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Foreword

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FOREWORD

Neil Hamilton†

Energy is at the top of the list of the state's priority issues. High energy costs and prices are seen as critical factors influencing the state's economic climate.

Utility rate regulation plays a major role in determining these costs and prices. Given their importance to the state's future, it is imperative that rate regulation be carefully analyzed to encourage improvements in efficiency whenever possible. This concern with reducing costs extends to both the cost of the regulatory process itself and the utilities' production costs.

Ironically, in a period of rapidly increasing energy costs, one of the key problems to be resolved is the financial health of utility companies. Investor owned utilities have been facing a financial crises. The performance of utility stocks and bonds in recent years has been shockingly poor. Almost all utility stocks are selling below book value. New equity financing thus dilutes the equity of existing shareholders. Downgraded bond ratings make bond financing extremely expensive.¹

In 1981, the utility industry had one of the worst profit performances in over twenty years.² In 1982, utilities were stronger performers. Although the outlook for 1983 is encouraging, the financial health of utility companies remains a major concern.³ A financially debilitated industry cannot ensure the state a long-run supply of electricity produced at lowest cost. Even if reduced energy demand continues, the United States will begin bumping up against estimated available energy supply by late in this decade.⁴

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1. Hitch, *Utilities in Trouble*, PUB. UTIL. FORT., Feb. 4, 1982, at 18.

2. *Utility Profit Margins Improve in 1981, But Still Near 25-year Low*, PUB. UTIL. FORT., Dec. 9, 1982, at 48.

3. *Id.* A recent investigation by the National Association of Regulatory Utility Commissioners (NARUC) concluded that electric utilities experienced serious and substantial financial difficulties in the late 1970's and up to mid-1981. NARUC concludes that the industry is currently undergoing a modest economic recovery. The continuance of this apparent recovery is uncertain. See Smartt, *Pages with the Editor*, PUB. UTIL. FORT., Sept. 30, 1982, at 6.

4. Lee, *Electric Utilities: Thinking the Unthinkable*, Wall St. J., Mar. 23, 1982, at 26, col. 3.

Persistent rate suppression producing low rates of return will distort the investment strategy of the industry so that these needs may not be adequately met, or met at higher cost through last minute accommodation. Thus, paradoxically, rates would be much higher and service less reliable if rates of return are suppressed in the short run.⁵

State utility regulators must take a leadership role in addressing both the problem of providing energy to consumers at the lowest, most efficient cost of production and the problem of the financial debility of the utility industry.⁶ This will be a difficult task. As a well known forecaster has indicated, "Unable to attack powerful oil interests, utilities have become the targets of consumer groups who feel helpless to control the rising cost of energy."⁷

The articles presented in this symposium make a significant contribution to the principled resolution of these problems by presenting differing views on important utility rate regulation issues in Minnesota. The papers may be categorized into the following general areas: 1) the public policy function of the Minnesota Public Utilities Commission; 2) the role of cost and non-cost factors in ratemaking; 3) recovery of abandoned construction costs; 4) public utility commission review of utility company capital structures; 5) proposals to expedite the regulatory process while preserving effective public participation; and 6) judicial review of rate of return calculations.

Although it appears that a prerequisite to operation of a public utilities commission is a clear understanding of the commission's proper function, the public policy function has only recently become a matter of discussion in public and private sectors. As one might expect, commentators are far from a consensus on the issue. Some argue that the role of a utilities commission is one of resolving the market failure of natural monopoly. They believe that the commission should be concerned principally with achieving economic efficiency in allocation of resources and production of services. It follows that a fundamental commission objective should be

5. Navarro, *Utility Bills: The Real Price of Electricity*, Wall St. J., Jan. 13, 1983, at 22, col. 3.

6. John Larkin, while President of the National Association of Regulatory Utility Commissioners, commented that state regulators had to raise public awareness of the utilities' financial plight. Hayes, *Why Not Listen to the People?*, ELEC. WORLD, Dec. 1981, at 3; see Hayes, *Can Privately Owned Utilities Survive?*, ELEC. WORLD, Mar. 1981, at 3.

7. Abrams, *John Naisbitt Makes a Handsome Living Reading Newspapers for Big Corporations*, Wall St. J., Sept. 30, 1982, at 50, col. 1.

to deregulate and rely on competition whenever possible. Others argue that utilities commissions are charged with the responsibility to achieve both economic efficiency and public interest concerns, such as social welfare. Reconciliation of these positions is a difficult, if not impossible, task.

Commissioner Juanita Satterlee presents the "human element" in the ratemaking process. She reflects over her role as a Commissioner with the Minnesota Public Utilities Commission and her experiences with persons facing power shut-offs because they cannot afford to pay their utility bills. Commissioner Satterlee argues that, as a regulator, she has a responsibility to ensure the utility an adequate return on equity, but also a responsibility to address the social concerns presented by low income utility customers.

Professor Neil Hamilton and Irving Colacci argue that economic efficiency should be the primary objective of the Minnesota commission. Hamilton and Colacci see utility regulation as an attempt to deal with the market failure created by conditions of decreasing average costs in natural monopolies. They conclude that the only appropriate regulatory response is to confine utility regulation to maintaining efficiency in allocation of resources and production of services, fairness in pricing across classes of customers, and accountability to affected parties. Hamilton and Colacci conclude that, within these objectives, marginal cost pricing is the proper rule of thumb and efforts to overcome obstacles to its use should continue.

