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Best Practices in Procurement of Default Electric Service: A Portfolio Management Approach

Portfolio management can help default service providers meet their obligation to provide low-cost, reliable electric service. Best practices include a laddered contract approach, with inclusion of longer-term contracts, renewables, and some use of the spot market and/or short-term contracts.

Amy Roschelle and William Steinhurst

I. Introduction

As in the past, the vast majority of retail electric customers in the U.S. continue to be served by their default service provider. This trend is likely to continue well into the foreseeable future due to the many barriers that limit customers' ability to switch to alternative generation companies. How can default service providers achieve low-cost electricity for the masses? We find that several states have adopted strategies for the procurement of

electricity that incorporate portfolio management techniques. There is a simple reason for this growing trend: A portfolio management approach is in the ratepayers' best interest, as it ensures reasonable and stable prices for default electric service. As an added benefit, a portfolio management approach decreases customers' exposure to a long list of risks, including, but not limited to risks associated with:

- Fluctuating wholesale market prices

- Future environmental regulations
- Fuel price and supply fluctuations
- Peak cost due to extreme weather
- System reliability and security
- Market power

In addition, there are reasons to believe that such an approach can lead to lower power costs, overall. Below, we explore switching statistics, as well as the portfolio management strategy and its relationship to best practices in default electric service procurement.

II. Most Customers Remain on Default Service

As shown in **Figure 1**, evidence in Massachusetts shows that residential and small commercial and industrial (C&I) customers are the least likely to select a competitive supplier. Non-switching customers (known as default service customers in many

states) represent a significant portion of overall electricity requirements; in Massachusetts, non-switching residential and small C&I classes represent 43 percent of total electricity load and 94 percent of total customers.¹ Similar results are seen in each state that allows electric competition. In fact, no state currently has greater than 15 percent residential switching, and there has been no indication that small customers will begin to migrate en masse in either the near or medium-term. In other words, residential and small C&I customers are likely to remain on default service for a considerable period. Such a non-switching reality need not be considered problematic. The real problem lies in how to provide stable, low-cost electric service for the masses.

III. Portfolio Management Manages Risks and Costs

In the financial community, portfolio management is a

well-understood concept used to manage risks and produce higher returns over the long run. In the electric industry, portfolio management is a procurement strategy that involves carefully choosing among a variety of electricity products and resources. The goal is to manage price risk and lower costs. A portfolio management strategy can and should incorporate each of the following:

- A laddered portfolio of contracts
- Renewable generation
- Energy efficiency
- Fuel diversity
- Technology diversity
- Demand response programs

Combining these features results in a more stable electric service for customers both over the short- and long-term future. Below, we focus on how a portfolio that includes both laddering and renewables can benefit consumers under default service or traditional utility service.²

IV. A Laddered Portfolio of Contracts Is Beneficial

In order to ensure that the majority of residential and small C&I customers receive low-cost default electric service, we recommend an approach that allows default service providers to systematically lock in contract rates for portions of their overall load. Specifically,

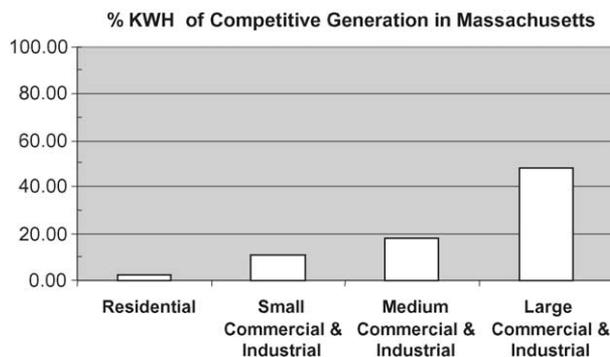


Figure 1: Switching statistic in Massachusetts show that Residential and Small Commercial and Industrial Customers are least likely to switch to a competitive supplier. These results are representative of all U.S. states that allow competition. **Source:** Mass.gov (March 2004)

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