MICHIGAN UTILITY REGULATION: THE PERSPECTIVE OF THE DISSENTERS

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ABSTRACT

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Through a detailed examination of the written orders issued by the Michigan Public Service Commission (MPSC) with regard to the Consumers Power Company and the Michigan Bell Telephone Company, a study of the utility regulatory policies of the MPSC is presented for the period from 1950 to the mid-1980's. The issue as to whether the main purpose of Michigan utility regulation was to protect the financial integrity of Michigan utility companies or whether the purpose was to protect ratepayers against the abuses of the monopoly power of utility companies is examined. This study concludes that Michigan utility regulation has generally been biased towards insuring the financial viability of the utility companies. Those commissioners favoring large rate increases for utilities have used such non-traditional regulatory concepts as fair value rate base, accelerated depreciation, projected test years, and earnings erosion allowances to accomplish this goal.

The thesis that since the early 1970's, public utility regulation has become increasingly complex and conflictual is also examined. This dissertation generally agrees with this proposition, but notes that in Michigan, utility regulatory

issues became more complex and conflictual as early as the mid-1960's. Utility regulation became more conflictual primarily due to the intervention of various ratepayer groups in utility rate proceedings. The Michigan Rate Payers Association appeared in Michigan utility rate proceedings in the late 1950's on behalf of residential customers. In the mid-1970's, business ratepayers appeared in utility proceedings as the Michigan Energy Users Group.

Also studied is the public controversy surrounding the construction of the Midland nuclear facility, and its eventual conversion into a natural gas generation facility. The dissertation concludes that the enormous cost increases for construction of this particular facility were primarily due to mismanagement of the project by the utility and its contractors, rather than to inadequacies of the regulatory process.

Also reviewed is the history of the Michigan Bell Telephone Company since the divestiture of the American Telephone & Telegraph system in 1984. Examined in detail are the issues of cross subsidization of some ratepayer groups by other classes of ratepayers, and between interstate and intrastate telecommunications services.

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CHAPTER I

INTRODUCTION

Prior to the nineteenth century, the common law in America was not regarded as an instrument of social or economic change. The common law was conceived of as a body of essentially fixed doctrine to be applied so as to achieve a fair result between private litigants in individual cases. Whatever change that did take place in American law was generally brought about through legislation.[1]

America in the seventeenth and eighteenth centuries was essentially an agricultural country, with a small urban population and virtually no manufacturing. If a conflict emerged between agricultural interests and commercial interests, the dispute was often resolved in favor of the agricultural interests. In this period, the growth, if any, in the economy was constant and unspectacular.

In the nineteenth century, judges came to view the common law as a vehicle for bringing about social and economic change. Common law doctrines were developed to favor the rise of manufacturing endeavors, often at the

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[1]Morton J. Horwitz, The Transformation of American Law (Cambridge: Harvard University Press, 1977).

expense of agricultural interests. Especially during the period before the Civil War, the common law performed at least as great a role as legislation in promoting and directing economic development. With regard to the change in judicial ideas about property, Morton Horwitz observed the following:

> As the spirit of economic development began to take hold of American society in the early years of the nineteenth century, ... the idea of property underwent a fundamental transformation - from a static agrarian conception entitling an owner to undisturbed enjoyment, to a dynamic, instrumental, and more abstract view of property that emphasized the newly paramount virtues of productive use and development.[2]

Thus, the common law in the antebellum period forged a productive relationship with newly emerging commercial and industrial interests. This relationship was a factor in commencing the process of change in America from a predominantly agricultural base to a manufacturing base that would eventually assume significance in all facets of American society due to the very rapid rate of the industrialization process.

After the Civil War, the federal government began to expand its activities and to have an increasing impact upon economic development, particularly with regard to policies to dispose of the lands in the western part of the

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[2]Ibid.

country.[3] In the 1870's, America's first major commercial enterprises, the railroads, came to maturity. In order to avoid economic ruination through cutthroat competition, many railroads engaged in price fixing or market allocation schemes. They also engaged in various rate discrimination practices, such as rebates, and long haul/short haul rate disparities. As a result, various farm interests engaged in the Granger Movement and brought about the regulation of railroad rates by various state commissions. Such state rate regulation was approved by the United States Supreme Court in Munn v. Illinois.[4] This type of state regulation was the first direct intervention by public authorities into areas of essentially hitherto private concern in the American economy.[5]

Regulation of railroad rates by individual state commissions proved inadequate for interstate railroad companies after the U.S. Supreme Court decision in 1886 in Wabash v. Illinois.[6] In 1887, the U.S. Congress set up the Interstate Commerce Commission (ICC) to regulate discriminatory rate practices of interstate railroad

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[3]See Morton Keller, Affairs of State: Public Life in Late Nineteenth Century America (Cambridge: Harvard University Press, 1978).

[4]94 US 113 (1877).

[5]James C. Bonbright, Principles of Public Utility Rates (New York: Columbia University Press, 1961).

[6]118 US 557 (1886).

companies. Public agitation in the populist era of the 1890's to grant additional authority to the ICC to set specific rates for interstate railroad companies resulted in the passage of the Elkins Act in 1901 and the Hepburn Act in 1906.

In the industrial sector of the national economy, business concerns began to merge and consolidate. The merger movement received impetus from per unit cost reductions for large scale manufacture due to economies of scale.[7] The merger movement led to cutthroat competition. Specific markets began to be dominated by a small number of very large firms. Oligopolistic market structures began to emerge where competitive markets had previously existed. These large business concerns appeared to have the ability to dictate artificially high prices for goods sold to consumers since competition was beginning to vanish. In order to produce competitive markets which would result in the lowest priced goods for consumers, the U.S. Congress passed the Sherman Antitrust Act in 1890.[8]

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[7]The development of new production technologies in the late nineteenth century resulted in American businesses utilizing mass production techniques. Even though the machinery needed for mass production was extremely expensive, output increased so fast that costs per unit of output dropped dramatically. Thus, increases in productivity brought about reductions in cost.

[8]The best legal and economic interpretation regarding the passage of the Sherman Antitrust Act is William Letwin, Law and Economic Policy: The Evolution of the Sherman Antitrust Act (Chicago: University of Chicago Press, 1965).

By 1890, the American economy had become very complex. In some sectors, nearly pure competitive conditions continued to exist. However, in a number of very important market sectors, oligopolistic conditions had emerged, and the Sherman Act provisions were implemented in an attempt to reinstitute competitive market conditions. Finally, in some sectors, monopoly or near monopoly conditions existed. An example of this was the railroad industry in many areas of the country. The eventual response of the government was to establish regulatory commissions to monitor prices through rate regulation.

One area of the economy that quickly developed monopoly market conditions was the distribution of electricity and natural gas to consumers. The electric utility industry came into existence in 1879 with the construction of the first generation facility. Almost immediately thereafter, state legislatures required electric power companies to obtain special franchises from the municipalities they intended to serve because the electric transmission systems required special use of municipal streets which other industries did not.[9]

By the turn of the century, technology had advanced in the areas of electric generation and transmission, which

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[9]For further discussion of the material contained in this paragraph see "Title I of PURPA: The Effect of Federal Intrusion into Regulation of Public Utilities," Notes, William & Mary Law Review 21 (Winter, 1979): 491.

enabled the building of facilities to transmit electricity over greater distances. Because power generation plants no longer had to be situated only in each individual city, municipalities lost the authority to regulate them. Accordingly, in 1907 both New York and Wisconsin passed legislation creating state public service commissions with jurisdiction to regulate electric utilities state wide. Between 1907 and 1914, twenty-seven states (including Michigan) enacted legislation creating such public service commissions.

In the next twenty years, the superior technology that provided greater opportunities for economies of scale in the generation and transmission of electric power also led to the financial consolidation of formerly independent and localized electric utilities. Small local companies continued to interconnect and merge, forming larger regional companies with combined financial and operating management. Seeking the advantages of economies of scale and more efficient management staffs, public utility holding companies acquired control over many regional utility companies by obtaining sufficient stock in each to direct its operation. One holding company, through stock ownership, could control many electric utilities located throughout the country. As a result of this concentration, a few stockholders controlled the direction and growth of the electric utility industry.

