Washington Utilities and Transportation Commission

History of Utility Regulation in the United States

Prepared for: The Kyrgyz Republic SEA

Patrick Oshie, WUTC Commissioner
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Mission Statement:

The UTC protects consumers by ensuring that utility and transportation services are fairly priced, available, reliable, and safe.

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Public Utility

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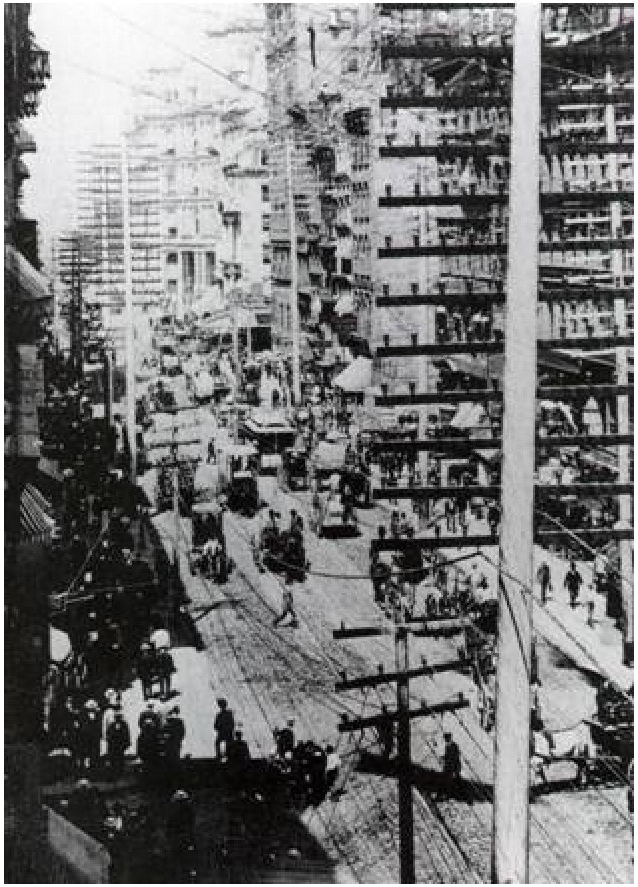
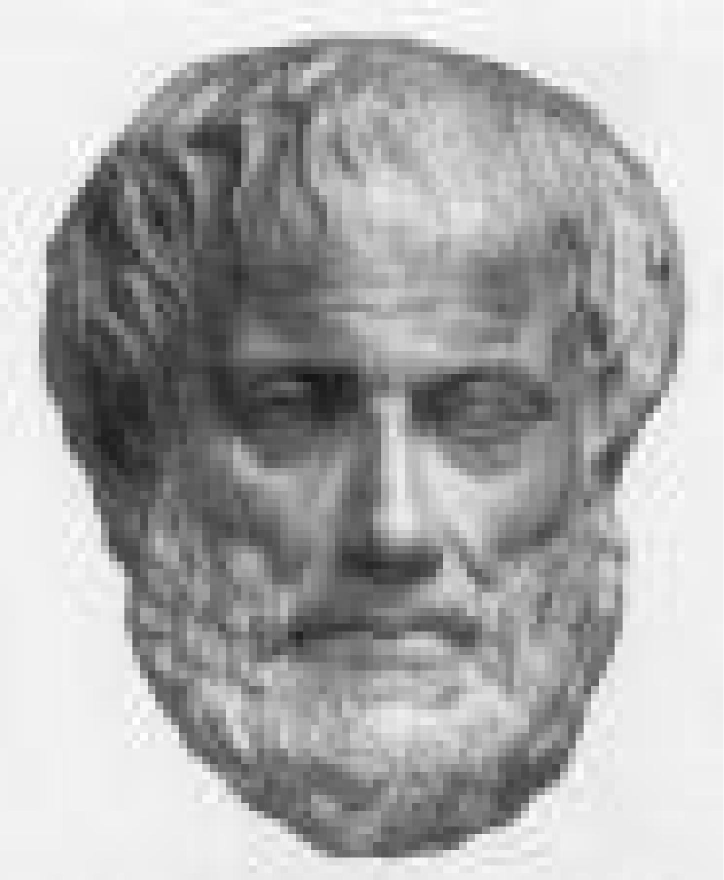
- A business required by law to render adequate service in its field at reasonable ("just") prices to all who apply for it.
- Supplies consumers with services essential to a broad section of the public health and welfare. Because these industries affect the "public interest," they have been subject to a greater degree of government regulation than other businesses.
- Frequently operate as monopolies in their markets.
- Sometimes operate under licenses or franchises that grant special privileges, such as the right of eminent domain.



