The Professional and Personal Attributes of Effective Regulators
Scott Hempling

I. Professional Attributes: Purposefulness, Education, Decisiveness, Independence

A. Purposefulness

1. Regulatory statutes require regulators to make decisions "consistent with the public interest." This command presumes that private interests diverge from the public interest. Public regulation is necessary to align private behavior with the public interest.

2. To apply this principle, the purposeful regulator takes five steps:

   a. Define the public interest.

   b. Identify the private interests involved.

   c. Understand how the private interests diverge from the public interest.

   d. Design forms of regulation that align private behavior with public interest.

   e. Evaluate the effectiveness of regulatory intervention, by determining whether (a) alignment actually occurs, and (b) the benefits of that alignment exceed the cost of intervention

3. **What is "the public interest**"?

   a. My definition of "public interest" My definition: "The public interest" is a composite of economic efficiency, sympathetic gradualism and political accountability.

   b. <u>Economic efficiency</u> means biggest bang for the buck. In economic regulation, it means achieving the best feasible benefit-cost ratio. Consider the opposite: An inefficient outcome means someone foregoes something attainable. That is not a public interest outcome.

c. Sympathetic gradualism means smoothing economic efficiency's hard edges. Benefit-cost calculation is sometimes unsympathetic to citizens' short-term situations. Sympathetic gradualism means moderating efficiency's short-term pain, to preserve the public acceptability necessary to long-term gain.

d. Political accountability means that the regulator must create political acceptance of the principles of economic efficiency and sympathetic gradualism. Political accountability does not mean caving in to interest groups. It means educating and explaining, adjusting the angle of change without not compromising the core.

e. The public interest, therefore, is a composite of these three components. It is a composite, and a compromise. It is not a compromise not among private interests -- residential consumers, industrial consumers, competitive providers, incumbent providers, shareholders, bondholders. It is a compromise among the components of the public interest. Understanding this difference between private and public interests is the prerequisite for purposefulness.

4. When do private interests diverge from the public interest?

a. Regulation affects many private interests. Examples:

(1) utility (profit maximization, market share maintenance, market share growth, solid community reputation)

(2) utility CEO (all of the above, plus high salary, career enhancement, job satisfaction)

(3) nonutility competitors (market entry, market share, access to bottlenecks)

(4) consumer (reasonable prices, reliable service, responsive customer relations, community presence)

(5) labor (reasonable wages, job stability, job satisfaction)

(6) environmental organizations (clean environment, utility leadership on environmental issues)

(7) shareholders (growth in company value, share price growth, financial stability, dividends)

(8) bondholders (cash flow, interest coverages, conservative business aims, non-delinquency)

b. The public interest can accommodate these private interests -- in their legitimate form. But private interests can tend toward the illegitimate -- consumers' desire for below-cost power prices and above-average reliability, investor desires for above-market returns and below-market risks, management desires for market domination. Then, the public interest must force alignment.

5. **Where does regulatory purpose come in**?

The effective regulator does not seek "compromises," "balance" or "consensus" among illegitimate private interests. The effective regulator establishes a centrifugal force, one that disciplines private expectations and hems in private behavior. That centrifugal force is the public interest. The purposeful regulator is the one who puts public interest first.

B. Education

Purposefulness is ineffective without education. The educated regulator knows regulation's six subject areas, its six legal sources, its five professions, its three processes and its many local facts.

1. Regulation's six subject areas: What verbs and nouns do we regulate?

Regulation focuses on verb and nouns: Regulated companies performing regulated activities. Statutes identify actions requiring regulation, then establishes the obligations of the actors. The verbs and nouns interact within six subject areas.

a. **Market structure**: Are customers served best -- in terms of efficiency, innovation and accountability -- by a competitive market or a monopoly market? Regulation first selects the market structure, then turns to performance. For monopoly markets, regulation establishes standards for pricing, quality, physical infrastructure, financing and corporate structure. For competitive markets, regulation licenses the entrants, opens access to bottleneck facilities, conditions market-concentrating events (like mergers) and monitors prices for reasonableness.

