Introduction

The electric utility industry is replete with difficult, unresolved public policy challenges. Parts of the country face reliability issues due to the lack of new transmission infrastructure. The lack of consensus on the need for regionalization of transmission operations.holds up progress on creating robust competitive wholesale power markets. New power plants are primarily constructed using natural gas as the fuel source, which causes fuel diversity concerns because of the difficulty building new coal or nuclear plants. Siting of liquefied natural gas (LNG) facilities proves difficult because stakeholders raise thorny environmental and homeland security issues.

Frequently, policymakers have sought to address such important energy issues by implementing a particular policy solution as the “answer” to the problem. The recently passed U.S. Energy Policy Act of 2005 adopts this prescriptive approach. It provides the U.S. Federal Energy Regulatory Commission (FERC) with additional transmission siting authority to address the need for more transmission. It provides new investment incentives to reinvigorate the nuclear power industry and to provide incentives for investment in coal gasification technology. It allows the FERC more authority on LNG siting issues.

While it is not our role to critique whether these are the right technical solutions to these public policy issues or to opine on whether these proposed solutions will succeed, we do believe that in many cases policymakers cannot resolve such issues by simply passing legislation or writing new rules.

We believe that solutions to these tricky public policy challenges will require an entirely different type of problem resolution framework because these unresolved policy issues involve a more fundamental problem: the failure to understand the leadership challenges rose by these situations. Our viewpoint is that technical solutions of the sort that policymakers traditionally implement may not properly address the underlying issues.

In this article, we suggest ways in which these issues require an entirely different approach than is traditionally used in energy policy. Instead of treating these policy issues as problems seeking a particular “technical” solution, we believe that policymakers should recognize that these issues instead raise “adaptive” challenges. As described in this article, an adaptive challenge is a situation that cannot be adequately addressed without a complete rethinking of underlying beliefs, values, or traditions.
The consequences of avoiding adaptive challenges can be devastating in critical industries such as electricity. The California energy crisis cost the state millions of dollars, much of which could have been avoided if policymakers had been willing to face hard issues sooner, namely admitting that there were fundamental flaws in the market design and the rules of the game. Unwilling to allow that market-based regimes for reducing emissions are doing a fine job and in fact work better at solving the “grandfathering” problem than New Source Review enforcement, the U.S. Environmental Protection Agency is pursuing lawsuits against utilities to enforce a command-and-control policy from almost 20 years ago that works against the cost-effectiveness of the current cap-and-trade policies.

In this paper we examine leadership issues in confronting adaptive challenges in utilities policy. We begin by distinguishing between technical challenges and adaptive challenges. This distinction is important because each requires a different approach for solutions, and because people often mistake adaptive problems for technical problems. We then explain how easy it is to confuse technical and adaptive challenges, and provide suggestions for identifying the latter. We conclude with ideas on how policymakers can exercise leadership in resolving such challenges.

**Technical vs. Adaptive Challenges**

Policymakers face two types of challenges: technical and adaptive. Technical challenges, which are the bread and butter of regulation, occur when there is general agreement on the existence and nature of the problem, the alternative solutions are clear, and work can be dealt with by subject matter experts. For example, a number of electric utilities are filing rate cases with their state commissions. Rate cases may be demanding and complex, but the challenges are largely technical because there is general agreement that the issues are how much, if any, a company’s overall rates should change, and how these changes should be distributed among customers. The alternative solutions are well understood by various subject matter experts—accountants, lawyers, economists, and engineers. These experts provide commissioners with analyses that lay out the pros and cons of the various options. The regulator’s role is to pick what she believes to be the best solution among the options provided. As this example illustrates, technical challenges are often complex and frequently controversial, but they can be addressed by getting the right experts working on the problems. Going back to the Progressive Era, reinforced by disciplines including administrative law, public administration, and the substantive disciplines, regulatory agencies are organized and staffed to resolve technical challenges, and often excel in doing so.

