Keeping up with Retail Access? Developments in U.S. Restructuring and Resource Procurement for Regulated Retail Service

Retail access states have been reaching a key milestone: the end of the initial "transition period," after which utilities generally are required to use competitive processes to procure supply for their continuing obligation to provide retail service at regulated rates. The authors present a survey of the current state of U.S. retail restructuring, discuss the policy challenges faced as the initial transition periods end, and document how distribution utilities are procuring power for customers who have not selected alternative suppliers.

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I. Introduction

The dividing line between states that have pursued retail restructuring and states that are staying with traditional regulation has become more pronounced and possibly solidified. States that embraced retail access continue to do so and are reaching important milestones in meeting customers' continuing needs. Meanwhile, states with a traditional utility industry structure have ceased looking toward retail access and are finding ways to combine retail

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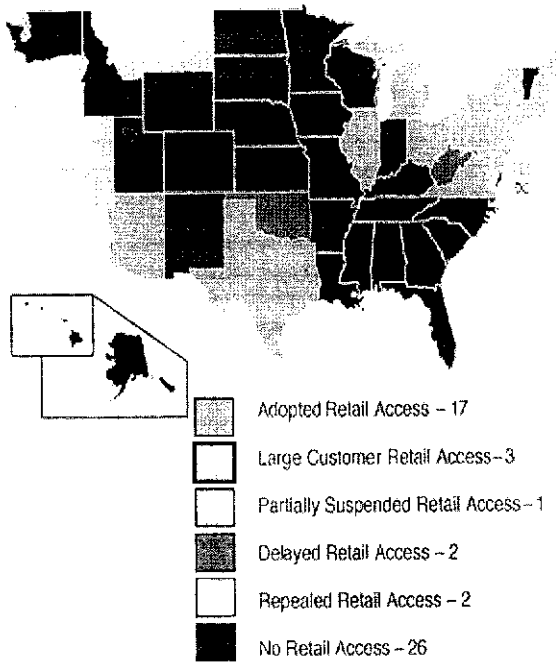
regulation with wholesale competition. In retail access states, a clear trend has emerged: Large customers are quite active in selecting service from unregulated suppliers, while residential and other small customers demonstrate a pronounced tendency to remain on the regulated retail service provided by the distribution utility.

A common challenge facing retail access states is the end of the so-called "transition period," during which retail customers who did not select service from an unregulated supplier could obtain regulated service from the distribution utility as the "provider of last resort" (POLR). During this period, regulated service was generally offered at capped rates with resources provided through buy-back contracts with the distribution utilities' generation affiliates or new generation owners. As this transition period comes to an end, policymakers and utilities have to address the continued need for regulated retail service and the procurement of generation supplies to provide that service. The way that this procurement process is structured has important implications for customer rates, utility cost recovery, the liquidity of wholesale markets, and the creation of a level playing field for unregulated retail access providers.

II. Status of Retail Restructuring in the U.S.



Source: EEI, Energy Central, The Brattle Group.

Figure 1: Summary of Retail Access in the U.S. (2004) *Source: EEI, Energy Central, The Brattle Group*

movement that has gained broad, but certainly not universal, support of state policymakers starting in the mid-1990s. In total, 25 states (including the District of Columbia)[1] have initiated a policy of utility industry restructuring through open retail access. Of these, 21 states are at present supporting retail access for all or some customer classes.[2] Four states have fallen away: Oklahoma and West Virginia have delayed their start dates of retail access, and Arkansas and New Mexico have repealed their retail access laws altogether.

Figure 1 shows a state-by-state summary of retail access. **Table 1** provides a more detailed snapshot of the current status of retail access access, listing states in the chronological order in which retail access was inaugurated. Table 1 indicates that the transition from a traditional, regulated industry structure to retail access was almost universally accompanied by a multi-year transition period. During this transition period, states dealt with three restructuring-related goals: (1) stranded cost recovery, (2) restructuring of generation ownership, and (3) protection of retail customers through continued provision of a regulated service option. These regulated service options are referred to as "standard offer service," "default service," "provider of last resort," and "basic generation service," although the precise meaning of

Table 1: Current Status of Competitive Market Development in States (Sorted by Inception Date of Retail Access)

