

Michael Matros

A NEW CHAPTER IN UTILITY REGULATION

The nuclear power debate no longer dominates the utility scene. Deregulation, diversification, and alternative energy sources have come to the forefront. Despite increased federal action, state regulators still have substantial power over utility operations.

by Steve Adams

Late on a cold afternoon last February, a van rented by Southern Bell Telephone and Telegraph Co. arrived at the loading dock of the Dobbs Building in Raleigh. Its cargo for the N.C. Utilities Commission was the paperwork for a rate case — 35 sets of a two-foot stack of documents.

Through the weighty business of a rate increase hearing, Southern Bell was seeking to boost its annual revenues in North Carolina by \$122 million. If the Utilities Commission approved the request, the monthly charge for basic residential local service would go from \$11.15 to \$17.40, a jump of 56 percent. Installa-

The N. C. Utilities Commission at a hearing on telephones.

tion of a residential telephone would be an even steeper increase of 65 or 85 percent (depending on whether wiring had already been installed).

A three-member panel of utility commissioners assembled to hear Southern Bell justify its \$122 million request. The February chill matched the mood not only of the public but also

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of the regulators towards the proposed jump in rates. Seven months later, in September, the panel made its ruling. It agreed to raise local residential rates by only 3.5 percent and gave Southern Bell less than 30 percent of its \$122 million request. The ruling showed the substantial power the Utilities Commission still had over telephone rates in 1983. But the panel's decision hardly settled the matter.

Before September was out, members of the Utilities Commission and its consumer-advocate Public Staff traveled to Washington in a rare effort to lobby the North Carolina Congressional delegation. Regulating telephone rates was quickly moving out of the Dobbs Building and into various arenas on Capitol Hill. On January 1, 1984, Southern Bell's parent company, American Telephone and Telegraph Co. (AT&T) was breaking up. Under AT&T's court-approved antitrust settlement with the U.S. Justice Department, the 22 local operating Bell companies spin off into seven "Baby Bells" independent of AT&T. These seven companies continue providing local service. AT&T — and competitors — provide long-distance service.

Historically, long-distance revenues have provided a heavy subsidy to local service. Now the "Baby Bells" have to make ends meet primarily through local-service revenues. Southern Bell sought the \$122 million in rate increases, in part, because of new pricing systems caused by the breaking up of AT&T. Meanwhile, the Federal Communications Commission was planning to require telephone customers to pay an "access charge" to local companies like Southern Bell to offset the lost subsidies from interstate long-distance service.

Some members of Congress objected to the FCC plans and sought to alter them. In a stunning setback to AT&T and the Reagan administration, legislation altering the FCC plan — the legislation which the N.C. Utilities commissioners had traveled to Washington to support — passed the House. The legislation (HR 4102) would, among its many provisions, eliminate the FCC access charge for residential and single-line business customers. Similar legislation is pending in the U.S. Senate.

Whether Congress can soften the blow of the AT&T divestiture on local telephone rates or not, one thing has become certain about utility regulation. The issues are changing. And so is the axis of power. The AT&T divestiture has set into motion a complex chain of events that involves not only the courts and the telecommunications industry but Congress, the Federal Communications Commission, state utilities commissions, and scores of business and public interest lobbying groups. State utility

regulators retain much authority over the utility franchises operating in their states. But ironically, as the Reagan administration pursues its policies of deregulation and "new federalism," more policymaking power seems to be shifting to — not away from — Washington. At the same time, new technology has catapulted the telephone industry into highly sophisticated telecommunications and data-processing fields.

Meanwhile the electric utilities, after two decades of hopes for nuclear power, are slowly but surely abandoning an old dream. Carolina Power and Light, for example, has put in mothballs the blueprints for Shearon Harris units number three and four. In December 1983, CP&L announced it had canceled Harris number two. Soaring capital needs for new nuclear facilities, slowed demand, and the fall from public favor due to the Three Mile Island incident are causing electric utilities to cancel nuclear plants, place more reliance on coal, and examine alternatives, including alternative energy sources (like solar, for water heaters) and conservation (like home insulation).¹

HR 4102 would reverse the Federal Communications Commission's access-charge decision.

Union Calendar No. 284

98TH CONGRESS
1ST SESSION

H. R. 4102
[Report No. 98-479]

To amend the Communications Act of 1934 to assure universal telephone service within the United States, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

OCTOBER 6, 1983

Mr. WIRTH (for himself, Mr. DINGELL, Mr. MARKEY, Mr. SWIFT, Mrs. COLLINS, Mr. GORE, Mr. LELAND, Mr. BRYANT, Mr. SCHUEER, Mr. WAXMAN, Mr. WRIGHT, Mr. WYDEN, Mr. DORGAN, Mr. DONNELLY, Mr. GUNDERSON, Mr. SIKORSKI, Mr. BONKER, Mr. KILDEE, Mr. TRAXLER, Mr. ALBOSTA, Mr. RICHARDSON, Mr. BOSCO, Mr. ROSE, Mr. WISE, Mr. CHAPPIE, Mr. TALLON, and Mr. TORRICELLI) introduced the following bill; which was referred to the Committee on Energy and Commerce

