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# Examining Alternative Forms of Utility Regulation: The Incentives and Disincentives of the Regulatory Structure

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# Examining alternative forms of utility regulation: The incentives and disincentives of the regulatory structure

*The traditional form of regulating public utilities – command-and-control – has been found inadequate by some to cope with marketplace changes that have introduced competition into previously monopolistic markets. Alternative forms of regulation, particularly incentive regulation, have been developed in various areas of the nation in response to the new competitive utility environment. In the following articles, former Maine Public Utilities Commission chair Ralph Gelder, New England Telephone Vice President for Maine, Edward Dinan, and Central Maine Power executive Vice President David Flanagan discuss these emergent utility issues. A fourth and quite different view of the present regulatory system and its alternatives is provided by Joseph Donahue, an Augusta attorney who frequently represents several major industries in utility proceedings.*

## Why alternative forms of regulation?

*by Ralph Gelder*

The question before us is "alternative forms of regulation." That raises the immediate question: Why alternatives? What's wrong with our traditional form of regulation? Is there something that may need fixing?

Let me put those questions in the context of the competitive model that governs most industries in the United States. Markets provide strong incentives for these industries to be efficient and also to succeed. If a firm is not efficient, then it will not succeed and it will disappear from the marketplace. But the electricity, telephone, water, and gas industries have not fit that competitive model, at least not for most of this century. These utilities were viewed as natural monopolies. Competing power lines and transmission facilities were viewed as inefficient. The conventional wisdom of the time believed that a monopoly was required to take advantage of the scale economies. On the other hand, public policy was concerned about price gouging and the incentive to offer poor service or to offer only limited services.

To deal with the downside problems of natural monopolies, the states and the Congress introduced the concept of economic regulation of monopolies. In exchange for an exclusive franchise to serve an area, utilities had to agree to comprehensive price and service regulation. Legislators and members of Congress did not want this function performed in the halls of Congress or the legislature, so they created regulatory commissions. Regulatory commissions had the responsibility to set a fair return on the rate of capital, one that was sufficient to attract the funds needed to operate the utilities. More importantly, the commissions were given the responsibility to see that monopolies serve "the public interest." This regulatory model was viewed as a surrogate for the market system; regulation would seek to assure safe and adequate service and guard against monopoly profits. Consumers, business, industry, and individuals should benefit by receiving lower, more stable prices than would be available under the pure monopoly system. The disadvantages of regulation are that it is very legalistic and litigious. The system is strictly cost plus. There is little incentive for the regulated monopoly to be efficient or creative, except to the extent that the regulatory commission can review the firm's performance after the fact.

### Emerging competition

In recent years, this traditional regulatory scheme has started to crumble. This disintegration has occurred not because regulators are inept or stupid (although I remember being called that a few times when I was on the Maine Public Utilities Commission). Monopoly is no longer an absolute characteristic of these industries. Competition showed up first in railroads, trucking and airlines. Then telecommunications began to acquire more competitive forces. And now competition is spreading into electricity and gas. As a result, competitive firms now exist, side by side, with monopoly firms subject to regulation.

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This emerging competition was not simply dreamed up by someone. Competition came because of technology. Trucks challenged the railroads. Microwave, computers, and cellular have challenged the telephone industry. This technology was really beyond anyone's control. But the initial regulatory reaction to these changes was usually to protect the industry against this competition. But when regulators begin to protect an industry from outside competition, we should raise questions about what is required to regulate that industry. The old Bell System model was a classic example. The prevailing model was, "The system is the solution." In fact, the Bell System argued that all of the system, including the manufacture of the phone sets in the customer's hand, had to be part of the Bell System. Otherwise, the Bell System argued, there would be chaos.

The current question is, given the realities of the marketplace, how can the regulatory structure overcome lack of incentives to be efficient in the utility business? Can you add incentives to regulation, or put more broadly, should

regulation eventually give way to competition as the primary regulator?

I do not have all the answers to these questions. But it is clear that if nothing is done, and if regulators insist upon the traditional regulatory model, competitors will eventually capture large segments of the market to the disadvantage of those **consumers who must remain with** the utility. Thus, regulators must **allow utilities to meet competition,** but they must also prevent preemptive pricing behavior that would stifle that emerging competition. Utilities must be provided with incentives to be efficient in order to meet these competitive challenges. These objectives define a very difficult task. Careful balancing is required. In recent years, regulators have given, or have attempted to give, more pricing flexibility for services subject to competition while trying to build a wall around the monopoly elements. Unfortunately, that wall is itself a problem. What is a monopoly today may be competitive tomorrow. Utilities **require the incentives to cut costs** and to downsize to meet the realities of market.

## New regulatory schemes

Some have questioned why regulation should reward utilities to do what they are supposed to do. Quite simply, without proper rewards, there is little incentive to seek wrenching changes. Meaningful rewards are required to motivate the desired behavior.

