Currents

Changing of the Guard (cont.)

Cato acquired the rights to publish *Regulation* from the American Enterprise Institute in 1989, and we relaunched *Regulation* in 1990. I have been the editor of *Regulation* for seven years, and it is time to change the guard.

"May you live in interesting times," I am reminded, is a Chinese curse. This has been an interesting seven years as witness to two contrary trends. On one hand, there has been a continued reduction of federal price and entry regulation—most recently in agriculture and telecommunications and soon in electricity—and the reduction of trade barriers under NAFTA and GATT. On the other hand, there has been a tightening of federal regulations on health, safety, and the environment and broader federal mandates on employers. Most of these changes, for better or for worse, provoked little partisan debate. The dominant character of federal regulation has changed, but the total burden has continued to increase.

Regulation has tried to focus a jeweler's eye on these developments, providing quality articles and comments on regulation, antitrust, and trade to a policy audience. The only significant change in format during this period was focusing most of the articles in each issue on a common theme. As editor, my own perspective on regulation has also changed incrementally. A better understanding of the substance of the major types of regulation has led me to evaluate regulation by a broader set of criteria, including but not limited to benefit-cost analysis. To my fellow editors, writers, loyal subscribers, and readers of *Regulation*, my thanks for your support of my continuing education.

Edward Hudgins, who has been our senior editor for two years, will be the new editor of *Regulation* starting with the 1997 Winter issue. Please give him the support, suggestions, and encouragement that you have given me. You will also see some changes in the format of *Regulation* to make it more visually appealing. Our mission, however, has not changed: Consistent with the mission of the Cato Institute, *Regulation* seeks to broaden the parameters of the regulatory debate to allow consideration of more options consistent with the traditional American principles of individual liberty, limited government, and peace.

W.N.

Milked to the Bone

In supermarkets across the country, the price of a gallon of milk is approaching $3, up 25 percent from last year. "Consumers will be paying the highest prices ever," said Howard Dean, chairman of Dean Foods Co., the nation's largest dairy processor.

Most dairy farmers blame the rocketing prices on the record-high cost of feed grain. It doesn't take an economic genius to realize that when it becomes more expensive to feed cows, farmers will either cut back on production or raise milk prices. Yet, the real culprit behind rising milk prices is not dairy farmers—it is the largely unnoticed federal government. Through the archaic rules of federal dairy market programs, the U.S. Department of Agriculture (USDA) has raised milk prices, distorted market signals, and stifled innovation and competition.

The USDA's Economic Research Service determined that if dairy market orders were eliminated, consumer expenditures on fluid milk alone would drop 14 percent. If the USDA's analysis of consumer expenditures is correct, federal market orders cost consumers an estimated $2.7 billion a year in higher milk prices. This is in addition to the amount taxpayers pay every year to fund the program's infrastructure. Moreover, by manipulating milk prices, the USDA effectively imposes a tax that disproportionately penalizes families with children—half of the fluid milk sold in the States is consumed by children.

In last year's congressional debate over agricultural reform, milk was one of the most contentious and volatile issues. At one point, the Republican congressional leadership backed an approach to reform called "freedom to milk," which would have phased out direct government payments to milk farmers and the milk market order system. The failure of this proposal was due largely to regional disputes. The chairman of the Agriculture Committee's Livestock, Dairy, and Poultry Subcommittee, Steve Gunderson (R-Wis.), spoke for Midwest dairy producers in favor of deregulation. The chairman of the powerful Rules Committee, Gerald Solomon (R-N.Y.), voiced the opposition of Northeast producers to deregulation. Ultimately, in the 1996 farm bill, Congress reduced, but did not eliminate, direct government subsidies and did little to reform the milk market order system. While the 1996 farm bill requires the USDA to consolidate market orders to "improve the operation of farm programs for milk," the USDA has made little effort to reform the program.

It's Not 1937 Anymore

Federal milk market orders originally were established by the Agricultural Marketing Agreement Act of 1937. Supporters of the legislation argued that small dairy farmers were at the mercy of local dairy processors who had cornered the market—poor roads and storage requirements severely limited the options available to many dairy farmers. Under this system, processors could reap large profits at the expense of dairy farmers, consumers, and society as a whole.

