



Fall 1987

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Recommended Citation

Joan T. Ellis, *State Regulation in a Deregulated Environment: A State-Level Regulator's Lament*, 27 Nat. Resources J. 799 (1987).

Available at: <https://digitalrepository.unm.edu/nrj/vol27/iss4/7>

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JOAN T. ELLIS

State Regulation in a Deregulated Environment: A State-Level Regulator's Lament

There is an old Chinese curse—"May you live in interesting times." Those of us who are involved in the very complicated and challenging scenario of the changing natural gas industry understand the sentiment behind that phrase.

For those involved with natural gas issues, the whole world has flip-flopped since the late 1970s. There were natural gas shortages and curtailments on the interstate lines. The New Mexico Energy and Minerals Department purchased royalty gas from the State Land Commissioner and had it transported through interstate pipelines to communities that were being severely curtailed. The first state Natural Gas Pricing Act was enacted to offset the discrepancy between interstate and intrastate gas prices and the impact of "favored nations" clauses.

How different it is today!—or is it? We have progressed beyond the point at which regulation of the natural gas industry is tolerated!—or have we? As a state regulator who has had to come to grips with these changes, I shall attempt to describe the limitations imposed on state-level regulatory options by traditional procedures, federal administrative actions, national policies, state legislative and court action and by competing economic, political and social interests. I don't presume to have all the answers; in fact, there are many issues I cannot discuss because of pending hearings.

So the question becomes—where are we on that road from regulation to deregulation and how do state-level regulators assist the process, or at least, not impede it. I wish to share with you my perspective of the problem.

The economists taught us the advantages of the "free market;" this means that supply and demand would set the price for natural gas and I, as a regulator, would no longer need to act as a surrogate for the market place. The simplicity of that substitution is belied by the many other directives I am given. The New Mexico State Legislature has given me some guidelines—I have general and exclusive power and jurisdiction to regulate and supervise every public utility in respect to its rates, service regulations, securities and every thing else necessary and convenient in the exercise of this power.¹ Although this power appears to be compre-

1. N.M. Stat. Ann. § 62-6-4 (1978).

hensive, we actually do not have the power to regulate the interstate pipelines in the state,² nor the municipal utilities unless they elect coverage.³ Nor do we have power to regulate Indians acquiring gas resources from sources wholly upon Indian reservations,⁴ or small single customer pipelines.⁵ Therefore we are left with power over one large⁶ and five small⁷ natural gas distribution companies—a somewhat limited base from which to impact the situation.

The legislature has given us a goal too—they want us to insure reasonable and proper services at “fair, just and reasonable rates” so that capital and investment may be encouraged and attracted for the construction, development and extension of plants and facilities.⁸ How does that goal track with the goal of deregulation? Will competition produce reasonable and proper services? Maybe, certainly more so than holding the price of gas at unnaturally low levels as we did in the past. In fact, the legislature has also ordered nondiscriminatory transportation of natural gas for a seller or purchaser to the extent of available capacity⁹—a definite move to stimulate competition. The interstate pipelines also received a similar mandate from the Federal Energy Regulatory Commission.¹⁰ So, as a state-level regulator I am still OK—I can fulfill my statutory duty and stimulate competition at the same time.

But wait! This service has to be provided at fair, just and reasonable rates.¹¹ The words “fair”, “just” and “reasonable” are loaded words—they imply a value judgment which is based, more often than not, on social, political and legal concerns. These concepts have no place in an economist’s vocabulary, for the “market” doesn’t care if rates are “fair”—they just “are.” We can perhaps better envision the difficulty in transferring these concepts to a deregulated environment by looking to two industries that are in various stages of being deregulated—the airline industry and telecommunications. Is it “fair” that airline passengers flying from New York to Los Angeles pay half the fare that we must pay to only travel half the distance? Is it “reasonable” for telephone users in

2. El Paso Natural Gas and Transwestern Pipeline are regulated by The Federal Energy Regulatory Commission.

3. N.M. Stat. Ann. § 62-3-3(E) (1978).

4. 1953-54 Op. Attorney General No. 5690.

5. *Llano Inc. v. Southern Union Gas Co.*, 75 N.M. 7, 399 P.2d 646 (1964).

6. Gas Company of New Mexico.

7. Hobbs Gas Co., Jal Gas Co., Midwest Energy Corp., Raton Natural Gas Co. and Ruidoso Natural Gas Co.

8. N.M. Stat. Ann. § 62-3-1(B) (1978).

9. N.M. Stat. Ann. § 62-7-18 (1978).

10. FERC Order Nos. 436, 436(A), *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, Docket No. RM85-1-000, FERC Statutes and Regulations (Regulations Preambles 1982-1985) 30,665 and 30,675 (1985).

