THE CONSUMER'S STAKE IN UTILITY REGULATION

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Consumers and consumer-oriented groups have, in the recent past, been concerned with such obvious every day abuses of the market place as packaging, interest costs, false advertising and the like. We have, in recent years, paid too little attention to the problem of public utility regulation. This has not always been so. At one time consumers were very much concerned with the problem. We helped to create the regulatory agencies. Why this apathy?

One answer is that we have abdicated our concern to weak, inefficient, under-staffed and, in too many instances, timid regulatory agencies in the hope that they would do the job for us.

At the same time, legislatures and courts have erected a legal maze for the protection of the property rights of the investor, with no corresponding protection for the property rights of the consumer.

It is to the issue of the protection of the property rights of the consumer to which I wish to address myself.

TO INSURE BEST SERVICE TO CUSTOMER

Public utility regulation is, at its best, a process wherein the state sits as the impartial judge in awarding adequate earnings to an investor in a state-granted monopoly, in return for controlled earnings and regulated rates, so as to insure the best service to the customer.

When the scale tips in either direction, either too much in favor of the company or too much in favor of the customer, the system has failed. There is good reason to believe that in the last 20 years we have witnessed a breakdown in the system in favor of the utilities at the expense of the consumer.

Recently, the National Rural Electric Cooperative Association (NRECA) aroused spirited debate when it declared that private electric utility companies had overcharged their customers some $3.4 billion in a seven-year period.

Naturally, the companies and several utility commissioners responded with vehement denials and an issue was brought to the fore which has troubled many of us who have been concerned with how well the regulated public utilities are being regulated.

The NRECA based its charges upon three assumptions:

First — That 6% is a fair and reasonable rate of return to be earned on investment.

Second — That the rate base or investment is the plant dedicated to the service, less depreciation and amortization reserves.

Third — That, the amounts classified as deferred taxes resulting from use of accelerated and investment credit depreciation should be treated as tax savings.

If these assumptions are correct, then all companies which are earning a return in excess of 6% are exceeding the permissible limits.

FAIL TO AGREE ON BASIC ASSUMPTIONS

Unfortunately, most state regulatory agencies fail to agree on these basic assumptions.

In Massachusetts, we have had a telephone rate case which went to our state Supreme Court, in which a return of 6.25% was deemed proper. (1) Other states have said that rates varying between 6% and 7% are proper and permissible.

Secondly, not all states agree on the use of the original cost theory of depreciation. These states have adopted the concept of reproduction cost, or so-called "fair value" treatment of plant, which permits a fluctuating rate base.

Third, the question of deferred taxes has been treated differently by the several states. Some have said savings should be passed on to the consumer by reducing rates. Others have argued that the companies will ultimately have to pay higher taxes when they exhaust the depreciation base, and in order to equalize the rates, the utilities report depreciation and taxes as if they were paying out normalized taxes and charging normal depreciation. This maintains a higher plant investment account for return purposes.

These, then, are the two approaches, simplified.

WHAT IS FAIR RATE OF RETURN?

Obviously, if we adopt the NRECA point of view, our rates should be reduced. In 1964, after some criticism by the Co-ops and others, several rate reductions took place. In Massachusetts, Boston Edison, the Telephone Co. and some others have voluntarily reduced their rates at the urging of the Department of Public Utilities, by some $22 millions in 1964. Other companies have not. But, the savings started in 1955. We waited for 10 years for the commission to prod the companies.

What is a "fair rate of return"?

We have all watched the companies pay out a very high rate of dividends each year. In one case with which I am familiar the pay-out rate averaged 87% of earnings over a 20-year period. When the company needed money for new plant, it came before the utility commission seeking rate increases so that it could attract new capital. American Telephone has proposed that tax savings be used to permit it to build new plant. Other companies contend that the money saved from tax cuts be used to raise the companies' rate of return without benefit of a hearing.

