

Pricing challenges facing Maine's utility regulators

*Decisions concerning the pricing of public utilities are rarely **made** without controversy. Electric utilities have garnered the lion's share of the attention in recent months because of the rising cost to consumers of electricity, despite surplus generating capacity and **relatively** cheap power available on the open market. But other regulated **utilities -- natural gas, telecommunications, and water --** also face important pricing issues in the months ahead. The PURE '94 Conference, sponsored by the Smith Policy Center's Project for the Study of Public Regulation and the Environment, explored several of these issues earlier this year. An important Maine perspective on pricing issues was provided by the chairman of the state's Public Utilities Commission, Thomas L. Welch. Welch, who succeeded Kenneth Gordon as PUC chair in 1993, cautioned against making public policy decisions that invest too heavily in narrow assumptions about what might happen in the future. Among other things, he underscored the importance of public acceptance of new **policies if** those policies are to be effective.*

Thomas L. Welch, Chairman
Maine Public Utilities Commission

Introduction

There is an old Chinese curse *that* condemns the victim to "live in interesting times." These are interesting times, and I suspect that all of us will be judged by how well, and with what degree of foresight, we can turn our shared curse into an opportunity.

I have been asked to address the Maine perspective on the direction of regulatory policy. There is a certain irony in this request, because most of you have been involved in utility issues in Maine for longer than I. Nevertheless, I hope you will find some value in the perspective of a former outsider turned enthusiastic insider.

Virtually all the parties who come before the Maine Public Utilities Commission (PUC) pay homage to the principle that prices for utility services in Maine should enhance, or at least not harm, the economic health of the state. Most parties also recognize that sound pricing policy is especially important now, because economic rivalry between Maine and its neighboring states is **increasing, and Maine's industrial, commercial and residential customers** are responding to the new opportunities opened by competition.

As countless religious wars have shown, however, agreement about the name of the deity is no guarantee of agreement on all points of doctrine. Any attempt to achieve sound pricing policy in Maine must do more than wave the banner of textbook theory. The process of regulating prices of utilities is itself a product, a product that must satisfy customers in its own particular geographic, historical and political markets.

The challenges facing Maine's regulatory process

There are, of course, significant obstacles to establishing price levels that achieve a sustainable balance among Maine's competing constituencies. Two significant public policy choices made in the past decade are

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important. Let me say first that I find no particular value in determining the level of responsibility to be assigned to each participant in these choices. Much more interesting to me is the level of creativity that all of us can bring to the process now, and the degree to which we can avoid decisions today that will frustrate future participants.

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The first of these public policy choices was Maine's aggressive pursuit of alternative sources of electric generation, which led to the execution of many substantial qualifying facility (QF) contracts. For reasons related in part to the structure of these contracts and in part to world events, the prices paid by Maine utilities for power under these contracts now far exceeds the value of the electricity to the utility, and almost certainly exceeds, at least on average, the economic cost of producing that electricity. When coupled with the current New England-wide surplus of electricity, the effect of these contracts is to create pressure on electric rates in Maine that may have ripple effects, mostly undesirable, on both the economic and environmental health of the State.

Maine is not unique in having QF contracts with prices that arguably are well above the cost of other available supplies. Maine may be exceptional, however, in the extent to which these contracts dominate the current average price of electricity. One broad lesson from this experience is that legislatures, regulators, and utilities should all be wary of any regulatory structure, or regulatory or company decision, that is dependent for its wisdom upon a relatively narrow set of assumptions.

There is also, in the QF experience, confirmation of what I call the law of unintended consequences: That is, the unforeseen and unintended consequences of a decision will often overwhelm the intended or expected consequences. The laws that led to QF contracts were intended in part to ensure a diverse and renewable source of energy and electricity for Maine, and thus preserve and enhance the environment. The price increases for electricity (compared to other fuels) caused by these contracts, however, have persuaded businesses and even individuals to install small, environmentally-suspect, diesel generators. I doubt this result was intended or even imagined by any of the decision-makers a decade ago.

The second public policy choice is the progressive dismantling of the telecommunications monopoly through legislative and judicial action. Because the costs of providing telecommunications services have declined, forced down by technology and competition, there appears to be a growing reservoir of telephone utility investment that would remain unrecovered if all services were priced at their marginal cost. Other firms are likely in the near future to enter the market for all telecommunications services, including local exchange services, with prices that reflect neither substantial embedded investments nor obligations to serve the entire community. The recent merger proposal by Bell Atlantic and TCI, and MCI's announcement that it intends to provide local service using cable TV facilities, merely highlight the speed with which the old structure is crumbling.

The emergence of competition is, of course, a broadly relevant feature of the Maine utility pricing landscape. Parenthetically, although we have not seen a great deal of competition emerge in the water industry, it would surprise me if major water users do not seek alternative sources for water that need not meet the Safe Drinking Water Act standards, especially in light of the extraordinary increases in water prices driven by the Act and by related infrastructure renewal. It seems to me that any regulatory approach that does not deal explicitly with the impacts of competition is doomed to failure. Where there is real competition, any policy that results in a price above the economic price of producing the unit of telecommunications service, electricity, or anything

else, will likely create an undesirable price umbrella for competitors and push existing customers to a competitor's services.

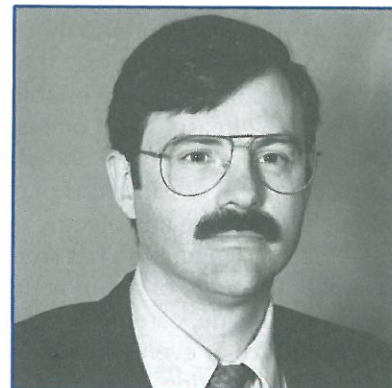
The uneven development of competition for utility businesses, however, presents another set of difficult regulatory issues. A regulator must determine both the extent to which real competition exists and also how to respond to that competition, or more precisely, to what extent a regulator can rely upon the utility to respond appropriately. Some customers will not have real competitive alternatives for the foreseeable future; the regulatory response to competition thus needs to be targeted as narrowly and precisely as possible. If the response is targeted too broadly, ratepayers without alternatives may be faced, under traditional regulation, with unreasonable and unjustified increases in their rates to balance the lower rates available to free riders. On the other hand, if the response is too narrow and utilities are prevented from meeting real competition with prices relatively unburdened by common overhead, subsidies and the cost of social policies, the cost ultimately imposed on the utilities' captive customers may be even more onerous.

Let me make a few observations about the context in which Maine regulators, consumers and utilities face these issues. I confess that I am not speaking from lengthy personal experience, but over the past few months I have had a chance to develop at least some sense of the relationship between utility regulation and the broader political context in Maine.

First, there is a history, although perhaps only a recent history, of very substantial public sensitivity to utility issues. I do not expect this sensitivity to diminish quickly. Once people become aware of the impact of utility prices on their business and on individual finances, they are likely to continue to seek an active and vocal role in the regulatory process.

A second characteristic of the Maine environment is that the legislature has demonstrated, over the last several years, a willingness to become involved in the specifics of utility pricing. I have no doubt that this reflects at least in part the desire of the general population that the legislature concern itself with such details.

Thomas L. Welch is chairman of the Maine Public Utilities Commission. He has held positions with the Pennsylvania Office of the Attorney General, Bell Atlantic, and Villanova University School of Law.



The willingness of the public at large to try to set pricing policy directly is reflected in, for example, the referendum banning mandatory local measured service.

I do not raise these two facets of the context for ratemaking in Maine to suggest that there is anything pernicious in this level of public awareness of and participation in the regulatory process. I raise them instead because the stability and sustained success of any approach to regulation or any pricing strategy adopted by utilities and the Commission will depend, to a significant degree, on broad public acceptance of the approach chosen. Pricing models that adhere slavishly to economic principles, however sound, but ignore the near term financial impacts on customers are likely to be overturned. On the other hand, I am optimistic that consumers and businesses may be willing to pay a modest near-term price for long-term benefits, to the extent that those benefits can be satisfactorily explained and justified.

A reexamination of regulatory policy

In the present context, utilities, regulators and other public policymakers must undertake a rapid and thorough reexamination of how they are achieving their objectives. For the PUC, this means that we must not only perform the usual review of utility rate requests and

pricing proposals, but also must reexamine in a systematic and comprehensive way the very process by which utility prices in Maine are established.

For these reasons and others, the Maine Public Utilities Commission will undertake, over the next year, an examination of variations of price cap regulation for Maine's telephone and electric utilities.

Price cap regulation has some particular advantages over rate base/rate of return regulation. On the telecommunications side, carefully designed price cap regulation can minimize or even eliminate some of the more intractable cost allocation issues that develop as competitive

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offerings increase in number and importance within a telephone company's portfolio of services. On the electric side, price caps may provide a vehicle for increasing public confidence in the stability of electric rates while creating a platform for the increased pricing flexibility needed to respond to competition. For any utility, price caps hold the promise of bringing market discipline to utility management by strengthening the link between efficiency and risk on the one hand and financial performance on the other.

Please do not read into my remarks any prejudgment of the issues – and there are many, including our legal authority – that must be resolved before we can decide whether we should move away from rate of return regulation to price cap regulation. In fact, I should share with you a few concerns that must be addressed before I am fully comfortable with this step.

First, any decision to move to a new regulatory paradigm must overcome the objection that change is simply a reaction to the perceived inadequacies of current regulation, rather than the discovery of a genuinely superior

model. Regulators may be especially susceptible to the argument that the responsibility for the crisis of the day lies with the regulatory tools at hand rather than the skill, or lack of skill, of those who wield them. As a relatively new commissioner, I have to fight the inclination to believe that my own insights into the process are necessarily superior to the insights of my predecessors. The regulatory status quo should not be viewed with undue reverence, but neither should it be discarded simply because it is the incumbent. Any exploration of the benefits of new forms of regulation should be accompanied by an honest assessment of whether the same benefits can be achieved under more traditional models.

Let me illustrate this point. It is not obvious to me that price cap regulation is a superior response to competition than rate of return regulation, even though the emergence of competition is often offered as a justification for moving to price caps. Pricing flexibility and the efficiency of the regulatory process may be more important with respect to competition than the particular relationship between a firm's prices and its profits. Price cap regulation may provide a better regulatory platform for accommodating pricing flexibility than rate of return regulation, but regulators should also ask whether a price cap approach would be superior to the existing structure once that existing structure has been refined to meet the same pricing objectives.

Put another way, if price caps can produce significant net gains for both consumers and utilities, as compared to rate of return regulation, their adoption would represent the emergence of a superior form of regulation. It is also possible, however, that any net gains would be swamped by the shift in pricing and by the inherent risk that price caps entail. For example, a bad guess in either direction concerning the achievable productivity gains under price caps would seriously undermine the stability of the model.

Just to make this assessment even more perplexing, there is very recent research, published in the December 1993 edition of the *Journal of Regulatory Economics*, suggesting that while pure price cap regulation is more efficient than cost-based regulation, hybrid regulation – where some of the profit-limiting aspects of rate of return regulation are preserved in a nominal price cap regime – may be less efficient than traditional cost-based

regulation. Let me hasten to add that the subtleties of the math in the article escape me, but it is certainly plausible that combining two models could lead to results consistent with the worst of both worlds as easily as it could lead to the best of both worlds.

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Another broad concern involves the extent to which a regulator has confidence that utility management will respond as economists predict they will respond under the new regulatory structure. This is the analog to some recent economics literature that seeks to prove, in a formal way, the proposition that people do not always behave as economists assume they will. Some interesting work on the behavior of corporate managers suggests that not all managers consider the long-term growth in the wealth of the company's shareholders as their sole motivating objective.

These behavioral observations caution that there is no reason to assume that utility managers will behave under a new regulatory regime any closer to the hypothesized behavior of the economic models than those same managers do under existing regulation. Indeed, one might even suspect that the distance between hypothesis and reality will be greater under the new model, simply by virtue of the change itself.

I do not argue that new models should be shunned: I only suggest that comparing an existing system as operated by human beings with a new system operating largely in the minds of economists may not be an entirely fair comparison. More pointedly, this comparison may be an inadequate basis for public policy choice. There may be some value in evaluating the likely performance

of the particular human beings of the particular utility in question before banking the expected net benefits of any new approach.

My final cautionary note concerns the limits of Commission power, and more broadly the limits of predictive models. If Maine's experience with QF contracts has taught anything, it has taught that an untempered faith in today's view of the future can be a very dangerous thing. I cringe when presented with estimates of inflation, oil prices, or virtually anything else, when those projections run ten, twenty and even thirty years into the future. I have been around forecasting and forecasters long enough to know that the basic rule-of-thumb is that, generally speaking, "the future looks like the present, only more so."

Where long-term projections are unavoidably fragile, any model of regulation that depends upon a particular set of projections is unlikely to provide the structural stability that regulators, and the public, should expect. Any new regulatory model, as well as the existing structure, should be tested under a very broad set of alternative assumptions to ensure that the expectations will not be shattered by predictably unpredictable economic and geo-political events.

Having cast this wet blanket on the party of regulatory reform, I should admit that, notwithstanding these concerns, I continue to have a strong affection for price cap models. This affection stems in part from my belief that consumers tend to be much more interested in price and quality than in the profitability of the provider. I also believe that the more a utility has to respond to competitive pressures – in other words, act like other businesses – the more it should be subject to the principles of risk and reward that are reduced by cost-plus regulation but may be enhanced by price caps. I have articulated my concerns about moving to a new regulatory paradigm because it is the responsibility of those who propose change to explain and to justify the reasons for change, not only to those who worship at the temple of Bonbright but also to those, including customers and legislators, who must be satisfied that our collective course is true.