

Utilities and Disaster:

The Regulatory Compact
Meets the Social Contract

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Disclaimer

Nothing in this presentation reflects
The official views of anyone I have
ever spoken with or worked for in my
life. I currently have no Louisiana
clients.

Questions

- Appropriate post-disaster relief for regulated utilities?
 - Comparison with unregulated firms
 - Size? Discretion in use? Special uses permitted for utilities?
 - What is basis for possible distinction?
 - Nature of industry's products?
 - Size of investment requirements?
 - Regulatory treatment of utility costs and profits?
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Social and Regulatory Contracts: Grounds for Conflict?

- Social contract: liberté, égalité, fraternité
 - Agreement re equality before law, freedom
 - Representative government defines property and personal rights
 - Legislation may include redistributions for valid purposes, such as disaster relief
 - Horizontal and vertical equity
 - Regulatory compact (Contract): assigns special rights and obligations to utilities
 - Used to rationalize stranded cost recovery
 - Any resemblance of disaster-caused losses to stranded cost?
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Why Care?

- Vigorous debate over amounts and types of disaster relief for utilities, but little discussion of principles
 - Not intended as a factual discussion of Louisiana
 - Decisions with national impact
 - Affect substantial amounts of resources
 - May provide precedents for future disasters
 - Important recent changes in legal understanding of regulatory relationships
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The Rise of the “regulatory compact”

- ❑ Law, politics, or economics?
 - ❑ First identified in print in 1980s
 - ❑ Advocates claim an implied contract among utilities, public, and regulators
 - Unlegislated, but said to be in case law
 - ❑ High point for advocacy: Sidak/EEI 1996
 - Case-based rationale for recovery of stranded costs and economic argument for its efficiency
 - Proposed as justification for broader range of regulatory policies
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The fall of the regulatory compact I

- Massive rejection of logic and relevance in post-1996 legal literature
 - No usual elements of contract – offer, acceptance, meeting of minds
 - Inappropriate metaphors re legislature and regulators acting on behalf of absent parties
 - Remember Sam Insull
 - Public is 3rd party beneficiary being asked to pick up costs
 - Consensus emerges that legal risks are of same nature as other risks facing utilities
 - Technological change?
 - Disaster risk?
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The fall of the regulatory compact II

- Does “prudent” mean approved by regulators?
 - Informational asymmetries between utilities and other parties to compact
 - Principle: Generally interpret ambiguity or incompleteness in contracts with government against the private party
 - “Unmistakeability” doctrine
 - U.S. v. Winstar (1996)
 - No utility ever took a stranding case to court using compact as rationale
 - Instead, they argued takings
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Let's Assume the Compact Really is a Contract

- "Law and economics" approach: contract should maximize joint gains of parties [efficiency, not distribution]
 - Including costs of transacting, handling risk
 - Incompleteness: Court infers provisions parties would have agreed to if contingency anticipated
 - Efficient risk allocation: assign risks to party that has the lower cost of preventing or insuring against them
 - Whether market insurance or self-provision
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Comparing Risk-Bearing Ability

- Re stranded cost and its risks, the regulatory compact is an incomplete contract
 - No evidence public agreed to bear stranding risk
 - Utility often better risk predictor than public, service obligations include anticipation
 - Weather, climate change, outages, lawsuits, technology
 - More experienced in insuring / reinsuring
 - Knowledge re self-protection of assets
 - Customers cannot diversify among power sources, utility shareholders can diversify among investments
 - Ownership / decision-making conflicts
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Are Disasters Like Strandings?

- Prudent unregulated firm insures or self-insures as necessary
 - Unavailability of some disaster insurance a fact of life, raises expected costs and motivates self-protection
 - Insurance generally recovers replacement values net of co-pays, deductibles, etc
 - Prudent regulated firm does likewise
 - Asymmetry of information vs regulators and public often leaves it best at cutting risks
 - And best to decide on insurance coverage, if any
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Losses of Customers

- Losses due to competition vs. departures
 - Business better than customers at prediction, asset disposal / downsizing
 - Unless they have contracts, vanished customers cannot be sued
 - Did vanished customers breach regulatory compact?
 - If so, who should bear risk of revenue shortfalls?
 - Remaining customers probably poorer predictors of depopulation and have higher cost of mitigating supplier losses
 - How about non-customers in other locales?

Mitigation: Incentives and pitfalls

- General contract duties to mitigate losses
 - For uninsured losses, utilities have ratemakings as backstop
 - Quick rate adjustments v. incentives to mitigate
 - Disasters offer new opportunities for revenue from non-customer sources
 - Can regulators anticipate this?
 - Asymmetric information between utility and regulators a bigger problem after disasters
 - Holding companies and ring-fencing?
 - New York delays in allowing 9/11 recoveries
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Back to the Social Contract

- With notable exceptions, people are nicer after disasters
 - Often consistent with self-interest rather than altruism
 - But there's some competition among donors, recipients, public officials
 - Private and public wealth to be allocated to individuals and businesses on their merits
 - Utilities are businesses and shareholders are individuals, neither distinguishable by their regulated status as special cases
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Summary

- ❑ The regulatory compact is at best a questionable doctrine
 - ❑ More conventional notions of social agreement argue for symmetric treatment of utilities and other entities
 - ❑ Economic models of contracting provide principles for efficient assignment of risks
 - ❑ These models provide few rationales for shifting disaster-related risks to customers
 - ❑ Importance of utilities may warrant different amounts of relief, but regulation does not warrant different types of it
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In closing...

- Politics as a determinant of who pays and receives
 - Don't like it? Think North Korea
 - Utilities' cases for relief must stand on merits, not compact metaphors
 - There is a near-total lack of research on how regulators should monitor utilities' disaster recoveries and the proper scope of this activity
 - No stranded vengeance: Disaster must not become a rationale to retaliate against utilities for past behavior
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