

Guest commentary

Time to rewrite the regulatory compact

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by **Rodger Kershner**

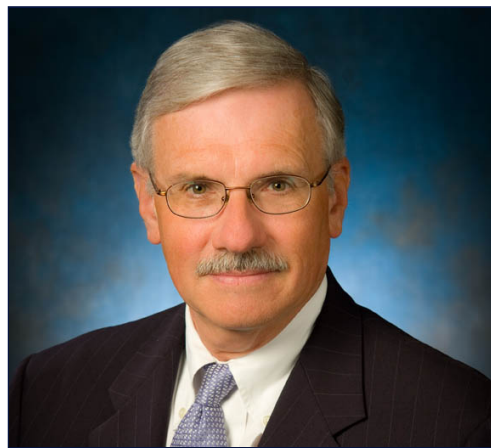


At a time when vitally important decisions are being made in regard to energy and the environment, Michigan needs to rethink its historic relationship to electric companies.

More than 100 years ago, when electric power for the masses was beginning to appear possible, the industry standard business model for electric companies had evolved around the idea of central power generating plants and large scale power distribution systems. Those infrastructure projects were hugely expensive. Understandably, investors were not enthusiastic about the capital commitments required for this construction without some demonstration of the investment's ability to generate revenue from electric customers. On the flip side, until the systems were constructed and in operation there could be no demonstration of the revenue potential of the industry. Railroads faced a like dilemma, ultimately solved by government grants in the form of free land to help finance construction.

Eventually, politicians and financiers together came up with a plan: by law, if utility companies invested money in their businesses, they would be guaranteed a monopoly over their customers, whom they could charge rates high enough to pay the utility a return on investment sufficient to attract all the capital they required.

This concept – sometimes called the regulatory compact – served its purpose to prove the viability of electric service as a business. These days, hundreds of companies



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operating without the benefit of the regulatory compact are lining up to build power plants, especially energy projects powered by wind and solar energy not favored by traditional utilities.

Under utility ratemaking principles used in Michigan and elsewhere, the only way utility investors can make money is by investing more capital, because every other expense of running their business is merely passed through to customers dollar for dollar. Those investments and returns are paid to the companies a tiny bit at a time with each kilowatt-hour of electricity they sell.

While the regulatory compact effectively solved the dilemma of getting utility companies to invest money in electric infrastructure, it created the fresh problem of getting them to stop.

Now we need to make decisions about what will become of existing infrastructure invested in by utilities with the understanding that they would recover the full amount of their investment, with an attractive return, in future electric rates. And we need to decide what investments will be made in new infrastructure, who will pay for them and how utilities will be compensated for whatever role they are to play in financing, building or operating those assets.

It should be clear that utility managers and directors are motivated by the regulatory compact to spend as much money on any new facilities as they can; in fact they may be legally bound to their shareholders to do so. It should also be clear that maximizing investment in new facilities may or may not be in the best interests of their customers from an economic point of view.

Even more important than the misalignment of financial interests between utilities and their customers is the simple fact that, in the main, nonfinancial considerations are not intended to figure into utility decision making. Global warming and the cost of curing people sickened by pollution have no formal place in utility or Public Utility Commission decision-making except to the extent that both groups are political animals and find it politically advantageous to occasionally say the “right” thing.

The bottom line is this: If we choose to let utilities make or even participate in making decisions that are so fundamental to all of our well-being, we have to take away their bias toward ever more consumption and investment. Rather than rewarding utilities for spending the greatest amount of money they can find justifications for, we have to align their interests with the rest of us. Let’s start right away to negotiate a new regulatory compact that will compensate utilities on the basis of minimizing energy use, reducing pollution and reducing reliance on energy sources that endanger people and the planet by the ways they are produced, transported and used.

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3 comments from Bridge readers.

Barry Visel

December 8, 2015 at 10:29 am (Edit)

Okay...good background. So, what's your proposal?

Rick

December 8, 2015 at 12:46 pm (Edit)

This is a good conversation starter. Yes, a new paradigm is needed. Business as usual won't work.

It would be nice if Mr. Kershner had laid out some more detailed thoughts (it appears he has the experience to make them) on what this 'new regulatory compact' would look like.

All I see now in Lansing is more the same old 'protect our monopoly' stuff and a legislature that will continue to play along and not think about the future or its citizens. Just campaign \$\$.

Charles Richards

December 8, 2015 at 4:19 pm (Edit)

Mr. Kershner says, "Under utility ratemaking principles used in Michigan and elsewhere, the only way utility investors can make money is by investing more capital, because every other expense of running their business is merely passed through to customers dollar for dollar." That is not quite correct. It would be more accurate to say, "the only way utility investors can make more money is by investing more capital." Investors are pretty much guaranteed a return on existing invested capital. There is no need to invest more capital in order for investors to secure an adequate return on existing capital. He is subtly misrepresenting the situation.

He is also being misleading when he says, "in the main, nonfinancial considerations are not intended to figure into utility decision making. Global warming and the cost of curing people sickened by pollution have no formal place in utility or Public Utility Commission decision-making" Has he forgotten the existence of the Environmental Protection Agency? Every utility has to deal with ever stricter pollution limits.