Regulatory Expense: Is Asymmetry Inevitable?

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Ratepayers pay for their utility's regulatory expense. Newcomers to regulation find this fact troubling. Why, they ask, should we pay the utility to persuade regulators to raise our rates? Yet the practice makes sense—if we can apply it symmetrically to the regulator's expense.

Utility Expense: The Legal Basis

A utility has a statutory obligation to serve: to provide the quality of service specified by statute or commission order. This utility obligation to serve must be matched by a ratepayer obligation to pay. That obligation is rooted in statutory law (the "just and reasonable" standard) and constitutional law (the Fifth Amendment's Takings Clause and the Fourteenth Amendment's Due Process Clause). Those legal sources entitle the utility to charge rates calculated to give the utility a reasonable opportunity to recover its prudent costs and earn a fair profit. Reasonable costs and fair profit are based on what comparable companies incur and earn under comparable circumstances, including business risk.

How do these legal facts lead to the recoverability of regulatory expense? The "filed rate doctrine" bars the utility from charging any rate other than the rate filed with, and accepted by, the regulator. So the utility cannot charge a rate until it persuades the regulator to set a rate. To persuade the regulator to set a rate, the utility must incur regulatory expense. Unless it incurs that expense, it has no way to receive the money promised by the state and the Constitution. That is why regulatory expense is a recoverable expense.

There is, of course, a limit on recoverable regulatory expense; a limit in both quantity and quality. In "just and reasonable" ratemaking, the standard for all cost recovery is "lowest feasible cost." As with power plants, no gold-plating and no excess capacity; no $500/hour consultants when internal staff will do, no five-person backup teams when one assistant will do.

In some states, the commission awards regulatory expense to intervenors based on the value of their contribution. The same logic should apply to the utility. Since the legitimate purpose of regulatory expense is to help the commission make public interest decisions, the recoverable amount should take into account not only the cost to the utility, but also the value to the Commission. The utility should not be seeking recovery of regulatory expense associated with utility efforts to (a) sell consumers more than they need, (b) seek recovery of imprudent or unreasonable costs; (c) seek returns on equity exceeding appropriate levels; (d) gain, through the regulatory process, an unearned advantage in potentially competitive product markets; or (e) make regulation more difficult, like resisting discovery or filing non-meritorious motions. The First Amendment accommodates discourse on these five topics, but the ratepayers should not be financing the utility's side of the conversation.

Commission Expense: The Symmetry Basis

Ratepayers are not shareholders. They don't invest money; they buy service. The shareholder's investment in utility infrastructure is deemed private property protected by the Constitution, while the ratepayer's payment for that service is guided only by the statutory just and reasonable standard. How does that difference affect regulatory expense? It means that commissions cannot skimp on the utility's regulatory expense, but legislatures can skimp on the commission's regulatory expense. As a result, for any given substantive issue or regulatory proceeding, most state commissions have fewer regulatory resources than utilities do.

This difference in constitutional value does not reflect a difference in public interest value. The quality of commission regulation is no less important than the quality of utility presentation. In rate cases, the purpose of regulatory expense is to get rates right, so that compensation tracks performance. In that effort, utility expenditure and commission expenditure are of equal value. So if ratepayers must fund the utility's reasonable regulatory expense, they should also fund the Commission's—at the level required to ensure performance.

The Consequence of Imbalance: Unexamined Costs, Insufficient Standards

A resource imbalance forces the Commission to triage. Triage means that some utility performance, and some utility expenditures, go unexamined. With what result? If non-examination meant non-approval, utilities would support sufficient commission regulatory expense, immediately and full-throatedly. But in most jurisdictions, utility expenditures are rebuttably presumed prudent. Non-examination, therefore, means auto-approval. Re-read the preceding sentence. Insufficient commission resources plus presumption of prudence equals the right to charge customers for costs the regulator has not examined. This result is contrary to competitive markets: When customers are free to find the most cost-effective supplier, inefficient sellers do not recover their costs.

If we want regulators to replicate the discipline of competition, we must make them the utility's informational equal. We must enable them to replace triage with mastery. That takes money. A utility's regulatory affairs team, bulked up by expert witnesses, knows the inside story. They know the utility's costs and its cost-saving options. And they control the information regulators need to assess the utility's performance. Without equivalent knowledge, the commission cannot competently do its job: establishing performance standards, applying those standards to distinguish prudence from imprudence, and assigning consequences through cost recovery or cost disallowance. Without equivalent knowledge, there is risk that efficiencies readily achievable by the utility will appear unachievable to the regulator. A knowledge gap can cause the regulator to set standards lower than necessary, or set compensation higher than necessary. Distinct from the knowledge gap is the expertise gap. Differentials in salary, benefits and job security mean that in many substantive areas, the utility's expertise exceeds the commission's. And then regulation has a credibility problem, because in regulation, the only credible judge is an expert judge.

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That a utility benefits from resource differentials and information asymmetry does not imply bad faith. Most commercial relationships have information asymmetry. Apple knows the iPad's cost better than its customers do; a lawyer taking a contingency case for one-third the winnings knows the probabilities better than her client does. But in those markets, the skeptical customer can shop elsewhere. Contrast the monopoly context, where customers cannot shop. This combination of information asymmetry and customer captivity requires a regulatory solution: a reduction in the asymmetry and a lessening of its influence. If the Constitution gives the utility what it needs, our political actors should give the regulators what they need.