An issue closely related to the discussion of the proper function of the utility commission is the role of cost and non-cost factors in the ratemaking process. Eldon J. Spencer, Jr. discusses the role of cost-of-service studies and the factors to be considered in distributing revenues among customer classes. He notes that, under Minnesota law, rates must be reasonable. Factors used in determining reasonable rates include accounting (embedded) costs, economic (marginal) costs, economic externalities, and non-cost factors, such as, value of service, ability to pay, tax consequences, and ability to pass on increases. In his analysis of cost of service studies, Spencer concludes that, given the speculative nature of such studies, the commission places too much emphasis on them. He recommends that the commission encourage all parties to submit cost of service studies in order to avoid sole reliance on utility gathered information.

The critical current issue of recovery of abandoned construction

losses is dealt with in two papers. Rodney A. Wilson discusses the regulatory treatment of such losses by the Federal Energy Regulatory Commission and state commissions. Specifically, he examines cases that have allowed amortization of losses, and cases that have not, in order to determine what principles govern the authorization of amortization. In addition, after reviewing a recent Ohio Supreme Court decision, Wilson suggests that there is an unconstitutional taking of property when the utility is denied the right to recover its investment loss and the decision to proceed and later to cancel was reasonable and prudent. Wilson concludes by suggesting a number of regulatory and administrative changes aimed at mitigating the uncertainties inherent in both load forecasts and long plant construction lead times. These reforms may also reduce the occurrence of plant cancellations.

Gene R. Sommers analyzes the prudent investment test for abandoned construction adopted by the Federal Energy Regulatory Commission and the Minnesota Public Utilities Commission. While approving of the prudent investment test generally, he criticizes the approach of both commissions in denying any return on the unamortized balance of the losses from abandoned projects. Even if the abandoned plant is not used and useful, it is the capital that has been dedicated to the public use and, therefore, that capital is entitled to a fair rate of return.

Two papers and two responses deal with commission review of utility company capital structures. James W. Brehl and James A. Gallagher begin their paper by noting the importance of the capital structure determination to the overall rate of return determination and the ramifications of severe changes or adjustments in the capital structure on the viability of the utility. After extensively examining telephone, gas, and electric rate proceedings over the past decade, Brehl and Gallagher note that, with only a few exceptions, the Minnesota commission has refused to impose capital structures upon utilities, thus leaving determination of the structure in the hands of utility management. The authors conclude that the Minnesota commission should continue to oppose attempts by intervenors to impose capital structures on the utilities.

Bruce M. Louiselle and Jean E. Heilman examine the capital structure issue and conclude that it is a crucial element in the establishment of just and reasonable rates. Louiselle and Heilman argue that state statutes, case precedent, and principles of utility regulation compel the commission to refrain from deferring to utility management decisions in determining the appropriate capital

structure upon which to set rates. In fulfilling its obligation to balance the interests of both the utility company and customers, and to assess the broad public interest, the commission must impose the appropriate burden of proof on the utility and reject the actual capital structure in favor of a hypothetical capital structure when the utility fails to sustain its burden of proof.

The capital structure debate is addressed further in a Response by Brehl and Gallagher and a Rejoinder by Louiselle and Heilman. These additional articles focus on specific arguments made in the preceding papers in an effort to refute, clarify, and elaborate on the positions advocated.

A commonly discussed problem in the regulatory field is that of "regulatory lag." Regulatory lag refers to the period in which the regulatory process takes place. It is most often used in a negative sense, since long lags may place significant burdens on the regulated utility. Richard De Long analyzes proposals to expedite the regulatory process while attempting to preserve effective public participation. De Long deals specifically with the due process requirements of interim rates and cost adjustment clauses, two common proposals submitted to deal with regulatory lag.

Under the interim rate scheme, new rates are set pending final determination of permanent rates. The cost adjustment clause allows the utility to adjust its rates to correspond with fluctuations in certain specified operating costs. After reviewing the development of interim rates and cost adjustment clauses in Minnesota and other states, De Long concludes that, in Minnesota, there are substantially less due process protections for utility customers in the interim rate provisions when compared with cost adjustment provisions. He suggests that an expansion of the types of costs passed through in cost adjustment clauses would reduce the need for application of interim rates, thus mitigating the effects of regulatory lag and strengthening due process protection of utility customers.

Finally, the symposium addresses the role of the judiciary in the review of rate of return determinations by utilities commissions. Samuel L. Hanson and R. Scott Davies define and discuss three rate of return approaches: comparable earnings, risk premium, and discounted cash flow. After reviewing Minnesota statutory and case law, the authors conclude that Minnesota follows the "substantial evidence" rule regarding the scope of judicial review of evidence supporting the factual findings on these rate of return determinations. The scope of review is analogized to appellate re-

view of jury verdicts. Hanson and Davies then discuss how constitutional law has dealt with the issue of confiscatory rates with regard to rate of return calculations. Concluding that the law is out of date, the authors suggest factors that should be included in any analysis of whether rates are on the one hand fair and reasonable, or, on the other hand, confiscatory.

Professor Neil Hamilton and Irving Colacci agree with Hanson and Davies that labeling the process of determining both rate of return and rate structure a quasi-legislative decision and imposing a very deferential scope of review is inappropriate. The scope of review should depend on careful analysis of the type of issue presented. For the same reason, Hamilton and Colacci disagree with the position of Hansen and Davies that it is appropriate first to label the entire rate of return determination as a quasi-judicial exercise subject to a more stringent scope of review, and second, to label the entire rate structure determination a quasi-legislative exercise, subject to a less stringent scope of review. This labeling approach ignores the different types of issues within the rate of return determination. Basic facts should be distinguished and subjected to a different scope of review than facts involving the frontiers of scientific knowledge or legislative policy determinations. All three are evident in rate of return decisions. Hamilton and Colacci suggest an appropriate scope of review to address these distinctions.