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Electric Competition: What's in the Contract?

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Competition in electric service has come to Pennsylvania in earnest. Customers can choose between the "default" electric utility in their area and its competitors for the portion of their bill that deals with the generation of electricity. Customers can seek the lowest price or find special services.

But what new legal issues are created for a business when it chooses to use a competitive supplier? What can businesses do to protect themselves from a "good deal" on paper going south in practice?

Some electricity supply contracts, which may be called power purchase agreements, can be confusing, particularly if you are choosing a competitive supplier for the first time. Suppliers will commonly present business customers with a fairly complex draft contract, and their willingness to negotiate contractual terms varies depending on the supplier and the size of the purchase. Not surprisingly, larger purchasers usually have greater ability to negotiate modifications. But this leads to the central question of this article: what and when does it make business sense to negotiate?

Negotiation or Not?

In our experience, large electricity purchasers always negotiate their supply contracts, and generally they should. But for small and mid-sized businesses, there is definitely a "cost/benefit" that needs to be considered. A central point of competition in electric service was to cut costs, but simply redirecting the savings to counsel seems counterproductive. Many general corporate lawyers, after reviewing the typical supply contract, will instinctively recommend a slew of changes, ranging from tightening the force majeure clause to changing the description of the product being purchased. With a complex contract governing a topic that counsel likely has only a limited knowledge of, those negotiations can often become protracted and expensive. Many suppliers may simply walk away from a deal rather than change the "approved" form contract, even when the modification is not likely to be material; they do not want to incur the costs of legal and other review involved in tailoring the contract to each business customer's specifications.

What should you do to get most of what you want while keeping the cost benefits of competition? First, remember that the electric market in this area is fairly competitive, and alternative suppliers to the one you are negotiating with or purchasing from will likely be available. As a failsafe, the law provides customers with an always-available option of purchasing electricity from the utility that provides "default service" in a given service territory. If the supplier takes advantage of some clause in the contract in an unreasonable way that amounts to a contract breach, the customer always has "default service" to fall back on as a backup. While that service should not be a customer's first choice, it provides assurance that a customer will not be held hostage if a supplier acts unreasonably. For that reason, we do not recommend extensive negotiation of contracts in order to craft neutral or "compromise" language throughout the contract. It isn't cost-productive and it generally isn't necessary.

That being said, there are certainly some key terms that need to be reviewed and gotten right. Here are some of the legal and contractual issues that are the most likely to the impact a business's interests as it shops for electricity.

Price: Understand The Offer

It is important for a business to understand the offer and what that offer includes. This can be done by conducting its own due diligence or by working with an energy consultant who has expertise in electricity. Electricity consultants or brokering companies can compare supply contracts, rates and suppliers. To avoid surprises on the bill, it is important for a business to make an "apples to apples" comparison of the utility's "price to compare" and the price being offered by the competitive supplier.

Generally, a supplier's proposal will compare its price with the utility's "price to compare," which is also known as the "default" price. The "default" price does not represent your total electric bill because it does not include charges made to distribute electricity to you, only the price of generating it. This "price to compare" can vary over time for a given business customer, sometimes even over the course of day. The default price includes the energy rate and transmission rate that are posted on your utility's website. It also includes a gross receipts tax. The price a supplier quotes may not include the same charges, and if it doesn't and you aren't aware of that, the supplier's rate will seem much cheaper — but will not be. Ask the supplier to compare its offered price to the default service "price-to-compare." This will be more difficult for larger business customers (whose "price to compare" may vary on an hourly basis) but average comparisons are still possible.

There are two key drivers in pricing electricity — the market price and the length of the contract. Wholesale electricity prices can be volatile. It is thus crucial for a business to attempt to enter into a contract at the right time. A couple of days or weeks can mean the difference in several dollars per megawatt hour, which can result in thousands or hundreds of thousands of dollars, depending on your load size.

Keeping in mind that prices can go up or down, thought must be given to the term of the contact. Most suppliers do not generate the electricity they sell. A longer term enables a supplier to purchase supplies further in advance, which usually results in lower energy costs for the supplier and the business. In Pennsylvania, many suppliers will offer contracts with a one- to three-year term with price terms fixed over that period, but in Texas five-year terms are available. If your business values price stability and predictably over the lowest possible charge, ask the prospective supplier what the fixed price would be on a long-term contract.

