

Title: Why RFPs Don't Work

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Abstract

When Astronaut John Glenn returned to earth after his first trip to space, he admitted having worried about riding in a machine, which was most likely, the result of a series of successful low-cost bids.

RFPs and competitive bidding has its place in modern day procurement in both the public and the private sectors, especially when the product or service is a commodity with definitive and quantitative characteristics. In such cases, “least cost” decision making makes sense. But when a purchaser is looking for the greatest value, relying on an RFP may, in fact, be counterproductive and add costs to both the delivered product and to society as a whole.

By definition, policy makers who want to increase the supply of renewable energy are doing so because of the **additional value** provided for society, communities, the environment and health when compared to non-renewable resources. This value is over and above the obvious value from a comparison of finite versus infinite and the intergenerational economics that result.

This paper will focus on the acquisition of wind energy resources in Ontario where both RFPs and a standard offer approach have been used. It will also compare and contrast the results in Ontario with those in other jurisdictions.

An assessment of results will not be limited to the amount of power produced, but will also examine in a qualitative way, the economic, social, industrial and community impacts of the different approaches.

The author will also examine the similarities and differences between the acquisition of demand side resources (conservation) and supply side resources with a view toward providing additional insight into the relative merits and disadvantages of RFPs.

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Paper

Using RFPs to Kill a Market

In the early 1980's, some state regulators in United States made utilities use Integrated System Planning (a.k.a. least cost planning or integrated resource planning). This had followed hard on the heels of a federal requirement that forced vertically integrated utilities to purchase electricity from Qualifying Facilities (QFs). In Ontario, we used a negative categorization and called them Non Utility Generators (NUGs). In the US, the proponents of QFs were subsidiaries of vertically integrated utilities attempting to penetrate the franchise territory of other regulated monopolies.

The regulated monopolies used RFPs to keep the economics skewed to their favour by making the bidding process, onerous, costly and intrusive. Many QFs that made it through that process were "approved" but were never built due to siting, financing and other problems. And so the regulated monopolies had to keep building new supply adding to their rate base and earning the relatively high rates of return from the high interest days of the 1980s. At the time, utilities did not have to go into the regulatory arena unless they were looking for a rate increase - with relatively high rates of return and declining interest rates, they were shrewd enough not take a change on getting a lower rate of return.

In the late 1980s, some state regulators then started to require 'all source' bidding, i.e., treating demand and supply the **same** (not necessarily equally). They again turned to their trusted defense mechanism, the RFP. It again had the appearance of fairness and good economics (least cost solutions) but did not deliver. In each state where it was tried, it became a disaster. It was at that time that Ontario Hydro was beginning its DSM Programs and there was a lot of pressure to follow the lead of the US and do demand side bidding. As manager of commercial/institutional programs, I resisted this approach with an argument that said we should at least wait to see how the programs in New York, New Jersey and California made out.

The All-source bidding was a disaster and so some regulators ordered the utilities to demand side bidding - to go out and get the cheapest "negawatts". These processes fared no better. All source and demand side bidding may be the only demand side program options that California has stopped using in its 30 plus-year history.

In 1991, I attended a "Demand Side Bidding Conference in Albany, New York attended by regulators, utilities and proponents - I had never attended a professional conference which had so many shouting matches. It was clear that regulators had forced the utilities to do something they did not want to do and the utilities had managed to make the process so awkward and difficult that proponents lost significantly financially. Of course neither regulators nor utilities lost a cent - all of their costs were recovered in rate base.

Not expecting fireworks, I had accepted an invitation to be the keynote speaker at the conference lunch. Preparing to use this opportunity to justify, as much as to my colleagues at Ontario Hydro as anyone, my reasons for pursuing a programmatic approach to working with energy service companies, I did not expect to leave the conference so convinced that we were on the right track.

Electricity in Ontario

In October 2003, the Ontario Electricity Sector was in shambles:

- After almost 7 years of study, an ideologically based market design that promised competition, lower prices, privatization and secure supply failed in less than 7 months.
- Generation capacity fell by 6% while demand had grown by 8.5%
- Over 1800 MW was taken out of service – equivalent to Niagara Falls going dry.
- Investment in transmission and distribution systems was almost non-existent as first, Ontario Hydro was disassembled and second, as local distribution companies had to invest significant capital in information systems to get ready for market opening – investments that they were unable to recoup given that their rates were frozen.
- The uneconomic 4.3 cents price cap resulted in an increase in Ontario Hydro's stranded debt and took away all incentive for consumers to conserve.
- Having to sell power below its production cost left Ontario Power Generation in virtual bankruptcy.
- Cost overruns at Pickering A - Unit 4 resulted in a \$1 billion expenditure
- Consumers were confused with "unbundled bills" and energy marketers with a plethora of offers at their door.
- No conservation programs existed; only a few pioneers had ventured into new renewable energy in spite of world wide developments in wind, solar, geothermal and bio-energy

The August 2003 blackout served as a wakeup call on just how fragile the system was. Although the initial cause was a problem in Ohio, bringing back Ontario's system to full power was problematic despite heroic efforts by workers as well as by consumers of all sizes who voluntarily reduced their loads to enable the system to be re-stabilized.

