The Regulation of Public Utilities

Theory and Practice

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PART II. The Theory of Public Utility Regulation

service and safety standards, although some believe that there has been a deterioration in the quality of service in more recent years[1] and the volume of complaints has increased dramatically. (In 1991, for instance, the New York Public Service Commission received approximately 20,000 customer complaints, as detailed in Table 12-1.) Further, there are a number of specific issues, particularly those surrounding the termination of service, nuclear power safety and management efficiency, that require analysis.

TABLE 12-1

Customer Complaints Received by the New York Public Service Commission, 1991

	Electric	*Gas*	*Telephone*	*Water*
Billing	3,348	945	1,503	764
Credit	3,630	600	1,698	59
Safety	91	78	67	4
Service	680	230	3,870	102
Tariff	296	78	455	45
Miscellaneous	231	129	1,016	39
Totals	8,276	2,060	8,609	1,013

Source: *Profiles of Regulatory Agencies of the United States and Canada, Yearbook 1991-1992* (Washington, D.C.: National Association of Regulatory Utility Commissioners, 1992), 112.

Relation of Service, Safety and Efficiency to Rates

There is a relation — perhaps an obvious one — between the quality and quantity of service, safety and efficiency and the rates charged consumers. In many cases, an increase in service or safety results in a rise of a utility's costs, and higher rates must be charged. Such is the case with the frequency of electric and gas meter tests or with one-party versus four-party telephone service.[2]

A utility also may be required to extend service to a small rural area that cannot afford to pay the full cost, thereby resulting in subsidization from service users in larger areas. The type of equipment that a utility uses is directly related to the cost of providing the service. Higher safety and/or environmental standards usually result in higher costs, such as with nuclear power generating equipment, while higher costs than necessary result from management inefficiencies.

The regulatory commissions cannot ignore this relation between service, safety and efficiency, and rates.[3] Equally important, commissions' policies regarding rate regulation directly affect the quality and quantity of service a utility may offer. Take, for instance, the depreciation problem. If a utility is permitted to accrue adequate depreciation or to amortize the unrecovered depreciation on its equipment when more modern or higher quality equipment is installed, technological improvements are encouraged. If a utility is not allowed adequate depreciation rates on equipment actually in use, however, it may not install new equipment until the old is fully depreciated. In short, commission policies have important effects on the quantity and quality of service a public utility offers.

Some types of service, as Thompson and Smith have pointed out, bear little relation to rates:

> It should cost but little to train employees to be courteous or to require the meter reader to clean his shoes before crossing the customer's threshold. In general, however, there is some connection between the quality of service and rates. And it goes without dispute that no higher quality or quantity can be demanded of a utility than the users are willing to pay for, assuming the usual economy of management.[4]

Not only is there a relationship between service, safety and efficiency, and rates, but there exists the possibility that service competition might become discriminatory. According to Welch:

> Clearly, no utility can refuse service to any customer, otherwise qualified, because of race, color, creed, or political consideration. It can, however, refuse demands for free service or service to persons outside of the service area, or to those who refuse to comply with regulations governing special charges that cover the extra expense of furnishing special or unusual service demands. It can also refuse to serve persons who abuse or forfeit their right to service.[5]

Several examples involve the airline industry prior to deregulation. In 1966, the Civil Aeronautics Board's Bureau of Enforcement filed formal complaints against nine domestic airlines, alleging that their special airport lounges ("clubs") constituted "unjust discrimination" since they provided "special and superior services" to selected passengers, while denying such services to other passengers who had paid the same fares.[6]

Legislative Provisions

The legislative provisions dealing with service and safety requirements are broad. The Colorado public utility law, for example, includes the following provisions:

Compulsory Extension of Service

There are two aspects to the problem of service extension. First, service may be extended within the same general market area that a utility currently serves. Second, service may be extended into a new market area. The state and federal legislative provisions are similar to those found in the Natural Gas Act, as amended, which provide that the commission, after a hearing,

> may by order direct a natural-gas company to extend or improve its transportation facilities, to establish physical connection of its transportation facilities with the facilities of, and sell natural gas to, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: Provided, That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell natural gas when to do so would impair its ability to render adequate service to its customers."[44]

Extension within Market Area. A public utility is required to serve all who ask for, and are willing to pay for, service within the area where it holds itself out to serve.[45] This area is usually specified in the commission's certificate or the city's franchise. As stated by the Supreme Court:

> Corporations which devote their property to a public use may not pick and choose, serving only the portions of the territory covered by their franchises which is presently profitable for them to serve, and restricting the development of the remaining portions by leaving their inhabitants in discomfort without the service which they alone can render.[46]

As a rule, therefore, a public utility can be required to extend its service as its specified market area grows. Most companies are willing to do so voluntarily in order to expand or grow with their markets. At times, however, an extension within a market area is not profitable. Here, the commissions will consider the prospective costs and revenues, as well as the social benefits, of such an extension. Some service extensions may be ordered even though costs are greater than revenues. The key issues are the effect of the extension on (1) the total return of the company involved[47] and (2) the ability to render "adequate" service to "existing customers."[48]

The commissions have an alternative to requiring service extension by the existing company; they have the authority to issue a certificate to a new company when the existing company is providing deficient service in its market area.[49] Neither a certificate nor a franchise, in other words, protects a utility from the entry of a competitor if a commission finds such entry to be in the public interest.[50]

Extension into New Market. A different problem arises when considering the extension of service beyond a company's present market area, since substantial investment in new plant and equipment is usually required. While many of the commissions have authority to require expansion into a new area, that authority is limited and has been used sparingly.[51] Thus, the Federal Energy Regulatory Commission (FERC) is authorized to order natural gas pipeline extensions to communities that are "immediately adjacent" to a transmission line or "to territory served" by a transmission company, but no farther. And a few commissions lack authority to require extensions into new markets.[52]

