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Emory Corporate Governance and Accountability  
Review

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Volume 1 | Issue 1

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2014

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### Recommended Citation

Scott Hempling, *"Regulatory Capture": Sources and Solutions*, 1 Emory Corp. Governance & Accountability Rev. 23 (2014).

Available at: <https://scholarlycommons.law.emory.edu/ecgar/vol1/iss1/4>

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## “REGULATORY CAPTURE”: SOURCES AND SOLUTIONS

Scott Hempling\*

*... [T]he Commission has claimed to be the representative of the public interest. This role does not permit it to act as an umpire blandly calling balls and strikes for adversaries appearing before it; the right of the public must receive active and affirmative protection at the hands of the Commission.<sup>1</sup>*

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As an advisor, practitioner, and expert witness in the field of public utility regulation, I have observed policymakers paradoxically concerned that using their powers risks losing their powers. Here are two examples.

**“We’ll lose our jobs”:** In one state, a major electric utility repeatedly resists the agency’s orders by invoking federal preemption, often groundlessly. The utility wanted its rights and obligations determined by the Federal Energy Regulatory Commission (where the state agency was a mere intervenor) rather than by the state agency (which had the power to issue and enforce orders). Under a proper reading of the federal-state jurisdictional relationship, the state agency is parent setting the expectations; while the utility wanted to drag the agency to FERC for family counseling.

In a competitive market, an unresponsive seller loses its customer. A utility has a monopoly franchise, but it comes with no lifetime lock. Why not let other, more responsive companies compete for the role? Some states have done exactly that: Hawaii, Maine, Oregon, and Vermont have transferred the traditional utility’s energy efficiency functions to an independent, commission-regulated entity, selected competitively. The risk of losing a century of steady income would jolt any incumbent into responsiveness.

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<sup>1</sup> *Scenic Hudson Pres. Conference v. Fed. Power Comm’n*, 354 F.2d 608, 620 (2d Cir. 1965) (referring to the Federal Power Commission), *cert. denied sub nom.*, *Consolidated Edison Co. v. Scenic Hudson Preservation Conference*, 384 U.S. 941 (1966).

But this agency reaction to this possibility was immediately and emphatically negative: “If we tried that, we’d all lose our jobs.” Refraining from picking the best company for a job for fear of losing your job—that’s conceding a lot. And note the asymmetry: When a regulated utility is the entity proposing to change the franchisee (such as when it is merging with or being acquired by an out-of-state entity), regulatory commissions routinely approve the transaction, with no fear of losing their jobs. But when the initiator of franchise change is the agency, there is fear of job loss. When the motivation for regulatory decision is job-saving rather than public-serving, we have “regulatory capture.”

***“They’re captured and there’s no rescue”***: Another state suffered from an electric utility’s frequent outages. A legislator I know blamed the state regulatory commission for failing to set standards and punish shortcomings. I suggested he get the commission more support—more staff and expertise, better salaries, more political cover for its tougher decisions. A stronger commission would have more credibility with which to create a culture of performance. That credibility would be even higher if the commission had the option of replacing a non-performing utility.

The legislator objected: “That’s not politically possible. The legislature has no stomach for more spending.” Yet the outage had cost state residents, according to this legislator, hundreds of millions of dollars in lost business and freezer spoilage alone. How was it not “politically possible,” albeit with patient, risk-taking leadership, to spend, say, 5 percent of that amount to reduce the probability of recurrence by half? It’s all from the same pockets—customer pockets. Why give ground to the short-term cost-cutters where spending saves long-term money? In any event, he added, “It’s useless, they’re captured.” Using “capture” as an excuse was itself a form of capture.

From these two examples, conscientious regulators can define “regulatory capture,” recognize its warning signs, and work to resist it.

#### *A. Definition*

“Regulatory capture” is a ringing phrase, too casually used. But because it is a hyperbolic phrase, it is too readily dismissed. With a careful definition, regulatory capture can be anticipated, detected, and resisted.

Regulatory capture does not include illicit acts—financial bribery, threats to deny reappointment, promises of a post-regulatory career. These things all

have occurred, but they are forms of corruption, not capture. Nor is regulatory capture a state of being controlled, where regulators are robots executing commands issued by interest groups.

