"Too Big To Fail": A Premise without Support

Scott Hempling
October 2014

A cafeteria contractor services a government building. Food poisoning kills eight people and hospitalizes dozens. Official investigations find food safety lapses. When fines are proposed, the contractor complains of the financial effects. Nobody takes him seriously. He's fined fully, his franchise is terminated. A new contractor is selected competitively.

Pacific Gas & Electric's pipeline explodes in San Bruno. Eight people perish, dozens are hospitalized. Official investigations uncover inspection procedure lapses. Regulatory proceedings, lawsuits and criminal indictments threaten penalties in the billions. The utility warns of the financial effects. Everyone listens; everyone—including the statute—insists that whatever the full penalty should be, it must be moderated to keep the company functioning.

Why the different treatment? What are the consequences of protecting a company from its errors? And why assume the utility is irreplaceable?

Protecting a Utility from Its Errors: Five Costs

1. Subsidies: Reducing the fines to save the company violates regulation's first principle: Cost-causers must be cost-bearers. If the utility doesn't bear its costs, someone else does. When a pipeline explodes, taxpayers fund the first responders, insurance premium-payers fund the hospitals, and ratepayers pay for the inefficiencies that flow from regulatory lenience.

2. Dulled motivation: Penalties function not only as punishments but as inducements--to avoid mistakes and improve performance. Competitive markets induce performance because the seller's choice is stark: Please the customer or lose the customer. In non-competitive markets the utility can't lose the customer, so to induce performance we need consequences. Cutting the penalties dulls the inducement.

3. Corrosion of culture: Pleading poverty to avoid consequences embeds a culture of entitlement, a sense that the utility is owed its franchise regardless of fault. The effect is to reverse right and wrong: to insist on accountability is destructive, to resist accountability is protective.

4. Distraction from the relevant: Framing the question as "What penalty can the company absorb?" distracts from the question "What penalty does the company deserve?" To decide what the company deserves, decisionmakers must ask: What were the harms? What deficiencies were the cause? What consequences will redress the harms? Beyond redress, what consequences will cause the company to change its ways, and warn others to do the same? These calculations are not simple, but they are feasible. Even if we cut the fines to save the company, these calculations tell us how much we are giving away.

5. Distortion of competition: Too-big-to-fail firms enjoy a cost-of-capital advantage. The economist Paul Krugman (Nobel Prize winner, New York Times columnist) explains: "[R]escues in times of crisis can give large financial players an unfair advantage: They can borrow cheaply in normal times, because everyone knows that they are 'too big to fail' and will be bailed out if things go wrong."[1] A bipartisan pair of U.S. Senators agreed: "Today's report confirms that in times of crisis, the largest megabanks receive an advantage over Main Street financial institutions."[2] The advantage affects both debt and equity.[3]

What does this have to do with the regulation of utilities? For 30 years, we have relied on competition to transform our electricity, gas and telecommunications sectors. The newest venue is distributed energy resources. To reduce our carbon footprint and lower customer costs, we need to democratize demand and diversify supply. That means home-based solar, microgrids, storage, demand response and energy efficiency—each option a competitor to the incumbent utility. But if we want competition on the merits, we must eliminate unearned advantages. If we protect incumbent utilities from their errors by giving them cost-of-capital advantages, prospective competitors will go away, making too-big-to-fail a self-fulfilling prophecy.

Irreplaceability: An Assumption that Ignores the Facts

Suspending a child from school makes no sense if he watches TV instead of studying. Making the struck-out batter do 80 pushups makes no sense if he's then too tired to swing. And penalizing a utility too heavily can leave it unable to serve. A penalty's design is not irrelevant to its efficacy. But relevance depends on context. In the utility space, penalty-moderators misunderstand the context, in three ways.

1. "Too big to fail" is inapplicable: A bank is too-big-to-fail if (a) when it fails, it's gone—its assets are no more; (b) its departure leaves its creditors and customers without alternatives; and (c) its size is so large, and its interdependencies so extensive, that its failure weakens the financial web that supports the national economy. Its internal failure causes external costs.

A local utility shares none of these features. Its finances may fail, but its assets—its generators, transmission network and distribution system—survive. The dollars needed for their operation will still flow—under FERC regulation for wholesale contracts, under state regulation for retail sales. A bank's finances are its assets—so when it fails, its assets evaporate. But when a utility fails, the physical, contractual and regulatory infrastructure that supported it remain—for whoever is next selected to serve. The losses are internal to the utility.

Unlike Morgan Stanley or Goldman Sachs, then, the local utility is not too big to fail. We view it that way only because we conflate our dependence on service with dependence on a particular company.

2. Alternatives are available: PG&E's territory area is not on some remote island, rocky, barren, sparsely populated and unprofitable to serve. Millions of customers buy essential service in predictable amounts, paying state-mandated rates that treat shareholder investments as constitutionally protected property. Plenty of competent companies would find the job attractive. The utility is not too big to fail because alternatives are available.

3. Transitions are feasible: To the utility that says "If you impose the fine you say we deserve, we can no longer operate," the commission can reply "You don't have to." The commission invites bids, then selects a winner based on merit. Mindful that capital flows only voluntarily, the commission promises the successor reasonable rates that satisfy the financial markets. The commission limits the buyout price to unrecovered book cost. (This measure ensures constitutional "just compensation" for the departing shareholders, while avoiding bidding wars that saddle the winner with acquisition debt.) Service doesn't stop and it doesn't degrade. The physical infrastructure and the fuel contracts remain; even the employees can stay, if the successor wants them—or if the commission requires.

Why does this conversation never occur? Not because transition is infeasible but because there are no plans. Their absence becomes the excuse—for moderating the penalty to protect the poor performer. But prudent people have plans. Parents buy life insurance, schools run fire drills, and state commissions should have contingency plans. There is a rough analog: the Dodd-Frank Act's requirement of a "living will." Banks whose failure could pose "systemic risk" must file "resolution plans" that provide for the "rapid and orderly" liquidation or restructuring of the company, "so as to "mitigate[] serious adverse effects on U.S. financial stability." The plans must "[f]ocus on identifying core business lines and critical operations and mapping to legal entities"; and must identify "funding, liquidity needs, interconnections and interdependencies, and management information systems."[4] If state commissions did something similar, adding to this list procedures for selecting successors, they'd be less hesitant to impose consequences commensurate with shortcomings.

* * *

Planning for replacement is not "anti-utility." It is "pro-utility," for the successor utility whose selection is based on merit. If commissions have alternatives, and if they have contingency plans, there is no reason to moderate a penalty to save a company. With clear thinking and careful planning, we can reconcile penalties with performance.

---

[1] Paul Krugman, "Obama's Other Success: Dodd-Frank Financial Reform Is Working," *The New York Times* (Aug. 3, 2014).

[2] Gretchen Morgenson, "Big Banks Still a Risk," *The New York Times* (Aug. 3, 2014) (quoting Senators Sherrod Brown and David Vitter, referring to a report of the U.S. General Accounting Office).

[3] See “Big Banks Still a Risk,” *supra*, where finance scholar Edward Kane faults the G.A.O.’s methodology for considering only lower debt costs, while ignoring “the lower cost of equity that taxpayer guarantees provide.”

[4] Federal Deposit Insurance Corp., “Living Wills Overview” (Jan. 25, 2012), available at https://www.fdic.gov/about/srac/2012/2012-01-25_living-wills.pdf.