

> competitive  
market | BENEFITS

>> FIRST QUARTER | 2007



**Constellation**  
NewEnergy®

➤ Given our history as pioneers in competitive energy markets, Constellation NewEnergy is frequently called upon to answer the question “how do competitive energy markets benefit consumers, and for that matter, the economy as a whole?” To address this question, we collaborated with retail energy customers to explore their perspectives and experiences in competitive energy markets. Combining their perspectives with the results of the numerous studies performed by energy industry consultants, economists, regulatory authorities, and wholesale market operators, we recount herein our perspectives on the key benefits of competitive energy markets.

Pondering the question “how do competitive markets benefit consumers, and for that matter, the economy as a whole?” brings to mind the comments of the staff of the New York State Department of Public Service (NYS DPS) in a March 2006 report<sup>1</sup>. “Retail competition gives consumers choice which promotes market innovation and creates an incentive to provide value. This choice provides consumers with a range of value-added services and pricing arrangements that monopoly

service would not otherwise produce.” According to recent discussions we have had with retail energy customers; they fully share the perspective of the NYS DPS. Retail energy customers have found that competitive markets offer them more product choices along with the ability to exert greater control in managing energy budgets. In our experience, competitive markets result in better-informed and more engaged consumers who can participate more meaningfully in the ongoing debates about energy policy at both the state and national level. Consistent with conventional wisdom, competitive energy markets motivate suppliers to bring about efficiencies by putting downward pressure on costs and providing incentives for efficient production and utilization of the energy delivery infrastructure. We have also found that by responding to customer demand, competitive energy markets act to accelerate the development and use of renewable sources of energy. Ultimately, we share the belief with our customers that competitive markets are the critical driver of innovation, continuous improvement, and the growth of productivity in the U.S. economy.

➤ | COMPETITIVE ENERGY MARKETS OFFER CHOICE, WITH CONTROL

A critical element of a competitive market is choice for consumers – choosing who supplies the goods and services they require and, just as importantly, choosing electricity sup-

customers by competitive electricity suppliers including fixed price, capped price, and indexed price, as well as offers that include renewable power, load control services, and energy

“ FOR HYATT HOTELS, COMPETITION MEANS WE CAN HAVE BUDGET CERTAINTY. WE UNDERSTAND THAT ENERGY PRICES CHANGE, THAT FUEL PRICES ARE VOLATILE. BUT IN A REGULATED ENVIRONMENT, WE ARE ONLY A PRICE TAKER. IN A COMPETITIVE MARKET, WE CAN WORK TO MEET OUR OPERATING OBJECTIVES. EVEN IN HIGH PRICE MARKETS, WE CAN MANAGE REALISTIC OBJECTIVES. WE CAN TAKE ADVANTAGE OF TOOLS TO CONTROL OUR RISK, OUR EXPOSURE TO THE MARKET. > BRIAN BURKE, HYATT HOTELS

ply products tailored to meet their specific needs. To many customers, the element of choice inherent in a competitive market means they can obtain an electricity supply agreement that meets their business objectives and risk tolerance.

In its March 2006 investigation, the NYS DPS found that a variety of electricity supply products were being offered to retail

efficiency assistance. At Constellation NewEnergy, our retail products are designed to support our customers’ specific energy strategies. We offer products that range in risk from a fixed price electricity contract, which fully protects customers against market price volatility, to a customized, flexible combination of fixed and variable market pricing. We also offer renewable

<sup>1</sup> Staff Report on the State of Competitive Energy Markets: Progress to Date and Future Opportunities, New York State Department of Public Service, March 2, 2006.

energy supply, energy management tools, and energy efficiency services and systems.

While it may be argued that fully regulated retail markets can offer consumers some limited product-service choices, in markets without retail competition, individual customers have no control over the terms and conditions associated with their

electricity supply contract. Traditionally, only the very largest industrial customers have the ability and opportunity to negotiate terms and conditions with their utility. In a competitive market, many more customers now have that same ability and opportunity to negotiate with their suppliers.



