Holley Hewitt Ulbrich, being duly sworn, deposes and says:

I am an Alumni Distinguished Professor Emerita of Economics at Clemson University and Co-President of the League of Women Voters of South Carolina.

I hold a Ph.D. in Economics (1969, University of Connecticut) and also a Master of Theological Studies (Candler School of Theology, Emory University, 2003). My primary area of research is state and local finance, I am the author of fifteen books and numerous articles and technical reports, and have served as a consultant and policy analyst for public agencies including local and state governments in South Carolina, the federal government, and the World Bank. In my capacity as Professor at Clemson University I have taught, among other topics in economics, Ethics and Public Policy and Political Economy and Public Policy.

The Base Load Review Act and the Public Interest

The September 26, 2017, Attorney General Opinion on the Base Load Review Act (BLRA, or “the Act”) states that “The Act fails to strike the constitutionally required balance between investors and ratepayers.” The Office of Regulatory Staff (ORS) cites this opinion as part of the foundation of the petition that they have submitted for rate relief in PSC Docket No. 2017-305-E. A review of the fundamental economic principles associated with the regulation of rates charged by utility monopolies supports this opinion offered by the Attorney General and cited by ORS.

One of the most important functions of government in a market economy such as ours is to “referee” the distribution of risk from any activity among the various stakeholders ranging from natural disasters to health insurance to contract enforcement to overseeing pension plans to environmental hazards to public utilities. When something goes wrong, how much of the cost of setting things right is borne by owners, by customers, by suppliers and employees, and how
much falls on the rest of us as citizens and taxpayers. One of the areas of risk management in which both state and federal goals have had a substantial responsibility for more than a century is the regulation of public utilities.

Public utilities are entities that produced goods or services for which there are very few substitutes and which are produced with large economies of scale, so a single supplier is the only available source for most customers in a given service area. Captive customers are not able to protest mismanagement high prices or rates, poor service, or anything else an unregulated monopoly might choose to do in order to generate its revenue as cheaply as possible.

Government regulatory commissions exist in order to protect the interests of all the affected parties, but particularly customers and the general public, which has an interest in minimizing the cost of failures and losses that may be shifted to them through tax-financed bailouts. Regulatory commissions also serve a broader public interest in that rates charged and quality of service offered by public utilities such as electricity and natural gas are something companies take into consideration in relocated, expanding, or moving away.

Electric power companies are regulated public utilities. They are regulated by states because historically they have been granted exclusive service delivery franchises, making them a monopoly. Left to their own devices, monopolies will charge all the market can bear, and then some. Most of these power companies are private, investor-owned corporations, so high prices and high profits would make their shareholders happy, but the customers might be much less satisfied. Customers in the service area where the V.C. Summers plant is located are already paying some of the highest electric rates in the country as they have been funding this failing venture for years.

The reason for granting monopoly power to electric utilities is that there are huge economies of scale in producing electric power. In ordinary language, most of the cost of electricity is in the generating and delivery equipment, or capital, not in the day-to-day operating costs. So the more customers they serve, the lower the average cost. To keep these firms from taking advantage of their captive customer base, public regulatory commissions have to approve their rates, or prices. The rates are based on the firm’s costs of operation, which include a “normal” profit—enough return on investment to attract the capital they need to build those generating and distribution facilities. The 2007 BLRA approved a rate of return initially set at 11.00% and since reduced to 10.25%, well within the range approved in other states. But in the normal course of regulation, that rate of return is not supposed to be a guarantee, just a cost estimate.

Enter uncertainty, or risk. Shareholders receive higher return than lenders (banks and bondholders) because they get what’s left over after all other costs have been paid. So shareholders’ income is supposed to be more variable than bondholders and other lenders because they are assuming more risk. The risk lies in the possibility that costs will be higher or revenue lower than expected. Shareholders then have an incentive to keep a close watch on costs.
in order to protect their return on investment. But if that rate is guaranteed, cost increases are passed on to customers, shareholders and the management they oversee have no incentive to hold down costs. That’s why the word “prudent” appears so often in the 2007 Base Load Review Act. But the actual effect of the BLRA is to limit the ability of regulators to demand prudent allocation, which encourages careless and risky decisions. Such decisions might include inadequate safeguards in contracting such as failure to tie pay to performance as well as insufficient direct oversight of contractor performance. The Bechtel Report on the V. C. Summer Project accurately noted that neither contractors or utility had a commercial incentive for efficient timely completion of the project, and notes specific deficiencies in these areas. This is a direct result of the BLRA, and of SCE&G contracting and management decisions that appear to be based on the protections of the BLRA.

If investors, or shareholders, are protected from risk, then what happens when things go wrong? Some of the risk is borne by customers, who pay higher rates. Those higher rates make their county or region less attractive to business firms or prospective residents who consider the cost of electricity in their location decisions. Letting electricity costs continue to rise faster in one service area compared to others is not a good economic development plan. In that case, some of the cost falls on the community served by the electric utility, often an area surrounding the plant where workers and suppliers live. They, too, bear some of the risk of failure, or of less than prudent decisions. This has occurred in the SCE&G service area, as SC Commerce Secretary Bobby Hitt has publicly stated, inhibiting efforts to bring industry to the affected service area.¹

All of us want to be protected from risk. That’s why Americans are second only to Canadians in their purchase of insurance, especially life insurance. The downside of being protected from risk by some kind of guarantee is that we have less incentive to be prudent, to manage costs and investments so as to make rate increases less likely. Shareholders need to bear some of the cost of failure, either because of decisions that in hindsight were not prudent or because of the normal risks beyond our control, ranging from earthquakes to development of new power sources to unavoidable cost overruns. In the long run, some kind of equitable risk-sharing between all the stakeholders—workers, customers, shareholders, and communities—will make everyone better off.

The BLRA violates these basic principles of economics related to the public interest. In violating those principles, the Act has done precisely the kinds of public harm that a basic understanding of regulatory economics would predict. The ORS petition therefore is justified in its request for rate relief in PSC Docket No. 2017-305-E.

APPENDIX B

AFFIANT FURTHER SAYETH NOT.

Holley Hewitt Ulbrich

Sworn to and subscribed before me
On this 10 day of November, 2017.

Notary Public for South Carolina

My Commission Expires

February 9, 2019