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# Peace, Love, Competition. An Initial Look at the Restructuring of Illinois Residential Energy Markets

*Robert Kelter\**

## I. INTRODUCTION

The electric, natural gas, and telephone industries are currently in the midst of a major transition. After decades of regulation under the assumption that utilities were natural monopolies, policy makers have now decided that problems such as high prices and poor service quality can be cured by opening markets to competition. The word “competition” has become the mantra of the new millennium, chanted by free market proponents reminiscent of hippie chants of “peace” and “love” during the 1960s.

Given the ramifications of this market restructuring for consumers, it is appropriate to analyze the transition to competition at every step to ensure that consumers receive the long-term benefits of efficiency that regulation has sometimes failed to deliver. Even the father of airline deregulation, Dr. Alfred Kahn, a proponent of limiting regulation in Illinois in the utility-affiliate rulemaking, noted, “It is necessary to confront the possibility, finally, that the benefits of the competition unleashed by deregulation will prove only temporary—that, as many opponents of deregulation have consistently predicted, competition will ultimately kill itself off.”<sup>1</sup>

Contrary to public statements by utility officials that consumers are demanding choice for their electricity and gas, the Citizens Utility Board (CUB) has received little input from constituents regarding the right to choose a new electric or gas company. While in the late 1980s and early 1990s many ComEd customers wanted to escape the company’s high rates stemming from its nuclear build up, even ComEd’s customers have been relatively quiet in the last few years.

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1. ALFRED E. KAHN, *THE ECONOMICS OF REGULATION* xxii (1988).

That is not to say that consumers do not want lower prices and better service, merely that many do not value choice in and of itself.

In Illinois, consumer advocates have taken the approach that competition is inevitable and focused on market structure issues, such as utility-affiliate rules, consumer complaint processes, and public education programs. Too often the response to consumer protection concerns during the transition is, "That's competition. You have to let the market fix the problem." This response is consistent with the premise that we are "deregulating," rather than "restructuring."

Critics of regulation address concerns regarding utility-affiliate abuses and fraudulent marketing by casting the debate in "either-or" terms, as in either you have competition or you have regulation. Yet, in reality, many industries that are "competitive" are highly regulated, such as food, insurance, and banking. Do consumers want to worry about how their bank is handling their money? Would consumers be comforted by the thought that competition will eventually weed out the bank if their money is not there when they go to make a withdrawal? Does it deter competition when grocery stores print the price per unit for competing products? Of course not. Good consumer protection laws enhance competition by encouraging efficiency and discouraging fraudulent marketing.

## II. COMPETITION DEFINED

In the simplest terms, competition should produce lower prices and better service in the long-term. The most efficient company should win the most customers, and every competitor should be forced to continually battle to become more efficient in order to maintain or increase its market share. While there are many definitions for competition, the Nevada Legislature provides as good a description as any:

"Effective competition" means, with respect to a particular service, a market structure and a process under which an individual seller is not able to influence significantly the price of service as a result of:

1. The number of sellers of service;
2. The size of each seller's share of the market;
3. The ability of the sellers to enter or exit the market; and
4. The price and availability of comparable substitutes for the service.<sup>2</sup>

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2. NEV. REV. STAT. 704.969 (repealed 2001).

Whether customer choice is a worthwhile end in and of itself is perhaps best summarized by the National Regulatory Research Institute (NRRI), the research and policy organization funded by the National Association of Regulatory Utility Commissioners:

But customer choice is not a worthwhile end in and of itself unless the choice is meaningful. Meaningful customer choice maximizes consumer welfare; that is, consumers are better off either because they value the services they are receiving more highly than services that they received before, or because they are receiving the services that they received before at a lower price, or both.

For customer choice to exist in a manner that maximizes consumer welfare, two preconditions must be met. One precondition is that there is in place a market structure that allows each customer to have a full range of available suppliers from which to choose. For this to occur there must be at least workable competition. If the market is a tight oligopoly or even a loose oligopoly where one firm acts as the dominant firm, then there probably is not the full range of available suppliers from which to choose. Workable competition is often defined as there being no fewer than five firms.<sup>3</sup>

While “competition” sounds enticing, in order to determine whether consumers ultimately benefit, the costs and risks of shopping must be evaluated. Consumers who shop may bear the risk of paying higher prices (as discussed below regarding the Nicor Customer Select program), and shopping may require considerable time and energy given the complexity of choosing a natural gas provider. Hence, the real issue is whether the market is structured in a way that consumers are likely to benefit.