> In other words, the customer becomes an investor without being paid for the use of his money. If the customer is to finance new plant, shouldn't he receive a fair rate of return for the use of *his* money? Yet, the utility uses the future returns for the benefit of the investor and the customer sees no reduction in his rates. Neither proposed alternative is fair.

When all else fails, the utilities resort to the fallacious claim that the company is a taxpayer. This is the most misstated theorem in the entire lexicon of utility regulation. The company pays no taxes on its income. It collects whatever taxes become due from its customers, while always retaining the so-called fair rate of return for its investors. **You and I pay the utility's taxes, not the investor.**

Let's compare the earnings and dividends paid out by non-regulated manufacturing companies with those of the utilities.

> For 1963, the private power companies paid 11.1% of gross revenue out in dividends. The telephone companies paid 10.1%. 180 manufacturing corporations paid out 3.7%. (2)
>
> If we compare net profits in relation to gross sales, power companies earned 15.4%, telephone earned 14.5%, while manufacturing earned 6.2%. Government regulation pays off handsomely.

What do these figures mean? For every dollar paid by the customer to the private power company 15.4 cents was net profit, out of which 11.1 cents was returned to the investor, for a 72.5% pay out rate compared with a 60% rate for manufacturing companies.

MUST EARN RETURN ON INVESTED CAPITAL

Certainly, these returns would appear to represent a "fair rate of return." In the legal context in which this term is used, however, this is not always so, for the company has to earn a return on invested capital. Sometimes the rate base is so constructed that even a return of 15.4 cents on every dollar is not enough to return 6% on invested capital. Should such a standard continue?

Critics have argued that the reductions, while welcome, are inadequate. Why then do the regulatory agencies accept inadequate compromises?

Simply, because the agencies are undermanned and are not prepared to pursue full-blown utility investigations. It becomes easier to compromise.

The reason for creating rate regulatory agencies has more than once been stated by the courts.

> Ten years ago, the Supreme Court in the Philips Natural Gas case restated the purpose as being "The protection of consumers against exploitation at the hands . . ." of the companies. *Philips Natural Gas* case, 347 U.S. 672, 683 (1954).

The ideal of regulation, the creation of administrative agencies, staffed by experts, who would protect the consumer by regulating the utility was the original concept.

As we become more sophisticated, other ideals have been added. The concept of regulation also requires the fostering of expanded service and more efficient service.

However admirable the sentiments and intentions of the drafters of utility rate regulations may have been, the system has, over the years, become less admired and more mistrusted by the consumer. Too often, it appears to the layman that his interests are being sacrificed for those of the utilities. Companies are permitted to continue with high-cost, low efficiency plants and to earn a return on a high cost structure.

RULES ARE NOT EASY OF COMPREHENSION

Unfortunately, the mechanics of rate regulation do not lend themselves to easy comprehension. The consumer's only knowledge of the existence of a public agency charged with his protection occurs when there is an interruption of service, a petition for rate change or the like. The consumers' only knowledge of the result comes when he receives his monthly, or more often his bi-monthly bill.

(A sidelight to bi-monthly billing in Massachusetts, at least, has been that it was originally proposed to effect a savings to the utility. If such savings have occurred, they have not been passed through to the customer.)

But what is the consumer's stake in public utility regulation? True, the cost affects us directly. If we can get less expensive service that is one goal for which we should strive. Cost of power, however, has a more important influence on all of us in the economic life of our community.

A vital, inexpensive and expanding power supply attracts and keeps industry, leading to high employment and economic well-being. Conversely, a high-cost, sluggish utility does not add to the community, but rather detracts from it. Certainly, the regulatory agency should take into consideration the efficiency of plant.

In New England, we have faced the problem of high-cost, low-efficiency utility operations for many years with the result that New England enjoys — or rather suffers — from the highest utility rates in the nation. We are the only section of the country which has not utilized hydro-electric power. For 30 years, the utilities have opposed the Passamaquoddy-St. John project, but have failed to offer low-cost power to the consumer.

