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A Comment on Regulation and Deregulation in a Nation With Multiple Sovereigns

*Thomas B. Leary**

I. INTRODUCTION

A keynote speaker presumably should introduce a theme that will carry forward through most, if not all, the individual panels that follow. That presents a considerable challenge in a program on a subject so broad and so important as “Competition, Consumer Protection and Energy Deregulation.”

To prepare for this task, I reviewed a number of the scholarly papers that were circulated in advance, as well as the Report on electricity restructuring recently published by our staff experts at the Federal Trade Commission.¹ There is a wealth of learning in these materials, which cannot possibly be summarized in a short speech. It is my personal view,² however, that one fundamental issue pervades much of this discussion. That issue is the appropriate allocation of responsibilities between the federal government and the governments of the individual states.

These opening remarks will therefore focus on the particular challenges presented by multiple, overlapping, and sometimes conflicting federal and state regulatory regimes. Issues of this kind—sometimes referred to as issues of “federalism”—are also significant in many other areas of our society, but are nowhere more important than they are in the area of electricity regulation and deregulation.

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1. FED. TRADE COMM’N, COMPETITION AND CONSUMER PERSPECTIVES ON ELECTRIC POWER REGULATORY REFORM: FOCUS ON RETAIL COMPETITION ch. II, at 13-31 (Sept. 2001) [hereinafter 2001 FTC STAFF REPORT], available at <http://www.ftc.gov> (last modified Feb. 5, 2002); see also FED. TRADE COMM’N, COMPETITION AND CONSUMER PERSPECTIVES ON ELECTRIC POWER REGULATORY REFORM: FOCUS ON RETAIL COMPETITION (2000).

2. Everything said here represents my personal views, which are not necessarily shared by any other Commissioners. I acknowledge the valuable assistance of Thomas J. Klotz and Michael S. Wroblewski in the preparation of this paper.

II. A CAPSULE POLITICAL HISTORY OF FEDERALISM

The allocation of power between the federal government and the states has, of course, been the subject of controversy since the constitutional convention of 1787. Three quarters of a century later, the controversy erupted in the Civil War and, even today, it still can arouse passionate feelings.

Sensitivity to issues of “federalism”³ or “states’ rights” is often associated with a “conservative” political philosophy but, in reality, it cuts across the political spectrum. An appeal to states’ rights was an important element in the conservative critique of expanded federal regulation under President Franklin Roosevelt. A half century later, the avowedly conservative President Ronald Reagan stressed the importance of state sovereignty. On the other hand, liberals supported state regulation of business over a century ago by citing the virtues of varied “laboratories of democracy.” Most recently, liberals used a states’ rights argument to help defeat federal tort reform. There are many other examples on both sides of the liberal/conservative divide.

My personal view is purely pragmatic, depending on the particular issue, with no ideological preference for either state or federal involvement. The states and the federal government will each have continuing roles in the electricity field. I believe, however, that we need to pay more attention to the potential for conflicts as we go forward.

III. FEDERALISM IN THE CONTEXT OF ELECTRICITY DEREGULATION

The Commission staff released its most recent report on restructuring after receiving a substantial number of public comments. One comment was notable for the vivid way that it described the problems created by the evolution of the electric power industry away from what was once considered primarily a local enterprise.

[W]hile the electric utility industry was constructed over many decades as an archipelago of electrical islands, it is rapidly evolving into a network of interstate transmission paths, increasingly analogous to the natural gas pipeline grid.⁴

The originally fragmented structure of the industry, however, still affects the way people think about it.

3. It is odd that people who describe themselves as “federalists” today tend to be concerned about states’ rights, but 200 years ago the Federalists tended to support a strong federal government.

4. Center for the Advancement of Energy Markets, Comments Regarding Retail Elec. Competition submitted to Federal Trade Comm’n 6 (Apr. 4, 2001).

[T]he electric power industry has been balkanized by law for so many decades that it seems perfectly normal to market participants to treat each state as a sovereign nation with conflicting rules and tariffs for “importing” and “exporting” power to fellow Americans.⁵

This point of view would seem simply bizarre in the context of any other industry. It can cause serious practical difficulties in a period of electricity deregulation.

There is a trend toward deregulation at the federal level. At that level, we have seen deregulation of the airline and trucking industries in the 1970s, natural gas in the 1980s and more recently, telecommunication.⁶ In electricity, federal restructuring began with the passage of the Energy Policy Act of 1992,⁷ which initiated the process of opening access to the transmission grid and encouraging independent operation of the transmission grid to increase competition at the wholesale level. Subsequent actions by FERC have continued to increase reliance on competition in wholesale electricity markets.⁸

On the other hand, some state regulators—particularly in light of the recent power crisis in California—overtly favor traditional cost-based electricity regulation. It is their view that traditional regulation is the best way to avert an unforeseen disaster like that experienced in California.⁹ They see reliability and foreseeability as paramount objectives, even if a deregulated industry may be more efficient in most scenarios.