Broadway, New York City (circa 1880). Pre-telephone regulation. 350 Wires visible.

Ancient Origins

- The "just price" is arrived at through voluntary agreement in which neither party asserts undue influence.
- The ultimate source of the "just price" concept may be Aristotle's Nicomachean Ethics, where transactional justice is described as a balance between what is received and what is given.
- 450-490 A.D. Roman edicts set maximum prices for ~800 articles.
- The duty to serve all comers on equal terms derives from the tradition to care for the stranger and the needy. This custom evolved into the "right of lot."



Aristotle

Medieval English Origins

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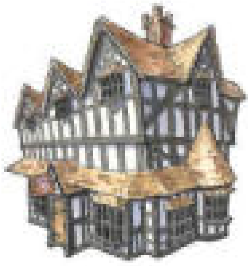
- The ancient notion that certain businesses (such as common carriers) should charge only reasonable rates carried forward to the medieval idea of the "just price" or "justum pretium."

- The "right of lot" was codified by the medieval period. The Grimsby Charter of 1259 states, "(t)that all freeholders of this country shall buy herring, fish, and such like victual without hindrance, as long as they themselves or their servants are present at the unloading of the boat carrying the victual."

- By the medieval period, the right to be served by those who hold licenses and franchises from the government to provide essential services was established.

Medieval English Origins

- By the late 1400s, the duty of certain professions (like innkeepers), but not others (like tradesmen), to serve all, had taken hold in the common law.



- Common carriers started to be held to a higher standard, liability for all loss, than other businesses by the sixteenth century. In 1689, Chief Justice Lord Holt, in *Coggs* v. *Bernard*, reinstated the common carrier’s duty as insurer against all loss, except by an act of God or enemy of the King.

The Public Interest

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- In *Lane* v. *Cotton* (1701) Justice Holt write the following about the liability of postal carriers for lost mail:

  "…whenever any Subject takes upon himself a Publick Trust for the Benefit of the rest of his fellow Subjects, he is *eo ipso* bound to serve the subject in all the Things that are within the Reach and Comprehension of such an Office, under Pain of an action against him…."

- Cooperation between government and business to provide essential services led to requirements that those businesses acting in the public interest respect government principles, such as that of equal citizenship.

