The San Bruno Explosion:
Were The Wrong People Penalized?

Scott Hempling
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Pacific Gas & Electric's shareholders have to pay more than $2 billion in penalties and remedies, because PG&E's executives mismanaged the company's gas transportation system. So ruled the California Public Utility Commission, responding to the San Bruno pipeline explosion that killed eight, injured 50 more and wiped out a neighborhood. The errors were made by executives, but the commission penalized shareholders. This disconnect, between decision-maker and penalty-payer, is common. But is it unavoidable?

We regulate to induce performance. We set rates to reflect prudent costs; we disallow from rates imprudent costs. We apply penalties for mismanaged outages. We jigger the return on equity when results exceed or fall short of standards. In all these examples, we aim our arrows at the shareholders. Using spurs, a ranch hand stings a horse's sides to make it run. Using "just and reasonable" ratemaking, the regulator stings the shareholders' returns to make management perform.

But the decisions we judge are not made by shareholders; they are decisions made by board members, executives, middle managers and employees. Regulators rarely apply their powers to those people. We assume instead that stinging shareholders produces performance by executives and managers. How solid is that assumption? Below are three examples of this disconnect between actor and consequence. Each is so firmly embedded in the status quo we consider it normal. But each deserves rethinking.

Whose Skin is at Stake?

Financial writer Gretchen Morgenson writes about the "perverse incentive." If a venture succeeds, bonuses go to executives; if it fails, losses land on the shareholders. Scholars studying executive decision-making have shown that "major players are encouraged to take outsize risks because they can earn princely amounts from their actions. At the same time, they know that they rarely have to ... face ... costly consequences from taking dangerous actions." She cites Citigroup, whose mortgage improprieties cost shareholders a $7 billion fine while leadership likely got bonuses. Heads I win, tails you lose. See "Ways to Put the Boss's Skin in the Game," The New York Times (March 21, 2015).

One solution, Morgenson says, is a performance bond. Independent directors would require executives to put part of their compensation into a "performance pool," where it would be forfeited if wrongdoing were found, thereby reducing the penalties paid by shareholders. Might this solution solve problems in utility regulation? Mississippi Power Company told the Mississippi Commission (whom I counseled) it was "confident" that the Kemper plant would cost less than $3 billion. The cost is now $6 billion and climbing. The

Commission has the power to pin the overage on shareholders. But the shareholders did not make the erroneous estimate, testify about their "confidence" or lose control of the costs. Would the executives have been so "confident" had the overrun been their financial responsibility?

What Skin is at Stake?

Ratepayers complain about outsized executive compensation. But a CEO's take adds only pennies to a customer's monthly bill. The real problem is not what is being paid, but what the payment is for.

Executive pay is set by the board. The board, representing shareholders, wants to see value—higher earnings and a higher stock price. Outside the utility field, in truly competitive markets, those two factors can align with the consumer interest. Since customers shop for the best, the CEO can grow earnings and stock price only by being the best. Paying the executive based on earnings and stock price induces the executive to please the customers—by cutting costs and lowering prices.

But in a utility monopoly market, paying executives based on earnings and stock price causes a conflict. When customers are captive, an executive induced to increase earnings can cut costs without lowering prices, or raise prices without cutting costs. Yes, we can try to prevent these actions by monitoring the price-cost relationship and resetting rates accordingly. But those intrusive steps, which require expert staff, expensive consultants and a lot of litigation, would not be necessary if there were no executive-customer conflict to begin with. As with responsibility for wrongdoing (see first example above), can regulators correct this misalignment of compensation and obligation?

"Incentives" for Whom?

What enhances performance is people: specifically, people who work at jobs, not people who wait for dividends. But in utility regulation, the typical "incentive" goes to shareholders, not workers. Yes, smart utilities share gains with line workers and their managers. But those dollars are small compared to the amounts at play in rate of return adders, accelerated depreciation and other "incentives."

Shareholders surely deserve a reasonable return. Capital is voluntary; it must be lured. But giving shareholders more to make workers work harder is not logical. Are we saying that absent the incentive to shareholders, the utility's managers and workers would not strive to do their best? The most ardent "incentive" advocate would never say so. So we have a third example of mismatch, between compensation and performance. In contrast, direct employee incentives can be micro-targeted to the precise performance desired, their effectiveness can be tested with control groups, they cost customers less and they are logical. What is the value add from shareholder incentives?

"Management Prerogative": Must It Block Solutions?

In the three examples above, compensation is misaligned with performance. Executives avoid accountability when their bets are covered by shareholders; CEO compensation can conflict with customer service; when workers are more productive, passive shareholders get the gain. Each arrangement arises from internal relationships: management to shareholders, board to management and management to employees. Regulators usually deal with the company as a whole. Can they regulate these internal relationships? The legal lines are unclear, but worth testing.

The "management prerogative" doctrine limits commission involvement in internal utility decisions. Loosely stated, the doctrine is this: The commissions sets the standards, management runs the company. When the Alabama Commission told the utility to stop using collection calls on delinquent accounts, the court invalidated the order. Same result when the Oklahoma Commission ordered a railroad to provide lockers for road crews. In both cases, the regulator was deemed to be "running the company." But the case law is not consistent. The California Commission directed a water company to "immediately replace" its system manager, due to poor performance. And the West Virginia Commission stayed a water company's layoffs, pending an investigation into the effect on service quality. So the legal guidance is inconsistent.[1]

Given these varied results, the "management prerogative" doctrine deserves more definition. Here is an attempt. Deferring to management decisions makes sense if the company's incentives are aligned with the customer interest. But not if that alignment is absent. Suppose the board adopts this rule for its executive team: "If in attempting to maximize profit you break the regulator's rules and get caught, the board will cover the consequences." A commission could make the board erase the rule, notwithstanding the doctrine. How different is a board rule that says to the CEO, "If you increase earnings we'll raise your pay, even if consumers pay more than necessary"? With alignment absent, the doctrine should not apply. The regulator should intervene.

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Rewarding executives for the upsides while shareholders cover the downsides, compensating CEOs for earnings that come at customer expense, "incentivizing" investors for performance produced by workers—each practice disconnects private compensation from public consequence. Commissions should intervene—not to run the company, but to align its interests with the public interest.

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[1] More detail on the management prerogative doctrine appears in my book, "Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction" (1st Ed.) at Chapters 2.D.3.d and 6.C.4 (American Bar Association 2013).