



## New Role for Regulators as Competition Comes to Utility Industries

Change has come swiftly to the electric utility and telecommunications industries. Long treated as natural monopolies, subject to both the benefits and hassles of regulation, these businesses face a difficult transition to a competitive market. Their success in the new environment, however, remains tied to the decisions of regulators. As new entrants seek admission to the formerly-protected marketplace, regulation — no less than operating efficiencies, marketing, and pricing — will determine the fate of the incumbent firms.

It is not only the competitors, however, who will be affected. (If it were, we might all just relax in the bleachers and enjoy the contest.) Although we've been through major deregulation in recent years — in the airline, trucking and natural gas industries, as well as in long distance telephone service — the next phase presents significant new challenges. The implications for the Washington economy are substantial.

The health of our economy rests upon our telecommunications and electricity infrastructure. In the past, telecommunication was straightforward: voices carried over wire. But as wireless communications and the Internet grow, as electronic commerce supplants the paper shuffle, our information-intensive industries place increased demand on the system. Decisions made today may determine this state's competitiveness for years to come.

Similarly, because our history of inexpensive electricity, Washington is home to a number of energy intensive manufacturers. The Pacific Northwest, with abundant water power, has had little reason to worry about the operating efficiency of our electric utilities. Hydro's low cost of generation has assured relatively low prices. But this is changing. Low natural gas prices and advances in turbine technology now allow electricity to be generated at costs below the prices charged by the Bonneville Power Administration.

Both electricity and telephone service traditionally were considered natural monopolies: having a single provider of each was deemed more efficient. In most industries, competition among suppliers serves to regulate price, assure quality, and allocate scarce resources. Under conditions of natural monopoly, however, competition breaks down. The market failure invites government intervention either through direct public provision of service or through regulation. With electricity, we have both government-owned and regulated private utilities, while telecommunications is almost exclusively private.

Here the market failures led to the creation of the Washington Utilities and Transportation Commission (WUTC). As a regulator the WUTC balances a number of objectives, assuring shareholders in regulated utilities an adequate return on investment, guaranteeing universal access to vital services, and protecting consumers from the abuse of monopoly power.

In balancing competing interests, regulators move slowly and prudentially, and as a consequence the firms they regulate cannot adapt swiftly to market demands. Fortunately, the natural monopoly model no longer applies to telecommunica-



tions and electricity. New technologies and growing demand have opened the playing fields. Competition is back. (Yes, back. In the early years of both industries, consumers had choices and utilities competed vigorously. The transportation commission in Washington was not given authority to regulate public utilities until 1912.)

Many economic historians now even question the extent to which the theory of natural monopoly explains the spread of public utility regulation in the early part of the century. Rather than a populist response to monopoly power, the spread of regulation is now seen as serving the interests of the utilities. The electric and telephone companies themselves, the revisionists say, sought regulation to bring stability to their markets. As Nobel Laureate John Hicks once wrote, the best of all monopoly profits is a quiet life.

Regardless, the quiet life is over for regulated utilities. And we may wonder whether regulation - which must be seen as a poor substitute for free, competitive markets - served either the consumer or the utility executive well. Economists know that regulation can perversely affect incentives. Regulators often set prices equal to costs plus a fair profit. In such an environment, there is little reason to hold costs down. Regulators may try to guard against cost escalation by carefully scrutinizing the utility's decision making, but this sort of micromanagement is deadening. Alternatively, regulators may discourage necessary capital spending by failing to assure an adequate return on investment, leaving the utility unable to profitably meet demand for new services.

When we rely on competition, rather than regulation, these problems are avoided. Alfred Kahn, the dean of American regulatory economists and head of the Civil Aeronautics Board during airline deregulation in the Seventies, writes, "Competition is far more powerful than regulation in forcing businesses ... to push down costs. In those situations in which competition is feasible, regulatory commissions should welcome it rather than rush to restrict it."

On the national level, the welcome mat is out. The Energy Policy Act of 1992 rewrote the 1935 Public Utility Holding Act. As a result, the wholesale market for electricity has opened up to competition nationally. In many states retail competition is quickly following as legislatures and regulators seek to reduce the prices residents pay for electricity.

The Telecommunications Act of 1996 extensively rewrote the Telecommunications Act of 1934. Competition has been developing since the late 1960s, when the Federal Communications Commission (FCC) issued key decisions in several cases. In the Carterphone case, for example, the commission moved to allow customers to connect privately owned equipment to the Bell network. In the MCI case the commission permitted MCI to operate a common carrier microwave system in the Chicago—St. Louis corridor and indicated a willingness to force other telephone companies to interconnect. In the Eighties, AT&T was dismembered. Seven regional operating companies were spun off to provide local service, while AT&T retained the long distance business. Under the new Act, that artificial barrier is coming down as regulators in the various states define the terms of competition in their local markets.

The intensity of competition in long distance can be measured by the number of marketing calls received during the average dinner hour. While we may dislike the intrusion, we enjoy the benefits of competition. The clear result has been lower prices. For many, cross-country calls are as frequent today as were cross-town calls in the 1960s. When the FCC authorized cellular service in the 1980s, it deliberately sought two providers for each market. The competition has resulted in the spectacular growth in cellular use. More recently, the commission has granted additional providers the right to offer mobile phone service in each market, intensifying the competition.

Governor Locke will soon be appointing a new WUTC chairman to replace Sharon Nelson, who held that position for 12 years. The decision may be critical for our state. In 1995, as telecommunications reform was being debated in Congress, Nelson told a meeting of the National Association of Regulatory Utility Commissioners, "I see state regulatory commissions moving away from price and profit regulation ... We will be guarantors of competition ... ."



For regulators that transition will be as traumatic, as fraught with risk, as the marketplace itself. In adapting to (and preparing for) competition, the regulated utilities have faced many hard decisions. We've seen the news stories describing major downsizing, mergers and acquisitions, executive reorganization, streamlining and reorienting. The regulatory body overseeing a dynamic market cannot remain static. Fresh thinking, reorganization and reconceptualization must accompany change.

More than fifty years ago, in a classic defense of capitalism at a time when the argument was by no means closed nor the victory assured, the economist Joseph Schumpeter stressed that the essence of competition is not in prices but in "the competition from the new commodity, the new technology, the new type of organization ... competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives."

It is simply not possible for a regulatory body to anticipate that kind of competition, to foresee the paradigm shift. Converging technologies, , radical transformation in the frequency and duration of transmissions inaugurated by the Internet, and the rapidity of change necessarily lead to a move from regulation to competition. What regulators cannot do in a year, the marketplace does in an instant: punish the inefficient, over-priced, and unresponsive; reward the excellent, innovative, and creative. The firm offering the best service at the best price survives.

There are, to be sure, important and difficult regulatory policies required to smooth the way to competition, often involving relationships between competitors, rather than between utilities and their customers, e.g., unbundling services, establishing the guidelines and costs for interconnection, and resolving the problems associated with subsidized service to high cost customers.

Control is the regulatory temptation, and regulators can be expected to want to control competition, to manage the market. That's an impossible and unwise objective. The umpire should neither be a player nor attempt to dictate the final score. In the new era, the WUTC should assure fair competition, and then back off.

The governor's next appointment may well be his most important one. The new utilities chairman must appreciate of the power of the marketplace, and recognize that the Commission's ability to advance the public interest will increase as its focus sharpens. In making his selection, the governor should identify a market-oriented candidate with a clear vision of the limits of regulation in a dynamic environment.

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