Director’s Take

Policy Essentials

Watching the swirling controversies in today’s regulatory climate, I try to keep in mind what Peter Drucker tells us in his book The Daily Drucker: “Precisely because change is a constant, the foundations have to be extra strong.” What are the foundations in regulatory policy that we need to keep strong?

One foundation is knowing when to regulate and when to deregulate. In the most recent release of his classic text The Economics of Regulation, Alfred Kahn reminds us that the original rationale for regulation in industries where competition is feasible, such as telecommunications and cable television, was a perception that competition was destructive to quality, continuity, and reliability. But if competition promotes these qualities, then the case for regulation is considerably weakened. Kahn also tells us that consumers are voters and expect regulation to give them economic protection. This insight reveals that not only must competition deliver, but consumers must have more faith in markets than in regulation before they will provide deregulation with the political support it needs.

Another essential is to strike the right balance among the competing needs for ongoing investment, price stability, and efficiency. Writing 50 years before Kahn, Martin Glaeser explains in his book Outlines of Public Utility Economics that utility regulation occurs when competition is infeasible and companies are “affected with the public interest,” which means that the rest of the economy is dependent on the utilities’ efficiency and adequacy. Glaeser concludes that regulation should treat utilities as “going concerns” with sufficient cash flows to ensure that new investments are forthcoming and with incentives for management efficiency. In his classic text Principles of Public Utility Rates, James Bonbright expands on Glaeser by emphasizing the importance of ensuring that prices cover the “rate base,” encourage efficient investment and service use, and enable customers to predict their bills. These principles help us with issues such as hurricane damage and, for electricity companies, fuel price increases, fuel mix, and compliance with new environmental regulations.

A third foundation is an expert, independent regulatory agency. Glaeser explains that utility commissions are important and must be knowledgeable because the details and complexities of regulation make it impossible for legislatures to make well-informed decisions in a timely fashion. More recently, Nobel Laureate Douglass North in his book Institutions, Institutional Change and Economic Performance, explains that formal government institutions, such as utility commissions, are needed to reduce risk for investors and constrain political opportunism. Other economists have shown that well-informed regulators are better able to protect customers than are less knowledgeable regulators.
I could go on, but maybe it is better to encourage you keep our foundations strong by reviewing these classic texts and making use of the Body of Knowledge on utility regulation.

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