

Remarks of Commissioner Travis Kavulla

Wellingham & Shields/Berenson West Coast conference

March 24, 2011

I must say, I'm terrible at jokes. So rather than opening with a joke, I'll just tell you a story which, in itself, is a bit of a joke. Last Monday, the State Senate's leadership in Montana was kind enough to reach out to PSC. I like it when I'm asked for advice, and when I heard of the legislative solicitation, I thought it might concern transmission planning or getting some real data about the cost of energy in our utilities' portfolio. So imagine my surprise when the topic was, in fact, marijuana—or, more correctly, “therapeutic marijuana,” the supposedly medicinal use of the herb to cure pain. And the Majority Leader wants us to regulate it. Quite apart from the gravity of the situation, this has unleashed a whirlwind of puns around the office. We want to be high-minded about this project, but we worry about getting into the weeds. In any case, we will be blazing new trails. That type of thing.

And while I am mortified at the prospect of having to regulate marijuana, others of the younger staff, who have just graduated college from Missoula and seem to be replacing people who've been at the PSC for decades—such is the cycle of graying and renewal everywhere in the utility industry and its attendant regulators—are for whatever reason thrilled about the prospect of regulating marijuana. Perhaps they think they'll get kickbacks.

I'm a newbie to all of this, and so I thought I'd tell you a little about myself which I think you will find informative of where I came from and where I'm going. I'm happy to be the youngest member of the PSC of Montana, and if I am not mistaken any PUC in the country. While I'd like to say I emerged from the womb quoting works of regulatory economics, but the reality is that I thought I would become a historian in college, ended up at *National Review*, and was helpfully informed by a sympathetic professor that a person with my political views—which I suppose are ultraconservative by the lights of the Ivies—might be able to find tenure at DeVry or other fine online institutions. And so I spent time reporting on a grab bag of pirates, ethnic violence, and religion in East Africa before returning to Montana a couple years ago, where I moved to the country and planned to write a book.

It was around this time that I became involved in the electric industry, because the city where I grew up, Great Falls, had what could be referred to as a “monorail” moment. Some of you may remember that episode of the Simpsons where a developer arrives in Springfield selling the next big thing: a monorail. Looking for something to jolt them out of their graceful post-industrial decline, the residents of Springfield seize on the prospect of

building a monorail. It's a needed bit of infrastructure, and all the towns are getting one, the Simpsons are told. Soon enough the people of Springfield are being led in an orgiastic chant, "Monorail! Monorail! Monorail!" by their huckster mayor. Something similar happened in Great Falls, Montana, when, after the reorganizational bankruptcy of our public utility, NorthWestern Energy, the good people of Great Falls were convinced that they could somehow cloister themselves away from the vicissitudes of the market forever if only they formed their own public power company which would sell "at-cost power:" as if a profit margin is the only thing that makes electricity expensive!

On top of this, the local government decided that it was a good idea to entice customers into buying power from the new city utility by offering electric supply to them at below-cost prices. This business strategy—if that is not too grand a term—was wildly successful, resulting in most large businesses (but few others) becoming customers of the municipal utility, even while it put city taxpayers (who themselves tended to be customers of NorthWestern) about \$6 million and counting in the hole.

Sometimes, there comes a time for someone to say, "The Emperor has no clothes". It never fails to amaze me how profoundly incompetent governments can be; and it is even more amazing that no one will stand up and point out the obvious, especially at a local level, where parochialism has a nasty habit of trumping policy.

The Great Falls public power situation taught me a couple things: 1) so-called "public power" is not an automatic and unmitigated good for the public and 2) there is a reason why we have incumbent utilities. Incumbents occupy an important quasi-public role, and one need only bear witness to the strong union protections the typical utility employee enjoys, which are comparable to those of public employees, to know that, although equity and debt fund operations, the companies have a distinctly public, governmental character.

A few months after I returned to Montana and pitched myself into campaign-manager mode, a new mayor and a new city council were elected to office, and there is now a new business plan for this failing muni, which will involve some very considerable rate increases. It was a tough course of action that needed to happen.

I ran for the Montana Public Service Commission—in Montana, it is an elected office—on this platform of being fair but tough. But more than anything, I view myself as a kind of elected nerd. And if there is ever a political office whose occupant truly needs independence and intellect, it is an elected PUC.

