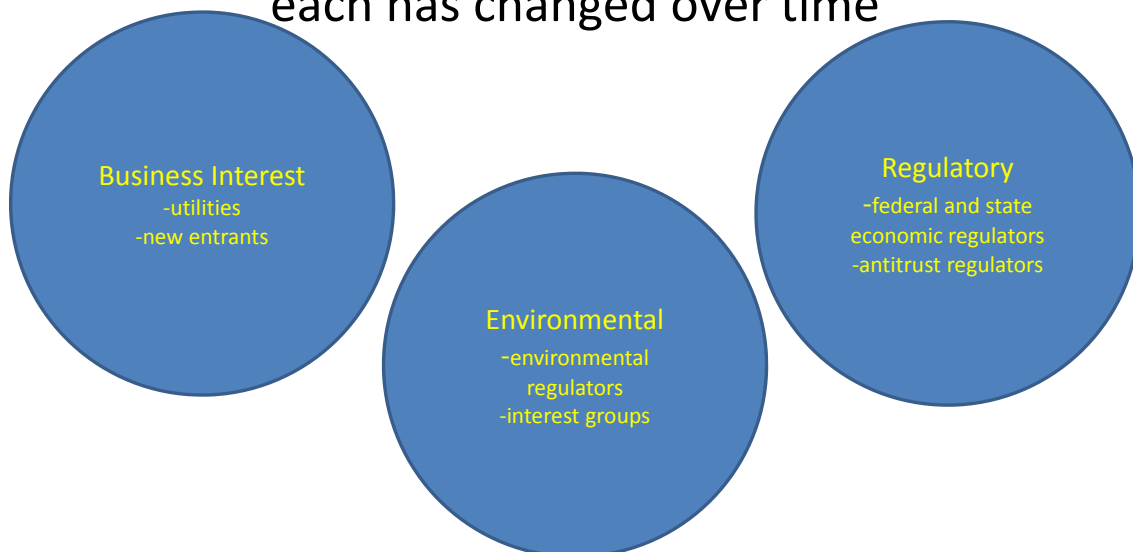


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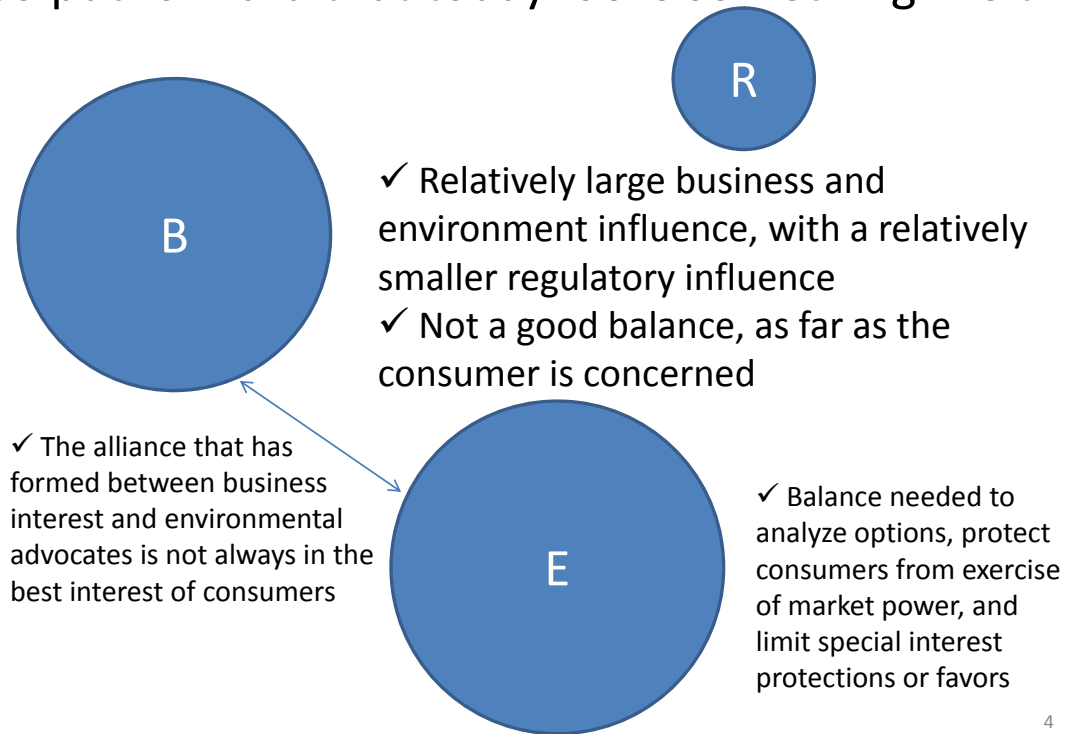
Why Regulation Matters Today— More Than In Decades