THERE IS A WIDER RANGE OF CHOICES FOR US UNDER COMPETITIVE RETAIL MARKETS. UNDER REGULATED MARKETS, WE HAD TWO RATE OPTIONS – MAYBE. WITH COMPETITIVE RETAIL MARKETS, THERE ARE DIFFERENT CONTRACT LENGTHS; CONTRACT TERMS ARE NEGOTIABLE, AND THE PRICING OPTIONS RANGE FROM HOURLY TO FIXED TO INDEXED. > **BILL LYON, FEDERATED DEPARTMENT STORES**



## COMPETITIVE MARKETS YIELD BETTER-INFORMED, MORE ENGAGED CONSUMERS

For the last 50 years, the focus on competitive markets in the U.S. has created a strong consumer culture with knowledgeable and demanding customers. Such customers are a positive



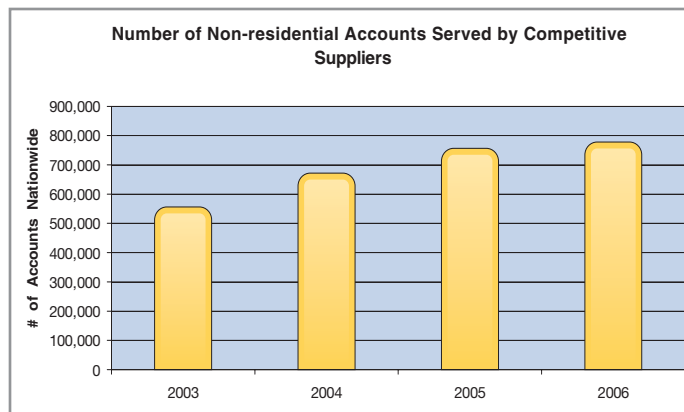
OUR VIEW OF THE ENERGY SUPPLY INDUSTRY HAS IMPROVED – THAT IS OUR REGARD FOR THE IMAGE OF THE ELECTRIC SUPPLY INDUSTRY. WHERE PREVIOUSLY WE FELT LIKE VICTIMS OF PROFIT-REGULATED UTILITIES WHO SEEMED TO HAVE LITTLE INCENTIVE TO BE RESPONSIVE TO CUSTOMERS OR TO BE EFFICIENT, WE NOW FEEL LIKE MARKET PARTICIPANTS.

> **JIM McANDREW OF BARTON MINES**

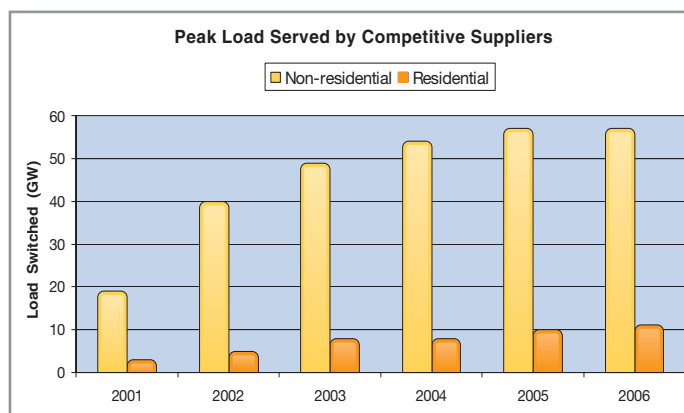
force for any industry, challenging the status quo, identifying weaknesses and signaling where improvements are needed. The energy industry is no exception to this rule. Dialog with energy customers reveals that their experience with competitive retail markets has helped them evolve into engaged markets participants.

The number of business and industrial energy consumers transitioning from passive electricity rate payer to valued customer and market participant is substantial and growing. Analysis performed by industry consultant KEMA shows that the

number of business customers served by competitive suppliers [in the U.S.] has grown to nearly 800,000 in the last four years.



These customers represent a significant peak load, calculated by KEMA to be nearly 60 GW as of September 2006.



Exploring this issue with customers reveals that the improved price transparency of competitive markets has helped them better understand market dynamics, and ultimately make better decisions about energy use. Brian Burke of Hyatt Hotels has this perspective. *“The greatest benefit [of competitive energy markets] is price transparency. In a deregulated market you get to know what the prices in the market are and what’s driving them.”* Burke says, *“We have to make business decisions and*

*we have sufficient transparency about what is going on in the market to make them.”*

Ultimately, the growing number of better-informed, more highly engaged consumers in competitive energy markets is becoming a meaningful and significant constituency participating in complex energy policy issues at the state, regional, and even national level. The industry can only benefit from this contribution.



