Looking Out for the Ratepayers

10.01.2008
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The following article was published in the October 2008 edition of 'Environmental Finance: Climate Change; Emissions; Weather; Investment; Lending; Insurance.' It is reprinted here with their permission.

Over the past few months, US taxpayers have learned the hard way what can happen when the federal government fails to shine the bright light of transparent regulation on esoteric financial securities trading. We have been forced to 'socialise' the downside of sizeable market inefficiencies because the alternative would (seemingly) be much worse.

A similar policy-based prisoner's dilemma is just beginning to work itself out relative to federal climate change regulation and how compliance costs should be recovered in the electric energy sector.

Current US political realities indicate that the electricity industry will likely be subject to regulation to constrain carbon emissions in some form in the next decade. The bedrock question for policy-makers is going to be which party should be responsible for the costs of energy sector compliance - the public and private utilities that created the problem, their ratepayers that have taken advantage of low-cost electricity, or taxpayers?

Generally, the answer is always going to be the ratepayers. They will pay because of how utility cost recovery regulatory mechanisms have evolved at the state level. The only other viable option would be massive federal subsidy of utility compliance costs, an option which - until recently - seemed extremely far-fetched, and probably still is.

Assuming ratepayers will likely be the ones on the hook for the majority of costs, the critical issue will be establishing retail electricity rates that can: accomplish real and progressively increasing carbon emission reductions; induce demand-side management, and enable prudent levels of utility cost recovery.

As we've witnessed in California and states implementing the Regional Greenhouse Gas Initiative, there is no simple or even uniform way to conduct this balancing act. The impediments are mainly federal jurisdictional limitations and regional power market differences as to how utility costs are recovered. Federal regulators have jurisdiction over wholesale rates while states have authority

over retail rates, and approximately half of the states are 'regulated' and employ cost-of-service rate making. The other half engages in deregulated competitive market pricing while their utilities participate at the wholesale level in multi-state regional power markets.

In states that maintain cost-of-service regimes, the utility must demonstrate to the public service commission's satisfaction an operational revenue requirement (inclusive of environmental compliance costs). The requirement provides the basis upon which retail electricity rates are set that allow the utility to prudently recover its costs. States that have moved to some form of reregulated competitive market let the market decide rates. Neither regulatory paradigm is able sufficiently (or accurately) to capture all costs related to a utility's attempt to curb carbon emissions.

In competitive markets, utilities and generators using dirtier feedstock (eg, coal) could find themselves on the short end of declining marginal prices because they will obviously feel the pinch of carbon allowance caps and scarcity pricing much than, say, a gas-fired or renewable generator. This will, in turn, increase and accelerate the utility's need to develop or purchase cost-effective alternative capacity. The stranded costs could be recovered through implementation of a carbon surcharge set at the regional power market level, socialised among utilities across state boundaries. However, that kind of surcharge would perversely disincentivise the development of cleaner capacity - and could end up promoting needless cost over-recovery.

In regulated states, there is potential for inaccurate, commission-driven retail rate-making that could disconnect the true and variable costs that will be incurred by a utility under a federal cap-and-trade programme, and the costs it would be allowed to recover. Also, and because a utility in entitled to recover its total cost of service, whatever it is, the utility's emissions abatement decisions will (at least in part) be influenced by the opportunity costs presented by carbon markets, rather than the increased variable market costs of dirtier generation. A stop-gap could be provided by a future state policy determination of what constitutes a 'just and reasonable' balance between curtailing dirtier generation and buying additional allowances.

So what does this all mean to ratepayers? It means most utility carbon compliance costs will be passed through to ratepayers at possibly dramatically different paces because of structural cost recovery inefficiencies. Some ratepayers will see immediate increases in their bills while others could see larger rate spikes all at once in later years. Policy-makers and states need to integrate the energy economics of carbon compliance upfront into federal cap-and-trade policy design, and rightly so.

Policy parameters could mean decoupling rate-making from energy commodity supplies in favour of established utility "revenue" targets. Less ambitious options could include: requiring state commissions to recognise emissions allowances as intangible assets treated (hopefully) as deferred income rather than traditional project-based inventory; if allowances are to be auctioned, they should be sold from a governmental entity that flows the funds directly back into demand-side management and clean technology improvements in the purchasing utility's territory; or, mandating rate discounts tied to set emissions standard performance.

Finally, and perhaps most effectively, if federal guidelines were to establish that the point of energy

sector regulation will be downstream - at, say, the load-serving entity level rather than the wholesale generators - carbon compliance costs may be limited and curb the distortive impacts caused by differing jurisdictional cost recovery mechanisms. "Allocation/auction to load", as the approach is called, would provide a true balance between market-based flexibility in a utility's abatement decision-making while protecting ratepayers from rate-based price shocks. The scheme would require additional emissions tracking and programmatic controls be in place, but effectiveness of the overall programme and its ability to mitigate costs would be far less opaque, presuming proper oversight mechanisms are in place - which, based on recent events, is unfortunately not a safe assumption.

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