In a new post, Dan Farber mentions performance-based regulation as a promising tool for encouraging energy utilities to be enthusiastic in supporting the transition to clean energy sources. There are a lot of people who agree with him. After all, traditional utility regulation tends to encourage the companies to overspend on infrastructure and under spend on operation and maintenance, while striving for higher sales, because those are the major ways to make a profit. But those traditional incentives are not necessarily compatible with accepted clean power strategies, which, among other things, rely on more efficient use of energy and the build-out of such distributed resources as rooftop solar.

This has caused regulators and legislators in many states to conclude that the old incentive structure must be replaced with a new one — an understandable way of thinking about the challenge. The theory is that the regulators would establish performance targets which, if exceeded, would lead to a generous economic reward. For instance, establish a benchmark for grid reliability, and reward the utility if it maintains a more reliable grid.

So what could go wrong? A lot. For instance, consider the performance incentives used by California regulators over the years — some of which are associated with fraudulent record-keeping and life-threatening catastrophic accidents. I outline some of that history in a recent report.

Does this mean that changing a utility's economic incentives is a bad idea? Not necessarily, but it does mean that any such program has to be very careful designed. Any new incentives have to be rigorously tested prior to adoption. The smartest analysts should be assigned to try to figure out how things could go wrong and work to design around them. And once new incentives are put in place, regulators need to be watching over the utility's proverbial shoulders and asking hard questions about how and why things are being done in certain ways. Policy makers usually assume that the use of economic incentives means that regulators can take a step back. To the contrary, the adoption of new policies is a time to increase oversight.

In other words, the success of any regulatory approach depends on good regulation. That is true regardless of the adopted policies — even if the policies are designed to motivate the utilities to do the right thing. We shouldn't forget, however, that regulated utilities are legally bound to follow the regulator's orders, whether or not there are carrots dangling in front of them.