

**California Public Utilities Commission
Forum on Governance, Management, and Safety Culture
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To Improve Utility Performance, Fix the Culture of Entitlement

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"Public services are never better performed than when their reward comes in consequence of their being performed, and is proportioned to the diligence employed in performing them."

Adam Smith, *The Wealth of Nations*²

Public services, performance, and consequences. To improve utility performance, we need the best performers. To get those performers, we must identify the public services we want, define the level of performance we want, attract the best talent and assign the right consequences. Carrying out these steps in California today requires us to address three questions:

1. Monopoly franchise and “too-big-to-fail”: Have we created a culture of entitlement?
2. Taking action: What near-term actions will best signal, to PG&E and its potential successors, the Commission’s insistence on performance?
3. Ending the entitlement culture: How might we explore alternatives to PG&E?

I commend the Commission for creating these panels to explore large ideas. There may be pressure for immediate action, but there are no quick fixes. Because our problems have deep roots, we must aim at the roots.

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² At Book V, Chapter 1, Part II, para. b20.

I. Monopoly franchises and “too big to fail”: Have we created a culture of entitlement?

Our efforts to fix our utilities’ performance must start from two premises.

First: No amount or type of "incentives" can fix a company infected by a culture of entitlement. We have granted our utilities monopoly franchises noncompetitively, for reasons no one remembers. Decades go by, performance slips, and no one reassesses the franchise grant. The natural result? A culture of entitlement—the utility’s entitlement to remain the monopoly franchise, indefinitely, no matter how many rules it breaks,³ no matter how much anticompetitive conduct it carries out,⁴ no matter how many felonies it commits.⁵

Second: In regulation as in life, one can act from a position of strength only if one has alternatives. When we treat our utility as "too big to fail," we act as if we have no alternatives. But as I will explain, "too big to fail" is a falsity because no utility is irreplaceable.

Combine a culture of entitlement with a too-big-to-fail premise, and we get three predictable results:

Dulled motivation: Competitive markets induce performance because the seller's choice is stark: Please the customer or lose the customer. A monopoly utility can't lose the customer, so to induce performance we need consequences. But by never questioning the franchise, and by softening penalties to save the company, we dilute the consequences. Diluting the consequences dulls the inducement and corrodes the culture.

Subsidized inefficiency: Diluting the consequences also violates regulation's first principle: Cost-causers must be the cost-bearers. If the utility doesn't bear its costs, someone else does. When a pipeline explodes, taxpayers fund the first responders, insurance premium-payers fund the hospitals. Costs rise for all.

³ See CPUC Press Release of Sept. 18, 2008 (describing Commission-imposed fine on Southern California Edison in Docket No. I.06-06-014 for violating reporting rules on performance-based ratemaking).

⁴ See *SCE Corp., Southern Calif. Edison and San Diego Gas and Elect. Co.*, Decision 91-05-028, 122 P.U.R.4th 225, 258 (Calif. PUC May 8, 1991) (describing Southern California Edison’s historical practice of “us[ing] its transmission dominance to undercut [municipalities’] efforts to lower costs to their retail customers”; and using its “strategic control over transmission to the competitive disadvantage of other utilities”).

⁵ See “PG&E Guilty of 6 Felony Charges in San Bruno Pipeline Explosion,” <https://thomasjhenrylaw.com/blog/premises-liability/pge-guilty-6-felony-charges-san-bruno-pipeline-explosion/>.

Distorted competition: "[R]escues in times of crisis can give large financial players an unfair advantage: They can borrow cheaply in normal times, because everyone knows that they are 'too big to fail' and will be bailed out if things go wrong."⁶ If we giving incumbent utilities cost-of-capital advantages, prospective competitors will go away, making too-big-to-fail a self-fulfilling prophecy. Some say that more "supportive" regulation will lower the cost of capital. They miss this point completely. Giving artificial support to an inefficient incumbent raises costs, because it deprives us of efficiencies available from others.

II. What near-term actions will best signal, to PG&E and its potential successors, the Commission's insistence on performance?