NOVEMBER 3, 1983

Additional sponsors: Mr. DICKS, Mr. LOWRY of Washington, Mr. DURBIN, Mr. PERRINS, Mr. BOUCHER, Mr. HARRISON, Mr. ANDREWS of North Carolina, Mrs. BOXER, Mr. KOLTER, Mr. OBERSTAR, and Mr. EVANS of Illinois

Deleted sponsor: Mr. PEPPER (October 25, 1983)

NOVEMBER 3, 1983

Reported with an amendment, committed to the Committee of the Whole House on the State of the Union, and ordered to be printed

[Strike out all after the enacting clause and insert the part printed in italics]
[For text of introduced bill, see copy of bill as introduced on October 6, 1983]

*The state grants
utility companies
exclusive
franchises as
natural monopolies*

The natural gas companies also face complex shifts in regulations and economic conditions. Deregulation from Washington, through the Natural Gas Policy Act of 1978, has resulted in both a glut on the market and, paradoxically, soaring prices to consumers. This economic paradox may have to be resolved by new *federal* actions. Meanwhile, as AT&T begins to spin off various telephone services into separate companies, natural gas companies and electric utilities have turned more and more to diversified activities. Electric companies have invested in uranium processing and overseas financial enterprises. Gas companies are expanding into propane and cable television.

These three issues — diversification, soaring capital costs, and deregulation — are recasting the regulatory landscape. After a decade of obsession with energy shortages and prices, utility regulation is slowly closing a chapter. Energy supplies will certainly remain an important concern. But, in the new regulatory era now beginning in North Carolina, attention will focus on corporate structures, high interest rates, and alternative energy sources. Above all, regulatory commissions will have to contend with new corporate priorities. In a two-page ad in major newspapers, E. F. Hutton, addressing the AT&T divestiture, characterized this corporate transition as “a turning point in American industry.” Even allowing for some Madison Avenue hype, state utility regulators obviously have their hands full.

Utility Regulation — The Whys and Wherefores

The state entered the utility regulation business in 1891 by creating the Railroad Commission. Fifty years later, in 1941, the legislature established the N.C. Utilities Commission, with three full-time members serving six-year terms. The commission now has seven members serving eight-year terms (see box on page 5). In 1977, the General Assembly, at the

urging of Gov. James B. Hunt Jr., reorganized the commission.

Despite the complexity of utilities cases and the quasi-judicial nature of Utilities Commission proceedings, until 1977 only a small contingent of lawyers from the state Attorney General's Office represented consumers. The commission staff reported to the commission and, in recent years, generally played a neutral, fact-finding role. (On occasion, the commission hired outside experts who played the role of consumer advocate.) The utilities, on the other hand, were able to hire experts to press their cases.

In 1977, as public concern grew over rising utility rates, the legislature, at Hunt's urging, divided the state's regulatory resources between the commission staff and a new “Public Staff.” The Public Staff represents ratepayers before the Utilities Commission so as to counterbalance the utilities' lawyers, accountants, economists, and other specialists.² For fiscal year 1983-84, the Utilities Commission has a budget of \$2.2 million with 56 staff positions; the Public Staff has a budget of \$2.6 million with 81 positions.

The Utilities Commission, like most regulatory bodies in Washington and Raleigh, exists in theory as an arm of the legislature. The legislature, which has delegated its authority to regulate utilities to the commission, monitors utility activities in the state through a six-member Utility Review Committee. The Utilities Commission functions under the administrative aegis of the Department of Commerce and through a quasi-judicial process of formal hearings and investigations. The commission regulates the rates and services of about 1,000 utility and transportation companies in the state. These include electric, telephone, natural gas,

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—Hugh Wells,
Former Utilities Commissioner

water, and sewer utilities as well as radio common carriers and rail and motor carriers of passengers and/or freight. The commission follows court procedures since its decisions can be appealed into the courts. But, unlike most trials, commission hearings have often been used as a public forum for policy debates.

The state grants utility companies exclusive franchises as "natural monopolies" since duplicating utility services — for example, building parallel electric wire or telephone cable systems — would be unnecessarily expensive. State regulation in effect serves a similar purpose for these monopoly franchises as does competition for companies without a state-granted monopoly. That is, state regulation is intended,

in the absence of competition, to ensure that the franchise holders provide needed services with acceptable quality and at a reasonable cost. As the N.C. Supreme Court has put it, "An uncontrolled legal monopoly in an essential service leads, normally and naturally, to poor service and exorbitant charges. To prevent such a result, the legislature has conferred upon the Utilities Commission the power to police the operations of the utility company so as to require it to render service of good quality at charges which are reasonable."³

The most visible of the Utilities Commission's "policing" duties is the regulation of rates. The commission may also initiate an investigation into a utility's operation on its

The North Carolina Utilities Commissioners

The Governor appoints the seven utilities commissioners (8-year terms) and the executive director of the Public Staff (6-year term), all of whom presently are Democrats. They make \$50,300 (except the Commission Chairman, who makes \$51,300). Note that the terms of two commissioners expire in 1985. The next governor will appoint these two to the commission shortly after being elected. In January 1984, Leigh Hammond resigned from the Utilities Commission. His resignation left a vacancy on the commission as this issue of North Carolina Insight went to press.

