June 14, 2001

Mr. Brian Soutiere
Vice-President
Canadian Marketing
Direct Energy Marketing Limited
Suite 1400
25 Sheppard Avenue West
Toronto, Ontario
M2N 6S6

Dear Mr. Soutiere:

Re: Proposed Gas Distribution Access Rule

The attached report provides an economic analysis of allowing gas marketer consolidated billing in Ontario.

Sincerely yours,

Professor Michael J Trebilcock
Senior Consultant
Charles River Associates

An Economic Analysis of Allowing Gas Marketer Consolidated Billing in Ontario

By

Micahel J. Trebilcock

1. As an expert in competition policy and regulatory reform, I have been retained by Direct Energy to provide an economic analysis of allowing marketer consolidated billing in the context of the proposed Gas Distribution Access Rule (DAR) issued by Ontario Energy Board Staff (OEB) on Feb. 6, 2001. My credentials for this task are contained in the attached curriculum vitae.

2. I have approached this analysis with an emphasis on consumer welfare. That is, I endorse the "demand pull" approach to consumer choice articulated by the Natural Gas Market Design Task Force.[1] This approach emphasizes the need to make consumer choice as attractive as possible rather than seeking to establish a system in which consumers are forced to choose a competitive supplier.

3. In summary, I support the billing options provided in the DAR. I reject arguments that these options will increase costs and reduce competition in natural gas marketing. Indeed I expect the opposite. The remainder of this report elaborates upon this opinion. Section 1 discusses the efficiency gains to be achieved from allowing customer choice in billing arrangements. Section 2 critiques the arguments articulated by Professor Richard Schwindt that allowing marketer consolidated billing could increase costs. Section 3 discusses the likely impact of allowing marketer consolidated billing on competition. Section 4 describes the role of the Ontario Energy Board (OEB) in assuring that consumers are offered a clear choice among all three billing options. Section 5 concludes.

[1] See Natural Gas Market Design Task Force, Report to the Ontario Energy Board, February 4, 1999 at p. 13-14.

I. Efficiency Gains From Allowing Customer Choice in Billing Arrangements

4. In a previous submission to the OEB on this issue, I argued that allowing consumer choice among billing options would likely yield economic benefits.[2] In recommending competition in billing and customer service, I am arguing that all three possible billing options be made available to consumers. That is, I support paragraph 8.3.1 of the proposed DAR which requires gas distributors to offer gas marketers three billing options: (1) distributor consolidated billing, (2) marketer consolidated billing, and (3) split billing.

5. Allowing consumer choice in respect of billing options would likely promote more effective dissemination of market information, and thus promote what economists term "allocative and productive efficiency".[3] Allowing marketers to offer various billing options to consumers would allow firms to differentiate their offerings and therefore lead to more choice and more robust competition. Thus, I recommended that the OEB take steps to promote competition in billing and customer service.

6. Consumer choice in billing options would also promote convergence of regulatory regimes in natural gas and electricity, further benefiting consumers. Recent international developments provide an exemplary example. In Australia, the second largest gas retailer (Origin Energy) recently purchased the electricity business of another company (Powercor) making it the second largest electricity/gas retailer in the country. In a December 2000 report, the U.K. regulatory authority (Ofgem) estimates that over 35 percent of the U.K. market has opted to receive both natural gas and electricity from the

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[2] Submission of Professor Michael J. Trebilcock in Motion by CENGAS under section 29 of the OEB Act, 1998, February 1999. This submission notes, for example, that consumer choice in billing options is quickly becoming the norm in natural gas markets in North America.

[3] Economists take the view that competitive markets reach equilibrium prices equal to both marginal costs of production and minimum average total cost of production while market prices signal consumers about the relative costs to them of consuming different commodities and thus assure that available goods and services are allocated to consumers most efficiently. Or, put somewhat differently, allocative and productive efficiency means going as far as possible in the satisfaction of wants within resource and technological constraints. For discussion of "economic efficiency" see, for example, Stanley Reiter, "Efficient Allocation", in John Eatwell, Murray Milgate and Peter Newman eds., *The New Palgrave: A Dictionary of Economics*, Stockton Press, New York, 1998 at pp. 107-199.

same supplier.[4] In March 2001, Ofgem issued a guidance note on regulatory issues on Energy Service Companies (ESCOs), under which the supply of energy (both electricity and natural gas) would be linked to the provision of energy efficiency goods and services and the customer could receive a single bill covering this package. In the guidance note, Ofgem outlines its efforts to assure that there are no unnecessary barriers to the creation of ESCOs.[5]

7. Beyond the U.K. there are also notable examples of consumer choice billing initiatives in the U.S. In Georgia, for example, the incumbent natural gas utility (Atlanta Gas and Light) has been required to offer billing services to marketers, but no marketer has elected to use the service. Instead, marketers have provided billing services in one of three ways: (i) develop their own internal resources including call centers and billing systems; (ii) outsource billing functions to a third party; or (iii) enter into partnerships with another energy company (e.g., a local electricity provider) who also provides billing services.

