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Why Default Service "Protections" Ultimately Harm Consumers

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Consumer advocates, Attorneys General and State Utility Regulators have worked diligently over the past several years to enact extremely onerous rules governing the services and pricing of competitive energy suppliers. On paper, the regulations might appear to protect consumers. But now, as we witness energy prices rise to possibly all-time high levels, we can see that consumers are being harmed by these practices, as the complexities placed upon competitive energy suppliers have effectively slowed the process of customers entering into competitive energy contracts. Only now, as we are experiencing some of the highest Default Service ("DS") rates for electricity and gas, are regulators and consumer advocates encouraging consumers to shop for their supply service. This is the wrong time to encourage shopping. The message being sent now is to "Buy High." Unfortunately, the opportune time has passed. We have spent too much time and effort "protecting" consumers from low prices.

Almost three years ago, I entered a three-year electricity supply contract at a very competitive rate, about half a cent per kWh below my default service rate at the time. My goal at the time was to protect myself from the inevitable energy price increases caused by the increased economic demand that seemed to be looming in that pre-pandemic era. Unfortunately, COVID happened, and the economic boom and greater demand for energy that I was hedging against evaporated. By the end of the first year of my contract, I was paying more to my supplier than I would have paid for default service. I wasn't mad about it. The difference was minimal. That decision cost me about $4.00 per month with my energy usage.

Fast forward to December 2022, my default service option is scheduled to increase to about $0.096 per kWh, which is 65% higher than my contract rate. I will be saving almost $0.04 per kWh, which equates to almost $80.00 per month in savings against the default service rate. My $240 in savings over the next three months will overwhelm the few months of "losses" from paying more than the default service rate. Luckily, I didn't listen to the fearmongering about suppliers. Imagine the savings if all 1.4 million customers in my service territory were on a similar contract. This equates to $100 million per month in potential savings lost because of regulatory burden.

Unfortunately, for many customers, it is only now that regulators and consumer advocates are urging them to shop for a lower-priced contract because DS prices are out of control. This is a bad policy call – urging customers to enter term contracts when prices are their highest – but one that is too late to correct. These recommendations should have been made over the prior twenty years.

Why are we here? The reasons are many, and they are all borne on paper and can be easily corrected. We must overcome the urge to over-regulate. First, and perhaps most importantly, default service is a pass-through of wholesale costs and, as such, is heavily subsidized by distribution rates. This subsidy gives regulators a political cover of providing the lowest-cost rates, but that is only a ruse. Studies have shown that the subsidy is between $0.01 and $0.02 per kWh. It is likely higher at some distribution companies. That might not sound like a lot, but that is 10-20% of today's elevated default service rates. For example, sworn testimony in 2018 showed the subsidy in the PECO service territory in Philadelphia to be $0.0125 per kWh. PECO's default service rate is increasing to $0.09856 per kWh on December 1, 2022. That reflects a whopping 13% subsidy in an elevated price market. Who wouldn't want a 13% discount on energy prices?

Unfortunately, the 13% discount is only a ruse, and that trick has deleterious effects on the competitive markets and, ultimately, on customers. Default service customers are paying for the subsidy in their distribution rates. It's only hidden from them. It is not truly a less expensive option. The hiding of costs in distribution rates only exacerbates the problem because customers who choose an alternative supplier are also paying default service expenses in their distribution rates. Shopping customers are subsidizing default service rates! This subsidy is patently unfair and has led to millions of customers remaining on default service.

This subsidy has also led to numerous bogus charges of competitive suppliers over-charging customers. A 2018 report published in Maryland suggested that Electric Choice Customers had been overcharged anywhere from 11% to 16%, amounting to a collective overcharge of $255 million across the state. Default service rates in Maryland at the time were in the $0.06 to $0.08 range. Applying the $0.0125 subsidy in Maryland suggests that shopping customers paid a very competitive price for electricity but were overcharged by the distribution company in the amount of 15% – 20%. Perhaps shopping customers were overcharged during that time, but it was by their respective distribution companies.

Default service, by its very nature, creates perverse incentives for customers, resulting in what has been referred to as "boom/bust" cycles in the competitive energy markets. Under prevailing default service rules, utilities procure wholesale energy in contracts that are entered into over a period of time. This results in a perpetual pricing lag. In rising price markets, default service prices are slow to rise. In falling price markets, default service prices are slow to fall. This is problematic on many fronts, but two are significant. First, most default service designs provide a free option to customers to leave the competitive market as prices are rising. This might sound good, but it creates an enormous barrier for suppliers to make long-term investments in a market. For example, to provide residential customers with long-term access to renewable energy opportunities, a supplier might consider entering into a long-term supply agreement with a solar provider. That opportunity might allow ample opportunity today to provide customers with electricity at $0.08 per kWh, a price that is below the default service rate. However, when default service rates come down, those same customers will be incentivized to leave the renewable contract and move back to the less expensive default service, leaving the supplier with an unsellable renewable resource. This free option to move back to default service creates a barrier (more than just a disincentive) to suppliers making long-term investments in these markets. The free option and price lag ultimately harm the market and customers by eliminating long-term options that benefit everyone.

Less noticeable, yet equally important, is that the price lag in default service prices sends inaccurate pricing signals to consumers. As we enter this winter of 2022-2023, we are being confronted with warnings of potential inadequate fuel resources to keep our houses heated. While some default service rates have incorporated this risk, many others include contracts from the COVID-era over-supply, which creates no incentive to conserve energy. Artificially low prices can lead to over-consumption. This could prove to be problematic.

State regulators should not be micromanaging competitive energy markets. Nor should they be filing lawsuits against suppliers because a supplier is charging a fraction of a cent more than the default service. Literally, millions of dollars have been wasted by states and by suppliers defending themselves against frivolous litigations. Regulators should be working to ensure fair competition in the markets and should always be encouraging customers to switch to competitive contracts.

The competitive retail energy markets are tilted significantly in favor of the default service suppliers (the utilities). The rates are subsidized. Default service design creates bad incentives and stifles long-term investments. Billing options favor the incumbents. Enrollment processes bias against a competitive sale. The competitive sales process is overly burdensome. Regulators should change their mindset and empower competitive suppliers and they should move swiftly. Prices will eventually fall. Competitive suppliers need to be able to provide robust services and savings to consumers. In the absence of regulatory corrections, the subsidies, the laddered default service contracts and the other “protections” will continue to harm default service customers for many years.