In contrast, adaptive challenges arise when fundamental changes in a group’s (or an individual’s) environment call for the group to rethink basic goals and strategies to thrive or even just survive. Consider the situations faced by the people affected by Hurricane Katrina. There have been many technical challenges, including predicting the storm’s path, restoring power and communications, and providing food and shelter. These challenges are substantial and difficult to solve, but experts in weather, power utilities,
and emergency management have the skills to address them. The adaptive challenges proved to be the hardest. Some residents chose between evacuating to protect their personal safety and staying home to protect property. Medical workers set priorities for moving patients and rationing patient care. Relief workers in New Orleans who were shot at chose between personal safety and helping people who were stranded in the flood. Politicians made trade-offs between the security of early evacuation and the political cost of possibly imposing a needless evacuation should the storm turn. Politicians also chose between protecting or respecting jurisdictional boundaries and removing the red tape and inertia that delayed relief efforts. They also decided between protecting political futures and accepting blame so that political energy could be focused on relief efforts. All of these adaptive challenges were difficult to face and forced people to confront new realities, relinquishing things they cherished to hold on to something they valued even more.

The situation with Hurricane Katrina illustrates the importance of identifying adaptive challenges. Before the hurricane struck at least some people thought that because technical solutions were in place, such as evacuation plans for the poor and supplies for displaced people, that damage would be minimized and people helped. But in some situations the population and officials in charge were unprepared to make the value trade-offs implicit in the emergency plans.

Energy policy and regulation in the United States has had its share of adaptive challenges. The oil embargo in the 1970s forced utility regulators to make trade-offs between economically efficient prices and prices that customers would find acceptable. It also led residential energy customers to reevaluate their lifestyles household budgets. Commercial and industrial electric customers had to reconsider long-held assumptions about energy prices and change how they managed businesses, designed buildings, and planned for the future. Although far from perfect, we often fail to appreciate how far the nation went in facing those adaptive challenges and permanently improving the ratio of energy inputs to economic outputs. We appear to be entering a similar period now.

The Three Mile Island nuclear power incident also created adaptive challenges. The incident created new beliefs about the implications of nuclear power, which caused people to reconsider trade-offs in environmental protection, energy security, and energy prices. Some utilities had to reconsider commitments to nuclear generation, which they had once thought of as too cheap to meter. Regulators had to rethink long-held regulatory practices on cost recovery. They also had to choose between price shocks for customers and possible financial ruin for utilities.

Situations with both Technical and Adaptive Challenges

It is sometimes difficult to distinguish between technical and adaptive challenges because the same issue could raise either type of challenge, or may raise both, depending on the circumstances. Wholesale electric market restructuring illustrates how complex issues can raise both technical and adaptive challenges.
While some jurisdictions have successfully implemented wholesale electric market restructuring, others have failed in implementing the exact same policies due to their inability to properly diagnose the stakeholder environment. For example, Texas was able to completely restructure its electric utility industry in less than a decade by implementing wholesale market reforms that opened the market to competition and then developed a regional transmission organization to manage the market. Texas policymakers built their solutions on a foundation that included years of hard, adaptive work that allowed the affected parties to come to a common understanding of the state’s situation. They learned what was important to keep and what to discard from the traditional industry structure, and to choose the necessary policy priorities. Once this common understanding was established, stakeholders were able to reach agreement on the new policy initiative and support its implementation.

In contrast, some of the same policymakers who succeeded in restructuring the Texas market failed in their attempts to implement similar reforms at the federal level. In 2001, the FERC attempted to implement a bold set of wholesale market reforms, called Standard Market Design (SMD) in the wake of the Enron scandal and the California power crisis, and at a time when the agency was being criticized for not taking strong action concerning wholesale market abuses. SMD was a set of sophisticated, technical proposals to implement wholesale market reforms in an economically efficient manner. SMD was greeted with fierce opposition by many of the state public utility commissions and stakeholders (consumer groups, sector members) that the FERC believed it was helping.

