Déjà Vu All Over Again: The Grass Was Not Greener Under Utility Regulation

Abandoning wholesale electric competition now, just as needed market signals have developed, and reinstituting an outdated, failed central planning approach – even one with a fancy name like integrated portfolio management – is a solution looking for a problem. And the consequences that it creates will not be short term.

Jonathan Lesser

Jonathan Lesser *is a Partner in the Energy Practice of Bates White LLC with more than 20 years' experience working for electric utilities, government, academia, and as an economic consultant. Prior to joining Bates White, Dr. Lesser was President of New England Economics Group. Previously, he has served in senior management roles as Director of Regulated Planning with the Vermont Department of Public Service, Senior Managing Economist at Navigant Consulting, Inc., and Senior Economist and Manager for Economic Analysis, at Green Mountain Power Corporation. He holds a Ph.D. in Economics from the University of Washington. Dr. Lesser is co-author of* Fundamentals of Energy Regulation *(Public Utilities Reports, Inc.), which was published in August 2007. He can be contacted at jonathan.lesser@bateswhite.com.*

I. Introduction

A rapid rise in electric prices the past few years has led some lawmakers and policymakers to call for an end to competitive electricity markets and a return to the ''good ol' days'' of regulated utility monopolies. Forget markets and competition among generators; in those days utilities built and operated their own generating plants. All costs deemed ''reasonable'' by regulators were automatically passed along to ratepayers. There were no incentives to reduce costs and none to improve efficiency, a consequence of a regulated monopoly structure that had been in place for decades. Under that structure, most utilities earned double-digit annual returns and, as long as they avoided egregious errors, faced few pressures to reduce costs and improve operating efficiency. As long as the lights stayed on and rates didn't go up too fast or too high, construction cost overruns and fuel price increases could be passed along to ratepayers.

II. Why the ''Good Old Days'' Were Not So Good for Ratepayers

With the benefit of hindsight, we know now the old monopoly model was inefficient: under that model, utilities had no monetary incentives to reduce their costs like competitive firms. A utility that reduced its operating costs would simply see its ''revenue requirement'' (i.e., the amount of money it was allowed to collect from ratepayers) reduced. As a result, everyone was worse off: ratepayers could not realize potential savings and utilities could not increase their profits. Although some regulators developed approaches to address this problem (called ''incentive'' regulation), those approaches did not address many of the fundamental problems that afflicted the monopoly model. Therefore, especially for those who say returning to this model is the best way to address our long list of energy challenges, a brief review of the recent history of the monopoly model may be helpful.

In the 1960s and 1970s, a number of utilities made significant and well-publicized missteps. Some utilities embarked on massive generation construction projects, particularly nuclear plants, at a time of great regulatory uncertainty and based on forecasts that assumed their ratepayers would never respond to higher prices by reducing their consumption. Others signed long-term contracts that turned out to be far more expensive than initially forecast. The result was a legacy of delays, billion dollar cost overruns, half-built and abandoned nuclear plants, and soaring electric rates that crippled electricity-hungry industries and outraged ratepayers.

State and federal energy regulators responded in two ways that, in hindsight, were inconsistent. First, in the late 1970s, the U.S. government created the roots of electric market restructuring, allowing a few select firms to produce and sell electricity to utilities, and obligating those utilities to buy it. Second, in the early 1980s, many state regulators introduced detailed new resource planning rules that, it was promised, would prevent future cost overruns: they required utilities to undertake *integrated resource planning* (IRP), which emphasized energy conservation first and new supply second. As part of these IRPs, many state regulators forced utilities to develop conservation plans and install energy saving devices in customers' homes and businesses. Some even required utilities to pay for customers to switch to other fuels to meet their energy needs.