Early America – Federal Government

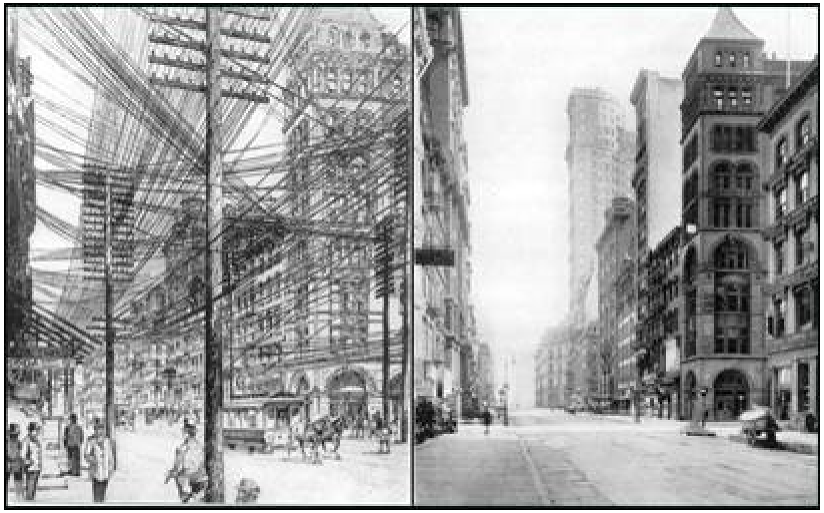
- A minimal role for government was embraced in theory, in the Declaration of Independence, and in the Constitution (Due Process Clause in the 14^{th} Amendment and the Taking Clause in the 5^{th} Amendment).
  - Adam Smith, Wealth of Nations, (1776). An economy operating under private enterprise is efficient, and in that end produces societal good.
  - The due process clause limits government interference in business by requiring that "[N]or shall any State deprive any person of life, liberty, or property, without due process of law.
  - The taking clause provides: "[N]or shall private property be taken for private use without just compensation." This requirement prevents commissions from setting rates so low as to be confiscatory of private property.
- The commerce clause (Article I) gives the federal government authority, "to regulate commerce with foreign nations, and among the several states and with the Indian tribes."

Early America – State Government

- The police powers of the states give them the authority to regulate intrastate commerce. (The federal government regulated interstate commerce.)
- 8 Of the states regulated almost every commodity price between 1776-1814. (Kelly, 6)
- This was followed by a period of lesser regulation.

19^{th} Century

- John Stuart Mill, in *Principles of Political Economy* (1848), describes monopoly as the most efficient organization of the London's gas and water utilities. A natural monopoly occurs when one firm can supply the market at lower cost than more firms.



New York City Street darkened by telephone wires in 1890, then cleared (by undergrounding) 20 years later.

19th Century

- *Lumbard v. Stearns* (1849). An implicit duty to serve all exists, even where not explicit in a charter or franchise. This duty derives from having accepted the government’s charter, or rights, such as eminent domain, use of public rights-of-way, certifications, franchises, or limits on competition.

Populist Era (1876-1932)

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Regulatory powers generally expanded during the first part of this period (1876-1920). The entire period is marked by greater public participation in utility regulation.

- The Interstate Commerce Act (1877). In response to rail industry concerns, required lawful rates, and prohibited pooling and discrimination.
- *Munn* v. *Illinois* (1877). In the 1860s, out of resentment over rate discrimination, 4 states passed the "Granger Laws" regulating railroad rates.
  - Upheld the Granger Laws and the right of government to regulate the use of property for the public good, including the right to fix charges.
  - Limited regulation by requiring that regulation bear a real and substantial relation to the public good, but otherwise held that rates set by the legislature are not subject to judicial review.
  - "Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large."

Populist Era

- States began to set up independent regulatory commissions in the format proposed by NARUC founder Thomas M. Cooley.

- States model commissions on the federal Administrative Procedures Act: quasi-judicial process, case-by-case approach, and passive review.

Populist Era

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- The Sherman Antitrust Act (1890). Declared illegal every contract, combination, or conspiracy in restraint of interstate and foreign trade.

- *Smyth* v. *Ames* (1898). Found that a Nebraska law violated the Fourteenth Amendment by setting unreasonably low freight rates.
  - Set forth the "used and useful" concept." A company is entitled to ask for a fair return upon the value of that which it employs for the "public convenience."
  - Specified how railroad plant should be valued: required valuation of rate base (net investment in used and useful utility assets) at present market value or replacement cost. Use of present market value, rather than cost to investors, was controversial, and posed practical difficulties for ratemaking.