A. Hartwell Campbell, 67, was a minister (B.D., Yale) before managing radio and television stations in eastern North Carolina. He served in the General Assembly (1969-79) and was appointed commissioner in 1979. His term ends in 1987.

Ruth Cook, 54, studied at New York University and first worked as a fashion copywriter. She has been a leader in consumer affairs, as director of the State Council for Social Legislation (1966-74), and as a member of the General Assembly (1974-83). Appointed in 1983, she completes her term in 1991.

Edward B. Hipp, 62, is an attorney (J.D., University of North Carolina), originally from Charlotte. He was special counsel for the N. C. General Statutes Commission Utility Law Revision (1962-63) and general counsel for the Utilities Commission (1963-77). Appointed (to fill an unexpired term) in 1977, he completes his current term in 1989.

Robert Koger, 47, is chairman of the Utilities Commission. A licensed professional engineer in North Carolina, he holds a B.S. in electrical engineering and an M.A. in economics from N.C. State University. Before joining the Utilities Commission staff as an engineer in 1967, he worked for the U.S. Rural Electrification Administration (1958-67). He was appointed to the commission in 1977 and reappointed in 1981. His term ends in 1989.

Douglas P. Leary, 48, graduated from East Carolina University in business administration. He worked for the Four County Electric Membership Corporation (1961-72) and was general manager of the Wake Electric Membership Corporation (1972-79). Appointed in 1979, he completes his term in 1985.

Sarah Lindsay Tate, 56, is an attorney (LL.B., University of North Carolina), formerly an associate with the Raleigh firm of Sanford, Adams, McCullough, and Beard. Originally from Charlotte, she has been an associate counsel for insurance companies. She was appointed in 1977. Her term expires in 1985.

own, but usually it monitors a utility when a company requests a rate increase.⁴ The commission usually decides cases in panels of three, as it did in the Southern Bell case. Because of the volume of evidence, hearings may last two weeks or more (see sidebar by Hugh Wells below for a step-by-step summary of this process).

Consumer reaction to rate cases inevitably concentrates on the size of next month's utility bill. But to reach that bottom line, the commission must examine three related, but separate, issues: 1) how much it costs a utility to provide service; 2) whether the utility operates efficiently; and 3) how much the utility needs to earn to retain and attract capital and be fair to its existing investors. State and federal law require the commission to set rates that permit a fair return for investors and financial stability

for the utility, so that the company can raise new capital on reasonable terms.⁵ The commission sets rates at a level that "will *allow* but not *guarantee* operation at a profit," as former Commissioner Hugh Wells put it in a recent *Popular Government* article (see sidebar).

Such words as "allow" and "guarantee" however, require judgments. First, the commission must employ awesomely complex measurement tools. Discounted cash flow analyses help determine the proper rate of return for investors; multiple regression analyses isolate the effects of a single variable in a utility's cash flow plans; heat rate analyses and other techniques measure the efficiency of power plants. But despite such sophisticated efforts, these measurements do not work with scientific precision.

In the Bell case, for example, the commission and the company used the same basic

How The Utilities Commission Establishes Rates

by Hugh A. Wells

Rates are established through this process:

- The utility company applies for new or different, usually higher, rates;
- The commission holds a hearing in which it hears evidence from the utility, the Public Staff, and other interested parties about whether the increase is needed;
- The commission issues an order deciding whether or to what extent the proposed new rates may go into effect.

The controlling statute, NCGS 62-133, requires the commission to go through five basic steps in each general rate case:

- 1) Determine the reasonable cost of the property used by the utility in furnishing service, called the "rate base";
- 2) Estimate the utility's revenue under its present and proposed rates;
- 3) Ascertain the utility's operating expenses;
- 4) Fix such rate of return on the cost of the utility's property as will both produce a fair return for its shareholders and permit the company to maintain its facilities properly and compete in the market for capital funds on reasonable terms; and
- 5) Fix the rates as such a level as will cover the utility's reasonable operating expenses and earn the utility the allowed rate of return.

While the process of utility rate-making often becomes complicated, the basic aim is quite simple: to set rates at a level that will allow the utility to recover its *reasonable* operating expenses; to recover its *reasonable* investment in plant facilities, through depreciation; and to make, by sound management, a *reasonable* profit for its owners.

The obvious key to the success of this process is that magic word "reasonable." And that, essentially, is what ratemaking is — or ought to be — all about. The absence of competitive forces in the marketplace requires that regulation become the substitute for competition, which leads to the possibility that regulated utilities may be only as efficient as they are required to be by those who regulate them. This proposition, while simply stated, constitutes an immense challenge to regulators.

