The Crossroads
Or
A Californian Looks at the New Regulatory Reality

Address of Commissioner John A Bohn
To the American Public Power Association
CEO Roundtable

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Good morning. Thank you for inviting me to appear on this august panel. I am a commissioner at the California Public Utilities Commission, one of five independent commissioners who regulate the investor-owned electric, gas, telephone, and water utilities of California. Today, in a very short period of time, I would like to discuss several regulatory problems from a slightly different perspective from that which we are used to.

Let's put our business as regulators in a larger context. We all are citizens of the wealthiest country in the world, one which depends on reliable, reasonably priced electricity to power its competitive engine. To generate that electricity, we use oil and gas from several nations around the world who sell us those commodities in exchange for photographs of famous Americans on green paper. They, in turn, trade those green pieces of paper among themselves and buy goods and services from us and others. We also use large quantities of indigenous coal, which is relatively cheap, plentiful, and under our control.

We are responsible to effect delivery of energy to our citizens. Our job is to set the prices and the terms and conditions of service under which our fellow homeowners, businesses, schools, and markets will operate. Moreover, imagine also that we are able to dictate policy, such as how much renewable energy our utilities must use, whether customers may choose alternative suppliers or alternative portfolios of electric generation sources, and how the utilities should deal with environmental issues, such as greenhouse gas. In a real sense, we have the power (and maybe even the duty) to “tax” the electric service customers in our jurisdictions to achieve the policy results we believe are necessary and correct.

Let’s make it real:

Our national economy is a little shaky. There are massive mortgage foreclosures going on against regular folks in our neighborhoods. Gasoline prices are the highest ever. Credit is tight, and consumers are hurting. Several large financial institutions have collapsed, and others are on the verge. School costs are rising. Jobs are increasingly hard to come by. The business community is clamoring for a better skilled workforce. The military, including men and women from our states and communities, is engaged in a costly global conflict. One result of that war is that many of those same folks who trade oil and gas for green paper don't like that green paper as much as they used to because there is so much of it, and it doesn't buy as much on the global market as it did. And, moreover, they don't like us much either. Finally, we don't have as much of that green paper as we used to, either.

Now, let's make it even more real:

A large and vocal group of our constituents have "discovered" a really big problem called "global warming." In the face of this "ultimate global peril," demands for action echo throughout the deliberative halls. Our legislators are falling all over themselves to get in front of the crowd to demonstrate leadership. Goals for conservation and renewables are set amidst thunderous applause, without regard to cost. Green is *in*. Coal, oil, and other dirty fuels are *out*. People go on line to buy carbon credits to assuage their consciences when they travel. Even the evangelists against nuclear power in California seem to have caught the fever.

If that were not enough, at the same time, the rest of the world has discovered that energy drives growth, and cheap energy drives it faster. Growth fuels public demands for more of everything. Fossil fuels drive production societies, and new and old coal drives power production for large parts of the United States and for most of the developing world. China continues to grow at 8-10% per year, building a new power plant each week while scouring the earth for supplies of oil and natural gas. India discovers that it is running low on electricity. South Africa simply runs out of electric power after a prolonged period of underinvestment intended to "keep the rates low."

So here we are with our hand on the purse while:

- The business community is screaming for lower energy costs so that it can survive against the competitive pressure;
- The rich seem to be very much richer, and oh, so progressive;
- The middle class are squeezed to the breaking point because of debts, mortgages, job flight, and feeling left behind; and
- The less fortunate fall further behind.

Your job, should you choose to accept it, is to make the electric utility system work, to provide reasonable rates that permit competitive growth while assuring reasonable returns on needed capital. All this must be paid for by someone, by the ratepayers, or by the taxpayers.

At the same time as all this is going on, some electric utility customers want to buy their own power separately from their utility, *i.e.*, they wish to reopen what we call Direct Access. Others want to opt for Community Choice Aggregation, create citizen owned distribution systems that will, so it is alleged, keep the rates down, make prices more competitive, and make the utilities more cost effective. Salvation in a box, as it were. Except that it is not quite that simple, as you already know.

Finally, at same time as you are doing all these things, there is another group of utilities that, for some reason, seem to have different dynamics. They are keeping their heads low as they try to avoid some of the costs that the customers of your utilities must bear. Their carbon footprint seems to be as big, or bigger, than the utilities under your jurisdiction. Moreover, they are closely interspersed among your utilities so that any rate disparities are immediately apparent. These are, of course, the municipal utilities, and the cooperatives, and the irrigation districts. Yet the outlook for both sets of performers is, I suggest, the same. The legislature has treated them differently. Why? And how do we reconcile these actors in the greater interest?