HAVE RETAINED HIGH RATE STRUCTURES

The companies have consolidated, using holding companies to purchase several small companies, but, rather then pass on savings resulting from such consolidation, have retained the high rate structures of the single companies which they have thus acquired. It is only recently that the regulatory agencies have started to insist upon consolidated rate schedules.

One Massachusetts company has some 20 zone rates in effect, reflecting the original companies merged into it. Each zone rate reflects an investment and cost factor for a company which no longer exists. We have "normalized" cost of capital, where no cost exists because of consolidated holdings.

Ultimately, the question must be posed, "Has public utility regulation been effective and has it accomplished its goals"?

Certainly, from the point of view of the regulated gas, electric and telephone companies, as we have seen, regulation has been very effective, in that they have benefitted from high earnings and very little interference. In the transportation field, where competition between carriers exists, and where no monopoly is created, regulation viz-a-viz the companies has had a heavy hand, with correspondingly lower earnings. But this is largely due to non-monopoly conditions.

If our concern is to be the benefits accruing to the consumer, then rate regulation has been far from successful — it has proven to be slow and ineffectual in passing on the benefits of tax savings, as well as reflecting the lower cost of money, or in fostering efficiency.

The basic reason lies in the procedures, policies and laws which have arisen to insulate the utilities from attacks by their customers. While the consumer has complained of high rates or inadequate service, he has ignored the legislative and legal processes. The utilities have not.

In my own state, the utilities maintain one of the most effective lobbies at the State House. This lobby has developed a very interesting relationship with newspapers, banks and insurance lobbies to present a united front in their dealings with legislators. It is fair to say that the legislative committee which is most intimately concerned with utility legislation has not, in recent years, seen fit to pass any legislation deemed to be unfavorable by the utility interests.

As rates are presently regulated by most states, the utility submits a proposed rate schedule. The commission then orders an investigation to determine whether the rates proposed are reasonable in relation to the company's rate base.

ONLY THE COMPANY PRESENTS EVIDENCE

In Massachusetts, whose procedure is comparable with most states, the commission holds public hearings, at which all interested parties may be heard. In practise, the utilities present evidence. Legislators and mayors make statements which are not evidence and occasionally the attorney general appears to question the company's witnesses.

The counsel for the commission questions witnesses for "clarification." I would estimate that in 99 percent of the cases not a single shred of evidence is introduced other than by witnesses for the company.

Budget limitations and inadequate staffing, coupled with administrative inertia prevent the introduction into evidence of an analysis by the commission's staff. And so, the hearings are concluded. The public is satisfied that it has been represented by reading the admirable press releases issued by its legislators and public officials, little knowing that in the judicial scales they count for naught.

Under our system, there must be evidence on the record sufficient to enable the commission to rule on the merits of the case. If the only evidence introduced is that of the company, the commission may disbelieve some of it, but, unless it rules considerably in favor of the company, the commission's rulings will be upset by the courts.

The Massachusetts Consumers' Council has intervened in rate hearings, but again without benefit of witnesses. An effective Consumers' Council or counsel with adequate funds and staff could act to correct such a deficiency. Unfortunately, the political facts are against such a development in the near future. The public utilities commissioners oppose such an approach as encroaching on their jurisdiction. The most we can hope to accomplish is to scale down the requested increase.

WILL OBTAIN RATE INCREASES

Recently, the Massachusetts Consumers' Council, together with the State AFL-CIO, was successful in blocking a projected 35% to 38% increase in non-group Blue Cross-Blue Shield rate increases mainly because the companies were not adequately prepared for opposition to their case and did not expect any meaningful examination. Our victory will not stand for long and the companies will obtain some rate increase because they will be better prepared. As the boy with his finger in the dike, we will eventually be unable to withstand them without assistance of expert witnesses and adequate counter-preparation.

Is there a solution? I believe there is one — there may be many others. What I am about to suggest is not new, is not revolutionary, but is rather a return to first principles — the protection of the consumer from exploitation, coupled with an attempt to guarantee a fair rate of return to the investor.