8. Promoting convergence of billing and customer service arrangements across natural gas and electricity by allowing maximum scope for consumer choice has several advantages including:

- Reducing barriers to entry facing potential competitors with a comparative advantage in offering billing and related services that are not yet present in the Ontario market.
- Increasing the number of customers potentially available to a new entrant by allowing them the option of offering a duel fuel option and, as a result, reducing the average cost of up-front investments in a billing system. The convenience of a single bill for energy services may be of considerable value to consumers.

[4] Ofgem, "A Review of the Development of Competition in Domestic Gas and Electricity Supply, December 2000, posted at http://www.ofgem.gov.uk/docs/dcmrgaselec.pdf. In paragraph 6.38, Ofgem estimates that there are about 21 million customers in the U.K. market and that about 7.5 million customer have chosen to receive both electricity and natural gas from the same supplier.

[5] Ofgem states its approach to ESCOs as follows: "It would not be appropriate for Ofgem, as regulator, to favour any particular business model for gas and electricity suppliers, and decisions on whether to bring forward ESCO schemes are clearly a matter for companies, not the regulator. However it is important that there are no unnecessary restrictions on ESCOs, and that suppliers and stakeholders understand the real opportunities for ESCOs which the regulatory regime now permits.

- Increasing the scope that marketers have to offer a wide variety of billing and customer service options (e.g., direct debit, electronic funds transfers, duel fuel discounts) that customers demand and other value-added goods and services.

- Assuring that artificial differences in billing arrangements between natural gas and electricity do not impede convergence of energy supply options.

II. The Impact of Consumer Choice in Billing Options on Distributors' Costs

9. In a letter dated February 23, 2001, Richard Schwindt argues that customer choice will increase distributors' billing costs and would be inefficient in the sense that duplicative billing capacity would be maintained. To reach this conclusion, Professor Schwindt assumes:

    - there are economies of scale in the billing function;
    - allowing consumer choice will substantially reduce distributors' billing activity; and
    - distributors will be required to maintain sufficient excess capacity to accommodate the possibility of substantial numbers of customers returning to the distributor system;

    As a result, the reduction in billing volume caused by allowing customer choice will act to increase distributors' per unit costs and these costs will be passed on to consumers. Professor Schwindt also asserts that these costs will be passed on to marketers opting to rely on the distributor for billing and customer services (e.g. ABC-T) and that this will impede new entry. I examine and reject each of these assumptions below.

Are there significant economies of scale in billing?

10. In assessing whether there are significant economies of scale in billing that could markedly impact the distributors' costs, it is necessary to disaggregate billing and customer service into the following six sub-functions: (1) billing software; (2) payment processing; (3) bill rendering (e.g., printing, stuffing and mailing); (4) bill collection; (5) billing inquiries (e.g. call centers); and (6) meter reading. As discussed in my earlier opinion, all of these services (with the possible exception of meter reading) are available to natural gas marketers and distributors from numerous supply sources who can

themselves realize economies of scale in these functions.[6] While there are some set-up costs involved in establishing billing software and call centers, much of the sub-functions of billing and customer service can be expanded or contracted with relative ease depending on customer volume.[7]

Will there be a substantial reduction in distributors' billing activity?

11. The assumption that marketer consolidated billing will necessarily reduce the number of customers to whom a distributor provides billing services ignores the possibility that natural gas retailers could at the same time increase the number of customers they supply billing services to by entering the electricity market. The potential scope for retailers to expand their customer base is illustrated in the U.K. where, in a December, 2000 review of the development of competition in the U.K., Ofgem reports that British Gas has built up a 10 percent share of customers (12 percent by volume) in the national electricity market.[8]

12. Furthermore, even if the costs of distributors' ABC-T service increases following customers leaving distributors for marketers, it does not follow that barriers to entry are necessarily increased. In fact, if new entrants can obtain billing services by outsourcing or partnering with another energy company at a per unit cost that is below the current ABC-T rate, barriers to entry would be <u>reduced</u> irrespective of what happens to the cost of ABC-T service. The experience in Georgia noted above illustrates that this is a realistic possibility.

