New Suppliers in the New Century:
Will Incumbency Trump Merits?

Scott Hempling
March 2014

In the 20th century, state law protected electric utilities from competition, leaving customers no choice but to buy from vertically integrated monopolies. Regulators based utilities' profits more on kWh sales and asset growth than on efficiency and innovation. The 21st century offers a chance for change: diversity among services and suppliers, where merits prevail over incumbency; and democratization of demand, where customers, hourly informed of the costs they cause, can custom-design their mix of suppliers and services and even produce their own supply.

Diversity and Democratization

Experiments in this diversity and democratization are taking multiple forms in multiple places. Maine, Hawaii, Oregon and Vermont have relieved their utilities of energy efficiency roles, shifting those roles to independent companies having no internal conflict between producing and conserving. Most importantly, these new "utilities" were selected competitively and enjoy no lifetime lock on their jobs. California has ordered its utilities to procure 1325 MW in storage; all must be selected competitively and no more than 50 percent can be owned by the incumbents. A Maine statute requires its commission to consider appointing a "smart grid coordinator" that would be independent of the incumbent utilities. Through net-metering and microgrid programs, states are encouraging customers and communities to be become self-generators. Connecticut, Maryland, Massachusetts, New Jersey, Ohio and others are directing their utilities to buy instead of build. (While some details of some state programs have drawn preemption challenges, a state's general decision to displace utility ownership with utility purchases is legally safe.)

FERC, too, is pressing for alternatives to the incumbent utilities: by requiring regional transmission organizations to accommodate and compensate demand-side bids (Orders 719 and 745), by encouraging vertically integrated incumbents to divest their transmission to independent owners (Order 679), by eliminating incumbents' "right of first refusal" to construct regional transmission facilities (Order 1000), and by making ancillary service markets more welcoming to new entrants (Orders 755, 784).

Customer Responsibility

Diversity and democratization empower individuals, but individualism can damage the commons. (See Garrett Hardin, *The Tragedy of the Commons*.[1]) For people excited about their new cars, the commons at risk is clean air and pedestrian safety. For people excited about private schools, the commons at risk is the citizenry's commitment to public schools. In the

electric industry, the commons is the central infrastructure: the infrastructure that incumbent utilities built for us, long before we had time-of-day pricing, demand aggregators, and rooftop solar; the infrastructure we'll need even when every neighborhood has its own microgrid. Because individuals need the commons, we should not be arguing about our obligation to pay—both for past costs prudently incurred, and for future infrastructure that even individualists will need. We should be focusing on defining and quantifying the costs and benefits of that infrastructure (including ways to reward the savers and self-generators for the costs—present and future, variable and fixed—that they help us avoid). We should not be contesting the principle that cost-causers must be the cost-bearers.

On this point—coupling customer empowerment with customer responsibility—the Joint Statement issued in February 2014 by the Natural Resources Defense Council and the Edison Electric Institute has it right. Customers should not have to buy "electricity" as a commodity from a seller whose profits depend on volume; they should be choosing among packages of electricity services that provide warm showers and cold beers at society's lowest cost. A utility's recovery of (and customer's responsibility for) prudent fixed costs, past and future, should depend not on kWh consumption but on cost caused and benefit received. Because TVs don't turn off when the sun goes down, customer-generators should pay for the electricity network they'll need. Customers, especially those of limited means, need rate designs, metering devices, energy efficiency services and education that empower them to cut their consumption while maintaining their comfort.

Incumbency or Merits?

But customers will not be empowered if their choices are constrained. And their choices will be constrained if states favor incumbency over merits. That is where the Joint Statement takes a wrong turn. It presumes that the new electric services require a continuing "utility" role—the term "utility" meaning (I infer from EEI's joint authorship) a member of EEI, the trade association of retail utilities that state law protects from competition. Of course we should link "profit opportunities ... to utilities' performance," as the document advises (provided we first establish the utilities' *obligations*; then calibrate compensation to reflect, symmetrically, their successes and failures in meeting those obligations). But why talk of profit opportunities only for "utilities"? It is one thing to link profit to performance; it is another thing to favor "utilities" when deciding who should provide that performance. Yet this is what the Joint Statement does. It asks regulators to "consider expanding investor-owned *utilities'* earnings opportunities," specifically for "initiatives to improve energy efficiency, integrate clean energy generation and improve grids." And it asks regulators to "support significantly enhanced utility investment" in "smart meters" and "smart grid." (all emphases added) There is no mention of non-incumbents. The document properly argues for economic efficiency and financial responsibility, but its exclusion of non-incumbents undercuts its aims.

The document offers no facts, law or logic for using government powers to favor ("support" is the term used) one type of supplier over another. We do need to address which services must be provided by the network owner and which can be provided by third parties; in airports, the traffic controller needs a monopoly while the bartenders have to compete. But the

Joint Statement skips over this distinction when seeking government "support" only for "utilities." And even for the air traffic controller role—i.e., the necessary monopoly—there can be competition to be the monopoly. "[T]he public has an obvious interest in competition, 'even though that competition be an elimination bout.'"[2] (For more on that subject, see my essay "Competition for the Monopoly: Why So Rare?")

We should feel neither surprise nor cynicism when incumbent utilities assert their indispensability. Dentists do it every six months; colonoscopists every five years. Nor is it shocking for businesses to seek preferences from regulators. But in the electric industry, where schools, hospitals, our national economy and our environment all depend on fact-based decisions rooted in objective inquiry, regulators are legally bound to find the best performers, extract from those performers cost-effective performance, and compensate based on value. Competition on the merits, not auto-"support" for incumbents, is the answer.

---

[1] "Picture a pasture open to all.... As a rational being, each herdsman seeks to maximize his gain. Explicitly or implicitly, more or less consciously, he asks, "What is the utility to me of adding one more animal to my herd?". . . [T]he rational herdsman concludes that the only sensible course for him to pursue is to add another animal to his herd. And another; and another.... But this is the conclusion reached by each and every rational herdsman sharing a commons. Therein is the tragedy. Each man is locked into a system that compels him to increase his herd without limit—in a world that is limited. Ruin is the destination toward which all men rush, each pursuing his own best interest in a society that believes in the freedom of the commons. Freedom in a commons brings ruin to all."

[2] *Hecht v. Pro-Football, Inc*. 570 F.2d 982, 991 (D.C. Cir. 1977), quoting *Union Leader Corp. v. Newspapers of New England, Inc.*, 284 F.2d 582, 584 n.4 (1st Cir. 1960).