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# Default service pricing – The flaw and the fix

## Current pricing practices allow utilities to maintain market dominance in deregulated markets



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## ABSTRACT

Utility default service has been priced incorrectly for two decades. Incumbent utilities serving as default service providers for both electricity and gas allocate few to no “costs to serve” to default service rates. The indirect costs not allocated include billing, customer care, enrollments, metering, and other overhead and add up to billions of dollars annually. These costs are paid in distribution rates. The resulting rate for utility-provided default service is a below-market price, allowing the utilities to maintain dominant market positions in the retail markets for residential and small commercial customers. This pricing practice distorts the relevant retail electric and gas markets and harms customers and the markets. NARUC cost allocation guidelines advocate that the cost of utility resources used in the provision of default service should be allocated to that service. This paper presents a Default Service Equalization Adjustment Mechanism (“D-SEAM”) that when deployed properly, will provide the default service utilities with a tool to allocate an appropriate amount of costs to default service rates and then adjust that allocation on a monthly basis to ensure the distribution utility is made whole financially as customers migrate off of default service. Without an appropriate allocation of cost to default service, incumbent utilities will maintain a dominant market position in the retail markets for residential and small commercial customers as a result of the significant subsidy provided by the distribution rates. Utilities should adopt, and/or the regulators should compel the adoption of a complete and appropriate allocation of costs to default service. It is only with this allocation that customers will be able to reasonably compare market offerings.

## 1. Introduction

## 1.1. Default service prices have been wrong for two decades

Several states have restructured their electricity and/or gas markets to allow for customer choice of energy suppliers. Most of these states have implemented a Provider of Last Resort (“POLR”) provider or Default Service provider to provide electricity to customers who do not select an alternative provider. As long as default service remains the benchmark against which other offers are compared<sup>1</sup>, it should be priced so that all of the costs incurred to provide default service are included. For it is only in that circumstance when competitive retail

energy markets empower customers to meaningfully compare energy offers. Testimony presented in recent rate proceedings for PECO electric distribution utility in Pennsylvania and PSEG’s electric and gas distribution utilities in New Jersey reveal the magnitude of the pricing subsidies that are present in those markets. The practice of not allocating costs appropriately to a utility business unit is in direct conflict with cost allocation guidance from the National Association of Regulatory Utility Commissioners (“NARUC”). Until the pricing distortion is corrected, utility default service providers will continue to hold an anti-competitive pricing advantage in the provision of what should be competitive retail electricity service. Regulators should act to correct this major market flaw.

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<sup>1</sup> For several reasons, including those discussed within this paper, utility-provided default service products and prices should not be a benchmark to compare any competitive service offerings. The default service price is for a very specific product with a very specific set of parameters associated with it. This rate is often reconcilable and reflects a price from a prior point in time in the market. Additionally, as this article notes, default service is heavily subsidized. It comes with a certain level of service and a very limited ability for it to be modified in any way to meet customers’ needs. Regardless, regulators in many states have mandated rules that require a comparison of all products to the utility default service price. These requirements include for example, a requirement that the default service price be placed on a customer’s invoice, even if the customer is being served by another supplier, with a different product. Some have required that all sales interactions include a notice of the utilities’ default service price.

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The majority of states that have restructured retail energy markets report statistics on customer migration away from the incumbent utilities. This data shows clearly that the incumbent utilities in restructured states continue to hold strong market dominance in the residential and small commercial markets. For example, after nearly 20 years of competition, the majority of restructured states show migration rates of less than 20% of the residential electricity customers.<sup>2</sup>

The explanations proffered by the so-called “energy experts” all miss the simple truth – the incumbent utilities still hold vast market powers granted to them by their respective regulators. Most notably, the cost of providing default service is nearly fully- (and in some cases fully-) subsidized by the host utility’s distribution customers. Yes, customers typically pay the full price for the electrons they receive. Customers, however, are not charged for billing, IT, overhead, or any other costs that should rightfully be allocated to default service. The simple thought experiment to see if appropriate costs are being allocated to the default service business is to imagine what would happen if default service was severed from the utility’s distribution business. Under this imaginary scenario, nearly every default service program would be bankrupt in a matter of days, if not hours, if it was removed from the distribution business. This simple example should allow the reader to clearly see that utilities are not allocating adequate costs to default service.