Part of understanding the offer is knowing what can change the supplier's price. In most supplier contracts, even a seemingly fixed price product will nonetheless be subject to certain price changes as a result of certain underlying and identified cost factors. Permitted price increases should be uniform (i.e., affect the entire industry) and justified by increases in the supplier's costs. Negotiating for "reciprocity," in which prices can go down as well as up, is also something to consider (i.e., cost increases may be passed on but cost decreases must be).

The bottom line is that the business must understand what's in the price that has been offered, and what's not; when the price may be adjusted, and when it can't. But, generally speaking, suppliers should be locked into their price for the contract term and not be able to change the price whenever the supplier feels it needs a rate increase.

Security For Payment

A business should conduct due diligence on the supplier's performance and track record. Similarly, suppliers may or may not investigate the credit worthiness of a potential business customer before entering into a supply contract. To minimize their risk, suppliers often have a general term in their contracts that enables them to request additional security — after the contract is signed — if the business's creditworthiness becomes unsatisfactory.

The business, to protect its interests, should generally limit changes in security to changes in specific credit standards (rather than the supplier's discretion), or should limit them in amount (such as two months of usage), or both. Moreover, it is worth considering, especially when dealing with smaller suppliers, requesting the ability to demand reciprocal credit security if the supplier's financial circumstances change for the worse.

Impact On Future Operations

Businesses must determine if the electricity supply contract will unduly facilitate their future operations or plans. Suppliers need to plan for their customers' electricity needs, and sudden changes in those needs can be problematic. Most supply contracts require a business to notify the supplier of anticipated changes in usage and may impose special pricing rules if the customer exceeds the anticipated demand; this reflects the fact that the supplier may have to buy more expensive electricity to satisfy the increased demand. These provisions are necessary to keep prices reasonable, as suppliers frequently contract with a generator to buy certain quantities of power at a fixed price.

To minimize their risk, suppliers may establish minimum and/or maximum levels of electricity usage. These limitations may prohibit the business customer from generating electricity using wind or solar facilities or from participating in energy efficiency and conservation programs. For most businesses, such limitations will not be a cause for concern. But, for other businesses, shopping for electric power may be only one part of a coordinated internal effort to reduce energy costs, and the business will want to keep all parts of the cost reduction program in play.

Businesses with multiple entities and/or multiple locations should also pay attention to the assignment provisions in the contract. likely at a higher price. Ideally, the contract should contain a provision to ensure that the extra costs of this replacement power are borne entirely by the supplier. In general, however, a business will be unaware of a "one-off failure" to deliver by the seller. Such failures are handled, invisibly to the customer, at the wholesale market level by the supplier and the PJM Interconnection (the power pool that coordinates the movement of wholesale electricity in most of Pennsylvania). But, if the supplier stops scheduling power deliveries to the customer via PJM, it's reasonable for the customer to declare a contract default, allowing a switch to another more reliable supplier without fear that the customer has breached the contract. Alternatively, the customer can revert to default service for a period until another supplier is found. In most cases, the rate charged for default service will be higher than the price under the supply contract, so this should only be a short-term solution.

It is also important for the business customer to understand the consequences of its failure to perform under the contract. Many contracts are for a fixed price and for a fixed term. Obviously, if the business cancels that contract and moves to a new supplier, the business may be subject to contract termination liability or liability for breach of contract. However, if the contract is month-to-month or cancelable at will, then the business has every right to switch suppliers if a better deal comes along.

But, a contract with those terms would likely be at a less attractive rate precisely because it contains those provisions. Usually, the larger the contemplated electricity usage, the less likely it will be that a business will be able to switch suppliers without penalty.

Additionally, it is common for supply contracts to contain indemnification provisions and provisions that limit the supplier's liability. Business customers should review them to make sure they understand the potential impact of these provisions on their potential remedies from the supplier — and to have comparable provisions protecting their interests.

Conclusion

Customers have the opportunity to negotiate electric generation packages that best meet their needs and may save them money. But, care must be taken to avoid the risk of paying too much and being snared into a one-sided contractual arrangement. •

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