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Review from Last Year: there are three “Spheres
of Influence” at play in utility regulation
- and posited that the relative importance of
each has changed over time



Review from Last Year (continued): Also put forward that today looks something like this



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A Recent Regulatory Rap Sheet

- Deepwater Horizon in the Gulf of Mexico
 - Failure of Minerals Management Service that was too cozy with the oil industry (“Culture of Ethical Failure”)
- Upper Big Branch mine disaster (less than 30 miles south of Charleston, WV)
 - 29 killed in the worst U.S. coal mine disaster since 1970
 - Regulated by the Mine Safety and Health Administration (MSHA) – also seen as inadequate
- Toyotas – and the National Highway Traffic Safety Administration
- Then there’s the financial mess – regulated by several authorities, including Securities & Exchange Commission, and for banks, the Federal Reserve Board, Federal Deposit Insurance Corporation, Comptroller of the Currency

Has Regulation Failed?

- These concern financial, health and safety regulations, not utility or energy regulations
- But can we say everything is all right with utility and energy regulations?
- Unfortunately, there may be some similar patterns in regulatory behavior
- First, some background from this economist's perspective

Regulatory Theory

- Regulation is intended to (among other things) mitigate market failures, such as,
 - “natural monopoly” or market power, information asymmetries, or negative externalities
- Some don't believe that markets fail
 - but government always fails when it tries to fix the problem – and will often make things worse
- So we have two schools of thought on this . . .

Two Schools of Thought

- The Public Interest View
 - use government intervention to correct market failures, such as natural monopolies
 - prevent the resulting market power pricing of a monopoly or oligopoly
 - apply it to public utilities (and to railroads in the past)
- Regulatory Capture View
 - “*regulation is acquired by the industry and is designed and operated primarily for its benefit*” (G. Stigler, 1971)
 - regulated interest groups dominate regulatory decisionmaking for their benefit, not consumers’
 - basically it’s a producer-protection (rent-seeking) racket

Schools of Thought

- The public interest view may be seen as more pragmatic and responsive to an observed problem and the public policy solutions being applied (utility regulation)
- The Capture view is more political-economy based – interest groups influencing law makers and regulators
- Behavioral economics beginning to influence regulatory theory more (for example, Thaler and Sunstein’s, *Nudge: Improving Decisions About Health, Wealth and Happiness*)

Evaluations

- Public interest mechanisms (e.g., cost-based regulation) are not perfect (but we knew that!) – very dependent on implementation (laws and rules) and the people in charge (that they believe in what they do)
- Capture theory may have a point on importance of political influence, but doesn't offer much of a solution to fix the problems – outside of don't regulate or deregulate
- Behavioral economics hasn't passed much beyond offering little *Nudges* yet – no comprehensive regulatory view of the world at this time (but can still be useful)

A Regulatory Capture View on Regulatory Change

- The capture view (or Chicago school) is generally seen as anti-regulation
- However, you cannot infer they would automatically favor all regulatory changes, for example, the restructuring of the electric supply industry
- They would see the process as still captured by the industry, maybe designed to increase efficiency – to have more for the industry players themselves to divide up
- Maybe table scrapes for consumers, but definitely not done for the benefit of consumers
- Here there might be some agreement between the two schools!