## 2. Background

Several states within the United States have deregulated or restructured their retail energy markets to allow consumers to choose their own electric and/or gas supplier. While the utilities in these regions continue to maintain monopoly franchise rights over their “pipes and wires” businesses, their electric generation and gas supply businesses are now subject to competitive forces and customer choice of supplier. With few notable exceptions, the deregulation models adopted in these states called for the incumbent utility to become the POLR or default service provider. While initially envisioned to serve a small number of customers who were in need of a “last resort” provider, the market rules incorporated into most restructured markets placed all customers on “last resort” service at the inception of retail competition<sup>3</sup>. Because “last resort” became such an inappropriate phrase for what utility service has become, the name has morphed to “standard offer” or “default service” – the service for customers who fail to choose a competitive alternative. Unfortunately, embedded in this process are default service prices that are heavily subsidized by the host utilities’ distribution companies. As a result, default service customers are misled about their retail market options and thus, frequently remain with their incumbent utility.

Some default service providers pass along some direct costs to their customers, such as the cost of credit to procure power in the open market. Some providers pass on no costs at all beyond the direct cost of the energy provided. No incumbent utility default service provider in the US passes along any indirect costs to its default service business. The indirect costs incurred to provide service to default service customers amount to billions of dollars annually and are being paid by distribution customers. This distorts significantly the retail energy markets, providing the incumbent default service provider with a pricing

<sup>2</sup> This paper focuses on competitive electricity markets. The same dynamics discussed in this paper are also present in the competitive gas markets. The distribution companies significantly subsidize the commodity price by failing to allocate costs to serve default service customers. The solutions provided in this paper are applicable to gas distribution companies as well.

<sup>3</sup> A few deregulation models were implemented differently, and customers were immediately placed into the competitive market upon inception of the market. Notably, Texas electricity customers and Georgia natural gas customers were placed with market participants at the inception, or shortly after the inception of those markets.

advantage that allows them to maintain market dominance in the residential and small commercial customer segments.

These subsidies are the primary reason that retailers focus on non-price issues and offer many value-added products and services. It is simply not practical to compete with standard offer service on price alone. In short, the default service rates offered to customers by incumbent utilities are artificially low, which leads to numerous market flaws: distribution rates are too high; default service rates are too low; customers are receiving incorrect and inappropriate price signals from their host utilities; consumers are not provided adequate information to make informed energy decisions; and customers who have switched to competitive suppliers are subsidizing those who stay on default service. This pricing incongruity allows the incumbent default service providers to maintain market dominance over customers in their service territories and it also has given rise to bogus claims of “overcharging” by competitive suppliers.

## 3. Data from recent analyses

Substantial analyses seeking to understand the magnitude of the distribution subsidy have been performed in recent distribution rate cases. The results of those analyses have been presented to Utility Commissions in Pennsylvania and New Jersey in the form of expert testimony in those cases. These analyses show that the subsidy is significant – a penny or more per kilowatt-hour – or more than 10% of the default service rate.

In PECO’s rate proceeding (PA PUC Docket No. R-2018-3000164), NRG Energy Company presented an analysis of PECO’s distribution rates that showed the subsidy of PECO’s default service by PECO’s distribution business amounts to 1.25 cents per kilowatt-hour for residential customers.<sup>4</sup>

In PSEG’s rate proceeding (NJ BPU Docket No. ER18010029), Frank Lacey (the author of this article), an energy markets consultant and president of Electric Advisors Consulting, undertook on behalf of Direct Energy, a similar analysis that showed the PSEG distribution rates were providing default service subsidies of 1.0 cent per kilowatt-hour to residential customers and 0.67 cents per kWh to C&I customers.<sup>5</sup>

## 4. Proposed solution

The distribution companies should allocate the portion of costs incurred to operate the default service business to the that business and collect those costs from its customers on the energy portion of those customers’ invoices. In order for the distribution company to fully collect its regulated revenue requirement, the distribution companies should also implement crediting, balancing and true-up mechanisms to ensure that it is never over- or under-collecting.

### 4.1. Cost allocation mechanism

Distribution resources that are used in the functioning of the default service business should be identified. The costs associated with these resources should be quantified as they would be in a rate proceeding. Once the bucket of costs is identified, an appropriate allocation

<sup>4</sup> Direct Testimony of Chris Peterson on Behalf of NRG Energy Company, Pennsylvania Public Utility Commission v. PECO Energy Company, Docket No. R-2018-3000164, June 26, 2018.

<sup>5</sup> Prepared Direct Testimony of Frank Lacey on behalf of Direct Energy and its affiliates before the New Jersey Board of Public Utilities, In the Matter of the Petition of Public Service Electric and Gas Company for Approval of an Increase in Electric and Gas Rates and for Changes in the Tariffs for Electric and Gas Service, B.P.U.N.J. No. 16, Electric and B.P.U.N.J. No. 16, Gas, and for Changes in Depreciation Rates, Pursuant to N.J.S.A. 48:2-18, N.J.S.A. 48:2-21 and N.J.S.A. 48:2-21.1, and for Other Appropriate Relief, BPU Docket Nos. ER18010029 and GR18010030, OAL Docket No. PUC 01151-18, August 6, 2018.

approach should be applied so that costs to run the default service business are properly attributed to that business.

