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The Op/Ed Page for Virginia's New Economy

Power Politics

Dominion touts electric re-regulation as a way to ensure energy independence for Virginia. But its vision requires more power plants, not conservation, energy efficiency or renewable fuels.

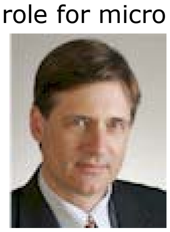
By James A. Bacon

Virginia's decade-long experiment with electric deregulation is coming to a close. Legislation under consideration by the General Assembly would submit Dominion, Appalachian Power and the smaller electric utilities to a form of "hybrid" regulation -- regulation lite, if you will.

A recent night-time hearing of the Commission on Electric Utility Restructuring was standing room only, packed with representatives of power companies -- big ones, small ones, independent ones -- as well as big industrial and residential consumers, academics and journalists. Not bad for a topic the details of which are so numbingly dull they could serve as novacaine.

There appeared to be a consensus in the room that the new law should balance twin goals: holding electric rates as low as possible while keeping power companies profitable enough to embark upon a major round of power plant expansion. Everyone gave a ritual nod to the need for "conservation" and "renewable fuels." But no one in the room made money by shrinking sales through conservation, and "renewable fuels" providers aren't big enough to hire a bug swarm of lobbyists and lawyers to push their interests.

Environmentalists, concerned about acid rain, nitrogen deposition, low-level ozone, mercury emissions and the release of greenhouse gases, were not invited to join the "stakeholders" who thrashed out a compromise. Defenders of property rights, opposed to forced takings of land for high-voltage transmission lines, had no seat at the table. Proponents of a "distributed grid" electric system, which would expand the role for micro power producers, were notably absent. Manufacturers of energy-saving technologies weren't even in the picture.



In other words, the vested interests -- the power companies, industrial customers and citizen consumers -- get a seat at the bargaining table and a hand in writing the legislation. Inevitably, the resulting regulatory regime will balance the competing interests of those groups. Equally inevitably, there will be no bold departure from the past.

In their book, "Revolutionary Wealth," Alvin and Heidi Toffler characterized the United States energy infrastructure as a product of the industrial-wave wealth-creating system. Built around heavy fixed assets, that system is inflexible and difficult to adapt in response to rapid change. But the legacy system endures, they wrote, because it is "politically defended by some of the world's biggest and most influential corporations."

The Tofflers could have been writing about Virginia. Electric "re-regulation" will serve the interests of the established players who were invited to participate in the process of drafting the legislation. The perspectives of other interests -- either too powerless or too nascent -- will be largely missing.

Still, it is instructive to know how we reached this point and what we have learned about electric regulation and deregulation. Perhaps we can gain some insight into what it takes for Virginia's electric infrastructure to one day encompass the conservation, renewable fuels and micro producers that will better serve us in the volatile energy economy of the 21st century.

To bone up on electric re-regulation, I sat down last week with David G. Shuford, vice president-state regulation for Dominion Resources Services, Inc. My first questions for him: Why was Dominion pushing for re-regulation? In what way had deregulation failed?

The simple answer: Virginia never truly deregulated. The restructuring of Virginia's electric utility sector did not work as anticipated, and no meaningful competition ever emerged. Shuford listed three reasons why.

First, the State Corporation Commission never permitted Dominion to divest its power plants. It is an axiom of electric deregulation that the people who generate electricity cannot live under the same corporate roof as the people who transmit and distribute it. For competition to work, power generators need a level playing field -- cross subsidies not allowed.

But Virginia's regulators had big reservations about breaking up the power companies. Should deregulation fail, they feared, it would be extremely difficult, as the analogy goes, to "unscramble the egg" and go back to the old regime of regulating vertically integrated power companies. Of course, such fears became a self-fulfilling prophesy. Without divestiture of the power plants, deregulation never had a chance to work in the first place.

"In Virginia, the folks at the Commission were not ever going to allow for that legal separation between generation and distribution," says Shuford. "That was cited routinely by competitive suppliers as a flaw in our process."