## COMPETITIVE MARKETS MOTIVATE GREATER EFFICIENCY

In an open letter to policy makers issued in June 2006, eight well-respected economists from both academia and the energy industry addressed the notion of the efficiency inherent in competitive markets and the benefits this creates for the industry<sup>2</sup>. In general, they noted, that since competitive markets shift infrastructure investment risks to the suppliers, they provide incentives for more prudent investment choices, more effective cost controls, and, therefore, more efficient outcomes overall. Beyond this basic dynamic, they further noted the price signals present in competitive electricity markets provide demand response opportunities for customers. Demand response, the economists say, has a significant price dampening effect and

and enable retail customer participation in demand response programs. Constellation NewEnergy offers customers online tools displaying and analyzing power usage, giving customers insights as to what they are spending, as well as where and when. We help our customers determine how to cut their costs, which often involves enrolling in various ISO-sponsored demand response programs. We both encourage and assist with demand response program enrollment.

The efforts of competitive suppliers are reflected in the level of demand response occurring in restructured markets. According to a recent Federal Energy Regulatory Commission staff analysis of demand response<sup>3</sup>, Independent System



I THINK RETAIL COMPETITION WILL GREATLY IMPROVE THE EFFICIENCY OF ENERGY MARKETS FOR EVERYONE BY CREATING PRICE INCENTIVES FOR CONSUMERS TO EXERCISE THEIR FLEXIBILITY IN REGARD TO USAGE PATTERNS. THIS SHOULD SAVE SYSTEM COSTS BY REDUCING THE NEED FOR NEW CAPACITY AND TRANSMISSION AND REDUCING USAGE OF LESS-EFFICIENT ENERGY SOURCES > JIM McANDREW, BARTON MINES

relieves the peak loading conditions on the electricity distribution infrastructure.

In our view, competitive energy suppliers are well-suited to facilitate retail energy customer participation in demand response programs administered by the central market operators in restructured markets. Competitive suppliers who work with customers to help them better manage their total energy costs offer innovative products and services that both encourage

Operator and Regional Transmission Organization administered demand response programs currently contribute 19 percent of national demand response resources. The PJM, NYISO, and ISO NE markets together provide nearly 8,500 MW of demand response potential.

While the business model of the competitive supply business is compatible with demand response program models, it is less clear that this compatibility exists in the regulated

<sup>2</sup> An Open Letter to Policymakers, dated June 26, 2006, signed by Paul L. Joskow of MIT, Alfred E. Kahn of Cornell University, William W. Hogan of Harvard University, Peter Cramton of University of Maryland, Howard J. Axelrod of Energy Strategies, Vernon L. Smith of International Foundation for Research in Experimental Economics, David W. DeRamus of Bates, White, and Gary L. Hunt of Global Energy Advisors.

<sup>3</sup> Assessment of Demand Response and Advanced Metering, FERC Staff Report AD-06-2-000, August 2006.

business. In the absence of a comprehensive regulatory mandate for demand response that decouples utility rates and revenues, utilities suffer a disincentive since reduced customer demand leads directly to a loss of utility revenue. Further, by their very nature, demand response programs require that retail customers actually “see” time-differentiated wholesale market prices, yet most retail tariffs are disconnected from wholesale prices. Competitive suppliers, however, can offer a variety of product pricing schemes, many of which are based directly on wholesale market prices. Customers accustomed only to bundled utility rates typically have far less understanding of the price risk and volatility experienced by those participating in competitive energy markets and thus may be less able to realize the value created by demand response. The greater price transparency and product customization available to customers in competitive markets allows them to collaborate with their suppliers and even other energy customers to shape their load

in response to market conditions.

This view of the value of improved efficiency through demand response has been echoed by other key industry participants. In an October 2005 speech<sup>4</sup>, Gordon Van Welie, President and CEO of ISO New England asserted: *“We need more direct participation of consumers in the markets. In order to achieve this outcome, consumers need to see and pay the price for their consumption decisions. If customers pay the same retail price hour to hour, day to day, month to month, they have no incentive to change how they use electricity. By seeing and paying the price for consumption decisions, customers are given the opportunity to reduce their overall energy bill by changing their consumption patterns. When customers begin responding to prices, the existing system is used more efficiently, which reduces price volatility, the need for additional capacity, and overall prices in the wholesale market.”*



## COMPETITIVE MARKETS ACCELERATE INTEREST AND INVESTMENT IN RENEWABLE GENERATION

We have found that many business customers are interested in purchasing energy from renewable energy sources. Customers in competitive markets can exercise those interests, thereby accelerating the development and use of renewable energy.

try sectors, 23 of them purchase green power from competitive suppliers.