In October 2003, Ontario voters elected a government whose electricity platform included the following elements.

- Will not sell off the electricity transmission grid.
- Will not sell any publicly owned generating stations.
- Keep electricity power rates frozen at 4.3 cents/kWh until 2006.
- Phase out coal-burning generating plants by 2007, and replace with cleaner energy sources.
- Require all electricity suppliers to get five per cent of their power from renewable sources by 2007 and 10 per cent by 2010.

- "Reward" those who reduce their energy consumption, and charge more to those who consume more than an average household
- Promote "smart meters," which track what time of day the energy is used, and charge accordingly.
- Create program to help consumers cut consumption by five per cent by 2007
- Expand generating capacity, such as the station at Niagara Falls.
- Build transmission link with Manitoba, representing 1,000 MW in a plan to add to the province's generating capacity of 30,702 MW.
- Create incentives for production of renewable energy sources.
- Reduce red tape for clean-energy projects.
- Work with businesses, commercial and institutional customers to reduce electricity consumption.
- Make all publicly owned power entities subject to freedom of information and salary disclosure laws.
- Create "truly independent watchdog" to regulate prices, utilities, and suppliers

In January 2004, an Electricity Conservation and Supply Task Force confirmed that the market design implemented by the previous government had failed and that major reforms were required. These reforms were aimed at protecting the interests of Ontarians and achieving the following objectives:

- **Creating a "conservation culture" in Ontario** : Making conservation, demand management and demand response strategies a cornerstone of Ontario's long-term energy future;
- **Reliability, diversity and affordability**: A reliable, sustainable and diverse supply of competitively priced power;
- **Effective consumer protection** : Consumers, especially residential and small business consumers, will be protected from excessive price volatility;
- **A stronger investment climate** : The government will encourage new investment in conservation, generation and transmission;
- **Cleaner Air**: The government will contribute to the clean up of our air by eliminating coal fired generation and replacing it with other, cleaner sources of energy.

Fast Forward – Ontario 2008

Since 2003, the electricity outlook is much improved. As of December 2007, the OPA had 10,867 megawatts (MW) of electricity supply capacity under contract, 1,025 megawatts (MW) of which was contracted through the Renewable Energy Standard Offer Program (RESOP). Excluding RESOP, the OPA is managing 38 contracts or 9,842 MW, based on average contract capacity. Of the 9,842 MW under contract, 1,713 MWs are in service, 5,973 MWs are under construction and 2,156 MWs are in various stages of planning and permitting. These 38 contracts represent an \$11.9 billion investment in the Ontario electricity system, beginning in 2005 and continuing through 2013.

With respect to conservation, the following were the highlights of 2007:

- Launched 14 conservation programs for all types of electricity customers: residential, commercial, institutional, industrial and agricultural.
- Worked with 77 local distribution companies for the delivery of three province-wide programs -- Summer Savings, The Great Refrigerator Roundup and **peaksaver®** --which reached 99 percent of Ontarians.
- Raised awareness and engaged consumer participation through our conservation programs. Market research results showed that more than 80 percent of Ontarians said they were aware of the OPA's conservation programs, and more than 50 percent said they had participated in at least one program.
- The Conservation Fund provided \$3.14 million in funding for 15 projects, valued at \$8.2 million, targeting the forestry products, residential, healthcare and education sectors.
- The Technology Development Fund provided just over \$650,000 to 10 projects, with more than \$11 million in leveraged external contributions.

But could we have seen faster progress, more local capacity developed and more open process to secure both demand and supply resources?

