Regulatory Resources II: Do the Differentials Make a Difference?

Scott Hempling
September 2008

The preceding essay argued that "[e]ffective regulation aims for excellence. . . . The process should induce continuous improvement in utility performance." Absent equivalence of expertise and sufficiency of resources, regulators cannot assess performance credibly. Comparing utilities' and commissions' expertise and resources, I asked three questions: Is there a differential? Why does it exist? Why does it persist? The present essay addresses three more questions: Does the differential make a difference? Why does it receive so little attention? How might we solve the problem?

Does the Differential Make a Difference?

Resource differentials undermine regulation's two most important infinitives: to evaluate and to anticipate.

The effective regulator evaluates: Conscientious evaluation requires substantive mastery. Under-resourced regulators can evaluate only what they know. When they don't know, they defer. It's natural, but wrong. An evaluator of performance does not defer to the performer. As a young musician I played many auditions and competitions. No judge deferred to my judgment. I was judged in relation to objective standards and to my competitors. Regulation should proceed similarly.

Some utilities oppose evaluation, including the necessary regulatory resources, on grounds of "the managerial prerogative," i.e., management decisions are the utility's exclusive domain. This reasoning is wrong. The prerogative allows the utility to choose how to perform; the regulator still must assess the choices and the results.

The effective regulator anticipates: Effective regulation aligns private behavior with public interest. Alignment requires anticipation: How might private behavior diverge from public interest, absent regulation? How do we channel that behavior without blunting its positive attributes?

Anticipation involves strategy: a plan of action that accounts for the actions of others. Consider industry structure. Industry structure involves such questions as who sells, what they sell, should we have monopoly or competition, what factors constitute competitiveness. The regulatory process of converting a market from noncompetitive to competitive, and keeping it competitive, requires strategy. A competitive market structure, in theory, aligns private behavior with public interest: The sum of every competitor's self-interested actions yields maximum consumer welfare. So say the textbooks. But theory confronts reality: Every competitor aspires be a monopoly. Regulation must anticipate this tension, between the purpose of competition and the purpose of competitors. Regulation thus requires strategy: It must prepare to act and adjust as players pursue their purposes. And strategy, its development, execution, and assessment, requires resources.

From stimulator to skeptic: Absent sufficient resources to evaluate and anticipate, the regulator can only react. Reactivity's results range from canvasbackery (terminological credit to Peter Bradford; see essay on decisiveness) to skepticism. Skepticism has its own range, from "No" to "Yes, grudgingly." In merger cases, "Yes, grudgingly" sometimes takes the form of "We approve this merger, with conditions." The anticipatory regulator would have articulated, prior to any merger proposal, a vision for market structure, then pursued a strategy to produce that structure. That is a better approach than waiting for a merger application, then saying, "Yes, grudgingly."

Why Does the Resource Differential Receive So Little Attention?

Let's go down the list of players, and ask why they say so little about a problem so obvious (and so readily resolvable). There will be more questions than answers.

Regulators: Do they want to avoid accusations of turf building, or admissions of unpreparedness? Do they see their job as presiding rather than leading, with presiding requiring fewer resources? (See essay, "Commissions Are Not Courts; Regulators Are Not Judges.")

Utilities: Do they treat "regulation" as something to diminish rather than strengthen? Do they equate more regulatory resources with more utility accountability? Do they see regulation as a contest, with regulators being an opponent?

Consumer advocates: Do they see the fiscal equation as zero-sum—the more resources for the regulator, the fewer for the consumer advocate? Do they see the regulator as an opponent? Or as a clerk, stamping "approved" on deals that parties arrange off the record?

The public: The regulatory resource differential is like underground water pipes: The depreciation is known by the experts but unseen by the public. The public sees a stream of official orders, long legal opinions, and procedural formalities. From these indicia of activity, one would not likely infer the overwork and thin-spreadedness endemic to many commissions.

Legislators: "Effective regulation" has no organized political constituency. There is no perceived crisis of effective utility regulation. Budget deficits, school testing results, poverty data, hazardous waste spills: These are the political urgencies that fill the limited time of the overworked state legislator. Crises of confidence in regulation (such as, in the electric industry, the public ire in California, Illinois, Ohio, and Maryland over experiments in retail competition) occur irregularly. And while these occurrences produce new policies (or returns to prior policies), they do not seem to stimulate soul searching on regulatory resources.

How Might We Solve the Problem?

We need an open conversation about these questions: What distinguishes effective regulation from ineffective regulation? What are examples of each? What roles do resources play? For starters, here are five ideas.

1. Match challenges with resources. Implement a systematic, continuous process for (a) identifying regulatory challenges, and (b) determining the professional skills necessary to meet those challenges.

2. View regulatory budgets as investments in utility performance. Successful investments make the economy more efficient, more responsive, more accountable. It does not make sense to limit the IRS auditing budget if the return on the investment is positive. The same goes for regulatory staff.

3. If we add responsibilities, add resources. A staff too small to handle the many rate cases filed cannot also handle the renewables portfolio statute, broadband expansion, investigations of nuclear power, and the proposed leverage buyout of the incumbent electric utility.

4. Eliminate the political distinction between ratepayer dollars and taxpayer dollars. Utility regulatory affairs budgets are paid with ratepayer dollars: tiny relative to total rates, unnoticed, uncomplained about. Regulatory budgets, usually funded by taxpayer dollars, receive multiples more scrutiny and skepticism. This differential does not make sense.

5. Lose the adversarial attitude. Regulation is not a battle, defined by rate-case victories and losses. Regulatory effectiveness assists utility performance, producing satisfied customers, legislators, and owners. Why oppose what benefits everyone?