11. See *supra* note 8.

rural Kansas to pay a much higher base charge than their urban counterparts? Depending on the criteria employed, it seems obvious that only a fully regulated environment can insure these "fair, just and reasonable" rates; while in a fully competitive environment the goal of fair, just and reasonable rates is a chance by-product.

What tools are we given to deal with these potentially conflicting interests and goals?—the traditional ones, of course. A basically adversarial process, coupled with high-priced expert witnesses who tout rigid, irrefractable positions, forces the regulator to choose between several divergent depictions of the "truth." We project the future by using a "test year" (historically based) and adjust it for anticipated or speculative future circumstances and their impact. Not only do we predict the future but we also shape it as the industry responds to the "signals" emanating from our orders and their interpretation. A stipulation is rare, though encouraged, and rarer still are joint problem solving and mediation sessions which lead to palatable solutions to all concerned. It is within this context that we are expected to "work ourselves out of a job" by deregulating the industry.

Some of the complexity and ambiguity that has clouded the regulatory process can be seen in the types of questions that must be addressed by state regulatory bodies. How can a state-level regulator stimulate competition without harming the utilities that are regulated and the customers that are served? Can all customer classes be treated fairly, or do some classes have more bargaining power and therefore more options? Who picks up the added cost to the pipeline delivery system when large volume customers are lost to competitors? By what mechanisms can we encourage the regulated utilities to compete?

Another host of questions concerns the rate structure for consumers. If each customer class pays the real cost of service to it, which institution will pick up the difference between the cost of that service and the customer's ability or willingness to pay? By the way, it isn't just residential customers that I am talking about, it's the industrial customers as well. Someone must pick up the difference between "incentive" rates to stay on the system and the true cost of service to that customer. Who should it be—the utility's shareholders, the remaining customers, the taxpayers?

Give up? But there's more! What are the tradeoffs between reliability of supply and cost of gas? What about contracts for gas—should they continue to have "take or pay" provisions? Who is eventually going to pay for accrued "take or pay" liability and in what way? Should the supply be diversified to include some "riskier" sources such as the "spot market?" What percentage of that currently cheaper but riskier source is it prudent for utilities to hold?

Still more confusion stems from ambiguous legal terminology. What does it mean to say that a utility has a "duty to serve?" What does the duty extend to—supplying gas, obtaining gas (at any price), transporting gas? Can a customer contract away his right to receive service—legally, and more importantly, practically and politically?

More questions concern the appropriate role of the State Commission. To what extent should we foster, discourage or stay neutral in regard to new entrants—brokers, pipelines, and other entrants? Is it worth the trouble and expense to make sure that New Mexico natural gas consumers are not jeopardized by federal legislation and Federal Energy Regulatory Commission hearings?

Finally, regulators are beset by a host of questions regarding the "reality" of present and future gas markets. Will the "gas bubble" burst? Will we have gas shortages in the future? Will the same natural gas rule and rate structures work equally well in times of excess supply or gas shortages? Are there any really new natural gas markets or are we just splitting up the same old pie among more participants? How has the push to increase natural gas consumption affected the "conservation ethic" prevalent over the last several years? Will New Mexico producers increasingly depend on the intrastate market for their revenues, thereby causing a conflict between the producing sector and the consuming sector of our state?

Such is the massive scope of the problem that confronts the state-level regulator. Given limited time, less than adequate state resources and human failings, these problems often seem overwhelming. But lest you think I have abandoned the goal of deregulation or have thrown up my hands in desperation due to the scope of the transitional dilemma, I wish to propose some modest but positive guidelines for those involved in state-level regulation of natural gas:

- (1) Be clear and consistent in your goals and make certain that all orders and rules support those goals.
- (2) Be aware of the shifts and activities of the federal government, the state legislature and the industry, and take every opportunity to educate yourself and your staff.
- (3) Acknowledge the built-in limitations of the process and stimulate non-adversarial discussions of the issues and problems.
- (4) Have more frequent discussion and planning meetings between your staff and the gas companies that you regulate.
- (5) Build up a recognized natural gas expertise within the agency so that other policymakers (such as the governor and legislature) will consult with you when they are considering changes in policy.
- (6) Meet with other state regulatory officials and keep current with the literature and programs in other states.

(7) Face each new situation and problem with courage, intelligence and above all, humor.

One final irony. The New Mexico Public Service Commission is dependent solely on appropriations from the General Fund, which, in turn, is dependent primarily on oil and gas revenues. Therefore, as we encourage the lowering of gas costs through competition and open access to transportation, we are also eroding the revenue pool which serves as our base. The better job we do, therefore, the fewer the resources we can expect to have for continued good performance.