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While IRPs did create some needed oversight *before* plants were built or contracts were signed, IRPs also made it much more difficult for utilities to react to rapidly changing market conditions, because of months-long administrative processes that were undertaken to ''approve'' IRPs. Thus, a utility could find itself in a situation where, having devoted significant effort to crafting an IRP and garnering regulators' approval of it, energy markets had already changed so much that the utility's IRP was outdated. Moreover, the planning processes used by utilities and regulators were themselves often too simplistic because they failed to adequately address the greater market uncertainties that began to dominate energy markets.

Regulators and utilities also had to address increasing opposition to siting and building new generating capacity to meet growing consumer demand. So, for example, although a new coal plant might be a ''least-cost'' resource in a utility's IRP, opposition could delay its actual construction and operations for years. As a result, utilities and regulators confronted a shrinking set of options, which made planning still more difficult. Energy conservation and improved efficiency helped, but couldn't offset all demand growth. Clearly, something else had to be done.

 1040-6190/$–see front matter , doi:/10.1016/j.tej.2007.11.001

III. In the mid-1990s, a New Competitive Model Emerged

By the early 1990s, as electricity prices continued to rise, politicians and regulators decided that having a few competitors around the margins, while utilities remained regulated, was not enough. So, a broader restructuring took place. Its central premise: generating plants would be built, owned, and run by competitive firms, which would be subject to the rigors and discipline of the market, and whose shareholders would bear the risks of cost overruns and poorly operated plants, rather than being allowed to pass along higher costs to ratepayers with impunity. The idea made sense. Electric rates were high but commodity fuel costs were low: there was a natural gas supply ''bubble'' and crude oil prices were less than $20 per barrel. New suppliers entered the market to take advantage of the new opportunities. They invested in new, more efficient generation and spruced up older plants. They improved efficiency and reduced operating costs.

Wholesale competition clearly worked, putting downward pressure on pricing and improving plant performance. But in the early days the new model was dogged by a number of challenges. Poor market designs and misguided political restrictions led to the financial collapse of two large California utilities. The Enron scandal raised fears that all wholesale suppliers were somehow ''manipulating'' electricity markets. And, most of all, soaring fuel costs led to inevitable increases in power prices. Combined with expiring price caps, which were included in many state restructuring laws as a way of providing ratepayers with ''instant'' benefits, higher fuel costs have led to much higher generating costs and ''sticker shock'' for ratepayers.

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Sticker shock has led some observers to conclude that the entire wholesale competitive model was flawed and should never have been allowed to occur. But price spikes are not unique to electricity. When gasoline prices rose to over $3 per gallon for the first time in the summer of 2006, there was an outcry, but also action. Consumers quickly responded, demanding more fuel-sipping hybrids and avoiding large SUVs. Yet, some so-called ''reformers'' say we should not apply this same model of consumer choice and supplier behavior to electric markets. Rather than allowing market participants to respond to higher prices – building new generating plants to take advantage of higher prices (and lowering prices as a result), creating innovative new demand-response programs that reward customers for reducing their electricity consumption in high-demand hours, and building more renewable resources that are immune from fossil fuel price increases – some politicians and regulators now want to recreate the past. They want to shut down markets and re-regulate electric utilities. They want electric utilities to again plan, build, and operate generating plants. Some even want to create whole new government agencies, called ''power authorities,'' to build, operate, and distribute ''low-cost'' electricity to the most deserving consumers.

IV. Integrated Portfolio Management: The Same Old Monopoly Mindset

The new phrase for these latest government mandates is called *integrated portfolio management* (IPM). Despite its fancy name, however, IPM is not new at all. It is just old-fashioned IRP – déjà vu all over again. IPM is a return to the failed planning methods of the pre-restructuring past. Rather than facing the discipline of the marketplace, electric utilities will again build generating resources, with ratepayers paying for all unexpected cost overruns. Rather

than using market incentives to reduce operating costs and improve efficiency, utilities again will be able to pass along all cost increases to ratepayers, who no longer will have any alternative but to buy electricity from their local utility. The results will be no different than they were before. Utilities will plod along, content to operate as monopolies, while their regulators tell them what to build, where to build it, and what to charge. In exchange, utility investors will earn double-digit returns, and captive ratepayers will bear the lion's share of the financial risks.

More than a century ago, the philosopher George Santayana observed that, ''those who cannot remember the past are condemned to repeat it.'' With many states now contemplating IPM or already requiring it, to say nothing of states' efforts to create new, government-run ''power authorities,'' the danger of mass amnesia is only too real.

History, however, is not something that should be forgotten. And, in some ways, the electric industry has been cursed by its own success. Today, most of us take electricity for granted: we flip the switch and the lights come on. We don't think about the complexities of the electric system and the remarkable job utilities have done to create and maintain an electric system that is the most reliable in the world.

Decades ago, planning for new generating plants and building them were fairly straightforward. Electric demand grew at a steady pace year after year. Environmental regulations were less prescriptive, were designed to address older and simpler technologies, and were informed by a narrower state of scientific knowledge. Building low-cost, high-emission coal plants in remote areas was easily accomplished, as was building the transmission lines needed to deliver the electricity produced by those plants to power-hungry consumers and businesses. Nobody was worried about global climate change.

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Those days are long gone. Cheap energy is a thing of the past and energy markets are far more volatile today than before. Building new infrastructure – whether generating plants or transmission lines – is a more contentious and time-consuming process because of stricter land-use and siting regulations. It has become more important to develop environmentally sound projects. Moreover, the need for new infrastructure investment has grown substantially since the period before restructuring. There is a growing need for new baseload (''round-the-clock'') generating plants to replace plants that have reached the end of their useful lives. We need to build new baseload resources, whether low-emission coal, or advanced nuclear plants that are safer and less costly than the previous generation of technology. And, we need to invest in new renewable technologies – wind, solar, biomass – that can diversify the pool of generation resources and reduce our dependence on fossil fuels

V. New Realities Create New Challenges

These new realities have created new challenges. Of course, facing new challenges is nothing new. The entrepreneurial spirit to develop new technology – and profit from it – is as strong as ever. That is why the call to turn back the clock and return to decades-old, government-mandated planning approaches, and to create new government bureaucracies that mandate electric ''winners and losers,'' makes little sense. It didn't work decades ago, and it won't work today.

Market competition, on the other hand, does not mean that prices will never increase. Competition cannot prevent a future Hurricane Katrina from wrecking natural gas infrastructure in the Gulf of Mexico and causing natural gas prices to soar. It cannot prevent

 1040-6190/$–see front matter doi:/10.1016/j.tej.2007.11.001

the increases in worldwide demand for electricity and fossil fuels that have driven electric prices higher. What competition *can* provide is the strength of the same fundamental market forces to cause prices to decrease. Higher prices will bring forth new generation investment and new sources of supply and demand response, as investors seek to capitalize on higher prices, and as alternate ways of meeting customers' needs become economically feasible. The move to competitive markets did not, and will not, eliminate the very necessary role of policymakers. Government policies establish the framework that fosters competition and competitive solutions, such as encouraging more renewable resources and reducing greenhouse gases. No amount of government intervention, however, can change the basic principles of supply and demand. Burdensome new regulations and price caps cannot keep prices low.

Government intervention in these fundamental marketplace dynamics distorts prices and destroys competition. Market-based pricing fosters competition, spurs innovation, and provides choices for customers. History is littered with the remains of failed rate freezes and central planning efforts, both in this country and elsewhere. Abandoning wholesale electric competition now, just as needed market signals have developed, and reinstituting an outdated, failed central planning approach, even one with a fancy name like integrated portfolio management, is a solution looking for a problem. And the consequences that it creates will not be short-term. Some government policies and regulations come and go . . . not this one. A return to government-managed electricity would be costly, risky for ratepayers, and long-lasting. The irony is we have a very good idea how a return to the ''good ol' days'' will turn out because, like déjà vu, we've seen this story before.■

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