Based on the numbers presented by PSEG in its recent rate proceeding, approximately \$300 million in expenses (out of a total of \$900 million) and about \$1.3 billion in rate base assets (out of a total of \$5.7 billion) were identified as utility resources or costs that were utilized in the provision of default service and as such, these costs should be partially allocated to default service.<sup>6</sup>

The most logical allocator to apportion these shared costs is revenue as the majority of the shared costs are incurred in the revenue or cash management function. These costs include those for the billing system, accounting and finance, metering, and others.

#### 4.2. True-up mechanism

If a static, one-time cost allocation is made to default service, as customers migrate to competitive supply, the utility would not be able to collect fully its distribution revenue requirement. In the PSEG rate case, a Default Service Equalization Adjustment Mechanism (“D-SEAM”) was proposed to address that shortfall.<sup>7</sup> The D-SEAM does not require a change to the overall distribution revenue requirement or the resulting distribution rates. Instead, the D-SEAM allocation mechanism includes a monthly upward cost adjustment to default service customers and at the same time, it calls for an incremental cost credit to distribution customers, resulting in financial neutrality to the utility. As customers migrate to competitive supply, the D-SEAM collections decrease, but at the same time, so would the distribution credit to customers. The D-SEAM would operate in almost the exact same manner that many decoupling mechanisms are implemented, although calculations and adjustments could be implemented monthly.

As customers migrate away from default service, this ratio of revenues is certain to change, however, the subset of systems, infrastructure and people utilized to support default service will not change. Therefore, only the allocation factor changes with customer migration. The table below shows how the mechanism can be used to keep the utility whole as migration away from default service occurs (Table 1).

As customer migration occurs, the charges and credits change, but the total distribution collections remain constant. Ultimately, if every customer was on a competitive service supply option, there would be no allocations and no credits.

#### 5. Freestanding default service businesses could not survive

To understand the foolishness of the current models, one only needs to contemplate how a default service business could operate if it was removed from the distribution company but kept its current cost structure intact. The short answer is that it would survive for only a very short period of time – technically, not even a day. If nothing else, a default service business needs to process tens of thousands of invoices and payments every day. In reality, the list of utility services utilized in the provision of default service is quite lengthy. Under the current framework, there would be no funds to pay for any of those services. Clearly, this is a fundamentally flawed system.

<sup>6</sup> The rate proceeding did not adequately identify the subset of costs, such as working capital attributable to default service or wholesale procurement costs that should be directly assigned to default service business. As such, those direct costs were included in the analysis as an indirect cost and included in the set of costs that should be allocated to default service. As a result, the final recommendation of a 1.0 cent per kWh allocation to default service is likely understated.

<sup>7</sup> PSEG’s default service is called Basic Generation Service or BGS. The equalization adjustment was referred to as “BEAM” in the PSEG rate proceeding.

**Table 1**  
Sample Calculations Showing D-SEAM and D-SEAM Impact on Distribution Revenue Collections.

Time Period	Number of Dist Customers	Average Dist Kwh/cust/month	Total Dist Revenue Requirement (\$)	Distribution costs allocable to BGS (30% of all costs)	Retail Choice Customers	Default Service Customers	Revenue-based Allocation Ratio to D-SEAM	Costs Allocated to D-SEAM	D-SEAM per Default Service Customer (\$/month)	D-SEAM Credit	D-SEAM Credit per Dist customer (\$/month)	Total Distribution Collections (\$)
0	1,600,000	577	46,160,000	13,848,000	-	1,600,000	0.50	6,924,000	4.33	6,924,000	4.33	46,160,000
1	1,600,000	577	46,160,000	13,848,000	200,000	1,400,000	0.47	6,462,400	4.62	6,462,400	4.04	46,160,000
2	1,600,000	577	46,160,000	13,848,000	800,000	800,000	0.33	4,616,000	5.77	4,616,000	2.89	46,160,000
3	1,600,000	577	46,160,000	13,848,000	1,000,000	600,000	0.27	3,776,727	6.29	3,776,727	2.36	46,160,000
4	1,600,000	577	46,160,000	13,848,000	1,599,999	1	0.00	0	0.00	0	0.00	46,160,000

## 6. NARUC principles require allocations to default service

The principles of cost allocation are fully endorsed by NARUC and should be applied to default service as they are to all other utility rates. The principles of cost allocation are the foundation for nearly every (if not every) utility rate, aside from default service rates. The principles of cost accounting are neither new nor novel to utility rate making personnel or regulators who approve rates. Yet despite the long history of cost allocation in the industry, the default service businesses have been allowed to operate since the inception of deregulation without an appropriate allocation of costs to serve default service customers.

