The Regulation of Public Utilities

Theory and Practice

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In 1981, the Supreme Court held that the first use tax of Louisiana violated the supremacy clause of the Constitution (because it interfered with federal regulation of the transportation and sale of natural gas in interstate commerce) and was unconstitutional under the commerce clause (because it discriminated against purchasers of gas moving through Louisiana in interstate commerce, due to various exemptions and tax credits).[198]

Conclusions: "The Thin Red Line"

Commission supervision of operating costs raises one broad question and countless specific problems. The latter have been outlined in some detail in this chapter. They are part of the broader question: How far should the regulatory commissions go in substituting their judgment for that of management?[199] The answer to this question, in turn, largely depends on one's personal philosophy.

Some feel that since public utilities operate within a free enterprise system, they should be subject to the same general rules that are applicable to nonregulated firms. If nonregulated firms can make annual contributions to charitable and educational institutions, or if they are permitted to benefit from filing consolidated income tax returns, so, too, should public utilities be afforded the same opportunities. Others believe that the very existence of regulation indicates that public utilities can and should be treated differently from nonregulated firms. Since they are public service enterprises, their basic obligation is to render adequate service at the lowest possible rates. Thus, charitable and educational contributions, they feel, should not be allowed as operating expenses, since they contribute little toward the achievement of this basic obligation, while the benefits from consolidated income tax returns should be passed on to consumers.

But when a commission does substitute its judgment for that of management, two issues arise. First, the process may be costly. "Regulators have frequently disallowed some expenditures, and curtailed others as being excessive or unwarranted. But the policing job is endless, aimless, and dubious, mainly because of the sheer impossibility of small staffs tracking myriads of payments."[200] The result is a major contribution to regulatory lag, since rate cases are extended. Second, an underlying assumption in the process may be incorrect. Wilcox put it this way:

> The regulated industry comes, in the end, to have two masters: its own management and the regulatory agency. Essential functions of management are duplicated. Managerial decisions are reviewed. Where the regulatory agency finds them to be wise, it allows them to stand. Where it finds them to be unwise, it exercises a veto power. It thus acts to protect management against the consequences of its own mistakes.

> If there were assurance that the business judgment of commissioners would be superior to that of managers in more than half of the cases (weighted by their importance), we might conclude that duality of management would produce a net gain. But commissioners, in fact, are unlikely to be the better businessmen. And even if they were, there would be offsetting costs.[201]

The broad issue becomes even more important as commissions have extended their challenges into areas other than the reasonableness of operating expenses such as innovation, capacity additions and so forth. "Commissioners," a former one has warned, "have neither the training, nor the skills, nor the incentives to manage."[202]

The dilemma is clear. A commission has the authority to overrule management if the latter abuses its discretion. But an abuse of discretion is a matter of judgment. Moreover, failing to draw a line between regulatory and managerial discretion results in serious consequences, including a heavier administrative burden, delay, a diversion of effort and the loss of managerial incentives. The dilemma has led some to propose that commissions must develop an incentive system of regulation — one that would demand high performance, but which would let management decide the ways in which service is to be provided. The issue is considered in later chapters.

Notes

**Mississippi River Fuel Corp. v. Federal Power Comm'n*, 163 F.2d 433, 437 (1947) (Prettyman, J.).

[1] *Chicago & Grand T. Ry. v. Wellman*, 143 U.S. 339, 345-6 (1892).

[2] *Missouri* ex rel. *Southwestern Bell Tel. Co. v. Missouri Pub. Serv. Comm'n*, 262 U.S. 276, 289 (1923), quoting from *Illinois Pub. Serv. Comm'n* ex rel. *Springfield v. Springfield Gas & Elec. Co.*, 291 Ill. 209, 234 (1920).

[3] *Acker v. United States*, 298 U.S. 426, 430-1 (1936). See also *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930); *Western Distrib. Co. v. Public Serv. Comm'n*, 285 U.S. 119 (1932).

[4] *West Ohio Gas Co. v. Public Utils. Comm'n*, 294 U.S. 63, 72 (1935).

[5] *Acker v. United States*, 298 U.S. at 31.

[6] *West Ohio Gas Co. v. Public Utils. Comm'n*, 294 U.S. 63; *In re New England Tel. & Tel. Co.*, 79 PUR(NS) 508 (Vt. 1949).

[7] *In re Potomac Elec. Power Co.*, 119 PUR4th 497 (D.C. 1991).

[8] *In re Ripon United Tel. Co.*, PUR 1924A, 171 (Wis. 1923); *Commerce Comm'n v. Public Serv. Co. of N. Ill.*, 4 PUR(NS) 1 (Ill. 1934).

