

**"INCENTIVES" FOR PURCHASED POWER:
COMPENSATION FOR RISK OR REWARD FOR INEFFICIENCY?**

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INTRODUCTION

Utility resistance to purchased power has prompted calls for "incentives." Proponents of incentives cite two main rationales: (a) reduced rate base and (b) higher risk. As to rate base, they say that buying instead of building reduces the rate base on which earnings are determined. The seller therefore should pay an "incentive" to "make the utility whole."

As to risk, they say that purchased power obligations are the equivalent of debt, and debt means risk. The utility needs a higher equity return, for which the seller should pay.

Both arguments are incorrect. To resist actions which impede profit maximization is legitimate in a competitive market. But the utility-as-purchaser is the sole purchaser of new energy resources. It has both franchise responsibility and market power. Efficient acquisition of low-cost power is obligatory; it is not an "option" to be coaxed with incentives. As for risk, utilities' purchased power "risk" is largely attributable to competitive loss. In regulation as in a competitive market, the risk of competitive loss is not compensable.

**I. PURCHASED POWER "INCENTIVES" IMPEDE
COMPETITION AND WEAKEN REGULATION**

A. An Inefficient Utility Should Not Profit from the Seller's Success

The generation market is competitive. If an independent can price below the utility's construction cost, the utility must admit defeat and buy. Lost profit is competition's penalty. Capitalism has no consolation prizes.

Once regulators establish effective generation competition, the market must set the power price. The ratepayer should pay that price and no more (plus the legitimate cost of utility distribution). The victor should receive that price and no less. Government-granted "incentives" muddle that market result.

Instead of "incentives," some utilities propose "index pricing." Index pricing would let the utility recover purchased power "costs" based on an index rather than actual costs. If the utility can force the seller's price below the index, the utility can keep the difference.

Index pricing gives incentives a market veneer. It might work in a competitive purchase market where sellers have alternative buyers. But the utility-as-buyer is that market's only buyer. The utility can extract price concessions from sellers using market power, not skill. Index pricing and incentives therefore commit the same crime: They exact a toll from efficient generators. Substituting index pricing for incentives simply replaces government interference with monopsony muscle.

B. The Risk From a Utility Purchase Is Rarely a Compensable Risk

Utilities equate purchased power with debt, and debt with risk. They then argue that under traditional cost-of-service analysis, increased risk requires increased return. To protect ratepayers from this increase they would insist on a price reduction from the independent seller. Compensation for the utility risk thus would come from the successful seller. In most cases, equity adjustment would compensate the utility for a noncompensable risk. There are three reasons:

1. The risk of competitive loss is not compensable. If the risk is the risk of reduced rate base (i.e., foregone profit), the risk is not compensable for the reasons described above: Competitive markets do not compensate losers. Shareholders must mitigate their risk by monitoring management or selling their shares.

2. Capital structure effect is not compensable. Some utilities argue that because the purchase obligation is like debt, the purchase alters the utility's equity-debt ratio. To rebalance its capital structure, the utility must issue more equity and earn the associated return. Like the risk of reduced rate base, this change in capital structure comes from

competitive loss and is not compensable. The competitive market does not promise growth or protect against shrinkage. Neither should regulation. The franchise relationship does promise a fair return on equity, but it does not say how much equity.

3. Since the business risk falls on the successful seller, there is no risk on the utility. The preceding two arguments assume the utilities' line of reasoning: Purchase equals debt, and debt means risk. That reasoning is flawed, because in most cases the utility purchaser has no risk.

A long-term purchase may resemble debt because it is a fixed commitment. But in a more fundamental sense, the purchase obligation is unlike debt because it carries no business risk. If the regulator orders or approves a purchase, any utility risk should disappear. The commission cannot direct the utility to purchase, and later deem the utility's involuntary action imprudent. It is a legal and logical impossibility. If the purchase turns sour, the risk will normally lie with the seller or the ratepayer (with appropriate price adjustments). The utility is only a conduit.

With real debt, equity is at risk because if the business fails, there is no revenue to pay off the loans. When the utility builds, the utility's equity holders bear a similar business risk: If the plant fails, revenues will drop, but the loan payments remain.

Contrast the utility purchase. If the seller's plant fails, the utility has no obligation. The risk is with the seller or the ratepayer, but not the utility. With purchased power, there may be a new purchase obligation, but there is no new business risk. There is in fact less risk, because the utility's risk portfolio has one less plant. "Risk" means risk to investment. If the new generation is owned by the independent, what utility investment is at risk?

Compensating the purchasing utility for "risk" would count the same risk twice. The successful seller already bears the risk of performance. It charges for this risk through its return, or shifts some to the ratepayer through the purchased power contract. There is no separate utility risk.

