

# **Reset for Regulation and Utilities: Leadership for a Time of Constant Change**

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## **Abstract**

This paper describes a process for a reset of regulation and utilities in today's environment of constant change. "Reset" means to develop fresh perspectives and knowledge about the future, all the while holding in trust the wisdom of the past. The paper examines three juxtapositions: (1) Focus on next practices, not best practices; (2) Emphasize learning the why of how things work and not just the what; and (3) Provide leadership rather than try to lead.

Keywords: Leadership; Change; Utilities; Regulation

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## Introduction

There are no easy answers for today's utilities and their regulators. Climate change policy for the United States is on the shelf at least for now, but the financial risks continue to loom large for utilities that fail in their political forecasts. Regulators, policy makers, and utilities are all trying to anticipate the future of smart grid, but that future depends upon the policies and regulations themselves, upon consumer response, and upon future technologies. Politics, customer responses and technologies are impossible to anticipate with much certainty, but getting them right is crucial: Recall how Western Union famously dismissed the telephones as mere toys? And the once dominant Microsoft has been seriously wounded because it wasn't ready for the Internet and cloud computing.

New policy initiatives, changing technologies, blurring boundaries between regulation and politics, and volatile economics and markets hold the potential to drive fundamental changes in the electricity industry and its regulation. Many traditions seem to be up for grabs: determinants of profit, regulatory independence, and system control to name a few. Are the examples of the Maryland legislature disbanding the Public Service Commission, or a former Florida governor announcing that commission rate decisions will determine his commissioner appointments anomalies or indicators of things to come?

With this much turmoil, how should the industry and its regulators think about their futures? When the future is unknown our natural tendency is to look for fixes or for someone who has the answer. That is why there are so many conferences where the brightest minds present their solutions or bring the latest news. That is also why people focus on statements from political leaders, business leaders, and expert consultants for guidance.

But what if the best among us don't have the answers, even if they think they do? Or maybe they don't even know the right questions? How can we reset stakeholders' expectations and help our own organizations accept that context had changed and that the strategies that made us successful in the past could be largely irrelevant for the future? How can a system tightly controlled by laws, legal precedence, sunk investments, regulatory processes and traditions, and the like be flexible enough to step back and invest in learning?

It isn't easy, but it is doable. Consider the experience several years ago a group of Caribbean utility regulators, who gathered in Jamaica to discuss how they might support each other as they strived to establish utility reforms, build their new regulatory agencies, and move towards greater regulatory independence. The outcome of their meeting was the Organisation of Caribbean Utility Regulators (OOCUR). The regulators did not know how OOCUR would evolve or what it would become, but they knew they had a common purpose and took the future one step at a time, which enabled them to form an effective regulatory alliance.

In uncertain times it is more important to ask the right questions (and risk getting wrong answers) than to get the right answers to the wrong questions. Rather than ask, "Is this smart grid investment prudent?" we should ask, "Does this investment teach us something that we need to know?" Rather

than ask, “Does this regulatory decision favor consumers or investors?” we should ask, “What options for the future does this decision create or foreclose?”

This is a reset of regulation and of utilities. “Reset” means that we develop fresh perspectives and knowledge about the future, all the while holding in trust the wisdom of the past. Reset does not mean that we engage in a grandiose redesign of utilities or regulation. To legitimately do this would require a belief that we know the future. Nor does reset suggest that everyone should reboot and erase institutional memory. Rather it means that we find smart, manageable experiments based on due diligence; systematically learn from our own experiments, share results with others, and learn from others’ efforts; and then decide what to try next. No one is the leader, but everyone practices leadership.

This paper explores three juxtapositions to describe how to engage in reset. The first is that we should focus on next practices, not best practices.<sup>1</sup> Best practice is about imitation and is important for following in someone else’s footsteps. A focus on next practice is needed when we are going into areas where no one has gone before.