5. *Id.* at 16.

6. *United States v. Western Elec. Co.*, 569 F. Supp. 1057 (D. D.C. 1983), *aff'd sub nom. California v. United States*, 464 U.S. 1013 (1983) (telecommunications); Telecommunications Act of 1996, Pub. L. No. 104-104, 1996 U.S.C.C.A.N. (110 Stat.) 56; Motor Carrier Act of 1980, Pub. L. No. 96-296, 1980 U.S.C.C.A.N. (94 Stat.) 793 (trucking); Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 1978 U.S.C.C.A.N. (92 Stat.) 3350 (natural gas); Airline Deregulation Act of 1978, Pub. L. No. 95-504, 1978 U.S.C.C.A.N. (92 Stat.) 1705 (airlines); Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations; Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 636, F.E.R.C. Stats. & Regs. (CCH) ¶ 30,939 (1992).

7. Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2776 (1992) (codified as amended in scattered sections of 42 U.S.C.).

8. *See, e.g.*, Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities, Order No. 888, F.E.R.C. Stats. & Regs. (CCH) ¶ 31,036 (1996).

9. *See, e.g.*, *Electricity Markets: Lessons Learned from California Before Subcomm. on Energy and Air Quality of House Comm. on Energy and Commerce*, 107th Cong. (2001) (statement of Carl Wood, California Public Utilities Comm'n), available at <http://energycommerce.house.gov/107/hearings/02152001Hearing40/Wood36print.htm>; *Retail Electricity Competition Before Senate Comm. on Energy and Natural Resources*, 106th Cong. (1999) (statement of Marsha Smith, National Association of Regulatory Utility Commissioners), available at http://www.naruc.org/Congressional/1999/marsha_smith.html.

Even though I might disagree, I cannot claim that this is an irrational position. A familiar and stable regulatory regime may be likened to an insurance policy, and insurance always costs something. Essentially, we are talking about societal judgments based, in part, on different risk tolerances, and it might seem appropriate for different state governments to reflect these different judgments. This is supposed to be a significant benefit of federalism. But, unfortunately, it is hard to see how a traditional regulatory philosophy can comfortably co-exist with deregulation either at the federal level or in neighboring states with different preferences.

IV. SPECIFIC EXAMPLES OF CONFLICTS

Consider three examples of situations where there can be serious tensions between deregulation at the interstate wholesale level and state autonomy with continued regulation at the retail level.

The first is the recent situation in California, where there were extraordinary wholesale price elevations, brownouts and bankruptcies. Knowledgeable people there simply did not foresee the extraordinary combination of factors that contributed to the emergency. In retrospect, it is clear that deregulation of wholesale prices, coupled with state price caps for customers not choosing a new supplier and state restrictions on long-term contracts, was a recipe for a disaster, which will burden taxpayers and ratepayers in California for a long time to come. The lesson is that price caps at one level of distribution and market prices at another level often do not mix comfortably in this industry.

The second is another, more general, example of inefficiencies associated with different federal and state regimes. There is general agreement that successful wholesale competition depends on efficient operation of the interstate transmission grid, because transmission can substitute for new generation services. An efficient interstate grid obviously requires regional cooperation in the siting of new or upgraded transmission facilities. Beyond that, efficient operation also depends on independent and nondiscriminatory open access to transmission facilities and efficient pricing of services. You cannot allow the states to erect tollgates.

But what happens if you have an overlay of state regulation that establishes pricing differentials for transmission services, depending on whether the customers are "wholesale" buyers of transmission services alone or "retail" buyers of bundled services?¹⁰ The disparate price

10. See 2001 FTC STAFF REPORT, *supra* note 1, at 20-21.

signals for use of the transmission grid will lead to inefficient utilization of facilities. And, as is true with all distortions produced by regulation, the inefficiencies tend to create incentives for further inefficiencies. (It might, for example, inhibit construction of more efficient local generating facilities or other cascading external effects.)

The third example involves efforts directed at the demand side. A lot of people believe that substantial savings are possible if the peaks and valleys of electricity demand are smoothed out by charging variable rates to retail consumers depending on the hour of the day. Such variable pricing is described in the recent Commission Staff Report.

Nearly every retail electricity market is missing one of the important components of effective market operation: variable pricing and rate information that allow customers to adjust the quantities they consume in response to rapid and substantial changes in wholesale prices of obtaining electricity It is insufficient to provide accurate price signals only to wholesale buyers (*i.e.*, retail suppliers), and not retail customers, because a wholesale buyer's demand at any point in time is directly derived from retail demand of its customers.¹¹

As customers react in a reasonable way, real-time pricing could reduce the need for investment in additional capacity to handle peak loads. It is obvious that the effectiveness of this strategy will be curtailed if some states in a linked region decline to impose real-time pricing, perhaps out of concern for consumers who are uninformed or perceived to be relatively inflexible.

