Regulatory Candor: Do We Own Up?

Scott Hempling

July 2018

To some excellent Canadian regulators (a redundant phrase) I once gave a session on the nine attributes of effective regulators: purposeful, educated, decisive, independent, disciplined, synthesizing, creative, respectful, ethical. When I asked for attributes I'd omitted, one regulator volunteered "candid." Yes—An effective regulator is candid, about the limitations of regulation and regulators. Here are four areas deserving more candor.

The qualitative matters as much as the quantitative

We deal with numbers and formulas: depreciation rates, heat rates, dividend growth models, financial leverages, reserve margins, Herfindahl-Hirschman indices, service interruption indices. In every subject area (physical capacity, operations, rates, service quality, mergers, market structure, corporate structure), and in every professional discipline (finance, engineering, economics, accounting, management), we are immersed in the technical and the quantitative. But regulation is not like physics, where for every question nature supplies a precise answer. In regulation, the answers come from human judgment. When regulators do quantify, we usually are establishing only guides or boundaries: ranges for return on equity, maximums for outage duration and frequency, tolerances for gas seepage. Within those ranges, it's all judgment. Regulation is as much qualitative and subjective as it is quantitative and objective.

Qualitative judgment can lead to intellectual looseness

Being quantitative implies rigor and sophistication. Yet if regulatory decisions were primarily quantitative, our commissioners could be high schoolers, since regulatory math rarely exceeds the complexity of 11th grade trigonometry. We want adult regulators because the qualitative component requires adult judgment. But when we move from the quantitative to the qualitative, judgments can become loose. Qualitative judgments are not inherently loose: Driving a car in the rain, we make judgments about speed, braking, trailing distance, when to start and smooth a turn. Those actions require qualitative judgments because we can't consult calculators; but we make those qualitative judgments as carefully as possible because staying alive depends on it. What about regulation? When regulators assess a merger that will reduce market players from four to three, or set a return on equity within some quantitative range, or decide how many outage hours to tolerate, or choose the market structures for electricity storage and electric vehicle charging stations, there is risk of replacing rigor with other things—like whether we will be viewed as "out of the mainstream," or whether we will offend powerful participants, or whether it's just easier to choose yes over no. Candor requires admitting that human thinking has quirks that undermine our claims to rigor and

objectivity. (For more on mental biases, see my essay, *A Nobel Prize for a Behavioral Economics Pioneer: Are There Lessons for Regulation?*)

We tolerate fact-stretching that courts would deem perjurious

Witnesses take oaths, but what they swear to is often not factual. Statements that would be perjury in a court are accepted in our hearing rooms. A CEO says he is "absolutely" committed to the customer, "100 percent." That cannot be true when her compensation is based not on customer satisfaction but on earnings and share value, both of which can be increased by persuading regulators to raise rates above the level necessary to produce a reasonable return. An economist testifies that any ROE below 12.5% would "cripple" his utility client; later he supports a settlement at 11.00%. A particular merger applicant witness case has testified, twice, that a feature of my merger testimony had been "rejected" by commissions when in truth this feature has never been addressed. I don't know which is worse—being rejected or being ignored—but there is a factual difference.

False statements, allowed routinely without consequence. Because in regulation the oath is only a formality? Because making economic decisions that affect millions of people and billions of dollars is so difficult, so consequential, that we can bear the responsibility only if we lighten up? (John Dos Passos: “Apathy is one of the characteristic responses of any living organism when it is subjected to stimuli too intense or too complicated to cope with. The cure for apathy is comprehension.") Because today some get their news from commentators rather than journalists, so for every fact there is alternative fact? Because the job of disciplining a loose-talking witness should be left to cross-examiners, lest the presiding officer be seen as "taking sides"? Taking the side of truthfulness and rigor is the very mission of regulation. Candor requires us to admit that by letting witnesses "have their say," however they want to say it, we cheapen the dialogue by marginalizing the more precise. Regulation is not brain surgery but it deserves the same care.

We repeat regulation's fundamental principle, then ignore it

Real competition disciplines performance so that sellers' self-interest is aligned with customers' needs. Monopolists don't face competition, so the missing discipline is provided by regulation. That's the tenet found in the first 25 pages of any regulatory text: The purpose of regulation is to emulate the outcomes of competition.

Except in regulation we don't do that. In competition, only the best succeed; the others lose customers, revenues, earnings and stock value. In regulation we don't demand the best. "Prudence," "the norm"—the average—is enough. And whereas competition replaces losers with winners, in regulation we insist on saving the incumbent. Even when the incumbent is a felon. Pacific Gas & Electric was criminally convicted for the poor maintenance,

recordkeeping and fact-suppression that to a fatal gas line explosion. At the California Commission's penalty hearing the CEO pleaded for leniency, saying that the maximum statutory fine (calculated by the Commission to range from $9 billion-254 billion) would "devastate" the company. The Commission lowered the number to $1.6 billion because state statute placed weight on the company's well-being. In real competition—the competition regulation is supposed to emulate—no customer worries about the company's financials because the customer has alternatives. But in monopoly regulation we rarely have alternatives. Candor requires us to tell the public why—because regulators rarely act to create those alternatives. We leave customers dependent on a single company, then allow CEOs to cite that dependence as justifying escape from the full consequence of the company's crimes. Failing to create alternatives means placing on the scales of regulatory justice a thumb that consistently favors the incumbent.

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Candor reflects honesty; it also creates value. Revealing the difficulties of regulating the incumbent gives consumers cause to seek alternatives to the incumbent. Regulators who admit to regulation's weaknesses implicitly warn parties away from exploiting those weaknesses. Most importantly, candor makes regulators accountable. Only by identifying the distance between our actions and our ideals can we progress toward achieving those ideals.