The second juxtaposition contrasts the question of “Why?” and the question of “What?”<sup>2</sup> When we ask ourselves “What should we do next?” we emphasize practice. But the practice needs a foundation of basic principles and values. So we should ask ourselves “Why have certain practices or experiments been successful or unsuccessful?” so that we engage in an analysis of our underlying priorities and of our context. This allows us to learn, keep what is important, and discard what holds us back. The third juxtaposition is between leading and leadership. A leader provides direction, which is proper when the right direction is known with a high probability. In contrast leadership mobilizes people to tackle difficult and often ambiguous problems and circumstances.<sup>3</sup>

### **Next Practice, Not Best Practice**

Utility regulation is probably the most technically complex function of government. Properly done, regulation involves the interdisciplinary efforts of financial analysts, accountants, lawyers, engineers, economists, public relations experts, and administrators. This technical work is the bread and butter of regulation.<sup>4</sup> For example the U.K. energy regulator’s plans for 2011-12 emphasize the completion of rate

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<sup>1</sup> Heifetz, Grashow, and Linsky (2009b).

<sup>2</sup> Collins (2009), pp. 36-42.

<sup>3</sup> Heifetz (1994), p. 15.

<sup>4</sup> Jamison, Rowe, and Perlman (2005).

cases, deciding funding for various infrastructure projects, and reforming market processes.<sup>5</sup> The U.S. Federal Energy Regulatory Commission's strategic plan identifies regulatory ratemaking, market oversight, and infrastructure development and siting among commission's primary instruments for achieving its goals.<sup>6</sup>

In performing their work, regulatory agencies often imitate the practices of other agencies in addition to following expert analysis. A former PURC student, Troy Quast, researched this issue in his dissertation and found that regulatory decisions of small U.S. states are heavily influenced by the decisions of the largest states in their respective regions even when the small states' circumstances are dissimilar to the large state's circumstances.<sup>7</sup> Similarly, a spot check of regulatory training programs and webinars shows that many emphasize best practices and experiences of practicing or former regulators.

Imitation is legitimate when we find ourselves in circumstances familiar to others, but can hurt us when we find ourselves in novel situations. Situations that are familiar present what are called technical challenges, which are problems where there is general agreement on the existence and nature of the problem, the alternative solutions are clear, and work can be done by subject matter experts, such as regulatory economists, lawyers, and accountants. In contrast, novel experiences present adaptive challenges, which are those that arise when fundamental changes in a group's (or an individual's) environment call for rethinking basic goals and strategies.<sup>8</sup>

How can we tell when circumstances are familiar or when they are novel? This is difficult and the tendency is to misidentify novel experiences as familiar ones.<sup>9</sup> But there are signals that alert us. One signal is stakeholders disagreeing on whether there is a problem or on the nature of the problem. Consider what happened in New Orleans when it was struck by Hurricane Katrina. The possible consequences of such a storm had been known for some time, but political priorities favored putting taxpayer money into projects other than building up the city's dikes. When the storm struck many people remained in denial about the consequences: Some residents refused to seek safety and some politicians let jurisdictional boundaries and face-saving be higher priorities than quick and efficient responses to the crisis.

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<sup>5</sup> Ofgem, "Proposed Corporate Strategy and Plan 2011-16," January 10, 2011.

<http://www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/Proposed%20Corporate%20Strategy%20and%20Plan%202011-16.pdf>, accessed March 12, 2011.

<sup>6</sup> Federal Energy Regulatory Commission, "The Strategic Plan FY 2009-2014," September 2009.

<http://www.ferc.gov/about/strat-docs/FY-09-14-strat-plan-print.pdf>, accessed March 12, 2011.

<sup>7</sup> Quast (2005).

<sup>8</sup> Heifetz (1994), pp. 3-9, 35.

<sup>9</sup> Heifetz and Linsky (2002), p. 14.

Other signals indicating adaptive challenges include stakeholders' embracing policy options that align with long held beliefs and biases rather than with the problem at hand, and refusing to change behavior and implement policies that have been agreed upon.<sup>10</sup> Consider the experience of one African country that created a multi-sector utility commission at the prompting from the World Bank. It took over a year to begin hiring employees and the country failed to adopt sector laws that would give the agency clear policy direction and authority. In the United States, discussions of aging workforce for utilities often focus on transferring knowledge and preserving traditions and values. In contrast one forward looking utility treated the imminent surge in retirements as an opportunity to engage in a difficult conversation about long-established beliefs and behaviors that should retire as well.

