

## **ON PENDULUMS, CIRCLES, AND SPIRALS**

by

DOUGLAS. N JONES

Prepared for the FRI Utility Symposium, October 30, 2003, College of Business,  
University of Missouri, Columbia, Missouri entitled "Utility Finances and  
Restructuring: Where Are We Now?"

## I. INTRODUCTION

Inquiring of fellow public utility economists at the Harvard Electricity Policy Group at the JFK School, the Public Utility Research Center at the University of Florida, and the Economic Policy Office at the FERC as to how they thought the electric sector had been doing financially in the context of restructuring the answers were “dismally to terribly” since 2002 – with precious few exceptions within the industry.

This is also the assessment one finds from ratings agencies like S&P and Fitch, financial houses like Smith Barney, and publications like *WSJ* and *Business Week*. For their part PUCs in a recent survey of 47 jurisdictions on the current priorities of the commissioners themselves ranked first the financial condition of utilities “and their insulation from unregulated activities.” Not so incidentally, federal/state jurisdictional relations ranked second, and transmission adequacy was third. Moreover, there was broad agreement that electric restructuring had stalled.

I suspect these findings are unremarkable to you. They probably fit your own perceptions of the general scene. Happily, however, distinctions can be made, and I believe your territory and your electric companies have generally benefited from these differences. The two big ones are (1) not being in the forefront of the restructuring movement, and relatedly (2) being among those that have not strayed too far from the core business under holding company structures with unregulated subsidiaries of various kinds – particularly merchant trading activities.

## A. Some Elaboration

On the first point, some 24 states started electric restructuring. Now seven of these have “suspended play” or reversed it, leaving 17 that are continuing in some fashion. There is a value in going slowly – if at all. In fact the evidence is that regulated operations are back in fashion. Rating firms celebrate a “back to basics” strategy, a return to the relative security of the traditional regulatory paradigm that most companies are comfortable with and can manage. It’s helpful to not worry so much about high reserve margins (now averaging 30 percent nationally); it’s probably a relief not to be confined by price caps and price freezes or other limiting provisions of the restructuring legislation; and it may even be desirable to have one’s company viewed as a “defensive investment” somewhat insulated from the economic cycle, and enjoying the preferential treatment of stock dividends newly provided for.

## B. And More

On the second point – “irrational exuberance” in diversification in search of supernormal profits – for those utilities that generally abstained, it must be gratifying to not have to service the large debt incurred and be part of the 18 percent of energy companies now rated *below* the investment grade cut-off of “BBB” (the figure was six percent two years ago). It must also be good to know that “tending to knitting” means not having to be consumed by attention to the complexities of Code of Conduct prohibitions applying to self-dealing and affiliate transactions. And of

course it goes without saying that the grief that comes with entanglement in corporate misbehavior in trading schemes and scandals associated with unduly creative “earnings enhancements” is absolutely to be avoided.

## II. ONE VIEW

In early 1998 I gave a talk in Kansas City at the 24<sup>th</sup> Annual Rate Symposium put on by another part of the University of Missouri. The symposium topic was the transition to competition in regulated industries, and my paper was on eight myths that surrounded the idea. While I know it is bad form to quote oneself, I would like to just identify six of the myths here. The reason is that I’ve always been a cautionary voice (read skeptical) regarding deregulation and restructuring and still believe these half-dozen propositions to be wrong guides to public policy. Quickly listed they are:

1. “Regulation is an idea whose time has passed.”
2. “Workable competition is everywhere if we’ll just let it happen.”
3. “Industry structure will soon be characterized by many rivals vigorously competing.”
4. “There is no such thing as premature deregulation.”
5. “Social goals have no place in the new utility environment.”
6. “Commissions can remain above the fray and still be relevant.”

Fortunately, I think, discussion and debate about deregulation – perhaps particularly in the case of the electric sector – is now a good bit more balanced.

Uncritical celebration of market solutions and overly critical denunciations of traditional regulation no longer pass for informed discourse. Professional conferences like this one now even have titles like “Retrench, Reregulate, or Proceed” ( an MSU Williamsburg conference) and “Speed Up or Step Back” (a Delft University of Technology/Benelux international conference). Furthermore, where electric restructuring has been arrested or fallen off state agendas, a number of jurisdictions (Oregon is an example) have begun to look for imaginative ways to achieve some benefits like increased consumer choice under unstructured traditional regulation. Finally, some former ardent advocates of electric deregulation now conclude that the forces are not in place to “do it right” and to continue would risk further discrediting of the concept, making for longer term harm.

It is difficult not to believe that fadism was a notable factor in bringing the deregulatory movement to the electric sector in the first place. The reasoning of the free market proponents seemed to be, “We’ve done it in surface and air transportation, long distance telecommunications, natural gas, and banking and finance, so why not electricity?” Not to say that it has gone all that smoothly in those other industries.

Of course the main worries of doubters of electric sector restructuring are (1) that the market structure we may be left with more or less permanently would be one of undue concentration, either of the dominant firm/fringe firm variety or of collusive oligopoly; and (2) that consumer safeguards as to pricing and profitability and

service reliability are inadequately attended to. (Doubters who are shareholders presumably worry about whether, on net and over time, the financial rewards of a restructured company actually outpace those of a utility operating under enlightened rate base, rate of return regulation.)