What some might claim made sense in 1937 is ridiculous today. No one can plausibly claim that dairy farmers are still held captive by milk processors. In fact, power has and will continue to slip away from the processors to the farmers. Improvements in roads and transportation over the past sixty years have freed dairy farmers from single processors, as have refrigeration, faster and more efficient trucking, and improved pumping. Perhaps even more important are advances in communications technology that make access to information nearly instantaneous, eliminating any informational disadvantage farmers may have had in the past.

Another concern in 1937 was the fact that farmers' incomes were considerably below the national average, but this is no longer true for dairy farmers. In 1990, the average annual income of dairy farmers exceeded the national average by several thousand dollars. Consequently, there is no need to continue subsidizing their incomes.

Setting Prices

In its attempt to control milk prices, the USDA has created a tangled labyrinth of regulations that is so complicated that even most dairy farmers do not understand how it works. The regulations for milk market orders are contained in their own volume of the *Code of Federal Regulations* that totals nearly one-thousand pages.

The USDA has divided the country into thirty-three different market regions. The boundaries of the market regions look as if Uncle Sam handed a three-year-old a map of the United States and a box of crayons. The gerrymandered regions range from individual states in the Midwest to a handful of small counties in western Kentucky. Some states are not included at all, such as California and Montana.

In each of the thirty-three regions, the USDA sets the price of milk that processors must pay to farmers. Processors must pay into a marketwide pool according to a series of formulas set by the USDA. Farmers then receive a payment out of the pool based on another USDA formula, the blend price. Determining the blend price is essentially a study in econometric vertigo. (See Chart 1.)

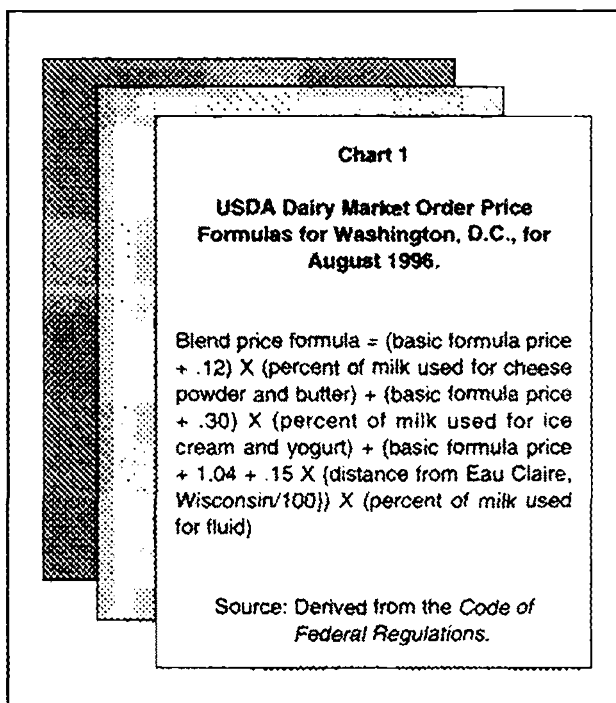
Chart 1

USDA Dairy Market Order Price Formulas for Washington, D.C., for August 1996.

Blend price formula = (basic formula price + .12) X (percent of milk used for cheese powder and butter) + (basic formula price + .30) X (percent of milk used for ice cream and yogurt) + (basic formula price + 1.04 + .15 X (distance from Eau Claire, Wisconsin/100)) X (percent of milk used for fluid)

Source: Derived from the *Code of Federal Regulations.*

In order to calculate the blend price, first the government determines the basic formula price (BFP). (See Chart 2.) The BFP is the previous month's average price of manufacturing grade milk in the Minnesota-Wisconsin market region adjusted for a 3.5 percent butter-fat content and changes in the price of butter, nonfat dry milk, and cheddar cheese. Once the BFP is determined, the USDA uses it to calculate class prices.

