

**PROVIDER OF LAST RESORT:  
LESSONS FROM THE INSURANCE INDUSTRY**

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## **INTRODUCTION**

The states which have moved to a competitive electric industry to date have universally addressed the issue of how to structure a provider of last resort. A provider of last resort is that supplier of electricity which is responsible for providing generation service in those instances where a customer is otherwise without service (including for nonpayment).

Decisions to date have assigned the responsibility for serving as provider of last resort to a single company, generally the incumbent utility. If a customer, for example, has his or her generation service terminated for nonpayment, that customer is assigned to the provider of last resort. If a customer shops for electric generation service and finds no-one willing to make such service available, he or she is assigned to the provider of last resort.

The provider of last resort model that has been adopted in the electric industry bears a striking resemblance to the "assigned risk plan" model in certain segments of the insurance industry (e.g., worker compensation, automobile insurance). The assigned risk plan was a first generation provider of last resort initiative to promote universal service in the insurance industry. Because of multiple shortcomings, however, the insurance industry moved to a second generation model, the joint underwriting association. Indeed, many jurisdictions have further refined the insurance provider of last resort concept and moved to a third generation approach, the reinsurance facility.

The provider of last resort structures adopted to date in electric restructuring decisions -- legislative or regulatory-- have the same shortcomings as the original assigned risk plans and joint underwriting associations did for insurance customers. Rather than continuing down that path, future electric restructuring decisions should adopt an electric industry equivalent to the

reinsurance facility as its provider of last resort structure. The reinsurance facility model is easily adaptable to the electric industry and advances the underlying public policies of (1) moving to a competitive electric generation paradigm, and (2) promoting universal service.

Before turning to that recommendation, however, this article will explain the different insurance provider of last resort models. Part 1 presents the three basic insurance structures. Part 2 explains the parallels between existing electric restructuring decisions and the early public pool models for insurance provider of last resort. Part 3 proposes a reinsurance provider of last resort structure for the electric industry and explains its benefits.

### **Part 1: The Three Insurance Models**

State and federal policy makers have long recognized the existence of residual markets in the insurance industries. These residual markets are populated by consumers that do not have access to "voluntary" insurance. As a result, both legislative and administrative efforts have mandated the offer of insurance through public market initiatives. These public markets exist at all levels of insurance, ranging from personal lines of insurance to workers compensation insurance to a wide array of commercial lines of insurance. As a general proposition, the residual markets for insurance are comprised of consumers that cannot obtain insurance in the private market.

Three models exist through which the insurance industry serves these customers.

**Assigned risk plans:** The first generation of insurance provider of last resort mechanisms involves the "assigned risk plan." Through these plans, state regulatory officials promulgate a standard set of rates and terms for customers served by the assigned risk pool. Insurance carriers

operating within a state are then assigned unwanted policyholders on a random basis to be served with that standard package. The number of customers for which any given company is responsible is dictated by that company's market share in the state.

Upon being assigned a public pool customer, the insurance company takes full responsibility for that customer. The company absorbs any loss from the customer and pockets any profit. In addition, the company performs all of the ordinary business functions involved with issuing an insurance policy. It accepts the customer's premium payments, pays the customer's claims, responds to customer inquiries, and the like.

**Joint underwriting association:** The second generation of insurance provider of last resort mechanism involves the joint underwriting association (JUA). Through a JUA, a limited number of "servicing carriers" agree to handle all of the "involuntary" business. Involuntary business includes all customers who the competitive (or "voluntary") market does not wish to serve. Through the JUA, the servicing carriers operate as "the" insurance company. They are compensated for the administrative tasks involved with this function.

While insurance policies are issued to JUA customers in the name of the servicing carriers, the risk of loss from these customers is borne by the association as a whole. Participation in the association is mandatory for all insurance carriers operating in a state. JUA participation is considered part of the cost of doing business in a state.

**Reinsurance facilities:** The third generation of insurance provider of last resort mechanisms involves the reinsurance facility. Through a reinsurance facility, the insurance carrier disconnects the *risk* of serving a customer from the *actual* customer. This is accomplished by having the carrier serve a public market customer in the same fashion as any other customer. The

carrier has the option, however, before agreeing to provide service, of ceding the *risk* of the customer's account to the reinsurance facility or retaining the customer's risk in its own portfolio. If a ceded customer's account incurs a claim, the costs involved with paying that claim are borne by the facility. Total costs to the facility are apportioned to all insurance carriers in the state. The customer's premiums are collected by the carrier but paid to the reinsurance facility.