The NARUC Cost Accounting Manual states:

“While opinions vary on the appropriate methodologies to be used to perform cost studies, few analysts seriously question the standard that service should be provided at cost. Non-cost concepts and principles often modify the cost of service standard, but it remains the primary criterion for the reasonableness of rates. The cost principle applies not only to the overall level of rates, but to the rates set for individual services, classes of customers, and *segments of the utility's business*. Cost studies are therefore used by regulators for the following purposes:

- To attribute costs to different categories of customers based on how those customers cause costs to be incurred.
- To determine how costs will be recovered from customers within each customer class.
- To calculate costs of individual types of service based on the costs each service requires the utility to expend.
- To determine the revenue requirement for the monopoly services offered by a utility operating in both monopoly and competitive markets.
- To separate costs between different regulatory jurisdictions.”<sup>8</sup> (emphasis added).

These observations from NARUC are especially prescient given the date of the Cost Allocation Manual – January 1992. At that point in time NARUC was envisioning an allocation of costs of monopoly services offered by a utility operating in both monopoly and competitive markets. Even though it is likely the NARUC Manual did not envision default service as it is being offered today, the principles hold true from an accounting perspective and from a regulatory rate-making perspective and should be applied to default service.

Notably, NARUC's Manual expressly calls out costs allocated to “segments of the utility's business”. In other words, it is appropriate to allocate costs to each business segment, even if it is not a separate business unit with profits and/or losses attached to it. Despite the foresight from NARUC, this guidance has been ignored by utilities in the provision of default service. This manual, dating back over 25 years is still available on the NARUC website.<sup>9</sup>

NARUC has separately published cost allocation principles. The principles should be applied, “whenever products or services are provided between a regulated utility and its non-regulated affiliate or division”.<sup>10</sup> Under NARUC's first identified principle, direct costs “should be collected and classified on a direct basis for each asset, service or product provided.”<sup>11</sup> The set of direct costs that should be charged to default service include, but is not limited to, the cost of credit, the cost of wholesale market departments, the costs of procurement, working capital, bad debt, the cost of communicating environmental attributes of default service supply (where required), and the cost of other regulatory requirements imposed on default

service providers.

NARUC principles further apply to default service stating: “The allocation methods should apply to the regulated entity's affiliates in order to *prevent subsidization from, and ensure equitable cost sharing among the regulated entity and its affiliates*, and vice versa.”<sup>12</sup> (Emphasis added.)

NARUC describes that the objective of its guidelines is to “lessen the possibility of subsidization in order to protect monopoly ratepayers and to *help establish and preserve competition in the electric generation and the electric and gas supply markets*.”<sup>13</sup> (emphasis added) In fact, to ensure the competitiveness of markets, NARUC states that generally, “the price for services, products and the use of assets provided by a regulated entity to its non-regulated affiliates should be at the *higher of fully allocated costs or prevailing market prices*.”<sup>14</sup> (emphasis added) NARUC's cost allocation guidance and objectives have been ignored for two decades and the data shows that the incumbent utilities' monopoly-like stronghold over customers, especially residential and small commercial customers, remains.

## 7. Default service pricing harms markets

### 7.1. Default service providers maintain market dominance

The default service pricing anomaly results in a significant subsidy that provides the incumbent utilities default service businesses with anti-competitive pricing power. Default service customers are simply not being charged an amount that is reflective of the cost to serve those customers. The lack of any meaningful cost allocations to default service allows (requires) the incumbent utilities in restructured states to understate the price of retail electricity and eliminates competitive suppliers from functioning effectively in those markets.

In an ironic submission to the New York Public Service Commission, Commission staff offered the results of a Herfindahl–Hirschman Index (“HHI”) analysis, while trying to show market power among competitive suppliers. However, what the results actually showed is that each of the New York electricity markets was “highly concentrated” when the analysis included the incumbent utility (with HHI scores above 7000) but was unconcentrated without the incumbent utilities (with HHI scores as low as 420).<sup>16</sup> Rather than showing market power among competitive suppliers, this analysis clearly demonstrates the market dominance of the New York utilities. Commission staff testified further that the 23 largest competitive electric suppliers were serving less than 20% of the New York residential market.<sup>17</sup> That means that on average, the 23 largest competitive electric

<sup>12</sup> Ibid, Section B.4.