USDA regulations divide milk into three classes according to its use: cheese and butter producers pay class three prices; ice cream and yogurt manufacturers pay class two prices; and, fluid-milk processors pay class one prices. The price of each class varies from region to region and from month to month. Essentially, the month-to-month adjustment accounts for the change in the processor's cost per-hundred pounds of milk. This change is intended to reflect the natural, seasonal fluctuations in milk production.

Class one prices are the BFP plus $1.04, plus the distance differential—that is, the farther away one gets from Eau Claire, Wisconsin, the more expensive class one milk becomes. The price per-hundred pounds goes up approximately 15¢ per every 100 miles. For consumers in Washington, D.C., and Baltimore, Maryland, this means an additional $2 is tacked onto the price of milk, a 20 percent markup. Once class prices, the BFP, and regional adjustments have been calculated, the USDA sets the blend price that all farmers within a region will receive for their milk.

Chart 2

Basic Formula Price

The basic formula price (BFP) = (last month's average price paid for manufacturing grade milk in Minnesota and Wisconsin + [current grade AA butter price X 4.27 + current nondry-milk price X 8.07 + current dry-buttermilk price X 0.42] + [current cheddar cheese price X 9.87 + current grade A butter price X 0.238] - [last month's grade AA butter price X 4.27 + last month's nondry-milk price X 8.07 + last month's dry-buttermilk price X 0.42] - [last month's cheddar cheese price X 9.87 + last month's grade A butter price X 0.238] + (percent butter fat - 3.5) X [current month's butter price X 1.38] - [last month's price of manufacturing grade milk in Minnesota - Wisconsin X 0.028])

Source: Derived from the *Code of Federal Regulations.*

Homogenizing Competition

One of the most detrimental effects of this pricing scheme is the virtual elimination of competition at the producer level. First, efficient producers cannot lower milk prices in order to increase sales. When prices are fixed, it is considerably more difficult for efficient producers to gain a larger share of the market. Ultimately, the dairy industry becomes less competitive over time.

Second, with the vast array of products made with milk, there is room for nearly infinite specialization among milk producers. Blend pricing, however, stops this specialization by paying dairy farmers uniform prices. The costs of nonspecialization cannot readily be seen or calculated. What innovations could have occurred had the incentive structure been better? No one knows, but the losses from foregone innovation and specialization probably are significant.

The federal government also guts competition in the milk industry by penalizing the transportation of milk from one region to another, even in times of shortage. To protect local producers from interregional competition, the USDA forces anyone who ships milk across regional boundaries to make a compensatory payment. Compensatory payments equate to paying local dairies for the "right" to sell in "their" market. This regional protectionism has subsidized inefficiency by sheltering producers from interregional competition.

International Markets

Lost and foregone innovation in reconstitution and similar technologies may explain why the American milk industry has not fared better in foreign markets. The United States leads the world in milk production but is virtually absent in global dairy markets. Countries with a comparative disadvantage in dairy production dominate international trade. For instance, Mexico is one of the world's leading cheese importers, yet the European Community exports 30 percent more cheese to Mexico than the

States export. This is largely because the dairy market order system makes producing fluid milk for domestic consumption more profitable than producing cheese or other dairy products for export. In contrast, New Zealand's market-oriented milk industry exports nearly 50 percent of its production. Before the United States can become a significant exporter of dairy products, it must let the free market shape the structure of the dairy industry.

Stop Milking Consumers

Deregulation of milk is not without precedent in the United States. The dairy farmers in the Wyoming-market region have chosen to forego federal market orders since 1981 and have witnessed no ill effects. Likewise, dairy farmers in the South Carolina-market region eliminated regulations in 1983 and increased per capita fluid-milk sales 12.3 percent from 1983 to 1988, while neighboring regulated areas showed little or no growth.

National deregulation would likely have similar results. Increased domestic competition will lead to greater efficiencies in milk production. In turn, these greater efficiencies should lead to increased international competitiveness.

