

BOOK REVIEW

THE COMMANDING HEIGHTS: The Battle Between Government and the Marketplace That is Remaking the Modern World by Daniel A. Yergin and Joseph Stanislaw (Simon & Schuster, 1998, 457 pages including notes and indices).

Reviewed by *Ken Malloy**

The Rt. Hon. Sir Winston Spencer Churchill (1874-1965) was reputed to have said: "If you are a conservative at twenty, you have no heart. If you are a liberal at forty, you have no brain." Drs. Daniel Yergin and Joseph Stanislaw's recently published book, *The Commanding Heights: The Battle Between Government and the Marketplace that is Remaking the Modern World*, convincingly demonstrates that the maturation of economic judgment at the core of this dictum applies to nation states as well as individuals. Given their prominence in the energy industry, however, there is less focus on energy than might have been expected. Following Churchill's adage and the thesis of *Commanding Heights*, the maturity of middle age is evident in much energy policy, both domestically and globally. Unfortunately, such maturity is not evident in retail energy restructuring policy which, while grudgingly approaching midlife, still clings nostalgically to its past predilection of making policy with its heart, not its brain.

Yergin is best known to us in the energy industry for his remarkable, Pulitzer Prize winning book, *The Prize: The Epic Quest for Oil, Money and Power*. Less remembered is the fact that Yergin was one of the editors of *Energy Future: A Report of the Energy Project at the Harvard Business School*, an important early contribution propelling energy's public policy dialogue.

As one has come to expect from Yergin, *Commanding Heights* cogently and comprehensively reviews an immense span of geo-economic developments in the 20th century. The title is derived from a statement made by V.I. Lenin in 1922, who, in response to criticism that he was soft on capitalism for allowing some minor market reforms (now that's a tough

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crowd), stated that the state would continue to control "the commanding heights" of the economy (p. 12). The skeleton of the book evidences the intricate manner in which Yergin weaves a mind-boggling amount of detail into an entertaining story.

How does the plot proceed? The first three chapters set out how governments took control of the economy in Europe, the United States, and the developing world, achieving what seemed by the 1970s to be an invincible position. Chapter four describes the first major counterattack, the Thatcherite revolution in Britain in the 1980s. Chapter five explains the forces that led the world in the 1980s and 1990s to change its "mind" about the balance between government and market. Chapters six through eight focus on Asia—the dynamics of the East Asian countries and the forces transforming them after the "miracle," the twenty-year turnaround from communism capitalism in China, and the efforts to dismantle India's "Permit Raj" and reorient that nation to the world economy. Latin America's wrenching move from dependencia to shock therapy is the subject of Chapter nine. Chapter ten explains how Russia's and Eastern Europe's "ticket to the market" got punched, and the bumpy journey to the world after communism that has followed. Europe's struggle to create a single market and slim down governments—and come to terms with the predicament of the welfare state—is the subject of Chapter eleven. Chapter twelve examines the United States through the framework of the overall process of global change, exploring the impact of fiscal rectitude on expansive government and the contrary directions in economy and social-value regulation. And finally, Chapter thirteen contemplates the future. What are the essential economic, political and social issues that are to be confronted in different parts of the world? Will there be a swing back from the market, or are more fundamental and permanent changes in place? Who, after all, will occupy the "commanding heights" in the next century—government or market (p. 17)?

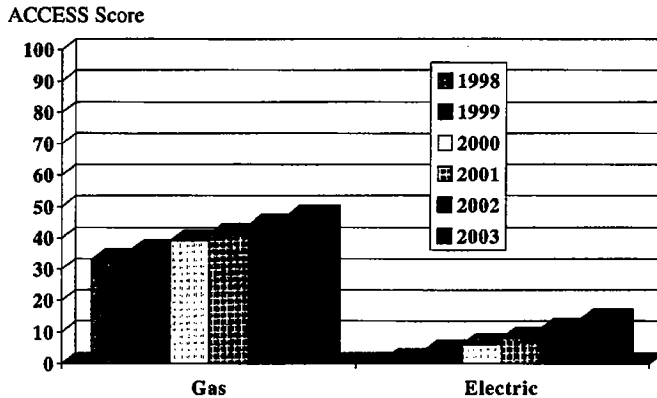
Of primary interest in *Commanding Heights* for readers of this Journal, is insight into what has been called the largest industrial transformation in the history of the world—the simultaneous reform of retail gas, electric, and telecommunications industries, which accounts for revenue of about \$500 billion a year in the U.S. alone. What started out several years ago as a giddy enthusiasm for the potential fortunes to be exploited by these transformational opportunities, has in the last six months degenerated into a gloomy realism that these markets will not open as quickly as we expected, based on the transformation of natural gas wellhead and pipelines, wholesale electric, and long distance telecommunications.