Current Dilemmas of Regulation

Keep Prices Low – or Promote Goals?

It is a fundamental point of regulation that we are here to monitor the costs of the electric utilities, and to keep costs, and hence rates, low. Yet we increasingly add goals to our policy discussions. To the basic goal of reliability we have added availability, environmental stewardship, and global competitiveness among others. Though the rich may be able to afford higher rates – and they may even *favor* higher rates if the result will be more conservation and a cleaner generation portfolio – I do not find that the rest of the customers are clamoring for higher rates! As early as 2000, for example, residents in California were paying rates 60% above the national average for IOU's, and that was before the current tiered rate structure went into effect. The ratio is higher now! But the economists tell us higher rates will lead to more careful consumption patterns, more installation of energy-saving devices, more installation of home solar systems, and all the other things that are desirable, and even necessary, for us to meet the legislated greenhouse gas targets. Moreover, those same high rates are necessary to pay incentives to promote the installation of these same devices, subsidize the less fortunate, and of course, move us away from dependency on those folks who don't like us so much.

I submit it to you: these goals are fundamentally inconsistent. Rates must and will go up if we persist.

What are People Buying in Electric Service?

Here is a second problem, or, at the least, a second way of looking at the problem of greenhouse gas and global climate change.

Electric service, gas service, water service, mostly cost money because of the handling of the product. That is, most of the cost of electric service is related to digging the coal, mining the gas, burning the fuel in power plants, transporting it across the miles over transmission systems, distributing it at lower voltages, reading the meters, and sending the bills. Compared to all of these costs, the cost of the actual fuel is modest. Some forms of fuel, such as sun, wind, and falling water, are actually free.

Now, with our self-inflicted concern over the greenhouse gas problem, something new is about to happen: We will have to pay for the privilege of putting into the air a substance that has always been there, that is necessary to life, and is omnipresent in the process of conversion of fuel into electric power and energy. This is a new cost, never before collected from customers. It is in a sense the "dues" required to belong to the club. But the dues are not uniform or even predictable. And club membership is not voluntary.

We Americans, not just Californians, but all Americans, are willing to assume the burden of fostering a clean environment. Few nations have done as much to make sure that when we use resources, we clean up after ourselves.

But neither we nor anyone else in the world has ever had to pay for the privilege of putting a non-toxic naturally occurring substance into the air. Now, we will. The process of making the payments could take many different forms:

- It could be a direct cost, such as a carbon tax, though let the record be clear that I do not advocate this solution;
- It could be in the form of a cap & trade system, which has the effect of putting a shadow price on electric generation. Either you cut back, or you pay. Either way, it is a price that cannot be avoided;
- It could, and undoubtedly will, be in the form of alternative generation mechanisms, such as solar power, that are far more costly than conventional

generation, and that may have other environmental costs of their own. In California, for example, we wish to build wind farms in remote parts of the state where there is no electric load. To use the power, we must build transmission lines, sometimes across pristine areas, and at great expense; and

- It will certainly take the form of inconvenient and expensive mechanisms to reduce load, conservation, changes in use patterns, and a host of other processes foisted upon us by legislators and commissioners. Time-of-use pricing, increasing-tiered rates, critical-peak pricing, penalty rates for so-called "overconsumption," are examples of what lies before you.

Regardless of the source of the cost, all of these are costs that cannot be avoided, and they all trace to the cost of using the fuel itself in natural and ordinary ways. These are not the kind of costs customers have endured over the last one hundred years. And customers are NOT going to like it when the bills start coming due.

How Should We Organize the Industry?

In every part of our lives we cherish the ability to make our own decisions and to keep our options open. But in the case of utility services, we have relied upon the theory of natural monopoly to insist that all people buying the service must buy from the one assigned natural monopoly provider, whether it is an investor-owned utility, a cooperative utility, or a municipal, or other governmental utility. For most of the last hundred years, that has been the natural way. But there have been examples of serious abuses and high costs.

Moreover, over the last few decades we have seen in many other industries changes in regulation, generally with extremely positive outcomes. Airlines, commercial trucking, railroads, and telephone service, all became competitive industries in the last third of a century, and despite some hiccups, all are far more efficient industries, with more responsive providers and relatively lower costs, than they were in their previous regulated incarnations.

