

THE REGULATION OF PUBLIC UTILITIES

By

Charles F. Phillips, Jr.

Public Utilities Reports, Inc., 1984, 812 pages

Reviewed by

*Steven H. Brose**

In 1965, Charles F. Phillips, Jr.¹ published the first edition of “The Economics of Regulation.” For two decades, that volume (as updated in 1969) served both as an introduction and a continuing basic reference point for countless practitioners who found themselves suddenly confronted with an unfamiliar problem in the area of economic regulation.

The twenty years since publication of “The Economics of Regulation” have witnessed significant, and in some cases truly profound, changes in the regulatory landscape. Whole industries — rail, trucking, commercial air transportation, telecommunications — have been deregulated and restructured. Others, including the oil and natural gas pipeline industries, have faced a fundamental reassessment of the basic premises on which their regulation rested for decades. The momentum of change has escalated to a point where today even the most experienced regulatory lawyers find themselves constantly dealing with new conditions and fashioning new responses.

The challenge Professor Phillips confronted in undertaking to revise his 1965 treatise was, in these circumstances, a formidable one. Adding to the difficulty of his task was the dilemma inherent in any work of this kind — the need to inform the novice while retaining the interest of, and giving genuine assistance to, the long-time expert. Professor Phillip’s task was far greater in this regard because, despite common perception, the “utility lawyer” is not as much a species as a genus. Electric rate lawyers may have a good deal in common with those who represent gas producers, or with telecommunications specialists, but their differences in experience and knowledge are real and perceptible. The goal of a treatise like this one is thus to produce a volume that will have value for practitioners in particular specialty areas, while remaining accessible to non-experts seeking to understand the regulation of an industry or an element of ratemaking that they have not previously encountered.

Professor Phillips’ new text, “The Regulation of Public Utilities,” meets these challenges admirably, and promises to be of significant worth to those whose practice involves the economic oversight of regulated companies by administrative agencies. This is particularly true for practitioners at the Federal Energy Regulatory Commission, in view of the special emphasis given to industries regulated by that agency. The greatest danger, of course, is that in the dynamic setting described above the text will become dated before its time. However, although some of his recitations of the state of specific aspects of the law inevitably will become obsolete,

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the most significant contribution of the volume — the articulation in an orderly and intelligible manner of why and how public utility rates are structured as they are — should nevertheless survive, at least as long as the concept of economic regulation remains a viable one in the American economy.

Professor Phillips states in his Preface that, with the exception of the format and “some of the institutional material,”² the book is a new one and not simply a second revision of “The Economics of Regulation.” That having been said, anyone familiar with the 1965 work will be readily at home with the new one. The basic organization, cadence and depth of the two volumes are substantially similar in all important respects.

“The Regulation of Public Utilities” is divided into an introduction, three substantive parts, and a concluding “appraisal.” For those completely new to utility regulation or seeking to rediscover its theoretical and conceptual roots, part I (“The Economic, Legal and Administrative Concepts of Public Utility Regulation”) is likely to have the greatest immediate value. There, Professor Phillips explores the historical and policy bases that have led to the singling out of particular industries for pervasive regulation. This section also explores the development and current role of the administrative agencies responsible for utility regulation on both the state and federal level.

Parts II and III will be of somewhat greater day-to-day value to the practicing regulatory lawyer. Part II, while denominated “The Theory of Public Utility Regulation,” quickly moves from such cosmic and amorphous issues as “The Goals of Public Utility Regulation” and “The Task of Rate Regulation,” into specific discussions of agency procedures, utility accounting, and rate-making elements. The latter category includes reasonably detailed expositions on such nuts-and-bolts topics as depreciation, deferred income taxes, rate base, rate of return and rate design. One minor criticism, perhaps reflecting more the orientation of the reviewer’s own practice than any real shortcoming in the text, must be noted: the two major ongoing oil pipeline cases,³ each of which has involved sophisticated and pathbreaking analyses of competing ratemaking methodologies, are given far less attention than might be desirable in a survey of this sort. That comment notwithstanding, this portion of the volume should provide a ready road-map for the rate-making initiate, while providing sufficient depth to be a useful resource for those already experienced.