Figure 1 shows my projections of the opening up of the retail gas and electric market over the next five years based on current policies in place.¹

1. These projections are based on a scale of zero, representing the complete lack of customer choice in the traditional retail model, and 100, representing customer choice completely unimpeded by regulatory distortion or market power, i.e. a choice based solely on the economic attributes of the

Since large gas customers have been fairly successful in getting retail access as part of the federal gas restructuring, gas retail access is far ahead of electric retail access. These projections to 2003 are, however, far more

Figure 1: Projected Opening of Retail Gas and Electric Markets



pessimistic than I would have predicted in April 1994, when California made its proposal on electric restructuring, the proverbial shot heard round the world. State legislatures and commissions have been far more solicitous of incumbent utility interests, more willing to reinvent the wheel, and more willing to drag out the transition. Additionally, the impediments to efficient restructuring imposed by each state, adopting its own colorful remnant in the patchwork tapestry, has become more evident as business strategies have tried to cope with a bewildering array of uncoordinated practices. Compounding this failure at the state level has been a near complete lack of appreciation of the magnitude and impact of retail restructuring at the federal level. This delayed onset is due to many factors but solace, perhaps even inspiration and optimism, can be found between the covers of *Commanding Heights*.

I came to Washington in 1981, when the Reagan Administration appointees dominated the Federal Energy Regulatory Commission (FERC), to test a simple, but at the time still provocative, proposition: how much could we rely on market forces in the historically over-regulated energy industry? At the time the idea of radical restructuring of the gas industry through open access was dimly perceived. But today it is difficult to find a critic of the outcome of the admittedly wrenching restructuring of the interstate gas industry. Given that many "lessons" of gas restructuring are now being applied to the wholesale electric industry, and to the retail

product. Separate scores are developed for each customer class (residential, commercial, and industrial) for both gas and electric markets in each state. Figure 1 represents an aggregation of all states and all customer classes.

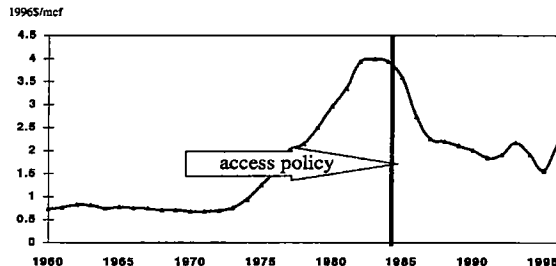
gas and electric industry, I eagerly anticipated what Yergin might say about the challenges in energy. I found that while *Commanding Heights* is remarkable for its ability to give a thirty thousand foot view of major worldwide economic trends without either losing relevant, interesting detail or becoming overly ponderous or scholarly, Yergin has not generally applied these observations to the energy sector in which he is a veritable icon.

For example, Yergin recounts the experiences of:

- airline deregulation and now-Supreme Court Justice Stephen Breyer's role in it (pp. 342-3);
- financial deregulation and the failure of government to internalize the risk of investments (pp. 348-9);
- the breakup of AT&T and Bill McGowan's tenacity (pp. 346-8);
- the FERC's foray into electric restructuring (pp. 349-50); and
- the privatization of Conrail and parts of the naval petroleum reserve (p. 358).

There is, however, only the briefest mention of retail energy restructuring and little mention of three of the more successful transitions in the United States from heavy handed regulation to market based policies, i.e., oil, natural gas (wellhead and pipelines), and trucking (pp. 342-353).