b. **Pricing:** Regulation aims to link pricing with performance. The first choice is between regulated prices and market prices. Then comes more complexity. For regulated prices: should we base them on average costs (so as to recover the "revenue requirement"), or on marginal costs (so as to induce efficient consumption and production)? For market prices: should we establish prerequisite levels of competitiveness (to protect consumers from "deregulated monopolies"), while guaranteeing some level of customer commitment (to ensure sufficient profit)?

c. **Quality of service:** Regulation establishes performance standards, then translates standards into metrics: calls dropped, frequency and duration of outages experienced, customer complaints serviced, costs levels incurred.

d. **Physical adequacy**: Regulation identifies the physical prerequisites for adequacy, then uses this knowledge to evaluate utility's ability to serve.

e. **Financial structure:** Regulation establishes expectations for financial condition, including the appropriate mix, quality and cost of debt and equity necessary to viability.

f. **Corporate structure:** Mergers, acquisitions, divestitures, product diversification territorial expansion, and interaffiliate transactions -- all affect everything else: market structure, pricing, quality, finance.

2. Regulation's six legal sources: What authority do regulators have?

The law of regulation answers three main questions: What are regulators' powers? What procedures must they follow when exercising using these powers? What are the sellers' and buyers' rights and obligations? The answers emanate from six legal sources: state and federal substantive and administrative law (that's four), and state and federal constitutional provisions.

a. Substantive law establishes (1) the regulator's duties and powers; (2) the sellers' and buyers' obligations, rights and powers; and (3) each player's remedies against the others. Administrative law establishes the procedures for decisionmaking and for resolution of grievances.

b. Five features of federal constitutional law protect parties by limiting regulators' powers. The "dormant" Commerce Clause restricts states' powers to regulate, and discriminate against, interstate commerce. The Contract Clause restricts states' powers to impair existing contracts. The Takings Clause prohibits government regulation which "takes" private property without justly compensating the owner. In utility regulation, this principle prohibits regulators from interfering with "legitimate, investment-based expectations," absent just compensation to the investors. The Supremacy Clause preempts states from enacting or applying state laws inconsistently with Congressional intent. The Due Process Clause requires fair hearing processes.

c. These six sources of law emanate from at least six fora: State legislatures, Congress, state and federal agencies, state and federal courts. And there are other regulatory agencies: land use, environmental, labor, tax and financial regulators, all intersecting with utility regulation.

3. Regulation's five professions: On what expertise does regulation depend?

a. Lawyers advise on the regulator's substantive jurisdiction, duties and authorities; on sellers' and buyers' rights and obligations; and on procedures necessary to lawful decisionmaking.

b. Accountants and finance experts deal with dollars. They apply cost-benefit analysis, recommend proper capital structure, and track costs. Cost-tracking catches cross-subsidies, and helps economists assign costs to cost-causers.

c. Economists aim for economic efficiency, by making cost-causers the cost-bearers. They recommend rate designs, and evaluate investment prudence. Where regulators use market forces to discipline seller behavior, economists measure and monitor competitiveness.

d. Engineers tell us how things work. They evaluate utility performance by identifying best available technology, and by assessing infrastructure adequacy and reliability.

4. Regulation's three processes: What do regulators do?

Regulation involves three main processes: information-gathering, decision-making and enforcement. Each process has variations in formality and finality. Who can prompt these processes? The regulator, legislators, the regulated entities, consumers or other citizens.

5. Regulation's many facts: What are the assets, structures, products and prices for the companies serving my state?

The educated regulator learns the industry-specific and state-specific facts for each of the five subjects addressed by regulation. Which companies are present; what services do they sell at what prices, under what corporate structure and with what market share; what are the relevant performance metrics and how do the utilities rate; what infrastructure exists and what is its capability; what are the financial conditions within each company and across each industry; what agencies have jurisdiction over which players and activities?

C. Decisiveness

"It has been a stereotype of political wisdom that the bureaucrat is ever ready to exercise authority arbitrarily. But there is the far greater danger that the second-rate, insecure personality who often finds his way into bureaucracy will become uncomfortable at having to exercise authority and will anxiously seek to placate as many interests as possible. This fear to offend, complaisance, and readiness to listen and be "fair" and "reasonable" clog the muscles of the will, and what begins in amiability can end in corruption."