Regulatory capture is neither corruption nor control. Corruption and control are actions of the regulated entity. Regulatory capture is characterized by the regulator's attitude, not the regulated entity's actions. A regulator is "captured" when he is in a constant state of "being persuaded": persuaded based on a persuader's identity rather than an argument's merits. Regulatory capture is reflected in a surplus of passivity and reactivity, and a deficit of curiosity and creativity. It is evidenced by a body of commission decisions or non-decisions—about resources, procedures, priorities, and policies, where what the regulated entity wants has more influence than what the public interest requires. The active verb "capture" signals an affirmative effort, to take someone captive. But the noun "capture," and the passive verb form "to be captured," signal a state of being. One can enter that state through one's own actions or inactions. One can allow oneself to be captured. One can assist, and sustain, one's own captivity.

If regulatory capture is a state of being, assisted and sustained by the captive, what roles are played by others? Regulatory capture is enabled by those who ignore it, tolerate it, accept it or encourage it: legislators who underfund the commission or restrict its authority, presidents and governors who appoint commissioners unprepared for the job, human resource officials who classify staff jobs and salaries based on decades-old criteria unrelated to current needs, intervenors who treat the agency like a supermarket where they shop for personal needs, and who treat regulatory proceedings like win-loss contests rather than building blocks in a policy edifice. These actions and inactions feed a forest where private interest trees grow tall, while the public's needs stay small.

### *B. Warning Signs*

If to be "captured" is to be in a constant state of being persuaded, by persuader identity rather than merits, what are the warning signs? What are the conditions and practices that contribute to and perpetuate regulatory capture?

***No vision, no priorities:*** In a captured agency, its leaders don't ask the big questions: What products, services and quality standards best serve the public? What price levels are necessary, and sufficient, to support those products, services, and standards? What market structures will yield the desired results?

And within those market structures, what corporate structures and practices will induce executives and employees to produce those results?

Lacking vision and priorities (and a work plan to carry them out), the captured agency over-allocates its resources to processing parties' petitions, while under-allocating resources to pursuing the agency's priorities. This is not necessarily the agency's fault. When legislatures impose statutory deadlines for processing parties' petitioners, while limiting agency funding without regard for its obligations, the result is predictable: The agency's work is dominated by what petitioners want rather than by what the public needs.

An absence of vision leads to deficit of motivation. A captured agency lacks a program of continuous self-improvement: a program that has for each department, department head, and employee a rigorous plan for professional advancement; a program whose resources and momentum are not compromised by the commission's other workload; a program that includes regularly recommending legislative changes to strengthen the agency's ability to improve industry performance.

***Issue-framing by the parties:*** “[D]escription is prescription. If you can get people to see the world as you do, you have unwittingly framed every subsequent choice.”<sup>2</sup> When a regulatory proceeding is initiated by an applicant seeking a government benefit, the applicant's profit motive induces it to frame the issues in pecuniary terms; i.e., what I want rather than what the public interest requires. Where profit is part of the statutory design, this type of positioning is not invalid. But the risk is that the agency fails to reframe the case to focus on its public interest mission.

Private interest framing can induce wrong answers. Robert Frank, a Cornell University economics professor, cites a psychology study done in the 1970s. The subjects had to spin a wheel, then guess what percentage of African countries were members of the United Nations. The subjects assumed the wheel was neutral, but it was rigged: For one group of subjects it always stopped on 10, for the other group it always stopped on 65. On average, the first group guessed that the percentage of African countries in the UN was 25 percent; the second group guessed 45 percent. The irrelevant wheel influenced judgment. The psychologists concluded, in a 1981 paper, that framing a decision appropriately is an “ethically significant act.”<sup>3</sup>

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<sup>2</sup> David Brooks, *Description is Prescription*, N.Y. Times, Nov. 25, 2010 (discussing Leo Tolstoy).

<sup>3</sup> Robert Frank, *The Impact of the Irrelevant*, N.Y. Times, May 29, 2010.

Drafting and filing an application for a government-granted benefit is an exercise in framing—framing a private interest quest (profitability, market share maintenance) as a public interest question (viability, reliability, jobs). As with the wheel-spinning example, this private interest framing inevitably influences regulators' decisions about what problems and solutions gain their attention.