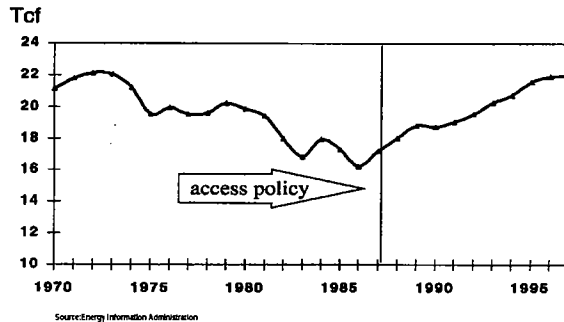
Figure 2: Natural Gas Wellhead Prices
Competition has led to lower wellhead prices



Source: Energy Information Administration

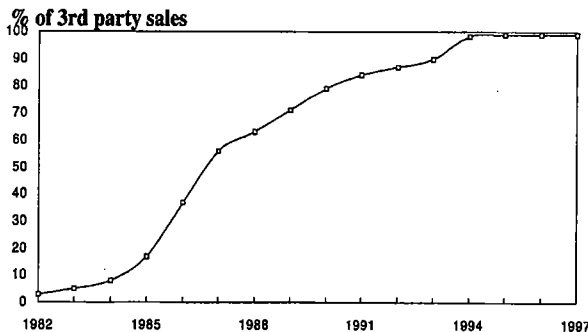
Given his expertise in energy, one would have expected more than an oblique, less-than-a-paragraph treatment of the mischief of oil and natural gas regulation (p. 64). While giving significant treatment to the beginnings of electric deregulation at the FERC, there is no discussion of the impact of the FERC's restructuring of gas markets during the 80's and 90's resulting in dramatic reductions of wellhead prices (fig. 2), significant increases in consumption (fig. 3) and the complex implementation of policies separating the conduit function (where regulation has some legitimacy because of market power) from the merchant or content function (where no such legitimacy resides) (fig. 4). This is all the more surprising since gas restructuring undoubtedly provides a template for the continually vexing challenges of restructuring conduit and content functions both in the U.S. retail energy and telecommunications market,

Figure 3: Natural Gas Consumption
Increases 25% since access policy



but also worldwide as energy and telecommunications privatization and restructuring represents perhaps the largest element of the phenomena that is the *raison d'être* for the book.

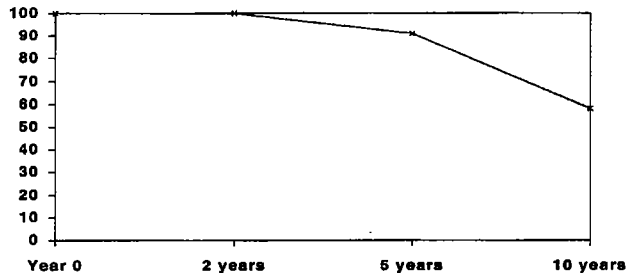
Figure 4: Increase in 3rd Party Access



Similarly, trucking industry restructuring has been successful in its own right (fig. 5). It is also yet another stellar example for the world of the complexities of network restructuring in terms of the sharing of responsibilities between different levels of government. Deregulation of interstate trucking took place in the late 1970s and early 80s. Intrastate trucking regulation persisted as a significant activity at many state commissions well into the 90s. By 1995, Congress had had enough of the quirky interplay of interstate and intrastate trucking markets and preempted any further regulation by the States.²

Railroad restructuring followed a similar path. As part of railroad restructuring, Congress required that states file tariffs for intrastate railroad rates with the Interstate Commerce Commission (ICC) for approval. States could voluntarily withdraw from such regulation and cede it over to the ICC. Over time, states tired of the charade and nearly all

Figure 5: Trucking
Price as a % of prices at start of deregulation



Crandall and Ellig, *Economic Deregulation and Customer Choice* (1997)

authority came to be vested in the ICC. And then the ICC transitioned into oblivion.

One can find numerous examples in electric, natural gas and telecommunication, especially the Telecommunications Act of 1996, of incremental absorption of historic state responsibilities into the fabric of federal decision-making. Indeed, so profound and universal is federal absorption of state authority as network industries mature under market-based policies, that it should be considered a principle of restructuring. Given the historic proclivity of state commissions to defend their turf, one can readily understand the mealy mouthed and utterly insignificant requirements being debated in Congress over whether to impose a date certain for retail customer choice, especially when that date certain is so far into the future.