Many retail customers are motivated to purchase electricity from renewable sources as a way of demonstrating their corpo-



A COMPETITIVE SUPPLIER WILL HELP US DOVETAIL OUR SUPPLY CONTRACTS TO ACHIEVE WHAT WE WANT. FOR EXAMPLE, WE WANT TO PARTICIPATE IN RENEWABLES. > [TOM COAKLEY, ST. LAWRENCE UNIVERSITY](#)

The vast majority of firms participating in the Environmental Protection Agency (EPA)’s Green Power Partnership program<sup>5</sup> are supplied with green power by competitive energy suppliers. The EPA’s data reveals that six of the top ten colleges and universities participating in the Green Power Partnership are buying green power exclusively from competitive suppliers. Competitive supplier green power sales to the top ten colleges and universities represent nearly 80 percent of the renewable energy volumes sold to these customers. Of the top 25 Green Power Partners, which are leading firms from a variety of indus-

rate environmental stewardship. Genzyme Corporation, a leading biotechnology company, promulgates an environmental policy statement which commits it to “operate its facilities so as to protect our environment and conserve our natural resources...” Consistent with this commitment, Genzyme has constructed a world-class green building for its corporate headquarters. All of the building’s electricity comes from renewable sources, either from a solar array on the roof or from a multi-year green energy supply contract with Constellation NewEnergy.

In an effort to respond to customer demand for renew-

<sup>4</sup> Remarks by Gordon van Welie, President and CEO, ISO New England at the ISO New England Regional Energy Forum, October 17, 2005.

<sup>5</sup> US Environmental Protection Agency Green Power Partnership, <http://www.epa.gov/greenpower/partners>.

ables, suppliers in competitive energy markets are enabling the development of new renewable resources by creating innovative financing vehicles, involving contracts for project output as well as the Renewable Energy Credits (RECs) generated by the project. Constellation NewEnergy supported the development of the largest solar array in New England, the 425 MW Brightfields project, developed by the City of Brockton, MA. The City of Brockton wanted to sell the project RECs in a long-term contract to provide the revenue stream necessary to cover lifetime operations and maintenance costs for the project as well as the debt service on the municipal bonds issued to finance the project. Thus the City of Brockton sought a purchaser willing to enter into a long-term contract, sufficient to cover the term of the project debt. Constellation NewEnergy, which had a preexisting relationship with the City of Brockton as its electricity supplier, was the ideal candidate to purchase RECs. Since we offer a green power retail product to customers in Massachusetts, we found value in the RECs and the project output

where other candidates, including the local electric distribution utility, could not. We played a similar role when we supported the development of two landfill gas projects in Delaware by signing a ten-year agreement to purchase the project output, knowing we had many customers interested in increasing the amount of green power in their purchasing portfolio.

As we participate as a facilitator of renewable projects and supplier of green power to environmentally conscious retail customers, we find these two roles ultimately harmonizing. One of our customers is exploring the possibility of evolving from a purchaser to a producer of renewable energy, attributing its participation in competitive markets as inspiring this initiative. *"We have an interest in exploring some wind power development. We are speaking with Constellation NewEnergy about an offtake agreement. The competitive market has motivated us to participate. Before, in a regulated environment, it was either too inconvenient or economical due to the tariff structure."* (Jim McAndrew, Barton Mines)



## COMPETITIVE MARKETS EVOLVE, ULTIMATELY DRIVING INNOVATION

As a competitive market evolves, its focus shifts. Initially, the introduction of competition puts all the focus on price. Certainly, we have seen that emphasis in competitive electricity markets amid allegations from various critics that competitive energy markets have not delivered lower prices to consumers. A number of studies have concluded that restructuring to a competitive market does not, in fact, result in electricity price increases, and can actually produce savings for customers.