	State	Inception of Retail Access	Customers Open to Retail Access as of 2004	Existence and Status of Capped Rates for Generation	Retail Access Penetration (% of MWh)***
[1]	Rhode Island	1/1998	All customers	Standard offer effectively capped until 2009 with fuel adjustment clause; last resort service is market-based since 6/2000	11%
[2]	Massachusetts	3/1998	All customers	In effect with fuel adjustment for Standard Offer through 2/2005; None for Default Service	23% (2% R; 35% NR)
[3]	California	4/1998 (suspended in 2001)	Only customers that were exercising retail choice prior to 10/01	Rate Freeze ended in 2001	13% (1% R; 20% NR)
[4]	New York	1998–2001 (varies by utility)	All customers	Varies by utility	23% (5% R; 33% NR)
[5]	New Jersey	11/1999	All customers	Ended July 2003	18%
[6]	Pennsylvania	1/2000	All customers	Varies by utility	11% (6% R; 15% NR)
[7]	Maine	3/2000	All customers	None	38% (0% R; 56% NR)
[8]	Connecticut	7/2000	All customers	Initial cap ended 12/2003; new cap in effect for Transitional Standard Offer period (1/2004–12/2006)	n/a
[9]	Maryland	7/2000	All customers	Varies by utility	16% (4% R; 29% NR)
[10]	Delaware	10/2000	All customers	2005–2006	n/a
[11]	D.C.	1/2001	All customers	In effect through 1/2005	33% (11% R; 38% NR)
[12]	Ohio	1/2001	All customers	Varies by utility	20% (18% R; 21% NR)
[13]	Arizona	1/2001	All customers	Varies by utility	n/a
[14]	Illinois	1/2001 (for non-residential customers)	All customers	In effect through 12/2006	24% (0% R; 34% NR)
[15]	New Hampshire (PSNH-Specific)	5/2001	All customers	2/2004 (Transition Service rate becomes a negotiated rate)	n/a
[16]	Nevada	7/2001 (for large C&I with 1 MW of demand)	Large C&I with 1 MW of demand	None	n/a
[17]	Michigan	1/2002	All customers	2005 and 2006 for small commercial and residential	11% (0% R; 16% NR)

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Table 1: *(continued)*

	State	Inception of Retail Access	Customers Open to Retail Access as of 2004	Existence and Status of Capped Rates for Generation	Retail Access Penetration (% of MWh)***
[18]	Texas	1/2002	All customers	"Price to beat" capped until 1/2007	43% (10% R; 62% NR)
[19]	Virginia	1/2002 (many Dominion Power customers delayed access until 2003)	All customers	7/2007	n/a
[20]	Oregon	3/2002	Only C&I customers with 1 MW of demand or more	None	7.3% of PGE's non-residential load
[21]	Montana	7/2002	Large customers (HB509 effectively assigns small customers to default provider until 2027)	Expired on 7/2002	n/a

Sources and Notes: EIA, state public utility commissions, FTC summaries, company 10-Ks and NARUC.
*** "R" indicates residential; "NR" indicates non-residential; "n/a" indicates not available or unknown. Switching data collected from recent postings on commission sites.

This transition period simultaneously provided time for competitive suppliers to develop packages of services that would appeal to the millions of small and large customers, to contact those customers, and to present market-based offers. A bundled, regulated, set-price offer of generation service was generally to be provided to serve as the interim offer until customers voluntarily switched to unregulated suppliers. Such regulated service would also be available if a competitive supplier suddenly discontinued its service to a customer or if customers wanted to return to regulated service. These regulated rates were offered over the entire initial transition period that generally lasted from three to 10 or more years—with the length of the period often determined by the need to collect utilities' stranded costs.

The pricing of the regulated service option was driven by restructuring policy and often consisted of rate freezes or capped rate paths. Policymakers in these states wanted to ensure that the highly visible regulated service offer provided some demonstrable benefits (i.e., a rate reduction) when competition was initiated. A partially unintended consequence was that this price affected the attractiveness (or lack thereof) of obtaining service from unregulated retail providers.[3]

To meet the utilities' regulated supply obligation service at capped rates, "buy-back" agreements tied to the regulated price were generally signed between the distribution utility and the generation assets that were being divested or transferred to unregulated subsidiaries.[4] This combination of rate freeze (or capped rates) and buy-back agreements with restructured generation assets during the initial transition period generally also meant that many of the restructured states did not immediately need to focus on how distribution utilities would procure resources for regulated service options once the transition-related contracts expired.

As the initial transition period has been or is about to be completed in the majority of retail access states, a new framework for utilities' continued provision of regulated service options was needed and has emerged. This post-transition framework requires resolution on two major policy issues:

- The type and pricing of regulated services (i.e., determination of the future availability, pricing, scope,

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duration, and other terms and conditions of regulated service options); and

- Resource procurement for these regulated services (i.e., establishment of an effective process for procuring the generation resources to support the post-transition regulated service options).

III. The Need for Continued Provision of Regulated Service Options

The factual record on retail access shows that customers' selection of alternative retail providers has generally progressed more slowly than initially expected. There are two patterns that emerge. First, the majority of total retail load is still on the utilities' regulated service offering. As Table 1 shows, two to seven years after the introduction of retail access, as little as 11 percent (Rhode Island and Pennsylvania) but no more than 43 percent (Texas) of total customer load has switched to unregulated retail providers. This "penetration" or size of unregulated retail market (measured in percentage of total MWh sold through unregulated suppliers) also shows that there is no correlation with the age of a state's retail access market (**Figure 2**). Second, as **Figure 3** shows uniformly across retail access states, large non-residential customers have switched to alternative retail suppliers in much greater numbers than residential and small non-residential customers. While average statewide retail access penetration for non-residential customers ranges from 15 percent to 62 percent, retail access penetration generally is still less than 10 percent for the residential class (which typically represents about 30 percent to 40 percent of total load but 90 percent of all customers).

