

D.T.E. 02-40-B

Investigation by the Department of Telecommunications and Energy on its own Motion into the Provision of Default Service.

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I. INTRODUCTION

On June 21, 2002, the Department of Telecommunications and Energy (“Department”) opened this investigation into all aspects of the manner in which default service is provided to ensure that it is compatible with the development of an efficient competitive market and to ensure that the benefits of a competitive market are available to all Massachusetts consumers at the end of the standard offer service transition period. Procurement of Default Service, D.T.E. 02-40, at 1 (2002). The investigation covered a broad number of issues related to the provision of default service. On February 13, 2003, the Department issued an Order addressing the effects of congestion costs and locational marginal pricing (“LMP”). Procurement of Default Service, D.T.E. 02-40-A (2003). This Order addresses (1) the cost components to be included in the calculation of default service rates, (2) default service pricing options and procurement strategies, and (3) the appropriate role of distribution companies in moving their customers toward competitive supply.

On July 23, 2002, the Department held a technical session. Initial and reply comments were submitted by the Attorney General of the Commonwealth of Massachusetts (“Attorney General”); the Commonwealth of Massachusetts Division of Energy of Energy Resources (“DOER”); Massachusetts Electric Company and Nantucket Electric Company (together, “MECo”); Boston Edison Company (“BEC”), Cambridge Electric Light Company (“Cambridge”), and Commonwealth Electric Company (“Commonwealth”), (together “NSTAR”); Western Massachusetts Electric Company (“WMECo”); Fitchburg Gas and Electric Light Company (“Fitchburg”); Bay State Consultants (“Bay State”); Centrica North

America (“Centrica”); Competitive Energy Services - Massachusetts (“CES”); Competitive Retail Suppliers (“Competitive Suppliers”); Competitive Power Coalition (“CPC”); Constellation Power Source, Inc., (“Constellation”); Dominion Retail, Inc., (“Dominion”); Duke Energy Trading and Marketing (“Duke”); National Energy Marketers Association (“NEM”); PG&E National Energy Group (“PG&E”); TransCanada Power Marketing, Ltd. (“TransCanada”); TXU Energy Retail Company (“TXU”); Associated Industries of Massachusetts (“AIM”); Cape Light Compact; the Energy Consortium (“TEC”); Massachusetts Community Action Program Directors Association, Inc. (“MASSCAP”); City of Newton Public Buildings Department; the Western Massachusetts Industrial Customers Group (“WMICG”); Union of Concerned Scientists (“UCS”); Massachusetts Energy Consumers Alliance; Massachusetts Public Interest Research Group, Clean Water Action Conservation Law Foundation, and the Environmental League of Massachusetts; Massachusetts Technology Collaborative (“MTC”); Northeast Energy Efficiency Council; and ISO New England (“ISO-NE”).

II. STATEMENT OF POLICY

As part of this investigation, several commenters urged the Department to clearly articulate our policy objectives with regard to electric industry restructuring, stating that having a clear understanding of the Department’s intentions will help entities make business decisions regarding the extent to which they will participate in the market in Massachusetts (AIM Reply Comments at 1; Centrica/TXU Reply Comments at 1; Competitive Suppliers Comments at 3-4; TXU Comments at 17-18). Centrica, the Competitive Suppliers and TXU

urge the Department to articulate a vision of the end-state of the restructured electric industry that identifies retail competition for all customers as the central goal (Centrica/TXU Reply Comments at 1; Competitive Suppliers Comments at 3-4; TXU Comments at 17-18). The Competitive Suppliers assert that the development of a vibrant retail competitive market is essential to the development of a competitive wholesale market, and that only under a system where competition exists both in the wholesale and retail markets will all electricity consumers enjoy the full benefits of restructuring (Competitive Suppliers Reply Comments at 2-3). TXU argues that retail competition will not develop as long as distribution companies continue to provide retail service to customers, and that the only way to create a market is to open these retail services to competition to the maximum extent possible (TXU Comments at 18-19). Under Centrica's and TXU's long-term vision of the electric industry, distribution companies would function strictly as wires companies, without direct contact with end-use consumers. Customers would interact with their retail suppliers, who would then interact with the distribution companies, when necessary, on behalf of their customers (Centrica Comments at 17-18; TXU Comments at 18-19).

The Attorney General and NSTAR assert that the Department should not pursue policy initiatives that focus on the development of a competitive market structure as a goal in and of itself. Rather, they argue that the Department's policies should be designed to secure customer benefits, using the competitive market as a tool to achieve that objective (Attorney General Comments at 5; NSTAR Comments at 6). NSTAR states that an appropriate goal for the Department is the creation of a market structure that produces customer benefit; that provides a

foundation for marketers to market; and that protects a customer's right to choose (NSTAR Comments at 4).

As an administrative agency, the Department derives its authority and guidance on policy from the Legislature. Therefore, our policy objectives in implementing the Electric Restructuring Act ("Restructuring Act" or "Act")¹ come first and foremost from the Massachusetts General Court, speaking through the Act itself. For the purposes of this investigation, the most relevant portions of the Act state:

[R]atepayers and the [C]ommonwealth will be best served by moving from (i) the regulatory framework extant on July 1, 1997, in which retail electricity service is provided principally by public utility corporations obligated to provide ultimate consumers in exclusive service territories with reliable electric service at regulated rates, to (ii) a framework under which competitive producers will supply electric power and customers will gain the right to choose their electric power supplier.

St. 1997, c. 164, § 1(c);

Competitive markets in generation should (i) provide electricity suppliers with the incentive to operate efficiently, (ii) open markets for new and improved technologies, (iii) provide electricity buyers and sellers with appropriate price signals, and (iv) improve public confidence in the electric utility industry.

St. 1997, c. 164, § 1(g);

[L]ong-term rate reductions can be achieved most effectively by increasing competition and enabling broad consumer choice in generation service, thereby allowing market forces to play the principal role in determining the suppliers of generation for all customers.

St. 1997, c. 164, § 1(k);

¹ St. 1997, c. 164.

[T]he primary elements of a more competitive electricity market will be customer choice, preservation and augmentation of consumer protections, full and fair competition in generation, and enhanced environmental protection goals.

St. 1997, c. 164, § 1(l).

The Department is also guided by its own precedent. In Electric Industry Restructuring, D.P.U. 95-30, at i-ii (1995), the Department stated:

Reducing costs, over time, for all consumers of electricity is the primary objective of the Department's efforts in restructuring the electric industry. The Department's overall goal. . . is to develop an efficient industry structure and regulatory framework that minimize long-term costs to consumers while maintaining the safety and reliability of electric services with minimum impact on the environment. Long-term cost reductions will be achieved most effectively by increasing competition in the generation industry through broad customer choice, thereby allowing market forces to play a principle role in organizing electricity supply for all customers. The primary elements of a fully competitive market therefore will be customer choice and full and fair competition in generation.

The Department has successfully created the framework under which competitive producers - not distribution companies -- supply electric power and all customers have the right and ability to choose their electric power supplier. We have endeavored to (1) ensure that electricity suppliers have the incentive to operate efficiently; (2) open markets for new and improved technologies; (3) provide electricity buyers and sellers with appropriate price signals; and (4) improve public confidence in the electric utility industry. For example, in Pricing and Procurement of Default Service, D.T.E. 99-60 (2000), we established policies intended to have default service function as a basic service that would provide consumers with the appropriate incentive to compare the prices offered by the distribution companies as a result of their procurements to the offers provided by competitive suppliers. In Metering, Billing and Information Services, D.T.E. 01-28 (2001), we established metering and customer payment

policies consistent with the development of a robust competitive market. Finally, our objective in Competitive Market Initiatives, D.T.E. 01-54, (2002) was to minimize or eliminate any barriers to competitive choice, and to identify and implement initiatives that could expand the range of competitive options available to consumers.