Second, the SCC imposed rate caps on Virginia's power companies. Except for modest cost-of-fuel adjustments, Dominion has not increased rates since 1996 -- despite a 28.5 increase in the Consumer Price Index over the decade. Capping rates adds another hurdle for competing suppliers, Shuford says: "They have to compete against an artificially capped price."

Virginia is not the only state to cap electric rates, Shuford says. While politicians like the theoretical notion that free markets yield lower rates on average than regulated rates, they are uncomfortable with the messy reality that free-market prices are more volatile, which means that they sometimes spike higher than regulated rates. After observing what happened in other states, Dominion concluded that Virginia policy makers would never lift the cap. "That made us wonder if retail competition really would develop to the point where it would be an effective regulator of prices in Virginia."

Third, there was a flaw to the restructuring plan that Dominion hadn't anticipated, Shuford says. Back in the 1990s, there was a sense of inevitability about deregulation. Railroads had deregulated, trucks had deregulated. Airlines, natural gas and telecommunications had all deregulated. But deregulation didn't pan out for the power industry. The issue was so complex that a number of states handled it badly -- California was a disaster -- and a number of states balked.

"Some states headed down this path but many states did not," Shuford says. "Some states reversed course. You had this balkanized landscape where some states to the south of us are in traditional regulatory mode, and Virginia and states to the north are not."

That put Dominion in a difficult position. After operating for years without building any new base-load generating facilities, Dominion now anticipates the need to spend $4 billion on new capacity over the next 10 or so years. Dominion will have to borrow most of that money.

"If everyone were deregulated, we wouldn't have to compete against regulated entities in the capital markets," Shuford explains. Under current arrangements, Dominion would have to go into the market as a merchant generator, with no guarantee of payback. "It would be very difficult to go to the capital markets and say, "Invest in us, we're going to build a $2 billion nuclear power plant. ... [Investors] will look at that option, and they'll look at Duke [a regulated company with guaranteed return on equity]. They'll invest in those companies where they're guaranteed a payback. Folks would look for a higher return on investment [with Dominion]. It would be a more expensive undertaking."

Translation: Either Dominion would have to pay a significantly higher cost for capital, which would mean higher electric rates, or it would have to import electricity from outside the region, which would require more high-voltage electric lines -- assuming that that wholesale power was even available.

As Dominion headed into the current session of the General Assembly, it wasn't anticipating any great legislative initiatives, Shuford says. But a bad experience with the lifting of rate caps in Maryland led to massive rate increases and a seismic political shock. Industrial customers, in particular, were hard hit. Alcoa, which has extensive operations in Virginia, had to shutter an energy-intensive smelting facility in Maryland when rates went through the roof. Legislators feared the likelihood that electric rates would rise precipitously when Virginia's rate caps expire Dec. 31, 2010. In Virginia, there is a growing sense that "deregulation" was a failure.

Rather than wait for the axe to fall, Dominion took the initiative: Pushing its own vision for re-regulation, the company advocated a "hybrid" model that strengthened SCC oversight but corrected deficiencies of the old system with a measure that would allow Dominion to reap a share of the savings from innovative cost-cutting programs.

That proposal was taken up by

the General Assembly commission to study electric utility restructuring. Sen. Thomas K. Norment, R-Williamsburg, turned the legislation over to William C. Mims, deputy attorney general, and a working group of stakeholders. After cramming 60 hours of work into two weeks, the volunteer stakeholders reached consensus on several key points, narrowed their differences on several more, but left a number of questions hanging.

As Dominion lobbyist Bill Thomas testified before the restructuring commission, the revised bill was "dramatically different" from the one originally submitted by Dominion, but it still preserved the features critical to the company.

Central to Dominion's strategy is preparing for the upcoming wave of construction projects -- three or more new coal- and nuclear-powered power plants to meet rising demand over the next 15 years.

Virginia, especially Northern Virginia, is racking up some of the greatest increases in electricity consumption anywhere in the country. "We add about 50,000 customers a year," says David B. Botkins, senior corporate communications representative. Some of those customers are humongous energy users. Northern Virginia has 14 giant server farms, each of which guzzles as much electricity as a small town. And "there are more on the drawing boards."

