Restructuring in the Rearview Mirror – a 10-Year Retrospective of California's Doomed Experiment with Electric Deregulation. By The Energy Overseer

Don't Sign on the Dotted Line Without Knowing What You're Getting

Two years into a semi-competitive market, California has already seen its share of shady characters, snake-oil sellers and outright frauds among the scores of honest energy service providers trying to survive the transition period.

Though not all fall into the suspect category, it seems there is a higher propensity for big promises and failed hopes among the "network marketers," plus an inverse correlation between the extent of "tremendous savings on your power bills guaranteed" and the marketer's actual ability to deliver the goods and the savings. One of the clues to watch out for those marketers who seek fees (ranging between $300 and $1,000) from "associates" who will then take their place in the projected pyramid of profits.

This week's story by regulatory correspondent Lulu Weinzimer offers yet another example to add to the pile of California Public Utilities Commission investigations into questionable and possibly fraudulent "power sellers." The company, appropriating the name ITT Powercom (gee, it sounds like a big multinational with lots of experience), turns out to be a house of smoke and mirrors with a cast of bad actors under assumed names but without the ability to deliver a single electron to customers.

Past examples included FutureNet, Boston-Finney and Friendly Power. This last company, I believe, had every intention of becoming a fully functional energy service provider, but its founders mistakenly turned to a group of boiler-room pitchmen to generate revenues by selling licenses to become a Friendly Power associate.

The US Securities and Exchange Commission determined that this amounted to the sale of unlicensed securities and successfully prosecuted company founder Scott Levine and his wife. When the Friendly investors tried to take over and remake the firm within more legal parameters, they found nothing left but a bad reputation.

Ask any legitimate ESP and it will admit the great challenges of securing competitive power supplies that are consistently less expensive than the market-clearing price of the California Power Exchange. It can be done, especially by those with active wholesale marketing operations or favorable contracts for excess supplies from, say, the Bonneville Power Administration. But the margins are thin, and, especially for those companies trying to serve the residential and small commercial classes of customers, it is nearly impossible to compete against the default utility.

The reasons are structural: a mandatory 10 percent discount, an inescapable competition transition charge and the high costs of marketing, administration and regulatory involvement. It's no wonder that the legitimate ESPs find themselves fighting for every fraction of a fraction of a penny for Power Exchange credits and against every mounting direct-access service fee imposed by the utilities.

By now it is an old headline. The vast majority of residential direct-access sign-ups are for green power, and the only reasons for that small success story are the tenacity and commitment of the sellers and the availability of renewable resource credits from the California Energy Commission.

At the commercial and industrial level, where there is no mandated discount but still lots of utility "economic development" and "anti-bypass" contracts to overcome, competitive energy providers have penetrated deeper into the customer accounts. With one in five industrial accounts--consuming one in three electrons purchased by that customer segment--the evidence suggests that savings can be achieved.

Big companies are notoriously quiet about what they pay and what they get in bilateral contracts with suppliers, but to the best of our ability, we've come up with informal reckoning that even the best deals provide something like 3 percent to 5 percent discounts off the otherwise available Power Exchange price for commodity energy. The reported savings among commercial aggregators such as the Association of California Water Agencies and the San Diego Association of Government are slightly less--perhaps 2 percent to 4 percent.

When there is a great deal of energy changing hands, as among manufacturers or purchasing pools, the dollar savings can add up. But for many aggregators, the costs of power procurement and contract administration wipe out the thin margins on commodity-only sales. That is why aggregators are trying to broaden their service offerings. Several aggregators, even the state of California's power pool, have been unable to elicit any worthwhile savings in electricity purchases.

As for ESP profitability, that is almost impossible to calculate, and so far, I've spoken with only a single power marketer in California who has claimed to be making money steadily at this still-early stage. That company follows a narrow niche of clients in small municipalities and public agencies.

It's been said that success in this new market depends on how much you are willing to lose. Even the affiliates of the biggest utilities could sustain only so much red ink. Although PG&E Energy Services claimed something like $3 billion worth of sales contracts, the portfolio fetched only $85 million from Enron in what was supposedly a competitive negotiation.