Framing happens so frequently it is easy to miss, especially within agencies that react to others' priorities instead of setting their own. And framing works (for the framer, that is), for three reasons. First, it depends not on deception—which would be detected and criticized—but on emphasis. No one gets sued for framing. Second, every framed proposal has some public interest component; e.g., cost recovery shouldn't lag expenditures, mergers can improve efficiencies, new power plants can avoid blackouts. Unlike the psychologists' wheel, the regulated entity's frame is rarely irrelevant. Third, framing rearranges the agency's priorities, since utility filings tend to trigger statutory deadlines while agency-initiated cases do not.

***Procedures that value positions over perspectives:*** Capture is implicit in how agencies organize their proceedings. In captured agencies, litigating parties emphasize positions over perspectives. The agency invites and rewards this practice by asking “What do you want?” rather than “What do you know?” When hearing orders (the initial orders stating the issues to be decided) merely restate the parties' requests, rather than articulate a public interest purpose, that is evidence of capture. The commission becomes a commercial interest arbitrator at best, a supermarket for private interest shoppers at worst. Policy leadership is missing. In the hearing room, the parties ask each other hours of questions aimed at their own interests. The commissioners and hearing examiners mostly observe, on the mistaken premise that oppositional sparks will light up a public interest path. The parties treat the agency staff as a mediator for short-term settlements rather than as a transmitter of the commission's vision (a real likelihood if there is no vision, as described above). The commission accepts these settlements instead of directing its staff to pursue its vision.

***Low professional expectations:*** In my field of public utilities, the regulatory agencies under-appreciate the need for employee credentials. States require licenses for pedicurists but not for rate case witnesses; regulatory organizations award “certificates” for conference attendance but not for subject matter mastery. Regulated utilities, in contrast, regularly require advanced

credentials for power plant operators, fiscal officials, executive officers—anyone whose hand or pen touches operations, finance, or management.

This difference in credentialing produces, and reinforces, a difference in salaries; leading to a difference in motivation and morale; leading, unremarkably, to a difference in tenure for the talented. They spend their formative years learning on the taxpayer dime, then move to the regulated sector. No one with the power to fix the problem notices or reacts. The “revolving door” then becomes a one-way door: more agency staff move to jobs with the regulated than the other way around. That’s capture. It is neither corruption nor conflict of interest; it is simply the natural economic result of the agency failing to insist on high-quality professionals and pay them their worth.

***External political actions and inactions:*** The opposite of regulatory capture is agency independence. Independence is undermined when interest groups take their case to the governor, who then pressures the agency behind the scenes. Agencies that have a choice: cave, or remind the governor that her influence over sitting commissioners is no greater than any other citizen. The wrong choice is evidence of capture. Also contributing to capture is political distancing for political convenience: when the commission makes the tough calls (e.g., utility service cannot be below-cost-but-high-quality, or shareholder investment cannot be low-risk-but-high-profit), politicians join the protests rather than signal support.

***“What’s good for the company is good for the country”:*** It is common for benefit-seekers to describe their private interests in public interest terms. In the public utility field, the typical applicant for merger approval cites its need to “position itself competitively.” Regulatory agencies sometimes adopt this argument as policy, viewing their regulatory duty as supporting the utility’s competitive interests. The irony of, and market distortion resulting from, issuing government orders to serve a single company’s competitive interest goes unnoticed. There is a difference between (a) keeping a well-performing utility monopoly financially capable of providing its obligatory service, and (b) becoming a volunteer in the utility’s competitive campaigns. When that difference disappears, when “bigger is better” becomes the guide for decisions, the utility’s goals become the commission’s. That’s capture.

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These warning signs are less the capturing actions of regulated entities, and more the capture actions—and inactions—of regulators and their colleagues in other government branches. This makes the term “regulatory capture” both imprecise and inaccurate. The “captured” commission’s cage is not locked and guarded by its enemies; its door is opened and closed by the commission itself.

### *C. Sources*

A common contributor to capture is a regulatory agency’s mistaken view that its purpose is to “balance” the interests of consumers and investors. This understanding of regulation as private interest balancing, so deeply embedded in regulatory conversation, practice, and psyche, has five main problems.

