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News and Commentary

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Commentary: Social justice, the price of potatoes, and "phase-ins"

by Ralph Townsend

It has come to my attention that the vagaries of consumer tastes have inflicted a serious injustice upon certain firms in the potato industry. After a lifetime of specializing in fine round white potatoes, many Maine farmers have found that they can no longer recover the costs of growing round whites, because the demand for potatoes has shifted towards varieties used for processing.

A few hard-hearted economists have argued that if we let the price mechanism operate, then the market will generate profit-and-loss incentives for change within the industry. However, recent research has indicated that this callous reliance on market signals would create intolerable injustice. Income data indicate that those farmers who still grow round whites have significantly lower income than those growing other varieties. Therefore, a laissez-faire policy will only exacerbate this income inequity. Moreover, these low-income farmers have very poor access to credit because of imperfections in the credit markets, so they cannot buy the equipment necessary to convert to other varieties. Some environmental groups have also suggested that allowing the unfettered conversion from round white cultivation to production for processing may have unintended environmental consequences, because different amounts and types of fertilizers and herbicides are used for different varieties of potatoes.

To allow the industry more time to adjust to this unforeseen change and to minimize the social disruption, it is clear that we should phase in the price changes via a tax on Maine growers of potatoes for processing. This tax would be phased out over five years. The proposed policy is very flexible, because if we find that by the fifth year the industry has still not adjusted, we can always phase out the phase-out of the tax.

The income from the tax would be distributed as a subsidy to the disadvantaged producers of round whites. Because the proceeds of the tax will all be redistributed directly to other farmers, there will be no net impact on the farm economy in Maine. Although a few of those aforementioned economists have suggested that potato processors might move out of state to avoid the tax, they have absolutely no data to support their theory. Potatoes are such a small cost of the final price of french fries at Burger King that the prospect of a firm relocating simply to save a fraction of a cent per order of french fries is implausible.

To an economist, the preceding example would have to be a script from the theatre of the absurd. Yet this is exactly the script played in electric rate-making over the past decade in Maine, albeit with the names of a few characters changed. The process of accounting for costs in electric rate-making shows that both regulators and legislators have subscribed to the all-too-prevalent theory that prices have no economic content and hence are easily bent to the popular political theories of the day. If market forces must ultimately be acknowledged, then at least the regulator should

impose the sort of orderly transition (i.e., a "phase-in") that is so characteristic of the market (Consider, for example, the orderly price movements for oranges that occur after a killing frost in Florida.)

In the current controversy over Central Maine Power rates, a deafening crescendo again calls for prices to be set to appease "political reality." And unfortunately, the political tea leaves suggest that we will indeed "solve" the current crisis by one or more phase-in policies.

In the political quest for a painless solution to this current crisis, we seem to have overlooked the contribution of the phase-in policies of the 1980s to the rate shocks of the early 1990s. As Elizabeth Paine indicated in her interview in this issue, the public seems to have misunderstood the impact of rate redesign, which recomputed the relative costs incurred to serve residences and businesses, in the rate increases. Increased overall costs, due almost exclusively to the purchase of relatively expensive power from non-utility generators, are at least as important to the rate increases experienced by customers. Most of this power is produced from co-generation projects at paper mills or by woodchip plants. Many of those increased costs were incurred three to five years ago, but were deferred, with interest, to the present by the PUC (actually, by a panel comprised of commissioners other than the present incumbents.)

For the record, the immediate controversy concerns about 30,000 CMP customers - those customers who have residential time-of-use meters. This group overwhelmingly uses electric space heat. This group has what is called a "poor load curve," which means that the amount of electricity that they use is highly variable. Electric plants must be large enough to meet not the average demand but rather the peak demand, so the cost to serve these customers includes the high cost of maintaining an idle plant to serve very occasional load. Therefore, these customers have time-of-use meters that charge higher rates on-peak (about 17 cents per kilowatt hour) than off-peak (about 8 cents per kilowatt hour). The rate-redesign increased the on-peak/off-peak differential for these customers.

In a narrow, rate-making sense, phase-ins are essentially a form of reverse construction-work-in-progress (CWIP) charge. The Maine PUC has always opposed CWIP charges, which would charge customers for the cost of plants not yet completed. CWIP charges result in higher rates in early years and lower rates in later years, relative to non-CWIP rates. Conversely, the phase-in of costs already incurred results in lower rates in early years and higher rates in later years, relative to non-phased-in rates. Most participants agree with the philosophical argument against CWIP charges: Customers ought to pay only for plant that is "used and useful," irrespective of the timing of rate effects. But if the "used and useful" standard were consistently applied, this would mean that customers should pay for plant that is in use, rather than delaying that payment until some convenient time in the future.

Phase-ins have become the regulatory equivalent to having-your-cake-and-eating-it-too. We can appease current critics of some policy by deferring the costs to some future date. We ought to abandon the wanton use of phase-in policies in electric rate-making for three reasons. First, the phased-in costs restrict future choices. At some point in time, and unfortunately that time is now, the bill comes due for the phased-in costs. Moreover, the costs that are deferred are financed at interest, and the consumer will ultimately pay both the financing costs and the deferred balance.

Finally, the use of phase-in policies means that one set of regulators can escape responsibility for their decisions. By deferring the costs of non-utility power, the previous commission members misled consumers about the real costs of their policies, and therefore deflected challenges to those policies. Had the public (and the legislature) understood the true costs of those policies sooner, we might well have altered those policies.

I am not necessarily arguing that expanded non-utility generation was fundamentally wrong. The policy of extensive purchases from non-utility generators was equivalent to the purchase of an insurance policy against higher oil prices. By relying on co-generation contracts, wood, and other alternate energy sources, Maine dramatically reduced its reliance on oil and insulated its electric customers against rapid oil-driven price increases. Had oil prices continued to increase, this insurance policy would have paid off handsomely. But if we had understood the true cost of the insurance policy, I suspect that we might have lowered the coverage to reduce the premium.

Lest my position on phase-ins be viewed as too absolutist, let me acknowledge that the pace of regulatory decision-making involves an inherent arbitrariness, and that some flexibility in timing is necessary to manage this arbitrariness. It is difficult to imagine a situation where more than a twelve-month delay would be required to manage this problem, however. At the very least, perhaps a workable rule might be that no commissioner (or legislator) should vote for a phase-in that extends beyond her or his current term.

So, let's phase-out the phase-ins. Like all phased policies, this phase-out needs a timetable. I would suggest that we start now.

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