The District of Columbia from 1913 until 1955 employed a method known as the "Boston Sliding Scale System" of rate regulation. (3) This system was abandoned in the Potomac Electric Company case in 1955.

I imagine Boston developed it and the utilities were successful in changing it, because I can find no reference to it in our statutes.

Briefly, this is how it works, as described by the Supreme Court in the case of *Vinson* v. *Washington Gas Light Co.,* 321 U.S. 489 (1944).

In that company's case, the commission started hearings in 1931, which concluded in 1935 at a cost of $750,000. Those hearings established a depreciated rate base for the company as of 1932. A sliding scale adjustment is then made annually by adding net property additions at cost. A rate of return and a rate of accrual to retirement reserve are then determined, in the light of which rates are adjusted annually.

HEARINGS DETERMINE RATE OF RETURN

Each year, the commission holds hearings which determine the rate of return earned by the company during a test-year running from July 1 to June 30, and, on the basis of the return so determined sets rates to be effective for the year starting September 1 and ending August 31, of the year following. Any earnings in excess of the predetermined fair rate of return are then applied to the following year's reduction.

Naturally, there may not always be reductions — some years will require increases. Nevertheless, the removal of the administrative lag would appear to be beneficial to the companies in years of declining return, and beneficial to consumers in years of expanding return. The economic effect I will leave to the economists in the audience, but I would imagine that serious objections could be raised to this method in a declining economy.

I hope the panel, and particularly Mr. Zeldin, may be able to supply information on how this system works in practise, but at first glance, the approach would certainly meet the objections raised by the NRECA.

The most important aspect of this statutory system is that the cost for administrative investigations, including appeals by the company from action of the PUC, is borne by the company with a limit of ½ of 1% of valuation initially, and a 1/10 of 1% limit annually. (D.C. Code, Sec. 43-412.) This cost is then capitalized by the company with the permission of the PUC. Most important would be the elimination of legislative restraint on the commission's budget through use of this device.

A major criticism of this plan could well be: "How will such a system work in a large state with many utilities, as contrasted with the District of Columbia which has four or five major utilities? Will not the burden become impossible?" I do not believe so.

If we utilize the annual reports filed by the companies, we could require the companies to submit the required analysis of a test rate of return in their reports. With competent staffs, analysis of the companies' reports, together with proposed modifications of rates, could be submitted to the commission by its staff. Unless the company objected, the commission's proposed modifications would go into effect.

Essentially, the reporting would provide the rate-changing mechanism. Are hearings really necessary to determine what a fair rate of return should be except in contested situations?

CONFERENCE METHODS ARE INCREASING

Conference methods of rate regulation are increasing. By this method, the commission and the company negotiate rate changes. Many new problems will certainly arise from the use of a method which is not subject to public scrutiny. Agreements made by commissions and companies will not always reflect the greatest benefit to the public.

Compromise of rate differences will result from the use of such a system unless the commissions have the funds and staffs to threaten a full hearing and mean it. Records of such negotiations should become public, so that interested parties could learn the reasons for rate changes, as well as the methods utilized in arriving at a fair rate.

Despite its shortcomings, the conference method of rate regulation presents the first real change which may prove to be of benefit to the consumer, in that it provides a speedier means of correcting inequities.

There is one more avenue of rate regulation which I might suggest and that is the encouragement of consumer self-interest.

For reasons which may have been valid 50 years ago, the power utilities, as contrasted with the transportation carriers, have been insulated, in most jurisdictions, from suits for the recovery of overcharges. The only relief to which the customer is entitled is the revision of rates for the future, but not to repayment of charges exacted over and above the rate of return found justified by the PUC's.

> Perhaps, if we provided for treble damages in such instances, much as we do in anti-trust, the consumer's self-interest in protecting his rights might prove to be a healthy incentive to effective rate regulation. Certainly, the small consumer could not take advantage of such relief, but larger users would be made more aware of their rights and of abuses which may have crept into the system. Such a tool could help to redress the balance of interests between customers and utilities.

