed to lower consumer prices while still allowing enough “headroom”¹⁰ to allow unaffiliated REPs to earn a profit selling electricity at a price below the PTB. Additionally, adjustments to the price to beat are prescribed in statute to be based on fuel factor adjustments as approved by the PUC, not on the actual costs of acquiring the electricity, as might be the case in traditional rate regulation. The difference between the PTB and traditional rate regulation was seen in Reliant Energy’s January 2003 application for a 23.4 percent rate increase in light of the increasing cost of natural gas. The increase was objected to by several interested parties¹¹ who testified that since only 42 percent of Reliant Energy’s power came from gas-fired generators, and the remainder from coal and nuclear units,¹² its

default customers (who, it should be noted, had the option of choosing another, lower cost provider) would see a rate increase greater than the actual increase in electricity costs. While this may or may not have been true, the argument ignored the fundamental statutory differences between a cost-based regulated rate and the PTB. The PUCT, following the PTB statute, approved the increase.

2. *The PTB distorts market prices and adds unnecessary uncertainty.* Even if an affiliated REP has only gas-fired generation, once it has applied for its second annual increase it can receive no further relief until the next year. If gas prices are rising rapidly, these restrictions distort market price signals and can give a default REP a competitive advantage. As an example, in October 2005 all five large affiliated REPs applied for adjustments. Since their last filings (mostly in April) gas prices had risen by an average of 49 percent.¹³ Thus between April and November (when the increases were granted) their fixed PTBs would not cover increased gas prices. If fuel costs had been automatically adjusted each month (either by regulators or the market), the difference between PTB and actual cost would have been much smaller. Delayed adjustment makes the PTB more attractive to customers than a competitive price that adjusts rapidly to fuel costs. A fixed PTB allows a default provider with deep pockets to retain—and possibly attract—customers it might not otherwise be serving. If rates do not closely track costs, customers can switch to the default REP when there is no valid economic reason for them to do so.

The Price to Beat distorts market prices and adds unnecessary uncertainty.

3. *Political factors can affect the PTB in ways that are inefficient and impede competition.* We have already seen one significant incident. Shortly after the 2005 hurricanes, affiliated

REPs reached an agreement with the PUCT to postpone their fuel adjustment applications until gas prices fell. The commission was un-receptive to arguments by unaffiliated providers that doing so would destroy confidence in the market. It also chose to disregard arguments that the postponement would benefit default REPs and harm unaffiliated ones by keeping the formers' rates steady while the latter were financially compelled to pass spiked prices onto their customers.¹⁴ If the PUCT is granted new powers to order cuts in the PTB, the potential scope for politicization of the market will further increase.

4. *There is an asymmetry between increases and decreases in a provider's PTB.* If an affiliated REP's customers fail to shop due to ignorance or misplaced loyalty, it will probably be quick to petition for increases when gas costs rise and slow to petition for decreases when they fall. Today's statutes and regulations do not require that a REP ever petition for a decrease, and one will probably do so only if competition threatens its hold on even these "sticky" customers. The first applications for a PTB decrease came from American Electric Power's two Direct Energy units in May 2006, fully 52 months after the start of retail access.¹⁵ After the requests were granted, the companies told industry media that they wanted to pass their fuel savings on to customers, something they would most likely do only if they felt competitive pressure.¹⁶

Giving the commission the ability to adjust the Price to Beat downward would further increase the uncertainty under which utilities, competitive REPs, and customers must set their courses in emerging competitive markets.

These reasons favor allowing the PTB to lapse at the end of 2006, as SB 7 intended. They also strengthen arguments against allowing the PUCT to adjust an affiliated LSE's PTB downward prior to 2007. Whatever the PUCT's legal powers in this area, giving the commission this ability would further increase the uncertainty under which utilities, competitive REPs, and customers must set their courses in emerging competitive markets. SB 7's provisions on upward adjustment of the PTB already create significant uncertainty regarding the timing of filings and the amounts that utilities apply for. Giving the PUCT new powers on downward adjustment can only increase that risk.

Conclusion

There is one final and best reason to end the Price to Beat on schedule: keeping the PTB or modifying it will dash the expectations of almost all market participants. No REPs, generators, or major users are on record as favoring continuation. They appear to unanimously expect termination, and are already forming and implementing plans to compete when PTBs are gone. These strategies are taking several forms.


Keeping the Price to Beat or modifying it will dash the expectations of almost all market participants.