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[6] For discussion of these sub-functions, see [6] Submission of Professor Michael J. Trebilcock in Motion by CENGAS under section 29 of the <u>OEB Act, 1998</u>, February 1999 at paragraphs 5.6 to 5.10.

[7] In my earlier opinion, I concluded that there was not enough evidence available at the time to be assured that market forces could be relied upon in the provision of meter reading services. As technology advances, one would expect that the competitive supply options for all revenue cycle services will increase, including meter reading. Interestingly, in the fall of 2000, Ofgem and Transco (the U.K. gas distribution company) laid out a project plan to secure effective competition in metering.

[8] Ofgem, "A Review of the Development of Competition in Domestic Gas and Electricity Supply, December 2000, posted at http://www.ofgem.gov.uk/docs/dcmrgaselec.pdf.

Will distributors be required to maintain considerable excess capacity?

13. It is unclear that allowing customer choice will necessarily require distributors to maintain sufficient excess capacity to accommodate substantial numbers of customers returning to the distributor system. As noted above, many of the sub-functions of billing and customer service are available from competitive supply sources and can be easily expanded if circumstances dictate. Thus, there is no need for distributors to maintain large amounts of idle capacity in these sub-functions just in case there are returning customers. Should a distributor's customer base shrink, the distributor can shrink the resources devoted to these sub-functions. If customers later return to the distributor's system, resources can be added back to these sub-functions to accommodate any increase in billing services.

14. In addition, in the event that there are transitional concerns about the ability of distributors to quickly expand billing capacity, it is still an open question whether it is realistic to expect that a significant volume of consumers will return to system gas in a short period of time. To fully assess this issue, it would be necessary to examine the institutional arrangements relating to when, and on what conditions, customers are returned to system gas.

III. <u>The Impact of Billing Options on Competition</u>

15. The promotion of billing options in natural gas will likely have two effects on the state of competition within the industry. First, as observed by Professor Schwindt, allowing customer choice will mean that distributors and/or their affiliates are no longer guaranteed a 100 percent share of customers over whom to average their billing costs. Second, it will mean that marketers will have an opportunity to build relationships with their customers (i.e. developing a brand name reputation and adding flexibility to billing options). In this section, I consider the likely competitive effects of these two aspects of allowing choice in billing including marketer consolidated billing.

16. As customers leave distributors for service from marketers, natural gas distributors' affiliates or other marketers will have an increased incentive to enter new markets, most

likely electricity markets. In the U.K., where retail competition has been a success story, entry by natural gas markers as electricity marketers has been a key element of the competitive landscape. The U.K. regulatory authority Ofgem reported in December, 2000 that there are 11 suppliers offering both electricity and gas and that gas and electricity markets have experienced increased innovation in the range of payment methods and complementary services offered by suppliers.[9] The same logic implies that there will be pressure on natural gas marketers to succeed in electricity in order to keep their average billing and customer service costs at competitive levels.

17. In order to maximize the procompetitive potential of having a customer choice billing regime, customer transfer mechanisms and other relevant aspects of the regulation of retail competition in natural gas and electricity need to be harmonized as much as possible. In keeping with this objective, section 6 of the proposed DAR makes important progress toward harmonizing the process by which service transfer requests are processed by distributors. The provisions mandating consumer choice in billing options would also promote harmonization since retailers are required to provide the same billing options in the Ontario electricity market.

18. As noted in my earlier opinion, there is a broad consensus on the economic benefits of allowing consumer choice in natural gas billing. Under consolidated billing, marketers will have incentives to engage in non-price competition by offering consumers a menu of billing and customer service options (e.g., direct debit, electronic funds transfers, dual fuel discounts) and other value-added goods and services. Enhanced non-price competition will allow the options that consumers value to win out over less desirable options. In a competitive retail environment, marketers will have incentives to offer and consumers will have incentives to choose the billing options that maximize their benefits (net of costs). As a consequence, a billing system that allows customer choice is much more likely to result in lower costs of billing overall as it expedites firms' offerings of innovative low-cost to customers.