From the customer's perspective, there is no difference between being assigned to the reinsurance facility or being retained in the voluntary market. The carrier provides the same service to the customer and offers the same prices. The transaction between the carrier and the reinsurance facility is completely transparent to the customer. Under the reinsurance model, the public market facility operates on a no-profit/no-loss basis. All losses are shared amongst insurance carriers in a fashion described in more detail below.

### **The Problems with the Assigned Risk Pool and Joint Underwriting Association Insurance Models**

The assigned risk pool and joint underwriting association models (collectively referred to below as public pools or involuntary pools) exhibited certain failings that prompted public policymakers to further refine the provider of last resort mechanisms for the insurance industry. The public pools had unanticipated consequences from both an industry perspective and a consumer perspective.

First, the public pool models created no incentive for insurance carriers to keep customers *out* of the involuntary (public) market pools. Originally conceived of as a tool to use in serving the worst insurance risks, the public pools quickly transmogrified into a way for insurance carriers

to avoid serving all but the best risks. Insurance carriers served those best risks and sent everyone else to the public pools.

As a result, the involuntary market pools soon became overpopulated. Instead of serving the residual market, the public pools became the primary provider of insurance in a state. One analysis of the workers compensation residual market, for example, reported:

Originally conceived as a last-ditch option for high-risk or accident-plagued businesses, the residual market has now become the nation's largest single provider of workers' compensation coverage. It accounts for almost 22 percent of premiums written in the 33 states where the [National Commission on Compensation Insurance] administers the pools.<sup>11</sup>

This overpopulation, however, is not unique to workers compensation. Under New Jersey's state Joint Underwriting Association (JUA) for automobile insurance, for example, "by 1988, there was no legal compulsion and little business incentive for insurers to write voluntary-market coverage."<sup>12</sup> More than half of New Jersey's drivers were insured by the JUA.

Second, from a consumer perspective, the pool mechanisms offered the worst of all worlds. With overpopulation came fiscal instability. Given the unanticipated (and unintended) numbers of public market participants, the public pools were required to pass on increasing costs to the voluntary market. In response, surcharges were often installed for public market participants to offset the overall costs of the public pool. Pool prices, therefore, were generally

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<sup>11</sup> David Weber, "The comp crisis: A special report," 51 *Insurance Review* 10:28 (Oct. 1, 1990).

<sup>12</sup> Samuel Fortunato and Joseph Yannotti, "Automobile Insurance Reform in New Jersey, In All Fairness," 23 *Fall Brief* 25 (1993).

higher than prices found in the voluntary markets. According to a 1974 Federal Insurance Administration study, rates in auto insurance public pools averaged 45% higher than rates for similar drivers in the voluntary market.<sup>131</sup>

In addition, while the assigned risk pool and joint underwriting association make automobile insurance available to the residual risks in the automobile insurance market, there is no pretense that *equivalent* insurance is available, let alone equivalent insurance on equivalent terms. One industry analyst observes that "in the case of residual market automobile insurance, almost all state plans limit coverage in both dollar amount and type of coverage, although less so now than in the past. Typically, the coverage was limited to the minimum requirements of compulsory insurance and financial responsibility."<sup>141</sup>

Similarly, in the public pools for residential property insurance, it was widely believed that FAIR plans<sup>151</sup> would make insurance available to all "insurable risks." Denied coverage in the voluntary market for whatever reasons, however, rejected applicants found themselves paying substantially higher premiums for less coverage. Some of the plans' rates were over three times those of the voluntary market. Upper limits on lines of coverage exist in order to spare the FAIR program single large losses. FAIR plan insureds often receive slower claims service and are usually denied a premium payment plan.<sup>161</sup> The consequence of the FAIR structure, therefore, was

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<sup>131</sup> U.S. Dep't of Housing and Urban Development, Federal Insurance Administration, *Full Insurance Availability* 1-3 (1974), U.S. General Printing Office: Washington D.C.

<sup>141</sup> Regina Austin, "The Insurance Classification Controversy," 131 *U.Pa. L.Rev.* 517, 523, n.27 (1983).