Today, there are nearly 100 different utility regulatory schemes, **or incentive regulation plans, across** country. But generally speaking, these schemes fall into two basic categories -- specific and comprehensive. Specific plans are designed to achieve a certain type of behavior. Conservation programs, plant performance standards, and **programs to reduce consumer** complaints are examples. We will **see more plans on environmental** performance standards to encourage utilities to use the market mechanisms built into the Clean Air Act of 1990. These mechanisms are trying to achieve specific types of improved performance and efficient behavior. The broader and more **comprehensive incentive programs** include price freezes, price caps, performance index standards, and activity indexes. The point of these comprehensive programs is to reward companies for the risks that they take.

There are older regulatory programs, which strike me as inappro- **priate in this new) competitive** environment. For example, the regulators need to move away from features like fuel adjustment clauses, which do not build incentives into the system. In fact, fuel clauses completely remove risk from the system; the risk is passed along to ratepayers. Regulators must let the market mechanism work. If a utility does well on minimizing petroleum costs, then they should be rewarded.

Today, most of the programs are still specific. But as competition



**increases, incentive programs will become more comprehensive in nature. We may even see an eventual migration toward economic** deregulation. Transportation certainly has gone that way. When I served on the Maine PUC, much of the Public Utilities Commission's time was absorbed by efforts to protect existing truckers, which did not make sense. So the legislature passed a bill deregulating the industry. Ten years later, the world has not collapsed. Some of the trucking firms disappeared, but that is the nature of the process. The market is being served better by competition.

## Incentive program requirements

I want to suggest some requirements of good incentive programs. First, we should design plans that are consistent with the company's self interests. Basically, regulation should fit into the corporate culture. Increasingly, that means profit incentives. If regulation emphasizes service, then companies will provide services. But they will provide it with more employees and higher costs. But if profits are emphasized, we will see lower costs. The second **incentive requirement is that we** move the company towards more competitive pricing. Although the fear is always that pricing freedom will result in higher prices, the experience has been that the prices go down with greater **competltlOll.**

A third incentive requirement is that the plan must be simple and easy to understand. The rewards must be clear. The plans also must be balanced. There should be extra rewards for extra performance and penalties or no rewards for poor performance. The rewards must be meaningful. Former Central Maine Power Company President John Rowe has said that "the rat has to smell the cheese." The utility executives must see meaningful benefits to be motivated to take advantage of them.

Plans should also be largely automatic once that they are in place. Regulators will review these plans but the utilities should be allowed make their own decisions. When utilities make mistakes, the inclination to micromanage should be resisted. Finally, the plans should be fairly long run. After three to five years, plans can be reviewed.

What will an alternative regulation program provide in the long run? I think that we will get lower prices, and also more stable prices, for consumers in Maine and elsewhere. Consumers will also receive the protection of choice. Competi- **tion, or an incentive regulatory** strategy, should provide choice. Companies and consumers can be much better off under incentive regulation. If states ignore the realities of competition and persist with a very heavy-handed form of regulation, the ultimate result will be higher prices for utility services. Incentive regulation must make it profitable to cut costs and to down- **size to provide service. If incentive** regulation achieve this, then prices at the very least will not increase and may even go down.

Conclusions

**In** conclusion, incentive regulation is a way of introducing flexibility into the regulatory process. Its goal is more efficient behavior, which is closer to the competitive model. New regulatory schemes must assure opportunities for people to choose the means of protecting themselves rather than relying on fixed prices with traditional cost-plus regulation. Yes, it will be difficult to accomplish this. It will be difficult to mix competition and monopoly. Trade-offs must be made. But technology cannot be reversed. New firms with new technologies and cost efficiencies cannot be kept from the market. Attempts to prevent new entry are fraught with problems for the regulated utility, for regulatory commissions, and for the people who pay for these services.

There is no single correct regulatory structure. A structure appropriate for Maine may not be appropriate in Florida or elsewhere in the country. Plans must initially be tailor-made for individual states. But, ultimately, these incentive regulation plans will become more generalized. Eventually, we may deregulate certain segments of the industry, much as has happened in transportation. More and more the marketplace will supplant regulation. Consumers will gain when competition assures that people have choices -- choices that can protect them from monopoly pricing and behavior.

# What do alternative forms of regulation mean for regulated utilities, consumers, and the environment?

*by Edward Dinan*

Introduction

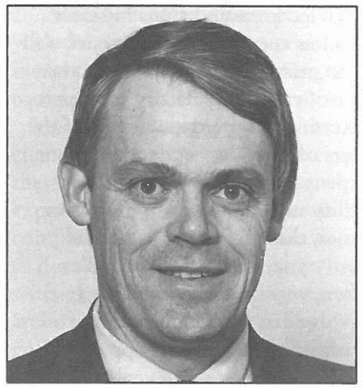
Alternative approaches to regulation have received much attention recently. The inherent weaknesses in the more traditional rate-of-return approach are widely appreciated. New regulatory concepts -- such as earnings sharing, price caps, and social contracts -- have been gaining wide support in many jurisdictions. Why are there the makings of a regulatory revolution out there? And what do these various alternative forms of regulation offer consumers and utilities? Or, as some traditionalists have asked the question, why should we change a regulatory structure that has worked well for nearly half a century?