[9] *In re Honolulu Gas Co.*, 36 PUR3d 309 (Haw. 1960). As one expert has put it, "Utility managements may not be arbitrary and capricious. And neither may regulators." A. J. G. Priest, "Utility Advertising and Other Operating Expenses," *Public Utilities Fortnightly* 75 (29 April 1965): 27.

[10] *Knoxville v. Knoxville Water Co.*, 212 U.S. 1, 13 (1909).

[11] *Denver v. Denver Union Water Co.*, 246 U.S. 178 (1918); *Kansas City S. Ry. v. United States*, 231 U.S. 423 (1913); *Lindheimer v. Illinois Bell Tel. Co.*, 292 U.S. 151 (1934).

[12] *Knoxville v. Knoxville Water Co.*, 212 U.S. at 14.

[13] *Columbus Gas & Fuel Co. v. Public Utils. Comm'n*, 292 U.S. 398, 404-5 (1934).

[14] *Galveston Elec. Co. v. Galveston*, 258 U.S. 388, 399 (1922). See also *Georgia Ry. & Power Co. v. Railroad Comm'n*, 262 U.S. 625, 632-33 (1923).

[15] Senate Subcommittee on Intergovernmental Relations of the Committee on Government Operations, *State Utility Commissions*, 90th Cong., 1st sess., 1967, Committee Print, Table V facing p. 34. Thirty-three state commissions have authority to require advance submission of budgets on capital expenditures. National Association of Regulatory Utility Commissioners (hereafter, NARUC), *Utility Regulatory Policy in the United States and Canada, Compilation 1991-1992* (Washington, D.C.: NARUC, 1992), 164-5.

[16] Ibid., 58-63. On automatic fuel clauses, see NARUC, *State Commission Regulation and Monitoring of the Fuel Adjustment Clause, Purchased Gas Adjustment Clause, and Electric and Gas Utility Fuel Procurement Practices* (Washington, D.C.: NARUC, 1978); Michael Schmidt, *Automatic Adjustment Clauses: Theory and Application* (East Lansing: MSU Public Utilities Studies, 1980); Roger D. Blair and David L. Kaserman, "Automatic Fuel Cost Adjustment Clauses: Issues and Evidence," *Public Utilities Fortnightly* 110 (25 November 1982): 27-32.

More recently, energy cost adjustment clauses have been substituted for fuel adjustment clauses. In addition to fuel costs, such adjustment clauses permit other costs to be recovered, including deferred expenditures associated with conservation and load management programs (see, e.g., *In re Western Mass. Elec. Co.*, 114 PUR4th 239 [Mass. 1990]), take-or-pay charges imposed on natural gas distribution companies by pipeline suppliers (see, e.g., *American Nat'l Gas Co. v. Laclede Gas Co.*, 110 PUR4th 260 [Mo. 1989]), and the energy charge associated with purchased power contracts (see, e.g., *In re Potomac Elec. Power Co.*, 110 PUR4th 66 [Md. 1989]). See *Utility Regulatory Policy*, 58-63. See also Robert E. Burns et al., *Current PGA and FAC Practices: Implications for Ratemaking in Competitive Markets* (Columbus, Ohio: National Regulatory Research Institute, 1991).

[17] "Recent Cases on Automatic Fuel Adjustment Clauses," *Public Utilities Fortnightly* 105 (13 March 1980): 45-48. See Elizabeth Warren, "Regulated Industries' Automatic Cost of Service Adjustment Clauses: Do They Increase or Decrease Cost to the Consumer?" *The Notre Dame Lawyer* 55 (1980): 333-55; Roger G. Clarke, "The Effect of Fuel Adjustment Clauses in the Systematic Risk and Market Values of Electric Utilities," *Journal of Finance* 35 (Papers and Proceedings, 1980): 347-58.

[18] *In re New England Power Co.*, 97 PUR3d 41, 45 (FPC 1972). There has been a trend towards closer regulatory scrutiny, including more formal hearings. See, e.g., *In re Detroit Edison Co.*, 72 PUR4th 585 (Mich. 1986); *In re Arizona Pub. Serv. Co.*, 76 PUR4th 399 (Ariz. 1986).

[19] See, e.g., *In re Louisville Gas & Elec. Co.*, 6 PUR4th 520 (Ky. 1974); *Western Mass. Elec. Co. v. Massachusetts Dept. of Public Utils.*, 366 N.E.2d 1232 (1977); *Wisconsin's Envtl. Decade v. Wisconsin Pub. Serv. Comm'n*, 260 N.W.2d 712 (1978); *In re San Diego Gas & Elec. Co.*, 29 PUR4th 613 (Cal. 1979); *In re Pennsylvania Power & Light Co.*, 27 PUR4th 609 (FERC 1979).

[20] According to Blair and Kaserman: