Harvard Electricity Policy Group
Forty-Fourth Plenary Session

Regulation and Hedging for Load Serving Entities: Which Risk is Greater, Regulatory or Speculative?

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Balancing risk and reward leads to good risk management decision making

- No Accountability (no risk to company)
  - risk on customers
    - poor decision making
      - either too little risk management or speculation that cost customers money

- Accountability (with risk and reward balanced)
  - caution
    - good decision making
      - both company and customers benefit

- All Accountability (without reward)
  - risk on company
    - benefits are taken away
      - costs are borne by company
        - poor decision making
Types of distribution companies

- Three types of companies now
  - distribution only – with no generation
  - vertically integrated – with G, T, and D
  - distribution companies with generation owned by parent or subsidiary

- Talking about distribution only companies
  - will relax this assumption later
Assumptions

- PUC staff are unable to judge whether details in a risk management portfolio are reasonable or unreasonable.
- Not a slam – it’s not their expertise nor should they be required to know.
- The PUC can judge the risk/reward balance and incentives that are in the best interest of the public.
- Such a balance exist and can be found.
The good and the bad

**Good**
- encourage responsible hedging and risk management
- allow recovery of reasonable risk management cost
- discourage speculation (although, may be okay on the company’s dime)

**Bad**
- too much up-front approval
- all risk, no reward
- all reward and no risk
Things to keep in mind

- The point is to encourage reasonable risk management
  - can be beneficial for both company and customers
- Managing risk and price volatility, does not make risk go away
- Risk management cost money
- Does not fix market problems
  - not a magical solution that fixes all problems
Getting the incentives right

- Approve the concept, not the particulars
- Traditional approach
  - subject to a prudence review, but not always reviewed
    - rebuttable presumption – presumed prudent unless shown otherwise
  - no “Monday Morning Quarterbacking”
    - opportunity to recover costs that were reasonable at the time incurred and given what was known or knowable at the time
- Incentive or performance-based approach
  - can a profit/loss sharing mechanism be developed?
  - what is the standard or measure of performance? (that is not MMQ?)
Hedging in a broader context

- Risk management should be part of a portfolio of long and short term bilateral contracts and some spot market purchases, along with reasonable hedging.
- Mix in some new and state regulated generation capacity?
  - including a diversity of fuels and sources
The three types of companies now, distribution only, vertically integrated, and distribution companies with generation owned by parent or subsidiary.

- Vertically integrated
  - Risk management still fits with both traditional regulation and incentive approaches (for power and fuel purchases, for examples).

- But, distribution companies with generation owned by the parent or a subsidiary presents a serious conflict of interest problem.
  - The distribution company is purchasing power on behalf of retail customers, while the parent’s interest is selling power.
  - The FERC/state jurisdictional split does not help.