The Regulated Utility Industry Has Too Many Revenue Guarantees

Utility rate cases before state regulatory bodies frequently contain proposals for automatic recovery of certain costs. These proposals emphasize a fundamental flaw in the whole concept of political regulation. Price and revenue regulation for utilities is based on the idea that costs determine price. Under state regulation all costs are added up, and a profit allowed based on investment requirements.

This is very different from actual market conditions where consumers set prices for goods and services by their willingness to pay. In the free market, sellers control their costs so they both make the sale and make a profit. In other words, in the nominally unregulated sectors of the economy prices set costs, not the other way around as utility regulation tries to do.

The granddaddy of all these was the fuel recovery mechanism instituted decades ago. The utility industry said it had no control over the cost of coal and so wanted a cost-pass-through provision in the regulation of their revenue. Their success in getting this arrangement led to the idea of other special cost recovery rates, most recently in the automatic recovery of the cost associated with financing nuclear generating facilities while under construction. Many regulators have allowed the separate recovery of the cost for environmental compliance, other approved capital expenditures, the cost of energy efficiency rebates, and under earnings.

In a market setting it is the threat of losses and the incentive of profits that causes an enterprise to cut costs and operate efficiently as consumers punish every business that provides a bad product or service. They also spread the word about bad companies to other consumers. Many consumers will even refuse to do business with companies that harm the environment. This form of regulation is enshrined in the phrase "the customer is always right."

Because of the customers, investors and lenders also regulate business owners to protect their investments from potential retaliation by dissatisfied customers. Sometimes this regulation involves direct oversight, sometimes the purchase of insurance.

Unlike the politicians and bureaucrats, insurance companies have their own money at stake motivating them to regulate the companies they insure. One such approach is product-testing through organizations like Underwriter's Laboratory. Insurance companies will only cover products that test safe.

Legal liability also regulates businesses. This liability is determined through due process in a government court, but it differs from government regulation in a crucial way. Government regulation attempts to prejudge which products and services may be harmful, and to dictate how this danger must be mitigated, in advance.

By contrast, legal liability presumes that a product or service is innocent until there is evidence of harm. This is the commercial equivalent of the principle we know so well from our criminal law: innocent until proven guilty.

It is a myth that a completely free market is also completely free of restraint. A free market actually has multiple levels of voluntary regulation. In fact, it is inherently impossible to have an unregulated economy, for the simple reason that consumers, investors, lenders, and insurance companies will always take steps to control or regulate what businesses do**.**

Automatic cost recovery undermines these incentives. State regulators are known for their lackadaisical oversight of states' utilities. The fact that all these automatic cost recovery rates are supposed to undergo agency regulatory review is scant protection compared to harsh and immediate punishment the market imposes on those who let their costs get out of line.

Jim Clarkson
www.rsmenergy.com