
The Regulation of Public Utilities Theory and Practice

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Some operating costs are determined by normal competitive forces and by tax authorities; others basically are determined by individual companies. Yet, commission supervision as to their reasonableness is essential for effective regulation.

Necessity for Supervision

The need for commission supervision of operating expenses might seem questionable given the development of uniform systems of accounts and the self-interest of public utilities. As earlier noted, however, uniform systems only specify the form and content of the statement of expenses; they do not solve controversies over permissible expenditures or their computation. Nor is self-interest always sufficient. Commissions seldom challenge expenditures controlled by competitive forces, such as those for plant maintenance, raw materials and labor. Conflicts do arise over whether certain expenditures should be charged to operating expenses or paid for by owners out of earnings.

Management might vote itself high salaries and pensions. Payments to affiliated companies for fuel and services might be excessive. Expenses for advertising, rate investigations, litigation and public relations should be closely scrutinized by the commissions to determine if they are extravagant or if they represent an abuse of discretion. In all cases, moreover, the commissions should require proof as to the reasonableness of a utility's charges to operating expenses.

Depreciation and taxes, too, receive special attention by the regulatory commissions. The accounting for depreciation affects rate regulation in two ways: as a current operating cost, and as a deduction from the value of the tangible and reproducible property in determining a utility's rate base. For many years, some regulated companies made large depreciation charges to operating costs in years of good earnings and low charges in years of poor earnings, while deducting little for accrued depreciation in determining the rate base. Such practices benefited investors, but not consumers. Taxes present important regulatory problems. Public utilities often are referred to as "tax collectors *par excellence*." Since taxes are included in operating costs (with a few exceptions), they usually can be passed on to the consumer in the form of higher rates. There is a conflict, therefore, between the commissions and consumers who seek minimum rates and tax authorities who seek maximum revenues.

Legal View and Managerial Judgment

The right of the commissions to exercise supervision over all three component parts of operating costs — operating expenses, depreciation and taxes — has been approved by the courts.

Operating Expenses

As early as 1892, the Supreme Court recognized that the power to determine reasonable rates required supervision of operating expenses. As expressed by Justice Brewer:

It is agreed that the defendant's operating expenses for 1888 were \$2,404,516.54. Of what do these operating expenses consist? Are they made up partially of extravagant salaries; fifty to one hundred thousand dollars to the president, and in like proportion to subordinate officers? Surely, before the courts are called upon to adjudge an act of the legislature fixing the maximum passenger rates for railroad companies to be unconstitutional . . . they should be fully advised as to what is done with the receipts and earnings of the company; for if so advised, it might clearly appear that a prudent and honest management would, within the rates prescribed, secure to the bondholders their interest, and to the stockholders reasonable dividends. While the protection of vested rights in property is a supreme duty of the courts, it has not come to this, that the legislative power rests subservient to the discretion of any railroad corporation which may, by exorbitant and unreasonable salaries, or in some other improper way, transfer its earnings into what it is pleased to call "operating expenses."¹

In upholding the commissions' right of supervision over operating expenses, however, the courts have distinguished between expenditures resulting from "arm's length bargaining" and have recognized the functions of management. With respect to the first, when expenditures are controlled by competitive forces, they are seldom challenged. For example, public utilities engage in collective bargaining with their employees as do nonregulated enterprises. Except in rare circumstances, the resulting contracts are not questioned by the commissions. But in the absence of arm's length bargaining, particularly when transactions occur between affiliated companies, commission supervision is required.

With respect to the second, how far can and should a commission be allowed to go in exercising supervision over a utility's operating expenses? Two cases provide a partial answer to this question. In 1923, the Missouri commission refused to include in Southwestern Bell's operating expenses the 4.5 percent of its gross revenue that the company was paying to the American Telephone and Telegraph Company (AT&T) as rent for telephone instruments and for managerial services. The Supreme Court overruled the commission, saying:

The commission is not the financial manager of the corporation and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as

258 *The Regulation of Public Utilities*

operating expenses unless there is an abuse of discretion in that regard by the corporate officers.²

Thirteen years later, in a case involving regulation of stockyard charges by the Secretary of Agriculture, the Supreme Court approved rejection of certain marketing costs on the grounds that they were unwise. Said Justice Roberts:

The contention is that the amount to be expended for these purposes is purely a question of managerial judgment. But this overlooks the consideration that the charge is for a public service, and regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs for these or any other purposes.³

To disallow an expenditure, then, a commission must prove "an abuse of discretion" on the part of management. Such an abuse, in turn, results from "a showing of inefficiency or improvidence"⁴ or from "extravagant or unnecessary costs."⁵ Public utilities, in other words, cannot spend freely and expect all expenditures to be included as allowable operating expenses. In effect, this means the commissions are permitted to question both the judgment and integrity of management. And if rates must be high enough to yield sufficient revenue to cover all operating expenses, the consumer has the right to expect that such expenditures will be necessary and reasonable.

At the same time, managerial good faith is presumed.⁶ Public utilities must be given the opportunity to prove the necessity and reasonableness of any expenditure challenged by a commission (or intervenor). To justify an expenditure, a company must show that the expense was actually incurred (or will be incurred in the near future), that the expense was necessary in the proper conduct of its business or was of direct benefit to the utility's ratepayers,⁷ and that the amount of the expenditure was reasonable.⁸ Moreover, it must be emphasized again that a public utility may still spend its money in any way it chooses. Management's function is to set the level of expenses; the commission's duty is to determine what expense burden the ratepayer must bear.⁹

Depreciation and Depletion

The right of a public utility to a depreciation cost allowance was stated by the Supreme Court in 1909. In the *Knoxville Water Company* decision, the Court recognized that a plant "begins to depreciate in value from the moment of its use," and added:

Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current