As stated in our Order opening the investigation, the purpose of this proceeding is to ensure that the manner in which default service is provided is compatible with the development of an efficient competitive market so that the benefits of a competitive market are available to all Massachusetts consumers at the end of the standard offer service transition period.

D.T.E. 02-40, at 1. To accomplish this goal, we are seeking to put in place a market structure that allows efficient competition to thrive. See Gas Unbundling, D.T.E. 98-32-B at 25, 30 (1999). Competition is the means to an end -- that end being maximizing consumer welfare. Maximizing consumer welfare means minimizing long-term costs to consumers while maintaining the safety and reliability of electric service. If consumer welfare is maximized with very few customers switching to competitive suppliers, it is not a policy failure, as long as there is free choice and there are no artificial impediments for either suppliers or consumers. In this Order, we are removing what we identify as artificial impediments and are creating a more efficient market structure with better price signals and a more stable market framework. Despite the availability of standard offer service priced at below-cost levels, an active competitive market, one characterized by a broad range of competitive options, has developed for medium and large commercial and industrial (“C&I”) customers (in this Order, the Department refers to these customers as “larger” customers). For larger customers, the

competitive market is already working to meet the policy goals of the Restructuring Act. Therefore, for larger customers, default service should function as a basic service that provides customers with the appropriate incentives to turn to the competitive market for more sophisticated or advantageous service offerings. See D.T.E. 99-60-A at 4. Larger customers should view default service as a short-term, last resort service, rather than a longer-term alternative to competitive supply.

Conversely, there are few competitive options for residential and small C&I customers (in this Order, the Department refers to these customers as “smaller” customers), as evidenced by the fact that almost all residential and small C&I customers receive standard offer service or default service. In carrying out Legislative policy, the Department has created the basic framework for a market for these smaller customers, all of whom are free to choose competitive alternatives to standard offer service and default service, but we must be cognizant of the significantly different pace at which a competitive market is developing for smaller customers. For the smaller customer classes, default service likely will continue to play a central role in ensuring that electric service will be available at a reasonable price, consistent with each person’s need to access electricity to function in modern society, at least for the first few years after the end of the transition period. As the market develops, it may become appropriate to bring default service policies for smaller customers more in line with those for larger customers.

III. COSTS TO BE INCLUDED IN DEFAULT SERVICE PRICES

A. Introduction

Currently, each distribution company's default service prices are based on the payments the company makes to its default service supplier.² The supplier is the wholesale load serving entity ("LSE") for the distribution company's default service customers. As an LSE, a default service supplier is responsible for the wholesale energy, ancillary, and capacity costs incurred on behalf of the company's default service customers. Default service suppliers bear the risk associated with fluctuations both in wholesale commodity prices and default service load, risks that suppliers must take into account when determining the bid prices they will submit in distribution companies' competitive supply solicitations. Thus, default service prices currently are based on the costs that suppliers project they will incur in their role as LSEs to default service customers. Beginning in 2003, default service prices also include the costs that distribution companies incur to comply with the Massachusetts renewable portfolio standards ("RPS").³

In Default Service Pricing and Procurement, D.T.E. 99-60 (1999), the Department acknowledged that distribution companies incur other costs (e.g., costs associated with the procurement of default service supply and unrecovered bad debt) that they recover from customers through their base distribution rates. We stated that, in principle, default service

² A distribution company may select more than one default service supplier. For the purpose of this discussion, the Department assumes that a single supplier serves each company's default service load.

³ 225 C.M.R. § 14.00, et. seq.

rates should include all costs of providing default service to allow competitive suppliers “a fair and reasonable opportunity to compete for default service customers.” However, the Department concluded that, because these costs were likely to be insignificant compared to the payments that each distribution company makes to its default service supplier, it would be administratively inefficient to include them in default service rates. D.T.E. 99-60-B at 19. The Department also rejected the inclusion in default service rates of an adder for marketing costs incurred by competitive suppliers, stating that it would be inappropriate to artificially increase default service rates for the purpose of spurring competition. D.T.E. 99-60-A at 11. In the present proceeding, the Department stated that we would reevaluate the price components to be included in default service rates, including administrative and bad debt costs. D.T.E. 02-40, at 5-6.

B. Summary of Comments

1. Introduction

Many commenters agree that default service prices should include all costs incurred by distribution companies in providing the service, in order to ensure that default service customers receive accurate price signals and that competitive suppliers have a fair opportunity to compete for these customers (Attorney General Comments at 6; Cape Light Compact Reply Comments at 11; Competitive Suppliers Comments at 6-7; Dominion Comments at 4; DOER Comments at 26-27; Duke Reply Comments at 2; Fitchburg Comments at 2-3; ISO-NE Reply Comments at 2, 6-7; NEM Comments at 3; NSTAR Comments at 9-10; WMECo Comments at 2; WMICG Comments at 3). However, as discussed below, commenters disagree on what

types of costs distribution companies actually incur as a result of their obligation to provide default service.

Many commenters also agree that it would be contrary to the public interest for the Department to artificially increase default service prices simply to foster competition by including an adder for the marketing costs incurred by competitive suppliers (Attorney General Comments at 4; Attorney General Reply Comments at 5; Duke Reply Comments at 3; ISO-NE Reply Comments at 2; NSTAR Comments at 9-10; NSTAR Reply Comments at 6).

Conversely, NEM and CPC state that it may be appropriate to include an adder in default service prices to assist in the development of a competitive market (NEM Comments at 3-4; CPC Comments at 2-3).

2. Procurement-Related Administrative Costs and Unrecovered Bad Debt Costs

The Attorney General, Cape Light Compact, DOER, Dominion, Fitchburg, ISO-NE, NSTAR, MASSCAP, WMECo, and WMICG identify two types of costs that distribution companies incur in providing default service that currently are recovered in distribution base rates: (1) administrative costs associated with the procurement of default service supply; and (2) costs related to unrecovered bad debt (Attorney General Comments at 6; Cape Light Compact Reply Comments at 11; DOER Comments at 26, n.21; Dominion Comments at 4;⁴ Fitchburg Comments at 2-3; ISO-NE Reply Comments at 2, 6-7; NSTAR Comments at 9;

⁴ Dominion identifies only unrecovered bad debt costs as appropriate for inclusion in default service prices (Dominion Comments at 4)

WMECo Comments at 2;⁵ WMICG Comments at 3). The Attorney General, Cape Light Compact, and NSTAR argue that these procurement-related administrative costs and unrecovered bad debt costs, and only these costs, should be included in default service prices (Attorney General Comments at 6; Cape Light Compact Comments at 11; NSTAR Comments at 9). NSTAR opposes the inclusion of costs associated with customer service and billing in default service prices, arguing that these are services distribution companies provide equally to all customers and, thus, a company's costs to provide these services do not differ between default service customers and competitive supply customers (NSTAR Reply Comments at 23-25).

DOER, WMECo, and WMICG state that a transfer of procurement-related administrative costs and unrecovered bad debt costs from base rates to default service prices can be accommodated without an adjudicated rate-case proceeding (DOER Reply Comments at 7-9; WMECo Comments at 2; WMICG Comments at 3-4). DOER proposes that, until a distribution company's next rate case proceeding, the Department adopt a revenue-neutral surcharge/credit mechanism. DOER proposes that a surcharge that takes into account these costs would be added to the company's default service prices, while a credit for these costs would be applied against distribution base rates (DOER Comments at 31-32). Conversely, the Attorney General contends that a rate case proceeding is required to accommodate the transfer

⁵ WMECo identifies only administrative costs as appropriate for inclusion in default service prices. It also argues that default service prices should also include a distribution company service fee in order to compensate the companies for their efforts and to better mimic a retail price (WMECo Comments at 5-6).

of these costs, citing to the Department's statement in D.T.E. 99-60-A at 10, that "identification and calculation of the administrative costs incurred by a distribution company in providing default service would appropriately be done in a base rate proceeding" (Attorney General Comments at 6, n.7).