In 1929, the stock market crash and the subsequent depression brought financial disaster to the holding companies by causing a twenty percent reduction in electric utility sales. Financed mainly by debt, the holding companies defaulted on their fixed interest payments when their revenues declined, and many eventually declared bankruptcy. As a result, in 1935 Congress enacted the Public Utility Holding Company Act, which established a federal regulatory scheme to correct the abuses of holding companies. Congress granted the Securities and Exchange Commission (SEC) the authority to limit a public utility company, with certain exceptions, to a single integrated generation and transmission system. By 1950, the SEC had nearly completed the task of reorganizing the holding companies. Also, New Deal legislation saw the passage of the Federal Power Act and the Natural Gas Act whereby the federal government assumed jurisdiction to regulate the rates charged by one utility company when selling power at wholesale to another utility company.[10]

The American Telephone Company originated in the late 1870's with the issuance of patents to Thomas Edison and the financing of his enterprise by Boston bankers. The patent protection provided the American Telephone Company a virtual

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[10]For a very detailed discussion of the New Deal legislation regarding big business see Ellis W. Hawley, The New Deal and the Problem of Monopoly: A Study in Economic Ambivalence (Princeton: Princeton University Press, 1966).

monopoly position in the American telephone market until the early 1890's. The marketing policy of this company was to charge a high price for each telephone call, and thus earn a high profit for each call regardless of the number of calls made. If the high price of telephone calls reduced the number of telephone calls customers would be willing to make, the telephone company would be earning a high per unit profit even if its total profits were being reduced by such a policy. Thus, telephone service was basically restricted to business and wealthy residential customers situated in America's largest cities. With the termination of patent rights in the 1890's, independent telephone companies emerged to serve the fringe areas of cities and rural areas located near the cities. The independent telephone companies began to lower prices for telephone service to get customers on their systems. This strategy worked well for them, and telephone service became more universally available in America.[11]

In the early 1900's, the American Telephone Company became American Telephone and Telegraph Co. (AT&T), and the Western Electric Company (Western Electric) was formed as the equipment manufacturing arm of AT&T. The telephone company was nationalized during WWI and returned to private ownership after the war.

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[11]John Brooks, Telephone: The First Hundred Years (New York: Harper & Row, 1975).

During the administration of Woodrow Wilson an antitrust suit was filed against AT&T, the primary purpose of which was to divest the company of ownership of Western Electric. An out of court settlement of this suit was reached whereby AT&T retained ownership of Western Electric, and AT&T agreed to permit its rates for telephone service to be regulated by the various state utility commissions in which it operated.

Thus, by the end of WWI, the electric and telephone industries had commenced to provide utility services to Americans on a widespread basis. AT&T possessed a virtual monopoly in large metropolitan areas, with competition from independent companies in smaller areas. The electric industry was basically a natural monopoly on a localized basis. The process of consolidation in the electric industry had begun by the merger process utilizing holding company corporate structures. Large interstate electric utility holding companies came into existence.

Federal regulation of rates for electric and telephone companies had not come into existence prior to New Deal legislation in the 1930's. Rates for local electric and telephone service were regulated by a large number of states, including Michigan. Basically, these industries benefitted from a favorable public attitude toward their enterprises, and in the case of AT&T, it had successfully avoided divestiture of its manufacturing company by the

federal government. In fact, AT&T believed its public image would be improved by agreeing to state regulation of its telephone rates.

This dissertation will provide an overview of Michigan utility regulation in the areas of telephone, electric, and gas services from the late 1940's to the mid-1980's. Attention will be focused on the Michigan Bell Telephone Company (Michigan Bell) with regard to telephone resources, and the Consumers Power Company (Consumers Power) as to electric and gas services. Particular attention will be provided to the dissenting opinions issued by certain commissioners on the Michigan Public Service Commission (MPSC) from the late 1950's through the mid-1980's. The focus these dissenting commissioners displayed in their various written opinions indicates that during this period utility regulation went through a transition from strict emphasis on rate-of-return economic regulation (i.e., proprietary regulation) to a consideration of broader social issues involving utility services as consumer groups became more active in the regulatory process in the 1970's.

Prior to the late 1960's, utility regulation could generally be considered as having achieved a "consensus of interests" between utility companies and their customers. This was evidenced by the fact that although the 1960's were a period of great social unrest and turbulence, there was

little deviance from traditional rate making practices in utility regulation.

With escalating oil prices and the construction of increasing numbers of nuclear generating facilities, rate payer groups began to participate in the rate making process in the 1970's. Initially, these rate payer groups essentially were composed of residential rate payer representatives; but later commercial and industrial groups commenced to participate actively in these proceedings. The traditional rate making process of the 1960's and before, began to be transformed into a forum to consider broader issues than just economic rate-of-return for utility companies, as evidenced particularly in the dissenting opinions of Commissioner William R. Ralls. This change in regulatory concerns has been characterized as a transition from proprietary regulation to compensatory regulation.[12] To a certain extent, the 1980's were a period of stalemate in utility regulation, inasmuch as utility companies and rate payer groups failed to reach an understanding as to the underlying principles that should govern utility regulation in the future.

The biggest issue in Michigan utility regulation from the 1960's to the present has been the construction of the Midland nuclear facility by Consumers Power. That issue is

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[12]Franklin Tugwell, The Energy Crisis and the American Political Economy: Politics and Markets in the Management of Natural Resources (Stanford, CA: Stanford University Press, 1988).

a microcosm for evaluating Michigan utility regulation in general. Although no definitive conclusions are reached in this dissertation as to the Midland project, a number of tentative conclusions are put forth. Certain public interest groups have claimed that the escalating costs for this project were due to utility mismanagement. The management of Consumers Power has placed the blame for the increased costs and the extended construction period on improper regulation by officials of the MPSC. A third alternative consideration will be presented that partial blame can be placed on government tax incentives such as liberalized depreciation, allowance for funds used during construction (AFUDC) and the Job Development Investment Tax Credit (JDITC) which encouraged both state regulators and utility management in the 1970's to focus exclusively on the completion of this project, regardless of the costs involved, rather than evaluating other cost effective alternatives, including the abandonment of this project as a nuclear facility in the late 1970's or very early 1980's.

The basic conclusions of this dissertation are that future regulatory policies in Michigan should be directed toward implementation of incentive regulation, and the design of studies which appropriately place the recovery of costs with those groups of users responsible for increased utility expenses through their usage of the utility system. By developing appropriate methods to allocate construction

and operating costs to the various rate payer classifications, the issues of cross subsidies between rate payer groups, and between monopoly and competitive services should be minimized.

CHAPTER II

MICHIGAN UTILITY REGULATION THROUGH THE 1950'S

THE MICHIGAN PUBLIC SERVICE COMMISSION PRIOR TO 1950

This chapter primarily focuses on the regulation of Michigan Bell and Consumers Power by the MPSC throughout the 1950's. Michigan Bell is the largest telephone company in the state of Michigan. Consumers Power is the largest combination gas and electric utility in the state. In 1950, Michigan Bell provided service to 1,841,206 telephone units; by 1990 that number was 4,250,631. In 1950, Consumers Power provided electric service to 645,328 customers and gas service to 316,272 customers. In 1990, the number of electric customers was 1,463,453 and the number of gas customers was 1,347,609.

It is not possible to present a complete history of utility regulatory activities in Michigan prior to 1950, because many documents issued by the MPSC were destroyed in the early 1950's by a fire which occurred in the Lewis Cass Building or by flooding within the State Capitol Building in Lansing, Michigan. Thus, this chapter presents an abbreviated review of the MPSC activities prior to 1950.

A topic that has preoccupied analysts of regulatory activity for approximately the last 100 years is the "capture theory" of regulation. The capture theory of business regulation had its birth in the progressive era. Literature began to appear claiming that due to their enormous financial resources, regulated corporations could directly and favorably influence the policies of regulators, particularly through legislative lobbying activities. Although the "capture" idea lapsed in the period of the New Deal due to the expansion of regulatory activities, it was resurrected in the 1950's. By the early 1960's, it was commonly assumed by many scholarly observers of the regulatory process that the regulatory agencies had been captured by the industries which the agencies had been established to oversee and that the promotion of the "public interest" played little or no part in the formulation of regulatory policy.

