

PERSPECTIVE

BOUNDARY ISSUES— THE “OBSCURED” REGULATORY CLASH

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As the U.S. power industry adjusted to the changes brought on in the mid-1990s, little did they anticipate that a decade later they would be embroiled in one of the oldest power struggles in our country's history: a jurisdictional regulatory clash.

The array of issues and challenges faced by the energy industry over the past ten years has been unrelenting. As retail energy consumption continued to grow rapidly, supply and transmission capacity margins shrank with waning or stagnant utility infrastructure investment, which was deferred at the time under the “clouds of deregulation.” Today, with a declining generation reserve base and many economic plants running at maximum capacity, rising demand and energy usage can no longer be satisfied with the “quick” installation of peaking. Baseload capacity is the necessary prescription.

Baseload generation development, however, faces many risks and much uncertainty, warranting significant attention by the power industry. These include:

- Rising construction costs, which are driven by labor and material shortages and exacerbated by the many years of minimal baseload development

- Environmental regulations, driven by public opinion and debate (e.g., carbon), with minimal consideration for increasing production costs and reducing power available at the busbar

- Renewables standards

being legislated by many states, some without regard to regional portfolio limitations (i.e., lack of renewable sources in the Southeast) or the long-range economic viability of technologies in “infant” R&D stages

- Aging workforces, threatening a utility's knowledge retention and creating potential reliability concerns for generation, transmission, and distribution functions

- Unprecedented world fuel demand, changing fuel price dynamics and the security of long-term utility fuel choices (e.g., EU market prices attracting LNG previously destined for the United States; more coal imports to EU to counter rising gas prices; China is now a net coal importer; nuclear resurgence is stressing “yellow cake” market supplies and prices).

The effort exerted by the power industry—as it grapples with these challenges and their long-term implications for reliability, cost, and customer satisfaction—obscures a more fundamental energy market “clash,” with particularly ominous implications to power industry investment recovery: the brewing conflict between state and federal government regulation.

THE “OBSCURED” REGULATORY CLASH

The balance of power between the state and the federal governments is a conflict that predates the Constitution. Historically, with the FERC regulating interstate transactions and states

regulating activities “inside their borders,” a degree of balance between these powers prevailed in the power industry. That uneasy sharing of regulatory power, however, is changing.

States are making incursions into traditional federal regulatory territory to achieve their policy goals for renewable generation and carbon emission reductions. In particular, some states are forming regional alliances to implement coordinated, multi-state standards and policies for meeting these goals. These policies are intended to achieve multi-state benefits in greenhouse gas emissions without ceding control of traditional state regulatory objectives, such as cost control, reliability, and economic development. Two examples of this activity include:

The Regional Greenhouse Gas Initiative (RGGI), which requires ten northeastern states to reduce greenhouse gas emissions. While each state will issue its own regulations, each is required to meet specific obligations; it also includes provisions for its own cap-and-trade program.

The Midwestern Regional Greenhouse Gas Reduction Accord, which was signed by the governors of six states and one Canadian province. Under this agreement, members make a commitment to reduce total energy consumption 2% by 2015, increase gas stations offering ethanol to 15%, and satisfy a region-wide renewable energy standard of 10%. The accord also calls for the developing a cap-and-trade mechanism

for greenhouse gases.

Likewise, the federal government is attempting to achieve its policy goals for robust, open energy markets and energy security by increasingly exerting its authority to direct investment in emerging supply and delivery technologies. This new federal authority is stepping into regulatory territory traditionally reserved for the states. Examples include:

NATIONAL INTEREST ELECTRIC TRANSMISSION CORRIDORS

The Department of Energy (DOE) has designated two transmission corridors: one in the Mid-Atlantic and one in the Southwest.

In the DOE's words, “now, more than ever, we must look at electricity generation from a regional and national perspective.”

THE ENERGY INDEPENDENCE & SECURITY ACT OF 2007

This act established a Smart Grid Advisory Committee to advise in part on the national transition to smart grid technology and services, including practical standards and protocols that ensure interoperability and inter-communication among smart grid devices. In addition, it is charged with developing techniques for measuring peak load reductions and energy savings from smart metering applications, demand response, distributed generation, and electricity storage.

By designating specific locations for these corridors and claiming the authority to take action if a state fails to act in a timely manner,

the DOE assumed a role traditionally reserved for state public utility commissions. Its defining resolution (i.e., federally approved transmission development) attempts to side-step state-level concerns. Ed Rendell, governor of Pennsylvania, stated, “This designation and action by the federal government is a blatant abuse of states’ rights....”

This crossover of regulatory authorities into each other’s sphere of influence sets the stage for a debilitating period of regulatory battles that pose significant risks for the power industry. Desperately needed rate cases and major project approvals could become bargaining chips between the regulators, which would significantly delay needed funds and projects. Also, the industry’s capital market access could contract significantly, due to the real threat of deferred investment recovery or outright disallowance. Caught in the middle of this fight—with rising construction costs, shrinking reserve margins, a dizzying array of new regulations, and limited capital—the power industry and its customers could suffer greatly. Here’s the good news: regardless of how the regulatory battles are resolved, there are actions that power companies can take now that will/can/would

benefit all stakeholders in the industry.

NO REGRETS IN A WORLD OF REGULATORY IMPASSE

First—and most importantly—utility management should recognize that traditional supply planning methods that rely solely on additional baseload generation to meet growth needs is a “non-starter” today. Although there will be cases where baseload generation is developed, high operating costs and investment risks, perceived negative societal implications, and emerging federal and state regulatory policy trends cited above will force baseload to take a “second seat” to renewables and other new market-side alternatives. Utility executives who choose to adopt these new options are likely to receive more favorable rate treatment, ensuring cost-effective customer service and operations while better securing investment recovery for shareholders.

Second, utility management should take deliberate action to prepare for and adopt emerging smart grid technologies. Managing both sides of the energy supply and consumption equation—which will delay the need for additional generation resources—will

be crucial. Federal and state authorities consider these “enabling” grid-level technologies top priorities for solving many of the long-term risks and uncertainties identified earlier, suggesting favorable rate treatment for these assets. Additionally, capital markets are likely to view this as the “safer” infrastructure investment (e.g., no carbon exposure) with significant sustainable value. As new supply and end-use technologies are adopted by leading companies, smart grid technologies will form the hub that enables robust power grid management, promotes reliability, and enhances cost management.

Third, the power industry must work even more closely with its regulators, communities, capital markets, and stakeholders to demonstrate the real economic impact of new regulatory priorities (e.g., carbon). When policymakers combine careful analysis with new customer and regulator expectations, balanced decisions have a much greater chance to prevail. This was demonstrated in the Arkansas PSC’s recent approval of SWEPCO’s proposed John W. Turk coal-fired power plant. Even though it required significant environmental impact mitigation measures, the PSC said

that, “...the economic need for the facility outweighed local environmental concerns as well as concerns related to the potential regulation of carbon...”

In this emerging state of the world, the traditional supply curve has been significantly modified. Instead of minimizing \$/MW or busbar energy costs, the new objective is to minimize new construction footprint and all types of emissions. How? First, utilities/power companies must pursue baseload generation alternatives in conjunction with deploying smart grid technologies that coordinate supply- and demand-side energy operations. Second, they must consistently demonstrate “sound and familiar” economics leading to “balanced energy choices. In doing so, the industry will continue to thrive under whatever regulatory structures are ultimately adopted.

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