

# How Many Regulators Do We Need?

by MICHELLE MICHOT FOSS

Here's a question: As the energy utilities move through an historic transformation, should we begin the next century with the regulatory landscape looking like it did at the beginning of this one? For all the discussion about industry convergence, restructuring and retooling in the name of adding

value to the customer and providing greater flexibility and choice, little is said about how this extends, or should extend, to the regulatory arena. I am speaking of fundamental change, not just the quality improvements that regulatory commissions, particularly state public utility commissions, have been making. Regulatory commissions in the U.S. have been streamlining their processes, learning and adopting new methods, acquiring new technology and gaining efficiencies. My question is more basic, and goes to the heart of utility regulation in the first place.

We all know that our federalist system of regulation in the U.S. reflects the basic desire for self-determination at the state level, and that federal regulation exists mainly to resolve coordination problems in interstate commerce. Depending upon one's historical perspective, the origin of regulation at the state level may have made a certain amount of sense. The usual thesis is that regulation emerged as an "ordering" mechanism, allowing development of local utilities to the benefit of both shareholders (who were losing out in the raucous competitiveness of the early days) and consumers (who needed protection from monopoly pricing — the

"regulation as a substitute for competition" strategy).

This view begs a few points. Although utilities are local businesses in one respect, holding companies emerged at an early stage to give these industries at least a regional, if not national, flavor. The interconnections that evolved across transmission and distribution systems were a solution to the search for efficient flows of gas and electricity. Also fairly early on, interconnections with Canada and Mexico were developed, suggesting what many of us would like to argue is a strong future possibility — seamless transactions of gas and electricity across North America, with flows dictated by comparative advantage rather than policy or regulatory edict.

These days, the energy utility industries are changing rapidly, perhaps more than some would like. Some energy entrepreneurs will try, are trying, to build synergistic, converged utility industries across North America with strong economies of scope. Some of the converged systems are likely to link energy utilities with other network services like telecom. Others will pursue niche markets that depend on ultimate

flexibility and access to an array of systems and technologies. Still more entrepreneurs will develop strategic models that have not yet been contemplated. All of these differ from the current system.

Given the general tendency for government to lag behind market developments, we can only imagine the kinds of problems on the horizon as these entrepreneurs bump up against our regulatory landscape.

Setting aside "states' rights" and constitutional issues for a moment, it is worth considering whether there should be a national solution, or at least a national conference to re-order the state public utility regulatory system. Here is why: Over the years, many researchers, including myself, have attempted to study and understand state public utility regulation. It is not an easy undertaking, yet there seem to be two broad, conclusions that are consistent with general wisdom. One is that there is an amazing if haphazard process by which changes in "regulatory technology," or new approaches to regulation, diffuse across commissions. The second is that this process tends to come in stages. Industry change, in energy technology for instance, creates lumpiness as individual state commissions seek to regulate evolving industries. The lumpiness eventually is smoothed out as methods that work well are adopted across commissions. Depending upon the extent of the initial disruption, the process can be either quick, or very long. The length of time required for diffusion of regulatory technology affects the marketplace, sometimes profoundly.

Sometimes events take place that are national in scope. All interests are affected, not just a few. One thing we should have all learned from the 1970s is that government policies that impose solutions are not



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the right ones. Government policies that allow markets to seek solutions seem to work better.

Because so many of the issues today are national in scope, we may want to level the playing field across the United States with solutions for transition and stranded costs that spread the pain as much as possible, thus loosening local politics and hastening the benefits.

For the strongest free marketers among us, take note: It is unlikely that regulators, at any jurisdictional level, will ride easily off into the sunset.

Some have remarked that regulators might themselves be "stranded" by the fast-moving marketplace. But the truth is that regulatory systems have survived many onslaughts through this century because of some pretty basic features of human socialization and a technical problem or two.

One is our fear of the unknown. During times of change, in particular wrenching change that alters our daily lives, we seek comfort in the status quo. If enough of us are too uncomfortable, the status quo becomes that much more difficult to break.