One historian, Gabriel Kolko, exerted a dominant influence over much of the literature in the 1960's concerning the "capture" thesis. In his study of railroad regulation from 1877 to 1916, Kolko concluded that railroad men were the most important advocates of railroad regulation in that era. The evidence indicated to Kolko that railroads relied on the ICC to attain their own ends. For Kolko, it was clear that federal economic regulation was essentially designed by regulated industries to meet their own needs,

and not those of the "public interest".[1]

The present condition of public utility supervision by the MPSC is the result of a process of evolution.[2] In exercising its supervisory powers, the MPSC has been aided by the applicable statutory enactments of the Michigan legislature, and perhaps even more importantly, by the judicial decisions of the Michigan and federal courts. During the 1870's, economic distress in the agricultural west, and the consequent Granger movement, brought the question of railroad rate regulation to the forefront.[3] As

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[1]Gabriel Kolko, Railroads and Regulation, 1877-1916 (Princeton: Princeton University Press, 1965), and The Triumph of Conservatism: A Reinterpretation of American History, 1900-1916 (New York: Free Press of Glencoe, 1963). For additional observations supporting the Capture Thesis, see Marver H. Berstein, Regulating Business by Independent Commission (Princeton: Princeton University Press, 1955). However, some observers have argued that the Interstate Commerce Commission could not have been captured by the railroads in the late 19th and early 20th centuries, since motor carriers were eventually permitted by the Interstate Commerce Commission to effectively compete with the railroads. See Albro Martin, Enterprise Denied: Origins of the Decline of American Railroads, 1887-1917 (New York: Columbia University Press, 1984). As to the motor carriers themselves, the Interstate Commerce Commission eventually deregulated the supervision of their rates and charges).

[2]See the discussion of the law relating to Michigan utility regulation in Callaghan's Michigan Civil Jurisprudence, Public Utilities (Mundelein, Il: Callaghan & Company, 1961), 20: 405-413.

[3]In the early 1870's, the farmers in the Midwest developed social organizations, the Granges, which sought to relieve the isolation and monotony of rural life. The Granges were initiated as mutual benefit agencies, and the local Grange meetings provided important social gatherings for the farmer and his family.

However, trapped by falling prices, tight money, high interest rates, rapidly increasing railroad rates, the farmer looked for villains to explain his declining economic plight, rather than abstract principles of laissez-faire capitalist economics. From the perspective of the Grange, the villains were the banks and the railroads. The Grange meetings developed a political dimension, as farmers pressured their state governments to combat the influence of the middlemen who, the farmers believed, were largely responsible for their economic plight. Anti-railroad agitation took a sharp upturn.

The farmers were often joined in their protests by local merchants, well aware that a bankrupt farmer was a poor customer. These farmers and local merchants met with considerable political success in their lobbying for railroad reform, which resulted in the passage of several pieces of "Granger" legislation.

a result, many states commenced to enact railroad laws. These state laws were contested in the courts upon essentially two grounds: (1) that the authority to determine the reasonableness of rates lay with the judiciary, and (2) that the state charters under which the railroads were incorporated granted them the power to set reasonable rates as a matter of contract immune to impairment by the state. These arguments were eventually rejected by the U.S. Supreme Court in a number of cases.[4]

The fact that courts traditionally could provide redress in cases of unreasonable charges for public service did not preclude legislative determination of what the reasonable charges should be. On the contrary, it was considered that price-fixing was clearly a legislative power, which, when exercised, was conclusive upon the courts.[5] Later, in dictum which anticipated the ultimate judicial resolution of the issue, the U.S. Supreme Court defined the limits of legislative authority to regulate rates:

> This power to regulate is not a power to destroy, and limitation is not the equivalent of confiscation. Under pretense of regulating fares and freights, the State cannot require a railroad corporation to carry persons or property without reward; neither can it do that which in law amounts to a taking of private property for public

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[4]Munn v. Illinois, 94 US 114 (1877); Chicago, B & Q RR Co. v. Iowa, 94 US 1555 (1877); and Peak v Chicago & NR Co., 94 US 164 (1877).

[5]Pingree v. Michigan Central R Co., 118 Mich 315 (1898); and Wellman v. Chicago & Grand Trunk R Co., 83 Mich 592 (1890), aff'd 143 US 339 (1892).

> use without just compensation, or without due process of law . . . . [6]

Comprehensive regulation of public utilities in Michigan was initiated with railroads by the adoption of the Railroad Commission Act in 1907.[7] The prototype of the initial Michigan regulatory law was the Federal Act to Regulate Commerce of 1887. Until the Hepburn Act of 1906, the Interstate Commerce Commission did not possess rate making powers. The Michigan Railroad Commission Act served the primary purpose of making the provisions of the Federal Act to Regulate Commerce applicable to the intrastate rail transportation of the state. The abuses which the Michigan legislation sought to remedy and prevent were in large measure thought by some to be peculiar to the railroad business.

At the time the Michigan Railroad Commission was created, a much debated question was whether the delegation of legislative power to an administrative tribunal was permissible. In an effort to avoid the issue of the legality of the delegation of legislative power to an administrative agency, there had come into use a form of language which equated the process of rate making to a matter of simple factual determination. In an earlier case, the Minnesota Supreme Court had stated that the legislature

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[6]Stone v. Farmers Loan & Trust Co., 116 US 307 (1886).

[7]Act No. 312 of the Public Acts of 1907 was reenacted, after the adoption of the 1909 Michigan Constitution, by Act No 300 of the Public Acts of 1909.

had not delegated to the Minnesota commission any discretion as to what the law shall be, but had merely granted a power to determine what rates were equitable and reasonable in a particular case.[8]

This fact finding theory may have been necessary at this time to sustain the vesting of rate making power in a regulatory commission, in the absence of express authority in a state constitution. In fact, it was the considered opinion of the Michigan Constitutional Convention of 1907-1908 that such a commission could not be created without constitutional sanction. For instance, the 1907-1908 Michigan Constitutional Convention defeated a proposal to authorize the establishment of a public utilities commission, (2 Debates, Constitutional Convention 1907-1908, page 1034); and the Constitutional Convention approved another proposal which permitted the legislature to create a railroad commission with power to fix maximum freight rates (2 Debates, Constitutional Convention 1907-1908, page 1439, Const, 1908, Art XII, Section 7). Eventually, the legal system recognized that in certain situations legislative powers could be delegated to regulatory commissions, and no longer attempted to justify such a procedure under the suspect theory that administrative commissions were engaged

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[8]State v. Chicago, M & ST P R Co., 38 Minn 281, 298 (1888).

merely in fact finding functions.[9]

Principles governing the delegation of power and the exercise of the delegated authority were outlined in 1935 by the U.S. Supreme Court:

> A proceeding of this sort, requiring the taking and weighing of evidence, determinations of fact based upon the consideration of the evidence, and the making of an order supported by such findings, has a quality resembling that of a judicial proceeding. Hence, it is frequently described as a proceeding of a quasi judicial character. The requirement of a 'full hearing' has obvious reference to the tradition of judicial proceedings in which evidence is received and weighed by the trier of the facts. The 'hearing' is designed to afford the safeguard that the one who decides shall be bound in good conscience to consider the evidence, to be guided by that alone, and to reach his conclusion uninfluenced by extraneous considerations which in other fields might have play in determining purely executive action. The 'hearing' is the hearing of evidence and argument. If one who determines the facts which underlie the order has not considered evidence or argument, it is manifest that the hearing has not been given.[10]

Initially, the authority of the Michigan Railroad Commission was confined to the railroad business. However, at that time, both the telephone and the electric utility industries were in a period of considerable expansion, and there was a public concern to ensure that such services could be secured at reasonable rates. To implement the element of rate regulation which was lacking under the general electric franchise law, a general statute was

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[9]See Michigan Central R Co. v. Michigan Railroad Commission, 160 Mich 355, 361 (1910).

[10]Morgan v. United States, 298 US 468 (1935).

enacted in 1909.[11] Thereafter, in 1911, a general law for the regulation of telephone rates was enacted.[12] These statutes, each independent and self-sufficient, conferred upon the Michigan Railroad Commission rate regulatory powers, together with other regulatory authority appropriate to the respective businesses.

Pursuant to the provisions of Act No. 419 of the Public Acts of 1919, the Michigan legislature abolished the Railroad Commission and terminated its offices. Under the new law, the governor was authorized to appoint five members to a new commission to be called the Michigan Public Utilities Commission (MPUC). This statute further extended the scope of regulatory authority to include the gas business, and conferred, with respect to gas, electric and telephone utilities, the same measure of authority as over railroads. By subsequent amendment, the furnishing of steam was included.

In 1939, the Michigan legislature created the MPSC. The MPUC was abolished, and its functions and powers were transferred to the new commission. (Act No. 3 of the Public Acts of 1939). The MPSC is composed of three members nominated by the Governor and confirmed by the Michigan Senate. No more than two of the commissioners can be

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[11]Act No. 106 of the Public Acts of 1909.

