Regulatory Resources I: Why Do Differentials Exist?

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... [S]trategies are not something you hope for; strategies are something you work for.

— Peter F. Drucker, *The Daily Drucker*, p. 340 (2004) (emphasis in original)

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Effective regulation aims for excellence. Regulators establish standards, design rewards and penalties, then evaluate and assign consequences. The process should induce continuous improvement in utility performance.

Judging utility performance requires experts in utility performance. New utility responsibilities, like replacing infrastructure, mitigating environmental effects, inducing efficiency, deploying new technologies, all require new forms of regulatory expertise. Expertise requires, in turn, personnel with the training, experience, and support sufficient to set and apply new standards.

Regulation's open secret is that most utilities have more expertise than most commissions. That differential undermines the regulatory purpose, because it leads to deference. Deference reverses the roles of regulator and regulated: The standards, and the pace of improvement, get established by the regulated and accepted by the regulator.

This essay asks three questions: Is there a differential? Why does it exist? Why does it persist? The next essay then asks three more questions: Does the differential make a difference in regulation's quality and credibility? Why does it receive so little political attention? How might we solve the problem?

Is There A Differential?

Why debate it? Does anyone really think that, outside of the largest states, commission staff is the resource equivalent of the utilities they regulate? The differential is everywhere:

Hearing room: The typical utility has a separate witness for each of five to ten major issue areas, with each witness supported by one or more number crunchers and reviewers. Representation is usually by outside counsel with decades of experience, backed by younger associates and inside counsel.

Audits: The utility will bring a separate expert for each cost center, backed by underlings and the outside auditor.

Career paths and mentorships: For each major position within the utility corporation there is a "farm team" of up-and-comers preparing, and being prepared, to take over.

Professional development: After hundreds of speaking engagements at all manner of industry conferences, I can testify that the majority of attendees come from the industry.

Why Does It Exist? Why Does It Persist?

Legislative discretion exceeds commission discretion: The commission's budget comes before the legislature, whose discretion is limited only by politics. The utility's budget comes before the commission, whose discretion is limited by statute and Constitution. So the legislature can line-draw—between spending and cutting, between effective regulation and ineffective regulation—according to its preferences. The utility's expenditure on regulatory resources comes before the commission. At the commission, if the utility's regulatory expenditure is reasonable, the commission must approve it. The utility's expenditure is not unreasonable merely because it is larger than the commission's.

Staffing practices, commissioner terms, and commission workload favor inertia: Staff sizes, job classifications, and salaries have roots in the 1960s and 1970s, when regulatory life was simpler: Rate cases and audits were the norm, consumer advocates and utilities were the lone parties. Regulatory life has grown more complex, but staff infrastructure has not kept pace.

The supermajority of commissioners enters office without utility experience; many stay fewer than four years. Commission chairs are no different. Add the crush of case processing, and it is nearly impossible to acquire the time and mastery necessary to restructure an agency.

Legislatures are more likely to enact mandates than to fund them: State commissions will receive (some have already received) multiple utility requests to approve the construction of nuclear power plants, with total costs in the hundreds of billions of dollars. What state legislature has recognized this reality by authorizing state commission hiring of nuclear construction experts? Similarly, over a dozen state legislatures have directed their utilities to purchase renewable energy in increasing quantities. Meeting these mandates will require physical and economic integration of diverse power sources into an electric transmission system constructed long ago based on different assumptions. What state legislature has backed this mandate with new state commission staff experts in integration?

Contrast this federal example: The Energy Policy Act of 2005 vested in FERC a new reliability role: the duty to review and approve (or disapprove) enforceable standards for the use, ownership, and operation of the nation's bulk power electric system. Congress authorized FERC's hiring hundreds of engineering professionals with reliability expertise. Resources kept pace with requirements.

The political culture tends to favor private expenditure over public expenditure: It happens every election cycle: Politicians promise cuts in public spending, while urging increases in private spending. This culture carries over to utility regulation. If an electric, gas,

telecommunications, or water utility asserts shortages of, respectively, control room operators, safe dig monitors, pole attachment experts, or chemicals testers, no one argues. But if the commission seeks staff to set standards for these same activities, the legislative response is, usually, "Make do." Ironic addition: As I write, multiple commissions are receiving, simultaneously, utility requests for rate increases (increasing company spending), and gubernatorial commands to cut staff (decreasing commission spending).

Utilities and their financial allies do not make regulatory resources a priority: There should be a unity of interests here. Utilities often call for "less regulation." The relevant focus is not on more versus less regulation, but on effective versus ineffective regulation. Less regulation does not help a utility if understaffing, inattention, and overwork lead to regulatory error. Attentive, objective regulation creates clear signals, lowers uncertainty, and rewards high performance. Those results are good for both consumers and investors.

Yet there is no vocal constituency for regulatory resources. Utility management, shareholder associations, bondholder organizations, rating agencies—these groups tend to "rate" commissions based on whether specific commission orders favor specific economic interests, not on whether commissions have the right resources.

The political culture warns against "regulation" and "turf building": In our political culture, we favor regulation when it protects; we disfavor regulation when it obstructs. Regulatory resource seekers bear the burden of proof, while their opponents accuse them of turf building. These factors discourage commissions from trying.