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Plan, Build & Recover: Constructing New Generation With the EPA's New Regulations and Today's Budget Realities

Impending retirements of significant baseload generation over the next three years and evolving Environment Protect Agency (EPA) regulations for next-generation power plants provide an opportunity for utility owners to plan an orderly transition to a cleaner and more efficient resource portfolio. Natural gas plants, renewable facilities, and energy-efficiency and demand-response programs will certainly be an integral part of these updated portfolios, but they cannot by themselves replace the baseload capacity necessary to power our economy. Rather, generation owners may need to rely, at least in part, on innovative – or at least not-recently-constructed – capital-intensive technologies such as nuclear and coal with carbon capture, both of which entail significant financial risks.

These risks will probably deter merchant generators from undertaking such projects, and regulated utilities, with their statutory right to recover prudently incurred costs, are more likely to be the early adopters of necessary innovations. But this statutory expectation does not obviate the economic risk for regulated utilities – as demonstrated by the billions of dollars of cost disallowances that occurred during the last nuclear generation build-out in the 1970s and 1980s. Careful and proactive planning is, therefore, essential to increase the likelihood of full cost recovery.

Recovering Capital Costs Requires Long-Term Planning

Under the current statutory regimes, utilities generally seek pre-approval of costs to study and then build a major new generation project but must return to the regulator for regular updates and to seek approval for additional costs if the cost estimate increases. This process – from when the utility initially seeks costs to study the project until construction is complete and the plant is operational – can take upwards of ten years and can create perilous obstacles if not carefully calculated. For these reasons, utilities should apply to their strategy for recovering prudently incurred costs the same long-term planning concepts they use in developing their generation portfolios and in constructing major projects. Just as a project manager must develop

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an execution plan that considers known and unknown challenges, managers anticipating their prudence defense should develop a plan that considers current and, most importantly, future challenges and that will guide this subproject from the early proceedings through its completion.

First, the utility must develop a foundation that will support the project against imprudence claims. This entails more than simply convincing a regulator that the project is a reasonable economic option to meet expected demand (*e.g.*, through an Integrated Resource Planning (IRP) analysis). The utility must convince the commission to buy into the project, *i.e.*, to agree that the project provides the best value to ratepayers. It is only then that the utility will have a legitimate possibility of recovering all its costs, if costs overrun estimates. Although an IRP analysis is often sufficient to demonstrate the prudence of the decision to construct a particular plant – especially because regulators generally defer to the utility in deciding what type of plant to construct – that initial IRP analysis may no longer appear as favorable to the new technology when costs increase, thereby casting doubt on whether the plant *ever* presented the best value to ratepayers. A comprehensive presentation that focuses on the financial and environmental benefits of the project, the benefits to the local economy, the extent to which the project will be able to address anticipated or even unexpected environmental regulations, how the project will be able to incorporate future technological advancements, and how the project fits into the utility's current and future portfolio – taking into account uncertainties about future technological advancements – will provide a much more compelling picture of the project's benefits. Such a presentation must also be brutally realistic about the construction and operating challenges the new technology poses, the greatest perceived challenges to completing the project on time and on budget, and the fact that some challenges are unknown and cannot be fully identified until the work begins. Having described these challenges, the utility must then explain in straightforward terms why the new technology nonetheless provides the greatest overall benefit to ratepayers.

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The utility must also identify, appreciate, and assuage any commission concerns. This includes not only regulators' concerns at the beginning of the project, but those reservations that will likely arise down the road if costs escalate or the plant does not operate as expected. For instance, if costs increase, a commission will legitimately question whether the cost estimate should have anticipated those overruns. To preempt those reactions, the initial cost estimate presentation should explain its assumptions, the confidence level associated with the estimate – and, importantly, what that confidence level means for costs ratepayers might be expected to bear – and the level of design and engineering work that supports the estimate. Regulators generally do not have engineering backgrounds and do not necessarily understand basic engineering and project management concepts. To assure unambiguous communications, utilities should take pains to explain these concepts in ways that commissioners will appreciate.

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The utility must also build confidence that it has the right managers on the job by offering testimony early on from key project managers to introduce them to the regulators. A thorough and candid evaluation of management's qualifications at the project's inception will provide sufficient time to assess any gaps in skill-sets and to permit supplementation with expert consultants and contractors as necessary. Further, introducing the managers to the regulators will help to establish the managers' qualifications and to develop trust before any escalating costs cause the relationship to become contentious. Moreover, because environmental regulations may dictate innovative technologies, managers may have only limited direct experience on these types of project. Opponents may seize on this point to argue that the utility's managers were not qualified. Although such an argument is misleading, it may be frustratingly effective unless those managers have already demonstrated to the commission that they are fully competent to manage the project.

In addition to laying a secure foundation of trust, the utility should anticipate that every statement it makes, even in the initial stages of regulatory proceedings, has the potential to create unexpected consequences. Context and candor should be the utility's hallmarks. For example, even a seemingly benign statement that the utility has "confidence" in its estimate could be viewed as deceptive if the commission learns years later that knowledgeable insiders at the company or contractors had undisclosed reservations about the estimate. Those apprehensions may have been resolved routinely or may have been unfounded, but the fact that they were not highlighted for the commission when the cost estimate was submitted may allow objectors to argue that the utility concealed material internal dissent. The utility need not detail every disagreement or alternative analysis, but it must be able to demonstrate that it sought to identify and disclose information it believed the commission could find relevant.

Make Prudence an Everyday Consideration

The legacy of the last big generator build-out in the 1970s and 1980s was billions of dollars in cost disallowances. Commissions often, and most likely wrongly, disallowed cost recovery because of mistakes a contractor made − even if the utility acted prudently − on the theory that the utility, not ratepayers, had the ability to manage the contractor and could seek recovery from the contractor. The fallacy of this reasoning is for another discussion, but one lesson to be learned is that economic regulators will not even consider approving significant cost increases after a project is approved unless the utility can demonstrate that it sought to protect ratepayers from cost increases.

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One way to make this demonstration is to make prudence an everyday consideration. This is not particularly onerous because prudence requires no more than that the utility manage the project reasonably and document decisions to provide concrete evidence that the utility considered relevant information and reached a reasoned decision based on that analysis. Utilities should, for instance, assess and document whether contractual provisions with their contractors protect the utility (and thus ratepayers) to the fullest extent possible given the market conditions, challenge – without interfering with – their contractors to ensure that they are acting reasonably, and, when necessary, enforce contractual rights. It is not sufficient to threaten a contractor or to preserve a litigation position; the utility should take proactive steps to resolve the dispute efficiently and with ratepayers' interests foremost. Prudence is not materially different from reasonable management nor is it burdensome to implement, but it requires a slightly different mindset that reflects constant consideration of ratepayers' interests and the regulators' perspective.

Conclusion

These are interesting times as the industry embarks on the build-out of new, cleaner, more efficient generating fleets. Given the contentious environment that seems to plague all innovative endeavors, there can be no guarantee of full cost recovery, but careful planning can significantly reduce the likelihood of a significant disallowance.