***Ambiguity:*** To claim that one balances interests is to muddle regulation with multiple ambiguities. Which consumers—large or small, industrial or residential, eastern or western, today’s or tomorrow’s? Which consumer interests—low prices or high quality? Which investors—buy-and-hold shareholders, pension funds, hedge funds, short sellers, or bondholders? Which company interests—this year’s profits or next decade’s viability? What time horizon—short-term or long-term? And what do we mean by “balance”? Balance implies equivalence—the precise midpoint between two interests of equal weight. Are the customer-investor weightings exactly equal? At all points in time? Or can they vary from equivalence at any point in time, provided the variations balance over some longer period of time? None of these questions (important to anyone with a stake in regulation) is answered by the phrase “balancing interests.”

***Nearsightedness:*** If a regulated service were merely a commercial transaction affecting only the buyer and seller, then balancing the interests of customers and investors would be a logical regulatory mission (provided we resolved the many ambiguities just discussed). But regulated services are rarely mere bilateral commercial transactions. In the public utility field, regulated companies create, operate, and maintain the infrastructure supporting our economy; the infrastructure that sustains life and its quality (think water shortage, electricity outage, no telephone service, no streetlights, no movies). Utility service also produces the multi-millennial residue of today’s production and consumption decisions: e.g., nuclear waste and carbon emissions from electricity generation, chemical residue from telephone pole treatment, leaks from gas pipelines. The regulatory lens must be both wide-angle and long-distance. Balancing interests misses this point.

***Presumption of conflict:*** A balance presumes two weights in opposition. But the legitimate aims of consumers and suppliers are not in opposition. Viable sellers, satisfied customers, no waste, no free lunch, reasonable prices and reasonable returns—these goals are consistent and mutually reinforcing. High-quality performance and efficient consumption benefit everyone: customers, shareholders, bondholders, workers, and the environment.

Opposition arises only from illegitimate aims: like the cost-causing consumer seeking to shift costs, the shareholder insisting on excess returns. If the regulator rejects the illegitimate aims, the assumption of opposites, and the perceived need to balance opposing interests, go away. But some regulatory fora do the reverse. They embed opposition into procedure, by tolerating private interest pleas that have adverse effects on others. They expect, and allow, parties to position themselves at the poles, paying no penalty for unreasonableness. They encourage these opposing parties to make deals—”settlements” that favor the better-resourced parties, settlements that then are approved by a boxed-in commission. The presumption of conflict embodied in the “balancing” perspectives leads to compromises among private interests rather than advances of the public interest.

***Passivity:*** An agency that balances private interests is presiding rather than leading. Outcomes are defined, and evaluated, by the parties’ desires, not the public’s needs. The forum serves the parties, instead of the parties serving the forum. This passivity leaves the public unserved, because the midpoint of two private interests is but a third private interest.

***Legal looseness:*** Regulatory proceedings are legal proceedings, bounded by statutes and constitutional law that create rights and obligations. The regulatory responsibility is to define the rights and obligations, then protect the rights and enforce the obligations. Balancing private interests diverts attention from the agency’s legal tasks. (Caveat: The occasional statute does contain a balancing-type phrase in its preamble. In that limited context, this legal argument has less force. But even in those situations, the interests requiring balance are the rights and obligations created by statute (which the agency must define), not the self-interests advanced by the parties.)

***The commission-court difference:*** Regulators who prefer to “balance,” who preside rather than lead, liken the regulatory agency to a court and the regulator to a judge. Doing so undermines the agency’s effectiveness. An agency’s purpose derives from its origins. The legislature receives its lawmaking powers from a constitution. The legislature then creates a

commission, delegating to it some substantive slice of its lawmaking powers. That delegation consists of commands and standards; e.g., establish “just and reasonable” rates, ensure “reliable service,” allow mergers if “consistent with the public interest.” Common to these commands and standards is a legislative purpose: make and carry out policy to promote the public interest.

That is not what courts do. A court is not a delegatee of the legislature, making and carrying out policies to promote the public interest. Courts resolve disputes brought by parties, disputes whose boundaries are drawn by the parties’ complaints and answers. Agencies and courts do have commonalities. Both make decisions that bind parties. Both base decisions on evidentiary records created through adversarial truth-testing. Both exercise powers bounded by legislative line-drawing. But courts do not seek problems to solve; they wait for parties’ complaints. In contrast, an agency’s public interest mandate requires it literally to look for trouble. Courts are confined to legal violations, but commissions are compelled to advance the public welfare. Even the narrowest of commission decisions—say, approving or disapproving a special contract between utility and industrial customer—affects a public larger than the parties: Will the low contract price shift costs to other customers or weaken the utility’s finances? Will the lucky buyer’s competitors seek me-too treatment? To what effect?

