"Reforming the Energy Vision": Did New York Get Everything Right?

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July 2015

The New York Commission's order on "Reforming the Energy Vision"[1] is extraordinary. A monumental effort of analysis and insight, it epitomizes regulatory leadership. But it has at its heart an assumption that deserves dissection: that the incumbent utility will remain in its role, and even see that role expand. For the distribution system platform (DSP) role, we will need a utility. But it doesn't have to be the existing utility. We should give the DSP job to the most qualified, not to the most familiar. That way, the jobholder feels lucky rather than entitled. And then we can skip talk of "incentives" to act, since incentives are illogical when action is obligatory. To illustrate these points, I excerpt passages from the order and offer reactions.[2]

Market Structure for Distribution Services

While New York's order is rich and complex, this excerpt distills its purpose:

> *The reformed electric system will be driven by consumers and non-utility providers, and it will be enabled by utilities acting as Distributed System Platform (DSP) providers.* ***Utilities*** *are responsible for reliability, and the functions needed to enable distributed markets are integrally bound to the functions needed to ensure reliability. Technology innovators and third party aggregators (energy service companies, retail suppliers and demand-management companies) will develop products and services that enable full customer engagement. The utilities acting in concert will constitute a statewide platform that will provide uniform market access to customers and DER [distributed energy resources] providers.* ***Each utility*** *will serve as the platform for interface among its customers, aggregators, and the distribution system. Utilities will respond to new trends by adding value,* ***thereby retaining customer base*** *and the ability to raise capital on reasonable terms.*

This passage illustrates the need to clarify "utilities." The DSP function will require a utility—a monopoly regulated by the state. But that utility need not be the existing utility—which is the meaning readers tend to assume, policymakers tend to mean and incumbent utilities seek to embed. If we refer instead to the "to-be-selected utility," verbal clarity leads to policy leadership. Reforming a vision should include selecting the "utility" based on merit, not seniority.

What about "retaining customer base"? "Retaining" means keeping; as in, keeping customers away from other suppliers. Since when does government help one supplier keep customers away from other suppliers—especially when the one receiving the help owes its role to policy inertia rather than operational merit? By coupling platform management with customer

retention, the "utility" is no longer a neutral party; it becomes a stakeholder with a "customer base" it needs to "retain." The job of the to-be-selected utility should not be to "retain customer base" but to perform a market-supporting function. Air traffic controllers don't "retain customer base;" they perform responsibilities. Like the air traffic controller, the to-be-selected utility does need stable compensation. But we can provide that compensation by giving the entity a monopoly role. That way, the utility is guaranteed customers; it need not "retain" customers.

> *The modernization of distribution systems must be accomplished in a way that meets and balances a variety of policy objectives, including system reliability and resiliency,* ***customer empowerment****, emission reduction, consumer protection, system efficiencies, cost-effectiveness, competitive markets, energy efficiency, power quality, and fuel diversity.*

An empowered customer is one who controls her economic fate. She chooses what to buy, how much and from whom. The ultimate empowered customer is a self-supplying customer—one who grows her own grain and bakes her own bread, rather than buying at the supermarket. If the DSP is to empower customers to self-supply, it cannot be striving to "retain customers."

> *The structure of the market will be a function of the needs defined by the DSP and customers, the products available in the market and procurement mechanisms for those products, the identity and capabilities of market participants and their interactions among each other and with the DSP, and policy guidance of the Commission.*

An excellent list of the forces that should shape a market's structure: customer needs, available services, transactional procedures, and participant skill. Omitted, wisely, are these forces: (a) inertia (e.g., rotely appointing the incumbent utility as the DSP, and (b) incumbent self-interest (e.g., the interest in retaining customers through government protection rather than competitive merit.

Monetization of Value

> *[T]he utility as DSP must be* ***in the position*** *to design and offer tariffs that allow it to monetize the value of DER as a mechanism to modify load and thereby support greater system efficiency.*

Here the Commission makes plain why we "monetize the value of DER": not to make the utility richer, but to make customers smarter—to "modify load and thereby support greater system efficiency." The question then is: How do we get the to-be-selected utility "in the position" to play this role? Utilities say they need "incentives." But to incentivize a monopolist is to act oxymoronically. By definition, incentives are inducements to act when there is discretion not to act. Having received the privilege to serve, the monopoly has no discretion not to act. If it had that discretion, it could refuse to act until it got what it wanted. That is not how regulation works. Busy intersections don't offer cars money for not stopping; the red light orders

them to stop. And in utility regulation, we set standards and require compliance. We don't (or shouldn't) pay "incentives." We define an obligation and we compensate for that obligation, based on reasonable cost and reasonable profit.

So the "incentive" for taking on the obligation to serve is simple and sufficient: freedom from competition and reasonable, legally defined compensation. Not to comply with the obligation, or to resist complying until more "incentive" is paid, is to violate the obligation and therefore to forfeit the franchise. Avoiding that forfeiture should be sufficient incentive to do the job that regulators require.

