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TOO MUCH DEREGULATION OR NOT ENOUGH

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In November 2002, I participated in a debate on Capitol Hill sponsored by the Cato Institute. My opponent was Peter Van Dorn, Cato’s director of regulatory analysis. The Cato Institute was one of the most extreme free-market policy shops in Washington and the debate was entitled Too Much Deregulation or Not Enough. It was one of many such debates over the course of several years, some of which became quite heated. At one point, my arguments against deregulation of electricity were characterized as “East German economics”.

Two years later, Cato flip-flopped in a paper entitled Rethinking Electricity Restructuring. Cato has discovered that this is not a matter of East German versus US economics; it is a question of empirical economics.

In regulated markets, it is usually quite easy for economists to demonstrate that consumers do not benefit from regulation, but unlike many other markets, electricity markets have characteristics that are difficult to manage through property rights and contracts. Accordingly, regulation has at least the possibility of a plausible rationale.

A collection of analyses published primarily after the implementation of electricity restructuring that provided the empirical basis for my opposition to deregulation of electricity and the key to understanding why Cato felt compelled to rethink restructuring.

As I said in the debate, I view the opposition to restructuring in terms of classical political economy. The Dictionary of Modern Economics provides an interesting definition of political economy, stating that “[t]he term has connotation of the interrelationship between the practical aspects of political action and the pure theory of economics.” It goes on to note that “[i]t is sometimes argued that classical political economy was concerned more with this aspect of the economy and that modern economists have tended to be more restricted in the range of their studies.”

The view of political economy adopted here is normative in the classic sense of political economy. It is predicated on the assumption that the institutions under which goods and services are delivered should be designed to achieve the values expressed by society. Rational choice is exercised in pursuit of those values in decisions about how to configure institutions to achieve the desired outcome. The approach is also positive in the sense that it assumes that institution building and choice should reflect an empirical assessment of the fundamental economic conditions of specific institutions and a real-world understanding of their social significance. The
normative approach gives way to the positive approach by being agnostic with respect to institutional forms.\textsuperscript{7}

While the perspective of modern economics has narrowed its focus to the point of view of pure efficiency considerations. Even from here, the claim that markets are the superior institutional form for organizing transactions is an empirical claim, and at most, a rebuttable presumption. As an empirical science, economics ought to accept the proposition that alternative forms of organization might be superior for achieving the desired outcome. The test should be practical, not theoretical; not the perfect world of perfect markets or perfect regulation, but the real world of imperfect markets and imperfect regulation. My studies of restructuring highlight the imperfections in electricity markets that present a compelling case for public interest regulation not deregulation.

The remainder of this article juxtaposes the argument presented in the deregulation debate with the recent rethinking paper. It starts with the prepared text of the speech I gave,\textsuperscript{8} then briefly shows how Cato has come to agree with the fundamental observations in my argument.

**Restoring Balance of Public Values and Private Incentive**

I frequently give a speech to Consumer Federation of America members in which I start with the bold statement that I am a devout capitalist, an evangelical preacher for capitalism. This almost always gets their attention, so I hasten to add that I am a member of a very specific sect of capitalist preachers—progressive, democratic capitalists. I believe that US capitalism dominated the 20\textsuperscript{th} century because we found the right balance between private incentives and public responsibilities. Unlike the Germans and the Japanese, who relied on industrial cartels, and the French and the English, who subjugated their capitalism to state bureaucracies, we found a way to impose social obligations without undermining the profit motive.

Progressive legislation at the turn of the 19\textsuperscript{th} Century stopped cartels, trusts, and monopolists from restricting competition and exploiting consumers. The institutional reforms of the New Deal established public interest obligations, imposed regulatory oversight to prevent abuse, and smoothed out the boom-and-bust cycle in infrastructure industries that are critical to an advanced industrial and post-industrial society.

Belief in a political economy is very much like belief in a religion, and every religion needs both a heaven and a hell. Visions of heaven are not enough to motivate people: you have to scare the crap out of them with images of hell, too. Obviously, my sect does not preach the heaven of frictionless markets and perfectly informed consumers. We preach the hell of monopoly power, externalities, and inequity. I recognize that regulation can go too far, creating too heavy a social obligation, which will slow the capitalist economic engine down. However, I also insist that we can go too far in deregulating, encouraging antisocial behavior, and allowing the capitalist engine to spin wildly out of control.

Balance is the key. In the 1990s, irrational exuberance for deregulation destroyed the balance between the public and the private in a number of critical, infrastructure industries—electricity, telecommunications, finance—and we are suffering for it.
The case for deregulation is weakest in the utility industries because they are different from other sectors. Utilities have unique economic characteristics and are affected by five public values. These can be found to some extent in other industries, but they play an important role in utility industries.