This experience has important implications as we near the end of states' transition periods. Since large numbers of customers cannot make switching decisions overnight, some form of regulated service offer continues to be needed for at least utilities' residential and small non-residential customer classes. Of course, lack of switching may be in part be explained by frozen regulated retail rates below the market-based rates that alternative suppliers could offer. Such below-market pricing is generally not sustainable after the buy-back contracts expire. Therefore, most

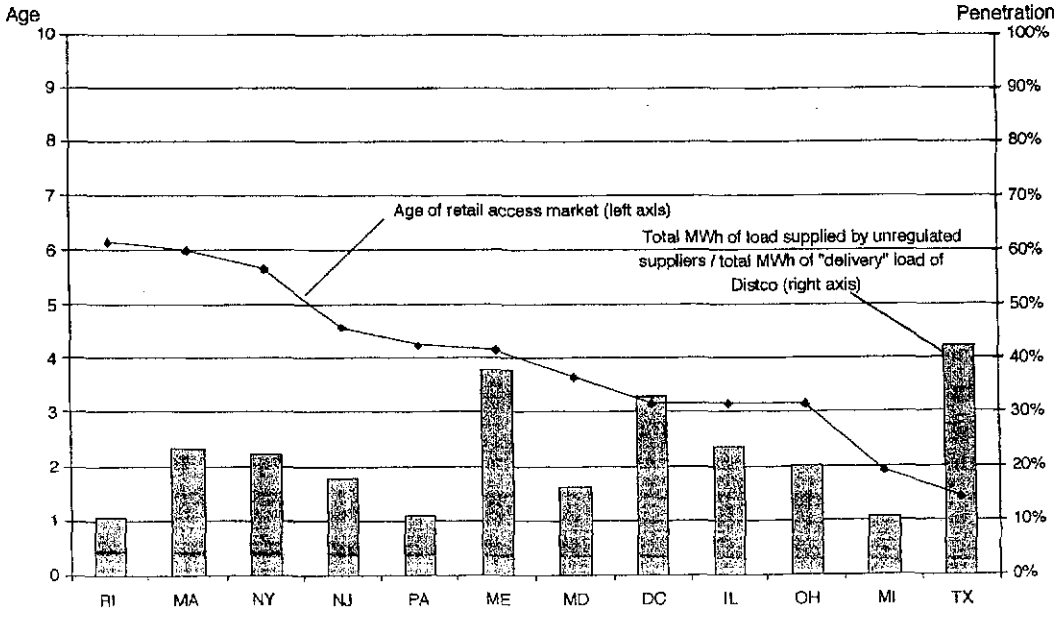

Figure 2: Age of Retail Access vs. Retail Access Penetration (2004)

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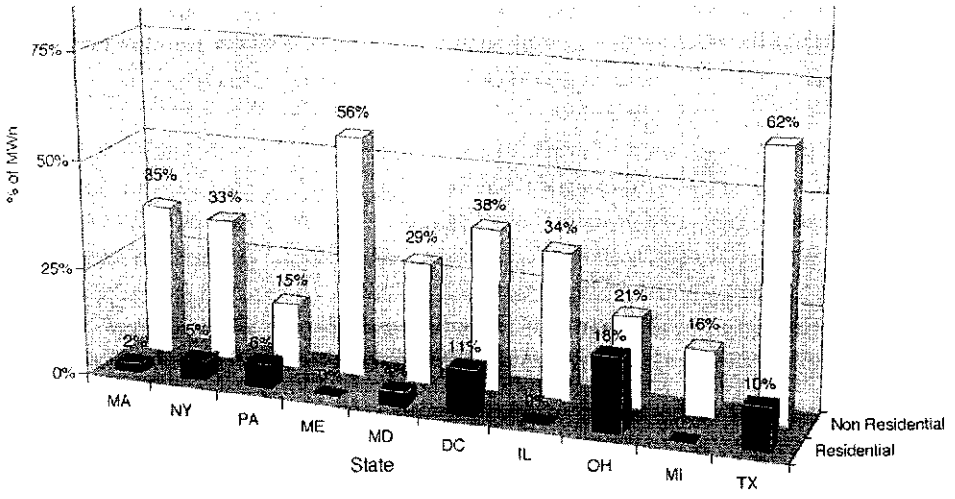

Figure 3: Residential vs. Non-Residential Retail Access Penetration (2004)

policymakers have concluded that the rates for "post-transition" regulated service options need to be reflective of market prices. This immediately also raises the question of how generation supply for these service offerings should be procured by the distribution utilities.

IV. Resource Procurement for Regulated Service Options

Many industry participants and policymakers agree that the objective of supplying post-transition regulated service options at market-based, competition-enhancing prices is best met through transparent, Commission-approved, competitive procurement processes that are open to a diverse group of suppliers. Such procurement processes will not only lead to appropriate pricing of the utilities' regulated service options, but will also enhance wholesale market competition. This also maintains a level playing field in which unaffiliated generation supplies are neither unduly advantaged nor disadvantaged in the procurement process relative to utilities' own generation or marketing affiliates.