<sup>13</sup> Ibid, Section D.

<sup>14</sup> Ibid, Section D.1.

<sup>15</sup> According to the US Department of Justice, the HHI is a commonly accepted measure of market concentration. The HHI is calculated by squaring the market share of each firm competing in the market and then summing the resulting numbers. The HHI considers the relative size distribution of the firms in a market. It approaches zero when a market is occupied by a large number of firms of relatively equal size and reaches its maximum of 10,000 points when a market is controlled by a single firm. Agencies generally consider markets in which the HHI is between 1,500 and 2,500 points to be moderately concentrated and consider markets in which the HHI is in excess of 2,500 points to be highly concentrated. See U.S. Department of Justice & FTC, *Horizontal Merger Guidelines* § 5.3 (2010).

<sup>16</sup> Prepared Direct Testimony of Joel Andruski, Associate Economist, Office of Market and Regulatory Economics, State of New York, Department of Public Service, *In the Matter of ESCO Track I Proceeding*, Cases 15-M-0127, 12-M-0476 and 98-M-1343, September 2017.

<sup>17</sup> Prepared Direct Testimony of the NY PSC Staff Panel: Bruce E. Alch, Chief, Retail Access and Business Advocacy, Office of Consumer Services; Craig Carroll, Utility Analyst 2, Office of Consumer Services; Peter Lavery, Utility Analyst, Office of Accounting, Audits and Finance; Kristine A. Prylo, Principal Utility Financial Analyst, Office of Accounting, Audits and Finance; David Shahbazian, Utility Auditor II, Office of Accounting, Audits and Finance, State of New York Department of Public Service, *In the Matter of ESCO Track I*

<sup>8</sup> NARUC, Electric Utility Cost Accounting Manual, January 1992, found at <http://pubs.naruc.org/pub/53A3986F-2354-D714-51BD-23412BCFEDFD>

<sup>9</sup> See: <https://pubs.naruc.org/pub.cfm?id=53A20BE2-2354-D714-5109-3999CB7043CE>

<sup>10</sup> NARUC, <http://pubs.naruc.org/pub/539BF2CD-2354-D714-51C4-0D70A5A95C65>

<sup>11</sup> Ibid, Section B.1.



suppliers each hold less than a 1% market share, while one New York utility still holds an 87% share in the residential market in its service territory.

The New York Staff's HHI analysis effectively proves the utilities dominance in New York. The same result would be found in nearly every other deregulated market. The question then is: why do the utilities hold such a dominant position? It is clearly not the lack of interest from competitive suppliers. After all, the New York Staff cites to the “23 largest” suppliers, indicating that there are many more than 23 vying for customers’ business. Do customers endear themselves to the utilities in every market? Not likely. Do the utilities offer one better product than the list of all products offered by competitive suppliers? Not likely. Or is the utilities pricing subsidy simply too great for competitive suppliers to overcome? Without performing any formal analysis on these first two questions, the answers seem obvious. The utility pricing advantage brought on by a lack of cost allocation is simply too great for the suppliers to overcome. All energy companies are purchasing power from the same wholesale markets. Utilities simply do not pass on the costs to service their customers. The pricing incongruity could not be more evident.

Because competitive suppliers must include all of their operating costs in their supply prices in addition to the wholesale cost of energy, competitive prices are frequently higher than those of the subsidized default service rates. Instead of regulators fixing the default service pricing, many have instead lobbed allegations of “overcharging” at the competitive suppliers.<sup>18</sup> Regulators and consumer advocates have launched investigations and suggested that residential markets be closed. As a result, competitive suppliers have spent millions of dollars defending their actions and fighting to maintain a presence in the markets.

### 7.2. Customer migration trends are consistent

The New York customer switching results discussed above are not unique. Table 2 below details the percentage of customers who have chosen a competitive electric supplier across many of the deregulated electricity markets. After two decades of competitive markets, we see a similar pattern of migration rates of customers to competitive suppliers across the restructured markets<sup>19</sup>.

The results in Table 2 are not unexpected. In order to compete with default service, a competitive supplier has to either wait for a cycle in the wholesale markets that will allow for a more economic offering than default service, or the supplier has to offer a better, typically more expensive product. It is difficult to compete with the subsidized default service price.

Chart 1 below shows the same data in graphical form. The graph shows that the migration problem is not unique to any one utility jurisdiction. Small customers do not migrate away from the utilities while the largest customers participate in the competitive markets at very high penetration levels<sup>20</sup>. It is not clear whether the outlier in the Large

(footnote continued)

Proceeding, Cases 15-M-0127, 12-M-0476 and 98-M-1343, September 2017.