There are some other downsides to utility deregulation that I think are more subtle, or at least less often discussed. I have in mind considerations like:

- .... the lessening of the “civic service” attitude among utility management and labor, reflecting the necessities of competitive behavior.

- .... the additional complexity and confusion in public understanding of utility operations and the attendant opportunity for marketing deception and fraud.

- ....some lessening of the utilities’ willingness to cooperate and be forthcoming with commissions and staffs occasioned by wider claims of “proprietary information” and “competitive secrets” on the one hand and the PUCs’ diminished authority on the other.

- .... the emphasis on efficiency over equity in goal setting.

- .... erosion of the public interest standard where dispute resolution is increasingly left up to “collaboratives”, “guidelines to getting to yes”, and trusting to market outcomes.

### III. COMMISSION INTROSPECTION

Turn now more directly to what can be said about *commission restructuring* in the new surroundings. Much has gone on here, as PUCs realized that standing pat on missions, agency organization, attitude and behavior was not an option if they were to remain relevant. If commissions failed to accommodate (and fairly promptly), the price could be high indeed. It could include reductions in staff and budget, loss of political support, loss of functions and programs, and severe wind-down – perhaps to the point of “catastrophic termination” of the agency. Moreover, they were aware that internally initiated change was much to be preferred to externally imposed change, i.e., by legislative mandates which often can be poorly targeted, hurriedly arrived at, and ill considered, especially in as arcane a field as utility regulation. Agency introspection about commission missions, practices, and organization began at several PUCs in the early 1990s and spread rather rapidly to most by mid-decade.

Commission adaptation to the demands of the new environment has been neither straight-line, generic, nor complete. With 51 PUCs (including D.C.), commissioner turnover (the average tenure actually served is something over four years), and with varying legal and institutional constraints in different state settings this was neither expected nor particularly desirable. But the most important reason was that commissions were faced with simultaneously transforming themselves in response to the restructuring of *parts* of the industries they oversaw while

maintaining the appropriate capacity to regulate the remaining monopoly elements. Thus, this mixed mission of PUCs now requires both a “light touch” where competition can demonstrably be relied upon and a “heavy hand” where it cannot – a tricky balance to strike in the context of vertical deintegration of utilities, unbundled services, and intra-corporate transactions.

If the main elements in agency transformation are as just mentioned, I would judge that PUCs are perhaps least far along on organizational change (though consumer affairs and educational activities have been beefed up), somewhat further along on attitudinal and behavioral change, and farthest along on mission redesign. In this last connection I note that almost half the states (22) make explicit reference to competition. Of these, twelve jurisdictions speak of “managing” the process toward competition, while the other ten go further by defining their missions as “promoting” or “fostering” competition. And three go so far as to imply that competition will reduce or eliminate their basic function (Beecher, MSU).

#### IV. PROSPECTS

In this context, then, of current utility finances and the current regulatory setting, what remedial initiatives or actions might we see? Sketching the landscape one can cite “supportive behavior” of various kinds by regulators. These include PUCs in Iowa, Indiana, New Mexico, Idaho, and Washington (state) giving assurance of capital recovery of new investments by a preapproval mechanism and

limiting the chance for prudence reviews. A number of PUCs have retained Automatic Adjustment Clause mechanisms, and a few jurisdictions have added them. Some states have allowed companies to transfer previously unregulated assets (e.g., merchant plants) to the protective comfort of the regulated rate base. Proposed federal energy legislation (H.R.6) contains new incentives for transmission improvements in exchange for mandatory reliability standards governmentally administered. It also would repeal the PUHCA, allowing still larger corporate entities to operate in more states but, some fear, beyond the regulatory reach of the states.

On the other side, general rate hikes may be harder to grant in an atmosphere tainted by recent holding company excesses and corporate misbehavior of various kinds. Intra-company transactions may get more careful scrutiny, as in a Kansas case involving shifting non-utility debt to the regulated portion of the company. Or as in the case of The Southern Company, the apparently successful strategy of locking in its regulated retail monopoly status in its territory while buying some 80 percent of its wholesale power from its own unregulated generator unit, is now being reexamined by the four state commissions involved. Further, just how PUCs will handle the attrition that came with Price Caps and Price Freezes written into most restructuring legislation as these begin to expire is uncertain and surely will vary from jurisdiction to jurisdiction.

## V. THE TITLE EXPLAINED

So what does all this have to do with “pendulums, circles, and spirals”? Simply this. It is difficult but important to know where one is on a path or trajectory – in this case the evolution of regulatory policy toward public utilities. My judgement is that (1) deregulation and restructuring are here to stay, but with some partial reregulation, and will proceed at a much more measured pace; and (2) commission regulation will be required to operate more or less permanently in a split mode with one set of authorities, processes, and rulings for the restructured portion of the utility industries and another set for the monopoly portion. This is to acknowledge that there is no “end game” in public utility regulation, nor is it a pendulum where we are brought back to where we started. Rather, the best metaphor is a spiral, which has some circularity to it but most importantly – and unlike a circle – has a direction.

Thank you for your attention.