

## **MONOPOLY AND REGULATION IN CONTEXT**

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I've been asked to talk about how the job of utility regulators is changing. I was eight years a regulator, so this is something I should be able to do. But as perhaps a couple of you in the audience know, before I was a regulator, I was a writer and a journalist, and before I did that, I was on a trajectory to obtain a Ph.D. in history—my specialty was the British Empire. And while I have never subjected an audience to my view of how this might be relevant to utility regulation, I intend to do so as you make your way through your lunch. Truly, either you listen to this, or you go hungry—am I right?

Today, I hope to discuss how certain corporations came to be chartered monopolies by looking to the first example thereof.

#### **LEGAL ORIGINS OF MONOPOLY**

Today, there exists a distinction between government commissions regulating, and big corporations undertaking, the special projects of government. This distinction did not exist in the 17th century. Beginning then and extending into the 19th century, English and then British history is filled with examples of government-sanctioned trade monopolies—most famously the East India Company, which was founded in 1600 and became a formal monopoly in the early 1700s.

All told, this is a history of extraordinary legislative delegation. Some of my colleagues on the political right have objected to the 'deep state,' the power of bureaucracies and the tendency of Congress to abdicate its function to other agencies within government. They frame this as a new phenomenon. It is not—and indeed, the delegates that Parliament vested with sovereign power throughout British history were far more tyrannical than even the most audacious federal or state agency today.

The East India Company, delegated its powers by Parliament, literally ruled India. One can understand the company both as a government agency and as a corporation. A power unto itself, the company was reined in by formal government only periodically. The 1780s saw the impeachment of the man who was essentially both the chief executive officer of the company in India and the governor of the possession: Warren Hastings. After Hastings was impeached in the House of Commons, Edmund Burke, the eloquent member of Parliament for Bristol, led his prosecution before the House of Lords. But Hastings was acquitted after a yearslong legal proceeding. Compared to the Hastings proceeding, the Mueller probe looks relatively modest.

It was only in the 1850s—after a century in which the company was in power in India—that India became a formal colony and an integral part of the British Empire. From that point until India's Independence was a shorter time than when the company ruled under delegation.

The most storied American utilities have nothing on the East India Company. It exercised what we would now recognize to be a quasi-legislative and a quasi-judicial function, in addition to its role as a corporate principal in trade itself.

This was the high-water mark of legislative delegation in the post-Renaissance English legal world—and America really did not see anything like it during the early days of the Republic. Indeed, America’s founders hated this kind of thing, because it meant that an accountable government had delegated to less accountable parties both the balancing act and the discretionary judgment that representative government requires. After American independence, only modest delegations of legislative power to get big things done occurred—for example, the creation of the Erie Canal Commission, an early ‘public-private partnership.’

That’s where this history ended—at least for about a century, until the dawn of the Progressive Era. The technological changes that occurred during the late 19th and earlier 20th centuries were arguably more profound than those of the digital age we are witnessing today. I realize we are all buried in our smartphones, but which is more revolutionary: a world before and after electricity, or a world before and after Uber?

In America, mere decades after the advent of the technologies, government had sanctioned electricity and communications monopolies. This period either caused or coincided with—depending on how you look at it—a theory of government that championed technical expertise in administration. Technocrats like Woodrow Wilson and then bureaucrats like Franklin Roosevelt believed that only a significant delegation of legislative authority to third parties was practical in this New World Order. State legislatures and Congress, these progressives were convinced, were not up to the job of regulating the pace of change.

While we think today of the Legislature delegating its powers to an agency, it is just as appropriate to conceive of this delegation occurring both to a company and to an agency. The Britons who grappled with the East India Company would certainly have had this in mind. And that remained true in the early 20th century and still remains true today, in our recognition that certain chartered corporations, such as electric utilities, enjoy certain powers of the state—eminent domain being the most notable among them.

So what utility regulation *really* is consists of a dual delegation: the delegated power, held by a corporation, to exclude potential competitors (along with the right to an opportunity to recover investment in providing service to franchised customers); and the delegated power, held by a governmental agency, to approve rates and terms of service.

This delegation wasn’t as grand as the powers given to the East India Company, but it was (at least outside of wartime) as broad a delegation of legislative authority as exists in American democracy.