“When all you have is a hammer, everything looks like a nail”

Ontario Regulation 426/04 under the *Electricity Act*, which set up the Ontario Power Authority requires:

1. that the procurement process and selection criteria are fairly stated and where possible are open to a broad range of bidders;
2. the procurement process being a competitive one to the greatest extent possible;
3. there being no conflicts of interest or no unfair advantage; and
4. the procurement process not having an adverse impact on project development independent of the OPA

The OPA's Integrated Power System Plan identifies three types of procurement: Competitive, Standard Offer and Non Competitive with Competitive being the preferred option. The Ontario Power Authority has interpreted this regulation in such a way as to equate competition to RFPs. Surely competition can be achieved in ways other than an RFP. And the use of the seemingly pejorative term “Non Competitive” (like the term Non Utility Generators) might have been better characterized as “Strategic Competition.

Although government direction has required the OPA to use the standard offer for small renewable projects, it has clearly demonstrated its commitment to use RFPs for everything else.

A UK consultant working with major community housing corporation on its redevelopment advised the corporation not to put its proposed Combined Heat and Power (CHP) plant for the district energy loop into the OPA's first RFP for CHP for the following reasons:

- The OPA process is too one sided and costly for projects of this size (under 10 MW)
- The OPA contract is "draconian"

- It appears that the OPA is not interested in supporting CHP or recognising the energy efficiency benefits of CHP.
- The risks and requirements associated with the OPA process are too great not participate.

Why don't RFPs work on the Demand side?

Any electric system should try to achieve all the demand side initiatives that are cost effective compared to the marginal cost of new supply rather than the cheapest savings.

Every kilowatt saved on that basis is cheaper than a new kilowatt of new generation. And in the case of Ontario's current situation where every new (marginal) kilowatt is more expensive than our average cost of existing generation, demand side savings reduce the upward pressure on rates and can actually reduce bills of those who conserve.

True, demand side programs have to be developed and delivered cost effectively, but going after the cheapest kilowatt savings does not get you all of the cost effective savings. It leads to **cream skimming**, where the low cost things are done first on a piecemeal basis and deeper, more permanent savings with a longer payback are left undone.

In addition to economic imbalance between demand and supply, there is another reason why RFPs can't treat demand and supply either the same or equally. There is a market imbalance that goes much deeper. If the government wants to buy new vehicles for its fleet, there is a well-developed supply chain for automobiles and both buyers and seller know what a car is and what it does. The products have specifications that can be compared. The decision process is straightforward and can be mostly analytical. Both the institutional buyer and the seller are interested in doing the best job possible. For the buyer it is least cost - for the seller it is "best margins". This is where RFPs and price competition work well: the product specs are clear and the products comparable or replicable.

This is totally unlike personal car shopping where colour, options, image, styling and yes even passion play an important role in both the sellers' marketing approaches and the buyers' purchasing decision.

Conservation is more like the latter; it is all about getting the best value, the best fit, i.e., the most economic savings not at **any cost**, but definitely not at the lowest cost because you will get what you pay for - if it costs nothing, it is worth nothing. Not all kilowatt savings are the same. Taking out every other fluorescent tube in an office lighting system will save energy at a very low cost, but if lighting is dim, the lamps go back in, or if the maintenance staff changes and the new person just thinks the lamps are burned out, they go back in.

In the early days of demand side management, switching from T-12/40 watt lamps to energy saving 34-watt lamps seemed like a good idea, saving 15%. They cost slightly more but only because the supply-chain treated them as a premium product. They would go into the same fixture with no adjustment required. Time and again, what happened was in the next order of lamps, the so-called cheaper 40-watt models were ordered and the 15% savings were lost. Contrast that with a fully redesigned lighting system with T5 - 25 watts, electronic ballasts, dimming capability and appropriate controls systems save 75% of the energy. Yes it costs more than the other scenarios, but these savings do last and actually provide better lighting, with modern glare protection recognizing that we are no longer clerical staff pouring over books and paper but professionals using computers.

How Conservation is like Renewable Energy

So if it is a fact that conservation is a demand side resource, and therefore shouldn't be procured through RFPs, why shouldn't RFPs be used for renewable energy – a supply side resource.

There are numerous reasons:

1. They are both infant industries in Ontario facing fragmented and uncertain markets.
2. There is a vast information gap about opportunities, technologies and economics.
3. The policies, regulations, by-laws, standard practices, technology comfort have evolved slowly and mostly organically over the past century and were all fashioned on the expectation of large central generation, major transmission and dispersed distribution.
4. Traditional sources of electricity are designed, operated and maintained by highly paid professionals. Resources like conservation and small-scale renewable energy are secondary job functions at best and often delivered by amateurs or volunteers.
5. **Think Global – Act Local:** personal and community engagement, finding site specific opportunities, understanding the immutable differences in as diverse a province as Ontario requires different approaches and adaptation to local needs: city versus rural, north versus south, big versus little.