MECo states that administrative costs should remain in distribution base rates, rather than being included in default service prices (MECo Comments at 34). Regarding unrecovered bad debt costs, MECo recommends different approaches for medium and large C&I customers, and residential and small C&I customers. For medium and large C&I customers, MECo recommends that unrecovered bad debt costs remain in base rates, because one or two large customers with credit problems could distort the credit risk of providing default service to these customer classes. MECo argues that including bad debt costs in default service prices for large customers would likely require suppliers to perform credit risk assessments and, therefore, increase the cost of providing default service to larger customers (*id.*). Conversely, for residential and small C&I customers, MECo recommends that bad debt costs be included in default service prices. MECo argues that residential and small C&I customers have uniform bad debt characteristics and, therefore, including these cost in default service prices should have no price implications (*id.*).

3. Other Costs

In addition to administrative and bad-debt costs, Centrica, the Competitive Suppliers, Duke, and TXU state that distribution companies incur other retail-related costs that should be included in default service prices in order to enable fair competition (Centrica/TXU Reply

Comments at 3; Competitive Suppliers Comments at 6-7; Duke Reply Comments at 2). These commenters identify costs associated with: (1) customer service, (2) distribution company overhead, (3) compliance with default service-related regulatory requirements (including preparing and distributing the disclosure label and compliance with RPS), and (4) billing (Centrica/TXU Reply Comments at 3; Competitive Suppliers Comments at 6-7; Competitive Suppliers Reply Comments at 4; Duke Reply Comments at 2).⁶ The Competitive Suppliers assert that moving these retail-related costs out of distribution rates and into default service prices is critical for fully opening the retail market for smaller customers (Competitive Suppliers Comments at 6, n.1). Finally, the Competitive Suppliers recommend that the annual reconciliation of over- and under-recovery of default service costs should be included in default service prices, rather than in distribution rates (Competitive Suppliers Comments at 7).

Centrica recommends an approach in which default service prices would be set at a level that would “replicate the price that a competitive retail entrant would charge, given prevailing wholesale market conditions and appropriate indicators of retailing costs” (Centrica Comments at 15). Centrica states that setting default service prices in this manner, rather than on the actual costs incurred by distribution companies, would ensure that default service prices “mirror as closely as possible the market price for retail electricity service” (*id.*). Under this proposal, prices would be based on (1) projected wholesale prices for the applicable default service term, using forward market prices for electricity, and (2) retailing costs incurred by

⁶ Duke only identifies customer service costs as appropriate for inclusion in default service prices (Duke Reply Comments at 2).

suppliers, including allowable profit margins, using comparisons to similar firms in other jurisdictions (id. at 16).

C. Analysis and Findings

1. Introduction

The Department continues to embrace the principle that default service prices should include all costs of providing default service in order to allow competitive suppliers a fair and reasonable opportunity to compete for default service customers. Our previous conclusion in D.T.E. 99-60-B at 19, that the “relatively small magnitude” of costs associated with supply procurement and unrecovered bad debt did not warrant the time and resources that would be required to identify these costs and transfer them from distribution base rates to default service prices, was based on the assumption that having default service priced at a level that was slightly below cost would not negatively effect the competitive market. However, with additional information, we are no longer convinced that inclusion of these costs will have a negligible effect on default service prices.

First, Fitchburg’s recent base-rate proceeding indicates that inclusion of costs associated with the services it provides to default-service customers would result in an increase in its default service prices of between 0.2 and 0.3 cents per kilowatt-hour. See Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25 (2002); DTE-RR-26.⁷ Although the

⁷ In D.T.E. 02-24/25, at 171, the Department permitted Fitchburg to remove generation-related bad debt from the distribution rates and instead collect these amounts in standard offer service and default service rates. The Department stated that the ratemaking treatment for other generation-related costs would be addressed in the

(continued...)

Department recognizes that price impacts certainly may vary among distribution companies, our investigation in D.T.E. 02-24/25 establishes the need for further investigation of each company's default service-related costs and the resulting effect on its default service prices.

Second, the slow rate at which a competitive market has developed for the residential and small C&I customer classes indicates the importance of ensuring that default service prices include the full costs incurred in providing the service. Default service may serve as a barrier to competition as long as competitive suppliers must recover all of their costs through the prices they charge customers, while distribution companies are able to recover some of their default service-related costs through their distribution base rates. Therefore, we find that it is appropriate to include the costs that distribution companies incur in providing default service in their default service prices.

2. Costs to Be Included in Default Service Prices

a. Introduction

In determining which costs to include in default service rates, it is useful to distinguish between wholesale-related and retail-related costs. Wholesale-related costs are costs associated with a distribution company's interaction with the wholesale market to procure default service supply, including the wholesale supply costs that are paid to the default service suppliers as well as the administrative costs associated with the procurement of the wholesale supply.

Retail-related costs can be divided into the following two categories: (1) "direct" retail costs

⁷(...continued)

instant docket. Id.

that distribution companies incur strictly on behalf of their default service customers; and (2) “indirect” retail costs associated with services and activities that distribution companies provide not only to their default service customers, but also to their standard offer service and competitive supply customers.

b. Wholesale-Related Costs

Wholesale costs are either supply-related or procurement-related. Default service prices currently include the supply component of wholesale costs. Clearly, all supplier payments should continue to be included in default service prices.⁸ Procurement-related wholesale costs are associated with (1) the design and implementation of the competitive bidding process, including the evaluation of supplier bids and contract negotiations; and (2) the ongoing administration and execution of contracts with suppliers, including accounting activities necessary to track payments made to suppliers. Distribution companies incur these costs solely because of their obligation to provide default service to their customers, they would not incur these costs if they no longer had the obligation to provide default service. Consistent with the policy goals of cost causation, the Department concludes that procurement-related wholesale costs should be included in the calculation of default service prices.

⁸ Upon implementation of the congestion management system in the New England wholesale markets, default service suppliers will be responsible for the congestion costs that will be included in the region’s locational marginal prices. See D.T.E. 02-40-A at 4.

c. Direct Retail Costs

Direct retail costs are costs that a distribution company incurs strictly on behalf of its default service customers. Direct retail costs are associated with (1) unrecovered bad debt, (2) complying with the Department's default service regulatory requirements, including required communications with its default service customers,⁹ and (3) compliance with RPS. Similar to wholesale-related costs, a distribution company would not incur these costs if it no longer had the obligation to provide default service to its customers. Therefore, the Department concludes that these costs should be included in the calculation of default service prices.

d. Indirect Retail Costs

Indirect retail costs are costs associated with services and activities that a distribution company provides to all of its customers alike -- default service, standard offer service, and competitive supply. Indirect retail costs are associated with the provision of customer service and billing to default service customers, and the reporting of default service customers' load to the ISO-NE. A distribution company would continue to provide these services, and incur these costs if it no longer had the obligation to provide default service to its customers. Viewed from a different perspective, if a default service customer were to switch to a competitive supplier, the customer would continue to receive the same level of the customer service, billing, and load reporting services from the distribution company. These services are related to distribution service, rather than default service. Therefore, the Department concludes that

⁹ 220 C.M.R. § 11.06.

indirect retail costs should not be included in the calculation of default service prices.

e. Other Costs

In D.T.E. 99-60-A at 11, the Department rejected the inclusion of customer acquisition costs in default service prices, stating that it would be inappropriate to artificially increase default service rates for the purpose of spurring competition. No additional information was received in this proceeding to merit the Department's reconsideration of this issue.

