What's Right With Utility Regulation

By DOUGLAS N. JONES*

At a time when deregulation of many traditionally regulated utility activities is widely urged, and "failures" of the regulatory process are cited to support that aim, a writer with broad experience in the academic and governmental arenas alike comes to the defense of regulation in the following article. In what is intended as a point-of-view essay rather than a thorough pro and con analysis, he points to flaws in a dozen frequently heard criticisms of regulation as an institution.

This could be an essay about three familiar themes that we have come to know in the communications sector (equal time, equal access, and even fields), but is really about what is central to all of them — the idea of fairness — and a call for its application to any appraisals of commission regulation of public utilities.

We should in fact insist on it, for it is at least ironic that so little fair-mindedness is applied to journalistic, political, and even academic assessments of commission regulation when fairness is itself the distinguishing feature, the bedrock of what we do with others. Commissions spend most of their time in pursuit of fairness: fairness to the regulated companies, fairness to the ratepayers, fairness to other parties to the enterprise. It is not, therefore, too much to demand that fairness also characterize evaluations and commentaries about this peculiarly American phenomenon — administrative regulation of utilities that are (mostly) privately owned but must be operated in a public interest fashion.

A prime example of the unfairness which I have in mind is the frequency with which critics of commission regulation make inappropriate comparisons with the beauties of markets. One should either compare imperfect regulation with imperfectly functioning markets or idealized regulation with idealized markets. It is entirely unfair to rail against the blemishes of commission regulation as though the obvious alternative were frictionless free markets of the Adam Smith variety.

In fact, of course, commission regulation of public utilities is but one of several arrangements we have contrived for the social control of industry. Antitrust, outright public ownership, public and private joint ownership, public members on corporate boards of directors, moral suasion, and jawboning are others that might be mentioned. It is a theme of this article that commission regulation has survived recent attacks on it not because of the power of narrow political constituencies, not because of agency resistance based on self-preservation, not because of public apathy and inertia, but because it has worked quite well.

The Criticisms and the Counterparts

Consider the main criticisms heard against commission regulation. There are a dozen of them that are often cited, and of these twelve eight are arguably bum...
raps, three are misperceptions of the task of regulation, and one is beyond the control of commission regulation in the first place.\footnote{The criticisms here listed are drawn generally from William G. Shepherd's and Clair Wilcox's excellent text, "Public Policies Toward Business," sixth edition, R. D. Irwin, Inc., Homewood, Illinois, 1979, p. 397.}

1) **Regulation is inflexible and slow.** But a mound of evidence points another way. Most economic regulation of transportation has been relinquished entirely when the new realities became persuasive. In the power field fuel adjustment clauses (including automatic ones) were quickly allowed to proliferate in gas and electric utility tariffs in the interest of nearly instant cost recovery upon the advent of the 1973 oil embargo and promptly gathered the revenue.\footnote{By the end of 1974 nearly all states allowed fuel adjustment clauses (FACs) in utility tariffs. Some indication of their importance in revenue raising can be gotten from the fact that for the 25-year period 1948-73, the general rate increases granted electric and gas utilities by state and local jurisdictions totaled $56 billion. In the first year after the oil embargo ratepayers paid $6.2 billion in utility bills attributable to FACs alone and half that amount again in general rate increases ($3.1 billion). Five years later (1979) FACs were bringing in $177 billion in revenues while general rate increases remained at the old level ($33.3 billion). Electric and Gas Utility Rate and Fuel Adjustment Clause Increases, 1978 and 1979, R. J. Profozich, D. N. Jones, and G. T. Biggs, the National Regulatory Research Institute, Columbus, Ohio, 1981, p. 3.} Moreover, future test-year calculations, trended costs, ample use of interim rate relief, construction work in progress, and various tax preferences like investment tax credits and accelerated depreciation (combined with normalization accounting) all served to prop up utility earnings in recent periods in a way that could not fairly be described as unaccommodating and slow. Also, commission adaptation to the postdivestiture period in telecommunications and deregulation in the natural gas sector has been both rapid and imaginative, for example in allowing flexible pricing schemes and setting the boundaries for competition within a regulatory framework.

2) **Regulation is costly and inflationary.** But the fact is that the actual budgetary costs of state and federal regulatory commissions are small compared with most other agencies, whichever party is in power. Furthermore, price rises allegedly attributable to the bad effects of regulation are (with the exception of transportation) not persuasively documentable and in any event are so small as to be lost in a $3 trillion economy. Finally, while a dubious way to calculate it, if all commission-ordered rate increases are to be counted as "inflationary," then fairness requires that utility rate requests denied should be counted as "deflationary" or at least as striking a blow for price level stability. And for the assertion to have any meaning at all, the issue should be cast as "costly" compared to what? Surely not the effects of unbridled monopoly enterprise.

3) **Regulation is inept and bumbling.** But all indications are that there has been a nearly straight-line increase in commissioner skills, commission staff size and technical expertise, information flow and analysis (including new computer-assisted research), and belief in data and evidence. "Seat-of-the-pants" regulation is now history. It should be noted too that changes in direction by a commission are not automatically to be equated with ineptitude and uncertainty but may instead be occasioned by changes in circumstance over time or changes in policy orientation. In all events this knock against regulation is incompatible with the previous one in that gaining expertise by commissions is almost always costly.

4) **Regulation operates with obscured doctrine, few principles, and vague criteria.** But what about the facts that the elements of a fair return set down by the Supreme Court in landmark regulatory cases have endured to the present and that due process, nonconfiscatory rate making, rights of eminent domain, and the paramount nature of the public interest, are clear tenets of regulation? One can also point to the prominence of costs, the centrality of risk and returns to risk, and the focus on efficiency criteria as mainstays in regulation while recognizing that equity is always elusive to operationalize.