The simple answer to all of these questions must come from the purpose of regulation itself -- that is to simulate a competitive, market-driven economy. Over the years, rate-of-return regulation of telecommunications has done a good job of mirroring the effects of a competitive environment by: (i) promoting the attainment of certain public policy goals, (ii) fostering efficient and prudent utility network deployment, (iii) stressing service quality, (iv) maintaining reasonable costs to consumers, and (v) allowing shareholders an opportunity to receive an equitable return on their investment. All was relatively well and stable in telecommunications until the 1980s when the characteristics of the regulated markets began to change at an accelerated pace. The break-up of the old Bell System, coupled with significant technological improvements and the advent of competition, brought about sweeping market changes and innovations. Unfortunately, the traditional form of regulation, rate-of-return regulation did not, and could not, keep pace with the dynamics of the marketplace.

The loud cries for regulatory reform are being wailed with the hope that regulatory policies and the resulting regulatory structures will be modified to keep pace with the dynamics of the marketplace. Too many of the regulatory processes employed in the State of Maine have become outmoded and burdensome, which severely hinders the efforts of regulated businesses to efficiently serve their customers, to expand their businesses, and to contribute to the economic expansion so desperately needed by the State at this time.

Historical approach to telephone utility regulation

Historically, the telecommunications industry has been characterized by two elements. First, the majority of its productivity gains were achieved by replacing labor with capital. Technology



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development made this replacement the primary opportunity to achieve productivity gains and, consequently, to lower prices. Second, the industry basically had a single product -- voice communications. This product was in healthy demand and the relatively simple task for the telephone companies was to supply this service efficiently. Given these two factors, regulatory policy appropriately signaled telephone company management to concentrate on the operations side of the business and to find the proper mix of labor and capital. Little attention was placed on the needs of the customer beyond plain old telephone service.

Rate-of-return regulation mirrored the then-existing focus on efficient operations. In the past,

the telecommunications business was less complex to regulate, as well as to manage. Regulators used the rate-of-return regulatory process to determine the reasonableness of the costs of these investments and expenses that were passed onto utility ratepayers. Even in simpler times, this litigious process was costly and time-consuming. Too often, regulators became overly involved in the details of the business-management proposals. Rather than taking the role of strategic overseers who review proposals broadly for compliance with set regulations and for consistency with established long-term policy goals, regulators tended to expand their oversight responsibilities by taking a "command-and-control" approach to their duties. Regulatory staffs took on the role of auditors in a business, and scrutinized investment decisions and day-to-day expenses. This tactical approach to regulation became difficult with limited staff resources and the growing docket of issues before regulators. Regulatory agencies, in essence, duplicated the management decision processes already undertaken by utilities. The duplication and transaction costs associated with the rate-of-return regulatory process can be substantial. In addition, innovation and the deployment of new technology and services were delayed. Yet, this litigious and often adversarial process did not yield substantial results, since rarely have the investments or expenses of telecommunications utilities been found to be imprudent.

## New operating environment

Today's telecommunications operating environments are becoming more and more complex, and thus more difficult to regulate under the traditional rate-of-return approach. The relatively simple times of the past have ended. The technology, the criteria to justify its deployment, the market opportunities, and customer expectations are all changing dramatically in today's world.

In the past, investment decisions were primarily driven by expense savings *(e.g.,* lower labor costs), where the expected results were under the internal control of the utility. But, with recently completed network upgrades now behind us in Maine *(e.g.,* switch replacements and fiber deployment), opportunities for significant expense reduction have been greatly reduced. The economic justification for further technology deployment has shifted from an expense-savings focus to a revenue-enhancement focus. This change in focus makes both management's decision-making process and the regulator's oversight responsibilities more complex. Investments driven by potential new revenues carry a greater risk than past deployment decisions, over which management had more control.

A change in the current form of regulation is needed to keep pace with the dynamics of the marketplace. New service revenues to support future network deployment will not come easily or automatically. Unlike simple voice communication, sales of new, innovative uses of the public network will become more involved and riskier and will require a higher level of marketing skill. The utility must understand not only its own business, but also the businesses and lifestyles of its customers. Future sales of communications services will depend on the ability to make business clients more productive and complex residential lifestyles more enjoyable and easier to manage. These are skills normally associated with a market-driven entity.