<sup>151</sup> FAIR plans involved Fair Access to Insurance Requirements, a public market mechanism made available pursuant to federal law.

<sup>161</sup> *Rights and Remedies of Insurance Policyholders--Discrimination by Property and Casualty Insurance*

not to protect the residual market, but to segregate it out for less service at higher prices.

## **Part 2: The Electric Industry's Provider of Last Resort Equivalent**

As nearly everyone recognizes, a state needs to establish a provider of last resort both for: (1) customers who have been presented with no offers for supply by alternative suppliers; and (2) those who have been dropped by their alternative supplier for any reason, including non-payment. A supplier of last resort is necessary to ensure that all retail consumers have access to power. While, however, it is important to ensure that *all* customers who need a supplier of last resort have access to one, it is also important to ensure that *only* customers who need a supplier of last resort are put in the position of needing one.

The problem found with suppliers of last resort in the insurance industry is that access to them is abused by competitive service providers. Opposite of what might be the concern of many *low-income* energy advocates, one of the primary concerns amongst all types of residual insurance markets is not that consumers will be denied access to the residual market, but rather that the market will grow to include consumers who ought *not* to be there. Under the existing model, what the electric provider of last resort service is likely to turn into is, like the insurance pools, instead of having all but the worst risks served by competitive service providers, with those demonstrably bad risks served by the residual market pools, only the *best* risks will be served by the voluntary market with the residual pools serving everyone else. That's how over-population

(. . .continued)

*Companies: Hearings Before the Subcomm. on Citizens and Shareholders Rights and Remedies of the Senate Comm. on the Judiciary, 95th Cong., 2d Sess. 91, 650-51 (1978) (statement of James Katz, Research Director, Mass. Fair Share).*

occurred in the insurance industry. And the electric industry provider of last resort is marching down that same path.

Several problems arise, also, from the consumer side. While provider of last resort service is generally seen as a market-based rate, in all likelihood, it will nonetheless be a scaled back service. Customers involuntarily taking provider of last resort service are thus denied the ability to take full advantage of competitive service offerings. While no-one is explicitly proposing to offer "inferior" service to customers served by the provider of last resort, it is generally stated that electric provider of last resort service will be "plain vanilla" service. This basic service approach is virtually identical to the now discredited, and virtually abandoned, assigned risk automobile insurance model of offering coverage limited to the minimum requirements of compulsory insurance and financial responsibility.

The electric industry finally appears to be headed down the path of higher rates for its provider of last resort market participants. While the generation service supplied through the provider of last resort would remain regulated, it would presumably be cost-based regulation. Siphoning the best risks (whether in terms of load profile, payment troubles, or profit potential) into the voluntary market, however, would leave a higher cost population to be served through the provider of last resort. Even a cost-based rate, therefore, for provider of last resort service would likely be higher than rates offered to the private voluntary market.

### **Part 3: A Reinsurance Model for the Electric Industry**

A reinsurance facility model is an appropriate provider of last resort for the electric industry that not only will address the problems historically found with the approach currently

extent in electric restructuring decisions, but will generate positive advantages as well. Such a facility will serve the same function as a reinsurance facility serves in the insurance industries.

A reinsurance facility serves three primary functions:

1. It creates a provider of last resort. Consumers perceived to be bad risks can nonetheless be served in the competitive market because the risk can be ceded to the facility.
2. While it serves as a provider of last resort, a reinsurance facility also creates incentives for competitive service providers *not* to cede customers to the facility. As described below, the costs of the facility are apportioned, in part, on facility usage. Thus, if Provider A cedes 100 customers to the facility, that Provider's cost allocation is based on all 100 customers, even if 90 of those customers turn out to be "clean" risks (*i.e.*, cause the facility to incur no costs). There is an incentive for the company, therefore, to identify those clean risks and retain them without ceding them to the facility.
3. It creates an incentive for the competitive service providers to manage their risks to reduce or eliminate the customers to be ceded to the facility (and ultimately used to apportion costs to the provider). If through risk management techniques, a customer's risk of loss can be reduced or eliminated, the customers can be kept in the voluntary market. That customer, therefore, is not used as part of the cost allocation process.

As can be seen, the functions served by the reinsurance facility are to create a provider of last resort for bad risks, while identifying clean risks to keep them *out* of the provider of last

resort, and creating incentives to manage mixed risk customers outside the provider of last resort framework. One major function is to keep people out of the public residual market and in the private voluntary market.

