Restoring and Transforming Puerto Rico's Electric Industry: Principles and Actions

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1. Utility Regulation: Principles and Duties

1.1. The purpose of regulation is performance.

1.1.1. High quality, reasonable cost: Regulation must produce results comparable to what effective competition would produce. The purpose is the same whether we are regulating monopoly providers or fashioning competitive markets.

1.1.2. To induce performance, regulators define standards, and assign consequences for meeting or failing those standards. By taking those steps, regulators align self-interest with the public interest.

1.1.3. Effective regulators envision the products and services that best serve customers, then design and oversee the market structures most likely to produce that mix of products and services cost-effectively. Vision without action is useless.

1.2. Economic efficiency comes first.

1.2.1. Economic efficiency means that we allocate costs to those who cause the costs, and allocate the benefits to those who produce them.

1.2.2. Economic efficiency is the first priority; allocating the gains from efficiency is the second priority. If we are going to fight over who gets the largest slice, let us first cooperate to make the largest possible pie.

1.2.3. In both regulation and competition, rewards and penalties must be based on merit, not on incumbency or on political connections.

1.3. "Competition" and "privatization" are not religions.

1.3.1. Religion is based on beliefs and prayers. Competition is a market structure. A market structure that is effectively competitive is based on facts: many viable suppliers, many educated customers, and low barriers to entry.

1.3.2. "Privatization" is not a religion; it is a form of ownership that, like all other forms, has benefits and detriments.

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[1] Hempling is an attorney and an outside advisor to the Puerto Rico Energy Commission. His comments should not be attributed to the Commission.

1.4. Competition and regulation are not in conflict.

1.4.1. Competition and regulation share a common purpose -- to align private behavior with the public interest. Effective competition induces competitors toward efficiency, customer service, and reliability. Effective regulation does the same.

1.4.2. Together, they induce accountability -- to the consumers, investors and the public. We need "the best possible mix, of inevitably imperfect competition and inevitably imperfect regulation." (Alfred Kahn, *The Economics of Regulation*)

1.5. Consumers are actors, not victims.

1.5.1. Rates are not "low" or "high"; rates are either right or wrong. Either they reflect reasonable cost, making them efficient; or they do not reflect reasonable cost, making them inefficient.

1.5.2. Customer demand affects prices. Because consumer are actors, not victims, it is necessary to empower them to act--and to act efficiently.

1.6. When regulators make decisions, what matters most are the facts.

1.6.1. For most of the last century, customers have been served by vertically integrated monopoly. Regulators assumed this fact: Vertically integrated monopolies enjoyed economies of scale that made competition inefficient.

1.6.2. But facts change. Economies of scale change, because other things change: cost structure, technology, customer preferences, and production processes. The alert regulator looks for changes in facts that challenge historic assumptions.

1.7. A regulatory agency must be expert and independent.

1.7.1. A commission is not a supermarket, where people shop for favors. A commission is an expert agency that makes decisions based on facts and logic.

1.7.2. To make those decisions, expertise and experience that is the equivalent of the market actors whose actions it regulates.

2. The Commission's Regulatory Framework (from Act 2014-57)

2.1. "[The Commission] shall be an independent government entity in charge of regulating, overseeing, and ensuring compliance with the public policy on energy of the Commonwealth of Puerto Rico."

2.2. "The Energy Commission created herein shall be the key component for the faithful and transparent execution of the Energy Reform."

2.3. The Commission --

2.3.1. "shall be able to guarantee the orderly and integrated development of our electrical system, thus ensuring the reliability, efficiency, and transparency thereof, and the provision of electric power services at reasonable prices."

2.3.2. "shall evaluate [PREPA's plans] regarding its obligation to efficiently generate electric power, various operational issues, and the integration of renewable energy, among other mandates."

2.3.3. "shall oversee all types of operations, processes, and mandates pertaining to the efficiency of the energy sector of the Island."

2.3.4. "shall oversee [that] PREPA's debt issues are in the public interest."

2.3.5. "shall approve the electricity rates proposed by PREPA."

2.3.6. "shall require that the prices included in any power purchase agreement, wheeling rate, and interconnection charge are fair and reasonable, consistent with the public interest, and compliant with the parameters established by this Commission...."

2.3.7. "shall... guarantee that PREPA meets its obligations to bondholders."

3. The Commission's Key Orders

3.1. Transition Charge

3.1.1. "The Transition Charge is a mechanism designed to reduce costs for PREPA's customers."

3.1.2. "[B]ondholders are willing to reduce the payments they receive only if the Commission increases the certainty that those payments will be made. The mechanism for increasing that certainty is the Transition Charge."

3.2. Integrated Resource Plan

3.2.1. Approval of temporary, limited spending on the Aguirre Offshore Gas Port.

3.2.2. Approval of permitting, maintenance and retirements for various fossil units.

3.2.3. Approval of certain investments in transmission and distribution, as necessary for system stability and operability.

3.2.4. Requirement of a detailed audit of contracts for renewable energy, for projects not yet operational, and pursuit of renegotiation or exit to the extent lawful and appropriate.

3.2.5. Requirement that PREPA create a competitive bidding process for certain new renewable energy projects.

3.2.6. Approval of certain energy efficiency resources.

3.2.7. Various findings re PREPA's compliance or non-compliance with the IRP rules; guidance to PREPA re preparing for the next IRP cycle.

3.2.8. Approval of a "Modified IRP."

3.3. Rate decision

3.3.1. Description of system deterioration
3.3.2. Set permanent rates but defer major decisions on rate design
3.3.3. Budget review to protect customers from unreasonable cost
3.3.4. Net metering credits

3.4. Other actions

3.4.1. Transparent bill
3.4.2. Performance proceeding

4. Challenges, Obstacles and Uncertainties

4.1. Preventing imprudent costs: With a non-profit PREPA, what are regulation's options?
4.2. Reviewing budgets before unreasonable costs are incurred: Two legal challenges
4.3. Commission budgeting and hiring

5. Next Steps to Effect Restoration and Transformation

5.1. Define the options: Resource mix, market structure mix, ownership mix.

5.2. Define the criteria for choosing among the options: Static efficiency, dynamic efficiency, reliability, cost, customer choice, customer responsibility, others.

5.3. Define the principles for decision-making: Objectivity, merits, transparency.

5.4. Achieve a common view of Commission's role.

5.5. Necessary: Understand each entity's roles, avoid conflict.