

# Separating Policy Mandates From Cost Consequences: Will the Public Lose Trust?

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*Public services are never better performed than when their reward comes in consequence of their being performed, and is proportioned to the diligence employed in performing them.*

— Adam Smith, *The Wealth Of Nations*, Book V, Chapter 1

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To the joker who asked to be taught the whole Torah while standing on one foot, Rabbi Hillel answered, "'That which you hate, don't do unto others.' The rest is commentary."

In my much narrower world, a law student asked me to explain "what utility regulators do" in one sentence. Here was my response:

*Regulators establish standards, tie compensation to performance, then design rates that both produce the compensation and cause consumers to consume efficiently.*

Three tasks, knotted together in tight interdependency. For newcomers to regulation, whether legislators, governors, their cabinet members, or average citizens, it is easy to miss these interdependencies. I commonly hear that "utility regulators set rates; policy is made elsewhere." The distortion caused by this brevity becomes clear on examining each part of the triad.

## Three Regulatory Tasks

***Establish expectations for performance.*** A regulated utility has an obligation to serve. That obligation to serve needs definition. Is the required quality level average, above average, top-flight, or just scraping by? Is the range of services the minimum of dial tone, electricity current, gas flow; or does it include broadband, time-of-use meters, energy audits, and storage? Is the obligation merely to keep today's lights on or does it include saving resources for our successors?

***Tie compensation to performance.*** The Constitution commands commissions to grant the utility "just compensation." ("...[N]or shall private property be taken for public use, without just compensation.") Utilities commonly argue that "just compensation" means "cost recovery." That pecuniary plea misses regulation's central purpose. The purpose is not to align rates with cost, but to align compensation with performance. Cost is input, performance is output. The proof of performance is not dollars spent, but innovations implemented, customers empowered, accountability displayed.

*Cause consumers to consume efficiently.* The arithmetic of ratemaking is straightforward: Divide the annual revenue requirement by the expected sales to get a dollar-per-unit rate. But that average rate has no relation to reality if reality is the costs consumers cause, since in each hour actual costs diverge from the average. Economic efficiency and societal fairness require that cost-causers be the cost-bearers. If so, an average rate fails both tests. But insisting on true cost causation triggers other concerns—metering and measurement costs, effect on low-income users, revenue stability, public acceptance. So some adjustments are necessary.

## **Interdependence and Inseparability**

Regulatory practice often places performance, compensation, and ratemaking into separate proceedings, even assigns regulatory responsibility to different agencies. But these three activities are interdependent and inseparable.

*Performance costs money.* No one chooses a Lexus over a Volkswagen without considering cost. Perfect reliability costs more than one-outage-per-year reliability. So standard-setters have to consider customer impact. Performance also faces technical limits. High schools don't require phys. ed. students to run four-minute miles. Renewable-energy requirements and broadband expectations must jibe with transmission constraints, access to raw materials, land and labor availability—all of which involve costs.

*Performance quality varies.* Electricity, gas, and water are commodities. Performance is not a commodity. The pace of innovation and improvement, the quality of construction and repairs, responsiveness to customers—all vary among utilities. In most industries, pay reflects performance; we pay less for the high school play than the Broadway musical. Where traditional utility regulation compensates for cost (with occasional disallowances for serious imprudence), future regulation must compensate for performance. To treat investors fairly, the signals must be clear; so those who determine performance standards, and those who set rates, must have common metrics for compensation.

*Efficient consumption depends on planning.* As rate setting moves from average cost to actual cost, regulators need to master what "costs" to reflect in rates. They can be actual costs caused, future costs potentially avoided, or a combination. Integrated resource planning identifies the resource mix (including resource-avoidance measures) consumers will need under stated assumptions. Because prices affect demand and demand affects prices, plans and prices must emerge from a common process.

## **Bureaucratic Separateness Undermines Cost–Benefit Accountability**

This inseparability argues for caution in bureaucratic separation. In traditional utility regulation, these three functions remained largely within the utility commissions. Armed with two concise statutory phrases—"just and reasonable rates" and "no undue discrimination"—the commissions set service-quality standards, established each utility's annual revenue requirement,

and then allocated that revenue requirement among customer categories and set rates based on predicted sales. "Performance" assessment was confined to outages and cost overruns.

In the past decade, the public and its representatives—legislatures, governors, and cabinet appointees—have recognized that utility service does more than deliver electricity, gas, water, and phone calls. It does damage—to the air, water, and delicate computer equipment. Properly guided, utility service also does good—by boosting economic development, diversifying fuel sources, building broadband, and weatherizing homes.

So policymakers outside commissions are injecting new policy goals into the regulatory process, supplementing—sometimes supplanting—the traditional regulatory role. They are establishing outage standards, renewable-purchase obligations, broadband-investment requirements, water-quality metrics, and energy-efficiency quotas. (For a comprehensive study of this trend, including its fate in the courts, see Eric Filipink's paper "[Serving the "Public Interest": Traditional vs. Expansive Utility Regulation](#)" (2010), published by the National Regulatory Research Institute.)

In some cases, responsibility for designing and even implementing these policies is landing with state agencies other than the traditional utility commission. This trend separates policies from their cost consequences. Policies are set by agencies that perform no rate analysis, while compensation and rates are set by an agency that performs no policy analysis. This double separation causes risk. Sellers can lobby for policies that favor their products, free of the cost–benefit discipline normally imposed by utility regulators who examine witnesses under oath. Separating policymaking from rate setting reduces accountability—like candidates who promise a police cruiser in every neighborhood without committing to the necessary tax increase.

## **Conclusion**

Utility regulation is political. Regulation makes value judgments, assigns rights and responsibilities, establishes rewards and penalties, all of which affect every citizen's lifestyle and wallet. Political bodies must be and should be involved. The challenge is to mesh that involvement with cost–benefit accountability and the professional standards that regulation's formalities ensure. Anyone with a thirty-year memory (nuclear power), twenty-year memory (savings and loan), ten-year memory (Enron), or one-year memory (investment banking) knows that when we separate policy excitement from cost accountability and add captive customers, we risk cost overruns, public distrust, and rollback of the very policies we intended to advance.