

Low Rates, High Rates, Wrong Rates, Right Rates

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*One fish two fish red fish blue fish
Black fish blue fish old fish new fish*

— Dr. Seuss (1960)

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Utility Cost Increases—Big Ones—Are Unavoidable

In the U.S. utility industries, the long-deferred capital needs are heading north of hundreds of billions of dollars. Electricity faces shrinking capacity margins, renewables-induced transmission demands, the possible return of nuclear power, and the likelihood of climate change legislation. Natural gas needs billions for new main and service pipes and compliance with new federal safety regulations. Water, too: The EPA says that over the next two decades, we need \$500 billion to \$1 trillion for water and wastewater infrastructure improvement and replacement. Telecommunications decisionmakers are considering universal access to broadband. Utility employees' pensions are now underfunded due to stock value declines.

Are we ready to raise rates? What are the obstacles? What are the solutions?

Is Regulation Ready?

Getting rates right is integral to effective regulation. The purpose of regulation is to align private behavior with the public interest. See essay, "The Effective Regulator: Purposefulness." Regulation focuses on performance: setting standards for excellence, then enforcing compliance. The traditional focus is on the performance of the sellers: How well are they operating today's infrastructure while planning and creating tomorrow's?

What about the performance of the buyers? As a legal matter, regulators regulate sellers, not buyers—utilities, not consumers. But: (1) Regulators serve the public interest, (2) the public interest includes economic efficiency (biggest bang for buck, maximizing benefits for all), and (3) economic efficiency requires getting prices right so consumers don't cause waste. So regulators do address customer performance. The question is: Where economical customer performance requires higher rates, are regulators ready to do the job? The answer depends on whether we recognize and remove four obstacles.

Four Obstacles: Blurred Mission, Lulled Customers, Skeptical Public, Utility Hesitance

Why is there tension between achieving regulation's purpose and making rates right? Four reasons.

Blurred mission: Utility regulation has a "consumer protection" component. Protection from what? In traditional markets, consumers depend on a single seller, so "protection" means protection from excessive prices and insufficient quality. Have we allowed this "consumer protection" purpose to transmogrify from protection against monopoly inefficiency to protection against high costs in general? Some regulators define their effectiveness by where their rates rank. Some lobby against climate change legislation because it will "raise rates." Rate rankings do not equal rate appropriateness; consumer protection does not mean protection from the right rates.

Lulled customers: Those years-long rate freezes lull the public into thinking rate stability is an entitlement. When, after ten years of below-cost rates, the commission realigns rates with cost, we know what happens: (1) Voters don't offer thanks for the prior windfall; they protest the new levels, loudly. (2) Politicians fan these flames, making rational policymaking difficult. (3) The compromise arrives, usually more pain-deferring than pain-sharing, usually skirting the underlying problem (the public's lack of acceptance that electricity costs, like all costs, rise). What works in politics—mediating between positions—rarely works in regulation, where the midpoint between two wrong answers is a third wrong answer.

Skeptical public: A utility's request for a rate increase triggers public skepticism, because the public is reflexively skeptical of bigness. The public reaction is asymmetrical: Citizens do not talk positively about many of the near-miracles of electricity production, water treatment, gas storage, and instant telecommunications, and the rarity of outages. They disparage rate increases.

This skepticism has its bases: the utility witness who swears that the \$100 million increase is necessary for "viability," only to settle, satisfied, at \$65 million; the merger proposal that cites "synergies" that no one can prove or disprove; the persistent resource asymmetry that allows utilities to occupy the most space in the public record. (See essays, "Regulatory Resources: Does the Differential Make a Difference?" Parts I and II). In regulation, trust requires verification; verification requires resources. If the public thinks all rates are rip-offs, efforts to explain will have no traction.

Utility hesitance: The utility has reputational risk. No one likes raising rates—the headlines, the commission audits, the legislators' castigations. There also is financial risk. Some utilities hesitate to make infrastructural investments without advance, project-specific regulatory commitments. (This hesitation, while discretionary, is not necessarily lawful. Regulatory law does not allow a utility to delay necessary infrastructure investment obligation because it worries whether regulators will set rates right. If rates are insufficient, the utility's recourse is not to avoid its obligations but to take the commission to court.)

In sum: The combination of regulatory hesitance, lulled customers, customer skepticism, and utility hesitance produces headwind in our efforts to make rates right.

Five Responses: Management Effectiveness, Regulatory Resources, Cost Recovery Commitment, Rate Design, Political Leadership

How can regulators create acceptance of infrastructure-necessitated rate increases? Here are five thoughts.

Management effectiveness: Commissions should obligate their utilities to produce an inventory of all capital needs, their cost, and a proposed schedule, continuously updated. Inside utilities, there should be task forces containing the relevant engineering, finance, quality control, and regulatory affairs experts to create and manage the projects. The public should see a full improvement plan before it hears of rate increases.

Regulatory resources: Regulatory staff must be sufficient in size, compensation, and expertise to evaluate billion-dollar proposals and multi-year performance. Insufficient staff means passive oversight—an oxymoron.

Cost recovery commitment: When should regulators commit ratepayer dollars: at project commencement, project completion, or project milestones? Each choice has tradeoffs. (See NRRI's study "[Pre-Approval Commitments: When And Under What Conditions Should Regulators Commit Ratepayer Dollars to Utility-Proposed Capital Projects?](#)"). Regulators must commit if utilities are to commit. What counts is not recovery certainty but policy clarity.

Rate design: Until the late 1980s, ratemaking focused on making the utility whole: We calculated the revenue requirement, then allocated fixed costs among customer categories. From there we set rates, based on some combination of customer presence, customer usage, and political sensitivity (the latter explaining the habit of deviating from equiproportionality by allocating some residential fixed costs to commercial and industrial customers). Economic efficiency made an occasional appearance (remember the studies on “marginal cost pricing” in the 1980s?), but it was hardly center-stage. Decades of declining costs gave no hint of today's infrastructural needs.

We know better now. Rate design is a key to consumer protection. To moderate cost increases, we must moderate the demands that cause costs. Rate design offers the double anti-oxymoron: Price increases are consumer protection, because price increases yield lower total costs.

Political leadership: Leadership requires followers committed to the leader's mission. See Garry Wills, *Uncertain Trumpets: The Nature of Leadership* (2007). Commissions must have understandings with legislatures about the capital program, the utilities' obligations, the commission's role, and the commission's resource needs. Those understandings will reduce surprises while discouraging forum shopping—those episodic, opportunistic efforts to have legislatures anoint some technologies or capital programs

over others, without basis in careful cost comparisons. Legislative appreciation of the regulator's goals also will facilitate the creation of poverty assistance programs, thus relieving regulators of the pressure to shield consumers from real costs.

All involved—commissioners, staff, utilities, legislators, practitioners, and the public—must share clear expectations: Infrastructure upgrade and modernization is essential, it must happen, and it will cost.