Regulator, Restructure Thyself

Presentation to the Harvard Electricity Policy Group

by Peter A. Bradford

Dallas, January 25, 1996

I was first offered a commissionership in Maine in 1971. Being 29 years old, I had some doubts and sought the advice of an economics professor who had specialized in the field.

"How long will it take me to learn the basics?" I asked.

"About a week, if you want to do it better than its being done now," he answered. "But if you want to do it well, it will take a long time."

He directed me to Bonbright and to Phillips, each much shorter than they are today. Fred Kahn's The Economics of Regulation hadn't been published yet.

Regulation twenty-five years ago consisted largely of applying the basic equations to proposed rate decreases and to rates designed to promote consumption. Nuclear controversy, thirty-dollar-per-barrel oil, energy efficiency, PURPA, telephone competition - to say nothing of divestiture were still years in the future, as of course was restructuring.

Certainly regulation adapts, usually under the impetus of substantial discontent relayed through legislative, elective and appointive processes. Today's circumstances pose the greatest of challenges, at least at the state level. Both telephone and gas deregulation were imposed by forces beyond the states - Judge Green in one case, FERC in the other. This time the regulators are trying to redefine their own mission, but as Charles Stalon wrote several years ago,

> "Economic regulation, which at first glance seems to be a fragile structure founded on the sands of economic mythology, turns out on closer inspection, to be a steel structure founded on the concrete of self-interest and tradition and guyed against all winds. Much of what regulators do can truly be called "nonsense on stilts," but the stilits will not fall without strong, persistent and well directed efforts by the regulators."[1]

---

[1]Charles G. Stalon, "A Federal Perspective on Bidding and Other Federal Reforms" in Alternatives to Traditional Regulation: Options for Reform, 1987 MSU Public Utilities Papers, ed.Harry Trebing and Patrick Mann, pp.3-16, at 12.

Since its inception at the turn of the century, utility regulation has operated on two levels: the textbook model and the smokescreen. On the textbook level, it has functioned as a surrogate for competition, bridling impulses toward consumer abuse that inevitably crept into monopolies whose only need to compete was for investor capital. On the smokescreen level, it has functioned quite differently, acting as a legitimizer of monopoly behaviors that the public, in the absence of governmental approval, would never accept. This latter role was explained at the outset by attorney Richard Olney, President Cleveland's Attorney General, in his memorable 1892 defense of regulation to utility executives:

> "...The Commission.....is, or can be made, of great use to the railroads. It satisfies the popular demand for government supervision of railroads, at the same time that supervision is almost entirely nominal. Further, the older such a commission gets to be, the more inclined it will be found to take the business and railroad view of things. It thus becomes a sort of barrier between the railroad corporations and the people and a sort of protection against hasty and crude legislation hostile to railroad interests....The part of wisdom is not to destroy the Commission but to utilize it."[2]

Over the past quarter century, both of these irreconcilable regulatory approaches have been yoked in uncomfortable harness on state and federal regulatory commissions and staffs. The onset of competition will heighten the tensions between them as the public comes to demand a different type of regulatory performance in a world in which customer preference supplants commissioner preference as the star by which utility executives must steer.

While some will argue that present circumstances already justify substantial cutbacks in regulation, a convincing case can be made for more, not less regulatory scrutiny in the transitional period. This increased level of regulatory effort will require skills and techniques different from those emphasized in the past. To acquire these, commissions are going to need to

---

[2]The Olney letter is quoted in Robert Engler, The Politics of Oil (Chicago, University of Chicago Press, 1961), pp 323-4. The Interstate Commerce Commission evolved as Olney foresaw and was abolished a century later, long past the time when competition in the transportation industries had left it with nothing useful to do.

review not only utility activity but also their own mission, practices and personnel to assure that all are well-suited to the challenges that lie ahead.

Incremental changes over the last twenty years have brought most state commissions a long way from the traditional rate case. Some functions – primarily transportation – have been moved or dropped. Others, such as integrated resource planning, demand-side management program evaluation, environmental impact analysis and avoided-cost projection, have been tacked on. Overall, the legal role has diminished somewhat, while the role of analysis – particularly economic analysis – has advanced.

