Regulatory Principles: Old Thoughts for the New Year

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Newcomers to utility regulation bring disparate ideas about its purposes and processes. These young professionals, a talented group of whom shared thoughts with me recently, deserve more clarity on what we do, how we do it and why. Here are five subjects requiring our attention.

Purpose of regulation

The purpose of regulation is performance. Effective regulators first define the desired performance, in terms of product mix, quality, cost, and safety. Then they determine the market structures—the mix of monopoly and competition—most likely to attract the players whose actions will most cost-effectively produce that desired performance. Then they provide ways to pay, or penalize, these performers for their performance. Effective regulation is leadership regulation: defining performance, then holding companies accountable for their performance. Sitting back, waiting for parties to say what they want, presiding instead of leading? That's not regulation; it's abdication.

One newcomer compared utility regulation to highway safety regulation. Yes, in part. Speed limits, like all regulation, align private behavior with the public interest. But safety regulation emphasizes protection. In the utility space, consumers are not mere victims to be protected; they are actors to be empowered. So regulators must empower as well as protect. When we re-examine decades-old monopoly market structures, when we test whether competition can improve monopolists' performance, we empower both consumers and competitors: Consumers reveal their diverse needs; new competitors strive to satisfy those needs. Performance improves. Effective regulators don't merely prevent harm; they demand excellence. If regulators satisfice while sellers maximize, we get lopsidedness.

"Protect" from what?

Protecting implies danger. Identifying dangers makes some regulators skittish, because no one likes to impute negative motives to nice people. But to design effective protections, we must be explicit about the dangers. Four are beyond dispute. First, every monopolist strives to keep and grow its monopoly. Second, every competitor seeks to become a monopoly, because (as economist John Hicks wrote) "the best of all monopoly profits is a quiet life." Third, consumers and sellers alike value their short-term interests more than the public's long-term interests. Fourth, if in regulatory proceedings winning depends on obscuring, distracting, and deceiving, some parties will do all three if the chance of success is high and the penalty, if caught, is low. So protecting the public interest means exposing these dangers, expressly and

directly. Wishing them away, looking the other way, favoring comity over candor—regulatory weakness lets dangers thrive.

"Balancing" what?

There must be something in the regulatory drinking water. Newcomers routinely describe regulators as "referees," and regulatory decisionmaking as "balancing stakeholder interests" after "looking at both sides." Substantively and psychologically, these sentiments are wrong.

Utility regulation is not a zero-sum contest, with a referee watching parties duke it out (or worse, watching parties settle because they distrust the referee). Regulating is policymaking. Policymaking requires framing the issues in public interest terms. Balancing means letting the parties frame the issues in private interest terms. A policymaking regulator—a leadership regulator—recognizes that parties define their interests narrowly. Some seek higher profit, some seek lower rates, some seek less pollution, some seek more secure pensions. If regulators allow such single-issue advocacy—this "my-goal-at-your-cost" posturing—they will get the balance wrong, because the midpoint between two wrong answers is a third wrong answer. See my essay, “The Regulatory Mission: Do We Balance Private Interests, or Do We Align Them with the Public Interest?”

Instead of balancing private interest slivers, effective regulators resolve tensions among public interest values: long-term efficiencies vs. short-term costs, the right price vs. the affordable price. Doing so takes guts and muscle. For as private parties try to pull the regulator outward, each narrow interest headed in a different direction, the regulator must pull everyone inward, a centripetal force directed toward a common purpose. "Balancing" is not a force; it is passivity—a scale sitting motionlessly, watching weights pile up on either side. Regulating is action.

As for "seeing both sides": No regulatory decision has only two sides. When only two sides come to the hearing room, effective regulators ask, "Who is missing?" Usually missing are the poorly resourced, the remotely located, the unborn. Regulation’s job is not to referee disputes among sides, but to ask the questions the sides have omitted, then demand the right answers. See my essay, “Commissions are not Courts, Regulators are not Judges.” And so the purpose of regulatory procedure is not merely to "give stakeholders a voice," as one newcomer suggested. Statutes and constitutions do grant a right to be heard. But effective regulators tell the parties what questions they want answered, what facts they want displayed, what slogans and oversimplifications they want abandoned. A regulatory proceeding is not a supermarket where parties shop for stuff; it's the regulators' tool for extracting the information and expertise they need to make public interest decisions.

Roles of legislatures and commissions

One newcomer said: "Legislatures set policy while commissions implement policy." Law and reality say otherwise. The typical rate statute says very little: Rates shall be

"just and reasonable" and not "unduly preferential." It says nothing about rate of return methods, depreciation rates, cost allocation principles, prudence metrics, executive compensation, worker pay, or anything else. The typical utility merger statute says even less: A merger must be "consistent with the public interest." The statutes say nothing about vertical or horizontal market power, interaffiliate relations, the acquisition price, merger financing, executive parachutes, or anything else. So when commissions decide rate cases and merger cases, they don't implement policy decisions made by the legislature; they make policy decisions delegated by the legislature. Implementing falls into the same passivity trap as "balancing": a commission waiting for parties to say what they want, rather a commission telling the parties what the public interest requires. See my essay, "Legislatures and Commissions: How Well Do They Work Together?"

What if, when making decisions within their delegated authority, regulators confront a problem outside their authority? What if a new rate reflects reasonable utility costs but is too high for the poor to pay? Or an energy efficiency investment outside the commission's authority would satisfy customer demands less expensively than a physical facility within the commission's authority? On finding they lack authority to do the right thing, effective regulators don't shrug their shoulders and clock out at 5:00; they bring their expertise and credibility to the legislature and propose a solution. That's leadership.

Regulators' responsibility to utilities

One discussant described a commission's role as "keeping utilities viable and profitable." No. It is definitively not the role of a commission to keep utilities viable and profitable. That's utility's management's job. The regulator's job is to set standards for performance, compensate appropriately for that performance, and hold the performers accountable for that performance. How does so deep a misunderstanding get into a regulatory newcomer's mind?

Any rational utility wants its regulators to see the company as indispensable—the only possible performer. Accepting that assumption then makes "public interest" synonymous with "keeping utilities viable and profitable." But accepting that view brings a bias—a thumb on the scale of the status quo. That status quo is a monopoly market structure controlled by the incumbent utility. Accepting that view means that decades go by—during which Presidents, members of Congress, and state legislators come and go, all regularly tested and replaced; but somehow the incumbent utility stays the same. Outsiders to regulation find this odd. They see a non-utility world in which technology, economic efficiency, and customer preferences align themselves not with any single performer but with performance. Regulators must do the same: Set standards for performance, find the best performers, then hold them accountable for performance. Then what will keep a company "viable and profitable" is not historical inertia and government protection, but customer-oriented performance.