3. Process to Transfer Costs from Base Rates to Default Service Prices

In the sections above, the Department identified the criterion to be used to determine the types of costs that should be included in default service prices. To ensure that this is a revenue-neutral process to distribution companies, these same costs must be removed from the companies' distribution base rates. The Department has recognized that the transfer of these costs from base rates to distribution rates is most accurately accomplished in the context of base rate proceedings. See D.T.E. 99-60-A at 10. However, waiting until each distribution company submits its next base rate filing could unduly delay the implementation of cost-based default service rates.

To transfer costs from distribution base rates to default service rates outside of the context of a rate case warrants a discussion of the Department's general bar on single issue rate cases. Pursuant to G.L. c. 164, § 94, a general increase in rates may be allowed only after a full rate case investigation. The Department is generally indisposed towards single issue rate cases. In Cambridge Electric Light Company, D.P.U. 490 (1981), the Department allowed a petition for base rate relief that "concerned only one major issue," recovery of a substantial

property tax increase unexpectedly levied by the City of Cambridge in 1980 and amounting to 60 percent of the rate increase just granted to the company in December 1997. The Department made an exception to its general indisposition toward to single-issue rate cases on limited and extraordinary grounds: (1) “the tax increase is dramatic and of such magnitude as to require the extraordinary treatment of this limited rate proceeding;” and (2) a “broad investigation [entailed in a general rate proceeding] would burden the ratepayers with a rate case expense in excess of any savings which might be attained by examining additional issues.” D.P.U. 490, at 2-3.

In D.P.U. 87-21-A, the Department sua sponte investigated the single issue of the ratemaking implications of the Federal Tax Reform Act of 1986 which reduced the maximum corporate Federal tax rate from 46 percent to 34 percent. The Department overruled objections that taking up the tax question was “inconsistent with the Department’s policy against single-issue rate cases.” D.P.U. 87-21-A at 11. The Department made an exception because the tax rate change was “generic” and its consequent “cost reduction applie[d] to all large utilities and its effect can be computed in a relatively simple, uniform way.” Id. at 7. Moreover, the “significant, known and measurable, and generic reduction in each company’s cost of service rebuts the presumption that present rates are just and reasonable. Accordingly, if the cost of service reduction were not reflected in rates to consumers, utilities would be permitted to reap an inappropriate windfall,” with the result of “unreasonable rates to consumers.” Id. at 7-8, 11. Avoidance of harm to ratepayers and windfall to companies from a major and generic change in the tax code amounted to an extraordinary condition that would

render otherwise presumptively just and reasonable rates, absent a correction, unjust and unreasonable. Exigent circumstances underpinned and warranted the exception to the bar to conducting a single-issue rate case. In sum, the Department's inhospitality toward single-issue rate cases is best seen as a prudential rule, which, though firmly enforced, is no absolute bar. The judgment on such petitions is necessarily circumstantial, concerning, as it must, the exigency of the problem and the importance of potential relief.

In the present case, several commenters argue that the transfer of costs can be accommodated without an adjudicated rate-case proceeding if the Department adopts a revenue-neutral mechanism (DOER Reply Comments at 7-9; WMECo Comments at 2; WMICG Comments at 3-4). A similar process was followed in gas unbundling when the Department approved the recovery via the gas adjustment factor of gas-related costs that were previously included in distribution rates and in electric unbundling when the Department approved the recovery via separate, reconcilable charges of transmission and generation-related costs that were previously included in base rates. See Berkshire Gas Company, D.T.E. 98-65 (1998); Colonial Gas Company, D.T.E. 98-64 (1998), Commonwealth Gas Company, D.T.E. 98-03 (1998), North Attleboro Gas Company, D.T.E. 98-61 (1998). In the instant case, we do not believe that the transfer of costs from distribution base rates to default service rates outside of the context of a rate case amounts to a single issue rate case. Therefore, the Department will open separate proceedings for each distribution company to determine (1) the amount of costs to be transferred from base rates to default service rates, and (2) the appropriate adjustment to be applied to each rate class' distribution base rates.

IV. PROVIDERS OF DEFAULT SERVICE

A. Introduction

Distribution companies function as the providers of default service for their customers. In this role, distribution companies conduct competitive solicitations to procure wholesale supply for their default service load for terms of six to twelve months. All default service-related customer and billing services are handled by the distribution companies' customer service representatives. In D.T.E. 02-40, at 6, the Department stated that we will consider whether distribution companies should continue to serve as default service providers, or whether this function can, and should, be provided by other entities.

B. Summary of Comments

1. Distribution Companies as Providers of Default Service

AIM, the Attorney General, the Cape Light Compact, Duke Energy, MASSCAP, NSTAR, and WMECo support the continued provision of default service by distribution companies (AIM Reply Comments at 2; Attorney General Comments at 6; Cape Light Compact Reply Comments at 6-7; Duke Comments at 2; MASSCAP Comments at 17; NSTAR Comments at 11-12; WMECo Comments at 5). The Attorney General and NSTAR state that different customer classes will migrate to competitive supply at different paces, and that the manner in which default service is provided is not the reason why few residential and small C&I customers have switched to competitive supply. As a result, these commenters argue that changing the structure of default service will not hasten the development of a market for residential and small C&I customers (Attorney General Reply Comments at 3; NSTAR

Comments at 6-8). They further state that, because default service may be the only viable energy option for small customers for the foreseeable future, having distribution companies continue as the default service providers will benefit these consumers by giving them access to market-based generation in the competitive wholesale market, ensuring that these customers can receive essential electricity service at prices that are stable and affordable (Attorney General Comments at 5; NSTAR Comments at 6-8).

DOER recommends steps the Department could take to increase the visibility of default service suppliers in order to educate customers that, in the restructured industry, distribution companies are no longer the primary suppliers of power. DOER proposes that the Department designate suppliers as the “power supply representatives” for default service customers. Under this proposal, suppliers would be required to operate toll-free telephone numbers to handle customer inquiries regarding default service-related issues. Distribution companies would identify the supplier, and its customer service telephone number, on customers’ bills. DOER further proposes that the Department require default service suppliers to be licensed as retail competitive suppliers (DOER Comments at 35-37).

The Attorney General and NSTAR support further customer education regarding available competitive options (Attorney General Reply Comments at 6; NSTAR Reply Comments at 20-23). However, NSTAR and other commenters raised concerns about specific provisions of DOER’s proposal. CPC, Fitchburg, NSTAR, and WMECo oppose requiring default service suppliers to be licensed as retail competitive suppliers, stating that such a requirement would limit the number of potential suppliers, thus reducing the competitiveness

of default service solicitation and likely increasing costs for default service customers (CPC Reply Comments at 4-5; Fitchburg Comments at 6; NSTAR Reply Comments at 22; WMECo Comments at 4-5). CPC and NSTAR oppose requiring default service suppliers to operate a toll-free telephone number, stating that such requirement makes no sense if the supplier is a wholesale generating company that has no interest in providing retail service (CPC Reply Comments at 5; NSTAR Reply Comments at 22-23). Finally, CPC and the Competitive Suppliers oppose DOER's entire proposal, stating that it would create the appearance of a relationship between the supplier and the customer that would not in fact exist (CPC Reply Comments at 4; Competitive Suppliers Reply Comments at 9).