<sup>18</sup> In the aftermath of the Polar Vortex in 2014, a handful of suppliers charged higher prices than were typical in the market at the time. Regulators in some markets determined that certain suppliers acted in bad faith and penalized them. However, the recent analyses presented that allege systemic overcharging have incorrectly and inappropriately compared market-based electricity products to the subsidized default service rates on an apples-to-apples basis.

<sup>19</sup> States that have implemented municipal aggregations programs are not included in Table 2. Municipal aggregations might lead to more robust migration numbers, but they are only a short-term regulatory fix that temporarily masks the distribution subsidy. Municipal aggregations do not solve the pricing incongruity over time.

<sup>20</sup> The research on this paper and in support of the PSEG rate case showed that the subsidy for larger customers is smaller, on a per-kWh basis, than the subsidy for residential customers.

**Table 2**

Electric Customer Retail Choice Migration Rates<sup>a</sup>

State	Utility	Percentage of Rate Class Switching By Customer Count		
		Residential	Small and Medium	Large
DC <sup>b,c</sup>	PEPCO	15.0	32.1	N/A
	BGE	23.9	41.0	96.5
MD <sup>d</sup>	PEPCO	19.8	42.8	87.9
	POTED	10.8	32.4	90.3
	Delmarva	13.8	35.8	96.9
	ACE	12.8	32.2	87.1
	JCPL	16.6	38.1	83.7
NJ <sup>e</sup>	PSEG	9.7	24.7	81.0
	RECO	6.9	18.4	74.5
	Duquesne	29.9	39.9	63.1
PA <sup>f</sup>	Met-Ed	30.2	45.1	86.3
	PECO	31.0	46.0	91.0
	Penn Elec	26.1	42.2	88.1
	Penn Power	24.2	46.3	100.0
	PPL	41.3	53.7	70.5
	West Penn	24.7	32.8	91.9
	Central Hud	13.1	23.1	78.0
NY <sup>g</sup>	Con Ed	22.8	29.8	91.6
	Nat Grid	16.1	38.5	80.2
	NYSEG	18.6	35.2	66.0
	O & R	33.5	45.9	26.4
	Rochester	16.2	42.0	93.2
Maine <sup>h</sup>	State-wide	14.1	42.6	84.2
Delaware <sup>i</sup>	Delmarva	9.8	32.2	

<sup>a</sup>Data in this table gathered from each state's PUC or related website. Each state has differing definitions for C&I customer classes. Data from Ohio, Illinois and Massachusetts are not included in this table because each jurisdiction has engaged in robust community aggregation programs. Rhode Island data is not presented because Rhode Island does not report by rate class, the number of customers not participating in retail choice programs, so percentages by rate class cannot be calculated. Connecticut data is not shown here as its last reported data period is year-end 2014 and it also does not break down enrollment data by rate class.

<sup>b</sup>See: [https://depsec.org/PSCDC/media/PDFFiles/Electric/electric\\_sumstats\\_no\\_cons.pdf](https://depsec.org/PSCDC/media/PDFFiles/Electric/electric_sumstats_no_cons.pdf). (Sept. 2018 data).

<sup>c</sup>See: [https://depsec.org/PSCDC/media/PDFFiles/Electric/electric\\_sumstats\\_cons\\_dmnd.pdf](https://depsec.org/PSCDC/media/PDFFiles/Electric/electric_sumstats_cons_dmnd.pdf). (Sept. 2018 data).

<sup>d</sup>See: <https://www.psc.state.md.us/electricity/electric-choice-monthly-enrollment-reports/>. (August 2018 data).

<sup>e</sup>See: <https://www.state.nj.us/bpu/pdf/energy/edc07.pdf>. (August 2018 data).

<sup>f</sup>See: <https://www.papowerswitch.com/sites/default/files/PAPowerSwitch-Stats.pdf>. (Sept 2018 data).

<sup>g</sup>See: <http://www3.dps.ny.gov/W/PSCWeb.nsf/All/4759ECE7586F24B85257687006F396E?OpenDocument> (December 2017 data).

<sup>h</sup>See: [https://www.maine.gov/mpuc/electricity/choosing\\_supplier/migration\\_statistics.shtml](https://www.maine.gov/mpuc/electricity/choosing_supplier/migration_statistics.shtml). (September 2018 data).

<sup>i</sup>See: <https://depsec.delaware.gov/electric-regulation/#consumer>. (April 2018 data).

Customer category reflects a data error on the NY PSC website, or if there is a market anomaly that results in the largest customers in that market remaining with the utility.

