A Wish for the New Year: Agreement on the Principles of Regulation

Scott Hempling
January 2020

Political philosophers ask this question: Suppose that at the time of your birth, you did not know your future: whether you would grow up to be a utility CEO, a coal-company shareholder, a gas pipeline owner, a renewable energy developer, a regulatory professional, a small residential consumer or a major automobile manufacturer. You knew not if you would be rich or poor. Now suppose that in that condition of utter ignorance, you could choose the principles that would apply to regulated industries. What principles would you choose, so that no matter what position you later attained, you would be treated fairly?I suggest you would choose these nine principles.

1. The purpose of regulation is performance. Under competition, sellers win customers by providing high quality service at reasonable cost. Regulation must produce the same results. To achieve those results, regulators define standards of performance, then award fair compensation for good performance and impose penalties for poor performance. Through these actions, regulators align seller self-interest with the public interest.
But first, effective regulators define larger goals. They envision an optimal mix of products and services. They design the market structures most likely to produce that mix, cost-effectively and reliably. They have a vision, then act to realize that vision, because vision without action is useless. They act predictably and unambiguously.

2. Financial success depends on merit alone. In both regulation and competition, rewards should be based on merit—not on incumbency, not on self-praise, not on connections to politicians, but on merit. For each job regulators need fulfilled, they should find and appoint whoever can do it the best. That goes for home improvement contractors, wind energy sellers, pepperoni pizza makers and "distribution systems platform providers." Giving the job to the incumbent, just because it is the incumbent, is like hiring the boss's son. It dispirits competitors and abuses customers. Lazy regulation invites lazy performance. Regulation is not bicycle repair, where grease is dispensed based on the loudness of the squeak. Effective regulators insist on excellence.

3. Economic efficiency comes first. Economic efficiency requires that we allocate costs to those who cause the costs, while allocating benefits to those who take the risks and bear the burdens. Economic efficiency comes first; allocating the gains from efficiency comes second. Inevitably we will fight over who gets the biggest slice. Let us first cooperate to make the biggest pie.

4. There must be symmetry of risk and reward, of burden and benefit. If investors want rewards for taking risks, they must accept the losses when they fail. If a company witness testifies that an IGCC plant will cost $2.4 billion, then when the cost rises to $5 billion his company needs to eat the excess. And if consumers want protection from risk, they must pay for it in the rate of return. No free rides on the ratepayer, no free lunch for the ratepayer.

5. "Competition" is not a religion; it is a market structure. Religion is based on beliefs and prayers. Effective regulators create competition not by believing and praying, but by working with facts. For competition to benefit the consumer, it must be effective competition, not theoretical competition, not theological competition. Effective competition requires facts: many viable suppliers, many educated customers and low barriers to entry. If these facts are absent, we will not have competition, regardless of how much we believe and pray.

6. Competition and regulation are not in conflict. They share a purpose—to align private behavior with the public interest. Effective competition presses competitors toward efficiency, reliability, customer service, innovation and differentiation. Effective regulation does the same. Together, they induce accountability—to the consumers, investors and the public. As Alfred Kahn wrote, the "central, continuing responsibility of legislatures and regulatory commissions [is] finding the best possible mix of inevitably imperfect regulation and inevitably imperfect competition." (A. Kahn, The Economics of Regulation: Principles and Institutions, Vol. I, Introduction at xxxvii; Volume II at 114 (1970; 1988 edition)).

7. What matters most is not historical habit but emerging facts. For most of the 20th century, regulators assumed that vertically integrated monopolies enjoyed economies of scale and scope, making competition inefficient. But facts change. Economies of scale and scope change, because other things change: cost structure, technology, customer preferences, and production processes. The alert regulator looks for changes in facts that challenge historic assumptions. Inalertness breeds inertia, depriving innovators of opportunities and customers of efficiencies.

8. Consumers are actors, not victims. Politicians talk about utility prices like they talk about incomes taxes: Both are too "high," and need to be "lower." But in regulation, rates are not "low" or "high"; rates are right or wrong. Rates that reflect reasonable cost are efficient and right; rates that reflect unreasonable cost, or fail to reflect all reasonable costs, are inefficient and wrong. In competitive markets, prices are not determined by sellers alone; prices are determined by sellers interacting with buyers—by supply curves intersecting with demand curves. Consumers, like sellers, can be inefficient, wasteful or dishonest. So consumers are actors; their behavior affects prices. Effective regulators help consumers not by lowering their rates below efficient levels, not by focusing on whether rates are "low" or "high," but by educating and empowering customers to shift their demand to low-cost periods, and to reduce their consumption overall. Rather than "protecting" customers from costs, effective regulators expose customers to reality, so they learn to protect themselves.

9. In expertise and in compensation, regulatory agencies must be the equals of regulated companies. For their judgments to be credible, those who judge performance must be experts in performance. Ratepayers are required to pay in their rates for a utility's expertise; they should pay similarly for their regulator's expertise—expertise that matches the utility's. The persistent differential between utilities and their regulators, in training, experience, expertise, salaries and benefits, is regulation's dirty secret. It must be exposed and fixed.

* * *

In the world and in our regulated industries, conflicts arise because each person invents arguments based on the position he is in, rather than the position he might have been in. But those arguments are not principles; they are rationalizations. For a year with less conflict, let's aim for objectivity, for respecting the "other." Let's accept the principles we would seek if we were born not knowing what our positions would be.