2. Competitive Suppliers as Providers of Default Service

a. Introduction

CPC, Centrica, the Competitive Suppliers, Dominion, MECo, MTC, NEM, PG&E, and TXU support competitive suppliers replacing distribution companies as default service providers (CPC Comments at 2-3; Centrica Comments at 10-11; Competitive Suppliers Comments at 7-9; Dominion Comments at 5; MECo Comments at 8; MTC Comments at 13-14; NEM Comments at 5; TXU Comments at 7, 19). Centrica, the Competitive Suppliers, and TXU state that the incumbency advantages enjoyed by distribution companies make customers reluctant to switch to competitive supply and, thus, threaten the development of retail competition. These commenters state that, in order for an efficient competitive market to develop for small customers, it is necessary for distribution companies to exit the role of default service provider (Centrica Comments at 10-11; Competitive Suppliers Comments at 7;

TXU Comments at 7). MTC states that having competitive suppliers provide default service would increase competition, which, in turn, would foster the development of a market for renewable products (MTC Comments at 13-14).

Several commenters argue that default service provided by competitive suppliers will assist in the development of a competitive retail market because it will enable suppliers to make large-scale entry into the market at a low acquisition cost per customer. This would allow suppliers to generate sufficient revenue to cover the level of capital expenditures required to do business in the complex electric industry (CPC Comments at 3; Centrica Comments at 10-11; Competitive Suppliers Comments at 7-9; Dominion Comments at 6; TXU Comments at 31). Centrica and Dominion add that the provision of default service by competitive suppliers would enable customers to gain experience in choice programs, which should help to drive the development of a competitive marketplace (Centrica Comments at 10-11; Dominion Comments at 5-6). The Competitive Suppliers emphasize that the Department can ensure that default service customers are appropriately protected by (1) requiring that default service rates be set through a competitive auction process, and (2) establishing the terms and conditions of default service (Competitive Suppliers Comments at 11). The Competitive Suppliers and TXU state that the Restructuring grants the Department authority to implement a retail auction, because such an auction is in the public interest (Competitive Suppliers Comments at 9-11; TXU Comments at 32-36, citing G.L. c. 164, § 1B(d)).

Conversely, several commenters oppose the involuntary switching of default service customers to competitive supply, stating that it would (1) violate the Restructuring Act, (2) be

inconsistent with the Act's promotion of retail choice, and (3) be unlikely to provide consumers with demonstrable benefits and, thus, is not in the public interest (AIM Reply Comments at 2; Attorney General Comments at 4; Cape Light Compact Reply Comments at 6-7; MASSCAP Comments at 5, 17; NSTAR Comments at 11; NSTAR Reply Comments at 17). As a "guiding principle," NSTAR argues that the Department should maintain a policy of spurring the competitive market by encouraging retail choice, rather than by forcing customers into a market in which they may have no desire to participate (NSTAR Comments at 12).

Centrica, MECo, and PG&E submitted specific proposals to accommodate the transfer or assignment of default service customers from distribution companies to competitive suppliers. These proposals are described below.

b. MECo Proposal

MECo proposes an approach in which "basic service" provided by competitive suppliers would replace default service for residential and small C&I customers (MECo Comments at 8). Under its proposal, MECo would divide its residential default service customers into three statistically similar groups and would conduct a separate auction for each group to select a competitive supplier to whom the customers in the group would be assigned (id. at 13-14).¹⁰ For each of the three auctions, MECo would select the lowest bid price, with the caveat that no supplier may become the basic service supplier for more than one of the

¹⁰ This section describes MECo's proposal for residential customers. Its proposal for small C&I customers is the same, except that there would be a single auction for all customers in this customer class (MECo Comments at 14).

residential groups (id.). Basic service suppliers would have the same retail and wholesale obligations as other competitive suppliers, except that basic service suppliers (1) would be required to use the single billing option (basic service suppliers would be provided a separate page on customers' bills), and (2) could not undertake activities for collection of arrearages (i.e., only the distribution companies could do so for basic service customers) (id. at 21-23). Each of the three basic service suppliers (i.e., winners of the three auctions) would be paid their bid price (id. at 15).

Under MECo's proposal, basic service prices would be set equal to the highest of the three winning bid prices in order to create (1) an economic incentive for residential customers to move to the competitive market, and (2) a margin for competitive suppliers, including the basic service suppliers, to market to these customers (id. at 15-17).¹¹ The resulting over-recovery of revenue would be credited to the accounts of those residential customers not receiving standard offer service (i.e., residential customer receiving basic service or competitive supply) (id.).¹² MECo recognizes that setting the basic service price equal to the highest winning bid price may result in higher basic service prices, but argues that this is outweighed by the benefits resulting from the development of a robust competitive market for

¹¹ This is different from the method currently used to determine default service rates, which uses the average bid price of the winning bidders.

¹² MECo argues that crediting the over-recoveries to the accounts of both basic service and competitive supply customers removes a disincentive to switch from basic service to competitive supply that would exist if the credit was limited to basic service customers only. MECo notes that, if its proposal is unsuccessful and no customers switch to competitive supply, there would be no overall impact on the bills of basic service customers (MECo Comments at 15).

these customers (id. at 17-18). MECo states that wholesale suppliers would be allowed to submit bids in the basic service auctions in order to provide customers with access to the wholesale market in case there are insufficient retail bids (id. at 10-11, 26-27).

Dominion submitted comments in support of MECo's proposal, stating that the pricing proposal included therein will "result in a more robust retail market among a greater number of supplier and a broader range of products and services made available to customers" (Dominion Comments at 5; Dominion Reply Comments at 2-3). Conversely, CPC, Centrica, the Competitive Suppliers and TXU oppose the MECo proposal, arguing that it is an example of an auction that is "retail" in name only, because no retail functions are transferred to the competitive default service provider (CPC Reply Comments at 2; Centrica/TXU Reply Comments at 5-6; Competitive Suppliers Reply Comments at 9-10; TXU Reply Comments at 5, 16). In order to be successful, these commenters argue that an auction must be a true retail auction, in which customers are switched to a licensed competitive supplier that would be responsible for all wholesale and retail supply obligations, including customer service, billing, and regulatory requirements (Centrica/TXU Reply Comments at 2,6; Competitive Suppliers Comments at 9; Competitive Suppliers Reply Comments at 6; TXU Comments at 32).

NSTAR also opposes MECo's proposal, stating that it "involves a high degree of complexity" and has the potential to create customer confusion and dissatisfaction (NSTAR Reply Comments at 18-20). NSTAR argues that the proposal's pricing provision would raise artificially the price of default service, under the presumption that the increased price would be justified in spurring a competitive retail market for smaller customers (id.). Finally, Fitchburg

objects to the provision in MECo's proposal that would require default service suppliers to be licensed retail competitive suppliers, stating that such a requirement would limit the number or potential suppliers, thus reducing the competitiveness of the solicitation and likely increasing costs for default service customers (Fitchburg Reply Comments at 5-6).

c. PG&E Proposal

PG&E proposes an approach in which distribution companies would include in their bills a ballot that lists Department-approved competitive suppliers from which residential and small C&I customers could choose to be their default service supplier (PG&E Comments at 7-9). The ballot would include the name of each supplier and the price it would charge for default service. PG&E recommends that the Department establish uniform non-price terms and conditions so that suppliers would compete for default service customers "on price, name and company reputation alone" (id.). Customers that fail to make a choice for their default service provider would be assigned to suppliers on a pro rata basis (id. at 8; PG&E Reply Comments at 5). PG&E argues that its proposal would maintain stable, market-based default service rates, while providing suppliers with ample opportunity to entice customers to leave default service and move to competitive supply by offering differentiated products such as "green power" and energy efficiency service, thus facilitating the migration of smaller customers to competitive supply (PG&E Comments at 9-10; PG&E Reply Comments at 6).