Populist Era

- Clayton Antitrust Act (1914). Supplemented the Sherman Antitrust Act by prohibiting exclusive sales contracts, price cutting and rebates to freeze out competitors, interlocking directors and stock holdings in corporations capitalized at $1 million or more in the same field of business.
- The Federal Trade Commission Act (1915). Set up as an independent agency of the U.S. government charged with preserving competition as an effective regulator of business except banks and common carriers.
- *Wolff Packing Co*. v. *Court of Industrial Relations* (1923). Upheld the validity of a Kansas industrial relations act requiring compulsory arbitration of certain industrial disputes, and the right of regulation of an industry in general in the public interest, so long as that regulation is not arbitrary or discriminatory.

Populist Era

- *Bluefield Waterworks and Improvement Co.* v. *Public Service Commission* (1923).
  - Allowed a rate of return on investment (in property used for the public convenience) that attracts adequate investment capital to allow for proper discharge of its public duties under efficient and prudent management.
  - Utilities have no constitutional right to the higher profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.

A forest of oil derricks in Baku, Azerbaijan, (early 20th Century) .

Populist Era

Where businesses did not affect the public interest, regulation was limited by the end of the Populist Era.

- *Tyson & Brother* v. *Banton* (1927).
  - Found that regulation of ticket brokers violated due process of law.
  - Dissenting opinions held that, “[A] state legislature can do whatever it sees fit to do unless it is restrained by some express prohibition in the Constitution of the United States or of the State, and that Courts should be careful not to extend such prohibitions beyond their obvious meaning...”
  - Later, the dissenting opinions would prevail.
- *Williams* v. *Standard Oil Co.* (1929). Voided state statutes fixing the price at which gasoline may be sold.
- *New State Ice Co.* v. *Liebmann* (1932). Voided states laws limiting competition in the manufacture and sale of ice through the withholding of licenses.

New Deal Reforms (1933-1944)

Period marked by increased economic regulation. Control of prices, market entry and exit, and the terms of service. Regulation no longer limited to business affected by the public interest.

- Industrial Recovery Act (1933). Declared a national emergency in response to the Great Depression. Suspended antitrust laws. Sanctioned industry alliances. Fixed prices and wages, established production quotas and entry restrictions. Allowed employees to unionize. In effect for about 2 years.
- *Nebbia v. New York* (1934). The milk industry could be price regulated, (although the milk industry is not a public utility, is not a monopoly, and holds no government charters or franchises), so long as a rational reason for the regulation could be constructed. Requires that regulation bear a reasonable relationship to its legislative purpose. Replaced the public interest test with a direct due process test to determine whether regulation is permitted.

New Deal Reforms

- Communications Act (1934). Created the Federal Communications Commission (FCC) to regulate broadcast and wired communications.
- Motor Carrier Act (1935). Placed the trucking industry under regulation by the Interstate Commerce Commission.
- Public Utility Holding Company Act (PUHCA) (1935).
  – Limits the influence of holding companies.
  – Forbids holding company control of control power plants and power distribution companies that are located in different states that are not contiguous.
  – Gives the Securities and Exchange Commission (SEC) the authority to regulate utility holding companies.
  – Requires that all side businesses be kept separate from the regulated business, limiting the ability of utility holding companies to subsidize unregulated businesses with regulated profits.

New Deal Reforms

- Robinson-Patman Act (1936). Supplemented the Clayton Antitrust Act by forbidding price discrimination when the effect would be to lessen competition or to create a monopoly.
- Civil Aeronautics Act (1938). Gave the federal Civil Aeronautics Authority the power to regulate airline fares and to determine the routes that air carriers would serve.
- Natural Gas Act (1938). Gave the Federal Power Commission (FPC) the authority to regulate interstate natural gas rates. Suggests ratemaking based on original cost (rather than present value) by authorizing the FPC to ascertain the cost of public utility property for ratemaking purposes. FPC utilized strict rules: costs were includable in rate base only if they were permanently and regularly used; experimental, abandonment, and real estate held for future use were excluded.

A forest of oil derricks in Bartelsville, Oklahoma (1907) prior to regulations on well spacing.

