

The Regulator's Challenge: Providing Stability While Leading Change

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Introduction

It is a paradox of our time that utility regulators are confronted with two seemingly conflicting challenges. On the one hand, regulators have their traditional and central responsibility of providing a stable regulatory environment, or perhaps more appropriately, a predictable environment, in which investors, operators, and customers can make long-term decisions with confidence that short-term political goals will not trump to any significant degree the long-term goals for efficient and sufficient utility services. On the other hand, the regulator must adapt the regulatory system to economic, social, and technological realities that are changing rapidly in directions that are at present unknown. This uncertainty makes it hard for regulators to plan and put at risk benefits that stakeholders have come to expect from the regulatory process.

In this paper, this challenge of regulating in a time of rapid and uncertain change is examined. It begins with an examination of the traditional role of regulation, namely that of controlling the exercise of market and political power, which left unchecked would limit investment in services. Successfully fulfilling this role requires that the regulator maintain some form of independence from industry and political forces and that the regulator be highly competent to perform the complex, technical work that is the bread and butter of regulator work. The current context for regulation, emphasizing the uncertainty that regulators, policymakers, and stakeholders face, is then examined. To be successful, regulators need to properly fulfill their technical roles while also helping the political process express the values that are to guide policy and helping the players in the policy and regulatory processes adapt to new realities as they emerge. The paper concludes with a description of the perils that regulators face in serving in these various roles.

The Central Role of Regulation

A classical view of the role of regulation is that the regulator controls industry market power and government political power (Newbery, 2001, pp. 1, 27). In this view, utilities are capital intensive, use long-lived assets that are immovable, and enjoy scale economies. These features lead to market power, which the operator can use to obtain supernormal profit. These features also provide opportunities for opportunistic behavior:

Once a utility's assets are in place and costly to redeploy, government officials face political pressures to take advantage of the situation by, for example, forcing price decreases to noncompensatory levels. This happened in Brazil with transportation utilities, in Hungary with electric tariffs, and in the United Kingdom with its windfall tax on utility profit (Wells and Gleason, 1995; Jamison, 2007). Knowing this, utility investors are sometimes reluctant to sink capital without some constraint on political discretion. Independent regulatory agencies serve as that constraint.

Another classical view of regulation is that it provides stakeholders with opportunities for rent seeking. In this view, regulation emerges from what would otherwise be a free market system because stakeholders with political power are able to entice politicians into imposing regulations that shift wealth from the less powerful to the more powerful (Newbery, 2001, p. 141). Political battles over structural and functional separation in telecommunications fit nicely into this view of regulation, as do battles over universal service subsidies. Separation policies are generally promoted by entrants that want to constrain an incumbent rival, by incumbents that want to impose limits on potential rivals, or by incumbents that want to avoid some other regulatory instrument they view as more onerous. Universal service policies often benefit operators more than they do customers.

A review of the development of independent regulatory agencies in the United States provides other reasons for regulation and adds richness to the classical views. Utilities in the United States were initially regulated either directly by political bodies or by the courts (see generally Glaeser, 1927). In some instances, city governments would negotiate contracts or concessions with entrepreneurs to provide utility services within the city. In other instances, state legislatures regulated prices directly. Regardless of the mode of direct political control, the outcomes tended to be as follows: (1) Prices became outdated as technology and economic conditions changed, often resulting in financial distress for the operator and poor service for consumers; (2) Politicians were out-negotiated by their utility counterparts, resulting in high prices and profits. In at least one instance the profits were so high that the utility was embarrassed and lowered its prices below the maximum negotiated by the politicians, resulting in embarrassment on the part of the politicians; and (3) Utility services were withheld from political opponents or

given free (or nearly free) to political friends. Regulation by courts fared no better than regulation by political bodies: Regulatory benefits were received only by stakeholders with the economic resources to pursue relief through the court system. As a result of these problems, utility service was inadequate and unreliable. To remedy this, about 100 years ago, legislative bodies began creating utility regulatory commissions with the power to regulate prices and with greater independence from operators and politics. The success of this approach by a few leading states led to its adoption by all states and by the federal government.