The sale price might serve as a rough proxy of expected profitability for those contracts, discounted, of course, by the razor-sharp Enron accountants. I figure a 2.8 percent margin over the life of those contracts, even under the best circumstances. That now gets rolled into Enron Energy Service's much larger accounts-receivable fund, backed by the energy giant's highly evolved wholesale marketing and financial-leveraging abilities. Enron has already eaten its start-up costs and claims overall profitability.

So, this is a long way of saying that prospective customers--of whatever energy user classification--should treat skeptically any offers from power marketers that purport to guarantee significant savings.

That's why I was interested recently to receive a copy of a contract offered by a power marketer to commercial customers. The seller, ACN Energy, is admittedly a "network marketer," but it has successfully signed up natural gas customers in Southern California and direct-access electricity customers in the Sacramento Municipal Utility District. In fact, ACN was the only active marketer in SMUD's program last time we checked.

On the surface, the offer to commercial and industrial power users is simple: Customers agree to pay $0.03/KWh for commodity energy, a fee for scheduling, a monthly service charge for metering ($5 per month for those without an hourly interval meter, $20 per month for those with a new meter), plus "applicable sales taxes."

The price for power does not include local utility distribution charges, CalPX or Independent System Operator fees, or fees to generating companies "to distribute and deliver your energy."

The scheduling fee, according to the contract, amounts to $0.0054/KWh--roughly half a mill.

So, states the contract, customers can expect to pay $0.0354/KWh for energy under the deal--except "in the infrequent case" where the California Power Exchange prices exceed $0.029/KWh. Then ACN will adjust the customer's price to add one mill to the CalPX price. States the contract, "if the price reaches 3.0 cents, the adjustment will equal 0.1 cents, and the total price per kilowatt-hour will be 3.1 cents."

All well and good. The contract additionally promises that customers in Pacific Gas & Electric, San Diego Gas & Electric and Southern California Edison territories will be getting 100 percent renewable power, under ACN's "Cool Green" product.

The marketer seems to have two ways of making money: by adding a skin-thin margin over the CalPX price and by pocketing the CEC renewable subsidy. But how does the customer save?

ACN Energy uses as a sales tool a sample PG&E monthly commercial customer bill totaling $1,525.57. In a hand-scribbled calculation on the sample bill, the discount is described as $237.36 savings--15 percent off the total bill, but 27 percent lower on the energy portion of the bill. This savings was based on 18,160 KWh of usage billed at the PG&E electric charge of $0.04847/KWh ($880.22), compared to ACN's promised $0.0354/KWh ($642.86). The rest of the bill comprises unavoidable and undiscounted costs for CTC, transmission, distribution, public-purpose programs and nuclear decommissioning.

That's quite an offer, but it's one that customers should refuse.

The comparison is bogus. By the very terms of the contract, the $0.0354/KWh rate does not apply, because the electric energy rate of $0.048/KWh is derived from the Power Exchange clearing price. The marketer would necessarily adjust that price upward, and the customer would actually be paying more than the low rate specified in the contract.

In a deal in which the price is contractually adjusted to be higher than the CalPX price, it makes no sense to promise "savings" compared to a PX price.

There are other factors for customers to consider. The CalPX clearing price is rising. From a $0.024/KWh average in 1998, it rose to $0.027/KWh in 1999, and Exchange managers estimate $0.03/KWh this year. Higher gas prices are part of it, as well as the increased understanding by sellers of how to maximize their gains through strategic bidding.

Then there is the time-of-use difference. The figures in these examples are average prices, with the CalPX average pulled down by much lower prices during off-peak hours. But most of these customers will be consuming energy in the higher-priced peak hours. Unless the marketer has a secret way of storing its off-peak purchases for delivery during the daytime, the average price comparison is almost meaningless. Customers without real-time meters fall under "load profile" patterns that attribute their usage patterns according to business type; those with interval meters will see the actual hourly prices. In either case, it may be rare indeed that the unadjusted contract energy rate actually applies.

For all these reasons, the ACN contract adds up to far less than might appear.

That is not to say ACN falls into the category of ITT Powercom, FutureNet or Boston-Finney. However, any customer who signs this offer without asking a lot of hard questions may be unpleasantly surprised in the not-too-distant future **[Arthur O'Donnell].**

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