### III. DETERMINING THE APPROPRIATE LEVEL OF REGULATION DURING THE TRANSITION

Assuming then that competition will not automatically produce benefits, the next question is what needs to be done to create an efficient market where the benefits to consumers outweigh the costs/risks. Regulation is particularly important during the transition from monopoly to competition. Few competitors in electricity, gas or telecommunications have chosen to enter all states and utility service

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3. Robert E. Burns, Esq., Kenneth Costello, Edwin Rosenberg, Ph.D., & Frank Darr, Esq., *Market Analyses of Public Utilities: The Now and Future Role of State Commissions* (draft, Nat'l Regulatory Research Inst., July 1999) (revised and published as ROBERT E. BURNS, ESQ., KENNETH COSTELLO, EDWIN ROSENBERG, PH.D., & FRANK DARR, ESQ., *DYNAMIC MARKET ANALYSES OF TRANSITIONAL UTILITIES: A ROLE FOR EVOLVING COMMISSIONS* (Nat'l Regulatory Research Inst., 2000)).

territories equally. In electricity, it has been clear that the few competitors venturing into new service territories base their decision whether to enter a market on the level of the barriers to entry. For example, Green Mountain Energy, touted by promoters of open markets as an example of a company providing the choice of purchasing environmentally friendly power, is not in every state that has opened its market for competition. Nor is New Power Company, one of the few companies that has targeted residential customers. Both of these companies have met with CUB and indicated that they will compete in Illinois only if they believe conditions are conducive to entry by new competitors.

Some of the barriers facing these companies are simply related to the price of the product.<sup>4</sup> For instance, the average price of electricity in Illinois (6.98¢/kwh) is much greater than in Indiana (5.29¢/kwh),<sup>5</sup> and the price in Ameren/CIPS's price service territory (7.42¢/kwh) is approximately 25% lower than in ComEd's service territory (9.31¢/kwh).<sup>6</sup> Naturally, competitors can beat the incumbent utility price more easily where the price is high. While incumbent utility price plays a major role in determining the level of competition, some barriers to entry can be controlled by the legislators and regulators.

#### IV. THE EARLY EVIDENCE INDICATES COMPETITION IS NOT DEVELOPING AS ANTICIPATED

While it may turn out that competition benefits consumers, today's reality indicates that legislators and regulators should be carefully examining how the markets are developing. The evidence in Illinois indicates that the warning of William G. Shepherd, economist from the University of Massachusetts is coming to pass:

Deregulation can veer into a market-dominance trap, rather than march firmly to effective competition. Only if regulatory economics (controls to get efficient outcomes even under monopoly) is replaced by industrial-organization economics (which is about real competitive

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4. The price consumers pay may include transition charges, designed to compensate the incumbent utilities for resources allocated to serve customers before restructuring.

5. Energy Information Administration, State Electricity Profiles tbl. 8 (Nov. 20, 2001), available at [http://www.eia.doe.gov/cneaf/electricity/page/fact\\_sheets](http://www.eia.doe.gov/cneaf/electricity/page/fact_sheets) (providing data for utilities in Indiana and Illinois in 1999).

6. ILLINOIS COMMERCE COMMISSION, A COMPARATIVE STUDY OF ELECTRIC SALES STATISTICS FOR CALENDAR YEARS 2000 AND 1999, RESEARCH BULLETIN NUMBER 145, at 3.

processes, with dynamic impacts) is there a good chance for the budding competition to become really effective.<sup>7</sup>

Despite optimism from commercial and industrial consumers that competition would deliver better service and lower prices, early results in Illinois are not particularly promising. In the electric industry, since the restructuring law of 1997, every major electric company in Illinois has been bought out by or merged with another company: ComEd/PECO, Illinois Power/Dynegy, CIPS/UE (now Ameren), Central Illinois Light Company/AES. The strategy seems to be that only by becoming bigger can a company be competitive. Or, only by becoming bigger can a company ensure that it can protect its own service territory from competition.