Addressing adaptive challenges requires experimentation and an active engagement in surfacing conflicts and gaps between the beliefs and priorities people hold on the one hand, and the realities they face on the other.<sup>11</sup> The number of hurricanes in 2004 and 2005 in Florida triggered cries for increased undergrounding of lines, more aggressive rules for maintenance and system recovery, and the like. But rather than jumping into sweeping policy changes, the Florida Public Service Commission, the utilities, and PURC engaged in a dialogue about what really happened during the hurricanes. This led to a research program that created new modeling capabilities and new methods for learning from severe weather events so that stakeholders could engage in thoughtful discussions about their issues and decisions could be fact-based.

This experience illustrates the importance of adaptive learning, which is the learning that takes place when new experiences help us close the gap between what we believe is true and what is actually true.<sup>12</sup> It also illustrates the multilateral nature of the learning because regulators, industry representatives, and independent researchers from academia all contributed to the process, and stakeholders could actively engage in the discussion. For effective co-evolution of regulators, utilities, etc. to occur, the system must have decentralized control, outside perspectives, multiple decision makers, experiments, and deliberate sharing of ideas and debriefing on trials.<sup>13</sup>

Without deliberate effort to suspend traditional practices and controls, we can find ourselves stuck. In Australia, the incumbent telecommunications company, Telstra, took an unyielding, oppositional stance towards the sector regulator with respect to measuring service costs and towards the government with respect to the government's desire for a national broadband network. The result was regulatory paralysis and a ruling that Telstra could not participate in bidding on providing the broadband network.

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<sup>10</sup> Jamison (2006).

<sup>11</sup> Heifetz (1994), p. 22.

<sup>12</sup> Heifetz (1994), pp. 244-245; North (2005), pp. 66-67.

<sup>13</sup> Jamison (2009).

In contrast, the history of electricity industry restructuring is a case study in multilateral learning. In the early 1980s Chile accepted the reality that state-owned monopolies were not going to provide the power the country needed and led the world in electricity reforms. The country made mistakes that it, other Latin American countries, and several European countries learned from. These countries engaged in their own reforms and, for the most part, avoided repeating Chile's mistakes as they experimented with different reform models. The United States learned as well, but as evidenced by the California electricity crisis, did not learn well enough and created a new set of mistakes that others observed and learned from.<sup>14</sup>

### **Not what, but why**

Emphasizing next practice over best practice is important in times of change because the practices that made regulatory agencies successful in the past may work against them for the future because the context has changed. Recall the example of the Maryland Public Service Commission. The Commission treated Constellation's over 70 percent price increase as a technical issue, focusing on revenue requirement, rate design, and transition issues. It failed to respond adequately to the political context and effects of its staff being unhappy with the treatment of some of its senior members. The agency and the state politicians missed part of the essential DNA of utility regulation, namely the productive tension between short term political will and long term political aspirations.<sup>15</sup>

To make sure that we understand the essential characteristics and features of our institutions and practices, we must be students of our work.<sup>16</sup> Consider how Jim Collins, author of *From Good to Great*, which was Amazon's number 1 seller on strategy and competition as of the time of this writing, describes the importance of a leader being a continual learner. He tells the story of a small, unknown American company in the 1950s that decided to emphasize discount retailing in small, rural towns. The company's visionary leader emphasized partnership with his people, everyday low prices, and accountability. The company decimated its Main Street rivals and competed effectively against its primary competitor, K-Mart, a large discount retailer that was at this time an industry leader. The company's stock value increased 6000 percent from 1970 through 1985 and it became one of the country's largest discount retailers.

Now if you are thinking that Collins is describing Wal-Mart, you are wrong. He is talking about Ames Department Stores, a company that no longer exists. Why did Ames go out of business while Wal-Mart, following almost an identical business plan, rose to number one in the Fortune 500? Collins says a big

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<sup>14</sup> Jamison (2009).

