Taking Advantage of a Regulatory Window

By DOUGLAS N. JONES

This article suggests that a window of opportunity has presented itself to state utility regulatory commissioners and their staffs, permitting them to reassess the need for, or the validity of, a great many policies and concepts adopted by them during a time of unusual financial turbulence and stress for the utilities which they regulate. The author identifies 13 different regulatory strategems or underlying concepts, many of them resorted to as means of coping with crisis or averting disaster, which in more normal or prosperous times would well bear reevaluation.

The purpose of this article is to consider the question, "What might regulators best do in this period of fewer rate cases and hence relative quietude on the front lines?" Posing the question this way assumes that fewer rate cases really does translate into a quieter time. It also assumes that this period of relative calm will last for a while. The point is that relief from successive waves of rate case filings that characterized the first four years of this decade (they averaged 235 annually) does allow regulators to control their own agenda a lot more (where filings the last four years average 112 annually) and be more deliberative in what they choose to focus on.1

A Choice of Directions

Broadly speaking, there are two directions to choose from as to how regulators might use this window of opportunity, and they are somewhat contradictory. One is to spend the available time and energy and brainpower on devising and perhaps experimenting with new concepts, practices, and procedures to improve public utility regulation. "Improve" in the current context often means facilitate, streamline, or relax regulatory oversight. Regulation by formula, by benchmarks, by appeal only, by stipulation, are examples of this pursuit. This is usually seen as a forward look. Its attractions are that almost everyone enjoys being visionary and on "the cutting edge" with the chance of "breaking new ground." Moreover, some such chances undoubtedly exist.

Another and quite different opportunity the present period allows is to revisit the concepts, practices, and procedures that were introduced in the years from, say, 1974 to 1986 when regulation was under extreme stress and see if they should be continued. This, admittedly, is a backward look. I favor taking advantage of the second opportunity, even though such a stance runs the risk of being labeled "reactionary." A more charitable characterization is that it represents a "traditionalist" view.

The argument that the best use of the period is for reexamination rather than more innovation flows from the belief that many things that regulation did in the past decade were improvisations, hastily put together, generally under duress, and often in response to the

*The views and opinions expressed in this article are solely that of the author and do not necessarily state or reflect the views, opinions, or policies of the National Regulatory Research Institute, the National Association of Regulatory Utility Commissioners, or NARUC member commissions.

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pulling and hauling of this or that stakeholder — rate-payers, stockholders, utility managements, governors, attorneys general, legislatures, consumers counsels. Furthermore, the circumstances that occasioned a number of these innovations may no longer be with us; for example, the rapid and unpredictable run-up in prices of factor inputs and the resulting financial straits of the utility sectors that required unusual commission responses. Now we have general price stability and the utilities are doing very well indeed. Accordingly, a steely eyed and reflective reassessment of the changes that were introduced in concepts, practices, and procedures would seem to be called for before commission regulation goes on to some “next plateau.”

Specific Policies and Practices to Be Reexamined

With these assertions, here are the specifics of what might best be reexamined. Thirteen subjects are sketched as the body of this commentary.

1. Fuel adjustment clauses (especially the automatic kind) should be reviewed with an eye toward getting them out of utility tariffs. While both their design and commission oversight of fuel adjustment clauses (FACs) and purchased gas adjustments (PGAs) have been improved in recent years (and some are working well on the downside) the occasion for instituting them in the first place no longer obtains. Recall that the original tests for whether an FAC would be allowed in a utility tariff typically were threefold: (1) that the fuel cost component in the utility’s total operating costs was really large enough to matter; (2) that fuel cost changes were volatile and unpredictable; and (3) that the purchased fuel prices were entirely outside the control of the buying utility. It is doubtful that all three of these tests are still being met in all instances where FACs and PGAs remain. Similarily, other automatic adjustment clauses (AACs) that have fashionably crept into utility tariff — e.g., applying them to the labor or interest cost components or (most recently) the idea of supplementing decommissioning plant funds through an AAC — deserve reappraisal.

2. The use of future test years rather than historical ones might be reexamined. Modifications like rolling test periods with quarterly “true ups” avoid some of the difficulties with predicting the future, but it would be still better in times of relative stability to return to actual numbers. The “known and the knowable” are to be preferred to the “perhaps and the foreseeable.”

3. Allowing construction-work-in-progress (CWIP) as a way of propping up utility earnings could be reassessed: The “used and useful” test for including utility plant in rate base would seem to be worth returning to. For one thing, utility earnings no longer need propping up. More importantly, despite tortuous reasoning to reconcile the two, the concepts have always been in conflict. In all events, a general rate case is a better vehicle for determining new earnings levels and cost recovery than questionable mechanisms like CWIP.