Another is the political nature of regulation. Regulation sends the wrong signals, provides the wrong incentives, and does so through a form of redistribution of wealth — which is why it is so politically appealing. We as consumers receive benefits from regulatory institutions in the form of redistributed monopoly profits via the regulation-as-substitution-for-competition arrangement. We could be receiving these same benefits, and more, in the form of savings generated by price competitive industries. Which is better? But which has more political appeal?

Also, distribution and much of transportation are still physical monopolies. There are, of course, lots of ways to confine the extent and effect of physical monopoly, to make markets at least contestable if not competitive. And there may be some surprises in how the marketplace reorganizes in the transition to more competitive delivery of energy services, that minimize the effect of physical network monopolies. Nevertheless, the tendency toward traditional regulatory management of monopoly infrastructure systems may remain.

Clearly, this is a time when we should be asking some basic questions. What is

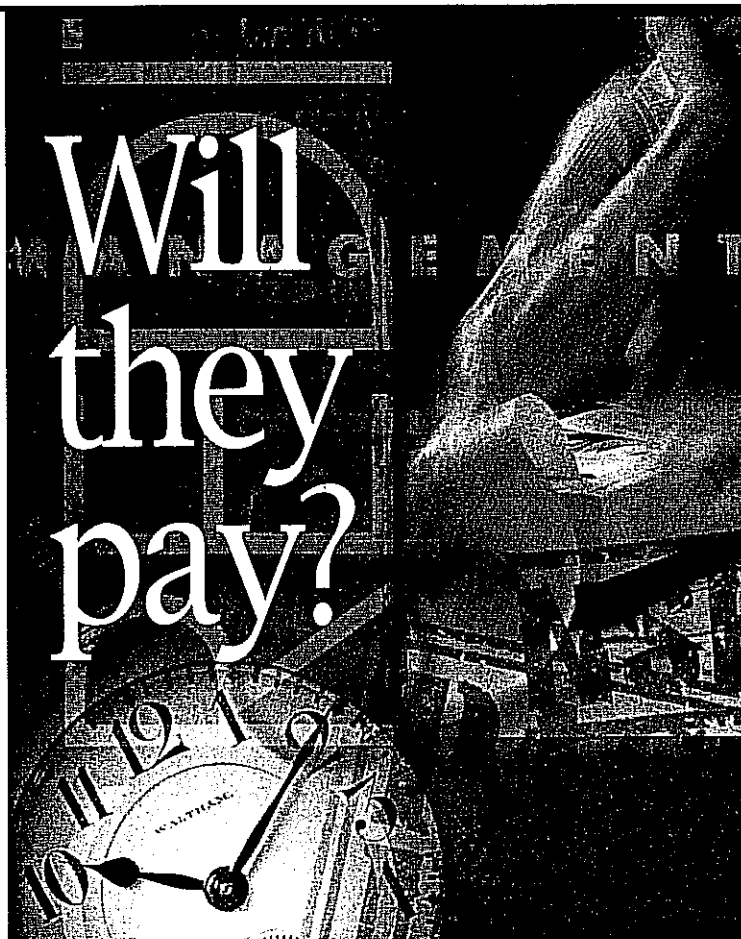
the role of regulation, if any, and who should be regulating whom, where regulation is justified?

Should we be adding potential layers of regulation to a dynamic marketplace? It's been suggested that independent system operators (ISOs) for electricity might begin to take on aspects of regulatory control. Can we afford the potential for more regulation at such a critical stage?

Who should be reviewing mergers? Do we need two layers of review at the federal

level (Department of Justice/Antitrust and the FERC)? Do we need review at the state level?

In economies and societies, there will always be actors who seek protection, sometimes justifiably, and coalition politics will always be a factor. Institutions that facilitate dispute resolution will be vital for the future North American market. But they need to reflect the marketplace realities of the next century, not this one. ◊



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