The goals of utility regulation came to be to ensure that utility service was efficient and sufficient for the needs of the economy and the population. More specifically, this meant that prices were not unduly discriminatory, revenue was sufficient to attract continued investment in the utility enterprise, costs were fairly apportioned, and efficient consumption was encouraged (Bonbright, Danielsen, and Kamerschen, 1988, pp. 377-384). These goals meant that regulators devoted their resources to analyzing utility finances, regulating prices, and ensuring each geographic area was assigned to a service provider that had an obligation to serve all customers in that area. More recently, regulators became interested in issues of market structure, first in telecommunications but now in other sectors as well. These were highly technical issues and dealing with them adequately required regulatory agencies to hire staff who were expert in law, economics, finance, accounting, and engineering.

But as illustrated below, getting the technical issues right only gets regulators part way to success. For sure, getting the technical issues right is a necessary condition for success; no regulator succeeds without that. But technically correct answers are not sufficient for success. To be successful, the regulator needs to recognize context and at appropriate times provide leadership and/or play the role of the politician.

Context

The current context for utility regulation is rapidly evolving, but in uncertain directions.

- Rapidly increasing energy costs are leading the media, politicians, and others to look for someone to blame. Regulators are sometimes convenient targets.

- Stakeholders have rapidly evolving and often conflicting expectations for environmental impacts of utility services, new applications of utility services (such as plug-in hybrid automobiles), and new technologies (such as broadband and information services). Regulation can reduce the adaptability of industry to new demands and new realities, but it can also provide a focal point for bringing new information to light and raising issues that are sometimes conveniently ignored in the political discussions.
- In that vein, political populism is leading to disconnections from realities. In one country for example, a new political party came to power, fired all of the utility commissioners, and then demanded that the new commissioners fire all of the staff and lower electricity prices below cost.
- The public has been making new demands for environmental policies, service reliability, etc., but resists when the costs for such policies impact utility prices.

Segmenting the Work of the Utility Regulator

These rapid economic, societal, and technological changes require regulators to go far beyond getting the technical issues right. Figure 1 illustrates this idea. The circle in the upper left – marked, What is possible? – represents the technical work of regulation. Here regulators deal with the constraints of engineering, economics, finance, law, and the like to ensure that, for example:

- Prices are both affordable to customers and sufficient for investors.
- Service quality is adequate for the needs of the population and the economy and affordable in terms of the costs required to make the quality possible.
- Operators are financially sound.
- Service is available.
- Utilities operate efficiently.