This is excerpted, with permission, from "Utilities Regulation in North Carolina" by Hugh A. Wells, Popular Government, Winter 1983 issue. Now a judge on the N.C. Court of Appeals, Wells served on the N.C. Utilities Commission (1969-75) and as the first executive director of the commission's Public Staff (1977-79).

measurement techniques. Even so, they did not agree on what profit level the company needed. Southern Bell claimed that its stockholders required a 17 percent return on their equity, but the Public Staff put the figure at 13 percent. The commission's judgment fell just below the midpoint at 14.75 percent.⁶ After all the measurements were said and done, the commission made a judgment — in essence, predicting that the stock market in general and the Bell investors specifically would view a 14.75 percent return as satisfactory.

Utilities function as a kind of closed hydraulic system with money being the fluid that keeps them going. If the Utilities Commission reduces the flow of fluid — i.e., cash — from ratepayers, the result is likely to be increased pressure elsewhere in the system. For example, if Southern Bell fails to earn an adequate return for its stockholders, the value of its stock may drop and the rate it must pay to borrow money may increase. Higher-priced loans and higher returns desired by existing and potential stockholders increase the company's cost of doing business, which in turn exerts pressure for higher rates — i.e., together, functioning as a closed system.⁷

This "hydraulic system" exists not only because of the absence of competition but also because public policy prevents utilities from responding as free-market enterprises would to adverse business conditions. For example, state law requires utilities to serve all comers; hence utilities are severely limited in how they can retrench during an economic recession.⁸ Because there are no competitors to provide necessary services, a utility cannot be allowed simply to go out of business. There has never been a utility bankruptcy in the United States, but if one should occur, a very large rate increase probably would be required to maintain service.⁹ In the final analysis, the Utilities Commission must attempt to keep utilities healthy and operating efficiently so that ratepayers receive reasonable and uninterrupted service.

Telephone Deregulation

The AT&T divestiture, combined with giant leaps in telecommunications technology, will radically alter the way telephone rates are set. To offset the loss of the traditional subsidy of local rates by *interstate* long-distance tolls, the Federal Communications Commission (FCC) proposes to require consumers to pay "access charges" to their local company. Southern Bell (and most independent telephone companies operating in the state) have filed a request with the Utilities Commission for a similar type fee to

offset the loss of intrastate long-distance subsidies.* By 1989, when the subsidies would be completely eliminated, the two proposed fees could increase Southern Bell's average monthly bill in North Carolina from the current \$11.58 to \$30.58, according to a position paper by the N.C. Utilities Commission. The Utilities Commission has adopted a resolution supporting the legislation now pending in the U.S. Senate to block the proposed FCC fees. Meanwhile, the Public Staff is opposing Southern Bell's proposal in North Carolina. If the FCC policy remains intact, however, the Utilities Commission probably can do little more than try to cushion the blow as local telephone rates rise.

In a related matter, the N.C. House of Representatives passed a bill in 1983 to allow competition in the *intrastate* long-distance market. Several companies offer such service, even though it is now technically illegal to do so. That bill, sponsored by Rep. George Miller (D-Durham), could come before the state Senate in 1984.

For further discussion of the many issues concerning telephone regulation, see the article by Utilities Commissioner Edward B. Hipp on page 28.

Diversification

As AT&T and perhaps its local operating companies eventually pursue other types of communication ventures besides telephone service, they will be following a path now well worn by other types of utilities. In North Carolina, natural gas companies are moving into unregulated markets in an effort to diversify their business and boost profits. Ironically, the 1956 AT&T antitrust settlement with the U.S. Justice Department, which the current divestiture settlement replaces, deals with almost exactly the same diversification issues that are growing in North Carolina. One of the purposes of the 1956 decree was to prevent AT&T from taking unfair advantage of its monopoly position and monopoly-generated revenues to compete in unregulated markets.

The Utilities Commission must determine how the utility companies' unregulated enterprises affect the ratepayers and the overall financial strength of the utility. For a detailed discussion of four types of "subsidization" between the utility franchise business and a spinoff venture, see the article on page 13.

*On December 16, 1983, in an *interim order*, the Utilities Commission rejected the proposed intrastate access charge. The commission is scheduled to release a broader decision by April 3, 1984.

The End of the Power Plant Boom — the Electricians Retrench

Nuclear power has not proven to be as cheap as people once thought it would be, primarily because of the massive cost of plant construction. The federal Nuclear Regulatory Commission regulates nuclear plant construction and safety. A wide range of factors, including the complexity of federal regulation, has resulted in huge cost overruns on almost all nuclear facilities. As construction costs increased, utilities had to raise larger sums of money, which drove the construction costs still higher.