### **The Operation of a Reinsurance Facility**

Through a reinsurance facility, the potential risks imposed by the public market population are "reinsured" through a public pool facility. A reinsurance contract is precisely what it indicates: a contract through which an electric generation provider procures a third person to insure against loss or liability by reason of the customer's contract for service.

Through the reinsurance facility, the potential risks posed by customers which industry participants do not want to serve need not be shouldered by competitive generation providers. Instead, such a generation provider may cede the risk of a potential customer to the provider of last resort, i.e., the reinsurance facility. Ceding this risk would be a paper transaction that is transparent to the customer. A generation provider may cede a risk at any time, and be compensated for any *subsequent* claim. The reinsured customer is otherwise treated the same as any other customer of the generation provider.

Several attributes of the reinsurance facility are worth noting:

**Who may be ceded to the facility:** A competitive service provider has an absolute right to cede a risk to the facility. The only criterion for cession will be that the provider does not want to serve the customer in the absence of risk cession. The risk might be one of late payment, or uncollectibles, or high collection costs, or the like. No objective criteria is established for measuring such risk. If an electric provider is then, in fact, faced with a claim from a risk that has

been ceded to the reinsurance pool, the reinsurance pool will compensate the company for that expense.

Different states have adopted different tests for what risks an insurance provider may cede to a reinsurance facility. Some states have adopted an objective measure, under which carriers may cede only "unacceptable" risks. An "unacceptable risk" is then defined as a risk that statistics prove will be unprofitable. The test proffered above is the subjective limitation. In these instances, insurance carriers have an absolute right to cede a risk to the state reinsurance facility. The only criterion is that the company does not wish to retain the risk without regard to any objective criteria. The subjective approach seems best suited for the electric industry.

**What gets paid by the facility:** If the competitive service provider experiences a covered event, it would file a claim with the provider of last resort. The claim would include a cost justification for the requested reimbursement. That reimbursement should provide no contribution to fixed costs. The purpose of the reinsurance facility is to hold harmless the competitive service provider for serving ceded risks, not to help pay for costs that would otherwise be included in rates to other customers.

A precise definition of compensable events is best left to a regulatory rulemaking proceeding. The important *policy* decision for regulators to establish is that there must be an "event," *e.g.*, a nonpayment of a bill, a termination of service, a write-off as uncollectibles, and the like. The reinsurance facility is *not* designed to compensate for the higher costs of serving certain populations based on, for example, load shapes or load characteristics. The administrative costs associated with operating the reinsurance facility, must be compensated, of course, albeit on a cost-basis.

**How do facility costs get paid:** The costs of the reinsurance facility can be apportioned through three basic mechanisms. First, cost apportionment can be based on market penetration. In this scheme, losses are apportioned based on a percent of premiums written in the state irrespective of the number of risks ceded to the facility. Second, cost apportionment can be based on facility utilization. In this scheme, losses are apportioned based on the degree to which a company uses the facility relative to total facility use. Third, cost apportionment can be based on a weighted average. Use of a weighted average might, for example, be based on 80% facility use and 20% market share.

The use of a weighted cost apportionment is justified. If cost apportionment is based exclusively on market share, there is no incentive for a competitive service provider to retain "close" risks in their own portfolio. A company can cede 90 percent of the customers it serves to the reinsurance facility without bearing any additional cost. Cost apportionment should be related to facility usage. In contrast, however, if cost apportionment is based *exclusively* on facility usage, there is no incentive for a competitive service provider to use the facility at all. By ignoring all potential reinsurance customers, the service provider neither contributes to serving all customers nor incurs any of the expense for serving potentially risky customers. Use of a weighted average creates an incentive for a company to use the facility without over-using the facility. Finally, use of a weighted average creates an incentive for service providers to work with the risks which they cede to the facility to assure that no expenses are incurred requiring compensation. If a provider has a 20% market share, in other words, it knows that it will pay 20% of the total costs of the reinsurance facility. It is economically beneficial, therefore, for that provider to seek to minimize total facility costs.

All residual market mechanisms that have been adopted in the insurance industries provide for a sharing of costs between companies. Whether cost allocations based on unweighted facility use, unweighted market share, or a weighted combination of the two is "fair" or not is not subject to objective evaluation. Each has advantages and disadvantages. On the one hand, using unweighted market share does not discourage excessive risk cession to the residual market. On the other hand, using unweighted facility use does not implement the underlying philosophy that support of the residual market is a "cost of doing business" in the state. Use of a weighted statistic seems to be the best approach.