### **WHAT IS PUBLIC UTILITY REGULATION?**

Nearly all the statutes that govern modern utilities use identical language: that all rates charged must be “just and reasonable.” After several theoretical battles about what this meant, it ultimately came to mean “cost of service”—the actual costs, plus a return of and on a utility’s invested capital, together with two sieves to disallow costs. Capital investments must be found “used and useful” before they may command a return. Operating expenses must be “prudent.”

These terms are purposefully vague. Let's take a run at "prudent," shall we? In 2016, Montana's largest utility brought suit against the Montana Public Service Commission after the commission disallowed costs related to a power-plant outage. Montana's Supreme Court, affirming the Commission's decision, wrote:

The meaning of "prudent" is largely self-evident. Absent statutory definitions, the plain meaning of the words used controls. The word has been applied in prior Commission decisions, which have used such terms for "prudent" as "marked by wisdom or judiciousness" or "circumspect of judicious in one's dealings" and its synonyms are "careful, cautious, sensible, practical, discreet, wise and farsighted." The Montana Legislature gave the Commission express latitude to determine if the given costs were prudent—careful, sensible, practical, discreet, wise or farsighted or, more apt in the regulatory environment, avoiding unnecessary risks—through its own fact finding and administrative authority. (Internal citations and punctuation omitted.)

Glad we cleared that up!

The ambiguity of the defining terms in public utility regulation serve the purpose of maximizing the delegation of power, allowing a commission to act as a mini-legislature and an ex post trier of fact.

The broad language is tempered by another concept: that anything filed by the other delegee of governmental authority—the utility itself—within a zone of reasonableness should be approved. After all, if "just and reasonable" is vague but the utility possesses the right to file a tariff of its choosing, then applying the standard could mean wide latitude to the utility. In the current mode, where we often think of utility regulators not as exercising their own quasi-governmental function but rather as governmental, and utilities as put-upon by government, this means, as often as not, that a utility whose filing meets the 'laugh test' gets its application waved through.

This was not necessarily a problem in utilities' early days. For many decades, more customers and more demand per customer allowed utilities to grow rapidly without increasing rates considerably. To put it another way, the twin delegations were aligned in the public interest: Because in some sense the utility industry is a natural monopoly, its costs have a declining marginal cost curve, and so as long as sales are growing, reliability and access to energy may increase even as the service remains affordable.

That norm did not last as, like much of the consumer economy in the 1970s and 1980s, growth slowed and the utilities ended up over their skis. It was at this point that utilities, possibly for the first time in their existence, actually faced a major disruption.

### **THE RATE BASE INCENTIVE**

During this era, many capital projects were discontinued, and the two delegees of government—commissions and corporations—were suddenly not aligned. Some of the largest states restructured their industry in fundamental ways.

What did not change, however, was the basic model of monopoly regulation—which is to say that a monopoly, whether vertically integrated or restructured, was regulated on a cost-of-service basis. This meant that profit continued to come from one of two things: First, from operating cost reductions between rate-setting intervals (however, with less sales growth, more rate cases meant that this could not be as much of a profit center as it had been); and second, from additions to a utility's 'rate base'—a byword for the total amount of capital invested—which produced a return on the capital invested.

This second item has become substantially more influential in modern utility regulation. And there is a relatively simple explanation as to why: The returns on equity, or ROEs, that regulatory commissions authorize are likely to be significantly more than the true cost of capital.

Even as customer growth has slowed, ROEs have accelerated. In the 1980s, when growth first slowed, the difference between the risk-free-rate of U.S. Treasury bonds and utility ROEs sat at about 200 basis points—that is, 2 percent. From that point, more and more tracker and pass-through mechanisms have ensured that utilities do not actually face the under-recovery risk or the cash-flow lag they once did. Arguably, these firms have become less risky than they were several decades ago; yet the differential between authorized ROE and long-term Treasury bonds has tripled since then, with authorized ROEs returning 600 basis points more than the risk-free rate. There are several minor reasons why utility stocks might trade significantly above their book value—which is to say, their rate base. But the only one that really explains the two-, three-, even fourfold multiples over book value in current utility stock prices is that authorized ROEs substantially overstate the actual cost of capital. This phenomenon creates a huge incentive to grow a firm through rate-base additions, which have less to do with sales growth but everything to do with increasing the portion of each kilowatt-hour sold that is attributable to capital investment.

This sits uneasily with a utility system whose major efficiencies may be associated with ‘software’—and not ‘hardware’—improvements. We have created a regulatory model that is hostile to utilities that might rely on third-party solutions and self-supply if they risk offsetting the possibility of utility-owned solutions.