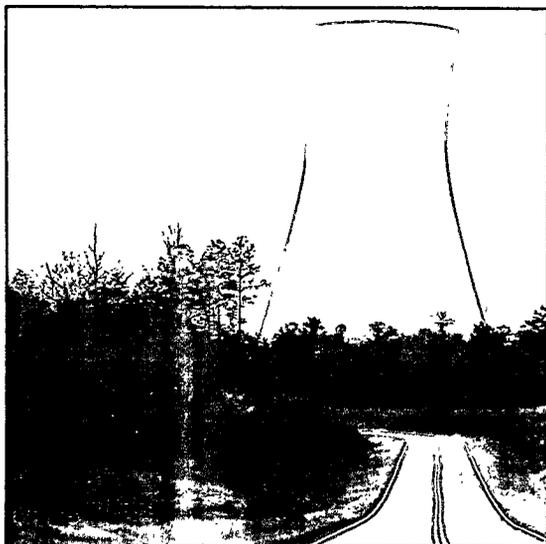
CP&L's first nuclear plant, H.B. Robinson (in South Carolina), came on line (i.e., into customer use) in 1971 at a cost of \$126 per kilowatt of capacity. Duke Power Co.'s McGuire nuclear plant in Mecklenburg County, scheduled for completion in 1984, will cost \$800 per kilowatt of electric capacity. In 1986, unit 1 of CP&L's Shearon Harris nuclear plant in Wake County is expected to come on line, at a cost of \$3,000 per kilowatt. In other words, in building Shearon Harris, CP&L is expected to spend \$3,000 to produce the generating capacity to light 10 lamps burning 100-watt bulbs (10 x 100 watts = 1 kilowatt). In 16 years, the cost of generating capacity at a CP&L nuclear plant jumped more than 20-fold. After McGuire and Shearon Harris, no major power plants are likely to be built in the state in the near future.¹⁰ A moderation in rate increases should occur.

"Even with higher costs for later units, the average cost of CP&L and Duke Power capacity will be low on a national basis," says CP&L's Chairman Sherwood Smith.

During the nuclear plant building boom, electric rates skyrocketed. "Two aspects of ratemaking for electric utilities have been particular targets of public indignation," says Hugh Wells, "fuel clauses and construction work in progress." In 1982, the General Assembly made changes in the statutes affecting both of these issues.

Fuel Clauses. In 1975, the legislature granted utility companies specific permission to come before the commission to ask for rate adjustments to reflect shifts in fuel prices. In these "fuel clause" hearings, held between general rate cases, the commission at first continued to consider the general efficiency of the utility plant. But VEPCO appealed this practice into the courts, and the N.C. Court of Appeals ruled that the "fuel-clause" law prohibited the commission from considering any factors other than fuel prices.¹¹

In 1980, after the Court of Appeals ruling, all three of CP&L's nuclear units were out of



CP&L's Shearon Harris facility under construction.

service during peak summer demand. CP&L had to produce electricity utilizing more expensive coal-fired generating plants or had to purchase electricity from other utilities. As a result, fuel expenses rose by some \$51.5 million, which was passed along to the ratepayers. The next year, 1981, CP&L's nuclear units were again out of service at the peak cooling time, and about \$50 million in fuel-related expenses were passed along to the ratepayers in higher rates. In these hearings, the commission was limited by the VEPCO decision to a consideration of fuel prices and could not examine the reasons for the nuclear plant shutdowns.¹²

In 1982, the General Assembly changed the law and gave the commission the authority to assess all aspects of a power company's operation during a fuel clause hearing. In addition, there can be only one fuel clause hearing per year.

Construction Work in Progress (CWIP). The commission bases its "reasonable" rate of return for a utility company on the company's plant investment, called the "rate base." The rate base thus is extremely important in arriving at the final rates consumers pay. Before 1977, only plants *actually in use* could be included in the rate base. In 1977, the same year it created the Public Staff, the legislature allowed, effective in 1979, utility companies to include "construction work in progress" in the rate base (see "CWIP: Shifting the Investment Risk to Utilities' Consumers," *N.C. Insight*, Spring 1979). CWIP is a tradeoff for both consumers and for power companies. For utilities, the provision improves cash flow but does not dramatically increase profits. For consumers, it means higher rates in the short term but — in theory at least — lower

rates than there would otherwise be after a plant goes into service.¹³

In 1982, the legislature gave the commission discretion over whether to allow utility companies to earn a return on money invested in CWIP. The old law *required* such a return. Since the change, the commission has generally allowed a return on CWIP only for major facilities nearing completion, including McGuire and Shearon Harris. In such cases, the commission has allowed fairly significant amounts of CWIP in the rate base in order to optimize financial viability and to avoid dramatic increases in electric rates. By phasing new investment into the rate base — rather than not using CWIP and having the new generating facility become part of the rate base all at once when completed — moderate, uniform rate increases will result, says Commission Chairman Robert Koger, not infrequent, exceedingly large rate increases (i.e., when the entire new plant becomes part of the rate base). Koger believes this practice will significantly lower the overall cost of electric energy and hence is in the public interest.

The Public Staff argues against this commission policy. Executive Director Robert Gruber agrees that the policy will mean lower rates in the long run. “Nevertheless, it requires current customers to pay now for benefits they may not receive in the future,” says Gruber. Secondly, says Gruber, the law authorizes the commission to allow a return on CWIP only when it is necessary to protect the financial health of the utility and when it is in the public interest. “It appears that the commission is allowing more CWIP than is needed in the rate base to protect the financial health of the industry,” argues Gruber. “It’s a matter of degree.”

As a practical matter, the CWIP debate is likely to become moot when the Harris unit is completed. Both the commission and the Public Staff say they expect no other major plants to be built in the near future.