In fairness, my own belief that federal preemption will be one of the key trends guiding energy restructuring was profoundly influenced by an official responsible for energy restructuring in a Latin American country. As we exchanged models of network industry restructuring in the late 80s, I asked him the question that was currently vexing me. How would he ensure that the provinces would adopt complementary approaches to the policies he was implementing at the national level? His answer was the proverbial two by four to the forehead of the jackass: "We won't give any authority to the provinces. Why would we?" It was then that I understood that I had adopted the existing U.S. framework for energy federalism as an economic, and therefore immutable, construct rather than as a political, and therefore mutable, construct. Once I looked at it from the perspective of developing a national network policy promoting efficient use of energy, the legitimacy of untrammelled state authority over the distribution network elements was less obvious.

Juxtaposed with federal restructuring efforts, as compared below, the state retail energy restructuring will be more complex and thus will approach mid-life more gingerly.

- Federal restructuring was accomplished by a public decision-making body focussing on a single network form at any given point in time (the

FERC dealt predominantly with gas in the late 80s and then turned to electricity in the 90s; the Federal Communication Commission (FCC) and Congress dealt with telecommunication restructuring during the 80s and 90s). Currently, states have to contend with gas, electric, and telecommunications restructuring simultaneously.

- Federal energy restructuring needed to adopt regimes that provided choice to a single type of customer—the large sophisticated bulk customer. States as a practical matter have to adopt three such regimes—a retail regime for the bulk customer, another for the smaller industrial and large commercial, and a third for the mass markets consisting of residential and small commercial. We are slowly realizing that each of these customer classes needs its own access revolution.
- Increased issues with enhanced politics are involved at the state retail level, than at the federal level.
- At the federal level, one commission has near plenary authority over the network elements, whereas fifty state commissions and their counterparts in Canada and Mexico each are holding on to a different part of the elephant. As in the parable, one's views, and presumably one's actions, regarding the elephant are heavily influenced by the part of the elephant one is holding. Whether the elephant can survive the ministrations of so many masters remains to be seen.
- The FERC and the FCC have to worry about significantly fewer regulated companies, as well as a diminishment of customers directly affected.
- The FERC had adequate funding for the challenge and was equipped with talented, experienced commissioners and staff. States struggle with funding and, at a time when state commission challenges are ascendant, many state budgets are in retrenchment.
- The FERC and the FCC made significant progress over about a decade, while initial results indicate that the retail transition may be long in coming.

This then helps explain why few are optimistic when viewing the transition before us on retail energy restructuring.

If *Commanding Heights* offers little insight on specific strategies for retail energy restructuring, where then does it offer insight into the nature of the transition in the U.S. retail energy market from regulation to competition?

It offers insight about the nature of the scholarly economics that govern the pursuit, chronicling the rise of Hayek, Stigler, Friedman, and the Chicago School (pp. 141-55).

It offers insight on the complexity and maddening illogic that sometimes governs the enterprise of reform. I was particularly buoyed by the discussion of the transitional problems created in Europe by removing barriers to chocolate and beer (pp. 308-309). If countries take chocolate and beer so seriously, maybe it oughtn't to surprise us that issues like stranded costs and divestiture are so difficult and intractable.

It offers insight into the nature of leadership. *Commanding Heights* is replete with stories of visionaries who committed careers and lives to the pursuit of their visions. The story of Altiero Spinelli and Jacques Delors' quest for a single European market (ch. 11) or Fred Kahn and Stephen Breyer's role in airline deregulation are just a few of the more inspiring. Where is leadership of such experience, intellectual depth, vision, and stature currently found at the federal level on such a monumental and consequential effort as retail energy restructuring?

Lastly, *Commanding Heights* lucid and methodical delineation of the quixotic, yet inexorable, paths that are traveled in the transition from regulation to competition provide some confidence that, though many a mid-life crisis can be expected, the road to retail energy restructuring is lurching toward maturity. Possibly not in our lifetime, but eventually, retail energy policymaking will cease to think with its heart and find its Churchillian brain.