Some first principles we can work with

- When a market is competitive (no significant market power—or potential) then it is best to leave to the market (except when necessary for safety and consumer protection)
- When a market is rival, but not competitive, then some degree of regulation may be necessary
- Some markets cannot be competitive due to characteristics (public goods will be under produced, for example)

Regulators can make two types of mistakes

- Type I: Regulate a market that could be competitive
 - Impact: higher prices from efficiency loss, lost opportunities for competitors
- Type II: don't regulate (or deregulate) a market that should be regulated
 - Impact: much higher prices, those with market power will take advantage
 - Less room for error—a small mistake can lead to big problems (ask California about that)

What is ideal regulation (when necessary)?

- Least control, minimum involvement by regulator
- Trouble starts when the regulator becomes a manager, picking technologies and obligating consumers
- Please: *Just because you support some form of regulation, does not mean you are against markets in general or are a socialist*

Are utility and energy regulators captured?

- Well . . . can we talk?
- There are different forms of capture
- While there are some that are clearly too close to the industry they are suppose to be regulating, many (let's hope most) are independent, or at least try to be
- A form of capture to watch out for is regulatory "cognitive capture" – kind of a Stockholm Syndrome for regulators – where the regulators form a bond with those they are suppose to be regulating

A Cognitive Capture Cycle

- Step 1: Convince the regulator there's a problem
- Step 2: Convince them that if they don't fix the problem it will jeopardize a policy goal that the regulators hold dear
- Step 3: Propose a solution as the only one that will work
- Step 4: Make the regulators think the proposal is their own idea (let them take ownership)
- Step 5: Heap unremitting scorn on anyone that disagrees
- Step 6: Once adopted, congratulate the regulators on their courage and foresight
- Step 7: Talk incessantly about how great it's working after implemented (no matter the actual outcome)
- Step 8: After some time has passed, return to Step 1 and repeat the cycle

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How do we counter this cycle

- First, remember that the *Jedi mind trick* only works on the weak minded
- So, be independent, ask questions, be skeptical of ideas that come from those with a vested interest on the topic
- Will a person, any person, risk a future cushy job in the industry they regulate and say no too many times?
 - if the answer is no, then we're doomed
 - but . . .

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Countering the capture cycle

- If the answer is yes, that is, it can be countered, then we need to do the following:
 - Make civil service respectable again
 - Pay comparable compensation (maybe not equal pay)
 - Make misconduct a bad thing again (MMS example where unethical behavior was not viewed as wrong)
 - Appoint people who care about public service (private sector does this – they don't hire people that don't believe in the product or service provided)
 - Have a balance of people with different experience, education, and background (amended)

Does increased complexity explain regulatory lapses?

- Complexity is certainly a factor with financial markets, maybe autos as well
 - but regulators should be able to keep up—this should be part of the job
- For utilities, complexity may be a contributing factor also—but not a creditable excuse
 - watch for unnecessarily complex solutions being proposed – may be rent-seeking devices
- What some MMS employees were doing would be unacceptable no matter the year or technology

Why regulation is more important now

- Partially regulated/partially market means that regulation is *more* important
- A relative small error can lead to big problems
- Beware – mechanisms put forward by some are for rent-seeking, not to benefit the market or consumers
- This can only be countered by analysis and asking good questions

Use what works now

- Don't lose heart, we've seen this sort of thing before – and survived
- Many of the regulatory tool already in the regulatory toolbox are still available or can be revitalized
- Some tools are gone (PUHCA, for example), but antitrust regulations are still in place and available – just need someone to apply them

And added new things to match new situations

- States need to be more involved in analyzing energy markets
- Too often states become unwitting partners in developing rent-seeking devices
- Be skeptical, be alert to self-serving proposals, and avoid the little errors that can be disastrous (and often irreversible)
- and . . .