[12]Act No. 138 of the Public Acts of 1911, reenacted and superseded in Act No. 206 of the Public Acts of 1913.

members of the same political party. Section 4 of this Act suggests why the Michigan legislature abolished the MPUC and created the MPSC:

> The Michigan public utilities commission, having failed and refused to properly carry out the legislative mandates with respect to the public safety, and having failed and refused to properly enforce the provisions of the several acts conferring jurisdiction upon it with respect to the use of the various highways of the state in a safe and proper condition, is hereby abolished . . . .

Act 3 of the Public Acts of 1939 vested the MPSC with complete power and jurisdiction to regulate all public utilities in the state, except any municipally-owned utility, and except as otherwise restricted by law. The Act vested the MPSC with power and jurisdiction to regulate all rates, fares, fees, charges, services, rules, conditions of service, and all other matters pertaining to the formation, operation, or direction of such public utilities. The MPSC also possesses authority to regulate the issuance of securities by public utilities; and exercises important powers over the extension of telephone, gas, and electric services into new territories, under the requirement of first obtaining from it a certificate of public convenience and necessity. Finally, it was granted the same measure of authority over railroads and railroad companies as had been granted to the predecessor commission, the MPUC.

The utility industry regulated by the MPSC at the

conclusion of 1960 had a profile as follows[13]:

TABLE 1
PROFILE OF MICHIGAN UTILITY INDUSTRY
AT THE CONCLUSION OF 1960

16	electric companies, 2 of major size
38	gas producing companies
8	gas transmission companies
11	gas distribution companies (selling directly to consumers)
96	telephone companies, 2 of major size
400	major bus and truck companies
1200	small bus and truck companies
14	oil transmission companies
24	railroad companies

During the 1950's, the number of telephone companies regulated by the MPSC decreased, primarily due to mergers of smaller companies by larger companies[14]:

TABLE 2
NUMBER OF TELEPHONE COMPANIES

1954 - 133	1958 - 110
1955 - 130	1959 - 105
1956 - 120	1960 - 96
1957 - 113	

Correspondingly, the number of telephones serviced by the independent telephone companies and Michigan Bell increased[15]:

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[13]Michigan Public Service Commission, Annual Report ([Lansing, MI]: State of Michigan, 1963), 10.

[14]Ibid., 32.

[15]Ibid., 33.

TABLE 3
NUMBER OF TELEPHONES IN SERVICE IN MICHIGAN DURING THE 1950'S

INDEPENDENT COMPANIES

1954 - 235,918	1958 - 305,131
1955 - 253,364	1959 - 323,737
1956 - 271,606	1960 - 338,831
1957 - 290,838	

MICHIGAN BELL

1954 - 2,247,787	1958 - 2,754,143
1955 - 2,403,653	1959 - 2,887,079
1956 - 2,556,352	1960 - 2,975,394
1957 - 2,690,885	

The 1962 Fiscal Year Budget Report noted that during the 1950's, there had been a growth in the overall work load of the Public Utilities Division, particularly with the activity involving rate case preparation.[16] For example, as of December 31, 1956, there was $1.4 billion of utility plant additions and retirements to be audited by the staff of the MPSC. By December 31, 1959, this figure had risen to $2.6 billion. The 1962 Budget Report observed that the auditing performed to determine the original cost of public utility plant was essential in preparing for frequent, major rate cases. The determination of the original cost of public utility plant was crucial to the process by which the MPSC Commissioners would make a finding as to what rates would be fair to both the public and the utility companies.

To more readily evaluate the various rate orders involving Michigan Bell and Consumers Power in the 1950's,

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[16]Department of Treasury, The Budget Report for the State of Michigan for the Fiscal Year Ended June 30, 1962 ([Lansing, MI]: State of Michigan, 1962), 1: H-36.

an introduction to some of the various regulatory concepts employed by the MPSC is essential. By the 1950's, a certain standard formula had been adopted to determine what rate increase, if any, should be approved for a utility company. In each rate proceeding, it is necessary to select a test period and to adjust the operating results in this test period for changes in revenue and cost levels so that the adjusted operating results will be representative of future conditions, and thereby provide a reasonable basis upon which to set rates which will be effective during the future period. According to this standard formula, the MPSC would first satisfy itself that the annual revenues of a utility would be sufficient to cover its reasonable and prudent annual expenses.

Next the MPSC would determine the proper value for the rate base of the Applicant, and apply an appropriate rate of return (i.e., interest rate) to that rate base. The net income of the utility would be measured against this figure to determine whether the utility was earning its authorized rate of return. If the utility was earning less than its authorized rate of return, this indicated that the utility had a revenue deficiency, and therefore its rates should be increased. If the utility was earning more than its authorized rate of return, a decrease in rates was in order. The final element of a rate case concerned rate design, or a determination of what rates should be charged

to the utility's various classes of customers.

The constitutional right of a public utility to a just and reasonable return requires the establishment of a rate base, or an evaluation of the property devoted by the utility to public service, on which an appropriate rate of return will be allowed by the regulatory agency, resulting in the amount of money which the utility may attempt to earn from the sale of its utility services.[17] In the 1950's, regulatory agencies considered three principal methods to determine the rate base for a public utility.[18] The primary method is "original cost". The Federal Power Commission (FPC) defined this as the cost of the utility plant to the person first devoting it to the public service. There are at least two variations on the original cost method. The "prudent investment" method is based upon the valuation of the plant at the cost of the original investment if prudently made. "Historical cost" is an estimate of the prudent investment made if actual cost figures are not available.

The second approach that could be used to compute the rate base of a public utility is "fair value", on the theory that the public utility is entitled to a return based on the

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[17]A.J.G. Priest, "The Public Utility Rate Base," Iowa Law Review 51 (1966): 283.

[18]See American Jurisprudence 2d, Public Utilities (Rochester, NY: The Lawyers Co-operative Publishing Co., 1972), 64: 665.

value of its property at the time of the inquiry as to rates and at the time the property is being used in the public service.

The third method of rate base valuation is the determination of the reproduction cost of the existing plant. In its original form, reproduction cost was ascertained by assuming that the existing plant was to be reconstructed as a whole at prices applicable on a chosen date, or alternatively, averaged over an appropriate construction period. Recently, cost trending is frequently utilized to update existing reproduction cost figures, or to reach a rate base by applying specific price indices to original cost.

However, the measurement of the rate base is merely the first step in calculating a fair return on the "value" of the property of the public utility. The second step is to determine a "fair" or "reasonable" annual rate of return on this rate base. Frequently, a great deal of conflict in the testimony of various expert witnesses in a rate case revolves around the issue of what constitutes a "fair" rate of return or the relative weights that should be given to multiple standards of fairness. Most regulatory commissions accept the basic standard that a fair rate of return should cover the cost of capital for a utility. The twofold rule that a public utility may charge rates designed to cover its operating costs plus a fair return has been converted into

the apparently singular rule that the rates of charge shall cover the company's total costs including its costs of capital. Capital costs are the fixed costs of long-term debt and preferred stock, short-term debt, plus a provision for reasonable dividends on common stock. A fair rate of return must enable a utility to cover its cost of capital so as to enable the utility to maintain its credit standing and enable it to attract new capital on terms favorable to the utility and its customers.[19] In addition, regulatory commissions may also evaluate four additional criteria in arriving at a decision as to what constitutes a fair rate of return on investment for a particular utility: (1) stimulation of managerial efficiency; (2) maintenance of rate level stability; (3) promotion of "consumer- rationing" through rates designed to encourage all consumption for which consumers are ready to pay escapable, marginal costs; and (4) provision of sufficient profits to insure "fairness" to investors.[20] A determination of a fair rate of return requires a balancing of these various criteria, since the various criteria are not necessarily compatible with each other.

Once the reasonable and prudent operating expenses, and

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[19]For an extensive analysis of the "cost of capital" concept as the basic standard of a fair rate of return see James C. Bonbright, Principles of Public Utility Rates (New York: Columbia University Press, 1961), 240-256.