In light of current producer incomes, inflated prices forced on consumers, and the clear lack of any real market failure, it is time the USDA eliminate dairy market orders. This would lower consumer costs and simultaneously put the dairy industry on a stable free-market path toward growth in the world market.

Repealing milk regulations would save consumers $2.7 billion per year. Unfortunately, Congress last year chose to continue milking taxpayers and consumers alike. Will the 105th Congress do better?

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Thirteen Steps to Reconciliation

Considering the billions of dollars at stake, it is not surprising that the discourse about whether electric utility companies should be permitted to recover costs that are likely to be stranded by competition consists largely of diametrically opposed statements by participants in adversarial regulatory proceedings. What follows is an attempt by one such participant, who generally has supported recovery, to resolve this intense debate with a baker's dozen of unexceptionable propositions. The fact that they are unlikely to satisfy any of your previous contributors will merely confirm the validity of one of my propositions: the stranded cost issue is essentially political and can be resolved satisfactorily only by pragmatic compromises that would strike a disinterested arbiter (of which there are precious few) as fair.

(1) Opponents of stranded cost recovery assert that the frequent references by utility companies to a regulatory "compact" or "bargain" trace back only to the time, ten to fifteen years ago, when the companies were suddenly given reason to fear that their claimed entitlement to cost recovery would not be honored. While I leave a definitive assessment of this claim to legal archaeologists, it is my impression that the opponents are essentially right.

(2) But the same could be said of the sanctity of the marriage contract or any other: the contract argument typically is invoked only when one or another of the parties perceives a possibility of its being breached. It took me about five minutes to find, in my *Economics of Regulation*, Justice Holmes's characterization of the task of setting a fair rate of return, back in 1912, as "not a matter of economic theory, but a fair interpretation of a bargain."

(3) If there was no previous understanding, what was the point of all those rate cases in which contending parties expended great amounts of energy and dollars arguing about the dimensions of the costs properly recoverable in rates? If, for whatever reason of politics, law, or aesthetics, one objects to characterizing the implicit basis of these intensely contested determinations as compacts or bargains, then, by good fortune, we have a historical precedent for an alternative appellation—let us call it a banana.

(4) To be sure, the implicit commitment to permit the recovery of prudently incurred costs was never absolute. So far as I know, recovery always was subject to a used and useful finding—a judgment necessarily based on how the expenditures turned out. Prudence, in contrast, can be judged

logically only as of the time when the costs were incurred. The *Market Street Railway* doctrine also exempts regulatory authorities from responsibility for attempting to permit cost recovery that changing technology or other exogenous market developments have rendered unachievable. It is surely an abuse of that doctrine, however, to justify disallowances when the entry of competition, which has arguably rendered some facilities unused and useless, was not an exogenous development but the consequence of a deliberate change in regulatory policy.

(5) Opponents of recovery further assert that if there was a bargain, it was a lousy one. Robert Michaels ("Stranded Investments, Stranded Intellectuals," *Regulation*, 1996 No. 1) points out that utilities actively promoted regulation in order to protect themselves against competition. I have found this reading of history persuasive ever since I encountered it in Horace Gray's eloquent "The Passing of the Public Utility Concept," published in the *Journal of Law and Public Utility Economics* (1950)—but it obviously contradicts the contention that there has never been a bargain.

(6) In the first decades of the century, the controversies over using an original- or replacement-cost rate base were, in effect, arguments over whether companies should be afforded an opportunity to recover costs that were incurred prudently or on the basis of how they turned out. No one, so far as I know, has argued for using first the one and then the other, depending on which produced the lower result at the time. Yet this is what the proponents of competition (of which I am one) and nonrecovery of stranded costs (of which I am not) are doing.