We have reviewed competitive procurement approaches to supply utilities' post-transition regulated service options and found that there are two general procurement models, which we labeled:

- the *standard offer approach* and
- the *portfolio management approach*.

Under the standard offer approach, the regulated utility competitively procures power under standardized full-requirements contracts, each of which either supplies a defined portion (e.g., a fixed percentage) of the utilities' regulated service obligation or a defined set of customers. As a result, wholesale suppliers (not the distribution utilities) assume the day-to-day responsibility of resource procurement and portfolio/risk management functions for the distribution company's regulated service load. The utility's role primarily involves developing a competitive procurement process, obtaining state regulators' approval of the plan, and executing the process, generally on an annual basis.

In contrast, under the portfolio management approach, the utility retains the day-to-day responsibility for directly procuring resources, managing price and volume risks, and providing full-requirements, load-following service for its regulated service customers. This

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would generally be done according to Commission-approved processes. The contracts within the utility's portfolio could be a variety of energy and capacity products (e.g., baseload, peakload, capacity release option, load-following, and ancillary-service contracts) of various durations and flexible pricing methodologies tailored to meet the expected demand for regulated service at reasonably stable costs.

The summary and comparison of the resource procurement approaches utilized in the identified 21 retail access states is presented in **Table 2**. The table is organized in three sections: (1) nine states which generally use the standard offer approach to post-transition procurement of regulated service supplies; (2) six states that use variations of the portfolio management approach for such procurement; and (3) six states that either cannot easily be categorized into one of the two general approaches or have not yet made a decision on post-transition procurement methodology.

V. Experience with Resource Procurement for Regulated Service

As shown in Table 2, there are nine states that already use or have selected the **standard offer approach**. They include Connecticut, the District of Columbia, Maine, Maryland, Massachusetts, Rhode Island, Texas, New Jersey, and Ohio. The Ohio commission has selected the standard offer approach as the default procurement method for the state's jurisdictional utilities, but is allowing utilities to propose alternative approaches. Texas uses a standard offer approach only for its "provider of last resort service" (the only safety net service for large customers and the backup service to the price-capped "price-to-beat" service offered to smaller customers), which is in place through January 2007.

These standard offer approaches share important similarities, including:

- The product procured is a full-requirements, load-following service for a share of the utilities' continued regulated service obligation;
- Much of customer switching risk is transferred to bidders;
- A tradeoff between rate stability and rates that are reasonably reflective of market

Table 2: Competitive Procurement Approaches for Regulated Service in Retail Access States (Grouped by Procurement Approach)

	State	Commencement of Competitive Procurement of Regulated Generation Service	Generation Divestiture*	Approach to Procurement of Regulated Generation Service**	Primary RTO
[1]	Connecticut	1/2004 (procurement for transitional standard offer	Complete	Standard Offer	ISO-NE
[2]	D.C.	2/2005	Complete	Standard Offer	PJM
[3]	Maine	3/2000	Complete	Standard Offer	ISO-NE
[4]	Maryland	7/2004	Mixed	Standard Offer	PJM
[5]	Massachusetts	3/2005	Complete	Standard Offer	ISO-NE
[6]	Rhode Island	6/2000 (Last Resort service)	Complete	Standard Offer	ISO-NE
[7]	Texas	1/2007	Transferred to affiliates	Standard Offer	ERCOT
[8]	New Jersey	8/2002	Mixed	Standard Offer	PJM
[9]	Ohio	1/2006	Transferred to affiliates	Standard Offer is default method (alternatives may be proposed by utilities)	MISO & PJM

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Table 2: *(continued)*

	State	Commencement of Competitive Procurement of Regulated Generation Service	Generation Divestiture*	Approach to Procurement of Regulated Generation Service**	Primary RTO
[10]	California	1/2003 (under the new Generation Procurement policy)	Partial	Portfolio management for loads no longer subject to retail access	CAISO
[11]	Montana	7/2002	Complete	Portfolio Management	None yet
[12]	Arizona	Procurement commenced in 3/2003 for delivery starting in 2003	Originally planned, but cancelled	Portfolio Management and Regulated Utility-Owned Generation	None yet
[13]	Nevada	Ongoing responsibility for the Eligible Large C&I	Originally planned, but cancelled when residential and small C&I access	Portfolio Management and Regulated Utility-Owned Generation	None yet
[14]	Oregon	3/2002	Partial	Portfolio Management and Regulated Utility-Owned Generation	None yet
[15]	New York	7/2001	Virtually complete	Variations of Portfolio Management (Divestiture-related fixed and variable-priced long-term contracts supplemented with spot purchases and hedging contracts)	NYISO
[16]	Pennsylvania	1/2000	Transferred to affiliates	Mixed (Some competitive solicitation to serve retail customers, but mostly purchased from affiliates at capped rates determined in initial settlement)	PJM
[17]	Delaware	2005-2006	Complete	TBD	PJM
[18]	Illinois	1/2007	Mixed	TBD	MISO & PJM
[19]	Michigan	TBD	Mixed; Once a market power threshold reached, transfer must occur	TBD	MISO
[20]	New Hampshire (PSNH-Specific)	2/2006	Delayed until end of Transition Service	TBD	ISO-NE
[21]	Virginia	7/2007	Transferred to affiliates	TBD	None yet

Sources and **Notes:** EIA, state public utility commissions, FTC summaries, company 10-Ks and NARUC (as of mid 2004).