Utilities as Distribution System Platform Providers

> *[I]t is our conclusion that requiring the utilities to serve as DSPs under our regulatory authority and supervision is in the best interests of New York consumers.*
>
> *The opportunity before us is to set forth a regulatory and business model for the traditional utility and its investors that prompts encouragement of this form of [distributed energy resources] competition, rather than opposition. In doing so we can avoid the inefficient use of capital that occurs when government and monopolists refuse to remove barriers to the benefits that occur from innovation and competition.*

Here appears the key error: Giving the incumbent utilities the job, based on their presence rather than their performance, because otherwise they will use their incumbent powers to oppose performance standards. If the goals are diversity and democratization, entrenching incumbents is an illogical approach. More logical, and consistent with the Commission's other themes, would be to choose the DSP based on competition. On this topic, see the essay "Competition for the Monopoly: Why So Rare?"

Plenty of markets transform themselves. (Think FedEx, Starbucks, eBay, Southwest Airlines.) The electric utility markets are not transforming themselves; that’s why government orders like New York's are necessary. Why then would we automatically appoint, as agents of transformation, the very companies whose failure to transform has forced the government to act? Why not look for companies who already "get it"?

> *[W]e focus on the changed **business model** for the distribution utility....*

What is meant by "business model"? Since the phrase is usually connected to "incentives," I assume it means "the utility's preferred way to earn its desired return." All businesses have business models. As a lawyer and expert witness in an intensely competitive market, I've got one much like everyone else's: "Provide services whose quality exceeds the market's standards and the clients' expectations in return for compensation consistent with market forces to the extent affordable to the clients." Nothing special. So why focus on the utility's business model? Why not focus on the business model of the market's most cost-

effective, responsive supplier? Rather than shape our policies to satisfy the utility's business model, we should cause competitors to shape their business models to satisfy our policies. That means choosing the DSP based on competition rather than auto-appointing incumbents.

Continuously estimating how to "incentivize" utilities is hard work. Let the hard work be done by the competitors. To win the job, they'll need to do their own estimating, about their capabilities and costs, and those of their unknown competitors. If we are devoted to innovation and competition, our foundation need not be companies not known for innovation and whose economic interests are opposed to competition. As the New York Commission forthrightly recognized, "[t]he Federal Trade Commission (FTC) cautions that an administrative determination of the DSP role **precludes other entities** from demonstrating that they could provide the same services on better terms."

> *Utilities* ***do not currently have experience*** *in operating an integrated grid on a large scale; grid operators may naturally be skeptical of the value of DER as a resource to secure reliable operations.*

Having sensibly—and unavoidably—recognized the utilities' experiential limitations, why make them our first choice? Yes, they are experts on their existing infrastructure. But a classic error in hiring is to choose the person who already knows the job, rather than the person who is the most intellectually nimble and most committed to excellence.

Utility Entry into Competitive Markets

The Commission properly excluded utilities from providing competitive DER services in markets where the utility is also the platform provider, with this exception; "unless markets have had an opportunity to provide a service and have failed to do so in a cost-effective manner." An example of an exception would be "where there *does not appear to be a developing market for DER* and the public interest warrants utility investment that will support such development."

But where a market is not developing on its own, public policy can stimulate it to develop. We know this intimately from our renewable energy experience. Facing a deficit in renewable power production, we did not grant utilities a monopoly on that production. We did the opposite. The federal Public Utility Regulatory Policies Act of 1978 ordered utilities to buy output from new renewable producers and cogenerators, while compensating those new sellers at the utility's avoided cost. Today's "renewable portfolio" statutes direct utilities to buy specified quantities of specified types of renewable power. Both approaches stimulate competitive markets by creating demand; neither gave up on competitive markets and handed the job to the utility.

Utility Compensation

The order refers to a "fundamental goal of **changing utilities' motivations** and business value proposition." It also stresses the need for "ratemaking reforms to secure equitable

allocation of benefits and costs among customers and to align utilities' financial interests with the objectives of reform."

We need worry about "changing utilities' motivations" only if one has committed to relying on utilities whose existing motivations are problematic. We need not change motivations; we need only find the entities whose motivations are inherently aligned with the goals. Holding a competition to find the best DSPs fulfills that need.

> *Under current ratemaking, utilities have little or no incentive to enable markets and third parties in creating value for customers. Rather, utilities' earnings are tied primarily to their ability to increase their own capital investments, and secondarily to their ability to cut operating costs, even at the expense of customer value. Utility earnings should depend more on creating value for customers and achieving policy objectives. Rather than simply building infrastructure, utilities could find earning opportunities in enhanced performance and in transactional revenues."*

Why is it necessarily true that "[u]nder current ratemaking, utilities have little or no incentive to enable markets and third parties in creating value for customers"? Is that a problem of "ratemaking," or of the Commission not establishing clear standards and enforcing them?

Conclusion

The common analytical error—favoring incumbency over merit—is embedded in our phrasing. We talk of "Utility 2.0," of "utility business models," of the "utility of the future." Those phrases all suffer from the same assumption: that the "utility" is central and that regulation must "reform" to support that centrality. The correct phrase is "market structure of the future," the correct vision is diversity; and what we need to reform is a monopoly market structure whose inertial resistance to diversity is what has caused the New York Commission to offer us these insights to begin with.

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1 New York Public Service Commission, Case 14-M-0101, Proceeding on Motion of the Commission in Regard to Reforming the Energy Vision, Order Adopting Regulatory Framework and Implementation Plan (Feb. 26, 2015).

2 All bolding within the quotes are emphases added by me.