LSE’s and Hedging: Critical Regulatory Issues

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Two Contexts of LSE Hedging Activity

I. Fully Regulated Market
   - Hedging at Management’s Discretion

II. Retail Competition Market
   - Consumer Discretion
   - PLR Product a Policy Issue
Symmetries: The Triumvirate

I. Regulatory Symmetry

II. Risk/Reward Symmetry

III. Competitive Symmetry
I. Regulatory Symmetry

Prudence Reviews
- Reviewing Hedging Activity
  - *ex-ante or ex-post*
- Reviewing Failure to Hedge

Evaluating Action and Inaction
- Historic Experience
- Analogy to Emissions Trading

*continued …*
I. Regulatory Symmetry (cont.)

**Economic Risks vs. Regulatory Risks**

- **Market Uncertainties**
- **Hedging/Not Hedging Equally Risky**

- **Administrative/Political Uncertainties**
- **Hedging Riskier Than Not Hedging**

**Shareholder Risks**

- **Non-Recovery**
- **No Upside Potential**

**Consumer Risks**

- **Price Volatility**
- **Self Choice of Supplier**
## II. Risk/Reward Symmetry

### Prudent Protection of Position
- Socialized Risk
- Socialized Reward
- Potential for Sharing Risk/Reward

### Speculation
- Privatized Risk
- Privatized Reward
- Self Choice of Supplier

### Distinguishing Position Protection From Speculation
- Size and Scale of Positions
- Nature of Positions (e.g., covering what you have to sell)
- Articulated/Documented Strategy/Objectives
- Nature of Hedges
  - Forward Positions
  - FTR’s
  - Capacity Arrangements
    - Self Generation
    - Contracts
- Demand Response Arrangements
III. Competitive Symmetry

- PLR Responsibility
  - Who Provides
  - Nature of Product
- Definition of Distributor Function
- Market Design Issues
  - Hedging PLR Product
- Wholesale (e.g., Horizontal and Vertical Market Power)
- Retail (e.g., Attractiveness of PLR Product)