* "Mixed" means that some utilities completely divested, while others transferred to affiliates or partially divested. "Partial" means that utilities divested part of their generation portfolio.

** "Standard Offer" means regulated utilities competitively procure full requirements contracts for a fixed percentage of regulated generation load or a defined set of customers. "Portfolio Management" means regulated utilities competitively procure capacity, energy, and risk management products to provide full requirements service for regulated generation load.

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prices is typically achieved for small customers through overlapping multi-year contracts, while regulated service for large customers, if offered at all, is procured and priced on a much shorter-term basis;

- Procurement processes are pre-approved by regulatory commission, which facilitates the almost immediate approval of procurement results;
- With the exception of Maine and Texas, where standard offer suppliers become retail providers of the generation service, the standard offer approach is based on wholesale contracts between suppliers and the respective distribution companies.

All standard offer states bid out shares of their regulated service load separately for different customer classes. The degree of aggregation or disaggregation varies by state. Furthermore, different states have made different choices on how to tailor the service for each group. For example, New Jersey, Maryland, D.C., and Ohio provide greater price stability for small customers than larger industrial customers, with overlapping one- to three-year contracts for residential customers. Massachusetts uses six-month procurement cycles with overlapping one-year contracts for residential customers, but this is in part driven by a state law that exempts contracts of up to one year from preapproval requirements. Annual or even shorter-term contracts are typically used to procure supplies for regulated service options offered to large customers, who generally require less price stability and who will be more predisposed to opportunistic switching between regulated and competitive service options in response to temporary price differences. In this regard, Texas and New Jersey are the extreme examples, with large customers

being offered only hourly wholesale spot market pricing. Massachusetts has moved to quarterly procurement and pricing of regulated service options available to large customers.

The following bullet points summarize the design and status of standard offer approaches in several of the retail access states that already completed (or are about to complete) their rate-freeze periods.

- **Ohio**. Based on a recent order by the Ohio Public Utilities Commission (PUC), the standard offer approach has been selected as the default procurement methodology for Ohio utilities, as some of them may transition out of their rate-freeze period at the end of 2005.[5] Although alternative processes can be proposed by the utilities, this default methodology requires utilities to establish competitive procurement processes for load shares of full-requirements service for residential, small non-residential, and large non-residential customers. These customer classes will be offered fixed- and variable-priced rate options based on overlapping supply contracts of one to three years in duration. The Ohio PUC encouraged independently monitored auctions as the procurement process, though implementation details have been left to the individual utilities. The PUC noted improved risk allocation (by placing the risk on the winning bidder as reflected in bid prices) as a benefit of this approach.

So far, however, most Ohio utilities have submitted alternative processes under which the initial transition period essentially is extended for several years. Nevertheless, the state commission has continued to demonstrate its preference for the standard offer approach by requiring that First Energy conduct an auction.[6]

- **Maryland and the District of Columbia**. The Maryland Public Service Commission (PSC) and the PSC of the District of Columbia have implemented very similar approaches. The Maryland approach, based on two PSC-approved settlements with a large group of stakeholders, implemented a post-rate-freeze procurement model in which regulated service load (called "standard offer service")

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is segmented into individual percentage shares of full-requirements service for residential and three groups of non-residential customers.[7] (Each load share was sized to represent an annual peak load of approximately 50 MW, with contract durations from one to three years.) The PSC found that this standard offer model represents a sound public policy choice, offering high transparency and giving customers price stability while also promoting reliability. The PSC also recognized that the majority of jurisdictions that have enacted retail choice have adopted the standard offer model. Additionally, the PSC found that bidders are already familiar with this approach, which should lead to greater participation and more competitive bids. The DC Commission issued an order on Mar. 1, 2004, that largely adopted the Maryland model as the procurement process for standard offer service after the District's utilities' rate freeze periods end in 2005–06.[8]

The Maryland utilities recently completed their first procurement cycle based on this model using a sealed-bid auction format with four rounds of bidding spread over approximately six weeks. As the PSC announced, the successful and "highly competitive bidding process" involved 25 wholesale suppliers offering four to five times the amount of supply solicited.[9] (The solicitation involved the complete retail needs of two of Maryland's utilities, PEPCO and Conectiv, and the non-residential load obligations of Baltimore Gas & Electric as of July 1, 2004. The load subject to procurement in this procurement cycle for these three operating utilities represented about 5,700 MW of peak load, which is about 45 percent of the Maryland total and 7 percent of PJM RTO peak load.) This process resulted in contracts being

awarded to a diverse group of 14 individual suppliers.

