



How Should Regulators Incorporate Claims of External Values into Utility Prices?

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Utility regulators have a long experience in evaluating concrete, measurable costs of providing electricity service: invoices for fuel, contracts with labor unions, the capital costs of building a new power plant. Regulators face a growing challenge, however, in responding to claims about a range of less measurable costs and benefits, Travis Kavulla, Vice Chairman of the Montana Public Service Commission, observed in a Monday seminar at the Harvard Kennedy School.

Most notably, claims that the social cost of carbon-dioxide emissions should be incorporated into utility pricing raise tricky problems for regulators traditionally focused on keeping costs reasonable. Utility regulators elsewhere have faced arguments that they should account for the benefits that result from creating and saving jobs in utility pricing. How should regulators respond to these claims? Very skeptically, Kavulla argues.

Kavulla explained the challenges of the regulator's position in attempting to incorporate environmental considerations. The utilities themselves, in an integrated market, have, if anything, an interest in over-responding to potential future costs. Any increased capital investment they make (for a large dam, for example), as long as it is approved by the regulators, can be folded into utility rates to ensure a full return with a profit margin. If the anticipated environmental regulations never occur, the utility itself loses nothing—only the ratepayers are stuck paying higher bills for assets that turned out not to be needed, or as valuable as projected.

So what is a utility regulator to do when a proposed investment invokes hypothetical values based on possible future regulations? On the one hand, ignoring the possibility of regulation means that utilities might invest in assets (like new coal plants) that might suddenly become uneconomic under a robust carbon pricing scheme. At the same time, the timing and costs of environmental regulation are very hard to forecast, Kavulla noted, observing that the Clean Power Plan, for example, would have been adopted in a “wildly diverse manner by the states”—and now it looks unlikely to come into effect at all.

Attempts to quantify environmental benefits, such as “value of solar” studies, invoke a whole range of values which themselves are difficult to measure and which could lead to double-counting of benefits or costs, Kavulla explained. In response to the ambiguous planning situation, Kavulla noted, regulators in vertically integrated monopoly states have some leeway to quietly tip the scales in favor of investments. Regulators in restructured states, on the other hand, have less direct control over utility investment decisions, and instead are tasked with identifying the definition and quantity of the thing that the market is charged with procuring. Competitive markets perceived not to incorporate these ambiguous values will continue to face political pressures and may return to a more “command and control style” of regulation. Regulators are experimenting with different models, including New York's Clean Energy Standard, and the recent New England Integrating Markets and Public Policy Initiative.

One thing a utility's economic regulators should not do, Kavulla suggested, is to take it upon themselves to craft environmental regulation—an approach that might lead to perverse incentives and open the door to rent-seeking behavior on the part of utilities. They should try as best as possible to let arm's-length dealmaking occur that gives regulation price points for external values, just as peer measurements exist for other utility costs.

Kavulla spoke as part of the Kennedy School's Energy Policy Seminar Series, which is sponsored by the Consortium for Energy Policy Research of the Mossavar-Rahmani Center on Business and Government.