First, REPs have announced a number of new rate plans they expect will attract and retain customers after termination. Some new rates facilitate risk-sharing. Reliant recently announced an optional residential rate with an embedded weather derivative. If temperatures are sufficiently above average in a summer month, Reliant will rebate \$50 to each customer under the plan.¹⁷ Others offer greater certainty if customers pay for it. Alongside its other plans, TXU recently announced a guaranteed price per kwh over the next year, but a customer taking that rate will have to pay \$200 for the right to switch to some other REP or other TXU rate plan. For those with different risk

preferences, TXU offers a rate that closely tracks the market price of gas.¹⁸ Default providers already compete in each others' territories at rates below the local PTB, and they expect that the competition will intensify after the PTB ends.¹⁹

Second, new types of service will be offered. With the growth of "renewable" power TXU now offers rate plans that incorporate different percentages of wind generation. Green Mountain Energy, the national leader in environmentally friendly power, is offering two packages of 100 percent renewables with an eye on next year. One will carry rates that fluctuate with market prices, and one carries a guaranteed rate equal to Reliant's PTB through the end of 2006.²⁰

Third, new services will make people more aware of their choices and help them pick those that are best for them. Houston's city government has certified seven competitive providers (others are also available) and begun a campaign to raise public awareness. New types of middlemen like "aggregators" bring together uneconomically small loads and purchase power for them at better rates. Constellation New Energy recently renewed its 130 MW contract with 39 south Texas cities and other agencies that provides power at 20 percent less than the local PTB.²¹

All of this is only the start, but for innovative competition to flourish market participants must not face the added uncertainty of a price to beat whose movements can only become more unpredictable if it is extended. Ending it on schedule will be a key step toward realizing the promise of customer choice for everyone in Texas. 

About the Author

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Endnotes

- ¹Figures are from the U.S. Department of Energy's Energy Information Administration. http://www.eia.doe.gov/cneaf/electricity/epa/epaxlfile2_3.xls and http://www.eia.doe.gov/cneaf/electricity/epa/epaxlfile1_1.xls.
- ²Roughly speaking, residential, commercial and industrial customers consume approximately 1/3 each of total power delivered in the U.S.
- ³Data are from the Electric Power Supply Association, the independent generators' trade group, at http://www.epsa.org/competition/quick_facts_mp.cfm and http://www.epsa.org/Competition/EPESA_Choice_Map.pdf.
- ⁴Historical data are from Natalie Scott, "Implementation of Senate Bill 7: The Implication of Stranded Cost Recovery for Residential Electric Utility Customers," *Baylor Law Review* 52 (Win. 2000) 237-269.
- ⁵Texas Util. Code Ann., 39.001(a).
- ⁶PUCT Substantive Rule 25.41(f)(2).
- ⁷These data appear in "Report Cards" from the PUCT, available at http://www.puc.state.tx.us/electric/reports/RptCard/Market_Share_Data.xls.
- ⁸PUCT, Report to the 79th Texas Legislature on Scope of Competition in Electric Markets in Texas (Jan. 2005) 52. http://www.puc.state.tx.us/electric/reports/scope/2005/2005scope_elec.pdf.
- ⁹Power to Choose, <http://www.powertochoose.org/electricchoice/compareresults.asp?zip=77019>.
- ¹⁰Headroom is defined and used in Title 16 (Economic Regulation), Sec. 25.41 of the Texas Administrative Code
- ¹¹PUCT Docket No. 27320, summarized at http://www.puc.state.tx.us/electric/rates/PBT/PTB_TCRF_Summary.pdf
- ¹²Testimony and Exhibits of Randall J. Falkenberg, PUCT Docket No. 27320 (Feb. 10, 2003) 12.
- ¹³http://www.puc.state.tx.us/electric/rates/PBT/PTB_TCRF_Summary.pdf.
- ¹⁴"Retailers Blast Market Intervention in Texas as Default Suppliers Reach Deals on Price to Beat," *Power Markets Week*, 19 Sep. 2005.
- ¹⁵According to PUCT Substantive Rules 25.41(g) an affiliated REP can only offer a rate other than the PTB until the earlier of 36 months after the start of choice or after the PUCT has determined that a threshold target (40% of residential customers) has been met. As of March 2006, 4 of the 5 utility-affiliated REPs had retained approximately 70 percent of their residential customers, while Texas-New Mexico Power's First Choice affiliate had retained 63 percent. See http://www.puc.state.tx.us/electric/reports/RptCard/Market_Share_Data.xls.
- ¹⁶"Texas PUC Oks Direct Energy Units' Plans to Cut Default Rates," *Platts Commodity News*, 30 May 2006. No other affiliated REP is known to have made a similar filing.
- ¹⁷"Houston Heat Could Drive Down Rates," *Natural Gas Week*, 27 Mar. 2006.
- ¹⁸"Debate on Competition in Texas Continues as Marketing Effort Picks Up," *Power Markets Week*, 13 Mar. 2006.
- ¹⁹For example, "Reliant Energy Announces Guaranteed Savings Plan for North Texas Customers," *PR Newswire*, 26 Apr. 2006.
- ²⁰"TXU Energy Offers Three New Renewable Power Rate Options," *Power Market Today*, 19 Apr. 2006; "Choice Initiative. Company Offering Two Pollution Free Electricity Products to Houston Residents," *Business Wire*, 5 Apr. 2006.
- ²¹"Constellation New Energy Finalizes Power Agreement with South Texas Aggregation Project, Inc." *PR Newswire*, 17 Feb. 2006.

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