FERC saw its SMD proposal as facilitating the development of wholesale power markets by allowing the transmission system to be run more efficiently. However, not all parties believed there was a problem with the existing system that SMD could fix the problem if there was one, or that SMD would meet the specific needs of their regions. Regulators and utilities in parts of the Southeast believed that a more competitive wholesale market would cause their retail rates to rise because their cheap power would flow to other, higher-cost areas. Stakeholders in the Pacific Northwest believed that SMD would not work because their power system depended on hydroelectric power which could not be efficiently dispatched and, even if it did work, the market could be subject to the same uncontrolled competitive abuses that they feared had caused the California energy crisis.

That stakeholders weren’t agreeing on a problem definition, let alone a set of solutions, should have been a red flag waving “adaptive challenge!” But instead of treating the problem as an adaptive challenge, the FERC adopted a series of technical fallback positions, including “Wholesale Market Platform” (SMD lite), and traveled the country meeting with stakeholders. Ultimately, SMD was abandoned, presumably in favor of approaches more consistent with traditional jurisdictional boundaries. Sadly, several years and much (but not all) good work by both SMD supporters and opponents alike were lost.
The SMD case highlights the complexity of working in situations that have both technical and adaptive challenges, but it is not unique in this regard. Consider the problem of organizing a regulatory commission. Existing regulatory bodies and newly formed ones both face challenges of organizing and reorganizing to reduce costs and improve effectiveness. There are substantial training and consulting resources available to design the organizational structure, identify desired skill sets, establish internal and external processes, and so on. These are important. However, a regulator involved in such an effort may have her career cut short if she does not appreciate the adaptive challenges, which in our experience working with new regulatory agencies around the world, may be more likely to undercut good policy than are technical challenges. For example, a new regulator is likely to take seriously “regulatory independence,” which connotes certain technical attributes. But this regulator will likely encounter stakeholders, such as the ministry, parliament, and incumbent providers, who must give up power for this regulator to have independence. In this circumstance, technical independence may be better thought of as “bounded” or “building towards” independence. One view of the regulator’s adaptive challenge is that she does the best she can in a constrained world by rethinking her views on independence and effectiveness. The other stakeholders also face adaptive challenges because research has shown they cannot have both infrastructure development and business as usual. Some countries have adopted what might be called “effective regulation,” giving up some traditional instruments of independence to place more emphasis on outcomes.

South Carolina provides an example where regulators confronted an intricate set of technical and adaptive challenges. The legislature in that state recently changed the nature of the regulatory commission by making it more like a judicial body. This created a technical challenge of changing rules and procedures, but it also required adaptive work on the part of the commissioners and staff as they reconsidered what they valued in their previous roles and aligned their perspectives with their new roles. The commission and stakeholders are learning new rules and new relationships that include restrictions on the flow of information that regulators traditionally use to overcome information asymmetries with utilities and to serve as subject matter experts for policymakers. Clear understanding of the adaptive challenges has made it easier for the South Carolina regulators to focus on the substantial technical challenge of developing an adjudicatory skill set.

**Identifying Adaptive Challenges**

As the above examples illustrate, clearly distinguishing between technical and adaptive challenges is important because technical work does not solve adaptive issues. There are numerous approaches for making this distinction but we focus on three broad categories of methods, namely looking for controversy in problem definition, identifying gaps in the solution space, and recognizing disparities between a group’s aspirations and its reality.

We begin with the issue of problem definition. In contrast to technical challenges, when people face adaptive challenges they sometimes deny the problem exists or disagree on
its nature. For example, while developing a role for state regulators in performing transmission planning as part of a new regional transmission organization, adaptive challenges were raised. Transmission planning may require a coordinated regional approach but needs to be implemented at the state level. In one recent instance, state utility regulators in the affected states saw this as a practical problem of policy management and developed a mechanism for coordinating their decisions. However, some attorneys general saw the problem as an issue of jurisdiction and concluded that the regulatory commissions could not legally coordinate with each other. These government officials faced adaptive challenges. Assuming for the sake of argument that the regulators had chosen an approach that made sense from a regulatory perspective, when confronted with the opinions of the attorneys general the regulators had to choose between what they saw as an efficient way of taking care of their citizens’ utility needs and their desire to avoid conflicts with their individual state governments. The attorneys general had to choose between utilities policy that made sense for this situation and a view of the law that was designed to limit regulatory discretion, ensure accountability, and make certain that stakeholders enjoyed effective due process.