A. Define the safety obligations of a prudent utility

"What gets measured, improves."⁷ What should we measure? What we should measure is outcomes. But outcomes require inputs, and inputs drive costs, so we also need to address inputs. If we isolate one goal from another we ignore the tradeoffs. So we need to define inputs and outcomes comprehensively, to "[a]void a band-aid approach."⁸

At bottom, we need to define prudent performance: by making best practices mandatory practices. Compliance reasonable compensation; non-compliance gets penalties and disallowances. That is true "performance-based regulation." Those are the basics. Here are some of the detailed questions to address:

If the Commission orders an action, is the utility relieved of responsibility for the results? Not necessarily. A mandatory action can be a minimum action—necessary for a finding of prudence but not sufficient.

By what criteria should the Commission decide when to order actions and when instead to require results, leaving actions to the utility's discretion?

⁶ Paul Krugman, "Obama's Other Success: Dodd-Frank Financial Reform Is Working," *The New York Times* (Aug. 3, 2014).

⁷ Attributed to Peter Drucker, author of *The Effective Executive* among other books.

⁸ Governor Newsom's Strike Force, *Wildfires and Climate Change: California's Energy Future* at 4.

What should be the consequence of a utility taking the mandatory actions: protection from any imprudence finding; or only assurance of recovering the reasonable costs of taking the action?

B. Order internal fixes to PG&E's accountability problem

The Commission should explore requiring PG&E to take the following actions:

1. Identify all situations involving a conflict between profit and safety. The new PG&E CEO's compensation is based on a combination of safety and profitability. When self-administered, those two goals are in direct conflict, because a dollar cut from safety is a dollar added to profit. More fundamentally: No one should need a personal financial incentive to do the right thing. What should depend on his safety record is not his compensation but his job.

2. Each PG&E Board member receives over \$200,000 annually for part-time work.⁹ PG&E should specify what each Board member is responsible for achieving in the next 12 months, and how the full Board will hold that member accountable for those achievements.

3. Consider whether the Board membership should include a union representative, who can assure that executives do not compromise worker safety for earnings.

C. Strengthen the state's safety oversight

The Commission should explore these options:

1. Ensure that the Commission's technical safety staff has expertise and compensation at least comparable to their utility counterparts.

2. Empower the Commission's technical staff to impose penalties, subject to review.

3. Order the utility to contract out the safety function, to an entity chosen by the Commission and paid for by the shareholders.

4. Require on-site safety monitoring by a Commission-appointed, independent entity, funded by the shareholders but accountable only to the Commission.

D. Cease "encouraging" companies with "incentives"

When we convert discretion into obligation, the need for "incentives" disappears. Much of "performance-based ratemaking" misses this point. And it fails—with the utility "drifting to failure" (Prof. David Hoffman, Apr. 15 Forum). Why? Four main reasons.

⁹ PG&E Corp, *Notice of 2018 Annual Meetings, Proxy Statement* at 30 (Apr. 10, 2018).

Compensation divorced from performance: The typical performance-based rate proposal does not align the utility's total compensation with total performance because it does not define total performance. Instead it offers supra-normal returns for merely prudent performance. That's the definition of monopoly rent.

Rewards for cost-cutting: Performance-based rate plans often reward cost-cutting, because the revenue stays constant while the costs decline. But cost-cutting is no proxy for performance. The "incentive" is to favor short-term cost cuts over investments in long-term performance.

Rewards for committing fraud: Combine earnings incentive with self-reporting, and you get incentive to mis-report. Between 1997 and 2003, to gain PBR awards Southern California Edison's "employees and management manipulated and submitted false customer satisfaction data," and submitted "false and misleading health and safety data."¹⁰

Worker-reward gap: What enhances performance are people who work at jobs, not people who wait for dividends. But performance-based rate plans increase earnings for dividend-collectors rather than salaries for benefit-creators. To reward shareholders for employees' performance assumes that executives won't press for performance unless there's money in it for shareholders. Executives with that attitude don't belong at a public utility.