- **New Jersey.** The New Jersey utilities recently completed the state's third annual auction for post-transition period "basic generation service."[10] Under the most recent procurement round, which was pre-approved by the Board of Public Utilities, all four New Jersey electric distribution companies simultaneously auctioned off shares of full requirements service for two product classes and two contract durations. Each load share was sized to represent an annual peak load of approximately 100 MW, with contract durations of one and three years. The two products are "Fixed Price" (FP) for residential, small and medium-size non-residential customers and "Commercial Industrial Electric Pricing" (CIEP) for large non-residential customers with peak loads greater than 1,500 kW. Bids for FP were a fixed, all-in price (cents/kWh) while bids for CIEP included only a capacity charge ($/MW-day) under which suppliers would provide energy charged at the hourly energy price of the PJM spot market. Under the New Jersey auction process, an Internet-based, multi-round "descending clock" auction format was used to determine a single market clearing price that is applied to all winning bids within each contract type (i.e., utility, customer class, and contract duration). The New Jersey Board found that this procurement process worked well and provided the best prices possible. A New Jersey commissioner also noted other advantages: (1) proper risk sharing (risk is borne by those who can manage it at lowest cost); (2) transparency (leads to more aggressive bidding); and (3) an appearance of objectivity and fairness (attracts more bidders and minimizes post-auction challenges).[11]

In the most recent auction, a total of 10,000 MW of FP load was auctioned off to a diverse set of 12 winning bidders. These winners were primarily traditional power marketers, but some notable success by Morgan Stanley and J. Aron showed the increasing presence of financial services firms in wholesale energy markets.[12] In addition, a total of

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2,460 MW of CIEP load was auctioned off to six winning bidders, all of whom were traditional power marketers. When combined, approximately 12,500 MW, which is 64 percent of NJ's retail load and 15 percent of PJM's, was contracted for during the most recent auction. Another 23 percent of New Jersey's retail load is still being supplied by winners from previous auctions and the remaining 13 percent is being supplied by alternative retail providers.

• **Massachusetts.** Massachusetts has two regulated service offers, "standard offer" for customers that have never switched and "default service" for new customers or customers returning from alternative retail suppliers. The "standard offer service" has been supplied by buy-back contracts from divested generation with the price based on a pre-set schedule and a fuel-price-index adjustment. It expires in February 2005 and all remaining regulated service customers will move to default service. For several years, the procurement of default service supply has been undertaken using a standard-offer approach based on a six-month cycle with overlapping one-year contracts. In an order released in the summer of 2003,[13] the six-month cycle was shortened to three months (procuring all supplies with quarterly contracts) for medium-sized and large commercial and industrial customers with monthly demands greater than 10 MWh and peak loads in excess of 200 kW. This modification to shorter-term market-based pricing was made to further the development of retail competition for large customers. The Massachusetts Department of Telecommunications and Energy (DTE) found that the overlapping contracts for smaller customers provide protection against spot market volatility, thereby pro-

viding stable market-based prices that customers can compare to other supply options.

• **Maine.** Maine's restructuring law, like that in Massachusetts, required divestiture of all generation and qualifying facility (QF) contract supply; but Maine also dispensed immediately with the price-capped transition period found in other states. Under Maine's retail electric access rules, which opened up retail markets in early 2000, the commission is tasked with ensuring that "standard offer service" is available. The procurement for Maine's standard offer service thus had to precede the start of retail access—at a time when the ISO New England was still in its infancy. The restructuring laws required that the Commission itself solicit retail suppliers through a competitive bid process in a variation of the standard offer approach. From the beginning, the Maine commission conducted its own "retail" procurement for full-requirements service, experimenting with annual and multi-year contracts.[14] While small customers are served through three-year contracts, in the most recent procurement cycle, bids to supply medium and large customers were solicited for six-month and one-year terms. The commission selected six-month terms to allow regulated retail prices to track more closely changes in market prices in two of its major utility service territories for both medium and large customer classes. Like in many other standard offer states, the Maine commission found that shorter-term pricing for large customers will facilitate service from alternative retail suppliers.

Table 2 also lists six states that utilize variations of the **portfolio management approach**, either alone or in combination with supply provided through utility-owned, rate-regulated generation or through buybacks from unregulated affiliate generation. It is difficult to generalize about the experience with this procurement approach since its applications are so heterogeneous. Arizona and Montana have retail access but only a very small share of retail access load. Montana divested all generation while Arizona mandated the retention

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of utility-owned, rate-regulated generation. Nevada and Oregon only allow retail access for large commercial and industrial customers and have not fully divested or restructured generation. Montana and California applied the portfolio management approach only after suspending retail access for most of their customers. Nevertheless, despite this suspension of retail access, California and Montana provide good examples of a comprehensive portfolio management approach.

