

## BOOK REVIEW

ECONOMIC REGULATION CASES AND MATERIALS by Richard J. Pierce, Jr. (Anderson Publishing Co., 1994, 391 pages).

Reviewed by *Mary E. Baluss\**

Richard J. Pierce, Jr., has produced an excellent survey of economic regulation. Part history, part economics text, part editorial, and uniformly thoughtful, "Economic Regulation" deserves a general readership among those who care about the future of regulated industries, particularly the gas and electric industries. It could not be more timely.

Pierce's premise is familiar to anyone who has read his articles in this journal: most economic regulation, however well-intentioned, has resulted in failure, and the failures have been exceedingly costly to many regulated companies and to society. This is hardly news; Pierce has long been a leader in the debate over regulatory change, and much of what he has advocated over the last fifteen years has become conventional wisdom. Nonetheless, economic regulation is hardly behind us, and it is extremely rewarding to work through the initial premises for a whole series of regulatory structures, along with the explanations for their demise. In this context, the welter of prescriptions for change that are now facing the energy industry can be examined more intelligently. The ingredients are here for both healthy skepticism of "quick fixes" and intelligent evaluation of new models.

Pierce begins with a useful review of basic economic theory. Those who never wish that they had paid a little more attention to their economics primer can skip it. For most, the section will provide a good frame of reference for the remainder of the book. In the process, Pierce begins to acknowledge, as he does throughout the book, the political pressures to use economic regulation to go beyond the nominal process of substituting regulation for market forces in natural monopolies. Cross-subsidies, prevention of windfall profits, and transfers of economic rents are concepts deeply embedded in economic regulation. One of the most interesting contributions to this discussion is an excerpt from an article by Richard Posner, arguing that regulatory pricing is not only a substitute for the marketplace and a political response to well-organized interest groups within and without the industry, but also a tacit form of public finance. Posner argues that whether good or bad, the effects should be calculated. As a consequence, a search for more effective forms for reaching public policy goals might be instituted.

A second section, on the "Basics of Regulation," is an excellent introduction to the legal structure for economic regulation. It begins predict-

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ably enough with *Smyth v. Ames*<sup>1</sup> and works through (briefly) *FPC v. Hope Natural Gas Co.*,<sup>2</sup> *Bluefield Water Works & Improvement Co. v. Public Service Commission*,<sup>3</sup> and other fundamental precepts of economic regulation. Cost allocation, rate design, marginal cost, stranded cost, prudence, treatment of AFUDC, and many other concepts are introduced with enough sophistication to make interesting reading, but without getting deeply mired in analysis. The economic basics are well interspersed with recent cases and some serious questioning of the efficacy of judicial management of complex economic issues.

The heart of the book, however, is its presentation of the failures of regulation and some descriptive and prescriptive thoughts about innovation and change. The failures are largely familiar. For the gas industry, Pierce traces wellhead price regulation under the Federal Power Commission (FPC), which was marked by regulatory assumptions about cost and supply that virtually guaranteed the shortage of the 1970s. (Pierce also suggests that the 1954 *Phillips*<sup>4</sup> decision would have had a different outcome in the post-*Chevron* era.<sup>5</sup>) Excerpts from previous Pierce writings similarly trace the faulty Congressional assumptions that caused the Natural Gas Policy Act of 1978 to restrict gas consumption even as a severe natural gas oversupply was in place.

Similar surveys outline the major efficiency losses in the electric industry. An interesting excerpt from a study by (now Justice) Breyer and MacAvoy (1974) argues strongly for requiring additional consolidation in the electric industry, including approaches such as vastly increased federal agency jurisdiction over planning and construction, government ownership of all or part of the industry, equal access to transmission, and/or creation of a more concentrated industry. Pierce's comments bring the article forward in time and reflect the current focus on transmission access and industry consolidation. All the writings chosen by Pierce in this section assume major efficiency savings from market deregulation and increased competition across the spectrum of regulated industries.

What are the innovative responses to regulatory failure? The section has many elements and cannot be adequately summarized. It begins with an extremely interesting review of the AT&T breakup and increased competition in the telecommunications industry which illustrates Pierce's concern for the many jurisdictions (including the courts) that involve themselves in regulation. One can question, however, whether the telecommunications industry with its lightning-paced technological change has much to offer the gas and electric industries, other than insights into the effects of eliminating cross-subsidies and some thoughts about the impact of widening the number of players. More directly useful are suggestions

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1. 169 U.S. 466 (1898).
  2. 320 U.S. 591 (1944).
  3. 262 U.S. 679 (1923).
  4. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).
  5. *Chevron, U.S.A., Inc. v. NRDC*, 467 U.S. 837 (1984).

that would replace price-cap regulation with other structures.<sup>6</sup> In analysis dealing more directly with the gas industry, Pierce correctly predicts a growing consensus that the secondary market in natural gas capacity will not evolve into a powerful force until the Federal Energy Regulatory Commission (FERC) is willing to remove some of the restrictions placed upon it by Order 636. For the electric industry, excerpts and comments urge more regulatory flexibility that will leave private contracts to govern the relationships between regulated utilities and independent power producers, with regulation focusing on prevention of harmful self-dealing between a regulated company and a non-regulated affiliate. Attention is also paid to incentive rates, replacement of price cap regulation, transition costs, and some of the state-initiated innovations.

Pierce recognizes some real impediments to change. He is particularly concerned about the conflicting jurisdictional pressures in the electric and, to a lesser extent, the gas industry. He notes that the FERC is pressing for reduction or elimination of cross-subsidies; state agencies may continue to insist on them. Multiple state agencies raise the potential for contradictory pressure where electric utilities merge across state lines. However, in one area of regulatory clash—gas utility by-pass—Pierce is solidly in the camp that favors by-pass. In the case of transition costs, he appears generally to approve full pass-through policy at the federal level. He raises but does not deal with the impact on captive customers.

The section on regulatory innovation, obviously, is far from complete. It is hard to imagine how a survey of this sort can be otherwise. The strength of Pierce's insights and his success as a synthesizer are such that one can only hope that his next book will put additional flesh on the bones of commentary that are embedded in this book.

For the meantime, however, "Economic Regulation" is a solid, thought-provoking context for much of the debate in energy regulation today. It is highly recommended.

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6. An excerpt from Alan Eithoven on managed competition in the health care industry is also included. The reading itself is interesting, but its connection with the remainder of the book is somewhat strained.