Disagreements on the solution set point to adaptive challenges because the conflicts indicate that at least some people do not want to believe that difficult trade-offs must be made. For example at a recent meeting, regulators from a developing region explained that they are responsible for siting new generating capacity and transmission lines. The population wants the electricity but certain environmental groups are opposing necessary infrastructure development. Important issues are at stake, such as improving the lives of the area’s poor, preserving valuable natural resources, and the credibility and legitimacy of the regulatory agency. The environmental groups are supportive of developing the economy and the regulatory agency, but almost all infrastructure expansion is off the table from their perspective. Economic development advocates sympathize with the environmental concerns and support a stable regulatory environment, but place greater value on the economy. The regulator sees that the controversy and some of the ideas supported by the groups threaten the agency’s viability.

Figure 1 illustrates this situation. Each oval represents one party’s solution set. Each group has common ground with the other two, but there is nothing in the combined solution sets that all three parties would consider to be on the table. Adaptive work would bring focus to this reality and help each group with its value adjustments to expand the ovals and create a viable solution set. This is more than simple horse trading because people must adjust their beliefs, goals, and objectives before any give and take can begin.

Distinguishing between legitimate problems with problem definition and solution space is difficult in utility regulation because many issues look like zero sum games. Stakeholders who stand to lose a portion of their share of the pie when a pending issue is addressed can benefit from delaying tactics, which might include denying that there is an issue, debating the nature of the issue, and posturing over possible solutions. Such conflicts do not necessarily involve adaptive challenges, although they might. To deal
with such situations, policymakers have to “get on the balcony” and look beyond the negotiating and procedural tactics to see if there is more than rent seeking activity going on.

Getting on the balcony is a metaphor for seeing what is going on outside of your usual range of vision. When you are on a dance floor, you can see only yourself and the people immediately around you. That gives you one perspective. But if you leave the dance floor and get up on the balcony, you can see everything that is going on; for example, what causes people to move in various directions, who is surprisingly not engaged in what is going on, and what people are doing in other areas. One regulator we know failed to get on the balcony during a debate on an important regulatory issue. She debated her side of the issue effectively during a committee meeting and persuaded the committee to adopt her position instead of the position of another regulator. But when the committee’s recommendation went to a higher level committee for approval, our regulator did not have a seat at the table but her opponent did. He told the higher-level committee that lower-level committee’s recommendation had been controversial. He offered his own recommendation as a non-controversial compromise, which the higher-level committee readily accepted. Had our regulator gotten on the balcony, she would have noticed that her opponent gave up his argument in the lower-level committee too easily and that the higher-level committee cared less about the substance of the issue and more about avoiding controversy.

Lastly, an adaptive challenge is present when there is a gap between stakeholders’ sincere aspirations and reality. Stakeholders have expectations for what regulators should do: investors believe that regulators should provide a predictable and compensatory return on investment. Consumers often believe regulators should hold the line on prices, ensure dependable and high quality service, and be available to address individual concerns and complaints. Politicians believe that regulators should keep constituents and stakeholders happy, avoid controversy, and be fully informed on all aspects of the utility industries. In situations where regulators cannot fulfill all of these roles they should help people understand the reality so they can make necessary adjustments in behaviors and beliefs. For example, in some states and in some countries, regulatory agencies support university research centers. Properly run, these centers make available objective information, provide forums for probing issues that are not ripe for consideration in formal regulatory proceedings, and inform policymakers, the media, and the public on how the local regulatory situation compares with other jurisdictions. The Danish Telecommunications Regulator, for example, periodically commissions an independent benchmarking study of the sector and of its performance, and then convenes a group of international experts to critique its performance, provide commentary, and discuss possible future directions. The relevant ministry and sector leaders are included in portions of this process.