<sup>15</sup> The DNA metaphor in a reset situation is developed and explained in Heifetz, Grashow, and Linsky (2009b).

<sup>16</sup> Collins (2009), p. 39.

part of the answer lies in Wal-Mart's founder's self-deprecating and inquisitive nature. Sam Walton famously interviewed his rivals' employees, taking copious notes on a yellow pad, and was well known for asking more questions than he answered when visited by foreign business leaders. This passion for knowing why things work, not just what works, was instrumental in propelling Wal-Mart to the top.<sup>17</sup>

Small differences can make all the difference because the "process of adaptation is at least as much a process of conservation as it is of reinvention."<sup>18</sup> What do we need to conserve? Modern utility regulation is about controlling market power, providing stability and continuity, and protecting investment from opportunism,<sup>19</sup> but these might not be the essential DNA. Controlling market power is really about ensuring wide spread service availability and affordability because utility services are considered to be affected with the public interest.<sup>20</sup> Stability and continuity are about controlling risk, as is containing opportunism. Are all aspects of utility services affected with the public interest? Because the expectation of profit is a key driver of innovation, and innovation is an essential element of adaptation, is controlling market power still the appropriate regulatory mechanism, or can we obtain service availability and affordability in another way?

The importance of knowing an organization's core DNA is illustrated by the experience of one of the authors of this paper, Araceli, with a company several years ago. The company hired a new regional marketing manager whose work would complement that of another regional manager in a different part of the country. This plan was clearly spelled out to both managers, but once the new manager was hired, the company marginalized the incumbent manager, who happened to be a single mother with two children, by shifting responsibilities to the new manager. The changes appeared unjustified by any changes in the market or by the performance of the incumbent manager. Interpreting this as a signal that the company's underlying values were in conflict with her own, Araceli ended her association with the company. Her reading of the company's core values was later confirmed when the executives were arrested and charged with corruption, although on issues unrelated to the manager positions.

### **Not leading, but leadership: The sweet spot**

Ensuring that we intelligently move from best practices to next practices, in part by continually investigating the why question and not just the what question, takes us to the third juxtaposition, namely that we should focus not on leading but on leadership. But before exploring that further, it is

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<sup>17</sup> Collins (2009), pp. 39-41.

<sup>18</sup> Heifetz, Grashow, and Linsky, (2009b).

<sup>19</sup> Jamison (2009).

<sup>20</sup> Trebing (1987).

useful to lay a foundation by explaining a model used at the PURC to think about analysis, politics, leading, and leadership, illustrated in Figure 1.

Figure 1 shows three basic questions involved in utilities policy. The foundational question is: What is possible? This is the realm of economics, engineering, law, and the like. Within these disciplines, experts tell us about cash flow requirements, costs of financing, legal rights and responsibilities, and what can and cannot be done with current technologies. The positive research<sup>21</sup> in the physical and social sciences are the major contributors to this foundation, but it is also the bread and butter of regulatory work. This is why many political scientists refer to expert regulatory agencies as a fourth branch of government, namely that the agencies are so highly expert that they often receive a higher level of respect from the population, from academicians, and from top level consultants than do the political branches of government.<sup>22</sup>

**[Place Figure 1 about here]**

A second basic question is: What is important? This is typically the realm of politics where through our elections and other political activities we establish visions and priorities for our nations and other levels of government. Research in this field is normative because it advocates goals, objectives, and instruments. The last basic question is: How can we do it? This question addresses many of the human processes that it takes to move from “What is possible?” and “What is important?” into accomplishment. This work is the domain of disciplines such as management and administration, including the act of leading people to perform the work of an organization.