In certain rare situations, there is utility risk that is compensable: where, for example, the commission "approves" the purchase but retains the authority to find, midway through the contract term, that (1) market prices have dropped; and, (2) the utility, although prudent to buy initially, should absorb the excess of contract price over market price.

This treatment shifts risks from ratepayer to utility and therefore requires equity adjustment. But advocates of incentives do not distinguish this special case; they see risk in all cases.

[Footnote: Incentive advocates sometimes call for a "return on purchased power." That is a logical impossibility. Return is associated with an investment. Purchased power is an expense. Mixing these concepts clouds the debate. Even if one accepted the debt equivalency argument, one never would talk about a "return on debt."]

II. UTILITIES SHOULD NOT CONTROL THE PURCHASE DECISION

The need for "incentives" assumes the utility controls the **buy vs. build** decision. If someone else makes the decision, however, no utility incentive is necessary. In competitive markets, e.g., residential real estate, the **buy vs. build** decision is made by the neutral market. For utilities comparing **buy vs. build**, neutrality is impossible. The only available neutral party is the regulator. The best way to remove the utility "disincentive" is to circumvent it, by placing the purchase decision in regulatory hands.

A. Utility Impartiality is Impossible

Wholesale power is not a mere commodity. It is a complex package requiring the exercise of judgment. That is where the danger lies. Here are three examples:

1. Project development experience. A utility will know its own project team better than its competitor's. The utility cannot compare the teams objectively. Suppose the utility and the independent each had built a plant the previous year, and each plant suffered unexpected outages. Both entities should lose points in the competition. How many points for each? Which outage was excusable? The utility-as-competitor cannot be objective.

2. Information on system operation. System data are critical to efficient project design. Equal access to the data is equally critical to fair competition. But not all data fall into this category. Who should decide? Before the competition, the utility has exclusive access to all system information. That access has competitive value. Someone must decide: (1) which data cannot feasibly be duplicated and therefore must be shared with competitors, and (2) which data are hard-earned nuggets that competitors should have to discover on their own. Someone must draw the line. The utility cannot do so objectively.

3. Competition with captive funds. Many utilities are "competing" with independents using staff and assets funded with ratepayer dollars. If common costs are not allocated carefully between the utility's competitive and monopoly functions, the competition will not be fair. Allocation requires judgment. The utility cannot make these judgments objectively.

4. Employee "Separation". Some utilities have proposed a "separation" between employees responsible for buying and those responsible for building. But employee separation cannot counteract corporate expectation:

A utility employee works for the shareholders, not for the commission and not for the public. The employee's job is to maximize shareholder value. It does not maximize shareholder value to select an independent over a [utility] profit.

There is no reliable way for the commission to ensure that utility employees are free of corporate pressures to select the company proposal every time.

The commission would have to review everything from employee introduction to promotion policies. The commission would have to ensure that the corporate philosophy inculcated into employees elevated the ratepayer interest over the shareholder interest. The commission would truly have to be sure that opportunities for advancement were not affected by an employee's selection of a competitor over the company. To obtain that assurance, the commission would have to involve itself too deeply in internal corporate affairs.

[Footnote: Direct Testimony of Barry N.P. Huddleston at 19-20, Investigation on the Commission's Own Motion Into Barriers to Contracts Between Electric Utilities and

Nonutility Cogenerators and Certain Related Policy Issues, Docket No. 05-EI-112 (Tr. 2526, June 29,1993).]

Employees may separate from each other, but they do not separate from the corporation.

B. What "Management Prerogative"?

Utilities argue that commission selection of wholesale power alternatives "interferes with management prerogatives." Where the utility has monopsony power, but also has viable competitors, its impartiality is impossible. It can have no "prerogative" to select itself.

III. CONCLUSION: CARROT OR CONTRACT?

Incentive proponents argue: "You get more with carrots than with sticks." A regulated utility already has received its carrot: the exclusive franchise. Its quid pro quo is to buy resources efficiently.

Suppose an independent generator, 15 years into a 20-year contract, sought an extra payment for the final five years. The utility buyer would point to the contract, not pay more carrots. The franchise obligation is no less binding. Utilities always say their "franchise obligation" is sturdier than the independents' "contract obligation." Now the shoe is on the other foot. If a legal monopoly can redefine its franchise obligation with each inconvenient task, there is no limit on carrots.

Arguments for "incentives" focus on the utility's interests rather than its obligations. The law of regulation is the opposite. The regulatory question is not "How do we make utilities whole?" but "How do we set prices at competitive levels?" In a competitive market, the loser is never "made whole"; it just tries harder.