### 7.3. Improper default service pricing harms Consumers

Customers are receiving an artificially low energy-price signal. This incorrect signal results in over-consumption of energy provided by default service providers. Because most residential customers are still on default service, the pricing anomaly results in system-wide over-consumption of electricity, increasing market prices for all consumers. On net, the artificially low price might actually yield what could be higher overall monthly costs to all customers because wholesale prices are impacted by increased consumption levels.

It is also impossible for customers to assess fairly a competitive offer

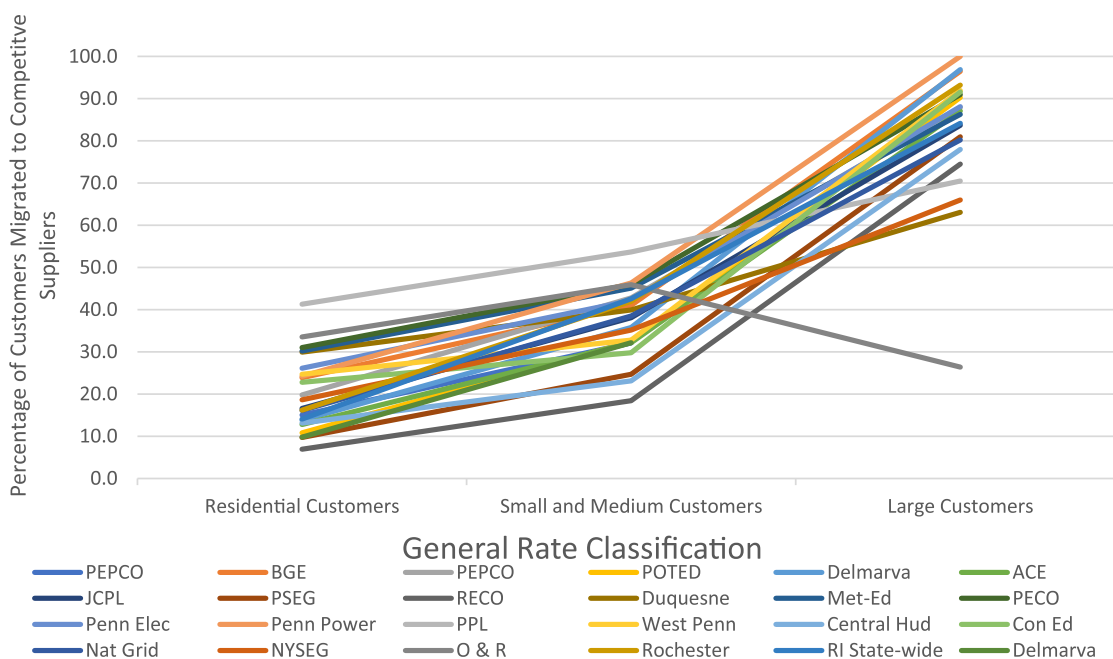


Chart 1. Customer Migration Trends are Consistent Across Markets.

when the utility price is artificially low<sup>21</sup>. Because the basic competitive commodity-only product would be viewed as uneconomic by the consumers, suppliers are less likely to invest fully in the market, depriving customers of other products and services including many that might reduce a consumer’s overall consumption, which would benefit the customers and the environment. These products and services are available in the more competitive regions of the country but are not as readily available where the subsidized default service rates stifle competition.

Finally, the distribution subsidy results in a distribution rate that is too high. Customers who have moved away from the utility are forced to pay costs that benefit customers who remain on default service.

The lack of residential and small commercial customer energy savings options, products and services is the result of a failed regulatory paradigm. It is not a reflection of a failed market.

### 8. Arguments against Cost allocation are flawed

Stakeholders have generally proffered four arguments against allocating indirect retail costs to default service. The typical arguments are:

- 1) The costs are not avoidable and will be incurred by the distribution business whether or not they provide default service;
- 2) If costs are allocated to default service, the distribution utility will not be able to recover its full distribution revenue requirement as customers migrate to competitive suppliers;
- 3) Allocation of costs serves no purpose other than to increase rates on customers so that competitive suppliers can better compete with utility pricing; and
- 4) Utilities do not earn a profit on the provision of default service, so an allocation of costs is not needed.

All of these arguments are flawed.

<sup>21</sup> Under no circumstance should any price, including the utilities’ default service price, be considered a benchmark price. See fn 1, supra.

### 8.1. Avoidable versus allocable costs

Simply stated, avoidable costs are direct costs. Fixed costs, which typically serve multiple purposes are considered indirect costs and should be allocated to the businesses which benefit from the resource. Direct or avoidable costs should be directly assigned (not “allocated”) to the business unit incurring the costs. The existence of avoidable/direct costs, however, does not mean that allocable/indirect costs don’t exist. In order for businesses to properly price products and services, indirect costs must be appropriately allocated to the cost centers benefiting from the incurrence of the costs.