Some argue that "incentives" are necessary to overcome utility "resistance." That's not win-win; it's lose-lose. Efficiencies lose and customers lose. Trying to "incentivize" someone who can't perform, won't perform, feels entitled not to perform, or who has a long history of not performing—that's the definition of insanity: repeating the same mistakes and expecting different results. Those who say "we can't force the utility to take action" are wrong legally and logically. The purpose of regulation is performance. Commissions exist to cause performance. Issue orders, compensate only if there is compliance. Less incentivizing, more ordering.

E. Assign financial consequences fully, because no utility is "too big to fail"

Behavioral psychologists have proven, repeatedly, that people are more inclined to avoid losses than to seek gains. Because "[l]osses hurt about twice as much as gains make you feel good," loss aversion "has become the single most powerful tool in the behavioral economist's arsenal."¹¹ And it should become a powerful tool in the regulator's arsenal. If the utility misses an operational target it should miss an earnings target.

¹⁰ See CPUC Press Release of Sept. 18, 2008 (describing fine of \$146 million in Docket No. I.06-06-014).

¹¹ Richard Thaler, *Misbehaving: The Making of Behavioral Economics* 34 (2015).

Some want to weaken consequences because the utility is “too big to fail.” They conflate our need for utility service with a need for this utility’s service. They are wrong, twice.

Wrong on legal grounds: Regulators have no constitutional duty to guarantee a utility's financial success, or even its viability. Courts and commissions have said as much, multiple times, for over a century.¹² And to the extent California statutes require the Commission to soften penalties to save the company, they undermine regulation’s core purpose: to produce the performance that competitive markets would produce. The Commission should seek changes to statutes that place an incumbent utility's financial health ahead of its prudence responsibility.

Wrong on practical grounds. A utility is not a "systemic" bank whose failure could bring down the economy. A bank's value is its assets. Its assets are financial. When its money disappears, the assets are gone. A utility is different. Its finances may fail, but its assets—its generators, its transmission network, its distribution system, its wholesale contracts—all survive. And its employees and customers will survive. So the power can flow and the funds can flow. A successor can replace the incumbent, take over the assets, hire the employees, service the contracts, and supply the customers. PG&E is neither indispensable nor irreplaceable.

III. Ending the culture of entitlement: By what steps can we explore replacing PG&E?

Regulating without alternatives is regulating from weakness. Our main source of weakness is our assumption that a utility’s monopoly franchise is a permanent franchise. It is not. The franchise is a privilege granted by the government; it is not an asset owned by the utility.¹³ Franchise permanence is a policy choice; it is not a necessity. And its roots lie in inertia rather than alertness. Other nations do things differently. (See Appendix on the European Union and the nation of Vanuatu.) Instead of permanently entrenching the incumbents, we

¹² See, e.g., *Covington & Lexington Tpk. Rd. Co. v. Sandford*, 164 U.S. 578, 596-97 (1896) ("If a corporation cannot maintain such a highway and earn dividends for stockholders, it is a misfortune for it and them which the Constitution does not require to be remedied by imposing unjust burdens on the public."); *Market St. Ry. Co. v. R.R. Comm'n of Cal.*, 324 U.S. 548, 567 (1945) ("The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or restore values that have been lost by the operation of economic forces.").

¹³ See *New Orleans Gas Co. v. Louisiana. Light Co.*, 115 U.S. 650, 669 (1885) (franchise “belong[s] to the government, to be granted, for the accomplishment of public objects, to whomsoever, and upon what terms it pleases”); *Bank of Augusta v. Earle*, 38 U.S. (13 Pet.) 519, 595 (1839) (franchises are “special privileges conferred by government upon individuals, and which do not belong to the citizens of the country generally of common right”).

should open our doors to all ownership forms, including investor-owned, state government-owned, and municipal government-owned.¹⁴

To identify and attract alternatives to PG&E, we need to take these steps: (a) identify the services customers need, (b) determine which of those services are monopoly services and which are potentially competitive services, (c) describe the company characteristics that produce the best performance, then (d) start the process of attracting and selecting the best.