5) **Regulation is passive and weak.** But a good case can be made that while there are certainly variations among commissions and even the same commission over time, administrative regulation is increasingly assertive, activist, and expansionistic as to purview. Further, it is often stringent, and constantly narrowing the circle of presumed "management prerogatives."

6) **Regulation is industry-minded.** This is a proper worry given (a) the enormous dollar amounts involved, (b) the origins of regulation with their intended tilt toward the public, and (c) the vulnerability of the process to manipulation. But the evidence is that the "capture theory" of regulation is largely discredited, and commission behavior in this regard is more likely to be explained by parallelism of interest, like concerns for service reliability and financial viability.\footnote{See for example Warren J. Samuels' insightful discussion of the point in his article "Consumerism and the Public Utility Institution," appearing in Challenges for Public Utility Regulation in the 1980s, Harry M. Trebing, editor, Michigan State University, 1981, pp. 445-456.} Also, checks and balances are increasingly built-in through consumers counsels, attorneys general, governors offices, courts, and legislatures.

7) **Regulation is characterized by intergovernmental (and intragovernmental) quarreling.** Perhaps, but indications are that much of this is merely "background noise" and evidence of a healthy tension.\footnote{I would place the federal-state jostling associated with the Public Utility Regulatory Policies Act in the "healthy tension" category, for example. Current struggles over Federal Communications Commission preemption activities admittedly go well beyond the "background noise" level.} Moreover, not all bureaucratic behavior is bad in that it is...
important that regulatory commissions remain independent and that jurisdictional boundaries be defended where encroachment is unwise or unnecessary.

8) Regulation inhibits technological progress. While the history of transport regulation gives some truth to this, in the other regulated sectors it can be argued that commissions have demonstrated great adaptability to innovation, for example, from the 1960s onward in telecommunications with the present postdivestiture period as "Exhibit A." In addition, commissions have been in the forefront of encouraging, not obstructing, inventive developments in power transmission and wheeling, and in the fostering of utility industry research activities like the Electric Power Research Institute and the Gas Research Institute and their own National Regulatory Research Institute.

It was earlier asserted that three of the dozen "most often heard complaints" against commission regulation were misperceptions of the task itself. Here is why. It is said that:

9) Commission regulation compromises divergent interests. But the point is that compromise is the very genius of the system of dispute resolution. By design commissions are not entirely judicial entities, but quasi-judicial ones, and the "quasi" element is the political dimension, in the sense of policymaking. Operating at their best, commissions are forums and facilitators for reconciling competing positions into a public interest outcome.

10) Commission regulation is backward looking and pre-occupied with the present. But this was largely the original design and intent of commission regulation. The past and present are always more certain of determination, while almost anything can be ascribed to the future. Much of the focus of regulation must be on accounting costs, known financial circumstances and results, and current profitability.

11) Commission regulation makes for capital starvation of utilities. This is an old argument in good times and bad, but the facts are that excess capacity in the electric sector continues commonly in the 30 to 40 per cent range; utility stocks often outperform the market generally and when taken together with rising dividends continue to be among the most attractive investments around; and since the rate base is central to public utility regulation, control of it is exactly the correct focus for steely eyed scrutiny by commissions.

Finally, it was stated that one of the dozen criticisms of administrative regulation was really beyond the control of commissions anyway. That is the complaint that:

12) The independence of regulatory commission is diluted by legislatures and governors on the big issues. Sadly, there is a lot to this. It is a current trend to be decried and resisted. Such actions are hurtful to administrative regulation and are ill-vised throwbacks to earlier periods of discredited legislative regulation.6

Fair-minded Appraisal

What, then does a fair-minded appraisal of commission regulation of public utilities involve? It seems to me the correct stance is to acknowledge that just as all of U. S. society's problems are not "with Washington," so all of the utility industries' problems are not "with regulation." Indeed, as has been argued here, commission regulation has historically been supportive, adaptive, and accommodating.

Like most institutions it probably is not perfectible, but it is improvable and that should be the quest.

When working for the Congress as a public utilities economist in the 1970s, one of the tasks the author occasionally had was to help arrange for witnesses to testify before the Joint Economic Committee, the Senate Government Operations Committee, and the House Interstate and Foreign Commerce Committee in various hearings held on the then-current issue of regulatory reform. To the writer's dismay it was always difficult to get witnesses to speak up for regulation, although it was easy to locate ones to denounce it.

The ideologues saw the period as an opportunity to "get government off our backs"; some parts of the regulated sectors which had long felt put upon saw the reform movement as a chance to strike back; the journalistic community largely failed to understand what was really at stake; the academic community, which should have known better, was either hiding or joining in the chorus of the Chicago and Virginia schools of free marketeers; and of course the practitioners who would come forward tended to be dismissed as having self-serving things to say. One would have thought that commission regulation of public utilities was the recent invention of Hubert Humphrey liberals bent on being unpleasant to American business, instead of being an institution of ninety years of standing — often with major accomplishments to its credit.

In the face of all this, however, and with no "equal access," no "even field," and little fairness directed toward it, commission regulation was able adroitly to handle tumultuous times in the transport, power, and now the communications fields. It did so primarily because it is an inventive, workable instrument of social control of that "half-way house" in American industry — the public utility sector.

It is a time to speak up for regulation for there is much to be said for it on the merits.

3The Big John Hopper and Ingot Mold cases are frequently cited as examples of Interstate Commerce Commission retardation of innovation in the interest of industry stability.