[20]Ibid. 260.

an appropriate rate of return on total plant investment are determined for a utility company, the next issue to be addressed is what rate structure should be adopted by the regulatory commission for the collection of these revenues. There are three basic categories of customers from which to collect revenues: residential, commercial, and industrial. The portion of the total revenue requirement for the utility company each of the customer categories will be responsible for is determined by essentially two methods. The more commonly accepted method is to set reasonable rates based on the standard of "cost of service". Under this approach an attempt is made to attribute to each customer category only those investments and operating costs which are directly associated with providing utility service to that particular category of customer. Under the cost of service approach, the price per unit of service will ideally be equal to the cost per unit. However, this is not the total of the second method of rate determination: the "value of service" proposal. Under this method, weight is also given to the "value" of the utility service to each of the categories of customers as distinct from the cost of producing service for each customer category. Pricing under the value of service concept is similar to a process whereby a retailer sets the price for a suit of clothes or a lady's hat.

Whether the regulatory commission used a cost of service or a value of service approach to rate making, it is

generally conceded that, historically, industrial and business users of utility services have been charged rates for service that were higher than strictly cost justified. Thus, business users of utility services have subsidized lower than cost justified rates for residential customers. This has been true in the telephone industry, where residential rates for local service have been kept at relatively low levels because the overall cost of providing service by the telephone utility has been subsidized by higher than cost justified rates charged for toll services primarily used by business customers.[21] In the 1950's, higher than cost justified rates were less a problem for businesses as evidenced by the fact that no business groups formally intervened in telephone or electric utility rate proceedings before the MPSC. Higher than cost justified rates for utility services were a relatively minor problem for businesses because these costs were included in the cost of their business products and were a relatively small percentage of the products' total cost. Since utility costs

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[21]The observations put forth in this paragraph regarding the cross-subsidization of residential rates by higher than cost justified rates charged for commercial and business related telephone services, has been the traditional positions put forth by representatives of the telephone industry. However, it should be noted that in recent years, various consumer advocacy groups representing residential telephone user interest have vigorously challenged this assumption and have claimed that in reality residential telephone rates are higher than cost justified since they are a monopoly service, and the excess revenues derived from other services have been used by telephone companies to set lower than cost justified rates for competitive business services.

were once a small percentage of total manufacturing costs and easily included in the price of the product, the fact that products may have been sold in a competitive market was not a problem for most manufacturers in the 1950's. This situation would change in the late 1960's and beyond when the rates for most utility services experienced a dramatic increase.

In the 1950's, the issue as to the appropriate levels of rates to be charged to various customer categories was not a source of conflict between residential and business interests or between business and the utility company. Business generally accepted the utility rate levels by the various regulatory agencies. Only in the late 1950's can we discern a conflict of interest emerging (between residential customers and the utility companies) as to reasonable rate levels. Although residential customers generally received utility services at less than cost justified rates, in the late 1950's some residential customers noted that utility expenses were taking a significantly higher percentage of their own personal disposable income.

The MPSC was created in 1938 by a statute that requires that there be three commissioners, who are appointed by the Governor and approved by the Senate. No more than two commissioners of the MPSC can be from any one particular political party.

With regard to the various members of the MPSC during

the 1950's, three are of particular interest: (1) Chairman James McCarthy; (2) Chairman Otis Smith; and (3) Commissioner James Lee. None of these persons were employed by a utility company either before or after serving on the MPSC. Chairman McCarthy was a State of Michigan highway engineer prior to being on the MPSC. When he left the MPSC he was employed as a highway engineer by a private firm. Chairman Smith was the Auditor General of the State of Michigan prior to joining the MPSC. After leaving the MPSC, he was appointed a Justice of the Michigan Supreme Court and eventually became Vice-President and General Counsel of General Motors. Commissioner Lee was an attorney engaged in the private practice of law before joining the MPSC. He retired when he left the MPSC.

Of the other members of the MPSC during the 1950's, none were employed by or affiliated with utility companies, except for William Elmer. Mr. Elmer was an attorney who was engaged in the private practice of law after leaving the MPSC. Mr. Elmer, however, primarily represented motor carrier clients, and never represented any major gas, electric, or telephone company.[22] This evidence as to the

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[22]Data regarding the employment status of the members of the MPSC in the 1950's was obtained in a personal interview with Albert J. Thorburn on August 21, 1984. Mr. Thorburn was an attorney engaged in the private practice of law, who had practiced before the MPSC from 1948 until his death in 1986. Mr. Thorburn did provide some evidence of "influence" by the utility companies with the MPSC members and the Staff of the MPSC when he indicated that it was not unusual in the 1950's for the representatives of utility companies to buy drinks for

employment history of the various members of the MPSC in the 1950's would lend support to the tentative conclusion that the MPSC was not a captive of the utility companies that it regulated in the 1950's.

BRIEF HISTORICAL REVIEW OF THE DEVELOPMENT OF THE TELEPHONE INDUSTRY IN MICHIGAN PRIOR TO 1950

To gain a better perspective as to the operation of Michigan Bell, it is helpful to provide a picture of the telephone industry in Michigan around the year 1950.[23] In 1951 there were three major telephone companies operating in Michigan. 2,039,259 telephones were connected with the wire lines of these companies. 1,841,206 telephones, approximately 93% of the total number of telephones, were operated by Michigan Bell. Next was the Michigan Associated Telephone Company (now the General Telephone Company of Michigan), with 83,303 telephones (4%), while Union Telephone Company had 59,849 (2.9%). In addition to these three large companies, 141 additional "independents" were registered with the MPSC in 1950. This figure compares with the 183 such companies in 1938, indicating a tendency for

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MPSC members and the staff during social hours at various bars and restaurants in the Lansing area. It is doubtful, however, that from this type of evidence, it could be conclusively determined that the MPSC was "captured" by the utility companies.

[23]The material for this part of Chapter 2 was obtained from Willis Frederick Dunbar, Michigan Through the Centuries (New York: Lewis Historical Publishing Company, Inc., 1955), II: 103 & 104.

these small companies to be absorbed by the larger ones, or to merge among themselves. The total number of telephones connected with the 141 "independents" as of May 26, 1952, was 26,933, or slightly over 1% of the number connected with the major companies. Generally, the independent telephone companies were organized in Michigan shortly after 1893, when the Bell patents expired.

The independent telephone companies varied widely in character and size. The smallest was the Alger Telephone Company with only 15 telephones. Several of the independent telephone companies had filed no rate tariffs with the MPSC, apparently being maintained and operated on a voluntary basis.

The majority of the urban centers in Michigan were exclusively served by Michigan Bell. The independent telephone companies primarily served the rural areas of the state. For instance, the Michigan Associated Telephone Company had its main office in Muskegon. Muskegon was the largest city in the state not served by Michigan Bell. The service area for Michigan Associated reached north from Muskegon as far as Ludington, and included a major portion of St. Joseph and Branch counties, scattered exchanges in southwest Michigan, six in central Michigan, and several in the thumb area of Michigan. The Union Telephone Company absorbed the Tri-County Telephone Company (Van Buren, Cass, and Allegan counties) after World War II. Its main offices

were in Owosso. Aside from this tri-county area, the Union exchanges were situated in the central and northeast portion of the Lower Peninsula. The largest concentration of rural and independent companies was found in the southeastern and south central counties of the Lower Peninsula, the northeast part of the Lower Peninsula, around Saginaw Bay, and in the Upper Peninsula. Large areas of the northeastern part of the Lower Peninsula and in the Upper Peninsula were classified as "unassigned" to any company by the MPSC.

At the mid-point of the 20th century, improvements in telephone service had been numerous since the first crude exchange was installed in Detroit in 1887. At first, a single instrument, placed alternately at the mouth and ear, was used for talking and listening. Shortly, however, it was found desirable to furnish the user with two identical instruments, one for talking (the transmitter) and one for hearing (the receiver). For many years, batteries were required at each subscriber's station to furnish the current for actuating the transmitter. Later, the common, or centralized battery system was devised, with a storage battery at the central office. When the operator responded, you gave the subscriber's name (or number) whom you desired to reach. Dial telephone systems became common in Michigan in the 1920's. The first dial central office was placed in operation in Detroit in 1923. By 1930, over 46% of all

telephones in the Michigan Bell system had dial service. By 1951 over 87% were operated by the dial system.

The provision of dial service was slower by the independents, and most of the small rural independents at mid-century were still without this type of service. The evolution of various types of telephone instruments was also striking. The old time wall telephone gave way to the desk models, consisting of a pedestal rising from a substantial base and supporting the transmitter, with the receiver hung on a hook. In the 1930's, the desk set was giving way to the hand set, in which the transmitter and the receiver were attached to the opposite ends of a handle, which rested on a cradle surmounting a base. Elaborate switchboard systems, connected with the "outside" lines, served thousands of Michigan industrial and commercial firms at the mid-century.