New Deal Reforms

- *FPC* v. *Hope Natural Gas Co.* (1944). Relieved the courts of the technical burden of calculating rates of return. Court's review ends with a determination that a (commission) rate order was not unjust or unreasonable. Commissions have greater flexibility to select different theories of ratemaking.
  - Established the end-result doctrine: ratemaking theory utilized is not as important as the effects that the theory had on rates. "Under the statutory standard of just and reasonable it is the result reached, not the method employed which is controlling. It is not theory but the impact of the rate order which counts."
  - "Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital and to compensate investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on a so-called fair value rate base."
  - Ratemaking "involves a balancing of the investor and consumer interests."

Post-World War II Period (1947-1959)

Period marked by relative stability in regulation.

- Atomic Energy Commission (1947). Both regulated and promoted nuclear technology. Abolished in 1975.
- *Phillips Petroleum Co.* v. *Wisconsin* (1954). Regulated wellhead natural gas prices.
- Hush-A-Phone decision (1956). Permitted customer-provided equipment that is not publicly harmful to be connected to the network. Refers to a noise reducing cover for a telephone’s microphone.
- FCC Above 890 decision (1959). Stripped monopoly AT&T of its exclusive right to all of the spectrum above 890 megacycles for long distance. Provided opportunity for AT&T competitor MCI.

Social Regulation (1965-1978)

Regulation focused on protection of health, safety and the environment (1965-1978). Greater consumer and public activism. Consumer protections, such as winter moratoriums and low-income payment assistance, began.

- FCC Computer Inquiry I initiated (1966).
  - The FCC concluded that computers that facilitate telecommunications are basic telecommunications subject to regulation as common carriers. Anything that involves a change in format, a change in message, data processing, or protocol conversion is an enhanced service that is unregulated.
  - Inquiry II (1976) required local monopolies to pursue business ventures in advanced services through separate subsidiaries.
  - Inquiry III (1986) waived separate subsidiary requirement for enhanced services where open network design and comparably efficient connection for competitors.

Social Regulation

- FCC MCI decision (1969). Opens some long distance service to competition.
- Economic Stabilization Act (1970). Gave the President the temporary right to set energy prices and wages.
- Occupational Safety and Health Act (1970). Establishes standards for the workplace intended to protect the safety of workers.
- The Clean Air Act (1970). Requires the EPA to set national air quality standards.
- Environmental Protection Agency (EPA) (1970). Consolidate in one agency a variety of federal research, monitoring, standard-setting and enforcement activities to safeguard the natural environment - air, water, and land – upon which human health depends.

Social Regulation

- Emergency Petroleum Allocation Act (1973). In response to sharp price increases due to the the 1973 Arab Oil Embargo, established a two-tiered pricing system for domestic crude oil. Crude oil from properties producing at or below their 1972 production levels was subject to a price ceiling while oil from new sources was allowed to be sold at market prices. The price of imported oil remained unregulated.
- Nuclear Regulatory Commission (1974). Replaced the AEC. Focused only on regulation (instead of regulation and promotion) of the nuclear industry.
- Railroad Revitalization and Regulatory Reform Act (1976). Authorized financial subsidies for upgrading rail facilities.

Social Regulation

- Federal Energy Regulatory Commission (FERC) (1977). Created within the Department of Energy to replace the FPC.
- Clean Water Acts (1977). Gave states responsibility for defining and setting federally approved water quality standards and required them to report regularly on attainment of water quality goals.
- Energy Tax Act (1978). Provided tax incentives for investments in renewable energy.
- Public Utility Regulatory Policies Act (PURPA) (1978).
  - Intended to encourage more energy efficient and environmentally-friendly generation.
  - Defined a class of generation as qualifying facilities (QFs) which normally self-generate for their own needs but occasionally have a surplus that utilities are obliged to purchase.
  - PURPA required that utility companies put out for bid the new power to serve load growth. Utility required to contract for power or conservation that would cost less over time than a utility-build option.

