Executive Pay: Should Regulation Play a Role?

Scott Hempling
September 2015

Utility executives make good money. But spread over countless kilowatthours of electricity, cubic feet of gas, gallons of water and minutes of telephone time, those dollars make little difference in our bills. So in utility rate cases, we rarely address executive pay.

This is a mistake. We should care about executive compensation—not about its size, but its shape. "The pay of many C.E.O.s is tied to factors like short-term earnings, rather than longer-term metrics, which naturally fosters myopia."[1] In the utility sector too, compensation design can affect executive decisions, in ways that undermine a commission's goals.

Can Executive Pay Bias Decisions Against the Public?

Basing compensation on earnings or stock price can cause conflict with multiple regulatory priorities. Fixing on earnings leads to cost-cutting. But cost-cutting helps the public only if it eliminates imprudence, not if it starves research and development or denies workers opportunities for advancement. Executives who cut the wrong costs are like legislative budget-balancers who cut school spending, then leave society's losses to their successors. Obsessing about stock price can cause companies to distort investment decisions and financial statements, leading to lost trust and higher capital costs. Basing pay on market share can spur excellence, but it can also produce acquisitions that reduce competitiveness and diversity in markets where consumers need more of each. Asset acquisition can make a company debt-heavy, less able to invest in customer improvements and more dependent on captive customers tied to traditional cost-plus revenue streams. Executives busy acquiring more companies and customers pay less attention to the ones they already have.

Aligning Executive Pay With Policy Priorities: Five Options

Cut the right costs: "What is measured, improves."[2] With "big data" we should be ranking utilities on everything from power plant heat rates and nuclear down time to water pumping costs, billing accuracy and solar installation speed. Executive pay should be linked to indices that advance efficiency. Cut the waste, not the meal.

Merge for the right reasons: Executives should focus on the couplings that reduce cost and add quality, not those that increase debt and erect entry barriers. Choose acquirers based on performance, not purchase price.

Treat workers well: Utility workers are not numbers on a spreadsheet, to be allocated, reallocated and reduced to meet quarterly earnings estimates. Workers keep machines running, customers informed and the public safe. Worker morale affects company performance. Why not

link executive pay to signs of worker satisfaction: upward mobility, professional development, and a culture that identifies and supports those who excel while weeding out those that do not? And the relationship of executive pay to worker pay matters. We need to get the ratio right.

Diversify the labor force: Public service companies serve the public. As our customer bases become more diverse, ethnically and linguistically, so should our utility work forces. In "Promoting Diversity and Prohibiting Discrimination: Is There a Regulatory Obligation to Society?", I argued that workforce diversity is a necessary part of prudent utility performance. There are symbols and tokens, and then there are real numbers. A high school principal once told me, "Trying is lying." Why not base executive compensation on progress toward diversity?

Help the needy to help themselves: Utilities make charitable contributions to their communities. But the amounts are small compared to what those communities give the utilities: near-permanent control of monopoly franchises that promise continuous profit. Other typical utility gestures, like rate discounts and winter shut-off bans, are not acts of charity, because the gap in revenue is normally filled by the paying customers. And instead of charity, how about empowerment? We can base executive compensation in part on the utility's progress in helping low-income families cut their costs. That cost-cutting should occur not through artificial rate reductions but through education about, and financing of, efficiency upgrades and renewable self-supply.

Reward offered: Email me an example of executive pay tied to a commission priority. The first 10 successful responders get a copy of my two books, *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* (American Bar Association 2013); and *Preside or Lead? The Attributes and Actions of Effective Regulators* (2013).

If Commissions Address Executive Pay, Can Utilities Challenge in Court?

In effectively competitive markets, customers need not care about executive compensation. Dissatisfied with quality or price at one company, they can choose another. But captive customers of regulated monopolies lack that luxury. So when executive pay conflicts with utility performance, regulators need to intervene.

But not before boning up on the so-called "management prerogative doctrine." Interpreting utility statutes, some courts draw this line: Regulators do outcomes (prices, quality, safety); while management does inputs (corporate organization, purchasing practices, hiring and firing). Put another way: Regulators set standards and judge performance, management runs the business.[3]

If the line between regulation and management were clear, executive compensation would fall outside regulation's domain. But the line isn't clear, because regulators do deal with inputs. They approve purchase power contracts, fuel choices, acquirers and acquirees, and refinancings. They address inputs because confining themselves to after-the-fact consequences

can land them in too-big-to-fail situations. See my essay, "Too Big to Fail': A Premise without Support."

Some schemes invite executives to gamble, earning rewards if they win but paying no penalties if they lose.[4] The larger the loss, the more limited the regulator's options. Rate disallowances and fines are possible in theory. But if a proportionally appropriate penalty weakens the company, the regulator is less likely to impose it—unless there is some alternative company ready, willing and able to replace the incumbent. Better to eliminate errant tendencies upfront.

* * *

Between executive compensation and regulatory policies, there is no perfect fit. But there is a practical beginning. Let's at least eliminate the conflicts—pay provisions that put executives at odds with the commission. From that foundation, we can more readily find opportunities for alignment.

---

[1] J. Surowiecki, "The Short-Termism Myth," *The New Yorker* (Aug. 24, 2015).

[2] Peter Drucker, *The Effective Executive*.

[3] *See* Hempling, *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* at Chapters 2.D.3.d, 6.C.4.

[4] See Gretchen Morgenson, "Ways to Put the Boss's Skin in the Game," *The New York Times* (March 21, 2015) (describing "perverse incentives" in executive pay).