Part III turns from the generic approach of Part II to an industry-specific analysis. This section, moreover, affords an interesting contrast between the current work and its predecessor. In 1965, Professor Phillips devoted much of his attention to the transportation industries, apportioning nearly 100 pages to issues relevant to the regulation of railroads, air carriers and other modes of common carriage. Indeed, the environment at that time led Professor Phillips to observe that “[t]he transportation industries are subject to the most detailed and complex regulatory activity found in the United States.”⁴

²C. Phillips, *The Regulation of Public Utilities* at vii.

³*Williams Pipeline Company*, FERC Docket No. OR79-1; *Trans Alaska Pipeline System*, FERC Docket No. OR78-1.

⁴C. Phillips, *The Economics of Regulation* 441.

Plainly, the deregulatory movement has made a similar statement today impossible. As a result, Professor Phillips has eliminated *any* significant discussion of the transportation industries from the new volume. Instead, he treats four public utility families in depth: the electric power, natural gas and telecommunications industries (each of which also merited separate detailed treatment in 1965), plus a new entry for what Professor Phillips refers to as “the forgotten industry” of water utilities.⁵ In these sections, Professor Phillips traces the development and structure of both the industries themselves and the regulation of them. In addition, issues of particular concern, such as the AT&T divestiture and the effect of the widely fluctuating supply picture on the health of the natural gas transmission industry, are given special attention.

These chapters appear to have the greatest value for those practitioners schooled enough in some form of utility regulation to be comfortable with basic regulatory concepts, but faced with a matter involving an industry with which they are largely unfamiliar. The industry-specific chapters provide an excellent historical context, and while the currency of the specific issues addressed is likely to diminish over time, identification of the particular regulatory slant and the key continuing issues at various agencies should continue to ease the lot of the stranger in an otherwise strange land.

“The Regulation of Public Utilities,” in short, is likely to prove to be at least as valuable to individual utility lawyers and firms with regulatory practices as was its widely-used predecessor. While another period of intense change could make the shelf-life of the new work a good deal shorter than that of “The Economics of Regulation,” Professor Phillips’ treatise has enough undoubted staying power to be a welcome addition to the regulatory lawyer’s library.

⁵C. Phillips, *The Regulation of Public Utilities* 685.

TRANSPORTATION AND MARKETING OF NATURAL GAS

By

William A. Mogel

Executive Enterprises Publications Co., Inc.

1985, 262 pages

Reviewed by

*Stephen A. Herman**

The natural gas industry is now in an extremely exciting period. Old institutional relationships are dissolving and new commercial arrangements are springing up. The impetus for this revolution is the introduction of competition into markets which were previously dominated by federal regulation. While the Natural Gas Policy Act of 1978 (NGPA) has been much maligned, it at least has allowed the competitive cat partially out of the bag. Once free market forces have begun to operate at the wholesale and retail markets, regulation has been unable to keep the old order in check.

The introduction of competition as a significant factor in the gas markets has been reflected in the nature of regulation. For example, the Federal Energy Regulatory Commission (FERC) is no longer focused upon the setting of "appropriate" well-head prices, and the ability for interstate pipelines to file for general rate increases is now superfluous since the market will not sustain higher prices. Within the past three years, a new body of regulation has arisen with its new jargon — "blanket certificates," "Section 311 transportation," "core markets," "SMPs," "discount rates" etc. It has been difficult even for longtime FERC observers to keep track of regulatory developments and to put new programs in perspective.

Fortunately, William A. Mogel, a leading FERC practitioner and Editor-In-Chief of the *Energy Law Journal*, has taken the time to produce an extremely useful work — *Transportation and Marketing Natural Gas*. Mr. Mogel's new book not only details recent developments, but also sets forth a concise history of natural gas markets and regulation. The author's historical perspective is particularly important since we cannot understand the significance of recent regulatory developments unless we know the genesis for changes in regulation.

