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California Public Utilities Commission
Forums on Governance, Management, and Safety Culture
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President Picker and Commissioners, thank you for your invitation today to address the topic of how the State of California may align the corporate governance of PG&E with the interests of consumers and the public at large.

There are two modes of utility regulation in which the Commission might engage. It can either become deeply involved in management of the company's safety program and organizational structure, or it can economically regulate the company and incentivize the accomplishment of safety objectives. This is not necessarily a dichotomy. The Commission could do both. However, in my view, it is a more productive use of your time to focus on rewards and penalties for safety performance.

In a perfect world, the Commission would establish financial consequences for PG&E's safety performance, and utility officials would execute the changes and improvements necessary to obtain rewards and avoid negative financial consequences. It remains unclear why, for PG&E, this has not seemed to work. PG&E has seemed impervious even to the very large fines assessed against it for safety conduct in the past. Moreover, a firm typically faces a strong incentive to avoid bankruptcy—and yet that is what has happened to PG&E.

It is important to note that, in more modest circumstances, the Commission has defined safety performance metrics for utilities—and the utilities *have* performed. In 1999, the Commission established performance-based regulation for San Diego Gas & Electric's electric operating company. As part of that program, the Commission established targets for employee safety, tying a relatively modest potential reward, $3 million, to achievement of a predefined metric. Ultimately, SDG&E beat the target and earned a bonus return.[i]

The stakes here are obviously higher, but the same principle could be applied to PG&E and other California utilities' performance in the face of wildfires and other public-safety risks. Metrics could measure the negative outcomes of utility-caused fires and explosions: How many people were killed,

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injured or dispossessed of their worldly possessions in a particular reporting period? How much property damage occurred as a result of the utility property's failure? Macabre though it may seem, these are ultimately the safety outputs in question. On the other hand, safety *inputs* are difficult to measure directly, and measurements of this kind risk reducing safety to a checklist undertaking: the very type of thing one might want to avoid.

What amount of money should be on the line for performance of this nature? California's electric utilities have proposed substantial premia in pending return on equity applications. They, in other words, have already come up with their estimation of the money that is or should be on the line. To my mind, however, it is somewhat odd that the risk/reward dynamic of wildfire risk would tie back to a return on invested capital. After all, as the Commission and its consultant NorthStar have recognized, it is primarily the corporation's actions in *relation to* capital assets that have caused safety problems. Spending on vegetation management, more frequent inspections, situational awareness, safety trainings: None of this attracts *any* return in the current utility business model, much less a premium. Indeed, these items would each diminish corporate earnings if their cost increased between rate cases.

Put another way: If safety improvements were obtainable primarily through increased capital spending, it would be reasonable to persist with the status quo, in which a utility's profit is a function of its "used and useful" capital investment. The existing regulatory model, which rewards a utility's equity investment, whether at 10 percent or 17 percent, ensures that. But if safety improvements will result primarily from operational improvements, then the cost-of-service, rate-of-return regulatory model appears misaligned to it. This would seem to be a powerful argument for tying a potentially substantial amount of the corporation's existing or incremental profit opportunity to safety performance.

Finally, the Commission has asked how the utility's senior management and board members might be properly incentivized. Usually, commissions regulate firms—not the people who work at those firms. One would expect corporate earnings to drive the behavior of the firm's principals and, in turn, their senior managers and employees. But investment and profit can occur in a manner that becomes unmoored from the earnings model that utility regulation creates, and which pivots instead toward speculation about California policymaking and bankruptcy court rulings. In these circumstances, it may be appropriate to ask whether financial incentives that exclusively face the firm are sufficient to induce performance.

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While the typical mode of public utility regulation is the regulation of the firm, there are notable exceptions. The Federal Power Act requires officers of public utilities to obtain preapproval from the FERC before they enter into a number of arrangements referred to as interlocking directorates.[ii] This is intended to safeguard the public from self-dealing and monopolization in the industry. When utility regulators require the submission of certain reports, they sometimes require a named individual to attest to the veracity of the information submitted. And in utility commissions' adjudicatory proceedings, testimony is sworn under oath: a corporate but also a personal obligation for truthfulness. So it would not be profoundly out of the ordinary if the Commission here, in these grave circumstances, caused PG&E's directors and management to have compensation tied to safety outcomes. This would surely underscore the matter in the board's policymaking, and would create board members as an ally to safety regulation's objectives.

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[i] Richard Myers & Laura Lei Strain, *Report of the California Public Utilities Commission: Electric and Gas Utility Performance Based Ratemaking Mechanisms*, Sept. 2000.
http://docs.cpuc.ca.gov/publishedDocs/published/report/1978.htm

The report describes the metric by which employee safety performance was measured as follows: "The standard compares SDG&E's regulated Occupational Safety Health Administration (OSHA)-reportable lost time and non-lost time injuries and illnesses, as adjusted for personnel changes due to the approved merger between Enova and Pacific Enterprises to an adopted benchmark frequency for those injuries and illnesses. The benchmark is 8.80 units, and there is a deadband of 0.2 above and below the benchmark. The $3 million reward is reached if actual performance met or was less than an OSHA loss time frequency of 7.4. The $3 million penalty is reached if actual performance met or exceeded an OSHA loss time frequency of 10.2. The incentive penalty or reward changes by $25,000 for every 0.01 units outside the deadband, up to the maximum amount."

[ii] Seth Lucia, "FERC Proposes Updates to Interlocking Directorate Regulations," *Energy Legal Blog*, July 23, 2018.
https://www.energylegalblog.com/blog/2018/07/23/ferc-proposes-updates-interlocking-directorate-regulations