REVIEW OF THE REGULATORY ORDERS ISSUED BY THE MICHIGAN PUBLIC SERVICE COMMISSION PRIOR TO THE 1950'S WITH REGARD TO MICHIGAN BELL

Michigan Bell was incorporated on January 26, 1904 under Act 129 of the Public Acts of 1883, as amended. At the time of its incorporation, and until 1982, Michigan Bell was a subsidiary corporation of AT&T. Control of AT&T over Michigan Bell was exercised by the ownership of a majority of the shares of the common stock of Michigan Bell. AT&T was incorporated under the laws of the State of New York.

The activities of AT&T fell into three categories: It acted (1) as a holding company; (2) as a servicing company; and (3) as an operating company.

On July 18, 1944, the MPSC gave notice to Michigan Bell (and other utility companies in Michigan subject to its jurisdiction), that an investigation would be conducted to determine if during the year 1944 it had paid any federal "excess profits taxes"; and if so, that downward adjustments would be made in its rates and charges, to avoid the subsequent payment of any such tax.

After an investigation conducted in the fall of 1944, in which the Attorney General, the staff of the MPSC, and Michigan Bell were parties thereto, the MPSC issued an Opinion and Order on December 28, 1944, in Case No. T-252.90. In this Opinion and Order, the MPSC noted that the issue of the appropriate regulatory treatment of the corporate interrelationship between AT&T and Michigan Bell had been before the Michigan Supreme Court on more than one occasion. In the case of People v. Michigan Bell Telephone Company, 246 Mich 198, 204, 205, (1929), the Michigan Supreme Court determined that Michigan Bell was a mere agent or instrumentality of AT&T. The Court held that

> where a corporation is so organized and controlled and its affairs so conducted as to make it a mere instrumentality or agent or adjunct of another corporation, its separate existence as a distinct corporate entity will be ignored and the two corporations will be regarded in legal contemplation as one unit.

In a second case, Michigan Bell Telephone Company v. Public Utilities Commission, 297 Mich 92, 113, (1941), the Michigan Supreme Court held: "The companies are so closely interwoven through the use of joint facilities, they must be considered together for regulatory purposes, notwithstanding that the forms of separate entities are maintained." In Case No. T-252.90, and in subsequent rate proceedings before the MPSC, the two corporations were considered together for regulatory purposes.

In Case No. T-252.90, the MPSC ordered Michigan Bell to reduce its annual revenues by approximately $3,500,000 because it found Michigan Bell's gross revenues for the year 1944 to have been excessive by that amount. It ordered Michigan Bell to make a refund to its customers of the said $3,500,000 for 1944. The $3,500,000 in excess revenues were based on a finding that Michigan Bell had paid U.S. excess profits tax of $4,404,000 of which $3,000,000 was deemed to have been avoidable. The MPSC also found $250,000 paid by Michigan Bell to AT&T under a license contract to have been excessive. This license contract required that various legal, accounting and management services be rendered by AT&T to Michigan Bell. The license contract payments were based on a percentage of Michigan Bell's gross revenues for a particular year. The MPSC expressed its opinion that in order for such services to be properly chargeable to Michigan Bell's rate payers, the services should not be

based on a percentage of Michigan Bell's gross revenues, but on a specific value for each service category, with the specific value being based on evidence relating thereto which had been introduced and cross-examined at a rate hearing.

The Michigan Supreme Court subsequently reversed the MPSC Order in T-252.90, holding that the MPSC had no statutory authority to make retroactive rates, and therefore, an order issued in December of 1944 could not reset rates for 1944 and could not require a refund of excessive rates collected in 1944.

Approximately one year later, on December 13, 1945, the MPSC rendered a final order in Case No. T-252.90, finding that Michigan Bell's rates subsequent to the date of the order should be reduced by $3,500,000. This determination complied with the mandate of the Michigan Supreme Court that rate reductions were to be prospective in nature, and not retroactive. The particular elements of Michigan Bell's rates that were found to be excessive were: (1) $3,000,000 of excess profits taxes that were avoidable; (2) $250,000 of excess depreciation that was also avoidable; and (3) $250,000 of excessive payments made to AT&T under the license contract.

In 1948, the MPSC issued several regulatory orders regarding Michigan Bell. Each of these orders was issued by the MPSC because Michigan Bell was facing a condition of

increasing demand for its telephone services. The decision with the least amount of financial impact was issued on September 18, 1948 in Case No. T-252-48.14, wherein the MPSC authorized Michigan Bell to offer in the Detroit metropolitan area mobile radio telephone services and established a rate therefore. A more important decision was rendered on April 1, 1948 in Case No. T-252-48.7, in which the MPSC evidenced its desire to see that telephone service in rural areas be technologically upgraded, even if it meant higher rates to the rural area subscribers. The MPSC adopted a plan whereby short-haul toll traffic previously handled by manually operated switchboards would now be handled by direct dial automated switching equipment. Rates would be immediately increased in rural areas due to increased investment for the automated equipment, but would eventually be reduced in five years. The MPSC concluded that under the proposed rates, thousands of customers would pay no more, whereas others, to whom the cost would be increased, would benefit the most by being brought into the larger trading centers, and eventually would save the most in toll bills.[24]

The most important order issued in 1948 by the MPSC was on September 28 in Case No. T-252-48.16. In that case, the MPSC authorized Michigan Bell to increase its annual

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[24]Opinion and Order of the Michigan Public Service Commission issued on April 1, 1948, Case No. T-252-48.7, 4.

revenues by $8,210,000, thereby providing a net return of 6% upon net intrastate telephone plant investment. Michigan Bell filed its application on April 27, 1947. In the application, Michigan Bell requested a rate increase of approximately $10,500,000. The three commissioners voted to approve an increase of $8,210,000, which was approximately 80% of the rate increase requested by Michigan Bell. Participants to this proceeding were the Attorney General, the MPSC Staff, Michigan Bell, and numerous representatives of civic, business and labor organizations, including Division 43 of the Communications Workers of America.

All parties to this proceeding agreed that Michigan Bell was rendering service in abnormal times, but that such condition was a healthy one in that it required Michigan Bell to expand its telephone facilities throughout the state. In fact, Michigan Bell was engaged in an extensive construction program in an effort to supply telephone service for all those persons who desired it, and to relieve existing congestion in both its local exchange and toll plants. The net additions for 1948 were estimated by Michigan Bell to be $60,087,000, and for 1949, $57,000,000. Michigan Bell's program included converting all manual offices to dial operation; and Michigan Bell expected to complete the conversion by the end of 1951. Under this program, Michigan Bell anticipated that it would furnish extended area service to all but 37 of its 242 exchanges.

In its written order, the MPSC noted that Michigan Bell had grown by 62.6% since 1941, having added a total of 581,465 telephones in the six years between December 31, 1941 and December 31, 1947. Over one and one-half million telephones were being served as of December 31, 1947. As of June 30, 1948, there had been a station gain of 82,761, which was an increase of 32,729 stations over the gain in stations for the same period in the year 1947. None of the parties to this case, including the labor unions, or the three commissioners on the MPSC, questioned the need for Michigan Bell to construct additional facilities to provide the additional services that Michigan Bell represented as being necessary.

The MPSC unanimously granted substantially all of the rate increase requested by Michigan Bell for the purpose of providing the funds required to construct the additional facilities. The major item of reduction between the request of Michigan Bell and the amount of the increase eventually authorized by the MPSC was the appropriate amount of the fees to be paid to AT&T for services provided under the license contract. In this case, there was no disagreement as to whether to utilize an original cost rate base or a fair value rate base. All parties agreed on using an original cost rate base, despite the fact that later decisions of the MPSC would indicate that legal precedent appeared to require the use of a fair value rate base. As

with the case of Consumers Power in the setting of electric rates, the MPSC determined to utilize a state-wide method of rate making for Michigan Bell, despite the request of the city of Detroit to be considered separately for rate making purposes.

It is important to note that in 1948, all the commissioners on the MPSC, both Democrats and Republicans, approved a substantial rate increase for Michigan Bell primarily for the purpose of providing monies for additional investment in telephone plant to meet the increasing demand for telephone service. None of the commissioners, nor any of the parties to the proceeding, were concerned with the effect of the increased rates on residential users of telephone services. Thus, it appears that at this time the MPSC was almost wholly concerned with the financial integrity of Michigan Bell, and paid little attention to any possible divergence in interest of residential users of telephone services from the interests of Michigan Bell.