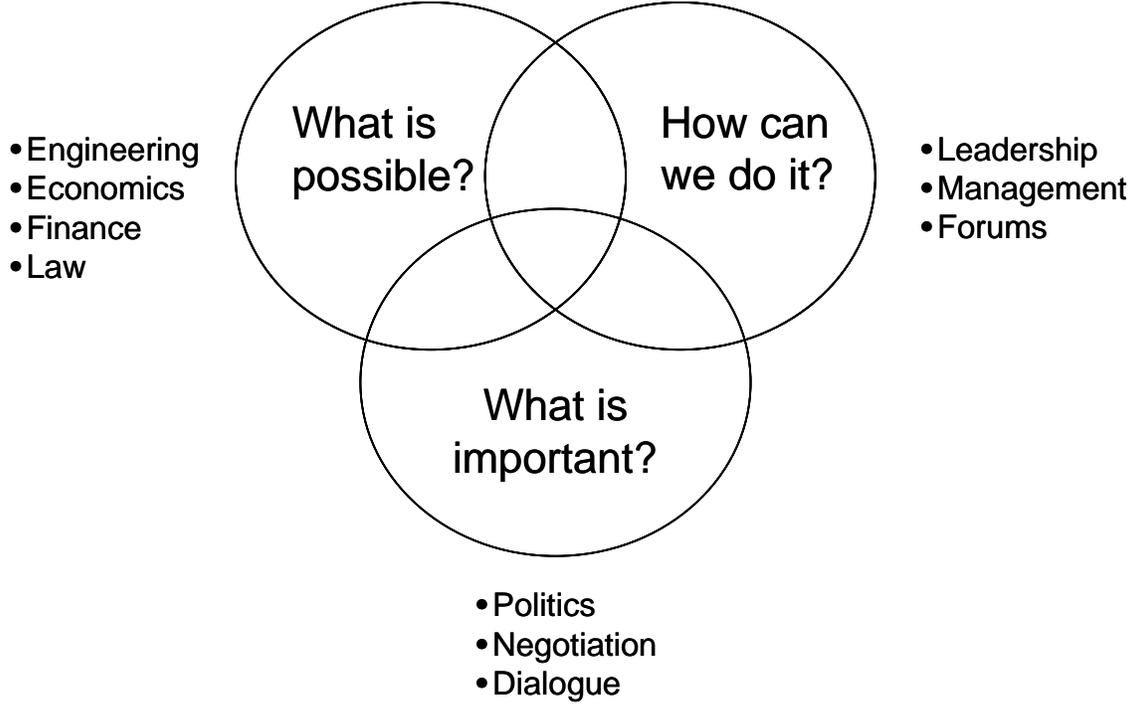


Figure 1. Areas of Work for Today’s Utility Regulator

Situations arise – and there may be many such situations today – in which regulators can and should step beyond their technical work to provide political work, which is reflected in Figure 1 by the bottom circle. Here regulators help address the question: What is important? Answering this question is normally left to the political institutions (Vilbert, 2007, p. 2), but many of today’s issues are highly technical, involve technical uncertainty, and change quickly. The value choices are unclear because policy impacts are unclear. Furthermore, value choices made today can be quickly outdated, necessitating new political dialogues and processes. But frequent updating of political choices can be at best costly, and at worst physically impossible, for traditional political institutions. Regulatory institutions may be better at making some of these decisions. A case in point would be electricity restructuring in California. The utility regulator had developed a plan that might have been workable if implemented, but the political institutions developed political compromises on some key elements of the restructuring plan, which made the plan unstable. When the flaws came to light, the political bodies

were unable to generate the will to make crucial changes in a timely manner, resulting in service failures, unnecessarily high prices, and financial collapse.

A challenge for regulators who engage in the political work of making policy choices is that they have to recognize the limits of their political authority, that the limits are fluid, and that there will not be unanimity on the extent of their authority. Regulators should address this challenge by “getting on the balcony.” Getting on the balcony is a metaphor for seeing what is really going on with yourself and others. On a dance floor, you can see only yourself and the people immediately around you. That gives you one perspective on what is happening. But if you leave the dance floor and get up on the balcony, you can see everything that is going on (i.e., who is dancing and who is not, how the music affects different dancers, where dancers are on the floor, etc.) (Heifetz and Linsky, 2002, pp. 51-74). Getting on the balcony requires stepping back from the fray and asking questions such as, Who cares about the actions I am taking? What seems to be happening beyond my vision? Why are some people engaged, and why are others not engaged? Who am I hearing from and, perhaps more importantly, who am I not hearing from? and What seems to energize particular people, and what seems to lead to resistance? One former regulator said she used to employ what she called the “smell test,” which meant that she would reject proposals that didn’t feel right even if she could not pinpoint the problem (Jamison, 2007).

Getting on the balcony is actually a tool of leadership, which takes us to the third circle in Figure 1, which addresses the question, How do we get it done? For technical work, this is simply an issue of management providing direction, order, and protection from outside forces. But when circumstances have changed and traditional approaches are no longer adequate, then leadership is required to engage people in investigations and dialogues on what has changed, what the changes mean, and how to react to the changes. This overlaps with the political work because leadership forces stakeholders to think through and make new value tradeoffs, but it is distinct from the political work in that it is not the regulator who is making the value tradeoffs, but the stakeholders whose realities have changed (Heifetz, 1994, p. 15; Heifetz and Linsky, 2002, pp. 11-20). In a sense, this area of work not only addresses the question of, How? but also the question of, What is “it”? because goals and aspirations are defined in this circle.