A. What services do customers need? Which are monopoly services and which are potentially competitive?

No longer is electricity a mere commodity, electrons traveling over wires. Electricity is a service taking multiple forms: generation, transmission, distribution, demand aggregation, conservation services, microgrids, storage, electric vehicle charging stations. These different services can be provided by different providers: vertically integrated monopolies, organized wholesale markets, retail competition, rural cooperatives, municipal power systems, community choice aggregators, consumers themselves. With so many possible services and service providers, electric policy needs to serve multiple purposes: ensuring safety, reducing emissions, improving power quality, and maintaining reliability. We cannot achieve all these goals simultaneously, because some constrain others. So the industry's regulators must decide: What mix of goals and services best serves the state's total needs?

Once we know what services we want, we need to decide what quality we want. Some want "first quartile" performance, others are fine with third. Some want 100% reliability, others will accept outages to lower their cost. But to the extent physics makes electric service a common good, there can be only one standard. So regulators need to choose that standard—necessarily a political judgment rooted in benefit-cost analysis.

The legendary economist and regulator Alfred Kahn wrote: The "continuing responsibility of legislators and regulators is to find the best possible mix of inevitably imperfect competition and inevitably imperfect regulation."¹⁵ So we next need to ask: Of the services we want, which services are natural monopoly services requiring a monopoly providers,¹⁶ and which are potentially competitive services that can be provided by competitive companies?

¹⁴ See Strike Force, *supra* at 4 (emphasizing that "no options can be taken off the table").

¹⁵ A. Kahn, *The Economics of Regulation: Principles and Institutions*, Vol. I, Introduction at xxxvii; Volume II at 114 (1970; 1988 edition).

¹⁶ A natural monopoly service has two characteristics: (1) a subadditive cost function, *i.e.*, its per-unit cost declines as output increases; and (2) the decline continues for the entire quantity of the defined market. "The term [natural monopoly] does not refer to the actual number of sellers in a market but to the relationship between demand and the technology of supply. If the entire demand within a relevant market can be satisfied at lowest cost by one firm

B. What characteristics should providers have, and not have?

Provider characteristics affect performance. They also affect regulators' ability to produce performance. Here are six characteristics that matter.

Ownership structure: We have government-owned and privately-owned; non-profit, for-profit and semi-profit; publicly traded and privately traded; holding company-owned and retail shareholder-owned; hedge fund-owned and widows-and-orphans owned. Different business forms bring different strengths. It's best to be open to all forms, but there are at least four minimums: (1) No conflict between earning profit and pursuing the public interest, (2) commitment to transparency, (3) commitment to the state's clean energy goals, and (3) respect for workers and their unions.

Skills and experience: There are the old-line veterans, experienced companies in the old ways; the start-ups inventing new ways; and the in-the-middle companies that came up in the 1990s as competition came to gas and electricity. Some are generalists, some are specialists.

Business activities and their location (past, current, future): There's pure play and conglomerate; local and remote; domestic and foreign.

Culture and governance: Who controls which decisions? Who is accountable to whom, for what types of performance? How does the company pay its people? Do compensation methods create conflict between executives' interest and customers' interest? Boardroom and workforce—do they reflect the communities the company serves?

Attitude toward quality: Does the entity aspire to excellence or does it rest on its government-protected laurels? Does it look for hazards to prevent—or does it wait for disasters to happen, then rush to claim credit for solving them?

Attitude toward regulation and regulators: Companies differ on regulatory purpose, on performance standards, and on the consequences of falling short. Each company assesses regulation's worth self-interestedly. Everyone wants regulation when it protects; but not when it obstructs.

