

own, but usually it monitors a utility when a company requests a rate increase.<sup>4</sup> 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.<sup>5</sup> 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).*