**How are market shares determined:** To apportion costs in a reinsurance facility model, regulators would be required to track the market shares enjoyed by each competitive generation provider in a particular state. Tracking market share has not proved to be difficult for insurance regulators in implementing assigned risk pools, reinsurance facilities, or joint underwriting associations. The electric industry should not pose greater difficulties than the insurance industry in this regard. Market shares will be based on kWh from retail sales to ultimate customers.

An electric provider of last resort mechanism, based on the reinsurance facility model, may wish to consider implementing a cap on the cost apportionment based on total revenues (or on net worth). The insurance industry experience indicates that new market entrants often offer lower prices, thus attracting a disproportionate share of higher risk customers. If cost apportionment is based exclusively on facility usage, which is not recommended above, the reinsurance mechanism would represent a barrier to entry. While cost apportionment based on unweighted market share would be competitively neutral, it has the different, and more serious shortcomings discussed above. Reinsurance facilities using a weighted approach, but which also cap cost apportionment at

some level of net worth (or income), are designed to prevent the facility from discouraging the entry of new market participants.

**Is universal service explicitly addressed:** Certain residual market mechanisms are substantially less effective in meeting the goal of universal service than other mechanisms. The assigned risk plans and joint underwriting associations, in particular, have been found to result in lesser service being provided at significantly increased rates. While, on paper, insurance is "available" to consumers through these pools, high prices resulting in unaffordability tend to make that availability illusory at best. There is every reason to believe that the same result would obtain in the electric industry. In addition, excessive cession of "clean risks" to assigned risk and joint underwriting pools impedes rather than promotes universal service. The reinsurance approach, through which customers are treated the same as would any other company customer, with the increased costs being passed through the facility, appear to be the more effective means of accomplishing universal service objectives.

**How are facility costs controlled:** Without specific incentives created for competitive generation providers, there is no incentive for such providers to control provider of last resort costs by moving consumers out of the residual market into the voluntary market. The reinsurance facility approach creates such incentives in three ways. First, a competitive service provider is left with the flexibility to determine whether the risk of a customer is sufficiently high that it should be ceded to the reinsurance facility. The provider can draw its own balance on the decision of whether it is better to shoulder the potential costs by keeping the risk of the customer in its own portfolio or the certain costs of increased facility cost apportionment by ceding the risk to the reinsurance facility (and thus increasing its facility usage). Second, a competitive generation

supplier is provided with an incentive to manage the usage/bills of a customer (whether through innovative payment plans, energy efficiency, or some other tool) to allow the supplier to retain the risk in the voluntary market. The supplier must look not only at what the risk of the customer *is* (today), but at what the risk of the customer *might be* given some intervention. Third, a competitive generation supplier is provided an incentive to manage the usage/bills of a customer whose risk has been ceded to reduce the overall level of facility claims and thus the overall level of costs to be apportioned back to the supplier. If a service provider, in other words, can develop effective ways to manage the risk of serving residual market members, the provider can minimize total costs that will be apportioned back to it. In contrast, the existing provider of last resort provides no incentive for, and no reward for, managing the risks in the residual market and lowering the cost of serving the residual market.

## **Conclusion**

The need for a provider of last resort is not a concept that is unique to a competitive electric industry. For years, policymakers have been addressing such issues in the various insurance markets. The residual class in these markets may but need not necessarily be low-income consumers. (Indeed, the markets need not necessarily be residential markets.) They are nonetheless consumers who present the potential for higher risks and higher costs.

Electric restructuring decisions to date have paralleled the early insurance industry decisions on provider of last resort. Assigning the customers who need a provider of last resort to the incumbent utility (or to some other single entity who bids on serving the provider of last resort market) shares the same conceptual foundation as assigned risk plans and joint

underwriting associations.

Those insurance models, however, have been found lacking and are increasingly being abandoned in favor of a reinsurance facility model. A reinsurance pool model is easily adaptable to a competitive electric industry and should be pursued. A reinsurance approach will not only serve customers in need of a provider of last resort, but will avoid the adverse consequences that can reasonably be anticipated through structures adopted to date.

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