Why do these company characteristics matter? A corporate family's business activities determine whether it has internal conflicts—between the utility's public service obligation and the holding company's private business priorities. Companies that mix utility and non-utility businesses have an internal conflict over scarce capital. Companies that compensate their

rather than by two or more, the market is a natural monopoly, whatever the actual number of firms in it." Richard A. Posner, "Natural Monopoly and Its Regulation," 21 *Stan. L. Rev.* 548 (1999).

executives based on share price or earnings have an internal conflict between shareholder interest and ratepayer interest. Companies with internal conflicts require more regulatory effort than companies without those conflicts. And regulatory effort does not always succeed.¹⁷

C. How do we attract and choose the best performers?

When Pope Julius II wanted the Sistine Chapel's ceiling painted, he didn't hire the house painter; he got Michelangelo. In the utility businesses, today's job requirements look nothing like they did thirty years ago. Yet we still are served by the same companies.

How do businesses find employees and manufacturers find suppliers? They search for the best, then choose the best. Rather than relying on inertia, regulatory policy-makers should do the same: Create competition for privilege of being a monopoly. "[T]he public has an obvious interest in competition, 'even though that competition be an elimination bout.'"¹⁸

We have a real-time example in South Carolina, where the Legislature is considering selling the state-owned utility, Santee Cooper.¹⁹ With ICF as its consultant, the Legislature sought competitive expressions of interest and indicative offers. It got 15 "strong and diverse" proposals: seven full purchase proposals and eight others—long-term asset management agreements, long-term power supply arrangements, and partial acquisitions.²⁰ *Ownning a monopoly is desirable.* We know this also from the mergers-and-acquisitions trend: Nearly 100 acquisitions over 30 years proves that California create an opportunity arise to take over a utility's government-protected franchise, there will be takers.²¹

¹⁷ See, e.g., this Commission's Decision No. 91-05-028, *supra* at 277 ("[I]f Edison's past violations of the regulatory compacts set forth in our ... decision [authorizing SCE's holding company] are any indication of what will transpire in the future, it will be increasingly difficult to ensure that inappropriate costs are not passed on to ratepayers. . . . Edison has attempted to use [that decision] to shield its activities rather than open the Commission's access to expeditious and thorough review. Such contentiousness produces increased burdens on the Commission. . . .").

¹⁸ *Hecht v. Pro-Football, Inc.*, 570 F.2d 982, 991 (D.C. Cir. 1977).

¹⁹ Primarily a wholesaler to rural cooperatives, the utility also serves about 170,000 retail customers. Its 2017 it had a revenue requirement of about \$1.7 billion, and assets of about \$13 billion, including about 5100 mW of generation.

²⁰ See ICF's evaluation of February 2019, available at <https://governor.sc.gov/sites/default/files/Documents/newsroom/ICF%20Evaluation%20of%20EOI%20Responses%20for%20Santee%20Cooper.pdf>.

²¹ For a long list of many of those acquisitions, and some reasons why they occur, see Hempling, "Inconsistent with the Public Interest: FERC's Three Decades of Deference to Electricity Consolidation," *Energy Law Journal* (Fall 2018), available at [https://www.ebanet.org/assets/1/6/15-233-312-Hempling_\[FINAL\]1.pdf](https://www.ebanet.org/assets/1/6/15-233-312-Hempling_[FINAL]1.pdf).

Why does this conversation never occur? Not because replacing the incumbent is infeasible but because we don't make plans. Parents buy life insurance and schools run fire drills. Regulators too should have contingency plans. Consider a rough analog: the Dodd-Frank Act's requirement of a "living will." Banks whose failure could pose "systemic risk" must file "resolution plans" that provide for the "rapid and orderly" liquidation or restructuring of the company, "so as to "mitigate[] serious adverse effects on U.S. financial stability." The plans must "[f]ocus on identifying core business lines and critical operations and mapping to legal entities"; and must identify "funding, liquidity needs, interconnections and interdependencies, and management information systems."²² If regulators did something similar—if they created plans by which they could replace their utilities, we'd be prepared to impose consequences commensurate with performance shortfalls. No longer would we hear "too big to fail."

Using competition to find the best performers, and having replacements ready to replace those performers, is the path to real performance. Granting someone a permanent monopoly, then trying to "incentivize" them to improve, is not. Juggling board membership for a company that faces no pressure to compete is not. But starting a Commission inquiry into how to solicit for expressions of interest—that will get our utilities' attention fast.