The peril in this third circle is that the regulator must be careful to maintain legitimacy when dealing with adaptive work, which in contrast to technical work is the work of learning about changed circumstances and making changes in values, traditions, attitudes, and behaviors that people hold dear. The need for adaptive work arises when fundamental changes in a group's (or an individual's) environment call for a rethinking of basic goals and strategies to thrive or even just to survive. Examples of major changes that have affected utility policy include the energy crisis in the 1970s, nuclear accidents at Three Mile Island and Chernobyl, decisions by multilateral institutions such as the World Bank to promote privatization and competition in utilities, and the development of the Internet, but numerous more minor changes exist (Jamison, 2007).

Dangerous Work

Regulating utilities in today's environment is, in some sense, dangerous work. The truth of that statement may not be obvious to everyone, but consider the following:

- Ugandans took to the streets of Kampala in June 2003 to protest a price increase allowed by the electricity regulator.
- The Labour Party came into power in Britain in 1997 in part because Labour successfully portrayed the Conservative Party as being soft on utilities (Jamison, 2007).
- The Maryland legislature attempted to disband the Maryland Public Service Commission in 2006 after a large electricity price increase (Jamison et al., 2006).
- Members of the Florida Public Service Commission came under a cloud of suspicion in 2004 for attending a regulatory conference that the Commission had organized and that was also attended by industry representatives. The accusations escalated when the Commission approved telephone price rebalancing – the first such meaningful change in telephone prices in over ten years.

Why is regulation dangerous work? The issues are important, controversial, and political. Communications issues pit large, conflicting economic interests against each other. Energy policy involves hard tradeoffs between economic growth, consumer affordability, the environment, and international affairs, each with its distinct interest

groups. Water policy is central to numerous environmental policies, but it digs into everyone's pocketbook and affects where economic growth occurs (Jamison, 2007).

Regulation is also dangerous because regulators play conflicting roles. As illustrated above, a regulator's primary job is largely technical implementation of policy – analyzing utility finances and tariffs, developing and enforcing market rules, and the like – but the regulator is frequently called upon to make policy choices and balance stakeholder interests: two areas that put the regulator squarely in the political arena.

Regulation is also dangerous because regulators have conflicting needs. A regulator must have intimate knowledge of the operators regulated to be credible and effective in his or her technical work. But an arm's length distance with the operators must be kept to maintain legitimacy. The Florida situation cited above provides a case in point: Some commissioners were brought up on ethics charges and heavily criticized in the papers for spending time with utilities. However, the Commission was also put under political pressure for not regulating details of how electric utilities prepared for hurricanes.

How can regulators survive and perhaps thrive in the midst of these conflicts and pressures? The critical skill seems to be seeing the context within which controversies occur so that the regulator can fulfill the most essential role – that of a technical regulator – and supply leadership and policy direction when needed.

Conclusion

Regulation in today's context means disappointing people at a rate that they can endure.¹ Regulation has always been about addressing problems with human behavior, not problems with technology. Certain technological and economic contexts simply gave some behaviors more opportunity than other behaviors to limit our economic and social well being. To be successful, regulators need to recognize context, changes in context, and patterns in the changes. But when changes occur, some people have to give up things that they have valued about the past, which adds peril to the regulator's job because the regulator might be blamed or scapegoated. Furthermore, the regulator might play an evolving role in policy development. But this, too, has perils because the role will be

¹ This phrasing is adapted from Heifetz and Linsky (2002).

situational, and important stakeholders will disagree on the boundaries of the regulator's political authority. But in the end, even though regulation might sometimes be dangerous work, it is always interesting work.

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