- **California.** Having sold the vast majority of their natural gas and oil generation plants and being required under restructuring to purchase all requirements through the PX day-ahead market, the California IOUs were devastated by the Energy Crisis of 2000–01, leading Pacific Gas & Electric (PG&E) to file for bankruptcy and Southern California Edison (SCE) to watch its credit rating drop from A to CCC. In early 2001, the California Department of Water Resources (DWR) was forced to step in to purchase spot power and also sign short- and long-term power purchase contracts to supply the retail loads of PG&E and SCE. In September 2002, Bill AB 57 became law, which was designed to put the IOUs back into the resource procurement business, using the portfolio management approach and guidelines that would promote regulatory stability and keep the IOUs creditworthy. Under this law, the California PUC must review and approve detailed utility procurement plans that clearly define selection criteria for subsequent utility purchases. The resource plans must cover: an assessment of price risk, definitions of resources to be procured, duration of procured products, details of a competitive bid system, inclusion of performance-based rates (if at all), general transaction cost recovery, procedures for

updating the plan, compliance with renewable and demand-side programs, risk management strategy, promotion of supplier diversity, and procurement-related administrative cost recovery. Of these elements, the PUC has pressed utilities for the most detail on risk management strategies, types of products to be procured over particular timeframes, and target quantities for each type of product. The PUC has also promulgated minimum standards, including: use of a competitive, arms-length procurement process; a clear code of conduct for all employees involved in the process; and prudent administration of resources coupled with least-cost dispatch.[15] Transactions that meet the pre-approved resource plans and procurement processes are automatically approved by the PUC, are presumed to be just and reasonable, and are fully recoverable in rates.

The California experience to date has shown that this process is quite involved. The utilities had to hire significant staff and expend substantial resources to develop portfolio/risk management capabilities. The complexity of this subject area also presents a significant challenge for the PUC and its staff. There is a clear tension between the utilities' need for flexibility in procurement decisions in the face of rapidly changing market conditions or unique procurement opportunities on one hand and the PUC's desire to manage carefully and pre-specify the entire procurement process on the other. Although a "Procurement Review Group" process established by the PUC has been a constructive forum for various stakeholders to discuss key issues, the utilities' major procurement decisions have been fairly contentious. While the PUC has approved 2003 and 2004 short-term plans for the utilities, a full reasonableness proceeding under the new rules has not yet been completed and even the "expeditious" review of quarterly compliance filings has been a somewhat slow and difficult process.

- **Montana.** Montana's initial legislation would have opened all customer classes to retail access

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by July 2002. However, in the face of the California energy crisis, retail access for small customers was initially postponed through July 2004. Most recent legislation essentially suspended retail access for small customers until 2027. After Montana Power's divestiture of its generation assets, the expiration of a transitional buyback arrangement with PP&L Montana, and the acquisition of Montana Power by Northwestern Energy, the regulated utility faced the task of assembling a portfolio of resources to meet its regulated service obligation. Regulatory rules and state legislation implemented in 2003 provide "guidelines" under which the regulated utility: (1) should procure the supply for its regulated service customers; (2) can ask the commission to pre-approve specific contracts, thus avoiding the risk of ex-post prudence review. These guidelines specify facts, analyses, and principles the utility should consider but do not mandate specific terms for how the portfolio should be structured.

In response to this regulatory framework, Northwestern Energy recently filed its "Electric Default Supply Service Resource Procurement Plan" with the Montana PSC. The plan contains an extensive comparative risk assessment of 12 different portfolios, each reflecting a different mix of base load, intermediate, and peaking contracts, along with renewable resources and demand-side management options. After ranking these portfolios based on cost/risk tradeoffs, the filing concludes that the current combination of base load purchase agreements with PP&L (due to expire in 2007) and spot purchases are high-cost/high-risk, and that spot market purchases should be largely replaced with increased reliance on dispatchable gas-fired generation or other firm contracts.

This is the utility's second attempt to obtain the PSC's endorsement of its supply strategy. (Some of the utility's proposed modifications of its supply portfolio were previously filed in 2001, but rejected by the PSC.) After the commission endorses the proposed supply strategy, the utility would assemble the supply portfolio through a series of RFPs and then seek the PSC's approval of the selected contracts in separate filings. Similarly to California, the experience in Montana suggests that obtaining regulatory preapproval of supply strategies and contracts under the portfolio management approach can be a complex and often contentious undertaking.

Of all the retail access states identified in Table 2, New York and Pennsylvania have perhaps the most difficult-to-categorize procurement approaches. New York has individual settlements for each of its utilities with different timelines and implementation details that are hard to characterize in terms of a statewide procurement policy. In Pennsylvania the utilities' regulated service option is provided at capped rates that were determined for the entire transition period in the initial restructuring effort. Pennsylvania restructuring law does not require utilities to competitively procure generation for these regulated service offerings. Rather, much of the resource requirements for these regulated service options are supplied under buyback contracts from the utilities' unregulated generation affiliates.

VI. Conclusions

The end of restructuring-related "transition periods" marks a critical milestone for regulators and utilities in retail access states as price caps and restructuring-related supply contracts expire. Since the majority of customers, in particular residential and small commercial, remain on the regulated service provided by their distribution utility, there is an implicit "demand" for the continued provision of that service. No state policymakers at this milestone have as yet chosen to

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The experience to date shows that many states have chosen to implement the standard offer approach.

force small customers to switch to unregulated suppliers.