It is only natural that the same forces that brought us so much good results in these areas would be at play here, too. Still, as you know, California made a botch of its restructuring process in the 1990s, and now we find ourselves in a sort of "suspended animation" with a hybrid system.

My natural inclination is to favor competitive systems over regulated systems wherever they are possible. I just do not know whether it is possible to have a competitive electric service industry in today's circumstances.

I can imagine an outcome that provides for customer choice among SOME customers, but not all. Perhaps it will work like this:

- Large customers, electric service users that are capable of assuming their own risks, and are willing to make choices AND assume the risks associated with those choices, could be offered the choice to take direct access. In doing so, they would be saying good-bye to regulated public service. In particular, they would be forsaking the opportunity to rely on the public utility's system of regulated service for some very long time period, such as a rolling five-year period. If for some reason such a customer wished to resume utility service, it would do so as a marginal-cost customer, ineligible to take advantage of regulated cost averaging for the duration of the lock-out period. Good public policy?

- Small customers, including residential customers and other "core" customers – the people who rely most on the protections afforded by regulation – might not be offered the opportunity to choose alternative suppliers. Instead such could be offered something different, such as the choice of portfolio within the utility's service. I imagine, for example, that customers could be offered "standard" service, or "greener" service, and maybe "very, very green" service. But because utilities have to plan ahead, and they have to purchase resources on a forward basis, even core customers would be required, once they signed up for anything other than "standard" service, to stick with it for some reasonable period of time. That way, customers who enthusiastically sign up for the greenest service, upon experiencing buyers' remorse, would not be able to stick the rest of the customers with the high costs they personally required the utility to accept. Good public policy?

- At the end of the day, all customers, whether engaged in Direct Access or not, whether Core or not, would still have to support the utility's infrastructure for transmission and delivery of service. All customers would still have to support the required programs of the PUC, including sharing in the costs associated with low-income tariffs and the like. And all suppliers would have to meet the minimum environmental standards set out by legislative and the regulatory authorities.

The Real Challenge – Organizing for the 21st Century

Finally, I would like to offer some thoughts about how we go forward. First and foremost, we must understand that our real problems cannot be solved locally. Regulators of investor-owned electric utilities must work with the regulators of the government-owned utilities if there is to be any hope of cost moderation. Recently, I spoke before the organization of municipal power agencies in Northern California. At that time, I introduced myself by saying that my agency regulates only the investor-owned electric utilities. *"All of you,"* I said, *"are NOT regulated by the CPUC, and for that you may be grateful."* That line was especially well received.

Though I was joking, there is a serious point. There are good arguments in favor of local control, and as a Republican I usually make them. Yet, I wonder how well it works for public policy purposes in the current circumstances. Regardless of the form of regulation, in the future there will have to be more coordination among the various energy providers at the state level. We have entered an era of complex global competition, new kinds of nationalism, and, at the same time, broad environmental and social reevaluation. Questions of what types of resources will be allowed, what types of incentives customers should face, how we will face the negative consequences of fuel cost changes and potential climate change, whether we will favor large centrally operated load areas or local systems, whether we want efficient (large) power plants away from people or local (small) plants close to load centers, these are questions that go beyond local jurisdictions, that stretch beyond the service territories of individual utilities. These are problems that need state-wide and national answers if we are not to erode the global competitive position of the United States.

In saying those words I may ignite a storm among you. Still, consider for a moment the types of problems we confront today, and think about how many of those problems are even <u>manageable</u>, never mind <u>soluble</u>, at the local level.

Municipal agencies in California have a great fear of the CPUC, and with good reason. I suspect the same is true in most of the other states. Still the future of California is not just the future of the IOUs – it is the future of the public agencies, too, for even though they are not regulated by the CPUC, they are still responsible to the legislature and to the general thrust of California policy. And, let me add, there is a limit to the tolerance of ratepayers and taxpayer for experiments at their expense.

Let me conclude: It is a new game for all of us as regulators, with new rules. The stakes are high and the arena is global.

This is not true only for California. Everywhere across the USA, there is a need for more coordination of policy and, ultimately, authority and enforcement. But wise leadership is not necessarily popular leadership. I like to think that we are heading in the direction of wise leadership, so we should take every opportunity to talk with each other and check in on how we are all doing. Maybe we, who are closer to the people, and to the problems, need to lead our leaders.

It has been a pleasure to be with you.