Deregulation Mythmaking Aside, the Answer Is Market Structure

Industry restructuring and a move to lighter-handed regulation should be based on sound and broad-based evaluation, not modeling assumptions and regulatory myths.

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The story of the accountant, the engineer, and the economist comes to mind. It seems they were marooned in a lifeboat after their ship had gone down in a remote part of the ocean. They had been marooned for some time, as there were no communications and a low cloud cover prevented detection by planes. Luckily, the weather was good and they had plenty of fresh water. But they had no food, no fishing equipment, and only one gun on board.

Time went by and they were giving up and nearing starvation. Finally, a big bird flew overhead—food and survival. The accountant grabbed the gun and fired, but missed—a little low. The engineer took the gun and fired, but missed—a little high. They turned to the economist and said, "Your shot." His reply was that he didn't have to shoot because, theoretically, the average of the first two shots had already brought the bird down.

With that you can possibly guess my theme. The application of neoclassical economics and a "let the market take care of everything" mentality is of limited value in understanding and dealing with industry restructuring and its often overemphasized subcategory of deregulation.

I give you fair warning: 1) I believe deregulation generally is a misspecification of the policy issue; and 2) my primary experi-

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ence over the last 25 years, with detours in the nuclear and oil and gas areas, has been with electricity and its transmission network. This means I see broader restructuring developments through the prism of the electricity industry.

I. U.S. Deregulation

The United States has embarked on a journey to displace the regulated monopoly that has characterized electricity markets for decades. The goal is a state of unregulated or lightly regulated competition.

This is a continuation of a trend begun in earnest in the 1980s to deregulate the nation's infrastructure utility industries: savings-and-loans, banks, and other financial institutions; trucking, trains, and airlines in the transportation sector; telecommunications; and, in energy, natural gas and now electricity at the end of this movement.

There are good reasons that electricity was tackled last. Not the least of these are the industry's size, its complexity, the ubiquitous and virtually nonstorable nature of electricity itself, and the fact that, in most dimensions, it was not badly broken and in need of fixing.

Inroads into achieving wholesale electricity competition were made with enactment of the 1992 Energy Policy Act and follow-up regulatory implementation by the Federal Energy Regulatory Commission (FERC). Over 20 states have since passed legislation seeking to enable competition at the retail or ultimate customer level through deregulation—a stripping away of the states' rate regulation machinery in favor of buyer choice and responsibility.

While it seems odd to have to legislate competition, this is necessary because regulated monopolies do not voluntarily give up their market power. To arrive at the desired destination of competition, however, given the U.S. starting point of regulated monopoly, legislation is needed to break down both the barrier of historic anticompetitive regulations and the barrier of entrenched monopoly power.

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This very important point has been all but lost in the noise of the free market rhetoric and deregulation mythmaking of the last 15 years. Nowhere is this more obvious than in the dueling sound bites of the political arena and its policy discussions. These are fires that have been fanned by those zealot economists offended by the notion that competition should be abridged to any degree by any measure of regulation.

For politicians, it is easy and lucrative for fundraising efforts to call simplistically for deregulation, using the usual clichés of getting government off the backs of taxpayers, shrinking the government—especially federal government—and getting rid of old, outmoded business regulations. However, entrenched and sustainable monopoly power is no less severe a market imperfection than outdated regulations. It is no less a threat to the holy grail of market efficiency that often seems to be the only goal for neoclassical economists, to the exclusion of other necessary public interest goals such as lower rates and fairness.

II. Deregulation Is Not Enough: The Experience So Far

Deregulation is not enough. As Thomas Friedman says in his insightful new book about broader globalization topics, *The Lexus and the Olive Tree*, "Less government without better government is really dangerous. If your free market is all freeways and no stoplights, it breeds chaos."[1] Recently coming closer to the same emphasis on market power are two distinguished economists with well-established neoclassical and other credentials who have been at the center of advocating electricity deregulation since the 1980s.

In electricity, the bottleneck essential facilities are the (largely) privately owned transmission highways. Paul Joskow of MIT filed comments with FERC last year, saying,

> My optimism about relying primarily on private market-based initiatives has waned with the experience with restructuring in the U.S. and other countries over the past few

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