L. Jaffe, "The Scandal in TV Licensing," Copyright 1957, by Harper's Magazine, Inc. Quoted in A. Kahn, The Economics of Regulation, Vol. II at 88 n.122 (1988 ed.).

The decisive regulator makes decisions (1) required by the public interest, (2) when the public interest requires it, (3) regardless of discomfort felt, (4) using a logical method and an active approach.

1. "Required by the public interest"

Regulation is docket-driven: rates, mergers, certificates, sitings, approvals, waivers. The public interest is not the sum, median or mean of these private requests. The decisive regulator therefore asks not <u>"What decisions do these parties want?"</u> but <u>"What decisions does the public interest require?"</u> Rather than answering only the questions posed by private parties, she identifies questions no one has asked. She thus converts private pleadings into public interest dockets: investigations, inquiries and rulemakings.

2. "When the public interest requires it"

a. Decision-avoiders speak with savvy: "We have to be cautious." "We don't want to box ourselves in." "Let's not get ahead of the other states." These words do not explain, or excuse, indecisiveness. When I ask commissioners why they have no merger policy, I get one of two answers: "We have no merger pending, so we don't care about it" or "We have a merger pending, so we can't talk about it. Twenty years and three dozen mergers later, regulatory "caution" has produced opportunistic transactions rather than coherent, competitive market structures.

b. Decisiveness is not impulsiveness. Decisiveness includes deciding to inquire: "It has been 10 years since anyone examined the mix of competition and regulation. Every 5 years we should reexamine. Let's begin." Like geological sediments, today's regulatory procedures comprise are layer on layer of historic habit. The decisive regulator questions the status quo. She asks continuously, "Why do we do things the way we do?" and "Why not try another way?"

3. "Regardless of discomfort felt"

a. Discomfort with decisiveness does have honest roots. Most regulators have few years' experience. Even the most experienced face challenges without precedent. For honest regulators, inexperience breeds humility; humility breeds caution; caution, unguided, becomes indecisiveness. In a docket-driven environment, indecisiveness leads to reactivity. Policymaking becomes not the promotion of public interest but the sum of approvals and disapprovals of private interest requests.

b. So what does the inexperienced regulator do? The <u>active</u> decisionmaker directs parties to the Commission's questions, organized according to the five steps. This approach converts private interest applications into public interest inquiries. To avoid bogging down in current filings, she refocuses them on future consequences. She critiques present practices (those of producers, consumers and the regulators), then realigns them with the public interest.

c. The <u>reactive</u> regulator answers the parties' questions, but does not direct the parties to answer her questions. Reactive decisionmaking involves some thoughtfulness, but is bounded by the parties' requests. The five steps toward effective regulation are absent. Consider mergers again. Reactive regulators ask "Is there any harm?" Active regulators ask: "What industry structure most likely will align private behavior with public interest?"

d. The <u>passive</u> regulators accepts parties' requests without independent thought. The indecisive regulator can cover up passivity with wig-and-scepter sentences like "We find that the opponents' speculation does not satisfy their burden of proof." The real burden of public interest promotion belongs with the regulator, not with the opponent.

D. Independence

The fourth attribute of effectiveness is independence. But independence from what? If we are casual with the concept we will not appreciate its power. I will distinguish literal independence (unachievable, undesirable) from effective independence (essential, but hard to achieve).

1. Literal independence

a. <u>Literal independence is unachievable.</u> Court challenges, legislative overrides, financial markets and public ire: These four pressures constrain independence, but they inject accountability.

(1) Court challenge: To avoid judicial reversal, regulators must respect substantive and procedural statutes, root their decisions in the record, reason logically and clearly, and explain departures from precedent.