Unfortunately, traditional rate-of-return regulation works to impair the development of these marketing skills. Risky investment is not stimulated under rate-of-return regulation. Fearing that regulators could disallow market-driven investments that prove unsuccessful, utilities temper their marketing approaches and choose only low-risk investments. True market-driven environments accept the challenge of trial-and-error approaches. In comparison, traditional rate-of-return regulation does not simulate the realities of the market conditions utilities now face. Regulatory systems must recognize the necessity of this iterative process and incorporate them into regulatory structures.

## Need to change approach to regulation

The current form of telephone utility regulation in Maine is out of date and needs to be revisited. To be truly effective, regulations must continually evolve to keep pace with the dynamics of the environments they were originally designed to oversee.

Maine's regulated industries are changing rapidly. The issues facing these businesses seem to grow exponentially, both in number and complexity. Regulatory bodies need to develop strategic partnerships with regulated industries to ensure attainment of established policy goals in a timely, cooperative and efficient manner. Restraint is necessary to avoid conducting detailed and time-consuming case reviews that no longer serve overriding policy goals. Established regulatory policies need to be revisited constantly to ensure that they reflect current conditions and the present needs of the State. For example, current regulatory policy goals need to become better balanced to incorporate economic development considerations to a larger degree.

All participants in the regulatory process need to spend more time concentrating on the strategic importance of policy goals, and less time on the process itself. These goals must evolve to keep pace with dynamic business environments. With a more strategic focus, regulatory participants can begin to foster a better spirit of cooperation, along with a better sense of mutual trust.

This concept of a more cooperative, strategic and efficient regulatory process should be expected from alternative forms of regulations. The actual form of regulation - call it profit sharing, price caps,

social contracts or even ERAM -- is not as important as the need to build a more flexible and evolving process. Regulatory bodies must take a broader goal-oriented (or strategic) approach to their duties, and thereby enable regulation to adapt more readily to the dynamics of the industries being regulated. The regulatory process can then become more efficient and helpful in fostering attainment of appropriate policy goals, without undercutting legitimate regulatory oversight responsibilities.

### Path for regulatory reform

Such dramatic, yet necessary, change to the regulatory processes of Maine cannot be expected to occur overnight. For telephone utility regulation, I see a natural three-stage progression away from the current, inefficient "command-and control" approaches of rate-of-return regulations.

The first transitional step is for the participants in the regulatory arena to build a more collaborative approach to effective regulation. I touched upon this concept earlier with the need to assume a more strategic approach to regulation. In addition to changing the mindsets of regulatory participants, it is essential during this "collaborative" phase to revisit the goals that have been established for regulation to ensure that they reflect current conditions and needs of Maine. The keys to an improved regulatory process are the establishment and common acceptance of appropriate long-term policy goals. All participants in the regulatory process must remain constantly aware of, and focused on, the current policy goals when evaluating the merits of the issues before them.

Certainly, the greatest challenge in this initial transition stage will be to gaIn a consensus on appropnate long-term policy objectives. Given the overriding effect that legislation has on policy decision-making, current statutes affecting regulatory policy need to be thoroughly reviewed and revised where appropriate. Legislation should be enacted to establish regulatory goals more reflective of today's environment. In addition to maintaining the long-standing goal of universal service, regulation needs to encourage the development and deployment of new technologies, the introduction of new service applications, and the efficient pricing of regulated services. There can be no question that pricing reform is necessary to promote economic efficiency and to support economic development in this dramatically different operating environment.

Once long-term policy goals are established and the need for pricing reform accepted, Maine can then proceed onto the next phase: "incentive regulation." Alternatives to the current rate-af-return regulatory approach need to be tried and adopted to keep pace with changing market conditions. And again, the exact form of this alternative regulation is not as important as creating regulation to encourage utilities to accept the new challenges of the evolving marketplace. At a minimum, this will require greater marketing and operational flexibility for utilities than what has been associated with rate-of-return regulation. In addition, earnings incentives will be necessary to stimulate risk bearing.

Overall, regulation must move from the current detailed approach to a more goal-oriented focus. Eventually, regulation will move to its final stage: "deregulation," or put more bluntly, extinction. Market forces and technological advances will continue to evolve until competitive markets abound and regulation will no longer be needed. The underlying purpose of regulation is to simulate a competitive, market-driven economy. Over time, the need to simulate such an environment will diminish as utility markets become increasingly competitive.

For the record, I do not propose to abolish all forms of regulation tomorrow. Until markets become more fully competitive, some form of regulatory oversight is necessary and useful. I do ask that regulation better reflect the conditions of the market, and evolve to keep pace with market dynamics. This has not occurred under rate-af-return regulation and a timely change to a more appropriate regulatory structure is essential.



## Electric utilities: Incentive regulation is the best option

*by David Flanagan*

After decades of glacial change in the era since the progressive movement first imposed regulation on electric utilities, the past few years have seen a dramatic increase in the pace and the scope of regulatory change. These changes are creating new forms of state and federal oversight of utility regulation that are fundamentally altering the regulatory landscape for electricity.