An example of one such problem is a case in which I am currently representing the Commonwealth of Massachusetts. Let me briefly describe the problem.

LIGHTING SERVICE FROM THREE COMPANIES

The Metropolitan District Commission, which supervises a large network of boulevards and parkways in some 40 cities and towns in Greater Boston, purchases street lighting service from three major companies. In setting up this service the companies set a rate which reflects the cost of providing lampposts, lights, wiring and electric power.

Over the years, the MDC chose, for reasons of its own, to provide its own lampposts, wiring, underground connections and even its own maintenance on several hundred such poles. In 1958, we discovered that the MDC was being billed full rates, without reflecting savings resulting to the companies from not having to furnish equipment.

One company had a contract rate which, by its own terms, had expired in 1936 without any attempt to rewrite the contract. In that case, the company was charging a city, which was its only other street lighting customer, a lower rate, and in that instance, the company furnished all of the equipment.

The Department of Public Utilities did nothing, even though the matter was called to its attention. Negotiation proved fruitless since the companies took the position that they owe nothing for past overcharges, even though there is a serious question whether the established rates even applied to the conditions found.

Ultimately, the attorney general brought a suit in court, and as a result the department took jurisdiction. The D.P.U. ruled that the MDC is entitled to lower rates to reflect the contribution of its own poles, but has thus far failed to grant relief for the underground contribution. We have appealed to the courts for relief as to the underground portion, as well as attempting to recover overcharges.

Since the matter is presently pending in court, I do not believe it proper to discuss the entire case, but it is interesting to note that we have been negotiating this matter since 1959 and litigating it since 1962. And this is a case where a state agency is the customer. What could a private customer do in such a situation?

Utilities should be just as amenable to suit for overcharges as any other person or corporation. I can appreciate the argument for insulating the company from numerous rate hearings, but if the companies charge a rate higher than is permitted by the PUC, why shouldn't a suit for overcharges be permitted?

SUITS DISMISSED WITHOUT HEARING

Yet, in most of our states, such suits have been dismissed without a hearing on the merits. Utility commissions argue that they may only set prospective rates, but may not order refunds, in the absence of specific provisions in the statutes.

The strongest form of regulation is that which can be exercised by the consumer to ensure that he is receiving fair and equal treatment. The simpler the process, the more effective the regulation.

What is needed is greater involvement by consumers, large and small, in the legislative and administrative process which determines their rates. We should encourage and foster new and lower cost sources of power. We should insist upon high-efficiency plants. We should insist upon greater representation of the public interest by those charged with the duties of regulation. And, we should insist upon proper budgets and adequate staffs to carry out these duties.

Involvement is needed to achieve again the ideal which the earlier framers of rate regulation intended, the protection of the consumer from exploitation at the hands of the companies.

Without such involvement, we face continued control by the utilities of the agencies which are supposed to control them — control because the public has lost interest and concern and because legislators are more aware of the lobbyist's interest than of the consumer's. The time has come to rethink the legislation, to reform the administrative process, so that it may accomplish what was originally intended.

The consumer must make his voice heard at the legislative level so that his interest will truly be protected. His stake is much more than the size of his monthly bill.

FOOTNOTES

(1) In that case, the stock was selling between \$80-\$85 per share, some 68% of which was held by A.T.&T. Under the applicable law, new stock could not be issued below a par value of \$100.00. The Court determined that a return of 8% on Common was required to attract new capital at \$100, and thus the market price had to rise to \$120 before new stock could be issued at \$100. This was so even though A.T.&T. was willing to lend money on bonds at approximately 3.9%. Query: whether this was not an open invitation to speculation at the expense of the consumer, rather than protection for investors?

(2) FPC Jan. 5, 1965 release on Class A & B electric companies. Federal Reserve Bulletin, July, 1964.

(3) D.C. Code Sec. 43-317, et Seq.