In the next few years, these trends seem certain to accelerate, with this acceleration expanding, not contracting the role of the commission. Commissions will be expected to function as architects and enforcers of competition, as designers of performance-based regulation and as protectors of consumers during a turbulent transition. At the same time, the public will continue to expect protections from environmental degradation and monopoly abuse. Indeed, one of the greatest threats to competition and deregulation seems likely to come from indignation and backlash that have already accompanied the creation either of a deregulated monopoly (such as cable television in the 1980s or small market airlines) or of windfall profits and excessive executive monetary self-congratulation (such as has recently occurred in Great Britain).

To adapt to this changing mission, commissions must also review the mixture of regulatory techniques they employ. Both in rate cases and in broader rulemakings, adjudicatory and other formal models are being replaced (or at least being extensively supplemented) by negotiating formats. Public participation is also being redefined away from the somewhat intimidating and unproductive formal hearings and toward more effective techniques for two-way communication.

To try to keep a step ahead of these changes, the New York Public Service Commission undertook an extensive self-assessment in the early 1990s. Working with an outside consultant

and the state Budget Office, the Commission reviewed all aspects of its mission and its functioning.

Many of the findings from this exercise are applicable to most regulatory agencies. Particular problem areas identified included:

The reactive nature of most regulation. The regulatory agenda and resource allocation tended to be shaped by the cases filed by outside parties rather than by the Commission itself. This is a serious drawback for an agency seeking to set policy in a forward-looking fashion.

The development of specialized fiefdoms within the agency. Historic failures of organization and communication impeded a melding of staff divisions into effective teams with common priorities. Lessons and insights from one field were not transferring well to others.

A continuing sense of overwork. The tyranny of the overflowing inbox was a deterrent to innovative regulation and to management improvements.

Discontent with perceived political influences on agency decisions. This concern centered specifically on relationships between the Governor's office and the Commission, but it also reflected a broader concern over ex parte communication.

Tensions between the concept of an independent trial staff and coherent agency management. Any reduction of the historic the trial staff independence from the commission enhanced the ability of management to assure that agency priorities are reflected in staff approaches to particular cases. This was a problem for trial staff for obvious reasons, but it also caused other parties to wonder whether two-way

communication was occurring. On the other hand, some parties welcomed increased assurance that the trial staff was not out of touch with commission thinking.

Training needs not given priority. The Commission had stressed and rewarded technical skills in its dealings with staff..Consequently, technical and casework priorities usurped the time and resources needed to develop managerial skills and training programs.

Failures of communication. Staff at many levels did not have a clear understanding of commission priorities or of the priorities of other divisions. Furthermore many staff members felt that felt that their concerns and knowledge were not being adequately conveyed to the commission.

As a result of this organizational assessment, extensive changes were made. The agency developed a mission statement (attachment A). It embarked upon a strategic planning process to develop priorities in light of its mission and to harmonize the schedules among those priorities for both workload assignment and budget preparation. Early examples of priorities include expanding competition in telecommunications, furthering performance-based regulation and improving the processes of public involvement.

Some divisions were consolidated to increase coordination, and management techniques to support coordination were developed. Mechanisms to improve communication both horizontally and vertically throughout the agency included better use of agency newsletters, expanded use of e-mail and other electronic information sharing and better accessibility of the Commission to the rest of the agency. New opportunities for training in both management and technical skills were created. Two of the seven commissionerships were eliminated, a small but symbolically significant downsizing, whose controversiality helped to stress to both staff and utilities that the Commission recognized an obligation to face up to the change imperatives that it was imposing on others.

Finally, the Commission realized that self assessment should not be an occasional, cataclysmic process but should continue as an ongoing function. The necessary human resource positions and structure were established accordingly.

The changes required by this assessment did not come easily, and they are not a panacea. However, a major lesson from this exercise is that no commission can expect to preside credibly over processes that require widespread dislocation and discomfort throughout all aspects of the utility industry without examining its own functioning as well.

This type of commission reorientation – especially in states with rates well above both marginal costs and national averages – will require approaches not used in the traditional rate cases. Proceedings in New York covered a comprehensive set of issues including the structure of the utility industry, the burdens imposed by state and local taxation, environmental impacts, economic development and the nature of effective electric utility competition. A traditional regulatory agency, using traditional rate-case procedures cannot hope to explore and find solutions to the full range of these concerns.