1. **Public Infrastructure:** Communications, transportation, and transmission facilities, available to all on a nondiscriminatory basis, support highly complex and interconnected activities of our post-industrial economy. Adequate and open infrastructure creates great fluidity and opportunities (economists call them positive externalities to confuse people) that individuals and businesses cannot capture directly through private actions. Economists fret about a free-rider problem when people use a network without accounting for every jot and twiddle of costs, but it is just as likely that the network is creating shared user benefits.

2. **Public Resources:** Certain resources, like pastures, fisheries, the air, water, and airwaves (the radio spectrum) occur "freely" in nature. These generally need to be “managed” to preserve their value, prevent overuse, and similar considerations. While they can be enclosed or privatized, sharing common resources may be more equitable and efficient from a societal point of view.

3. **Public Participation and Cooperation:** In the past half century, US capitalism has drawn our citizens into deeper participation in the economic system by spreading the base of private ownership of publicly traded corporations far beyond anything previously achieved by capitalist societies. This ability makes huge amounts of capital available for investment to support the ever-increasing scale and scope of modern enterprises.

   Perhaps even more important, this spread of ownership creates a personal commitment of employees to their enterprises. This ingredient is critical for economic success in the information age, where human capital is the most important factor of production. Undermine the basis for this participation and you will starve our economic engine of financial and human capital.

4. **Public Responsibility:** Accountability and responsibility of management to the public is central to this modern enterprise. The financial darlings of the dot-com nineties—stock options and IPOs—were quintessential schemes to take the public’s money and run. Once CEOs and entrepreneurs cashed in, responsibility for the continuing viability of the enterprise was weakened. It is hard to convince the public to invest in companies for the long term when management will not.

5. **Public Information and Knowledge:** Thomas Jefferson wrote in 1813 that “Ideas should freely spread from one to another over the globe, for the moral and mutual instruction of man, and improvement of his condition.” Today ideas circulate effortlessly on the Internet, providing fuel for experimentation and creative thinking from unexpected and nontraditional sources. Pressures to patent and copyright everything for an eternity in cyberspace or build controls into hardware in order that equipment dictates how information can be used threaten to destroy this open environment. This trend drains away resources from the next generation of inventions, creating a fear of infringement claims that chills creative endeavors and forecloses consumers as a source of innovation.
These public values deeply affect electric and telecommunications utilities, which are quintessential infrastructure industries. Capital-intensive assets in these industries are long-lived, sunk, and inflexible parts of an integrated network. Their value is to the network as a whole and not easily allocated. Long-term, public commitments are needed to support these infrastructure projects. Economics of scale and scope result in very small numbers of facilities and little head-to-head competition.

For wires industries, use of public rights-of-way is at the core of transmission and distribution. Because of the nature of these utilities, the cooperation of all entities participating in the industry is critical to its smooth operation. The competitive ethic that pervades markets frustrates the achievement of the necessary cooperation, increases costs, and weakens the base for coordination and integration of supply and demand.

On the demand side, public rights-of-way are necessities with low demand elasticity for a service that is consumed by virtually all households and businesses on a continuous basis. Transmission systems have a tendency for high peak loads and are not storable, so that storage takes the form of excess capacity. The “e” in “e-commerce” stands for electronic. Both the electrons and the bits must flow smoothly and reliably in huge quantities to sustain our information economy.

Public responsibility has a uniquely powerful expression in these industries, reflecting their demand side importance. For all the focus on market efficiency, the ultimate test of electricity service is keeping the lights on. Loss of dial tone is equally unacceptable. Merchants can withhold supply and “only” suffer a financial loss; utilities cannot let the lights go out.

Electricity and telecommunications services are not shoes or shirts. You cannot manufacture them in Taiwan, transport them to Brooklyn and store them for a year. They are not blueberries, which can easily be foregone or substituted with cherries, or apples, or bananas.

Because public policy recognized that these industries are “affected with the public interest” almost from their inception a century ago, the United States developed a uniquely pragmatic approach that blended private and public interests. Unlike most other capitalist countries, where state monopolies provided these services, we relied primarily on private capital that was subject to direct oversight by state utility commissions. Utilities were granted franchises to serve in specific areas, which allowed them to finance projects with a low-cost, long-term mix of debt and equity. In exchange, they shouldered public responsibilities like the obligation to serve all comers on demand, a commitment to “keep the lights on” or ensure the dial tone to a high level of reliability by building capacity, and a duty to interconnect on “just, reasonable and nondiscriminatory rates, terms and conditions.”