Other Electric Issues. As power companies turn from new plant construction to refurbishing older plants, the commission will remain responsible for exerting pressure to promote efficiency, as it has done when it penalized power companies for poor management in recent rate cases.¹⁴ Beyond that, the hydraulics of regulation may stabilize—that is, provided new forces do not appear. Dennis Nightingale, director of the Public Staff’s Electric Division, sees acid rain clouds gathering on the horizon. Solving the acid rain problem, he says, may require massive investments to clean up emissions from coal-fired plants.

Natural Gas Deregulation

Consumers are paying record prices for natural gas despite a huge glut on the market. The situation appears to violate the law of supply and demand, but there’s scarcely anything the Utilities Commission can do about it. The National Association of Regulatory Utility Commissioners describes the predicament this way: “. . . [T]he largest cost components in burner-tip [retail] gas prices are controlled only at the federal level. Our experience thus far in making the transition to partial deregulation of wellhead prices shows that state regulators are forced to deal with the *consequences* of a poorly fashioned transition . . . but are precluded from making the regulatory decisions which are actually *shaping* it.”¹⁵

The natural gas industry has three components: 1) the gas producers (concentrated in the South and Southwest); 2) the gas transporters, which operate an interstate business and hence are regulated by the Federal Energy Regulatory Commission; and 3) the gas distributors, which operate within states and are thus regulated by state utilities commissions. Residential natural gas prices have nearly doubled in North Carolina since passage by Congress of the Natural Gas Policy Act of 1978, which calls for gradual deregulation of producer—i.e., wellhead—prices through 1985. The residential increases are almost entirely the result of these wellhead



hikes. Transcontinental Gas Pipe Line Corporation, the transporter supplying all North Carolina gas, has actually lowered its markups over wellhead prices; the N.C. gas distributors have increased their markups over the Transco prices only slightly.¹⁶

Increases in wellhead prices, while beyond the Utilities Commission's control, do impose new pressures on the companies the commission does regulate. For example, heavy fuel oil is now less expensive than natural gas for some industrial uses. *If industrial use of natural gas declines, residential rates rise* because the fixed costs of operating the distribution system must be spread over a smaller quantity of gas.

To help limit residential rate increases, the Utilities Commission has adopted two strategies to keep industrial customers using natural gas. First, industries are generally allowed to buy gas directly from producers and may contract with Transco and the distribution companies to ship it to them. Second, industries may negotiate their own rates with gas distributors in order to compete with the cost of industrial fuel oils.

The action on natural gas, however, is in Washington. Both houses of Congress are considering a number of bills to modify the Natural Gas Policy Act. One Senate bill (S 1715) would, for example, lift all remaining regulations on natural gas prices over a 44-month period. Various House bills would make more modest changes. Most proposals would give pipelines, such as Transco, relief from contracts that require them to pay for gas they cannot sell.

Conclusion

Many of the factors that most dramatically affect the rates consumers pay — producer gas prices, the cost of nuclear plant construction, federal telecommunications policy — are beyond the control of the N.C. Utilities Commission. Further, the “hydraulics” of regulation limits the ways the commission can respond to various financial market pressures.

Edward B. Hipp, who chaired the three-member panel that decided the Bell case in September, acknowledges that the decision might be no more than a holding action against pressures beyond their control. “You could expect the company to want to be prepared [for the federal changes],” says Hipp. “But they’ve got to experience it before they can start charging for it.”

Commissioner Ruth Cook, a former legislator and a consumer advocate, was also on the panel. “There is no question there will be major changes in the years ahead,” says Cook. “But



Utilities Commission Chairman Robert Koger and Commissioner Ruth Cook.

we will deal with those changes as they happen.”

Commenting on the Southern Bell case, the *Greensboro Daily News* said, “It’s tough to say who is wedged more firmly between the rock and the hard place these days: Southern Bell or the N.C. Utilities Commission.” The telephone company will have to operate in a significantly new environment after divestiture, the newspaper acknowledged. “But the state’s utilities commissioners live in a slightly different environment. They must take into account not only economics, but political realities.”¹⁷

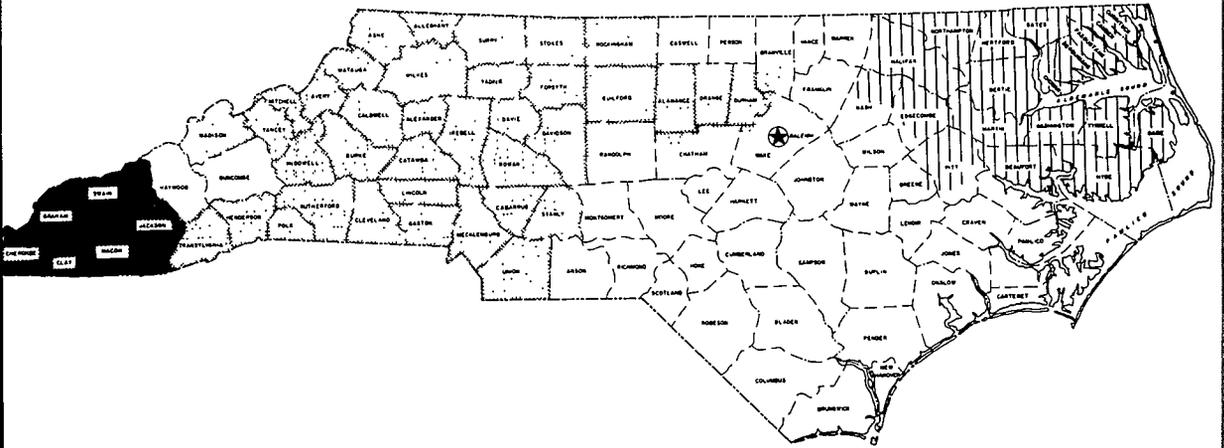
Consumer advocacy and public pressure play an important part in utilities regulation. The furor over electric rate increases in the early 1970s led Gov. Hunt to make utility reform a major part of his platform in the 1976 gubernatorial race. The creation of the Public Staff was a direct result. It is clear that the Public Staff has improved the quality of arguments put before the commission on behalf of consumers. It is equally clear that in the last six years the utility commission has been more attentive to consumers.