All commercial customers have been eligible for choice in Illinois since October 1, 1999.<sup>8</sup> As of July 1, 2001, not one customer had switched in Central Illinois Light Company's (CILCO) service territory.<sup>9</sup> In Ameren/CIPS's territory 820 out of 45,013 eligible customers had switched, for Illinois Power 1,026 out of 91,928, and for ComEd 14,165 out of 527,450 had switched.<sup>10</sup> While ComEd's service territory seems to have some level of legitimate competition, the enthusiasm is tempered by the fact that over half of the ComEd customers who "switched" are merely taking service from ComEd under a different arrangement, called the Purchased Power Option (PPO), which allows customers to buy power from the utility at the market rate.<sup>11</sup> Moreover, the statistic does not reflect the fact that half of those who actually switched providers (i.e. not taking the PPO) have switched to ComEd's generation affiliate. While the Illinois Commerce Commission (ICC) statistics do not list competitors' shares, ICC statistics indicate three competitors in ComEd's service territory captured 83% of the market.<sup>12</sup> One of these competitors is a ComEd affiliate, another was Enron, and the other is AES.<sup>13</sup>

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7. William G. Shepherd, *Deregulation from Monopoly Only to Dominance?*, 17 NRRI Q. BULL. 149 (1966).

8. 220 ILL. COMP. STAT. 5/16-104(a)(1) (2000).

9. ILLINOIS COMMERCE COMMISSION REPORT OF CHAIRMAN'S FALL 2001 ROUNDTABLE DISCUSSIONS 11-12 (Nov. 2001).

10. *Id.*

11. *Id.* at 13. Despite these statistics to the contrary, at recent legislative hearings on competition in Springfield, CILCO, which has not lost one customer, and the others claimed that competition is working in Illinois.

12. Illinois Commerce Commission, *Assessment of Retail and Wholesale Market Competition in the Illinois Electric Industry*, Apr. 2001, at 10, available at <http://www.icc.state.il.us/icc/ec/docs/010503genrepcomp.doc>.

13. *Id.*

V. EXAMINATION OF THE NICOR CUSTOMER SELECT PROGRAM  
DEMONSTRATES THE POTENTIAL FOR AFFILIATE DOMINATION

Since the onset of competition, the Citizens Utility Board has focused extensively on ensuring that new rules regarding utility-affiliate relationships limit the ability of utilities to transfer unearned economic advantages to their affiliates. CUB's cause for concern has been that by passing on advantages to affiliates, utilities can continue to dominate the market in a way that creates a new monopoly. Kenneth Costello, Associate Director for Electric and Gas Research for the NRRI, outlined the concern in a recent NRRI report on gas customer choice programs:

The evidence from various programs coincides with economic theory saying that the savings must be adequate to offset the risks and transaction costs associated with consumers switching to a new provider, this condition is especially relevant in a market where the local utility has been the sole provider and the only entity with name recognition. Overcoming this so-called first-mover advantage, which is not necessarily problematic, makes it more difficult for independent marketers to establish themselves and create a presence that erodes the dominance of the incumbent utility. In all markets, incumbents have an inherent advantage over new entrants; one reason derives from the positive reputation of an incumbent (if that is in fact true), which a new entrant must try to neutralize with advertising and other informational activities. Consumers, in turn, have to incur high costs to acquire information on new entrants.<sup>14</sup>

The opening of the gas market in Illinois demonstrates some of the problems outlined by Mr. Costello. The two largest gas utilities in Illinois, Nicor Gas and Peoples Gas, have allowed commercial customers to shop in recent years, and Nicor has allowed 15% of its residential customers (260,000) to shop under its Customer Select program.<sup>15</sup> While Peoples has not released any statistics regarding competitor market share, the numbers in the Nicor pilot are telling. Nicor's affiliate, Nicor Energy, has dominated the "open" market, gaining 93% of the residential customers choosing a new provider and 72% of the commercial customers.<sup>16</sup>

Despite a myriad of problems with the market in Nicor's service territory, the Illinois Commerce Commission recently voted to expand

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14. KENNETH W. COSTELLO, HOUSEHOLD PARTICIPATION IN GAS CUSTOMER CHOICE PROGRAMS: SOME FACTS, EXPLANATIONS, AND LESSONS LEARNED, IV (Nat'l Regulatory Research Inst., No. 99-05, Jan. 1999).