The traditional rate case was designed to resolve differences of opinion between the utility and its various classes of customers as to prices and the allocation of costs, with some attention also given to minimizing environmental impacts. Parties might disagree about many issues, but they agreed on the fundamental purpose of the proceeding.

The types of cases regulators face today do not enjoy such underlying agreement. Some participants join the proceeding primarily to gain information about the utility and its customers. Others may participate to influence not the prices that the utilities charge but the prices they pay to their suppliers. Some parties take part delay the process by keeping any conclusion from being reached for a substantial period of time.

Conducting these proceedings requires expanded regulatory skills. Traditional accounting functions must be beefed up with skills to assess and promote competitive markets. Traditional legal and adjudicatory skills must now blend with skills in mediation, negotiation and facilitation. As Dr. Stalon observed as long ago as 1988

> "Attempts to introduce competition into a formerly regulated area require changes that are difficult....Skills needed, but not customarily present are those commonly found in antitrust agencies.....These skills are those of distinguishing between constructive and nonconstructive forms of competition, those that relate industry structure to industry performance, and those that emphasize and predict not only the direct but also the indirect consequences of agency decisions. Such persons are few."

Mechanisms for earlier commissioner input are necessary. The process cannot function well if the parties labor for months and years to produce a consensus that the commission substantially rejects in the end. Within the commission, the traditionally strong line organizations – historically prized for their mastery of technical subject matter and their ability to provide advice thereon – must give way to more complex matrix management relationships in which the work of employees may be evaluated in part by supervisors who are not in their division at all. This change will alter promotion and resource control decisions as well. Also essential is the ability to work cooperatively with other state agencies in the environmental, economic development, taxation and legislative spheres.

The concept of public involvement is also in a state of flux. The experience with telephone deregulation makes clear that the consumer protection function of utility regulation does not cease quickly. Customer expectations are diverse and often inconsistent. Many people still rent their telephones from AT&T even though they could buy them for less than a year's rental. At the other extreme are customers eager to make aggressive and sophisticated choices among energy vendors.

The traditional public hearing, at which a parade of witnesses makes five-minute presentations to the commission or an administrative law judge, does not begin to allow for an effective interaction between the commission and the public. In New York, the Consumer Services Division pioneered a number of innovative, two-way approaches. These included focus groups, roundtables and even the use of closed-circuit televised meetings. The theory behind many of these gatherings was to get the groups concerned about directions in utility regulation talking not just to the commission but to each other to come up with more creative and comprehensive solutions. Whether focussed on a particular rate proceeding or on broader generic topics, these forums provided a much more productive opportunity for the public, the commission and the commission staff to interact.

Through all this, the requirements of procedural due process of law must still be met. Hearings must be made available to any party who seeks to present arguments to the commission in favor of outcomes different from those agreed upon through other processes. However, the scope and contentiousness of such hearings are likely to be substantially reduced if procedures that foster discussions among different viewpoints are instituted.

Finally, the success of performance-based regulation also requires the application of these new techniques. The development of performance yardsticks requires not only new regulatory skills but also new types of public input as well, especially in the area of service quality standards. Service quality standards are also important for utility workers. They are the best safeguard against a utility attempting to cut its workforce as it prepares for competition.

The Washington Post editorialized not long ago that competition "doesn't mean deregulation. To the contrary, it means more work for the regulators. It's up to them to see that competition is genuine and produces the promised benefits without weakening any part of a system on which the country's life and livelihood depend."[3] This perspective is the other side of

---

3.Washington Post editorial, May 3, 1994

Attorney General Olney's embarrassing words at the front of this essay. The mission of midwifing constructive competition into the electric power industry is as crucial as any ever faced by the regulatory community. It should be approached in that spirit.

Mission Statement
of the
New York State Department of Public Service

Our purpose is to ensure that all New Yorkers have access to reliable and reasonably priced utility services provided safely, cleanly and efficiently.

We seek to excel in all aspects of this mission. We will be fair, expeditious and responsive to public concerns and to individual consumers.

We seek to stimulate excellence in New York utility operations. We intend the profitability of New York utilities to reflect their efficiency, their responsiveness to their customers and to the environment, and the reasonable expectations of their investors.

Within the Department we value commitment, competence, creativity, diversity, independence, integrity and teamwork, as well as mutual respect and opportunity for training and advancement to each employee's fullest capability.