### Electric regulation

Before I move to these changes, I would like to provide an overview of the different types of regulation that are now applied to electric utilities. Electric utilities are regulated at both the federal level, by the Federal Energy Regulatory Commission (FERC) and at the state level, by state public utility commissions. Federal jurisdiction applies largely to interstate commerce and to issues of national policy, including most conspicuously, the Securities and Exchange Commission and the Nuclear Regulatory Commission. Regulation of the activities of intrastate electric franchises, such as Central Maine Power, Bangor Hydro or Maine Public Service, largely occurs at the state level. This includes, for example, issuance of certificates of public convenience and necessity

before new transmission or generation facilities are built and, above all, determination of the rates paid by customers.

Dual federal and state jurisdiction over the industry appeared nearly as early as electric regulation itself. The Federal Power Act, adopted in 1920, created a Federal Power Commission (now FERC) and defined federal versus state jurisdiction within the industry. This landmark legislation was followed by the Public Utilities Holding Company Act of 1935, which was intended to oversee the operation of multi-state utility combinations and to limit their power vis-a-vis individual states. In 1978, Congress responded to the Arab oil embargo with the Public Utility Regulatory Policy Act (PURPA). This act created a whole new class of generation facilities known as "qualifying facilities" (QF's), which were given very valuable regulatory exemptions and tax advantages.

In October, 1992, Congress enacted another major law, the National Energy Policy Act of 1992 (EPAct), which holds the potential to change dramatically the character of our industry. Under EPAct, utilities may compete for generation business in each other's territory through a new type of entity called the "exempt wholesale generator" (EWG's), and through reduced restrictions on access to transmission facilities in other franchise territories. Although the regulations and clarifying judicial opinions for this thousand-page federal act are still being written, it is evident that this act will intensify competition in the electricity business. This, in turn, will affect the amount of regulation that will be meaningfully possible at the state level.

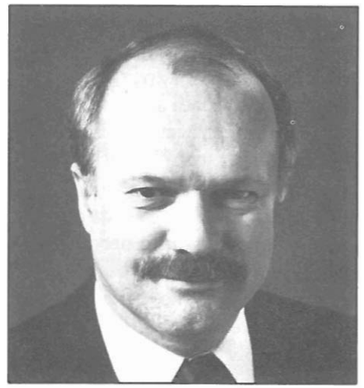
## FERC and power generation

In the generation area, FERC administers, to some extent, PURPA, which radically changed the market for new generation. Despite its federal origin, PURPA delegated to the states the ability to create their own rules on how utilities would purchase power from qualified facilities and other non-utility generators. In Maine, the Public Utilities Commission developed rules to determine each utility's "avoided cost." In turn, CMP and Bangor Hydro developed an auction system to acquire new generation by bid. This has had a dramatic impact on the sources of power generation in Maine, to a greater extent than virtually any other state in the country. CMP, through some 92 separate contracts, is now getting forty percent of its power from independent producers of power, which range from hydro facilities to trash burners to paper mills. These contracts have had a tremendous impact on both the sources of power generation and the cost of electric generation. The National Energy Policy Act of 1992 has continued the deregulation of electric power generation by creating these exempt wholesale generators, which will lead to more competition in the generation area.



Likewise, in the transmission area, there is also a significant federal role. Here, the FERC plays a large role by setting tariffs for both interstate and intrastate bulk power transfers and wheeling. Under the 1992 act, the transmission market has been opened up by empowering FERC to order utilities to wheel wholesale power, without regard to existing customer relationships. Utilities now have sixty days to respond to a request for wheeling, after which an applicant can request FERC to order wheeling services. It is even possible under this new act that utilities would be required to build more capacity to allow a competitor transmission access. However, FERC has not yet ordered retail wheeling. (Retail wheeling is the transmission from a generator to an individual customer not in the generator's franchise area.) State governments continue to have the authority to govern retail marketing areas for electric utilities. Retail wheeling is clearly an area of future contention. We can reasonably expect to *see* efforts in the next few years to mandate retail wheeling. Retail wheeling would have rremendous impact upon the share of electric service cost born by industrial customers, who would have bargaining power to seek bulk power from other sources, and by residential customers, who are unlikely to have that same kind of bargaining power.

FERC also has a role to play through its regulation of regional transmission groups, such as NEEPOOL, and the various regional electric reliability councils. The NEEPOOL utilities are negotiating a regional transmission access agreement, pursuant to the authority and encouragement in the National Energy Policy Act. In a very short time, such a transmission access agreement may be in place. Recently, there have been proposals for several other kinds of regional regulation, including the idea of having regions such as New England deal on a multi-state basis with issues of common interests, such as the environmental impact of utilities or integrated resources plans. So, in the future, the role for regional regulation may expand even further.