In recent years, consumer advocacy has increased, by the Public Staff and others. Meanwhile, the proportion of companies’ rate requests approved by the commission has generally declined, according to the Public Staff. For electric companies, for example, from 1974 to 1977 (pre-Public Staff), the commission granted 90.3 percent of the companies’ rate requests; from 1977 to 1980, the figure dropped to 70.2 percent.

In the day-to-day world of utility regulation in North Carolina, the seven men and women who make the final decisions must contend with the short run and the long term at the same time. Sorting out the avenues of power available to them requires reflection and balance.

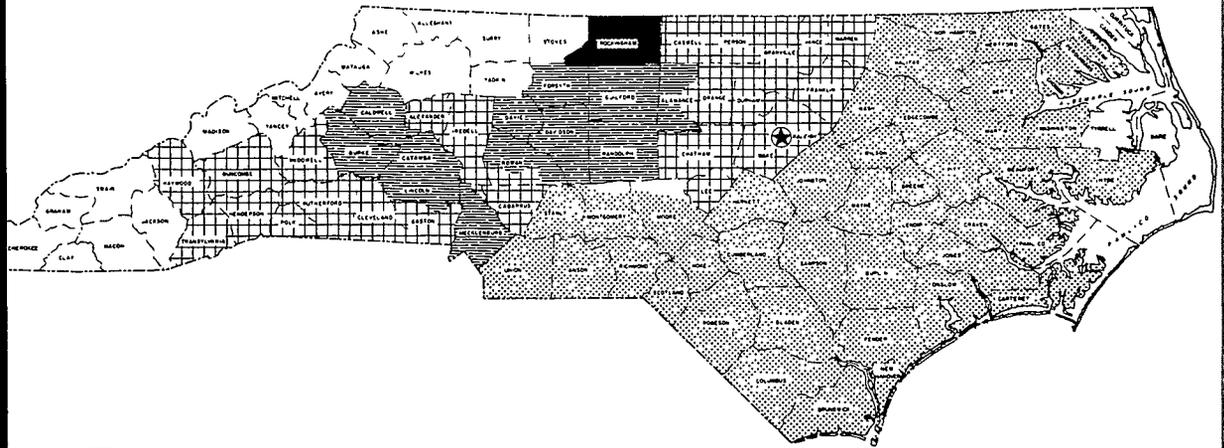
Many factors that directly affect utility rates are beyond the control of the N.C. Utilities Commission. Even so, many aspects of the utility franchise system are regulated by the commis-

Private Power Company Service Areas in North Carolina



- Carolina Power & Light Co.
- Duke Power Co.
- Virginia Electric & Power Co.
- Nantahala Power & Light Co. (serves portions of indicated counties)

Natural Gas Service Areas in North Carolina



- North Carolina Natural Gas Co.
- Public Service Company of North Carolina Inc.
- Piedmont Natural Gas Co. Inc.
- North Carolina Gas Service, Division of Pennsylvania and Southern Gas Co.
- No natural gas service

sion. Because of the increased cost of utilities in general and the factors at work in Washington and on Wall Street, the N.C. Utilities Commission may not be able to keep a \$75 utility bill from rising, but its decisions might keep the bill at \$85 or \$90 instead of \$100.

A new chapter in utility regulation is beginning. While many of the regulatory trends are in transition, the utility companies continue to function for the most part under the same monopoly franchise system that has existed for a generation. Given this framework, how can the N.C. Utilities Commission best function to ensure reliable service at reasonable rates? Answering that question may be the most important public purpose to be served by utility regulators, legislators, political leaders, and the concerned public. □

FOOTNOTES

¹In a pre-publication review of this article, Carolina Power & Light Chairman Sherwood Smith emphasized that utilities still believe that uranium should play a major role in meeting the country's energy needs in future times. "The nation is making a mistake in not pursuing breeder reactor technology as a source for the future, particularly since it is being pursued in other parts of the world," says Smith.

²For a review of the first six years of the Public Staff's activities and accomplishments, see "Public Staff Power Struggles" by Barry Jacobs and Dee Reid, *N.C. Independent*, September 16-29, 1983.