[9] Ofgem, "A Review of the Development of Competition in Domestic Gas and Electricity Supply, December 2000, posted at http://www.ofgem.gov.uk/docs/dcmrgaselec.pdf at paragraphs 10.5 and 10.15.

19. The scope to offer marketer consolidated billing would also improve the efficiency with which market demand and cost information is transmitted to consumers. Marketers will have an incentive to compete by offering customers a menu of contracts and contract terms with varying levels of insurance or price fluctuation with the market. Non-price competition could also be manifest through different choices of frequency of payment. That is, competition will encourage marketers to develop innovative billing solutions and incorporate value-added services for the customer, providing opportunities for marketers to differentiate themselves and compete for new customers.

20. Experience in other jurisdictions such as the U.S. and U.K. illustrate that allowing marketer consolidated billing allows marketers the flexibility in structuring and presenting their bills that is necessary to allow them to offer a wide range of product offerings, not all of which may be energy related. Some of the services that have been offered on websites of natural gas marketers in other jurisdictions include gas appliances (such as water heaters and fireplaces), telecommunications and Internet services, home insurance and security, auto services (such as insurance, breakdown coverage and financing), energy efficiency advice and travel insurance. Energy efficiency advice is likely to be a particularly strong growth area for firms providing the duel fuel option to consumers.

21. Professor Schwindt's claims that marketer consolidated billing will increase costs fail to take into full account the potential cost savings of marketer consolidated billing. In a situation where all billing options are permitted, marketers will have the option to provide a single comprehensive bill to consumers that includes natural gas distribution charges, commodity natural gas <u>and</u> these other services. In contrast, under a regime where only distributor consolidated billing is permitted, consumers would have to receive two bills, one for natural gas commodity and distribution charges and a second for all the other services that can be found on natural gas marketer websites in other jurisdictions. Alternatively, if distributors were to be required to provide every marketer with a distributor consolidated billing service which includes marketers' offerings of products other than natural gas, this would likely significantly raise information management costs because of the different combinations of offerings of each marketer. Under marketer

consolidated billing, in contrast, the marketer can combine the distribution charge, the commodity charge and charges for any other services offered in a manner that reflects the efficiency of its own differentiated service offering. In other words, marketer consolidated billing may be the most efficient solution from the perspective of consumers.

22. An important reason that marketer consolidated billing is attractive to marketers is that it will allow them to build relationships with customers. Some may argue that such relationships can create switching costs and customer inertia, and therefore make entry more difficult. In my view, however, the degree of customer loyalty that would be created by these (efficient) relationships in natural gas are no larger than in any other industry where customers have continuing relationships with their suppliers, and therefore should not be considered a significant barrier to entry.

IV. <u>Assuring Effective Customer Choice</u>

23. Once the provisions in the proposed DAR requiring distributors to offer gas marketers all three billing options are adopted, the OEB must continue to play a role in assuring effective consumer choice. I concur with the submission of Union Gas that consumers should make the choice of bill providers for a consolidated commodity and distribution bill, and that consumer choice is both achievable and desirable only where there is a robust competitive commodity market.[10] However, I differ with Union Gas with respect to the remedy. To the extent that institutional or other imperfections frustrate consumer choice, the most appropriate course is to remedy the institutional arrangements that frustrate choice rather than eliminating the ability of consumers to choose among the three available billing options.

24. In keeping with this, the *Code of Conduct for Gas Marketers* (Code of Conduct) has an important role to play in assuring effective consumer choice among billing options. While there are components of the Code of Conduct that I support, I also find that it was developed in a regime where only distributor consolidated billing was permitted. Thus, it

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[10] Union Gas, "Comments of Union Gas Limited on the Draft Gas Distribution Rule", 3/9/2000 at p. 22.

may be appropriate to update the Code to assure that marketers' contracts with customers address the billing option agreed upon.

25. Finally, as a general matter, the OEB should have the tools necessary to enforce Codes of Conduct (e.g., the *Code of Conduct for Gas Marketers* and the *Affiliate Relationships Code for Gas Utilities*). Bill 57, which is currently before the legislature, would promote more effective enforcement by providing scope for the OEB to impose administrative fines. In my view, monetary penalties that vary in proportion to the severity of the breach of the Code of Conduct found by the OEB are more credible.

IV. Conclusions and Recommendations

26. In conclusion, I support the billing options contained in the proposed DAR. I reject arguments that these options will increase billing costs and/or reduce competition in natural gas retailing. Indeed I expect the opposite.