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Deregulation continues to be a key topic for electric regulation. EPAct reforms are clearly moving electric utilities down a path similar to the deregulation that occurred in the natural gas industry. In natural gas, deregulation eventually led to the breakup of the vertically-integrated industry into producers, pipelines, and local distribution companies. These more fragmented companies are scrambling to secure reliable supply and transmission contracts in the gas industry. But, on the whole, natural gas prices have dropped over the years. Similarly, a future can be envisioned in which Maine utilities break into separate generation companies) transmission companies, and distribution companies. If such a transition does occur) it will be painful for some, and the role of the states will be dramatically redirected.

As Edward Dinan and Ralph Gelder discuss elsewhere in this issue, rate base regulation has many short-comings. Rate base regulation distorts economic allocations towards more capital intensive uses. It discourages flexibility. Rate base regulation provides no reward or recognition for service as opposed to capital investment, and it leads to command-and-control regulation that encourages utility managers to be very risk averse and very conservative in their decision making, probably to the ultimate detriment of the customers.

## Incentive regulation

Incentive regulation is an alternative that ought to be examined. However, if we approach alternative regulation in a piecemeal fashion, such as giving a specific incentive for one specific program goal, alternative regulation probably will not substantially change the overall direction of the utility. Under a more comprehensive kind of incentive regulation, such as has been tried or proposed by San Diego and by Public Service of Indiana, the new incentives will have much more dramatic impacts upon utilities. There is also a kind of regulation called "performance-based regulation," which the state of Mississippi has tried for the last few years. Some flexibility in rates (as we understand it, up to four percent) is allowed on the basis of a formula. The state of Mississippi sets out seven goals that the state would like to see achieved.

But in order to get to that point, where we might consider such worth while models, there first has to be some kind of collaboration among the utilities and the regulators and the interested parties to arrive at some shared goals. Until we identify the goals which we have in common and directions in which we want to go, we are unlikely to achieve very much. The example of the recent transportation collaboration in the aftermath of the turnpike referendum may be a model. People from the Maine Department of Transportation and from various interest groups were able to find some common understandings as to goals. Similarly, common goals that apply to electric utilities can be found if thoughtful people work together towards some common understanding. We have identified some of those. Obviously, in a business as big and complex as ours, it's very difficult to enumerate them all.

## Conclusion

One goal that is not conspicuously present in today's implicit goals is economic development. If Maine is to end the stagnation and its concurrent reduction in the quality of life and the standard of living) then a new initiative for economic development is required. But the pieces are not in place yet for the state to really undertake that course. Central Maine Power, and probably all other utilities, would be willing to work with the state and with other interested parties to move in that direction. Economic development is a key element on which we have not yet reached an understanding.

In conclusion, traditional rate base regulation is no longer sufficient to meet today's needs. Utilities need some kind of incentives to move ahead, but only on a comprehensive, not piecemeal, basis. Collaboration between regulators and all the communities that are interested and concerned with electric utility issues is really the best hope for Maine in the future.



# An argument for a prudent approach to alternative forms of regulation

*By Joseph G. Donahue*

## Introduction: The need to take a step back

The current debate over alternative forms of regulation for Maine's utilities presumes agreement on the need for an alternative to the current regulatory system, as well as agreement on the fundamental objectives of utility regulation. This may not yet be the case. Further, the debate over alternative forms of regulation is often expressed in terms of a need to develop forms of "incentive regulatIOn," as if the providing of incentives to utilities is new. As we all know, all forms of regulation (or the lack of regulation) provide incentives of different sorts, magnitudes and directions. Therefore, before going too far down the path of incentive regulation, public policy makers must first decide whether and to what extent the current regulatory scheme is capable of accomplishing this State's fundamental policy objectives, creating the incentives that promote the achievement of those objectives, and performing efficiently and fairly. Obviously, the first question must be: What should be this State's utility policy and how is it different than our current understanding of the policy?

It often seems that much of the debate over alternative or incentive forms of regulation confuses the

necessity for alternative forms of regulation with an individual's views on what ought to be the fundamental policy objectives. For example, it is argued that **incentive regulation is necessary in order to promote economic** development. The function of public utilities, regulators, and utility customers in promoting economic development is a fundamental policy question, not yet fully decided. While the Public Utilities Commission appears to have taken modest steps in directions which may provide some assistance for economic development (for example, Bangor Hydro's economic development rates and CMP's incremental energy sales), the fundamental policy debate has not been fully developed.

Closely related to the issues and **arguments surrounding economic** development is the issue of pricing flexibility. Utilities argue that they need pricing flexibility in order to meet the challenges of increasing **competition from alternative means** of serving ratepayers and users. The current discussion over alternative forms of pricing again presumes the need for a fundamental change in the traditional policy of utility price structuring, *i.e.*, the segregation of customers into classes and the non-discriminatory application of similar rates to all customers within a class. The argument over price flexibility presupposes a need for complete flexibility and, often, a desire for no regulatory oversight. Again, the Public Utilities Commission has made modest steps in this direction in response to specific situations. However, the fundamental debate has not yet concluded.