AIM supports PG&E's proposal on a pilot basis, as long as customers participation is voluntary, and not mandatory (AIM Reply Comments at 2). The Competitive Suppliers state

that the PG&E proposal would need to be more fully developed before merits of this proposal can be determined (Competitive Suppliers Reply Comments at 10).

d. Centrica Proposal

Centrica proposes an approach in which the Department would select “competitive” default service suppliers that, in addition to providing generation service, would provide a wide range of retail customer services (including customer service, and billing and collections services) currently provided by the distribution companies (Centrica Comments at 15-20). Centrica argues that it is important to give suppliers the opportunity to manage the retail aspects of the customer relationship, in order to “recast the customer relationship as one between the default customer and the retailer, rather than with the distribution utility” (id. 17-18).¹³

Centrica proposes that each distribution company categorize its default service customers on the basis of geographic location, average and peak monthly consumption, customer class or other classifications deemed commercially significant. Competitive suppliers would submit bids for the right to acquire blocks of accounts and serve those accounts at the pre-determined default price¹⁴ during a specified transition period (id. 18-19). Revenue

¹³ TXU supports the concept of having suppliers provide retail services, asserting that selecting suppliers to act as alternate default service providers “will not help the retail market in Massachusetts if they are only allowed to provide generation service” (TXU Comments at 32).

¹⁴ As described in Section III.B, above, Centrica proposes that default service prices be set at levels that replicate the retail price that competitive suppliers would charge for similar customers and for a similar term.

obtained in the auction would represent the value that suppliers place on customer relationships, above and beyond the profit stream from providing retail service, and would be returned to customers through rebates on customers' monthly bills (Centrica Comments at 18-20). New default service customers would be allocated to suppliers on a pro-rata basis, while standard offer service customers would be allocated through a new auction process, upon the expiration of standard offer service (Centrica Comments at 18-20). At the end of the transition period, customers would continue to be served by their competitive default service supplier, but at unregulated prices (Centrica Comments at 16-18).

C. Analysis and Findings

As we discussed above, there are two equally important principles that serve as guidelines for the design and implementation of default service. First, default service should be provided in a manner that is compatible with the present development and future sustenance of an efficient market structure for retail generation services. Second, for those customer classes for whom an efficient retail competitive market may not be available, default service should be provided in a manner that ensures that electric service will be available at a reasonable price. In addition, the Department has long recognized the importance of minimizing customer confusion and dissatisfaction during the transition stage of restructuring, stating that such confusion and dissatisfaction "could undermine restructuring efforts and reduce the anticipated benefits of an improved industry structure." Electric Industry Restructuring, D.P.U. 95-30, at 45 (1995).

The Department is not convinced that having competitive suppliers provide default service would significantly assist in the development of an efficient competitive market for smaller customers. There may be several reasons why such a market has yet to develop. First, smaller customers' lack of participation in the competitive market may be due to the small level of available savings; small, that is, when compared to a household budget or a modest commercial customer's operating overhead. It is doubtful that designating competitive suppliers as default service providers would overcome this problem. Second, suppliers may be hesitant to enter the market for smaller customers because of the high per-customer costs incurred in acquiring and serving these customers. Although competitive default service would allow the winning supplier to acquire a large number of customers at low cost, other suppliers would continue to face the same high per-customer costs that currently exist. Thus, it is not clear that having competitive suppliers provide default service would result in an increase in the competitive options available to smaller customers. Instead, smaller customers may simply continue to receive default service from the supplier to whom they were assigned. Finally, customers may not yet be sufficiently informed and educated about their competitive options. Although customer assignments would produce some educational benefits, these benefits would likely be far outweighed by the confusion and dissatisfaction that may arise from default service customers' perception that they have been, so to speak, "slammed" (i.e., switched to a competitive supplier without their affirmative authorization), even if they continue to receive default service. As the Department noted in D.T.E. 01-54, at 14-15, "any decrease in consumer confidence caused by negative public reaction to allegations of electricity slamming

could work against the Department's long-term objective of establishing a robust competitive marketplace." In addition, legitimate questions have been raised about whether customer assignments in the manner proposed would be consistent with statutory prohibitions against slamming.

Whether competitive markets can find smaller customers attractive in single numbers is an ultimate question of electric restructuring. Many of the proposals amount to little more than Department-directed delegation of the distribution company's statutory default obligation to marketers. The features of some proposals are matters that only the Legislature, rather than the Department, can authorize. The cost of some restriction of retail customer choice, the Legislature has already answered the question: municipal aggregation. Mandatory bundling of smaller customers (with limited opt-out opportunity) by municipalities, whether singly or in concert, remains the simplest and best approach, one that economically bundles smaller users and makes their collective load available to marketers in convenient and attractive blocks. Only the standard offer service hurdle stands in the path of municipal aggregation.

Based on the above, the Department concludes that it is appropriate that distribution companies continue to function as default service providers for their customers. For medium and large C&I customers, an active competitive market has developed, despite the availability of standard offer service that is priced at below-cost levels, and despite the distribution companies' role as the default service provider for their customers. For smaller customers, it must be recognized that the distribution companies' provision of default service in the manner

directed in this order may be the most efficient market structure. The Department does not want to adopt policies that prevent the most efficient market structure from developing.

Finally, with respect to DOER's proposal, the Department supports DOER's underlying objective of better educating customers about the competitive options available to them in the restructured electric industry. However, we conclude it would be inappropriate to require default service suppliers to (1) be licensed as retail competitive suppliers, and (2) provide customer services to default service customers. Default service suppliers function as the wholesale providers of supply for default service customers. There is insufficient rationale and uncertain statutory authority for imposing these retail requirements on default service suppliers, which would limit the pool of available suppliers, thus potentially increasing costs.

V. PROCUREMENT AND PRICING OF DEFAULT SERVICE

A. Introduction

Distribution companies procure default service supply through competitive solicitations for terms of six to twelve months. Supply is procured separately for the industrial, commercial and residential customer classes. Bidders are required to submit monthly prices for each month of the procurement term, with the bid prices submitted by the winning bidder(s) for each customer class forming the basis for the default service rates for that class.

D.T.E. 99-60-A at 6-9.

Customers have two pricing options: (1) a variable pricing option where the default service rate changes monthly, and (2) a fixed pricing option where the default service rate

remains constant for six months. Id. Distribution companies initially place medium and large C&I customers on the variable pricing option, while residential and small C&I customers are placed on the fixed pricing option. All customers have the opportunity to change their pricing option. D.T.E. 99-60-B at 6-10. Customers on the fixed pricing option that leave default service during a procurement term have their bills recalculated using the monthly prices in effect each month that the customers received default service. Id.

Commenters addressed issues associated with the procurement and pricing of default service separately for larger and smaller customers, based on the level of competition available for these customers.

B. Medium and Large C&I Customers

1. Summary of Comments

The Competitive Suppliers state that the manner in which default service is provided should take into account the characteristics of different customer classes, the state of the competitive market for those classes, and the business realities of providing competitive service to those classes (Competitive Suppliers Comments at 5). The Competitive Suppliers argue that for large customers,¹⁵ upon the end of the standard offer service transition period, default service should serve as an emergency or interim service that will be available only for a brief period of time while the customer finds a competitive supplier (id. at 12). For medium

¹⁵ The Competitive Suppliers define large customers as those with peak loads greater than 200 kilowatts (Competitive Suppliers Comments at 5).

customers,¹⁶ the Competitive Suppliers argue that default service should continue unchanged in the short term, but should transition into an interim service as the competitive market for these customers develops further (id. at 12-13). With regard to pricing options, the Competitive Suppliers and Dominion argue that the recalculation provision that applies to customers on the fixed pricing option that leave default service during a procurement term creates customer confusion and dissatisfaction. As such, they recommend that the Department eliminate the recalculation provision (Competitive Suppliers Reply Comments at 7; Dominion Comments at 4). As an alternative, the Competitive Suppliers state that the Department could eliminate the fixed pricing option for medium and large customers (Competitive Suppliers Reply Comments at 7).

