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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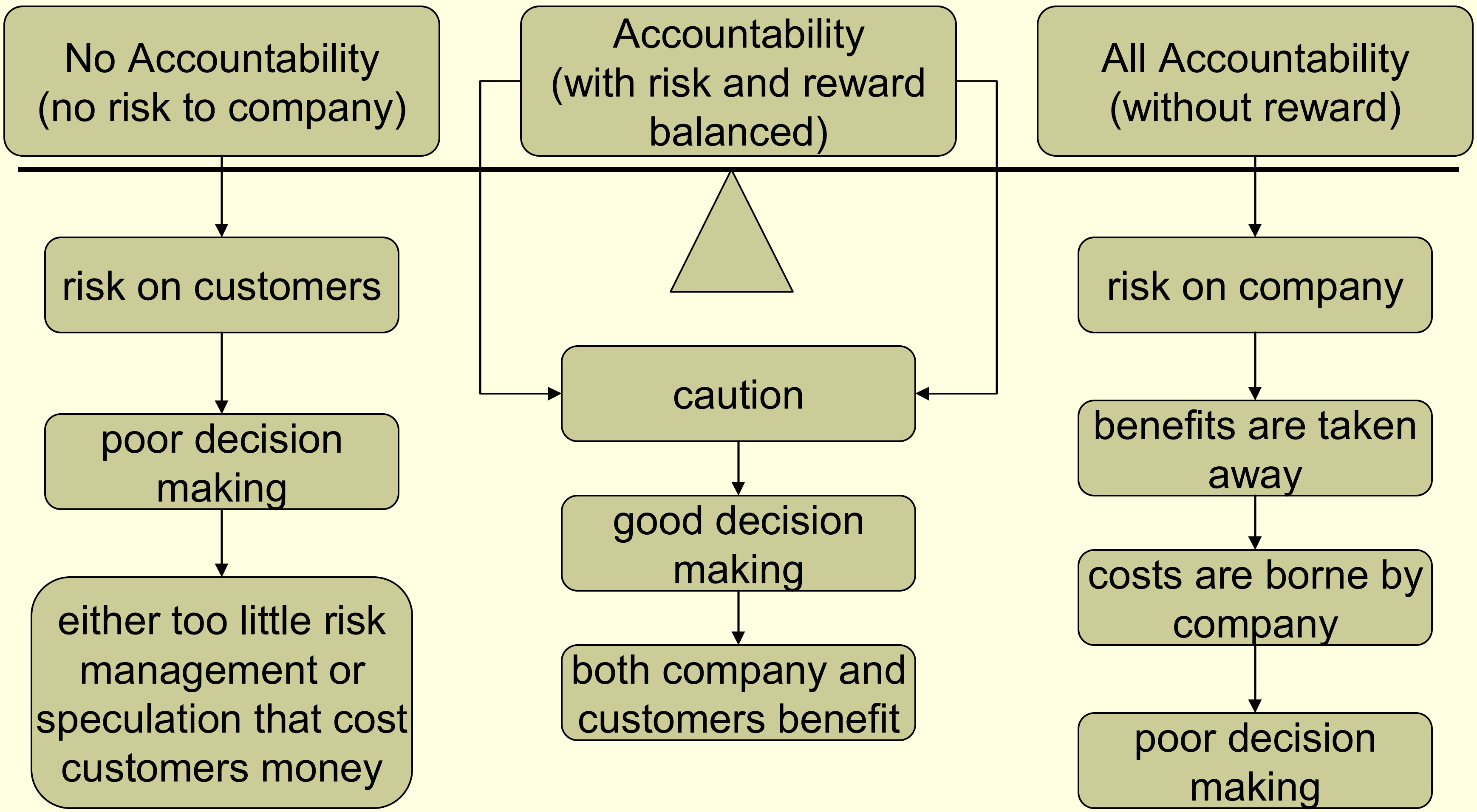
Balancing risk and reward leads to good risk management decision making



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 <u>can</u> 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

Back to types of distribution companies

- 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