15. Illinois Commerce Commission Order No. 00-0620 & 00-0621 at 3 (July 5, 2001), available at <http://eweb.icc.state.il.us/e-docket>.

16. *Id.* at 9.

Customer Select to all Nicor Gas customers.<sup>17</sup> The Citizens Utility Board, the Illinois Attorney General, and the Cook County State's Attorney all opposed any further expansion until the Commission addressed the problems with the program, particularly the dominance by Nicor Energy.

Throughout the proceeding in which the Commission considered Nicor's application to expand competition to all customers, Nicor emphasized that customers wanted choice, and the company ignored concerns that the benefits of shopping did not necessarily outweigh the costs/risks.<sup>18</sup> In some months of the pilot Nicor Energy customers saved money, but in some they did not. The offers customers received were confusing to the extent that no residential or small business customer could possibly understand what they were purchasing. Two years ago, Nicor Energy customers signed up for an offer that they thought locked them in at 26 cents per therm, when in reality that offer only locked them in at that price if the market price dropped to 26 cents per therm. The offer was actually for a price based on the Natural Gas Intelligence monthly index plus 3.5 cents per therm—a truly incomprehensible offer to a typical residential or small business customer. Last year, only two other companies besides Nicor Energy registered to serve residential customers, and only Nicor Energy actively pursued customers. Corn Belt Energy offered customers a variable rate based on the company's gas costs, plus 3.9 cents per therm, FirstEnergy Services offered the Natural Gas Intelligence price plus 3.8 cents per therm, and Nicor Energy offered the Natural Gas Intelligence price plus 3.89 cents per therm.<sup>19</sup> These rates were neither comparable to each other, nor to the regulated Nicor Gas rate. The average customer has no idea how Nicor Gas purchases gas for its customers or how that price gets passed through in their monthly bills. The average customer has no idea how Nicor Gas's prices compare to other utilities around the country, or why its unregulated affiliate, Nicor Energy, would be able to provide lower prices than the utility.

What customers do know, however, is that Nicor Energy uses the Nicor Gas name and logo. Moreover, Nicor Energy's marketing implies that customers will save by switching to Nicor Energy and

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17. *Id.*

18. Utility gas customers already pay market-based rates passed through by the utilities. The law requires that utilities provide this gas prudently. See 220 ILL. COMP. STAT. 5/9-220(a) (2000).

19. *Nicor's Customer Select Program*, CUBFACTS (Citizens Utility Board, Chi., Ill.) Winter 2001, available at <http://www.citizensutilityboard.org>.

downplays or completely ignores the risk that the company is unregulated, and customers might in fact end up paying a higher price if they switch. Thus, the customer perceives an opportunity to save money with little risk.

The Citizens Utility Board and the other consumer representatives in Illinois have stressed that the Commission needs to prohibit Nicor Energy from using the Nicor name and logo. This would not only level the playing field for new market entrants, it would drastically reduce the chance that customers will sign up for offers they do not understand because they believe that Nicor Energy guarantees them savings or that Nicor Energy is regulated by the Illinois Commerce Commission.

In essence, the record in the investigation of the Customer Select program indicated that the Customer Select program represents nothing more than Nicor Gas's attempt to shift customers to its unregulated affiliate Nicor Energy.

## VI. LESSONS LEARNED FROM THE NICOR CASE

### A. *Limit the Ability of the Utility to Determine the Framework*

The problem started from day one when the Commission allowed Nicor Gas to design the Customer Select program. It is simply inconceivable that Nicor Gas would propose a program that would truly open the market to competition in a way that would encourage new market entrants and permit erosion of Nicor's profits. Such a proposal by the company would clearly violate its obligation to its shareholders.