Deregulation (1978-)

Focus is on relaxing government intervention in private business (1978 -). In the United States, many public utilities have been privately owned since their inception, unlike in Europe where deregulation has first or also required privatization. At the federal level, many of the New Deal regulations were undone in this period. By the 1990s, states began to restructure utility industries by ending exclusive franchises.

- FPC Order 555. Relaxed application of "used and useful" to allow for some future costs to be recovered. The rationale for "used and useful" is that costs borne by ratepayers should be directly related to benefits derived. Specifically, allowed Construction Work in Progress (CWIP) in rate base for pollution control, conservation, and in instances of demonstrated financial distress. Normally, companies are allowed, through Allowances for Funds Used During Construction (AFUDC) only to capitalize interest on funds used to build new plant, but not to draw a return until the plant is operational.

Deregulation

- Natural Gas Policy Act (1978). Effective 1985, deregulated most natural gas prices at the wellhead.
- Airline Deregulation Act (1978). Deregulated airline rates.
- Motor Carrier Act (1980). Deregulated interstate trucking rates, reversing the 1935 Motor Carrier Act.
- Staggers Rail Act (1980). Deregulated railroad rates.
- AT&T Divestiture (1984). Per a 1982 settlement, AT&T divests itself of 22 local operating companies to settle an antitrust suit filed against it in 1974. In exchange, AT&T is allowed to enter new businesses.

Deregulation

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- FERC Order 436 (1985). Allowed interstate pipelines to unbundle (offer transportation-only, rather than merchant service)
- Natural Gas Wellhead Decontrol Act (1989). Completed deregulation of wellhead natural gas prices.
- FCC Video Dial Tone decision (1991). Defined common carriage service called video dial tone (VDT) under which local exchange carriers would offer video transport and nonprogramming services.
- FERC Order 636 (1992). Required interstate pipelines to unbundle (offer transportation-only, rather than merchant service).

Deregulation Pauses?

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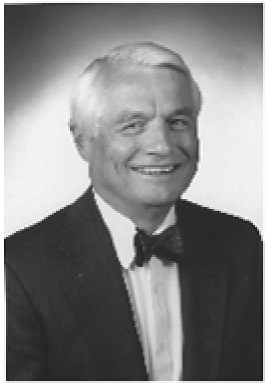
- Cable Consumer Protection and Competition Act (1992). Prior to 1984, the cable industry was regulated by local governments. Cable was deregulated in 1984, but, due to consumer complaints, this law allowed the FCC to regulate cable rates.
- Energy Policy Act (1992) Set 3 new federal standards for electric utilities and for states to consider:
  - Integrated Resource Planning: Plans required, must incorporate public participation and must be regularly updated.
  - Investment in Conservation and Demand Management should be at least as profitable as investments in generation, transmission and distribution plant.
  - Energy Efficiency Investments in Power Generation: Encouraged.
- California Energy Crisis (2000-2001). Electric utilities were required to divest their generation assets and purchase power on the spot market (rather than through long-term contracts), and were not allowed to pass the price increases for a set period of time. Spot market prices skyrocketed, and the state was forced to make purchases for its utilities to avert economic damage from blackouts. The utilities themselves contributed to the crisis through market manipulation and price gouging. As a result of this crisis, some states, such as Nevada, repealed their deregulation laws.

Regulation Today

- Deregulation works best when there are effective substitutes, high price elasticity, the ability to store a product/service, low barriers to entry and many market participants.
- Regulatory principles have evolved, and continue to evolve, based on custom, statute, case law, and policy.
- Where competition is effective, economic regulation, such as entry and exit from the market, should be relaxed. However, the duty to serve all without discrimination is deeply embedded in custom, may continue to be required.

Chairwoman

Marilyn Showalter



Commissioner

Richard Hemstad

Commissioner

Patrick Oshie

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