(7) Apart from the constipation of the regulatory and judicial process caused by attempts to apply the reproduction-cost standard, the economic consideration that carried the day for prudent investment was the recognition that if investors were promised a reasonable opportunity to recover their incurred costs, then the utilities' ability to attract capital in the future would be ensured. With respect to this strictly economic function, the antagonists typically overstate their cases. The opponents of recovery either ignore this function or claim investors have already been compensated for the risk of regulators changing their minds (see propositions ten and eleven). J. Gregory Sidak and William J. Baumol ("Recovering Stranded Costs Benefits Consumers," *Regulation*, 1996 No. 2) seem to insist on 100 percent recovery and clearly imply that consumers would lose more in the form of higher capital costs henceforward than they would gain directly from illegitimate disallowances—an assertion that cannot be made with confidence.

At the other end, the rationalizations by the opponents of stranded cost recovery hardly increase one's confidence, or that of investors, that what they are urging is anything more than simple regulatory opportunism. To the extent that their argument justifies the expectation that rules changed once may be changed back under altered circumstances, it cannot but increase the cost of capital. Michaels offers the modest suggestion that any utility claiming a nuclear stranding be required to show that regulators gave it no choice but to build or complete the plant despite the utility's preference for an alternative—a "guilty if not 100 percent innocent" rule that ignores the government's active encouragement of the nuclear alternative. Michaels's suggestion also blatantly ignores the entitlement of utility companies—even under his proposed rule—to recovery of the multibillion-dollar obligations to purchase independently generated power that were forced on them by governments.

(8) These considerations take on additional weight if the opportunism of regulators, in the form of a flip from cost-plus to competition, gives rise to a reasonable possibility of a future flop in the opposite direction. There was virtually no significant pressure for deregulation of electric power until the 1980s. What has generated those pressures in the last decade, above all else, is the emergence of a situation in which the rates of the utility companies, particularly on the East and West Coasts, have exceeded competitive levels and, indeed, exceeded their own short- and long-run incremental costs because of the preceding double-digit inflation, the sudden cessation in the growth of demand, the nuclear fiasco, PURPA, the collapse of fossil fuel prices, and the emergence of combined-cycle gas turbine generation.

If the pressure for competition is primarily the adventitious consequence of a combination of historical circumstances that reversed the relationship between regulated prices and marginal costs, what will happen if that relationship is reversed again? A look at what happened earlier this year when the price of gasoline jumped from an average per-gallon cost of \$1.22 to \$1.42 as a

simple consequence of market forces offers little hope for regulatory or deregulatory consistency.

(9) The problem posed by the prospect of stranded costs is essentially political in both the narrowest and broadest sense. As for the latter sense: even though we cannot find an objective measure of the costs of regulators playing "heads we win, tails you lose" giving investors original cost or market value, franchised monopoly or competition—whichever produces the lower price—there is an inescapable question of the extent to which governments can change rules in this way consistently with a healthy market economy.

(10) On the other hand, those rules (as interpreted by *Hope Natural Gas*) clearly gave regulators a substantial margin of discretion in determining what results would be equitable and, in the present circumstances, a fair distribution of the burden of what have proven to be huge mistakes. It is here that contentions such as those made in opposition to recovery by Irwin Stelzer and Robert Michaels become relevant. Stelzer ("Stranded Costs, Strained Rationale," *Regulation*, 1996 No. 2) says investors have had plenty of notice, at least since the early 1980s, that even prudently incurred costs might be subject to disallowance based on hindsight. The typically lower market-to-book ratios of electric companies with heavy involvement in nuclear plants in the 1980s lends support to this assertion. If that realization took the form of a demand for higher returns and regulators permitted those returns only on investments that turned out successfully, there would be no way arithmetically by which investors could have earned that cost of capital on average—that is, on the totality of their prudent investments.

(11) The fact is, however, that for the last forty years, except during the periods of double-digit inflation, the market price of electric utility shares has exceeded book value. This must have reflected an expectation by the majority of investors that returns would be greater than the cost of capital—an expectation presumably vindicated on average over that long period of time. I cannot say with conviction that this fact legitimizes governments frustrating those expectations by opportunistically changing the rules under which they were generated. On the other hand, it surely has a bearing on the political question of what would constitute a fair settlement.