(2) Legislative override: The commission is a delegatee of the Legislature, never fully independent of it. The breadth of the delegation -- the extent of commission discretion -- depends on legislative trust: trust that the judgment, expertise and speed necessary for regulatory decisions is achieved best by a separate entity. (The breadth of legislative delegation might also reflect the Legislature's desire to distance itself from regulatory decisions. I will address the many facets of Legislature-Commission relations in a future essay.)

(3) Financial markets: Utilities are capital intensive. Capital intensity means capital dependency. The suppliers of debt and equity do not always act rationally, patiently, farsightedly or public-spiritedly, but their confidence in commissions is essential to utility survival. The regulator cannot ignore their demands.

(4) Public ire: The regulatory ideal of pure objectivity, pure merit, pure facts and pure logic does not exist. The section on purposefulness pointed out that the public interest has many components -- health, safety, economic survival, environment, long term interests, short term interests -- many of which conflict with each other. Regulators must maximize the totality of these interests at reasonable cost. Then regulators must defend their decisions before a public whose irritability exceeds its expertise. The possibility of public ire thus induces responsible decisions and clear explanations.

(5) Because these four pressures are unavoidable, literal independence is unachievable. It is unachievable because the regulator is only one of many actors. Courts overturn, legislatures change their laws (e.g., replacing "just and reasonable" with "rates shall be fixed for five years"), lenders lower bond ratings (e.g., because a commission disallows imprudent costs), large customers self-generate (a response to high rates, but resulting in higher rates for the customers left behind). Literal independence is unachievable because the regulator must anticipate these actions.

b. <u>Literal independence is undesirable.</u> No regulator should be independent of forces that make democracy work: legislative mandates, professional accountability, judicial review, administrative procedures, ethical obligations, engineering principles, economic principles, financial realities. A regulator who acts in ignorance of others' reactions becomes a passenger in someone else's airplane.

2. Effective independence

a. Effective independence means independence from forces that reduce accountability, forces that attack the purpose of regulation.

b. What forces, then, block alignment of private behavior with public interest? At minimum, a regulator must be independent of financial or employment inducements (although professional ambition does not undermine independence if that ambition is connected to public interest purpose.).

c. But there is more. A regulator's decisionmaking should be independent of arguments that are unverifiable (e.g., "An authorized return on equity below 14% will cripple us."); or legally irrelevant (e.g., "We need this merger to remain competitive.").

d. Independence is assisted, paradoxically, by attentiveness to the forces that undermine independence. The saying -- "Keep your friends close and your enemies closer" -- applies here. Attentiveness does not mean selling out; it means studying and monitoring the parties' motivations, so as to spot and exploit opportunities to align those motivations with the regulatory purpose.

e. Independence does not mean independence from one's own pre-existing views. A hunch is not a bias. A bias is an inability or unwillingness to examine facts and reason objectively. A hunch is tentative conclusion, based on education, observation and experience. No practitioner wants a regulatory bench who says "my mind is a complete blank." The regulatory mind is not blank; it is full of experiences, prior readings, stray facts diligently and casually acquired. These experiences, readings and facts produce hunches. Hunches are unavoidable and useful -- as long as the regulator establishes a systematic, objective method for testing them, on the record.

II. Personal Attributes: Disciplined, Synthesizing, Creative, Respectful, Ethical[1]

A. The disciplined regulator

1. Regulation is its own discipline. What distinguishes regulation from a series of facts about engineering, economics, accounting, finance, law and management; from the subject matters of electricity, gas, telecommunications and water?

2. The discipline of regulation is not merely the sum of these other disciplines. Regulation has a distinct purpose: to induce high quality performance from entities that, absent regulation, would perform suboptimally. The discipline of regulation requires mastery of the motivations and forces that cause this diversion of private performance from public interest. These diversions call for regulation but also define its proper boundaries, because private behavior aligned with public good needs no regulator.

3. The disciplined regulator therefore focuses on forces that undermine optimality. Sales can increase profits but cause environmental costs. Acquisitiveness can increase scale economies but weaken competitive markets. Technology can excite innovation but distract from the mundane, like wifi distracts kids from reading books.