Figure 1 shows an overlap of the three questions, implying that there is a core, or a sweet spot, where what we would like to achieve is technically feasible and can be worked through the human processes. But what if this overlap does not exist or what if it is difficult to find? Consider PURC’s recent experience assisting in the development of an event where scientists and policy makers discussed how to improve the scientific basis for energy policy. One politician gave the disturbing answer that basing policy positions on scientific evidence is generally ineffective because scientific input is too complex to be communicated and made relevant in the few moments that policy makers have with their constituents. From one perspective this is a communication issue, but it may also be based on issues of prior beliefs, embedded values, and lack of trust: We are not caused by our history -- our industries, policy successes and failures, and institutions -- but these are the lenses by which we view our future. Whatever the reasons, if facts are left out of the policy process the resulting policies are little more than fantasies and

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<sup>21</sup> Positive research describes how things work or what things are. The research by Quast (2005) described earlier is an example of positive research. In contrast, normative research describes what the author believes should be. It is prescriptive. The immediate paper is normative because it describes what the authors believe regulators and others should do to achieve particular objectives.

<sup>22</sup> See for example Vilbert (2007).



lead to greater dysfunction, frustration, and conflict. Furthermore the scientific work that is intended to influence policy occurs in a vacuum, resulting in research that is increasingly irrelevant to people's priorities and everyday lives. So instead of finding the sweet spot where the three circles intersect, we find ourselves with disconnect.

Leadership is needed to overcome the disconnect that occurs when the core does not exist or is difficult to locate. In contrast to leading, which is the process of providing direction for a group,<sup>23</sup> leadership is about mobilizing people to identify disconnects, adapt the group to new situations, and determine direction. Oftentimes the person providing leadership is not the one with formal authority. In fact, lacking formal authority can be an advantage for a person providing leadership because she does not have the conflicting burden of trying to keep the organization calm and functioning while promoting the disruptive work of exploring disconnects.<sup>24</sup>

This issue of providing leadership without formal authority has implications for the opportunities for regulatory agencies to provide leadership. Other stakeholders in the policy making process – politicians, businesses, consumer groups, and the like – have constituencies that they serve and, to stay in the game, must maintain a certain loyalty with those supporters.<sup>25</sup> This is less true of independent regulatory agencies because their independence means that their loyalties should be to the regulatory process. The independence gives the regulator greater latitude to raise issues that cause conflict between the various constituencies. However, the lack of a constituency leaves the regulator more open to political attacks that are difficult to defend against.<sup>26</sup> The solution to this friction is often to orchestrate experiments and dialogues that help groups find or create the sweet spot shown in Figure 1. This conflicts with regulatory agencies' traditional roles of providing expert answers, obtaining policy direction from the political process, adhering to process, and staying out of the management of utilities, but is an important role during times of change.

## Conclusion

This paper develops a model for resetting regulation and utilities in today's uncertain environment. Given that the future is unknown and probably unknowable, and that at least some countries face situations where particular policies that gave success in the past now hold the countries back, it is important to engage in adaptive learning. The model for adaptive learning includes focusing on next practices rather than best practices when faced with novel situations, studying why some practices have

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<sup>23</sup> See for example Kotter (1996).

<sup>24</sup> Heifetz (1994), pp. 184-188.

<sup>25</sup> Heifetz, Grashow, and Linsky (2009a), pp. 91-96.

<sup>26</sup> Jamison (2007).

been successful and continuing to learn from attempts at next practices, and focusing on leadership rather than leading to ensure that all elements of the system – regulatory agencies, service providers, customers, and the like – engage in adaptive learning.

The practice of leadership in the current environment can be described as stirring and steering. The context needs to be stirred to surface problems, contradictions, and opportunities. But the system also needs to be steered, not in the sense of leading a particular direction, but rather ensuring learning, providing opportunities for resolving conflict, and orchestrating experiments into next practices.

Marty Linsky of Harvard University summarized the paradox of leadership for a reset this way:

“...you have to be completely committed to what you are doing in order to step out there and take the risks, but at the same time, with equal persistence, you have to hang on to self-doubt, always keeping open the possibility that there is a better idea out there. Otherwise, how can you ever learn and grow? But, then again, I might be wrong about that.”<sup>27</sup>

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<sup>27</sup> Linsky on Leadership, <http://www.cambridgeleadership.blogspot.com/>, accessed August 26, 2009.

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**Figure 1. Framework for basic questions**

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