Critical to any fundamental debate over policy objectives are the needs and views of the customers of utilities. Interestingly absent from much of the debate which has taken place to date is this customer perspective. Rather, the debate appears to focus on the need for the utility to compete, in order for the utility to remain viable. Thus, incentives are weighed in the context of their ability to allow the utility to be more competitive. While there are very good arguments that allowing the utility to be competitive will benefit customers, the interests of customers is often the ending point, rather than the beginning point, for the discussion. I suggest that the debate over alternative forms of regulation must also start from the funda-mental question of what do **customers need.**

Finally, the participants in the debate over alternative forms of regulation almost universally decry the current system as overly **litigious, time consulning, and** expensive. While improved efficiency is important, it must also be kept in mind that, in regulation, the medium is often the message. For example, regulatory lag, despite its annoying features, provides a substantial incentive for greater utility efficiency. Similarly, the litigation process is a rough embodiment of the institutional role of the **Commission to act as a substitute** for the rough and tumble of the competitive marketplace. Despite **its unpleasantries, the competitive** market model is emulated across the world because of the results that it produces. Similarly, the debate over the need for alternative forms of regulation should keep in mind whether the results produced are consistent with public policy, notwithstanding whether the process is not particularly pretty.

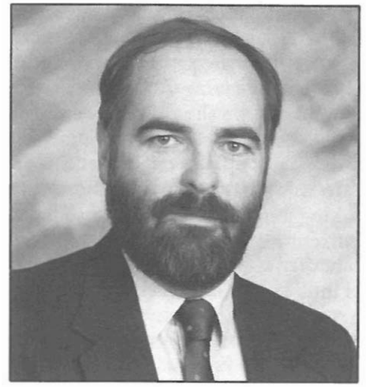
Accordingly, I believe that both Mr. Dinan and Mr. Flanagan are correct in their views that the first step in moving toward alternative forms of regulation is to establish the long term policy objectives. Once the goals are established, the adequacy of the current and alternative regulatory systems to achieve those goals can be assessed.

What is our objective and how do we get there?

The reaffirmation of current fundamental objectives or the **creation of new directions requires** the input of all interested and affected parties. The debate cannot be dominated solely by the regulated entities and the regulators. As I noted earlier, the needs and concernS of utility customers and the general public must be a major focus of the discussion. Further, the makers of general policy in our executive and legislative branches should be involved. In the end, however, policy will be established by the Legislature or the PUC, or both, depending on the issue. Although a "collaborative" process may be used to get views and perspectives into the process, in the end the decision must be made by those who have the responsibility to make those decisions. The drive towards efficiency and less burdensome regulation should not lead to unwarranted abdication of responsibility of the policy makers, either with regard to deciding on policy, or with regard to carrying out the policy through regulation.

Once the policy objectives are clearly established, the debate can move immediately and meaningfully to whether current regulation can promote the objectives, whether some modifications of current regulatory systems are necessary, or whether an entirely new form of regulation is required. In weighing alternative regulatory schemes, the fundamental criterion will be results. Results will be measured both in terms of whether the regulation produces the desired results *(i.e.*, greatest achievement of the policy objective) and whether it produces undesired results (side affects and counter- incentives). We can be more tolerant of the processes if the results are correct.

Obviously, in addition to results, it is important that the process be efficient and fair. These latter attributes get to the fundamental point with regard to any form of regulation, *i.e.*, the public must



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have confidence in the process and in the regulators. If the public believes that the process is fair and that it is achieving the results they want, then we should have considerable confidence that regulation is working.

In this regard, it may be worth taking a moment to consider our current regulatory objectives and whether regulation is working. It is interesting to note that there is a great deal of similarity among the objectives of the promoters of regulatory reform who have authored the other articles in this series, and that these common objectives have a great deal of consistency with the objectives of the current regulatory scheme. We all agree on the basic maxim of utility regulation that regulation should act as a surrogate for or simulate a competitive market-driven economy, because we want the results of low (competitive) prices and quality service. The basic idea is that regulation should produce incentives for efficiency and cost cutting, just as those are produced by the competitive marketplace. As discussed earlier, there appears to be growing consensus for a role for economic development and for pricing flexibility in the process. However, at the same time, the fundamental regulatory and legislative objectives of least cost planning and demand side management for electric utilities and universal service for telephone utilities have not been fundamentally altered, although recent legislation has arguably modified the emphasis. Thus, while we now move towards greater pricing flexibility, a concern remains with regard to protecting core customers and state energy policy.

As discussed below, in the context of CMP's experience, I submit that the current regulatory process is not doing all that badly and, given encouragement, is capable of doing better. Furthermore, it remains to be proved that alternative forms of regulation will be any more successful or acceptable in achieving our policy objectives.