4. Disciplined regulators focus on performance: aligning the behaviors and performances of actors and assets with the public service obligation. Mastering the discipline of regulation requires asking the right questions. The right questions are not "Are you for or against decoupling?" or "How do you feel about smart grid?" or "Should we approve this merger?" The right questions are: "What actions must the utility take to carry out its general obligation to serve the public at reasonable cost?" and "What actions must regulators take to induce those actions and compensate appropriately?"

[1] These five personal attributes are drawn from Howard Gardner, *Five Minds for the Future* (2008).

B. The synthesizing regulator

> "I have been through this wringer. Synthesizing massive amounts of data, intelligence, slants, opinions, tactics, and trying to maintain a strategic big picture was a challenge. You feel it creeping up into your brain like a numbing cold and you just have to choke it down, sift faster, and stay with it. [It's] challenging to be sure, but if you practice it, you develop a good tool for the leadership toolbox."
>
> Navy Captain Richard Severs, quoted in Howard Gardner, *Five Minds for the Future* (2008) at pp.46-47.

1. Regulators face the same wringer. Multiple industries (electricity, gas, telecommunications, water, ferries, taxis, even grain elevators in South Dakota), multiple cases (each one dumping a paper pile high enough for the pole vault), multiple disciplines (engineering, law, economics, finance, accounting, management), multiple policy goals (reliability, cost-effectiveness, environmental responsiveness, affordability), multiple pressures (shareholders, bondholders, employees, consumers legislators, staff). Like Captain Severs, regulators have to "choke it down, sift faster, and stay with it." Success, it seems, requires the ability to synthesize.

2. "Perhaps the most ambitious form of synthesis occurs in multidisciplinary work," Gardner writes at 47. I look up to lawyers who can talk capital structure with the economists, economists who can talk transmission with the engineers, financial analysts who write with the clarity of Ernest Hemingway. Regulatory organizations too must replicate this cross-cultural literacy. The best regulatory orders result not from stapling together each department's reports, but from the professional toothbrush-sharing that occurs when different disciplines literally live in each other's dormitories.

C. The creative regulator

1. Gardner says: "[C]reativity is never simply the achievement of a lone individual or even a small group. Rather, creativity is the occasional emergent from the interaction of three autonomous elements."

2. "The *individual* who has mastered some discipline or domain of practice and is steadily issuing variations in that domain. ..."

   Most utility commissioners do take office before having mastered the discipline of regulation. We can make that reality a weakness or a strength. It's a weakness if we disable their creative potential, by discouraging their ideas or by making mastery unnecessarily difficult. It's a strength if we (a) view the new appointee as unhampered by old habits, as already "disciplined" about the important things (like establishing clear missions, fostering openness, living with gradualism); and, then (b) pair that person with individuals who have mastered regulation but who also crave creativity. Pairing creativity with mastery can produce the "steadily issuing variations" that Gardner describes.

3. "The cultural *domain* in which an individual is working, with its models, prescriptions, and proscriptions. ..."

   At least four factors can impede creativity. (1) If the dominant voices in regulatory proceedings are not objective experts but competing interests, it is hard to maintain the clearheadedness, the unpressured mental balance, necessary for creativity. (2) If the ratio of work to workers, and of deadlines to days available, is unfavorable, creativity becomes more luxury than necessity. (3) Asymmetry of knowledge and expertise between regulator and regulated can cause commissions to avoid options with unclear consequences. (4) The inflexibility of civil service rules can slow efforts to re-align staff skill sets with the new regulatory challenges. (5) Finally, creativity often results in failure. Gardner 83. Does our regulatory culture accommodate experiments and failures; or, does the risk of judicial or legislative reversal cause commissions to avoid creativity?

4. "The social *field* -- those individuals and institutions that provide access to relevant educational experiences as well as opportunities to perform."

5. The access-providers, Gardner asserts, should see themselves as incubators of creativity, responsible for attracting and exposing new ideas, for giving the spotlight to risk-takers. Look for the most knowledgeable people; they are not always the most prominent people. The control room operator who watches the power plants ramp up and down as the system's wind generators ramp down and up can explain the challenges of intermittency better than the utility spokesperson whose position can be mistaken for opposition.