Putting aside how you *reward* capital, there is also the question of how to *evaluate* the capital that is proposed for rates. Previously, utility commissions and utility corporations might have been relatively well matched on questions like this. After all, “used and useful” is easier to apply to questions such as Power Plant A versus Power Plant B: Either the plant is or is not operational, either it appears economical or not compared to the alternative. But other capital items that appear necessary to some degree, such as spending on cybersecurity and physical security, are more impervious to this analysis. Other capital investments are driven by nebulous public policy—for example, what is the optimal amount of electric-vehicle charging stations a monopoly utility should provide versus the optimal amount that a more-free market version of service stations should provide?

Put simply, the public purpose of utility regulation once meant solving for two variables—affordability and reliability (in addition, of course, to obtaining service in the first place).

Yet regulators are now being asked to explicitly or implicitly solve for many, many more variables, including environmental impact, public safety, national security, customer empowerment, social justice and economic development. These variables trade off against one another: Do we really expect utilities and their regulators to solve for all these variables in a rational way?

If the question is whether these problems can be solved by capital deployment, clearly the regulated utilities will answer “yes” in the current ROE environment. So, too, do certain regulators have certain individual motives: They want to pitch in to solve climate change, or cut the ribbons of new investments, or make sure that severance payments flow to communities affected by coal closures. But when do we reach a point where we question whether the broad delegation that utilities and their regulators enjoy is being abused?

In my view, many of these issues are fundamentally not problems we should expect utilities and utility commissions to solve. A good example of a problem we should expect them to solve comes from environmental regulation. The Environmental Protection Agency's standard-setting process has been a remarkable success for things like acid rain. But it worked because the EPA established the standard—constraining economic productivity that, left unchecked, would have negative social consequences—and because utilities then incorporated those costs that economic regulators and commissions allowed them to incorporate. If we ask utility commissions to solve this problem, they will be wearing at least two hats: one in which they are charged with keeping rates reasonable, but also one in which they must undertake environmental regulations that may strain that proposition. Asking utilities and utility commissions to solve additional public policy problems is really asking them to become mini-legislatures on energy policy. In this case, they would exercise a considerable power already delegated to them by ambiguous language, but applied to a wider ambit of topics. Do we really want an East India Company for the American energy economy, a state within a state convened for the purpose of resolving energy policy questions?

### **PERFORMANCE-BASED REGULATION**

In my view, we should leverage utilities for social good, as the core meaning of the word 'utility' implies. But if we are going to do so with respect to variables other than cost or reliability, we should be more conscious about what we set these utilities out to do. And in doing so, we should first constrain the problems with the cost-of-service regulatory model, which is misaligned to the state of the economy.

In a perfect world, we would hold a reverse auction every few years where companies possessed a franchise on a utility's physical infrastructure for a time—let's say 10 years. Bidders would be asked to submit either a revenue requirement or a rate for the period of service, and the lowest bidder would be selected as 'the utility' for that period. This would recognize that what we are dealing with is indeed a natural monopoly while also introducing competition into that natural monopoly function.

However, we don't exist in that world. Utilities own their property, and while regulation may influence its value and cause it to be worthwhile (or not), for the present owner to continue its tenancy, the above solution would operate as a kind of dispossession.

What we *can* do is have a multiyear rate-setting where a utility exists within known rates for a predefined period of several years and where part of its ROE is up for grabs as a function of prespecified performance, or where the utility receives a bonus for performing on certain additional tasks it would not otherwise be obligated to perform.

The United Kingdom—through its version of utility regulation—already does this, holding utility rates to economy-wide measures. And it does a much better job at establishing a regulatory return close to what investors minimally demand. The company's U.S. operating company is proposing one of the most cutting-edge rate cases in this regard this year in Massachusetts. Everyone should pay attention to it.

Meanwhile, utilities elsewhere in the United States—including those in Utah—should understand that an opportunity exists not to play the constant 'Mother May I?' game with regulators, but to act like real businesses.

If we are going to tolerate the supra-normal returns that appear to exist almost everywhere in American utility regulation, we should at least tie some of that return up in the accomplishment of other goals—whatever policies a legislature might choose—but ones that are clearly defined and only then delegated.

Thank you for the opportunity to speak to you today. I would be happy to take a few questions.