Several commenters state that the Department should consider short-term default service supply procurements for C&I customers in order to maintain a close relationship between the default service price and wholesale market prices (AIM Reply Comments at 2; Attorney General Comments at 6; NSTAR Comments at 12; MassCap Comments at 17; WMICG Comments at 4-5). WMICG states that the current method in which distribution companies procure default service supply for periods of six to twelve months, results in default service prices that depend on the date in which the supply was acquired. WMICG argues, therefore, that default service prices diverge from market prices over the term of the procurement period, creating an uneven, confusing, and ultimately, unsustainable market for

¹⁶ The Competitive Suppliers define medium customers as those with (1) peak loads between ten and 200 kilowatts, or (2) peak load less than ten kilowatts with interval meters (Competitive Suppliers Comments at 5).

power suppliers and customers (WMICG Comments at 4-5). WMICG states that, at least for large C&I customers, default service prices should be adjusted monthly based on an accepted fuel or electricity price index, in order to more properly reflect current market prices.

WMICG argues that customers seeking to purchase a longer-term, fixed price product should properly do so in the competitive market. Finally, WMICG supports time-of-use default service pricing for large customers (id.).

2. Analysis and Findings

The manner in which default service is procured and priced for medium and large C&I customers clearly will have a large effect on whether these customers will have the appropriate incentives to turn to the competitive market for more sophisticated or advantageous service offerings (see Section II, above). Commenters in this proceeding identify the six-to-twelve month procurement period for larger customers as a deficiency in default service, because the resulting prices are not indicative of wholesale market price over the course of the procurement period (i.e., default service customers are not receiving efficient price signals). In addition, the current procurement terms provide default service customers with a level of price certainty that is more appropriate provided by the competitive market, thus promoting default service as a longer-term alternative to competitive supply, rather than as a short-term, last resort service.

Default service may serve as a viable alternative to competitive supply if it provides similar types of services in three areas: (1) the level of protection from spot market price

volatility; (2) the degree of price certainty; and (3) the actual price to be charged.¹⁷ Under the current procurement and pricing model, default service competes with competitive services in all three areas. First, default service provides full protection to customers against spot market price volatility. A customer that seeks protection against price volatility will view default service as a viable supply option. Second, default service provides customers with price certainty for periods of six months. Again, a customer that seeks price certainty will view default service as viable supply option, although in this case, competitive suppliers can provide certainty over a longer time period. Finally, default service prices may be at or below market levels, depending on market conditions at the time that the distribution company conducts its competitive solicitation. To the extent that a company's default service prices are competitive with market prices, a customer evaluating supply options will likely choose default service. A customer may defer a decision on whether to enter into an agreement with a competitive supplier until default service prices for the subsequent six-month procurement term are known.

In order to function as a basic service, default service should provide customers with efficient price signals. However, extended periods of price certainty for what is, after all, last-resort service, serves to undermine retail competition. The most direct way to resolve this problem would be to structure default service as a passthrough of the hourly wholesale spot market prices. Customers that value price certainty and protection from price volatility would

¹⁷ Prices will vary, to some degree, based on the level of protection and price certainty that is included in contractual arrangements, because (1) suppliers require a premium as compensation for the market risk associated with fixing a price for a commodity with relatively volatile input costs, such as fuel, and (2) customers presumably will pay such a premium for increased protections against price volatility and greater price certainty.

appropriately turn to the competitive market for these services. Such a procurement and pricing model would not necessarily result in higher overall costs for default service customers, as spot market pricing does not always result in higher costs than longer-term bilateral contract prices. However, such a model would expose customers to significant risk that spot market prices could skyrocket during certain hours, causing substantial financial harm to customers. See D.T.E. 99-60-A at 16. This is an unacceptable risk for customers that may appropriately be using default service as a short-term, last resort service. California's experience with exposing customers to spot market fluctuation all the time is a cautionary tale whose message should not be dismissed. In addition, basing default service on spot market prices would likely create significant billing complexities for the distribution companies.

A more viable approach to ensuring that default service provides large customers with the appropriate incentives to turn to the competitive market may be to reduce the supply procurement term from its current six-month level. General Laws c. 164, §§ 1B(d) directs distribution companies to design their competitive solicitation for the procurement of default service supply so that "all bids shall include payment options with rates that remain uniform for periods of up to six months." In D.T.E. 99-60-B at 6-7, the Department interpreted the phrase "up to" as requiring that a fixed-price, six-month default service option be available to all default service customers. We recognized, however, that the words "up to six months" could be taken to mean any period from one month but not more than six months.¹⁸

¹⁸ The Department stated that "we believe the Legislature intended to extend to customers an option of price stability for "at least" six months. At the time, that conclusion
(continued...)

At the time that D.T.E. 99-60-B was issued, the competitive market was relatively undeveloped for all customer classes. At the present time, an active competitive market has developed for larger customers. Because of this, we consider it appropriate to reevaluate the six-month pricing option as it relates to medium and large customers. A persuasive, though not yet convincing, case can be made for the proposition that a procurement term of one month would (1) provide efficient price signals to customers because the resulting prices would track wholesale market price on a monthly basis; (2) provide customers with an appropriate level of price certainty; and (3) provide appropriate protection from spot market price volatility.

Under this approach, distribution companies would procure their default service supply one month in advance, on an on-going basis (e.g., companies would procure supply for May 2003 during April 2003). Customers, in turn, would know the level of default service prices for only the next month. As discussed above, customers that seek greater price certainty could appropriately turn to the competitive market for these protections. Although ongoing monthly procurements would likely increase the administrative costs incurred by distribution companies, the benefits of monthly procurements, in terms of supporting the continued development of the competitive market for larger customers, should outweigh these additional

¹⁸(...continued)

seemed more consonant with the protective purposes of the 1997 Restructuring Act. D.T.E. 99-60-B at 6-7. However, we conclude that it is more appropriate to require price stability up to a maximum of six months. As discussed later, the protective purposes of the Act for smaller customers are better served with longer procurement terms.

costs. The Department expects that monthly procurements would become more routine, standardized, and less costly over time.

Although monthly default service supply procurements for larger customers may fully satisfy the objectives of this proceeding, we do not direct the distribution companies to adopt such an approach at this time. In order to allow us to better understand the logistics associated with monthly procurements, the Department will schedule a technical session to discuss these issues.¹⁹ The technical session will be held at the Department's offices, One South Station, Boston, Massachusetts, at 10:00 a.m. on May 15, 2003.

C. Residential and Small C&I Customers

1. Summary of Comments

Many commenters support longer default service supply procurement terms for residential and small C&I customers as the best way to achieve stable and affordable default service prices (AIM Reply Comments at 2; Attorney General Comments at 6; Cape Light Compact Reply Comments at 10; ISO-NE Reply Comments at 8; MassCap Comments at 17; NSTAR Comments at 12). ISO-NE argues that procurement periods must be sufficiently lengthy to give default service suppliers the financial incentive to encourage their default service customers to pursue demand response actions (ISO-NE Reply Comments at 8). NSTAR suggests a procurement strategy where, every six months, a distribution company would purchase 50 percent of its default service load requirement for a one-year increment.

¹⁹ The Department seeks comments at the technical on the appropriateness of applying monthly procurements to small C&I customers as well.

NSTAR argues that this strategy represents a reasonable balance between price stability and market responsiveness (NSTAR Reply Comments at 31-32).