An April 2006 study by the Analysis Group<sup>6</sup> concluded that the trend of increasing prices for electricity is not unique to states that have allowed for retail competition. *"Our analysis indicates instead that strong relationships exist between changes in consumer electricity prices and changes in fossil fuel prices, even in states that have not undergone significant change in regulation and industry structure at the retail level,"* according to the study. *"Given these strong relationships, it is reasonable*

*to conclude that in recent years, increases in fossil fuel prices used to produce power are being passed along to consumers in the form of higher electricity prices in both restructured and non-restructured states."* A September 2006 white paper issued by the New England Energy Alliance<sup>7</sup> concluded that electricity restructuring has saved the region's consumers between \$6.5 and \$7.6 billion under a combination of state restructuring efforts and establishment of a regional competitive wholesale electricity market compared to pre-restructuring price trends. A November 2006 study conducted by LECG, LLC<sup>8</sup> concluded that the implementation of competitive, coordinated electricity markets, with their reliance on market mechanisms, have produced efficiencies in generation and delivery that served to reduce the increase in average consumer rates that ultimately occurred as a result of dramatic increases in input (fuel) costs. LECG estimated reductions in average rates resulting from im-

<sup>6</sup> The Analysis Group, "Electricity and Underlying Fuel Prices. A Survey of Non-Restructured States," April 2006.

<sup>7</sup> Polestar Communications & Strategic Analysis, "A Review of Electricity Industry Restructuring in New England," prepared for Members of The New England Energy Alliance, September 2006.

<sup>8</sup> LECG, LLC, "Analysis of the Impact of Coordinated Electricity Markets on Consumer Electricity Charges, November 20, 2006.

plementation of coordinated markets in the Mid-Atlantic region over the 1998–2004 period range from \$0.50 to \$1.80/MWh, which at the low end of the range translates to \$1.2 million per day and \$430 million per year of total savings, and at the high end of the range translates to \$1.3 billion per year.

As competing suppliers become less differentiated on the basis of price, the focus in a competitive market shifts to improved service and service quality. Customers in competitive electricity markets, with their greater insight on price drivers and market volatility, are rather sanguine on the issue of prices and have shifted their focus accordingly. *“Electricity price increases were inevitable whether we were in a regulated or unregulated environment. So whether we like it or not, it is time for us to do something. One thing I have noticed is that competitive suppliers have forced the incumbent utilities to shape up and worry more about their customers. Certainly, having competitive suppliers has helped consumers in a high price environment. We are much better off in a high price environment with a competitive market.”* (Tom Coakley, St. Lawrence University, Canton, New York)

However, the definitive stage in the evolution of a competitive market and its ultimate benefit is innovation. It is our belief that innovation comes from opportunities driven by access to customers. In a famous 1996 speech entitled “Competition and Innovation: Bedrock of the American Economy,” then-U.S. Department of Justice Assistant Attorney General Ann Bingaman said, *“Innovation, whether in the form of improved product quality and variety or production efficiency that allows lower prices, is a powerful engine for enhancing consumer welfare. By prohibiting private restraints that impede entry or mute rivalry, antitrust seeks to create an economic environment in which the entrepreneurial initiative that is the hallmark of the U.S. economy can flourish; it creates and maintains opportunities for bringing innovations to market.”* Her speech continues,