Continuation of regulated generation service raises two important policy questions: (1) How should regulated retail service be provided after transition-period price caps expire; and (2) How should distribution utilities procure resources to meet their continued regulated service obligations? Of the states that have already addressed these issues, the majority concluded that rates for regulated service should be reasonably reflective of market prices and that resources for the utilities' continued regulated service obligations should be procured through transparent, competitive processes that are open to all suppliers.

The selected procurement processes have fallen into two general approaches, which we labeled the "standard offer approach" and the "portfolio management approach." The experience to date shows that many of these states have chosen to implement the standard offer approach under which shares of the distribution companies' regulated, full-requirements supply obligation are bid out. The advantages that policymakers appear to see in this approach are that it is a relatively simple, highly transparent, competitive procurement option that allows for a more streamlined, less contentious regulatory process and that allocates risks to bidders that can manage them most efficiently. Also, while contracts are highly standardized, policymakers can and do offer differing degrees of rate stability to different classes of customers through fixed-priced contracts of varying durations.

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The states that have selected some form of portfolio management approach often use it to integrate new wholesale contracts with utilities' existing long-term contracts or remaining cost-of-service regulated generation. The perceived advantages of the portfolio management approach include its roots in integrated resource planning and greater flexibility in the type of wholesale products that can be integrated into the supply portfolio. These include longer-term and unit-specific contracts, and even new utility-owned generation.

Of the 21 states with retail access, we have identified nine that have already addressed post-transition procurement for regulated service through the standard offer model, and six that have pursued variations of the portfolio management approach.■

Endnotes:

1. For simplicity of exposition, the District of Columbia will be included in the "states" in this article.

2. California is included here, with about 13 percent of the total load being competitively supplied, although further retail switching was suspended in September 2001. A new policy that would reintroduce retail access for large customers is now being discussed.

3. These rate reductions were not necessarily inconsistent with market prices since the competitive price of generation service was expected to be low enough so that unregulated suppliers could compete with regulated service rates. However, wholesale market price have been higher than expected, making it difficult for alternative retail suppliers to provide guaranteed savings while maintaining a level playing field.

4. Note, however, while the more common approach, this kind of a transition was not used by all retail access states. For example, Maine did not include negotiated, capped rates for regulated service, did not sign any buy-back agreements with restructured generation assets, but went directly to procuring resources at market-based rates. In Texas, even in the beginning, large customers were

not offered any regulated service option, only a default service (i.e., provider of last resort service) for periods when service obtained from unregulated retail suppliers was unavailable (e.g., due to supplier default).

5. See Ohio PUC, order dated Dec. 17, 2003, *In the Matter of the Commission's Promulgation of Rules for the Conduct of a Competitive Bidding Process for Electric Distribution Utilities Pursuant to Section 4928.14, Revised Code*, Case No. 01-2164-EL-ORD. Since the PUC issued this order, several Ohio utilities (e.g., DP&L, CG&E, AEP, and First Energy) separately filed alternative proposals that would extend rate caps through 2008.

6. *Auction Could Give Toledo, Ohio-Area Residents Another Utility*, TOLEDO BLADE, Aug. 24, 2004.

7. See MD PSC, Order Nos. 78400 (dated Apr. 29, 2003) and 78710 (dated Sept. 30, 2003), *In the Matter of the Commission's Inquiry into the Competitive Selection of Electric Supplier/Standard Offer Service*, Case No. 8908.

8. See DC PSC, Order Adopting Wholesale Standard Offer Service Process in Case No. 1017, issued Mar. 1, 2004.

9. MD PSC, MD PSC Announces Successful Completion of Bidding for Electric Standard Offer Service (press release), Apr., 2, 2004: http://www.psc.state.md.us.

10. See New Jersey Board of Public Utilities, New Jersey Board of Public Utilities Certifies Results of the Basic Generation Service Auction (press release), Feb. 11, 2004. The NJ procurement processes were pre-approved by the Board of Public Utilities: Decisions and Orders in Docket Nos. EX01050303 (dated Dec. 11, 2001), EX01110754 & EO02070384 (dated Dec. 18, 2002), and EO03050394 (dated Dec. 2, 2003).

11. Frederick Butler, Presentation at the Illinois Commerce Commission Post-2006 Symposium, April 29, 2004, at 8.

12. No information has been released about how many tranches of load of various types were awarded to specific winning bidders.

13. Massachusetts D.T.E. Orders 02-40-A, 02-40-B, and 02-40-C, *Investigation by the Department of Telecommunications and Energy on its own Motion into the Provision of Default Service*, dated Feb. 13, 2003, Apr. 24, 2004 and Sept. 12, 2003.

14. Maine Public Utilities Commission, Standard Offer Study and Recommendations Regarding Service After Mar. 1, 2005, Dec. 1, 2002, Appendix E: Detailed Summary of Standard Offer Bid Processes and Results.

15. California Public Utilities Commission, *Order Instituting Rulemaking to Establish Policies and Cost Recovery Mechanisms for Generation Procurement and Renewable Resource Development*, Decision 02-10-062, Oct. 24, 2002.

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