(12) The historical developments peculiar to electric power that have generated the pressures for competition and opportunistic behavior by regulators over the last twenty years constitute the strongest case for deregulating the generation end of the business and turning it over to the discipline of competition. History clearly demonstrates the superiority of a system in which, while mistakes of the kind we have witnessed may be made, they are less likely because of the elimination of cost-plus regulation; and if mistakes are made, the onus will fall entirely on investors. The other side of the coin is that when investments are successful, the benefits must accrue entirely to those investors.

(13) It is time to resolve the multibillion-dollar question of a fair distribution of the costs of past mistakes and move as rapidly as possible toward a competitive regime in which costs are apportioned by the market rather than by temptation-prone regulators.

(This is a compressed portion of an article scheduled for publication in the Winter 1996 issue of the *Natural Resources Journal*.)

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Who Guards the Guardians?

Insulated from creative destruction—the process by which the more efficient destroy the less efficient—the government does not set a high value on creativity or productivity. In fact, Congress impedes bureaucratic efficiency by advancing an interminable assortment of paranoia-inspired regulations that breed mistrust of the Civil Service and deny federal workers the opportunity to exercise judgment.

Truly Petty Cash

For instance, I learned of a federally employed field supervisor with a $100 petty-cash fund who has access to only one of two dissimilar keys that open the cash drawer—and every three months a third individual performs an audit. By contrast, Commissioner Owen of the Surface Transportation Board (STB) owns a private-sector corporation that provides a petty-cash fund of $250 that

is replenished upon presentation of invoices—and no audit is required. "If I couldn't trust employees with $250, why would I have them collecting $100,000 in rent each month from my apartment complexes?" Owen asks rhetorically.

Can I Get Some Paper Clips?

Another example of congressional inefficiency and waste is the federal procurement process. To obtain office supplies, an agency member must submit multiple forms for processing within the agency; next, the forms are transmitted to the General Services Administration (GSA) for further handling; and finally, they are funneled to a GSA warehouse where the agency faces a three-week wait for the item. Commissioner Owen, instead, used a portion of his lunch hour to walk several blocks to Staples where he purchased the supply at a lower price, involved only two people in the transaction (himself included), and put the item to immediate, productive use.

Justice Delayed

Our judiciary too can be slower than a three-toed sloth. It was in 1968, when Lyndon Johnson was president, that the New York Central Railroad merged with the Pennsylvania Railroad. Within weeks, seventeen furloughed employees filed suit to collect unpaid benefits. A federal district court took until 1979 to issue a written decision ordering that the claims be arbitrated. Arbitration hearings continued through November 1990.

The court issued an award in 1994—after the issue festered in the court system for twenty-six years—and an appeal of the arbitration award immediately was filed with the STB. Actually, the claimants' attorneys continued to supplement the record through May 1996, and, in August, the board found no reason to upset the decision of the arbitrators, which was based upon the merits of the case. So the claimants' attorneys have filed yet another appeal with the Sixth Circuit Federal Court of Appeals (*Michael J. Knopik, et al. v. Surface Transportation Board*). As Congressman Sonny Bono might say, "I got you, babe."

Let's Get Involved

A former commissioner of the Interstate Commerce Commission (now the STB) once inquired, *"Quis custodiet ipsos custodes?"* meaning "Who is to keep guard of these guardians?" The elimination of outdated, unwarranted commands and the granting of greater individual freedom would dramatically improve the effectiveness, image, and morale of the federal workforce. Indeed, if the government is less efficient than the private sector, it is because of a failure to create incentives to encourage the best and the brightest from the private sector to share their leadership skills with the Civil Service. Changing the culture and direction of something as large as the government requires more than a campaign promise, a speech on the House or Senate floor, or an op-ed in the *Wall Street Journal*. It demands a sabbatical and entails opportunity costs.

Leading any group, public or private, toward the cutting edge is rewarding. Certainly that is why Professor Newt Gingrich works with pupils of the embattled and belittled District of Columbia public schools—an endeavor for which he has sought no publicity, and received little. If Libertarians are to be agents of change who create a more efficient government while trimming its sails, each of us must accept greater responsibility and invest our own time and effort within the belly of the bureaucracy.

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