D. Don't wait for the bankruptcy court to say who will provide electric service

A bankruptcy trustee's job is to put creditors' interest first. So if PG&E is sold, it will be sold to the highest bidder, not the best performer—unless the Commission acts now. The necessary Commission action: *Make clear to the bankruptcy court that it will approve a new owner of PG&E, or a new successor to PG&E, or a rate path for PG&E or its successor, only if that entity, among all possible entities, best meets the Commission's criteria for performance.* By taking that action—and only by taking that action—can the Commission's priorities prevail.

The bankruptcy court's approval of an acquirer does not preempt a state commission's authority to reject that acquirer. We know this from Texas. The retail utility Oncor was owned 80 percent by Energy Future Holdings Corp ("EFHC"). EFHC went bankrupt. The federal bankruptcy court approved the Oncor's acquisition by NextEra (which owned Florida Power & Light). But the Texas Commission rejected NextEra because NextEra wanted control of Oncor's utility cash flow to pay off NextEra's high acquisition debt. The court then approved Sempra's bid—again subject to the Commission's approval. Both times, no one argued preemption.²³

²² Federal Deposit Insurance Corp., "Living Wills Overview" (Jan. 25, 2012), available at https://www.fdic.gov/about/srac/2012/2012-01-25_living-wills.pdf.

²³ On Oncor, see *Joint Report and Application of Oncor Electric Delivery Company LLC and NextEra Energy*, Docket No. 46238, Tex. Pub. Util. Comm'n, (Apr. 13, 2017). On Sempra, see *Joint Report and Application of Oncor Electric Delivery Company and Sempra Energy for Regulatory Approvals*, Docket No. 47675 (Mar. 8, 2018). While bankruptcy litigants

This Commission should not follow Texas's approach of waiting for the bankruptcy court outcome. Doing so makes a Commission a spectator rather than a decision-maker. The Commission should make clear, now, that it will approve only the best performer, not the highest bidder.

* * *

The Commission is the policy leader. Rate-setting and auditing are essential activities, but they are essentially reactive—to utility decisions on what to spend and how to spend it. Leadership means empowering customers to state their desires, channeling those desires toward a common good, setting the standards for performance that attract the best performers, then enforcing those standards without sympathy for those who fail to meet them. With this type of leadership, we can replace “drifting to failure” with heading toward success.

behave as if the state commission is not preempted from rejecting a bankruptcy-approved acquirer, that specific question has not been litigated. The Ninth Circuit has held that a court-approved bankruptcy reorganization plan is preemptive of state regulation "relating to financial condition." *See Pacific Gas and Electric Co., et al. v. People of the State of California*, 350 F.3d 932, 937, 948 (9th Cir. 2003). It is not clear whether regulation of corporate structure or ownership type is regulation "relating to financial condition."

Appendix on Utility Franchises

European Union

Article 18 (Directive 2014/23 on Concessions): Duration of the concession

"1. The duration of concessions shall be limited. The contracting authority or contracting entity shall estimate the duration on the basis of the works or services requested.

"2. For concessions lasting more than five years, the maximum duration of the concession shall not exceed the time that a concessionaire could reasonably be expected to take to recoup the investments made in operating the works or services together with a return on invested capital taking into account the investments required to achieve the specific contractual objectives.

"The investments taken into account for the purposes of the calculation shall include both initial investments and investments during the life of the concession."

The nation of Vanuatu: Utility concession for the capital city of Port Vila

Three ways to replace the incumbent:

1. At end of the 30-year concession, paying for any unrecovered costs.
2. At any time, paying for any unrecovered costs plus 7 years' profit.
3. At any time for breach of the concession, paying for unrecovered cost.

Contrast typical U.S. treatment: Indefinite term of years; revocation only with egregious failure—with opportunity to cure.

Contrast U.S. electric utility acquisitions: Our unstated premise is that the monopoly franchise is the incumbent's to keep or sell for gain. We see this in the 30 years of mergers and acquisitions, nearly 100 total.