³State ex rel. *Utilities Commission v. General Telephone Co.*, 281 N.C. 318, 189 S.E. 2d 705 (1972).

⁴NCGS 62-132; NCGS 62-130.

⁵NCGS 62-133; *Federal Power Commission v. Hope Natural Gas Co.* (1944), 320 U.S. 591; *Bluefield Water Works & Improvement Co. v. West Virginia Public Service Commission* (1923), 262 U.S. 679. Federal cases cited in "A Bankrupt Utility — What If?" (see footnote 9).

⁶"Return on equity" refers to the return "common stock" shareholders in utility companies earn on investments in the form of retained earnings and dividends. Bondholders and preferred stock shareholders have first claim on revenues above operating expenses. Their returns are fixed and are not ordinarily in dispute in rate cases. Profits, after all other costs, accrue to the common shareholders, the owners of the company.

⁷For a discussion of the effect of regulation on rates see "Does Electing Public Utilities Commissions Bring Lower Rates?" by Malcolm C. Harris and Peter Navarro, *Public Utilities Fortnightly*, September 1, 1983, p. 23 ff. The authors note that both opponents and proponents of elected (rather than appointed) commissions believe that elected regulators tend to adopt strategies intended to hold rates down in the short term. However, they cite academic research showing that such efforts at rate suppression actually can lead to higher rates in the longer run. In their own analysis, the authors conclude that the method of selecting commissions has a negligible effect on rates and that other factors, particularly geographic location, are highly significant.

⁸NCGS 62-32 and 62-42.

⁹"A Bankrupt Utility — What If?" by Robert D. Stewart Jr., *Public Utilities Fortnightly*, September 15,

1983, p. 15 ff. Stewart, an attorney for Oklahoma Gas and Electric Co., calculates that rates of a hypothetical but typical electrical company would jump by nearly 50 percent if the company went bankrupt and was bought by another utility. The increase would occur because the utility's long-term bonds would become due immediately, forcing refinancing and higher rates, and because investors would require a higher return on common stock because they perceived the investment to be riskier.

¹⁰Interviews with Robert K. Koger, chairman of the N.C. Utilities Commission; Robert Gruber, executive director of the Public Staff; and Dennis Nightingale, director of the Public Staff's Electric Division. Until December 1983, a second Harris unit was still on CP&L's construction schedule. When a power company cancels a plant after a sizeable investment, the commission splits the cost between investors and consumers by allowing the company to amortize the investment over a 10-year period.

¹¹48 N.C. App. 453, 269 S.E. 2d 657; certiorari denied by N.C. Supreme Court, 301 N.C. 651, 273 S.E. 2d 462 (1980).

¹²In a subsequent general rate case, Docket E-2, Sub 444, the commission did find that CP&L had not operated Brunswick unit No. 1 efficiently and thus penalized CP&L \$14 million. CP&L also contends that it actually under collected its fuel-related expenses by \$82.5 million during the 1980-81 time period, a contention which still may have to be addressed by the commission.

¹³In general, NCGS 62-133 allows utilities a return only on "property used and useful in providing service," which does not include plants under construction. Without CWIP, utilities claim on their books an "Allowance for Funds Used During Construction" (AFUDC) — a paper, return on their investment. AFUDC appears on the company's books as revenue and is added to the cost of the plant when it goes into service, raising the rates consumers must pay at that time. Generally, Wall Street has accepted AFUDC as revenue in the year it is claimed. However, in the early and mid-1970s, when utilities were engaged in massive construction programs, AFUDC accounted for a large proportion — in a few cases all — of electric utilities' profits. Investment analysts expressed concern that this diminished cash flow would cause investors to perceive an increased risk, driving up the company's cost of capital and consumer's rates.

¹⁴CP&L was penalized \$14 million and \$13 million, respectively, in its last two rate cases. In 1980, the commission penalized Virginia Electric & Power Co. five percentage points in return on equity for inefficiency, poor maintenance, and failure to convert quickly enough from expensive oil to more economical coal.

¹⁵Letter circulated to chairpersons of state regulatory agencies and members of the U.S. Senate by Linda Kent, director of congressional relations, National Association of Regulatory Utility Commissioners, October 21, 1983.

¹⁶Between 1978 and 1982, Transco's markup on gas dropped by six cents per 1,000 cubic feet. During the same period, N.C. Natural Gas (NCNG), which serves eastern North Carolina, increased its markup by only four cents. Even so, the price of gas to an average NCNG residential customer increased \$2.16, from \$3.00 to \$5.16 per decatherm (a metric measure of energy content similar to a BTU, almost exactly equal to 1,000 cubic feet of gas). The source of the entire \$2.16 was the change in wellhead prices, controlled entirely by federal regulations. Rate changes for Piedmont Natural Gas Co. and Public Service Co. of North Carolina showed a similar pattern. Although their markups increased by more than NCNG's, they accounted for only a fraction of the overall increase. Calculations based on figures provided by Public Staff.

¹⁷"Southern Bell's Rock" (editorial) *Greensboro Daily News*, September 16, 1983, p. 10.