4. Provisions for mandatory shortened consideration periods in rate cases and the permitting of panicking of rate cases are two other candidates for review. Nearly instantaneous cost recovery is no longer required with the current financial strength of the utility sectors, and in extreme hardship cases, the use of interim rate relief would suffice. At the moment, regulatory lag in fact benefits the utilities and not consumers; hence, there is some “switching of sides” on the importance of this phenomenon. The promptness by which recent decreases in tax liabilities and increases in utility productivity get translated into lower rates is a proper concern of commissions. Finally, the kinds of cases typically before commissions nowadays are complex and time consuming, and it is therefore questionable whether mandatory shortened consideration periods are appropriate. Similarly with the successive filing of rate cases by the same company before the prior one is resolved.

5. Allowing further diversification of regulated utilities into unregulated business enterprises (especially of the nongermane variety) should be reconsidered as a policy. While the downside problems of cross-subsidy, risk shifting, and cost shuffling that regulators worried about this past decade have not generally eventuated, neither has the financial boon hoped for by the utilities resulted from their diversification efforts. What has mostly happened is a cluttering up of regulation by the need for additional and costly oversight. The production of high-quality utility services would seem to be enough of a challenge for managers without diverting scarce executive attention (not to mention financial resources) to tangential ventures like real estate and farming.

6. The idea of yardstick regulation might be worth reviving. At an earlier time, the comparison usually was between private and public power, and there are still some chances for this. Now the advent of cogenerators, small power producers, and (most recently) independent power producers should add opportunities for cost and pricing comparisons. The telecommunications sector has its counterparts with the advent of resellers, bypassers, cooperatives, and new long-distance carriers juxtaposed with the operations of “the telephone company.” While unpleasant for the participants, regulation by invidious comparison has a useful place in public oversight of business enterprise.

7. Relatedly, commissions might revisit the difficult business of devising improved methods for measuring and monitoring utility performance. It is a very tough nut to crack, but it is a proper one to work on. In the absence of market discipline, efficiency has to be sought in other ways. Several approaches still have some promise. Management audits as a tool were somewhat discredited earlier for various good reasons, but recently
they have been better focused, better designed, and more seriously pursued. Cross-section and time-series analysis can be revealing where one crucial performance indicator (of either the engineering or financial variety) is compared among several utility companies that are similarly circumstanced, or is traced over time with the same utility. Both the decision analytic approach and data envelopment analysis may have applicability in this difficult area.6

If commissions can avoid “giving away the store” in the bargain, some form of incentive regulation may be worth having. Various types have been proposed or tried, all involving some kind of splitting of the savings (gains) from “superior” performance between shareholders and ratepayers. While many have felt that the stronger side of the argument was that regulation did not have to give extra rewards for particularly good performance just because it penalized especially poor performance, it may be necessary to reluctantly yield on this view.7 Symmetrical treatment is probably better, but more on grounds of the reality of human behavior than on the logic of the case.

Finally, old-fashioned jawboning may be too little used nowadays as an informal incentive in shaping utility behavior. It can be an effective force in certain circumstances — perhaps especially where there are basically good relations between the regulators and the regulated companies, characterized by mutual respect and trust.

8. In tariff design it is fair to inquire if perhaps rates have been flattened too much, as against promotional pricing; if we have unbundled too much, as against system averaging; and if we have pursued lifeline rates in all sectors in a well-intentioned but inappropriate fashion. Volume discount pricing, pooling of costs and revenues, and taxpayer rather than ratepayer provision of minimum utility services may be the preferred route in certain circumstances.

The other side of examining whether rate design has become too flattened in general tariffs is whether in some instances tariffs are too steeply discounted for particular customers — large ones with supply alternatives and an inclination to use their real or presumed leverage. The prohibition against undue price discrimination in the utility and transport fields is an old cornerstone of regulation. Elusive as is its determination in either legal or economic terms, there is need to be particularly watchful now where commissions are increasingly faced with system bypass arguments, surplus capacity, special pleadings for economic development and incentive rates, and the dangers inherent in overseeing a partially regulated and partially unregulated environment.8

9. In the twin considerations of equity and efficiency that occupy so much of a regulator’s time, it may be that a tilt toward the former (equity) is now in order, lest the free marketeers, cost causation analysts, and the correct price signalers “do in” decent public policy in the name of efficiency. A dominant concern for fairness has always been a special strength of the quasi-judicial nature of administrative regulation. It is time to reassert this traditional focus and be unapologetic for it.

10. The relatively quiet period we now enjoy allows tackling again the elusive and endless issue that is so central to public utility regulation — the relating of returns to risk to the risk taken. The dynamics of the utility sectors mean that riskiness has almost certainly changed, but by how much? And even in what direction? The wrestling of this issue to some provisional conclusion would be a great service, as regulation decides upon allowable earnings levels for jurisdictional utilities in the near term. Begging the whole question by adopting an approach which abandons profit regulation in favor of price surveillance is not the recommended outcome.

11. It is to be hoped that commissions will reassert the presumption of market failure as characterizing the fixed utility sectors. The word is “presumption” and not “fact” because, of course, there are instances where workable competition exists and can be harnessed for the public good, and regulation can be commensurately relaxed. But that is very different from the stance in which some would place the regulator — having the burden to demonstrate that utility markets are monopolistic or nearly so.