Like an agency, a court’s decisions can affect non-parties. A class action suit under the civil rights or securities laws, an antitrust suit against a Microsoft, can set policy for a generation. But consider this difference: A judge’s power to act is still defined by, and confined to, the issues stated in the plaintiff’s complaint. For an agency, a petitioner’s filing is stimulation but not limitation. The agency can add issues, combine proceedings, invite other parties, or convert a two-party complaint into multi-party rulemaking, all as the public interest demands.

Given these differences, a regulator that acts like a judge undermines the agency’s effectiveness. He assumes that the parties, their interests, their arguments, and their legal citations comprise the full intellectual universe requiring regulatory attention. This assumption relies on one or more of the following premises, each one wrong: (1) the scatterplot of private interests appearing in a proceeding will display some pattern from which the commission can discern the public interest; (2) the public interest is synonymous with satisfaction of those private interests; (3) the private interests’ evidentiary submissions will produce information sufficient in

relevance and objectivity to discern the public interest; (4) the opportunity for access equals the reality of access (i.e., all possible private interests have hearing room resources sufficient to get the commission's ear); or (5) through the static and friction of private interest opposition, a regulatory "truth" will emerge.

Accepting any of these premises undermines effectiveness, by: (1) inducing intellectual passivity, because the proceeding and the record become party-centric rather than public-centric ("What are the parties seeking?" instead of "How do I advance the public interest?"); (2) imposing the wrong time horizon (the parties' short-term goals rather than the public's long-term needs); (3) reducing the regulator's objectivity (because the regulator learns the issues from parties' arguments rather than impartial sources); (4) distorting the regulator's time management, because as the parties load the record with conversation among themselves (testimony, cross examination, and briefs), procedural law compels the regulator to read every page, leaving insufficient time and mental space to read and think on her own; or (5) substituting private settlements for public interest solutions (regulation, unlike marital dissolutions and fender-benders, requires policymaking, not dispute resolution).

Yet many regulators prefer the "judicial" mindset, for at least four reasons. First, it's familiar. In regulatory procedure, adjudication holds center stage. We use it in the "big cases." Its formality commands respect. Its familiarity defines the forum: because it uses judicial techniques, it is "*quasi*-judicial." The prefix *quasi* is the tipoff. There is nothing "quasi" about making policy for the public. Adjudication is only a procedural device, used to discern and declare the public interest. Second, many regulatory appointees are generalists. Faced with regulation's complexity, the generalist prefers to examine the arguments of the more experienced, rather than frame the arguments her own way. The third reason is overwork. If one is overrun by paper, it is easier to preside than to lead. Fourth, acting like a judge carries less risk; politics punishes errors of omission less than errors of commission.

#### *D. Resistance and Escape*

Attempts at regulatory capture are unavoidable; everyone does it.<sup>4</sup> Attempts are not avoidable, but capture is not inevitable. If regulatory capture is a state

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<sup>4</sup> See Cole Porter, *Let's Do It, Let's Fall in Love, on The Very Best of Cole Porter* ("Birds do it, bees do it, even educated fleas do it . . . . Some Argentines without means do it; I hear even Boston beans do it.").

of being persuaded, based on the persuader's identity rather than a policy's merits, how does an agency resist; or if already captured, escape?<sup>5</sup>

As explained, an agency is susceptible to capture when there are (a) policy voids instead of vision, (b) priorities and procedures that reflect parties' requests rather than public interest needs, (c) chronic resource differentials between the regulator and regulated, and (d) fair-weather politicians whose support for regulation sags when pressured by those who would weaken it. Successful agencies shrink their susceptibility to capture, using several strategies.