One of the good things about running for election to a utility commission, as opposed to being a creature of gubernatorial appointment, is that you are at liberty to say many more things than your “mum’s the word” colleagues on appointive commissions. And one of the bad things is that elections make the office occasionally susceptible to ignorant or grandstanding candidates. I’ve made a personal pledge to treat my constituents as the adults they are. It’s not only my duty as a decision-maker to make the decisions which balance the two demands of consistency and affordability in rates, and reliability and safety of service; but more than that, it’s my duty to explain to the public why rates inevitably will increase when the implements of generating and delivering electric power expire or are phased out. I don’t think it is lost on anyone in Montana that our electric generation, transmission, and distribution infrastructure is aging. New infrastructure means jobs. But it also means higher rates. And nearly every rate case in America results in a rate increase. Explaining those outcomes can be a thankless, unfun job—but a job nonetheless.

Let me now turn to discuss some major policy issues which face Montana and, I suspect, much of the rest of the nation with regard to the generation and transmission of electrical energy.

Not that the reality of the statement is contingent on my belief in it, but I do happen to believe that there are markets in everything. And in the famous words of Alfred Khan public utility regulation is a balance between imperfect competition and imperfect regulation. It is my personal views that, precedent to regulation by state officials, the price of natural resources will rise to whatever level is necessary either to reduce demand or to increase supply. Yet, clearly when it comes to a good like electric energy, demand has so far proven to be relatively inelastic for the simple reason that energy, as the 19th century economist William Stanley Jevons described it, is “the factor in everything we do.” There is a point at which consumption becomes practically irreducible.

But as cheap Energy Efficiency (EE) programs have demonstrated, we have not reached a point of irreducibility. It is still relatively easy to reduce demand, and opportunities to reduce our use of electric energy through technology and timing still are ahead of us. Some states have even showed downward trends in their energy consumption, although this is variably attributable to load flight and the kibbutz mentality of the State of Vermont, where people have been softly oppressed into changing their behavior. Montana, interestingly, has a law allowing EE investments to be rate-based at the authorized rate of return plus an additional two-percent premium, although none of our utilities have sought that treatment under statute, instead expensing EE improvements.

Unfortunately, listening to some of EE's proponents or the small-is-beautiful crowd talk about it, the listener could be forgiven for coming away with the message that you can somehow conserve your way into an abundant supply. That, of course, is not true. EE is especially vulnerable to the law of diminishing returns, and because people still do consume energy (and not the absence of energy) EE is doomed to be something of a sideshow. The real question at this point is not about catching up to an inclining demand, but replacing existing generation assets to meet the present demand.

As the cheapest-generating assets in America's fleet of generators reach either the end of their depreciation lifespan or are retired early because of rules adopted by the Environmental Protection Agency, some kind of generator must replace the 40-70 GWs of coal-fired generators, mostly small and old, that are expected to be retired in the next five years. That simply is not an amount of energy that you can conserve your way into having, even if we accept one of the more popular tropes of the environmental community that "energy efficiency" is a supply resource.

Ironically, from an investors' perspective, little could be better than the imposition of EPA rules as restrictive as those applying to mercury, sulfur and, possibly, greenhouse gas emissions. The utility industry typically has taken the lead in opposing such rules, but if one were to be cynical about the proposition – not that I am cynical – one could identify this behavior as a feint, meant to clothe industry in an attitude of "we tried our best" in preparation for the inevitable round of capital investment coal-dependent utilities seemingly will have to engage in, whether that is retrofitting coal-fired generators or building entirely new generation resources. Obviously it will be up to me and my fellow regulators across the states to approve prudently incurred expenses of utilities, which include actions undertaken to comply with federal agencies' mandates. Speaking broadly, without commenting on any particular utility, I foresee an outcome to the current environmental-regulation debate that is positive for industry, who will have unprecedented new cap-ex opportunities, but detrimental to ratepayers who will inevitably pay for them.

This round of generation-asset retirements will pose unique political challenges. The nanny state attitude of the EPA is going to ruffle a lot of feathers across the country. In a state like Montana, almost entirely reliant on property taxes, a power plant is a giant ATM for county, city, and school governments; people who have a power plant in their backyard are not going to be happy about the EPA riding in to save them from themselves. Especially insofar as coal plants tend to synch up with areas of the country which already have fallen victim to industrial and manufacturing decline, the EPA rules are going to be as nails in the coffin of once-thriving communities.

The broad categories of decisions industry and regulators will have to make include whether to build power plants at or near same site of retired plants or to spread plants in a more economically efficient manner, tied together by transmission. Moreover, to some degree, we are retiring generators which were built to provide base-load energy and capacity to vertically integrated utilities who were until recently the exclusive lords of their own balancing authority fiefs. But in many places today, organized markets have obviated the need for larger regulating reserve capacities and proven that even these vertically integrated utilities thought of in monolithic terms still can gain from market participation.