Both the academic and trade press are currently very active in claiming the widespread presence of vigorous market competition if only commissions will get out of the way. Some such markets are there and more may well materialize. But the prudent course to follow is to keep the perspective one of “competition within a regulatory framework” and not one of “regulation within a competitive framework.”

12. It is, of course, not something that regulatory commissions control, but there is a clear need for public utility commissions to resist (better still try to roll back) the recent incursions of state legislatures into the historical domain of the commissions. The prescribing of outcomes on important regulatory questions, like legislating that there will (or will not) be CWIP or FACs, that there will be lifeline rates, or that there will be deregulation of certain telephone carrier services comes to mind as particularly unfortunate examples. These matters should be left to the independent regulatory commissions for decision on the policy merit.

While a commission is a creature of the legislature, this ought not to mean that legislatures should “reach in” at their whim on this or that issue. To do so is to “set the clock back” to the legislative era that was abandoned when administrative commission regulation came to the fore. Public utility commissioners could now be active in convincing their state legislatures through their oversight committees that the public, and surely state government organization, are best served if legislatures
largely limit their role to providing (1) strong permissive statutory underpinning to the commission, (2) ample budgets for their effective operation, and (3) a thorough confirmation process for nominees to the commission.

Though it is here argued that commissions should in some sense "distance themselves" from the reach of their state legislatures, at the same time this period of relative calm in rate case filings should allow public utility commissions to "get closer" to sister state agencies that have important ancillary roles to play in utility regulation. State divisions of taxation, environmental protection, and safety are prime candidates for collaboration. All too often in the pace of things there is insufficient recognition accorded the benefits of interagency cooperation.9

13. Finally, the limited view that sees commission regulation as merely a proxy for competition needs to be contested. Regulation is a larger idea than that, and it has been unfair and hurtful in the debates of the past decade to cast regulation as something arrived at by default; a last resort, a necessary evil. Rather, it is an instrument of social good that allows accomplishing desirable things that markets will not or cannot do. Repair of that vision of public utility regulation would be a happy outcome indeed.

**Best Use of an Opportunity**

It is recognized that public utility commissions do not control all of these items. Legislatures work their own wills. Regulated utilities would likely resist some, though presumably not all, of these suggested reviews. They would probably consider many of the current practices as representing hard won gains not to be casually yielded up. But revisiting does not mean prejudging the outcome, and it might well be that a number of them have survival value.

What is unarguable is that only occasionally do public utility commissions have a period of time when they can largely set their own agenda and take initiating roles. The claim here is that best use of that opportunity involves reexamination of the main improvisations of the prior tumultuous time before turning to inventive solutions to new problems.

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**Endnotes**

1These averages were reported by the Honorable Dennis Thomas, chairman, Texas Public Utility Commission, in an unpublished paper entitled "Regulating Without Rate Cases," given at the Mid-America Regulatory Conference, Rapid City, South Dakota, June 19-22, 1988, p. 4, citing Regulatory Research Associates, Inc., data.


3Some 20 state commissions and the FERC allow full or partial forecasting of test years. *Ibid.,* Table 13, p. 417.

4For two treatments of the subject see Robert E. Burns et al., *Regulating Electric Utilities with Subsidiaries* (Columbus, Ohio: National Regulatory Research Institute [NRRI], 1986), and David Chesser et al., *Unregulated Enterprises of the Bell Regional Holding Companies* (Columbus, Ohio: NRRI, 1986).

5See, for example, Daniel J. Duann et al., *Competitive Bidding for Electric Generating Capacity: Application and Implementation* (Columbus, Ohio: NRRI, 1988).


8Significantly, the board of directors of the National Regulatory Research Institute in September 1988 requested the NRRI staff to prepare a study on this subject in 1989 (J. Stephen Henderson and Robert E. Burns, *An Economic and Legal Analysis of Undue Price Discrimination*).


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**Review of Least-cost Utility Planning Is Available**

Energy economics specialists at Lawrence Berkeley Laboratory and Oak Ridge National Laboratory have reviewed recent activities among utilities and public utility commissions on least-cost utility planning (LCUP) and made recommendations on future work. Both are presented in a new report, "Least-Cost Planning in the Utility Sector: Progress and Challenges." The report calls LCUP a new way for utilities and regulatory commissions to assess various demand and supply resources consistently in order to meet customer energy-service needs cost-effectively. It differs from traditional utility planning in at least four ways: (1) It explicitly includes conservation and load-management programs as energy and capacity resources, (2) it considers environmental and social factors as well as direct economic costs, (3) it involves public participation, and (4) it analyzes the uncertainties and risks posed by different resource portfolios and by external factors. Among the recommendations made are an assessment of regulatory alternatives that reward utilities for successfully implementing least-cost plans, and expanded technical support activities that share planning successes, analytical tools, and innovative regulatory strategies among commissions and utilities. The report is available from the National Technical Information Service, U.S. Department of Commerce, 5285 Port Royal Road, Springfield, VA 22161.