6. Look for people unaffiliated with entities having business before commissions. Among the best speakers I've observed were professors, employees of the DOE-funded national labs, researchers from consulting

firms with client bases so diverse that their independence is unquestionable.

D. The respectful regulator

1. Gardner: "The insights from sociobiology and evolutionary psychology are genuine. No doubt human beings have deeply entrenched inclinations to delineate groups, to identify with and value members of their own group, and to adopt a cautious if not antagonistic tone to other comparable groups, however defined and constituted. But such biologically accented explanations have limitations... [E]ven if biological bases can be found for dichotomization, stereotypy, or prejudice, human beings in every generation must attempt to deal with these proclivities and, when possible, to mute or overcome them."

2. I have seen inter-party disrespect from my earliest days in regulation. It was not a pretty sight.

   a. Nuclear power opponents in the 1970s and 1980s were labeled "tree-huggers," anti-growth, anti-jobs.

   b. Independent co-generators in the 1980s and 1990s were derided as "fly-by-nighters" and "PURPA machines," certain to shut down at the first hint of high winds.

   c. For several decades prior to FERC's landmark Order No. 888, proponents of transmission access -- mostly small municipal utilities -- were caricatured as opportunistic cream-skimmers insensitive to reliability.

   Then there's Hush-a-Phone. In a subsection entitled "Alien Attachments, Alfred Kahn's *The Economics of Regulation* recounts the Bell Companies' opposition to this cup-shaped device which, when snapped on to the phone, gave the speaker privacy and reduced room noises). Hush-a-Phone typified what Bell called, in 1955, "foreign attachments which are marketed by persons who are have no responsibility for the quality of telephone service but are primarily interested in exploiting their products." (FCC granted Bell's request to ban Hush-a-Phone; it "impair[ed] telephone service" because "the person to whom the Hush-a-Phone user is speaking hears a lower and somewhat distorted sound.")

   In these situations, disrespect depends on demonization: a technique comprising oversimplification, exaggeration and hyperbole, while attaching moral significance to a policy difference. The goal is not merely to win but to vanquish: to persuade decisionmakers that the winner is the sole source of truth, that denying the opponent's existence would make the world a better place.

Disrespect's antidote: Openmindedness, knowledge, achievement.

E. The ethical regulator

1. Paradoxically, we can define ethics in terms of self-interest. Gardner asks: "In what kind of a world would we like to live if we knew neither our standing nor our resources in advance?" His answer: "I would like to live in a world characterized by 'good work': work that is excellent, ethical, and engaging."

2. Can these thoughts help us solve regulatory problems? Any number of regulatory challenges involve tensions between narrow self-interest and broad ethics. Self-interest has multiple versions: my company, my union, my state, my technology, my agency, my customers, my generation. Addressing these tensions, we can always behave ethically, in the narrow sense, by avoiding bribes, ex parte contacts and conflicts of interest. But what would a broader ethical view require? Two common challenges follow.

3. What if it's "not my department"?

   At a Canadian conference, I took a question from an eloquent advocate for low-income consumers. She urged regulators to address high prices. My inadequate response follows:

   > "It is painful to say this to someone devoting her career to a cause I care about. But it is not regulator's job to make service affordable. The regulator's job is to get prices right: not low, not high, just right. If that right price hurts the poor, it is a legislative problem. Legislators should not shift their own public interest obligations to regulators."

4. The questioner thanked for my "candor" but it was clear I'd committed the error of "it's not my department." I do maintain, as a regulatory professional, that economic regulators should focus on utility performance and infrastructure sufficiency, not on wealth redistribution. And they should not lower prices below economically efficient levels. But the better answer -- the more ethical answer -- would have been this: "Regulators are in the best position to know whether price increases are imminent and

painful to the poor. They then should use that expertise to engage the appropriate branches of government; to argue that the credibility of utility regulation is linked to the credibility of all government action, and that a government that fails its poor -- or picks short-cut solutions like artificially low prices -- benefits no one."

5. The ethical answer is not to hide behind professional boundaries, but to use one's professional expertise to cross boundaries and stimulate solutions.