

# Regulation of Gas Utilities: At Odds with Conservation

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### Recommended Citation

Flippen, Edward L. "Regulation of Gas Utilities: At Odds with Conservation." *Sustainable Development Law & Policy*, Spring 2007, 38-39.

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# REGULATION OF GAS UTILITIES:

## AT ODDS WITH CONSERVATION

by Edward L. Flippen\*

### INTRODUCTION

According to *Annual Energy Outlook 2007*, released by the Energy Information Administration in February 2007, it is forecasted that long-term trends in oil supplies will remain tight—with prices declining gradually through 2015, but rising after 2015 as demand continues to grow and higher cost supplies are brought to market. Likewise, wellhead natural gas prices are projected to decline from current levels through 2015, but rise after 2015.<sup>1</sup>

Since 2000, world oil prices have risen sharply as supply has tightened, first as a result of strong demand growth in emerging Asia, most notably in China, and later as a result of supply constraints resulting from domestic disruptions and inadequate investment to meet demand. Higher oil prices have impacted, and will continue to impact, natural gas prices in the United States.<sup>2</sup> In fact, a June 27, 2006 *Wall Street Journal* article points out that the United States has among the highest natural gas prices in the industrial world and if these prices remain high, companies will be driven to other countries, costing U.S. workers their jobs.<sup>3</sup>

### IMPACT OF CUSTOMER CONSERVATION

With the projected tightening of fuel supplies and inadequate overall investment to meet demand, which is part of the result of severe impacts on U.S. infrastructure and offshore drilling from Hurricanes Katrina and Rita,<sup>4</sup> the United States is starting to focus on conservation. Along with certain other countries, the United States has enacted policies encouraging demand side management, energy efficiency, and customers curbing their use of natural gas. However, in the United States, the interests of natural gas utilities and their customers are often at odds.

Natural gas customers have seen their bills increase by as much as two hundred percent in the last few years. At the same time, earnings for many of their respective gas utilities have been below expectations. A primary source of this reduction in earnings is due to customer conservation. For example, NiSource Inc., the parent company of local



Courtesy of Chad Teer

An offshore oil platform located in the Gulf of Mexico.

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distribution companies serving 3.3 million customers in nine states, announced that residential usage decline due to customer conservation efforts has increased from a historical average of between 0.5 percent and one percent per year to approximately four percent in 2006. This decline in usage, which is independent from the normal variations in usage caused by weather, is anticipated to reduce the company's profits by approximately \$20 million in 2006.<sup>5</sup>

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In the long run, customer conservation is the product of equipment efficiency changes. Natural gas utilities can adjust to the decline in customer usage, mainly resulting from more efficient consumer appliances and equipment, with increases in firm productivity. However, there are few short-term off-setting steps to the price-driven decline in utility sales. For example, gas rates are designed by regulators to recover a part of a utility's profits in the commodity or fuel charge component of rates. As the United States becomes more aggressive in pushing conservation and decreased consumption results, natural gas utilities increasingly will be negatively impacted with lower profits.

### THE IMPORTANCE OF PARALLEL INTERESTS

Unfortunately, the historical solution for utilities with declining profits—filing applications with regulators for increased rates—only exacerbates the problem. As a result, there is a misalignment of interests. What is needed to resolve this misalignment is to provide customers with incentives to conserve and, at the same time, provide a mechanism that allows natural gas utilities to remain financially sound. A profitable solution for the utility is as important as conservation is to the consumer. Without the former, the latter is near counterproductive because utilities will simply seek to increase prices to offset the lost profits resulting from reduced consumption.

Clearly, it is in a utility's interest to encourage and even promote conservation to both attract new customers and maintain existing ones. That means, however, realigning the customers' and the utilities' interests so both are attempting to achieve the

same outcome, specifically lower natural gas bills. Unfortunately, there is little if anything in the Energy Policy Act of 2005 to direct federal and state regulators to realign the interests of utilities and their customers. However, words of encouragement are coming from state regulators. A resolution adopted in 2005 by the National Association of Regulatory Utility Commissioners

(“NARUC”) states that “. . . innovative rate designs including ‘energy efficient tariffs’ . . . may assist, especially in the short term, in promoting energy efficiency and energy conservation and slowing the rate of demand growth of natural gas. . .”<sup>6</sup> Importantly, the resolution notes that “. . . current forms of rate design may tend to create a misalignment between the interests of natural gas utilities and their customers.”<sup>7</sup>

### CONCLUSION

State regulators, of course, are not policymakers. But they understand the problem and are attempting to address it collectively through NARUC. Many utilities also support changing financial incentives to encourage energy conservation. As of February 2007, a dozen of the nation's largest utilities signed on to a “National Action Plan for Energy Efficiency.”<sup>8</sup> Now federal and state policymakers must respond by augmenting the regulatory process to provide natural gas utilities with incentives to manage costs, maintain or improve reliability, and reward improved performance. They should focus on results and outcomes rather than on outdated regulatory models developed decades ago. If natural gas conservation is important—and surely it is until someone finds an unlimited supply—regulation of natural gas utilities cannot continue to be business as usual. 

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## Endnotes: Regulation of Gas Utilities

<sup>1</sup> ENERGY INFO. ADMIN., ANNUAL ENERGY OUTLOOK 2007 2-3 (2007), available at <http://www.eia.doe.gov/oiaf/aeo/index.html> (last visited Apr. 15, 2007).

<sup>2</sup> ENERGY INFO. ADMIN., *id.* at 4.

<sup>3</sup> John J. Fialka, *Politics & Economics: Unlikely Duo Tackles Drilling — Democrat, Republican Lead Push to Open Natural-Gas Sites*, WALL ST. J., June 27, 2006, at A6.

<sup>4</sup> Chairman Joseph T. Kelliher, Opening Statement at the Conference on the State of the Natural Gas Infrastructure (Oct. 12, 2005), available at <http://www.ferc.gov/EventCalendar/Files/20051020121515-10-12%20Gas%20Conf%20Opening%20Statement.pdf> (last visited Apr. 11, 2007).

<sup>5</sup> NISOURCE, INC., 2006 FORM 10-K: ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 24, available at

<http://ir.nisource.com/reports.cfm> (follow “NiSource’s 2006 Form 10-K” hyperlink) (last visited Apr. 11, 2007).

<sup>6</sup> NARUC Resolution on Energy Efficiency and Innovative Rate Design, Nov. 16, 2005, available at [http://www.aga.org/Template.cfm?Section=Congressional\\_Testimony&template=/ContentManagement/ContentDisplay.cfm&ContentID=21846](http://www.aga.org/Template.cfm?Section=Congressional_Testimony&template=/ContentManagement/ContentDisplay.cfm&ContentID=21846) (last visited Apr. 16, 2007) [hereinafter NARUC].

<sup>7</sup> NARUC, *id.*

<sup>8</sup> Matthew Dalton, *The Bottom Line: Utilities Typically Have Had Little Incentive to Reduce Demand for Their Product; States are Trying to Change the Math*, WALL ST. J., Feb. 12, 2007, at R4.