**Leadership for Adaptive Challenges**

How can regulators provide leadership for adaptive challenges? The examples we cite above describe several approaches. One line of attack is to focus attention on topics that
raise tensions without moving towards resolution. In 1993 state regulators held a summit in Keystone, Colorado, to consider whether the days of local telephone monopolies were over. This was a difficult topic for state regulators because many of the telephone traditions they valued were tied to the monopoly structure. The regulators who organized the summit had not reached conclusions about local telephone competition. Instead they recognized that growing tensions over subsidies, line of business restrictions, access charges, and the like were all linked to the monopoly market structure. They also recognized that if local competition was coming, state regulators could either drive the train or be run over by it.

During the summit the regulators discussed new technologies, the strategic interests of potential rivals to the telephone monopolies, and trends in market structure. Deciding to embrace the notion of local telephone competition and to lead the regulatory work rather than leave it to the federal government, the state regulators worked in small groups following the summit to identify issues raised by local telephone competition and to consider what from the past they needed to hang on to and what they could leave behind. Because they effectively worked through the adaptive challenges, the state regulators were able to produce a multi-volume technical document to guide the introduction of local competition, which was an important complement to the 1996 Telecommunications Act.

The effectiveness of these state regulators’ adaptive work was evinced by the deep commitment of many state regulators to lower barriers to entry, reduce or reform retail regulation, and refocus regulatory resources. In lobbying around the 1996 Act, the National Association of Regulatory Utility Commissioners (NARUC) did not oppose federal preemption of state barriers to entry, a position that would have been unthinkable before. In the late 1990s, NARUC and the National Regulatory Research Institute held several commissioners-only retreats which, while not using the phrase, were really concerned with the adaptive challenges facing regulation across all sectors, and even raised the prospect of the “sun setting” of state regulation.

Confronting and solving adaptive challenges require learning, which means using workshops, joint investigations, and dialogues to bring attention to the elephants in the room, provide a safe environment for risk taking, and creating joint responsibility for successes and mistakes. For example, when states began confronting electricity restructuring issues several years ago, many commissions set aside traditional processes and used work groups and forums. In Florida, for example, the Public Utility Research Center (PURC) provided open forums for the government and stakeholders so that people could air perspectives and learn. In another instance Florida wanted to consider how telecommunications regulatory policies might change to promote the advancement of information technologies in the state. Here PURC served as an academic advisor to the work group and provided a workshop, research, and a focal point for the work of other academic experts.

Another technique for providing leadership is to provide support for people who are willing to confront difficult issues. Sometimes a regulator may recognize that there is an
adaptive challenge, but she cannot bring attention to the issue herself because she runs
the risk of embroiling herself in a controversy that could make her ineffective. For
example, one regulator recognized a dysfunction in the staff that was keeping people
from sharing information and marginalizing capable employees during important debates.
In this situation the regulator could not simply exercise her authority over the issue
without creating animosity and leaving the impression that the issue was personal rather
than substantive. So instead she provided resources to a staff member who she knew
would confront the problem given the opportunity. This brought the dysfunction out in
the open so that staff could engage in adaptive work that included identifying why people
had allowed the situation, who needed to change how they worked, and what
organizational changes would be needed to improve staff effectiveness. Ensuring that the
staff saw itself as responsible for this work placed the adaptive work where it belonged
while allowing the regulator to use her position to address other issues.

This example highlights another key to providing leadership for adaptive challenges,
namely, ensuring the adaptive work is done by the people who need to learn and rethink
their traditions. Often executives and commissioners can assign technical work to
subject matter experts. However, each person must do his or her own adaptive work.
Adopting new beliefs, keeping or discarding valued traditions, and gaining new
perspectives on one’s work are personal acts that cannot be performed by someone else.
One often-used tactic to avoid making hard choices is to get someone else to take
responsibility for it. This fails for obvious reasons, but the tactic serves the purposes of
someone who is avoiding an adaptive challenge. For example, in one regulatory
commission the senior staff valued a traditional ratemaking policy that had a long history
at the commission but that was inconsistent with fundamental changes that were
occurring in the industry. Rather than make the hard choice between tradition and the
future, the senior staff assigned a junior staff to develop a technical fix that would let the
senior staff have its cake and eat it too. Of course, this effort failed and several years
later the commission abandoned the traditional process.

