Utility regulation today is built on lessons that we have learned and forgotten many times over our history. This talk emphasizes two lessons: We have to get the economics right and we have to get the politics right.

The economics of regulation fall into three categories. One is the role of information. Initial attempts at regulating prices for utilities were done by courts – based on lawsuits from disgruntled customers – and politicians, largely in their negotiations with potential utility service providers. Both approaches failed to commercially sustainable prices because judges and lawyers lacked information on what prices could make economic sense, lacked time and expertise to use such information even if it were available, and at least the politicians were unable to separate their political interests from the long term planning needs of the utilities. Finally in the early 1900s a system called service at cost regulation was tried utilizing the more sophisticated accounting systems that had emerged from the development of large corporations. The experiments proved sustainable and service at cost regulation, which has taken many forms over the years, has proven to be the only system that can regulate regulators, in effect anchoring their decision making to utilities’ actual experiences.

It was immediately recognized that this approach to regulation had a basic flaw, namely that it gave utilities little incentive for improving efficiency. Fixing that incentive is the second area of economic challenges in regulation. The answers that were developed at the time and that continue to this day, including auditing utility accounting and management practices, and providing utilities financial incentives to improve their efficiency. The incentive mechanisms have improved over time, but they remain dependent on two features: Delinking pricing from accounting to provide incentives for efficiency, while relinking pricing to accounting to keep regulators grounded in reality.
The third economic issue relates to markets. The basic challenge is to deregulate the process of deregulation, borrowing a phrase from Alfred Kahn. Regulators, like everyone else, view the future based on their past experiences and so make decisions that assume that competitive markets will simply be rearrangements of monopoly markets. This isn’t true. Competition always surprises us. Telecom regulators adopted many policies trying to regulate the emergence of competition. These policies always failed because, once companies and customers were given choices, they found things that no one had anticipated. Energy regulation appears to be repeating this error as we see tightly regulated approaches to introducing solar energy, for example. This approach may benefit some economic interests, but it is unlikely to benefit customers.

The pressures that politics brings to regulation means that regulators need to serve their regulatory role well. Regulation by independent agencies was formed to place a (more) predictable regulatory decision making system between politics and industry investment. This places the regulator in a situation where he or she is telling politicians, industry, and other stakeholders “no” on a regular basis. Rent seekers constantly pressure the regulator to compromise that independence, but the regulatory agency compromises its basic purpose when it yields to that pressure.

More recently a leadership role has emerged for regulators. Stakeholders are subject to what psychologists call the illusion of knowledge, to wit, possessing a little knowledge on an issue, they form the belief that they are fully informed and launch campaigns to pressure or disrupt the regulatory process. The regulator often finds him- or herself managing a political environment, a role that should formally belong to the politician, but that in today’s world of social media, 24-7-365 news coverage, and the like, the regulator is often in the best position to manage and maintain the overall regulatory system. In this context the regulatory system is more than just the formal, legal structure, but includes the media, NGOs, consumer groups, and the like. Of course, regulators are also subject to the illusion of knowledge and so must maintain humility, resisting temptations to regulate competition and make management decisions for companies.