As with extensions within a market area, a utility is usually willing to expand voluntarily into a new market area. Few cases have resulted and only two have reached the Supreme Court. In the first case, the New York commission ordered a gas company to extend its service to several communities adjacent to the city where the firm operated. After giving considerable attention to the prospective costs and revenues, the Court upheld the commission's order for the extension as a reasonable one. The Court warned, however, that:

> Under the guise of regulation, the state may not require the company to make large expenditures for the extension of its mains and service into new territory when the necessary result will be to compel the company to use its property for the public convenience without just compensation.[53]

The second case involved the only extension of a railroad line ever ordered by the Interstate Commerce Commission (ICC). The commission ordered a subsidiary of the Union Pacific to make a 187-mile extension in Oregon that would cost nearly $9 million. The Court refused to uphold the order, believing that the commission's authority did not "embrace the building of what is essentially a new line to reach new territory."[54] The Court concluded:

> We should expect, if Congress were intending to grant to the Commission a new and drastic power to compel the investment of enormous sums for the . . . service of a region which the carrier had never theretofore entered or intended to serve, the intention would be expressed in more than a clause in a sentence dealing with car service.[55]

When companies, because of the prospective costs and revenues, are unwilling to extend service to new market areas voluntarily, commissions can often make such extensions attractive. A company may be permitted to

charge higher rates in the new market than are charged in the old market. In this way, the new customers will pay the costs of extending the service. A company may be permitted to raise its rates in the old market, thus charging more for the same service than in the new market.[56] The old customers will thereby subsidize part of the new service. Finally, a company may be permitted to raise rates in both markets, so that the new and old customers will pay the same rates. Both groups will pay the costs of extending the service. Commissions generally prefer either the first or second alternative, and there are many instances where each has been employed. Suburban bus rates commonly are higher than downtown city rates; city telephone service is usually more expensive, relative to cost, than rural service.

Curtailment of Service: Interstate Gas Pipelines[57]

Beginning in the early 1970s (and continuing until 1979), the demand for natural gas exceeded the supply in the interstate market, resulting in pipelines curtailing deliveries of gas to some of their customers. In April 1971, the Federal Power Commission issued Order No. 431, requiring every jurisdictional pipeline (1) to report to the commission whether curtailment of its deliveries to customers would be necessary because of inadequate supplies and, if curtailment were deemed necessary, (2) to file a revised tariff to control deliveries to *all* customers.[58] Thereby began a debate over issues of the basis for curtailment (e.g., curtailment based on end-use versus curtailment based on pro rata reduction of contract entitlements), the method of implementation (e.g., fixed base period versus moving base period) and curtailment-related compensation.

In Order No. 467 (issued January 8, 1973), the FPC set forth eight curtailment priorities based on end-use criteria, but stated that "in specific cases, opportunity will be afforded interested parties to challenge or support this policy through factual or legal presentation as may be appropriate in the circumstances presented."[59] Substantial controversy surrounded both the order itself[60] and proposed curtailment plans, with the result that it took years of hearings (and numerous court appeals) before final commission decisions were made.[61] A typical FPC curtailment plan, however, is the one approved in 1976 for Panhandle Eastern Pipe Line Company. Five priorities were established:

1. Residential and small commercial (less than 50 Mcf per peak day) requirements.

2. Large commercial (50 Mcf or more per peak day) requirements without alternate fuel capabilities, industrial requirements for feedstock, plant protection and process use, and pipeline customer storage injection requirements.

3. All industrial and commercial requirements not specified in (1), (2), (4) or (5).

4. Industrial and commercial requirements of more than 300 Mcf per day, where alternate fuel capabilities can meet such requirements, other than requirements for boiler fuel use.

5. Industrial and commercial requirements for boiler use of more than 300 Mcf per day, where alternate fuel capabilities can meet such requirements.[62]

In establishing these priorities, the commission rejected its "firm-interruptible dichotomy" in Order No. 467-B, primarily on the ground that curtailing interruptible service first incorrectly assumes that such sales service inferior end uses.[63] The commission adopted a fixed, pre-curtailment base period to implement the plan — a fixed thirty-month base period (April 1, 1969, to October 31, 1971) — with entitlements calculated according to the twelve months of maximum takes during the period and with curtailments on a monthly basis.[64]

The issue of curtailment-related compensation arose in most curtailment plan proceedings. Any curtailment of supply (and the subsequent curtailment of sales) has an adverse impact on the curtailed customers. Both the FPC and the FERC took the position that they lacked the power to approve compensation proposals.[65] That position was reversed in several cases,[66] but the FERC has never approved a compensation proposal.[67] A second curtailment-related compensation issue involves liability for contractual damages (i.e., breach of contract). Thus, in 1978, a customer was awarded $23.8 million in damages,[68] and, in 1984, two customers were awarded $84.7 million.[69] Many similar cases are pending in state and federal courts against pipeline and distribution companies.

As a consequence of the various energy-related acts passed in the late 1970s, jurisdiction over interstate pipeline curtailment policy has been bifurcated. Under the Department of Energy Organization Act, the Secretary of Energy has the authority to establish curtailment priorities.[70] That authority, however, is subject to the specific priorities delineated in the Natural Gas Policy Act. First, "high-priority user," meaning:

any person who —

(A) uses natural gas in residence;
(B) uses natural gas in a commercial establishment in amounts of less than 50 Mcf on a peak day;
(C) uses natural gas in any school, hospital, or similar institution; or