## The regulatory experiences of Central Maine Power Company

The experiences of Central Maine Power Company, its customers, and its regulators during 1993 provide an interesting and meaningful case study in a number of the issues surrounding the quest for alternative forms of regulation. The year 1993 began with the PUC ordering the demise of the major incentive ratemaking experiment known as electric rate adjustment mechanism (ERAM). The year ended with the Commission's decision in a traditional rate case, in which management efficiency was the principle issue. During the year, the Commission moved forward with efforts by CMP, its customers, and its own staff in the area of greater pricing flexibility.

As many of us are all too well aware, the PUC's experiment with ERAM for CMP has cast a pall over incentive ratemaking. In 1991, the Commission and numerous parties, believing that command-and-control regulation was not sufficient to provide encouragement for conservation) adopted a mechanism to insulate CMP from changes in volume of sales of electricity. In order to achieve the result of insulating CMP from the effects of lost sales due to conservation, the Commission also produced the result of insulating CMP from a much greater threat during the early 1990s, *i.e.*, the effects of the recession that shook Maine. Thus, while creating an incentive favorable to conservation, ERAM also removed the incentive to preserve sales. While CMP and its customers wrangled over requests for reconsideration of ERAM, fuel clause proceedings, and rate design, CMP's sales base eroded. While customers faced declining profits, layoffs, and economic insecurity, CMP's revenues and earnings remained healthy. In fact, certain industrial customers argued that the PUC should conduct a rate case for CMP, in order to bring it back in touch with reality. Finally, in January, 1993, the Commission decided to terminate ERAM in December 1993 (three months ahead of schedule).

The ERAM experience has one silver lining: it has taught us all a lesson. In the future, it will be increasingly necessary that any alternative or incentive ratemaking innovation have clear objectives and is analyzed and designed to achieve those objectives without undermining other objectives. Consensus will be important. It will also be important that real and not amorphous limits be placed on the amount of damage that can be caused by the experiment.

The ending of ERAM ultimately forced the filing of CMP's rate case. Customers who had experienced the ravages of the recession and the need to economize, and who had observed CMP's lack of similar incentives (both as a result of cost-plus regulation and ERAM), insisted that CMP also feel the constraints of the competitive marketplace in its revenues and thereby achieve necessary cost savings and efficiencies. The Commission ultimately decided that CMP's costs included substantial inefficiencies and slashed CMP's Tate increase request. (It is more than ironic that the amount the PUC deducted because of management inefficiency was remarkably close to CMP's first year of accruals under ERAM!)

CMP's rate case also brought the Commission and the parties directly in touch with a real live competitive issue: *i.e.*, CMP's loss of its wholesale customer, Madison Electric Works, and the associated retail customer, Madison Paper industries. In an area in which there were not regulatory constraints on CMP's ability to bid and to compete, CMP was not up to the challenge, in the view of many. Thus, the question arises whether the problem is the existence of regulation or the company's own internal culture and incentives.

The answer to this question will be found to a large extent in how CMP responds to the Commission's decision in the rate case. We have already seen public announcements that CMP is planning substantial layoffs. If these layoffs produce savings as well as a change in corporate culture, then the Commission's decision in the rate case will have had the desired effect. The Commission's rate case decision was made by the application of standard regulatory ratemaking principles. Thus, change at CMP will be indicative of the success of traditional ratemaking and its ability to respond to current issues. (The current debate among the three Commissioners over the

adjustment for attrition is also indicative of the potential for traditional regulation to change in response to new issues, without the need for an entirely new scheme.)

With regard to the flexibility of current price regulation, the Commission has reviewed and approved a number of proposals for flexible pricing for Central Maine Power Company during the course of 1993. Discount rates for industrial customers in order to keep them on the system or to increase their purchases, thereby benefiting all other customers, have been reviewed and approved by the Commission. The Commission has also worked to streamline the process for review. Also, CMP is on the verge of filing a proposal for flexible pricing in order to retain its residential water heating load. All of these developments are taking place under the "traditional" regulatory regime.

Finally, the Commission has announced a strong interest in pursuing the issue of alternative or incentive ratemaking for CMP in the form of a possible price cap. The details will be explored in 1994. However, many customers already believe that 1993 has shown that traditional regulation applied strongly can work and possesses enough flexibility to deal with new Issues.

In the final analysis, it would appear that the success or lack of success in the regulation of utilities has less to do with the formal engines of regulation and more to do with the quality, concern, and energy of the persons who operate those engines. While some desire to achieve regulation in which the results are not dependent upon the abilities and attentions of the regulators, the fact remains that our entire political and economic system is strongly affected by the quality of our political and business leaders and managers. It is difficult to imagine that it should be any different for our regulatory institutions that act as a surrogate for this market economy.



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