Given the fact that competitors have choices, the market must be structured in a way that limits barriers to entry. Moreover, the transition period is critical because once one competitor gains dominance, it can often reduce competition by exerting market power. Regulatory and utility sources indicate the cost of customer acquisition for residential customers can range anywhere from \$150<sup>20</sup> to \$200<sup>21</sup> per customer. The flow of money stops when investors deem a market to be a lost cause. And in fact, in both the CILCO and Nicor pilots this has turned out to be the case. In both cases the utility's affiliate gained early dominance of the market, and competitors left. As mentioned above, in the Nicor Customer Select pilot five competitors offered residential

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20. Indicated to CUB in an off-record conversation with supplier.

21. Costello, *supra* note 14, at 17.

service in 1999, and by 2000 the number was down to three,<sup>22</sup> with only Nicor Energy actively pursuing customers.

*B. Limit the Ability of the Utility to Transfer Unearned Competitive Advantages to the Affiliate*

The utility-affiliate abuse issue has been around for a long time. Ameren/CIPS's witness in the electric utility-affiliate rulemaking, the aforementioned Dr. Alfred Kahn, noted the incentive for abuse many years ago:

[T]he regulated companies—even more, their promoters and managers—have extracted some of these potential monopoly profits by paying excess prices to affiliated, unregulated companies for equipment, supplies, financial advice and underwriting, engineering, and managerial services—charges included in the cost of service and recovered from customers.<sup>23</sup>

Today, the risk remains great, but it has changed with the times. Instead of utilities paying affiliates too much for products and services, now the risk is that the utility will transfer unearned economic advantages to its affiliates, including, foremost, instant name recognition and credibility, in a way that benefits the affiliate to the detriment of the market.

In Illinois, after significant effort by consumer advocates to ban gas affiliates from using the utility name and logo, the Commission has required affiliates to add a disclaimer warning customers that the affiliate is unregulated and that regardless of which company the customer chooses to supply its gas, its service from Nicor Gas will not be affected.<sup>24</sup> However, a disclaimer is not likely to clarify the situation sufficiently to reduce the likelihood that consumers will sign up with an affiliate much more readily than with a non-affiliate competitor.

*C. The Commission Needs to Actively Monitor the Market*

To a great extent, each state commission must decide how active a role it will play in the restructuring process—whether it will passively wait to see how things play out on terms set by incumbent utilities, or whether it will attempt to set a framework that encourages the development of competition. On the electric side, the legislature

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22. *Customer Select—Making the Right Choice*, CUBFACTS (Citizens Utility Board, Chi., Ill.) Apr. 2002, available at <http://www.citizensutilityboard.org>; *Nicor's Customer Select Program*, CUBFACTS (Citizens Utility Board, Chi., Ill.) Winter 2001, available at <http://www.citizensutilityboard.org>.

23. KAHN, *supra* note 1, at 28.

24. Illinois Commerce Commission Order No. 00-0586 at 9 & app. A (Sept. 18, 2001), available at <http://eweb.icc.state.il.us/e-docket>.

specifically states the ICC “should act to promote the development of an effectively competitive electricity market . . . .”<sup>25</sup>

Experience in Illinois indicates that commissions need to take initiative and ensure the market is properly structured at the outset. Additionally, the commission should take an active approach in monitoring marketing materials and listening to consumer concerns, without waiting for customers to bring formal complaints. Individual residential and small business customers often do not suffer enough financial injury to justify bringing a costly complaint, but that does not mean that their interests should not be protected. Moreover, competitors are often reluctant to spend resources challenging a competitor, particularly if the competitor is a utility affiliate. Not only is cost an issue, but the competitor is dependent on the utility for delivery services.

#### VII. THE GOAL SHOULD BE TO PROVIDE CONSUMERS WITH THE GREATEST LEVEL OF BENEFITS POSSIBLE

Some economists, and of course many utilities, argue that just because there are no competitors other than the utility affiliate, it does not mean that competition is not working if consumers have saved money. Their position is that if the threat of entry by competitors forces utilities to keep prices lower than they should be, then competition is working. However, this response answers the wrong question. The question should not simply be whether consumers saved any money in the short-term. The question should be: Is competition producing long-term efficiencies in a way that provides optimal benefits to customers?

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25. 220 ILL. COMP. STAT. 5/16-101A(d) (2000).