The Western United States in particular has a profound need to knit together its Balancing Authorities in a more economically efficient manner. But this has proven an immense challenge.

However, the circumstances which would propel a market have altered considerably since the last attempt to kickstart a market. The huge amount of wind coming online in the Northwest has led the Bonneville Power Administration to become more responsive to the possibility of participating in an organized market, and while once upon a time only the prospect of dispatchable base-load and peaking generation was in play, now the effort to control variable generation like wind – or ameliorate the variability of these generators by stitching many variable generators together—has given a completely new valence to any discussion of an organized market in the Western Interconnection. Encouragingly, FERC has indicated that mere participation in an organized market whose wholesale aspect is subject to FERC jurisdiction does not mean that market participants themselves are *ipso facto* subject to federal jurisdiction; this was much less clear in previous times, leading to reluctance on the part of non-jurisdictional entities like BPA.

There are other important regional and federal processes in play, too. One is power scheduling, and the move to shorter power-scheduling intervals. The Joint Initiative of the Northern Tier Transmission Group has set its sights on a 30-minute interval, rather than the one-hour increment typical of the West. This is a wise move, and I hope the FERC will not preempt it by mandating a shorter 15-minute interval, although a shorter interval should be an eventual goal.

FERC is also contemplating the establishment of a new schedule allowing firming services provided to integrate renewables to be cost-recovered from those generators. Especially at a time when small public utilities like NorthWestern are to have the additional responsibility of integrating variable generation, this is an important step to make sure the principle of “cost-causer pays” adheres in the Brave New World of wind.

And last but not least, let's talk about transmission. There is nothing more important today than connecting remote energy resources, like Montana's vast supply of wind, to centers of demand. Transmission build-out needs to be viewed as a priority which not only will contribute to the development of the rural West's energy resources, but also to soften and to some degree obviate what is a looming but disparate need to build generation plant.

I think there is room enough both for a participant-funded merchant model which is not based on the cost of service, which has seen its rise most of all in the West, as well as the traditional transmission design that is built on cost of service. Again, this is an area where FERC should not adopt a single model of cost allocation, which would overturn the very apple cart of transmission build-out the FERC wishes to see remaining upright.

Locally, in Montana, there have been myriad policy issues to transmission build-out. Transmission has a strange band of discontents, motivated by NIMBYism, worries about market exposure and upward price pressure, socialized cost-allocation, environmental damage, and everything in between.

The opposition to transmission build-out makes very little sense in the context of Montana's wider history, which has always taken a positive view toward encouraging infrastructure. One person who spoke against an eminent-domain law in Montana's legislature recently happened to mention that, as a farmer, she did not seize others' property to plant her crops. But, of course, she does depend on the embedded eminent-domain power expressed via the massive network of county roads, state highways, and federal interstates without which her product would never arrive at the market. Although they now are arrayed against it, agriculturalists and rural populations have benefitted enormously from the use of eminent domain throughout their history. Part of the change in attitude is that, 70 years ago, eminent domain brought obvious benefits to rural people. Electrification was the result of a power line in your backyard. Today's high-kV facilities lack an appearance of public use. They are intended mostly for export and even when they provide real benefits to native-load customers, the benefits provided are intangible, like an increase in reliability.

Add to this the change in how property is valued, with subdivision giving birth to pricey ranchettes, and viewsheds taking on a value of their own, and it is clear that eminent domain has not really kept up with how people conceive of property and its value.

A few policy fixes are in the offing on these questions. There is necessity for parity among those collecting royalties. Everyone wants a wind farm for the royalties it pays. No one wants the transmission line necessary to bring that wind power to market. There also needs

to be more flexibility in the laws which govern state licensing authorities' permitting, which would allow developers and landowners to come to mutual terms without interference of the third wheel, Big Government.

Regardless of the political debate about the particulars of transmission build-out, it is beyond dispute that more transmission is needed and I hope those policymakers working on the issue take the long view of the political problem they face. Build-out is such an economic no-brainer that, sooner or later, the federal government will tire of handing out ARRA money to back loans to transmission lines, only to see them hampered, as in Montana, by local intransigence. In the alternative, the feds will simply command an agency to build them directly, thereby creating a new prerogative unto government and using eminent domain powers which are not contingent upon the say-so of a state court. This is not a desirable solution, but it is the solution which ultimately be delivered to the doorstep of Western states who prove incapable of solving this problem themselves in a manner worthy of our shared obligations under America's federalist system.

--Mr. Kavulla was elected last November to serve a four-year term on the Montana Public Service Commission. The above opinions are his own, and do not reflect his views on any contested proceeding before the MPSC.