V. TENSION BETWEEN DEREGULATION AND "NON-ECONOMIC" REGULATION

The potential for conflict is not diminished just because a particular state regulation seeks to foster what are thought of as "non-economic" goals. People often draw a distinction between so-called "economic" regulation of business, which addresses matters like price and entry, and "non-economic" regulation that addresses matters like health, safety or the environment. The difficulty is that even overtly non-economic regulation can have serious economic consequences.

One obvious example, cited in the FTC Staff Report, concerns the standards for authorizing the construction of generating plants.¹² The Report recommends specifically that states should not require a demonstration that the facility is required to meet a "local" need for power. Obviously, the most efficient configuration of generators in an

11. *Id.* at 33.

12. *Id.* at 26.

interstate electricity grid is dependant on a number of factors above and beyond local demand—including, for example, the feasibility and cost of meeting local demand from distant sources or the relative costs of supplying fuel to the generating plants.

States may be reluctant to authorize installation of capacity beyond that necessary for local needs, even if it is efficient from a regional point of view for a number of reasons—including environmental considerations, a “non-economic” goal. The 2001 FTC Staff Report expressly declines to address environmental issues,¹³ presumably to avoid the impression that the agency is intruding into sensitive matters beyond its regulatory authority and expertise. But, even as we in the Commission acknowledge that other government bodies have the responsibility for dealing with environmental or other “non-economic” concerns, we should not forget that we have a particular responsibility to be advocates for competition and for efficiency across the board. If other government bodies choose to adopt policies that are not economically optimal, that is their privilege—but at least we can contribute to the debate by helping people understand what the stakes are.¹⁴

Another example of potential conflicts among state regulations arises in the area of consumer protection, that is, state standards for assuring that consumers obtain accurate and non-deceptive information about sources and prices of power. This is particularly important in a restructured environment where consumers are called upon to make choices they have never made before. Consumer protection is, of course, also an area where the Commission has its own authority and expertise, but a proliferation of potentially inconsistent requirements can create burdens for interstate enterprises.

Again, local authorities traditionally have had considerable autonomy in these matters.¹⁵ The conflicting considerations were summarized in the FTC Staff Report, as follows:

Alternative retail suppliers and others widely viewed a lack of state

13. *Id.* at 27 n.83.

14. The Federal Trade Commission was originally created to serve as a non-partisan body of experts on the competitive process. The Commission’s exercise of this role led Congress to enact the Public Utility Holding Company Act in 1935. *See* FED. TRADE COMM’N REP. TO THE SENATE, UTIL. CORPS., S. DOC. NO. 92, at 24 (1935).

15. There is currently no federal regulation that would pre-empt regulatory action by state authorities. *See Electricity Supply and Transmission Act of 2001: Hearings on H.R. 3406 Before the House Comm. on Energy and Commerce*, 106th Cong. (2001) (statement of Sandra L. Hochstetter, National Association of Regulatory Utility Commissioners), available at <http://energycommerce.house.gov/107/hearings/12132001Hearing449/Hochstetter762.htm>.

uniformity in regulatory practices, including supplier licensing and customer switching rules, as sources of substantial costs that unnecessarily reduce headroom and entry incentives. At the same time, many states believe that certain policies are necessary to serve important consumer protection and other public policy objectives such as increased system reliability.¹⁶

I do not suggest that pre-emptive federal standards are necessarily the solution. I do suggest that issues of federalism, involved in both “economic” and “non-economic” regulation, need to be openly acknowledged and addressed. We in the Commission are continuing to look at these problems, and we welcome your thoughts.

VI. CONCLUSION

These brief introductory remarks are intended to highlight a potentially difficult issue that lies beneath a number of the specific problems in energy regulation that will be considered by other speakers. Federalism is a particularly delicate issue because it has ideological and emotional connotations that cut across many other areas of political debate.

Federalism is also a difficult issue in the context of electricity restructuring because of the long tradition of treating retail electrical service as primarily a local enterprise. It is not local any longer but, up to now, “reform of retail [electricity] markets has been a hodgepodge of highly disparate efforts.”¹⁷

We need to consider whether there are better ways of addressing these issues. Solutions are not easy. A conference like this one, which brings together a broad spectrum of views, will make a valuable contribution to the effort.

16. 2001 FTC STAFF REPORT, *supra* note 1, at 64 (footnotes omitted).

17. Center for the Advancement of Energy Markets, *supra* note 4, at 6.