***Agency as framer:*** An applicant may have a legal right to seek a benefit, but not a right to frame the case. An alert agency reframes an applicant's private interest request as a public interest question. Looking at products, prices, performance, the agency asks: what do customers deserve? Looking at market structures and corporate structures, the agency asks: which ones produce the best performance? Reframing means the public interest dog wags the applicant's tail, not the other way around. It means organizing each proceeding by asking "How do we advance the public interest?" not "What do the parties want us to decide?" In major policy areas like performance standards, mergers, and rates, agencies focused on framing will create substantive policies before adjudicatory proceedings occur. Then the parties' proposals will track commission priorities, not the other way around. Or if the relevant policy has not been established, the alert commission will open the proceeding with staff papers that frame the issues in objective terms, specifying public interest questions that all parties are obligated to address.

***Agency as evaluator of industry performance:*** Regulation works when it links inputs to outputs. The agency must (a) describe a public interest vision, measured in results (investment, innovation, prices, quality of service, safety); (b) shape internal agency actions (budgeting, staffing, education) to prepare for external actions (agency orders aimed at industry performance); (c) take external actions (promulgating rules, issuing orders, recommending new

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<sup>5</sup> "Captured" can describe both a person and an institution, so the solutions are both personal and institutional. This Essay focuses on the institutional solutions. Personal protection requires an armor of personal attributes, including purposefulness, education, decisiveness, and independence. *See generally* SCOTT HEMPLING, *PRESIDE OR LEAD? THE ATTRIBUTES AND ACTIONS OF EFFECTIVE REGULATORS* (2nd ed. 2013) (these attributes and others are discussed more fully in chapters one to ten).

legislation) to induce utilities and consumers to produce that performance; and (d) evaluate and revise.<sup>6</sup>

***Agency as committed employer:*** Successful agencies offer their employees indispensable roles and opportunities for advancement. They connect professional expectations to industry performance, creating a commission culture that supports the statutory mission. They insist that each department have for each department head and each employee, a work plan that emphasizes indispensability, propels workers to achieve, and expects them to advance. That work plan must be backed by an education plan that grows juniors into seniors. Achievement is reflected in salaries similar to those paid by the regulated entities, salaries uncompromised by arbitrary budget caps. Developing a corps of professionals, and paying them their worth, is more cost-effective than wishing and watching: wishing regulated entities would perform better, and watching the best agency employees migrate to private-sector jobs.

***Resources based on demands rather than politics:*** When agency resources depend on legislative decisions, there is risk of rollbacks based on stakeholder dissatisfaction, or arbitrary caps that base budgets on last year's totals rather than next year's demands. A better combination of budgetary independence and fiscal accountability is to allow the agency to fund its own budget, through fees on regulated entities. With this authority, the agency can vary the funding source with the regulated activity. The fees can reflect case complexity, ensuring sufficient resources while assigning costs to the cost-causer. When a utility proposes a conglomerate merger lacking any public interest purpose, with the agency statutorily obligated to prevent harm, the cost of regulatory review belongs with the merging parties, not the taxpayers. For commission-initiated work, such as industry-wide rulemakings, the revenue source can be general fees charged to the regulated based on some combination of revenues, profits, and assets, with these fees recoverable through prices, since customers are the beneficiaries.

Caution: Objectors to fee-based agencies worry that the agencies will over-fund or under-deliver. But until such evidence emerges, the realistic assumption is that the risk of over-funding is lower than the risk of under-regulating. For commissions that spend inefficiently (which is different from over-regulating), the solution is not to cut their staff but to help them spend

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<sup>6</sup> See PETER DRUCKER, *THE EFFECTIVE EXECUTIVE: THE DEFINITIVE GUIDE TO GETTING THE RIGHT THINGS DONE* (2006).

wisely. A regular assist from independent experts in commission management, coupled with supportive legislative and executive oversight, should be par for all regulatory agencies inside and outside regulation.

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My most inspiring encounters have been with regulatory agencies that combat capture with quality. To their entire professional staffs, from the thirty-year veterans to the six-month novices, their leaders deliver this message: “We will leverage our statutory authority and our professional ability to bring excellence to the industries we regulate, starting with excellence within our own organization. We will do this by putting ourselves on a path to self-improvement so rigorous, so disciplined, so transparent, so determined, and so optimistic that we will persuade the utilities, the legislators, and the courts that we deserve not only their respect but their deference.” These agencies remain works in progress, but their progress is undisputed.