“Public ownership” was used to meet specific needs in parts of the country where private capital would not go and to provide a benchmark comparison between service areas. It was kept close to the people through municipal or direct consumer ownership, which prevented the growth of entrenched national bureaucracies. These segments of the industry, which avoided being swept up in the deregulation frenzy, have fared much better than the rest of the industry.
This pragmatic, diverse approach exhibited inefficiencies. Nevertheless, the balance between public and private was critical to ubiquitous, affordable, and reliable service. The result was the best utility sector in human history.

While economic theory could find ways to make these utilities better, economic reality proves the core characteristics are too powerful and important to fool with. Deregulation did just that, imposing market transactions and encouraging competition where vertical integration and cooperation are more efficient. The destabilizing effects of deregulation emerged first and worst in the competitive electricity and telecommunications sectors because these utilities require long-term perspectives and public obligations that are ill-suited for the “one size fits none” commodity market structure that policy makers imposed on them in the 1990s. Policy makers tried to force people to shop in the market for innovative utility products, when reliable, affordable service was all they wanted and really needed. “Deintegration” quickly turned into disintegration because capital and commodity markets would not support the public functions served by these industries.

Deregulation undermined the long-term perspective needed for funding and stability of utilities, resulting in a dramatic increase in the cost of capital. Both electricity and telecommunications are “wires” industries, dependent on public rights of way and use of common resources (air, water, and airwaves). Deregulation underestimated the need for management of these public assets and bottleneck facilities. Deregulation let the lights go out and removed the obligations to provide just, reasonable, and nondiscriminatory access to vital networks, imposing substantial disruption costs on the public. Deregulation short-circuited the cooperation (seamless interconnection and smooth operation) necessary to run highly complex, integrated networks, thus raising transaction costs. Deregulation has not produced transparent, dependable sources of information, making it difficult to gather and share information on network operations and conditions, making management arduous and less efficient. In short, deregulation increased costs by raising the cost of capital, creating excessive scarcity rents, increasing transaction costs, and increasing reserve requirements.

The New Deal laws that governed electricity and telecommunications for 60 years (the Public Utility Holding Company Act (PUHCA), the Federal Power Act and the Communications Act) were heavily criticized as out-dated in the 1980s and 1990s. Recent events make these laws look far more reasonable.

PUHCA was designed to simplify ownership structure of electric utilities. Properly implemented, PUHCA would require simplified structures, examine accounting practices, review affiliate transactions, and restrict diversification by requiring direct functional relationships between activities.

The 1934 Communications Act paralleled PUHCA in some respects by keeping different communications media separate and ensuring access to communications services. Removing these restraints has not created competition, particularly among the incumbents who never enter each other’s service territories, preferring to leverage their market power in their own service areas and core monopolies.
The Federal Power Act and the Communications Act enshrined the concept of just and reasonable rates based on cost, rejecting the concept of allowing monopolies to charge whatever the market would bear in the hope of inducing competition. They strove for universal service. They focused incentives within strictly defined lines of business, providing more than adequate returns to induce investment in the provision of these basic necessities. They suppressed abuse and created a stable investment environment.

Misled by the effectiveness of this legislation, deregulation undervalued consumer and investor protections as well as the importance of smoothing out boom and bust cycles. Deregulators assumed that the correlation between the sharp increase in public interest obligations codified by the New Deal legislation and the subsequent growth in these industries was just a coincidence. However, there is growing evidence that they were wrong.

The success of electrification and deployment of telecommunications was largely accomplished in the half century after New Deal legislation established a national commitment to universal service in these industries. The evidence does not stop there. Take a look at the analysis published by the Cato Institute under the title The Greatest Century that Ever Was: 25 Miraculous Trends of the Past 100 Years. If one looks closely at the figures, the title should have been The Greatest Half-Century That Ever Was: How the 50 Years after the New Deal Transformed America. If one looks at improvements in public health, education, wealth, and welfare, it was the half-century after the New Deal that made the 20th Century the American Century.

If one insists that gains prior to the New Deal be recognized, I insist it was the antitrust laws and the trust busting of the early 20th Century that prevented monopolization and cartelization from slowing our economy down. The current defense of unfettered monopoly capitalism, that is so popular under the guise of Schumpeterian theory, is simply inconsistent with the experience of the American Century.

I have talked about the capitalist part and the progressive part; now let me deal with the democratic part. Democracy means that people get to write the rules under which they live. That applies to the economy in spades. Economic institutions should fit the empirical conditions of specific markets and they should promote the values that society wants to reflect in its daily life. We get to vote for governments to implement those policies. Just as the 20th Century was progressive in the economy, it was inclusive in the polity, a trend that contradicts the Schumpeterian affinity for elitism, which, of course, is inextricably linked to the affinity for monopoly capitalism.