Specifically, the author has focused on key elements of the Natural Gas Act of 1938 (NGA), which are still of critical importance in the regulation of transportation and sale of natural gas, and has also highlighted important provisions of the NGPA. Mr. Mogel has directed particular attention to the regulation of gas transportation by the FERC. The work includes a very useful review of prior FPC transportation programs, a primer on standards and procedures for transportation under Section 7(c) of the NGA, a helpful analysis of transportation pursuant to NGPA Section 311, and a distillation of current FERC transportation and marketing programs (blanket certificates, SMPs, off-system sales, special discount rates, and rate design). Mr. Mogel also discusses the potential for contract and common carriage, both under existing law and proposed legislation. The author has included extremely informative chapters dealing with assessment of the antitrust laws as applied to gas transportation and marketing, and a discussion of the potential

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impact of recent FERC transportation programs on local distribution companies.

While *Transportation And Marketing of Natural Gas* is written for the reader who is not experienced in the details of FERC regulation, the work provides a convenient resource for all FERC practitioners. Even though the footnotes have been kept to a minimum in order to make the book more readable, the author's citations make the work a valuable source for quick research.

THE COST OF CAPITAL

By

A. Lawrence Kolbe and James A. Read, Jr., with
George R. Hall
A Charles River Associates Study
The MIT Press, 1984

Reviewed by
*Jacob Goldberg**

This is another treatise on the elusive, enigmatic and esoteric subject of a "fair" rate of return for the equity capital of a public utility. This book of 183 pages, including appendices, bibliography and index, is the outgrowth of a study on rate of return which the California Public Utilities Commission requested Charles River Associates, Inc. to make for the use of that agency. Though no writing on this subject makes for easy bedtime reading, this volume opens up new vistas, with a reappraisal of old methods and a forward-looking approach to new methods for estimating (the authors seem to prefer this expression) the cost of capital or fair rate of return on equity.

Five methods for estimating this cost are discussed: Comparable Earnings (CE); Discounted Cash Flow (DCF); Capital Asset Pricing Model (CAPM); Risk Positioning (RP); and Market-to-Book Ratio (MBR).

The weakness of the CE method, in the eyes of the authors and leaving aside the choice of the sample of the comparable companies, rests on the facts that: (1) the earned returns depend on the accounting practices used by each of the companies in the sample; (2) the book returns may not reflect the impact of inflation on the asset value; and (3) the use of regulated entities in the sample results in circularity. The DCF method rests on the formula for computing the present value of a cash flow stream. Thus, the selection of the g (or growth) factor in the formula gives rise to debate. The CAPM methodology, a relatively new methodology in rate of return calculation, is based on a firm's β (beta) risk value measured against the market, which is then "factored" into a market-risk premium (the difference between the expected rate of return of the market and the risk-free rate of return). The authors recognize that the statistical tools for the CAPM application are complex and sophisticated, with associated higher costs. However, the CAPM method should not be discarded, but has promise of improvement with further use. The RP method, or risk premium method, which adds an explicit premium for risk to a current non-risk interest rate, such as government bonds, understandably gives rise to controversy over the amount of the risk premium. The MBR method is based on the theory that the market value of a company's common stock should equal book value, and will do so if the allowed return equals the cost of capital. The problem with this method, which is not widely used, is that if it is perceived that the regulatory agency will use this method, then the market price will anticipate its use and bias the results.

The authors recognize that none of the above methods gives the "correct" result for the cost of equity capital. They believe that: (1) the comparable earnings method

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is the worst of the five methods; (2) the DCF method is conceptually sound under stable conditions; (3) the CAPM method has the best score on consistency and theory, but the worst on related costs; (4) RP has too many variables in finding the risk premium; and (5) MBR is biased by circularity. In summary, the authors should be commended for focusing our attention on the merits and demerits of the various methods of determining a "fair" rate of return.

SUBMITTED COMMITTEE REPORTS