Our economy is replete with examples of businesses that allocate costs to more than one product, service or business unit. But we do not need to look past the rate cases prevalent in the utility industry to see cost allocations implemented. Under the theory of avoidable costs, one could argue that commercial customers shouldn’t pay for distribution wires because if the commercial customers left the grid, the utility would still need to have the distribution wires in place to service residential customers. Of course, that argument is foolhardy. The cost of the distribution wires and services related to it are largely fixed costs that benefit all rate classes and are therefore allocated to all rate classes based on cost causation principles. It is inappropriate that utilities do not similarly assign direct costs and allocate an appropriate amount of indirect costs to default service.

### 8.2. Cost recovery

Utilities have argued against allocations to default service because if costs are allocated to that service and customers move to competitive supply, the utility will not be able to fully recover its allowed rates. This argument assumes a static accounting paradigm. If a utility simply lowered its distribution rate by one cent per kWh and increased default service rates by one cent per kWh, that argument would hold some validity. Further accounting and pricing tools can be developed that would ensure the utility is kept whole. The D-SEAM described above was presented in the PSEG rate case and fully resolves the cost recovery issue.

The cost recovery argument is a red herring. Utility tariffs are chock full of riders, true-ups, monthly adjustments and “make whole” mechanisms. It is clear that a true-up mechanism can be deployed that will

ensure that default service customers are seeing a competitive energy price that will also ensure utilities are fully compensated for their revenue requirements.

### 8.3. Facilitate competition

Stakeholders have argued that any attempt to place cost on default service should be thwarted as the increased default service prices are simply a ploy to allow competitive service providers to compete more effectively on price. This argument is similarly flawed. The lack of allocation of costs is contrary to all rational business accounting practices, is contrary to NARUC guidance on cost allocation and allows utilities to maintain market power in the residential and small commercial customer segments. Incumbent utilities' default service market dominance has been maintained because the cost to serve default service customers is being subsidized inappropriately by distribution rates. No rational or prudent business would price products or services without a full and appropriate allocation of costs included.

Further, if the cost allocation is done correctly, every dollar allocated to default service is similarly deducted from distribution costs. In other words, it is a cost reallocation, not a cost increase. On net, default customers will pay no more for bundled energy (electrons and delivery) than they would pay prior to the reallocation of costs. The premise of competing against "higher rates" is simply a false premise.

### 8.4. Utility profitability

Some utilities have argued that there is no reason to allocate costs to the default service business because they do not earn a return on the provision of default service. Regardless of the validity of that statement, it is not a reason to justify an allocation approach. A properly run widget manufacturer should allocate costs to profitable and unprofitable lines of business. In the absence of such an allocation, the unprofitable line of business might be viewed as profitable, resulting in decisions that would cause further financial harm to the overall widget company (i.e., lowering the retail price on what are already unprofitable products). These irrational pricing decisions are the exact decisions that the default service utilities have been making (default service prices are too low and distribution rates are too high). If both services were truly competitive, the distribution would be run out of business by its lower-priced competitors and the underpriced default service "successes" would bankrupt the company. However, the utilities are protected from these irrational behaviors by virtue of the

distribution monopoly.

The four primary arguments used to support the status quo are weak, at best. A cost allocation mechanism that keeps distribution companies whole as customers migrate on and off of default service could and should be implemented at all utilities that provide default service. The cost allocation implementation should include a comprehensive review of all utility costs inclusive of rate base assets, and all expenses, including executive salaries, legal departments, rate departments, customer service departments and all other employees and expenses. A measurable portion of those costs should be appropriately allocated to default service in accordance with NARUC guidelines and consistent with NARUC policies and objectives.

## 9. Conclusion

Default service pricing in the majority of the competitive retail energy markets is fundamentally flawed and allows the incumbent utilities to maintain a stronghold over their legacy customers in the residential and small commercial markets. Consistent with NARUC guidance, an appropriate amount of costs to serve default service customers should be allocated to default service rates. This is a critical next step in creating more competitively neutral retail energy markets in the US. This one step will not create the perfect market, but it will remove a significant pricing advantage held by incumbent utilities. It will also remove a subsidy that forces competitive supply customers to pay distribution rates that benefit default service customers, and it will help create a market in which competitive suppliers are more willing to invest. At the same time, if implemented correctly, it keeps distribution utilities financially whole. It is a win-win-win solution benefitting all market participants.



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