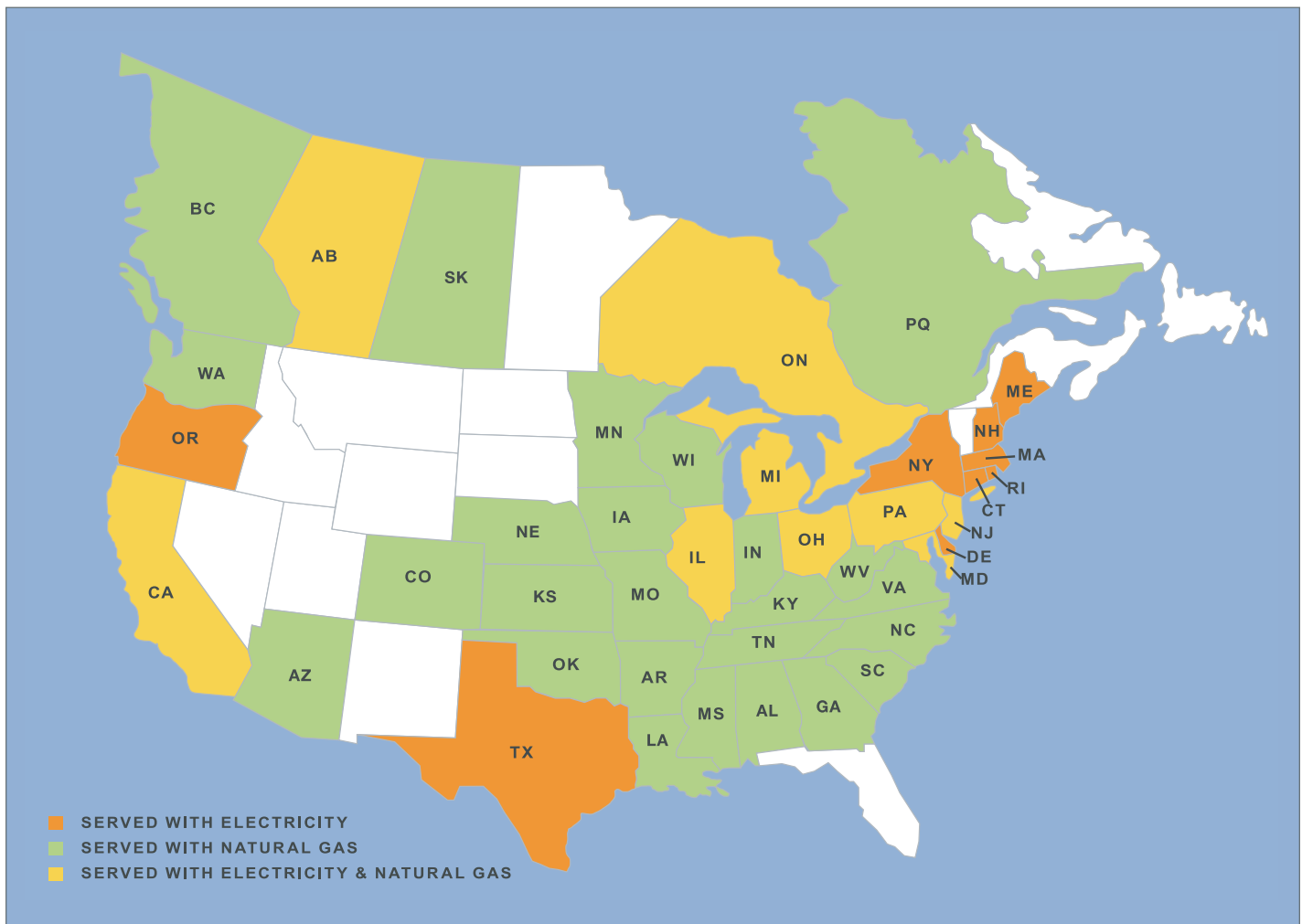
highlighting the telecommunications industry as an example. *“We need not look solely to theory for evidence that competition promotes innovation. The government’s monopolization case against AT&T presents a clear ‘before and after’ snapshot showing the beneficial effects of competition policy on innovation. Consumer choice was hardly the hallmark of the integrated AT&T system. For the most part, improvements appeared at a pace dictated by AT&T and its lengthy depreciation schedules, not by the needs of business or residential customers. In terms of innovation, the results have been spectacular. Fiber optic cable was promoted by Coming to Sprint and MCI. The advances in fiber optics triggered responsive, unexpected improvement in coaxial cable, through digital compression and other techniques. At the same time, satellite and other wireless technologies have advanced to offer still more options. One thing is clear — intelligent competition policy served as a catalyst to technological innovation in telecommunications that is extraordinary by any measure. And the best technology is most likely to succeed in a competitive environment.”*

Competitive energy markets drive suppliers to gain a better understanding of customers. Utility culture, like the old AT&T of Bingaman’s speech, is traditionally and necessarily focused on infrastructure. Tim Merrill of the NRG Energy Center Pittsburgh puts it this way: *“Cost-of-service based regulation forces people into a cost-plus mindset. Competition totally eliminates that way of thinking and drives people towards a ‘price minus’ view. Competition introduces new ways of doing things, new perspectives. A cost-based focus would never bring this sort of thinking.”* In a competitive energy market, suppliers strive to innovate, to be the first to introduce new products at a price and level of quality consumers want. It’s a rather exciting prospect — Constellation NewEnergy hopes to stay on the forefront of it for years to come.



## ABOUT CONSTELLATION NEWENERGY

We're the No. 1 competitive energy supplier in North America and a wholly-owned subsidiary of Constellation Energy (NYSE: CEG), a Fortune 200 integrated energy company. We've been helping businesses better manage their electricity costs for more than 10 years. From Main Street to two-thirds of the Fortune 100, our customers depend on our expertise to make smart energy decisions.



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