During the 1990s, stodgy “old economy” utilities, with their slow growing but secure, dividend-paying stocks, were reviled on Wall Street in comparison to the “sexy” paper returns of the dot-coms. Utility stocks reflected the economic environment that public policy had created for them, one founded on the principle that the infrastructure building blocks for the rest of the economy need stability and long-term commitments.

It turns out that the dot-coms lacked value and their managers, auditors, and regulators lacked values. Now that the bubble has burst, investors will flock back to a dull sector that offers a solid
and stable total return provided that public policy rediscover the principle that electricity and telecommunications are deeply “affected with the public interest” and restores the balance between private incentives and public interest in these industries.

**Cato’s Rethinking**

Cato has discovered that the grid is a public good. In economic jargon, it provides the stage for a comedy of the commons. For example, the alternating current (AC) grid is a “commons.”

Power added by any generator on an AC transmission system follows all paths but favors those with least resistance rather than the shortest distance between generator and customer. Thus, bilateral contracts between any willing seller and buyer of electricity affect all other buyers and sellers within each interconnected system in ways that are not captured by prices—the textbook definition of externality (6). 11

Moreover, transmission additions confer benefits across all generators and consumers on the grid and thus have public good characteristics. The development of property rights and prices that internalize those characteristics is very difficult. (6)

Demand elasticity is extremely low.

Market forces, it was hoped, would introduce marginal-cost pricing and as a result reduce peak demand, increase off-peak demand, and reduce the needless political fighting (most notably, the eternal fight over more supply versus less demand) that inevitably arises in electricity markets because of the absence of prices as a signaling device. (3).

Prices in San Diego were free of all control from July 1999 though August 2000: a doubling of prices resulted in a demand reduction of 2.3 percent, an extremely disappointing response.

Even though demand does respond to price, many observers have concluded that demand responsiveness is too low, and, therefore, price spikes would be too high for too long in a truly deregulated environment with tight supplies.

Cato has discovered the problem that utility assets create because of their long-term fixed nature. The problem that results is one that frequently afflicts common pool resources, a tragedy of the anti-commons:

[I]n an unregulated world, the relations between electric firms and consumers would likely be governed by long term contracts because the dedicated nature of electricity assets implies that each side can “hold up” the other.

In short, the weakness of the private solution is the inability of investors to capture the full benefits of their investment. (7)

Administrative challenges strain the grid:
Although the blackout was not caused by market forces, it is likely that the increased loads and flows across a transmission grid that has experienced little new investment is causing greater stress upon the hardware, software, and human beings that are critical components of the system. (4)

Supply-side scarcity rents are extreme in this industry:

In unregulated electricity markets, then, marginal sources of electricity – such as high cost generators typically in operation only during the peak-demand periods – would need to earn at least a normal return. That implies that those facilities with lower marginal costs whose supply is limited... would receive payments in excess of marginal cost (and a normal return) in an unregulated market. (5)

If we are correct, this implies that gains to trade not occurring under the current balkanized system are much smaller than many observers believe. Accordingly, the fight between the old regime and a restructured regime (that is, the case for a transmission-intense versus balkanized system) is a fight about wealth rather than efficiency. (6)

The authors also discover political economy.

This is why low-cost states vigorously resist a national integrated electricity market – it would allow their electricity to go to the highest bidder rather than to those who happen to reside within an electric utility’s current service territory.

State decision makers understandably resist using ratepayer dollars to pay for investments that will primarily help parties outside the state. (4)

Conclusion

When members of the Consumer Federation of America make up the audience and the spirit of the moment grabs me, I suggest that America saved capitalism from the dust bin of history. It was the populist and progressive movements in the decades around the turn of the twentieth century that preserved the commitment to competition and checked the accumulation of economic power by corporations. It was the imposition of public obligation in the new deal that ensured a broad base of equitable economic progress would spread across the land and through the population. These are important principles and lessons that were forgotten by policymakers in the deregulatory frenzy of the 1980s and 1990s and utility consumers have suffered mightily as a result. “I told you so,” can be petty, but this one is very important. The utility sector and the economy will not thrive until we restore the balance between private incentives and public obligations that worked so well in the past.

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Notes

1 In a subsequent interview on C-SPAN where I debated Jerry Taylor.


3 Ibid., p. 6.


8 An MP3 of the speech is available upon request from the author.


11 Numbers in parentheses in this section are page numbers in Taylor and Van Doren.