Dominion met surging demand over the past decade without building more base-load plants by importing electricity from other states. The key was joining the PJM wholesale electric power pool, which serves a 13-state region mostly north of Virginia. "PJM does a lot of things really, really well," says Shuford. "They give us access to lower-priced, base-load power, mostly coal power several states away. ... In the old days, we would have run our own power plant to serve our native load. Now, unless ours is the lowest cost power, it doesn't get dispatched. PJM ensures that the lowest cost power flows to [Virginia]."

But there are limits to how much Dominion can continue relying on PJM's cheap electricity. One problem, says Shuford, is that the transmission lines into Virginia have limited capacity. Dominion needs more transmission lines to import more power. A longer range problem is that "at some point, western states will start using up their own cheap electricity. Nobody's building new base-load generation in the PJM area. We need to build our own for energy independence in Virginia."

Dominion's preferred solution seems to be doing more of what it already knows how to do well -- build more power plants and electric transmission lines. Shuford acknowledges that conservation, renewable fuels and a distributed grid all need to be part of the energy future, but it's clear that Dominion hasn't put much thought into them.

Shuford makes polite noises about conservation. "Twenty years ago," he says, "there was a lot of emphasis on load management and demand response," in which customers would drop off the grid during periods of peak demand to spare Dominion the necessity of running its most costly power generators. "But it's difficult to do it on a large scale with residential customers. Once you get past devices that automatically turn your water heater down, you're not going to see people adjust their behavior but so much. Are you going to do your wash at on o'clock in the morning to shave $2 on your electric bill?"

Shuford says he's seen little evidence in other states that variable rate structures will "obviate the need for new power plants or transmission lines."

But in a moment of candor, Shuford also concedes that power companies don't have much incentive to push conservation. "The problem has been ... the end goal of conservation is for the utility to sell less power. Utilities won't devote significant resources to sell less of the product they make unless you can figure out how to make it worth their time." Figuring out how to "decouple" the power company's profitability from the volume of electricity it sells is a regulatory condundrum.

Distributed generation also will be part of the energy future, Shuford says. It makes sense to put small generators closer to the sites where they are needed. But "it may take a while for that to come into play. It's never going to supply the larger needs of a statewide population, but it could address certain situations."

Shuford did not say this, but it seems evident to me: Like conservation, there's no profit in "distributed generation" for Dominion. If independently owned photovoltaic arrays, wind turbines and cogeneration units start supplying electricity to thousands of residential and commercial customers, that's less business for Dominion -- especially if they sell their surplus power back into the grid. In sum, the power company has every motivation to say the politically correct things about distributed generation while actually doing as little as possible.

The regulatory regime contemplated in the restructuring commission's hybrid regulatory model is geared to helping Dominion and other power companies build new infrastructure -- what I call "Big Grid," large power plants in isolated areas with transmission lines to wheel electricity to the customer base. Dominion's bill, even as modified by the stakeholders, would put this need front and center by guaranteeing a Return on Equity comparable to that of a peer group of regulated utilities in the Southeast U.S., around 12 percent per year.

But Dominion asked for no such incentives in the original draft of its legislation to promote conservation, distributed generation or renewable fuels. An amendment proposed by Del. Clark N. Hogan, R-South Boston, would encourage power companies to draw as much as 12 percent of their power from renewable energy sources in 2022 by increasing the company's allowed rate of return by half a percent. It's not clear, however, whether power companies could meet such ambitious objectives even if they embarked upon a crash program tomorrow, much less what such efforts would cost or how well electric customers would embrace the idea of paying for them with higher rates.

This year, the main issue likely to be resolved centers on how to ensure the construction of massive new generating capacity in Virginia without sparking a ratepayer revolt. The renewable fuels issue is in play, though the current proposal does not look practicable. As for conservation, energy efficiency and opening up the system to micro-generators, those look like topics for a future generation.

-- **January 22, 2007**

Read more columns by Jim Bacon at
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