DOER proposes a staggered approach to the procurement of default service supply for smaller customers, where each distribution company would conduct quarterly competitive solicitations to procure one-eighth of its default service supply (DOER Comments at 17-19). Suppliers would submit bids to provide the identified load for a two-year period, with the winning supplier receiving its bid price. Upon full phase-in of DOER's proposed approach, each company would have a portfolio of eight two-year supply contracts in place, with a new contract introduced into the portfolio on a quarterly basis (id.). DOER states that the current procurement approach impedes the development of competitive options for smaller customers because changes in wholesale supply costs are not included in default service prices in a timely manner, resulting in default service prices that are subject to significant and abrupt changes, and exposing customers to the "vagaries of the wholesale market" (id. at 12-13). DOER argues that its proposal represents an improvement over the current procurement strategy because it balances the sometimes competing goals of the development of an efficient market, price stability and market responsiveness (id. at 19-21).

The Attorney General, the Competitive Suppliers, Fitchburg, NSTAR, and WMECo oppose DOER's proposal (Attorney General Reply Comments at 6; Competitive Suppliers Reply Comments at 8-9; Fitchburg Reply Comments at 3-4; NSTAR Reply Comments at 28-32; WMECo Reply Comments at 4-5). The Attorney General and NSTAR state that, while in principle longer-term and staggered supply procurements have merit, DOER's

proposal is unduly complicated, unnecessarily burdensome and has the potential to increase default service prices by eliminating purchasing economies (Attorney General Reply Comments at 6; NSTAR Reply Comments at 28-32).²⁰ Fitchburg and WMECo state that, because of their relatively small default service loads, DOER's proposal for smaller quarterly solicitations could increase their supply costs (Fitchburg Reply Comments at 4; WMECo Comments at 4).²¹ Finally, the Competitive Suppliers, Fitchburg, MECo and NSTAR state that DOER's proposal would insulate default service prices from market conditions, to the detriment of the competitive market (Competitive Suppliers Reply Comments at 8-9; Fitchburg Reply Comments at 3; MECo Reply Comments at 4; NSTAR Reply Comments at 29-30). The Competitive Suppliers state that default service prices are brought back in line with the market every six months under the current system. However, under DOER's "blended price" proposal, the Competitive Suppliers argue that prices would always be out of step with the market, which would be particularly problematic when market prices rise (Competitive Suppliers Reply Comments at 8-9).

Finally, MTC and UCS note that, as providers of default service, distribution companies must comply with the RPS promulgated by DOER. These commenters recommend that the Department authorize and encourage distribution companies to enter into long-term

²⁰ The Attorney General notes that DOER's proposal could be implemented as a voluntary pilot program, but only after a full Department investigation and adjudication (Attorney General Reply Comments at 6).

²¹ WMECo states that the proposal would also increase its procurement costs (WMECo Reply Comments at 4).

default service supply contracts with renewable generation resources in order to allow for the development of these resources (MTC Comments at 7-8; UCS Comments at 7-11). They claim that the current short-term supply agreements are not compatible with the needs of renewable resources developers, who require long-term commitments (i.e., 10 to 20 years) in order to receive financing (MTC Comments at 8; UCS Comments at 4). MTC also recommends that the Department require the distribution companies to offer a “green” default service option, in order to ensure that all customers, even those without competitive options, can purchase power from renewable resources (MTC Comments at 11-13).

NSTAR states that it supports the development of reliable and cost effective renewable resources, but opposes the use of long-term default service supply contracts to accomplish this objective (NSTAR Reply Comments at 33). NSTAR argues that reliance on long-term contracts would be inconsistent with the policies embodied in the Restructuring Act that attempt to reduce distribution companies’ stranded generation costs (id.). NSTAR adds that long-term contracts are not necessary to support the development of renewable energy resources because the Restructuring Act includes provisions aimed at providing financial incentives for these resources (id.). Finally, the Competitive Suppliers oppose a “green” default service option, stating this type of service should be provided by the competitive market (Competitive Suppliers Reply Comments at 10-11).

Regarding default service pricing for residential and small C&I customers, the Attorney General, Fitchburg, MASSCAP, NSTAR, and WMECo state that the Department’s existing pricing options should be maintained (Attorney General Comments at 6; Fitchburg Comments

at 3; MASSCAP at 17; NSTAR Comments at 13; WMECo Comments at 3). WMECo does not object, however, to having a one-year fixed price option (WMECo Comments at 3).

Conversely, DOER recommends that the Department eliminate the fixed, six-month pricing options, and require that all default service customers pay variable prices that change monthly (DOER Comments at 24-25).

2. Analysis and Findings

Unlike the market that has developed for medium and large C&I customers, the competitive options available for residential and small C&I customers are limited. As such, the pricing and procurement strategy for smaller customers must ensure the availability of electric service at reasonable and stable prices.

With respect to the default service pricing options available to smaller customers, eliminating the fixed, six-month option would be inconsistent with these customers' wishes for price stability. On the other hand, setting the fixed pricing option to a longer term could be inconsistent with the Department's objective of keeping default service prices at market-based levels. There is a balance to be struck between providing sufficient price certainty as well as efficient price signals. Based on the comments received, the Department believes that the current fixed, six-month option is the appropriate balance for current and foreseeable market conditions for these customers.

With respect to procurement, shortening the procurement term would ensure that default service prices would more accurately reflect market prices. However, a shortened term would increase the volatility of default service prices. Conversely, lengthening the

procurement term would provide for more price stability, but would weaken the connection to market prices. While a staggered solicitation approach may improve the current procurement strategy, DOER's proposal is too complex and would be overly burdensome to implement. For these reasons, we are not convinced that DOER's proposal would provide its intended benefits.

The Department sees merit, however, in revising the current practice in which each distribution company procures 100 percent of its default service supply every six months. Because prices in the wholesale market can change quickly, procuring 100 percent of supply at intervals of six-months contracts could result in prices that represent an anomalous market condition. NSTAR's suggestion to procure 50 percent of its default service supply semi-annually, for twelve-month terms, strikes a better balance between price certainty and price efficiency than does the current approach. Therefore, the Department directs each distribution company to implement such a procurement strategy at the time of their next default service supply solicitation.

Because of the large number of customers that receive default service (and also standard offer service), the manner in which distribution companies comply with their RPS obligations will have a significant impact on the market for RPS certificates. The Department directs each distribution company, in all future default service and standard offer service filings, to fully describe the manner in which it has complied, or intends to comply, with its RPS obligations. Although the Department does not specify any RPS compliance strategy, we will review the

filings to ensure that the distribution companies take appropriate steps to minimize RPS compliance costs.²²

The Department will not require distribution companies to enter into long-term contractual arrangements with renewable resources as part of the companies' RPS compliance strategy, because long-term contracts are not consistent with the uncertain nature of default service loads over an extended period of time. However, if a distribution company identifies long-term contracts as an efficient way for it to comply with RPS requirements, the company may seek Department approval for such an approach. Similarly, the Department will not require distribution companies to offer "green" default service options to their customers, because such options are more appropriately offered by the competitive market. However, a distribution company that seeks to provide a "green" product to its default service (and standard offer service) customers may submit a specific proposal to the Department for our review. Such proposal must clearly demonstrate that providing such a product is compatible with the development of competitive options for the customer classes to which the product would be available.

²² As stated in Section III, above, each distribution company's RPS compliance costs will be included in its default service prices.

VI. ORDER

Accordingly, after due consideration, it is

ORDERED: That all electric distribution companies comply with the directives contained herein.

By Order of the Department,

Paul B. Vasington, Chairman

James Connelly, Commissioner

W. Robert Keating, Commissioner

Eugene J. Sullivan, Jr., Commissioner

Deirdre K. Manning, Commissioner