Conclusion

Whether in public service or the private sector, we all face adaptive challenges and are
more effective in our work when we recognize them and are equipped to respond. One of
us, for example, served as a regulator when Delaware’s dominant utility was caught in a
true financial death spiral, and ultimately filed for Chapter 11 bankruptcy reorganization.
This was viewed within the state as part of the aftermath of electric restructuring and was
also tied to the telecom crash. There were plenty of technical challenges, including
organizing an intervention in Delaware federal bankruptcy court. But is was impossible
to address the technical bankruptcy challenges without facing the adaptive challenges of
developing new ways for the commission to work together and with other stakeholders,
addressing questions of public confidence that had been building for years in the
aftermath of restructuring, and harmonizing state regulatory actions (ongoing contested
cases and an investigation) with bankruptcy court practices that are commercially-
focused and driven much more by negotiation than by litigated outcomes. Ultimately, a
unanimous state commission was able to approve a bankruptcy court settlement with both
the utility and the consumer advocate (which had been a co-intervener with the
commission). The settlement addressed a number of long-standing concerns in state
regulatory policy. The utility emerged much stronger and more focused than before.
Consumers were protected from harm by the bankruptcy, and now have protections they
previously lacked.

The important lessons are to distinguish between adaptive and technical challenges and to
provide leadership for adaptive work. However, providing this leadership is often
difficult for regulators. The following saying, attributed to the Chinese philosopher Lao-
Tzu, seems to describe this situation well: “A leader is best when people barely know that
he exists. Of a good leader, when his work is done, people say, we did this ourselves.”
The challenge is to exercise leadership by keeping people focused on addressing their
own adaptive challenges without compromising their technical work, which is the bread
and butter of utility regulation.
## Sidebar:

<table>
<thead>
<tr>
<th>Kind of Challenge</th>
<th>Technical</th>
<th>Technical &amp; Adaptive</th>
<th>Adaptive</th>
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<tr>
<td>Problem Definition</td>
<td>People know the problem and are ready for solutions</td>
<td>People know the problem and are ready for solutions</td>
<td>Requires learning because people disagree on whether there is a problem and the nature of the problem</td>
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<td>Solutions and Implementation</td>
<td>People know the problem, are ready for solutions, and accept the technically correct answer</td>
<td>Requires learning because people disagree on what is most important in possible solutions</td>
<td>Requires learning because people disagree on what is most important in possible solutions</td>
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<td>Primary Locus of Responsibility for the work</td>
<td>People in authority task the work to technical experts</td>
<td>Stakeholders engage in adaptive work. People in authority provide resources and space for learning and implementation.</td>
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| Sample Tools and Approaches       | • Delegation to experts (accounting, economics, law, etc.)  
• Provide resources and training for subject matter experts  
• Traditional hearings and legal proceedings  
• Negotiations | • Get on the balcony  
• Exercise leadership to help stakeholders see problems rather than “solving” the problem  
• Think politically about stakeholders’ relationships and perspectives  
• Manage stress levels |
Figure 1. Illustration of a Situation where Stakeholders’ Existing Interests do not Coincide

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1 This paper grew out of a workshop, “Leadership in Utilities Policy” that the authors taught on July 23, 2005, at the NARUC meetings in Austin, Texas. The authors would like to thank the workshop participants for contributions and Rossana Passaniti for organizing the workshop. Special thanks are due to Marty Linsky and Alexander Grashow for their advice, to Julia Johnson and Robert Gee for serving as facilitators during the workshop, and to Paul Sotkiewicz, Lynne Holt, and Sandy Berg for their advice on this paper.

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7 There are elements of a similar rethinking underway now. Without using the terms, a number of state regulators have been able to sort out technical and adaptive challenges and suggest ways to reform telecommunications policy in ways more consistent with market developments, including tackling tough issues around federal and state jurisdiction.

8 PURC’s efforts did not set policy direction; rather they helped decrease uncertainty by facilitating an open exchange of information and ideas. Florida ultimately decided to not pursue restructuring its electricity sector.