A review of the orders issued by the MPSC at this time gives no indication that there was a divergence or conflict of interest between residential users of local exchange telephone service and business users of toll services. Apparently, the business subscribers to toll telephone service were of the opinion that the rate increases that were applied to them could be passed on to the users of

their services and products without any adverse effect on their competitive position in the market place.

USE OF FAIR VALUE RATE BASE TO BENEFIT MICHIGAN BELL; AND REGULATORY PREFERENCE FOR THE FINANCIAL INTEGRITY OF MICHIGAN BELL

On June 19, 1950, the MPSC granted its first rate increase of the 1950's to Michigan Bell. The rate increase was authorized in Case No. T-252-50.6, which case was the companion case to an earlier decision by the MPSC in Case No. T-252-49.14. The decisions in Case Nos. T-252-49.14 and T-252-50.6 were the result of an application filed by Michigan Bell requesting authority to increase its annual gross revenues by $20,400,000. Michigan Bell also sought from the MPSC immediate authority to increase its rates by $9,800,000 prior to the holding of any evidentiary hearings in this matter.

In Case No. T- 252-49.14, the MPSC granted immediate rate relief to Michigan Bell in the amount of $4,861,000, or approximately one-half of the amount requested by Michigan Bell. In Case No. T-252-50.6, the MPSC granted final rate increases in the amount of $8,200,000. The two rate increases of $4,861,000 and $8,200,000 granted by the MPSC, were approximately 65% of the $20,400,000 rate increase originally requested by Michigan Bell.

With regard to the order issued on June 30, 1949 in Case No. T- 252-49.14, all three of the commissioners on the

MPSC approved the immediate annual rate increase in the amount of $4,861,000. To produce this increase in gross revenues, rate increases were authorized in the toll message telephone services provided by Michigan Bell, but not in the local exchange service rates. Increased rates in toll services were authorized because the MPSC found that the testimony and exhibits filed with the application of Michigan Bell demonstrated that the earnings from the toll telephone services were such that Michigan Bell found itself in a "severe" financial position. At page 6 of the order, the MPSC stated the following: "The evidence indicates that the Company is earning considerably less than a 6 percent rate of return on its net plant investment and that intrastate toll rates are producing gross revenues considerably less than the cost of such services." In fact, the MPSC stated in a later portion of its order that Michigan Bell was only earning 3.73% from its toll telephone services. Such a situation constituted an "emergency" in the opinion of the MPSC, and on this basis it granted an immediate rate increase in toll services in the amount of $4,861,000, so as to produce a 5.3% return upon net plant investment for toll services.

With regard to the order issued in Case No. T-252-50.7 on June 19, 1950, the MPSC granted a final rate increase to Michigan Bell for both toll and local exchange telephone services in the amount of $8,200,000. Although the

application had been filed in 1947, the increased rates were based on projections for the operating results in 1950.[25] In addition to Michigan Bell, the Attorney General, and the Staff of the MPSC, other parties to this proceeding were various municipalities located throughout the state of Michigan. Two commissioners on the MPSC, both Republicans, voted for the final rate increase of $8,200,000. One commissioner, Chairman James H. McCarthy, a Democrat, wrote a dissenting opinion wherein he expressed his belief that no increase should be authorized.

The most significant factor accounting for Chairman McCarthy's conclusion that no rate increase was merited, as opposed to the approval of the rate increase by Commissioners Stuart B. White and Schuyler L. Marshall, was the difference of opinion as to how to determine the value of Michigan Bell's investment in facilities to provide telephone service (i.e. rate base). Before determining a specific value for Michigan Bell's facilities for 1950, the majority opinion set forth certain principles to be utilized in determining rate base:

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[25]It would be approximately 25 years before the MPSC would again use projected test year data to set utility rates. In the intervening years, the MPSC would rely exclusively on actual historical financial data to set utility rates that would apply in the future. In the mid-1970's, when the frequency of rate increase proceedings rose dramatically due in large part to inflation, the MPSC began to require the submission of projected test year forecasts as a means of establishing rates that would more accurately correspond to future increases in expenses.

> It is a fundamental principle of regulation, with respect to the fixing of rates, that the utility in question shall be entitled to earn a fair return upon its property used and useful in its business. A utility is a public service corporation and, as such, its property is devoted to public use which, in turn, subjects it to the regulation of the state.
>
> Conversely, the constitution guarantees that property of the utility shall not be taken for public use without just compensation. At the same time, the utility may not be permitted to charge rates which are exorbitant or unreasonable from the standpoint of the rate payer. Accordingly, between a return which is fair and a charge which is unreasonable lies a zone of reason within which the regulatory body must, in the end result, establish and fix the rates to be charged for the service rendered. (Emphasis added)[26]

Michigan Bell presented evidence which utilized a reproduction cost method to determine a value for its estimated 1950 rate base. This value was $399,457,000. The Staff of the MPSC calculated the 1950 rate base on the basis of an original cost approach. The value it derived was $296,379,000. Commissioners White and Marshall were of the opinion that the state and federal legal precedents mandated the utilization of a "fair value" rate base, and that this value would be somewhere between the original cost estimate of the Staff and the reproduction cost calculation of Michigan Bell. Accordingly, they arrived at a value of $350,000,000, to which they applied a 6% rate of return, so as to arrive at the amount of yearly revenues Michigan Bell

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[26]Majority Opinion of Commissioners Stuart B. White and Schuyler L. Marshall, issued on June 19, 1950, Case No. T-252-50.7, 18&19.

would be entitled to for providing public utility telephone services. These commissioners determined that Michigan Bell was not presently earning the amount of annual revenues to which it was entitled by their calculations, and therefore, authorized Michigan Bell to increase its rates by $8,200,000 on an annual basis.

On the other hand, Chairman McCarthy was of the belief that state and federal legal precedents required the MPSC to utilize an original cost approach to rate base valuation, and adopted the Staff's estimate of $296,370,000. He also disagreed with the other two members of the MPSC who thought that 6% was a fair rate of return on investment. Chairman McCarthy stated that 5.7% was a fair rate of return for a regulated telephone company. Applying the 5.7% rate of return to the rate base of $296,379,000, Chairman McCarthy concluded that the revenues that Michigan Bell would be entitled to by such a computation were less than the revenues actually being earned by Michigan Bell, and therefore, Michigan Bell was not entitled to a rate increase.

Chairman McCarthy made some interesting observations concerning what he characterized as the "arbitrary nature" of the fair value rate base approach used by the other two members of the MPSC:

> The conclusion of my colleagues is that 'Upon a careful examination of all the elements entering into the formation of a sound judgment' they deem

> to decide the present fair value to be $350,000,000.
>
> They also state that they have made "due allowance" for depreciation and depreciation reserves but do not divulge the amount nor the way in which they arrive at this 'due allowance'. I find these nebulously arrived at concepts to be difficult to reconcile with the decision in the Consumers Power Company (Gas) Case D-2948-49.2 (1949), in which they participated, which stated that 'The determination of fair value of utility property requires a consistent standard'. Where is the standard in this instance, and where is the consistency in view of previously cited cases where net investment rate bases were adopted? . . . . On what is their 'fair value' based and what study have they made to determine the amount of existing depreciation in the property?[27]

In addition to dissenting as to the amount of the rate increase granted to Michigan Bell, Chairman McCarthy also dissented as to the method utilized by his two colleagues of distributing the increase among customers. The other members of the MPSC had adopted increased rates which would be proportionately higher for certain classes of customers in the Detroit area than for similar classes of customers in other parts of the state. Chairman McCarthy was of the opinion that this would result in legally prohibited rate discrimination. The rate discrimination to which Chairman McCarthy objected was essentially a geographical one between the Detroit metropolitan area and the out-state areas, as opposed to a rate discrimination between various classes of

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[27]Dissenting Opinion of James H. McCarthy, Chairman, issued on June 19, 1950, Case No. T-252-50.7, 17.

customers such as residential and business classes. In his dissenting opinion, Chairman McCarthy stated:

> The rates and charges approved by the majority are based on arbitrary selection related to the 'value' of the service. The rate schedule of the Company as proposed and adopted includes specific rates for different classes of service in Detroit and suburban zones and in several out state groups determined by number of stations.
>
> It is the duty of this Commission not only to prescribe reasonable rates for the Company on an over-all basis, but also to test the reasonableness of individual rates. Discrimination exists if the differences in price between two classes of service or different groups is greater or less than the differences in the conditions surrounding the service.
>
> Mere differences in price is not a criteria for the determination of discrimination. Such differences may be justified upon both the basis of the cost and other economic conditions affecting price differential. In theory, prices for each service should be predicated upon actual costs for rendering service. It is apparent that the application of rate increases in the majority opinion have been predicated upon bases other than cost, since there was no basis before them for determining them on costs. The results of a determination of increases on the so-called value basis will impose upon the Detroit area unequitable rates unless it can be shown that the determinations are properly related to the costs of service.[28]

From this particular case, one can discern in the majority opinion as opposed to the dissenting opinion, a difference in approach to rate making by the various members of the MPSC. It is probable that these differences in approach to rate making reflected differences in political philosophy among the commission members. Chairman McCarthy, a Democrat, appears to have been of a more liberal

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[28]Ibid., 27.

philosophy than his other two colleagues. This is indicated by the fact that his dissenting opinion reflected a concern with the impact of increased rates on the rate payers of Michigan Bell, and a sensitivity to the issue of discriminatory rate treatment with regard to users of telephone services situated in the Detroit metropolitan area. McCarthy's conclusions that Michigan Bell did not need a rate increase, indicates that he was not as concerned with the promotion of Michigan Bell's financial integrity so as to provide necessary revenues for increased investment in telephone facilities to meet increasing demands for services, as were his other colleagues on the MPSC. In order to minimize the need for a rate increase for Michigan Bell, McCarthy was more willing to employ conservative methods of financial analysis, such as original cost rate base, than were his colleagues.

On the other hand, Commissioners White and Marshall, both Republicans, were more inclined to utilize the more non-traditional analytical tool of fair value rate base, so as to provide additional revenues to Michigan Bell for expansion purposes. These two commissioners appear to have been more politically conservative than McCarthy, since their majority opinion reflects no consideration of the impact of increased rates on the current subscribers of Michigan Bell's telephone services.

THE EARLY 1950'S, A TIME OF LIMITED RATE INCREASES FOR MICHIGAN BELL

On May 14, 1951, Michigan Bell filed another application with the MPSC seeking an increase in its gross annual revenues of approximately $22,000,000. The application requested that this increase be implemented immediately. Parties to this proceeding were Michigan Bell, the AG, the Staff of the MPSC, and various municipalities purporting to represent rate payer interests. The municipalities requested that the MPSC dismiss the application. The MPSC, with all its members concurring, issued a written opinion in Case No. T-252-51.19, which denied an immediate rate increase to Michigan Bell, but which authorized further hearings to be held in the near future for the purpose of taking additional evidence.

The MPSC in Case No. T-252.51.9 made note that one of the arguments advanced by Michigan Bell to justify increased rates was that telephone rates, on the average, had increased 21% since the end of World War II while the "earnings of the public generally" had increased 100% and price levels had increased 84%. Michigan Bell also noted that the weekly pay rate in the manufacturing industries had increased by about 136% between 1940 and February of 1950 as contrasted with the 21% increase in telephone rates for the same period. The MPSC determined that these comparisons were relatively meaningless for the purpose of establishing rates for telephone service for the following reasons:

> The statute charges this Commission with finding rates that are 'just and reasonable' which we have always interpreted to mean that the rates should be adequate to cover total costs of providing service, including a fair return and reasonable return on the capital investment necessary to supply the service.
>
> This is entirely independent of what wages, prices, or other costs might have done except as these enter into the cost of providing telephone service.[29]

One of the most interesting observations made by the MPSC for rejecting the use of the comparisons presented by Michigan Bell for the purpose of making rates, was that the use of such comparisons would be of little consolation to the rate payer who would be required to pay higher rates which were not related to increased operating expenses. Thus, the MPSC expressed the following conclusion in its order:

> It is granted that the cost of living has increased from earlier days. We do not see that this is any argument that telephone rates should increase proportionately without regard to increased usage, advancements in the art, technological improvements, operating economies or other factors.
>
> Would the company be happy with unconsidered rate reductions proportionate to any decline that might take place in the customer's price index in the future?[30]

Despite the sound reasoning put forth by all the members of the MPSC for not setting rate increases on the

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[29]Opinion and Order of the Michigan Public Service Commission issued on July 16, 1959, Case No. T-252-51.19, 16.

[30]Ibid., 17.

basis of comparisons with price increases in other sectors of the economy, Michigan Bell in its annual reports for the years 1955 through 1958 continued to present such dubious comparisons to its stockholders as reasons justifying continuing requests to the MPSC for rate increases. For instance, in its 1957 annual report, Michigan Bell stated the following:

> Since 1940, rate increases have raised our revenues by only 21 percent while the price of most things has about doubled . . . . Since we have not been permitted by regulation to reprice our service in a realistic manner, Michigan Bell has been earning a rate about half that of typical industrial companies with which it competes for capital necessary to meet the public demand for service.[31]

A major reason why the MPSC denied Michigan Bell's request for a rate increase in Case No. T-252-51.19 was that certain evidence indicated substantial improvement in the financial position experienced by Michigan Bell, as indicated by the fact that since 1948, operating revenues had increased 18 percent, operating expenses and taxes 10 percent, and net operating income 108 percent.

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[31]Michigan Bell Telephone Company, Annual Report ([Detroit, MI]: Michigan Bell Telephone Company, 1957).

TABLE 4
SUMMARY OF NET INCOME PER TELEPHONE FOR MICHIGAN BELL

Year	Operating Revenues Per Telephone	Expenses and Taxes	Net Income Per Telephone
1945	$71.62	$61.85	$ 9.77
1946	67.44	62.03	5.41
1947	71.14	65.40	5.74
1948	75.35	67.36	7.99
1950	79.96	68.54	11.42
1951	84.03	72.07	11.96

From the above table, the MPSC concluded that although prior to 1948, the operating expenses per telephone were increasing faster than revenues, thereby reducing net income to Michigan Bell, under the rates then in existence in 1951, net operating income, after all operating expenses and taxes, was still increasing. In such a situation, all members of the MPSC felt that there was no need to provide a rate increase to Michigan Bell.

On June 5, 1952, the MPSC issued an order in Case No. T-252- 52.13, wherein it evaluated the $22,000,000 rate increase applied for by Michigan Bell on May 14, 1951, and concluded that Michigan Bell was only entitled to an increase of $7,221,882, or approximately one-third of the Michigan Bell request. This rate increase was approved by all three members of the MPSC, including Chairman McCarthy. Although a small portion of the rate increase was due to the need of Michigan Bell for additional revenues to construct new telephone facilities to meet increased demand for

service, most of the rate increase was related to specific increases in operating expenses:

(a) Federal income taxes had increased from 47% to 52% of Michigan Bell's taxable net income due to a revision of the Federal Revenue Act.

(b) State income taxes had increased due to new legislation.

(c) Increased wages and pension costs for employees had increased due to a new labor contract.

Because the rate increase was related almost wholly to increased operating expenses, even Chairman McCarthy, a Democrat, approved this substantial increase. If the increase had been primarily for construction of additional telephone facilities, one might speculate that McCarthy might not have approved the rate increase.

One of the most important elements necessitating the increase in rates was the MPSC's conclusion that Michigan Bell was entitled to an increase in the rate of return on its rate base from 6.0% to 6.45%. Such an increase in the rate of return was endorsed by Chairman McCarthy as necessitated by changed economic conditions. As further justification for the rate increase, the MPSC noted that in 1951 the net operating income per telephone was $11.34, but that this figure had declined in 1952 to $9.74. As an indication that the mid-1950's would be a period of

inflation which might require Michigan Bell to seek frequent rate increases, the MPSC stated the following in its order:

> Rate making, it has been said, looks to the future. However, because of the tempo of the present economic conditions, the discernible distance ahead approaches zero. Under such circumstances the pragmatic adjustment of rates and charges seems most reasonable. Suffice it to say that applicant's net revenues for the year 1952, will permit it a reasonable return and that the rates and charges required to produce such return are presently just and reasonable. It is possible that future events may render such rates and charges unjust and unreasonable and in that event, we have adequate power to correct the situation . .[32]

Although Michigan Bell had been granted a rate increase as recently as 1952, it filed an application with the MPSC on June 9, 1953 seeking a rate increase of $22,283,481. By unanimous consent of all three commissioners, this particular application was denied on May 11, 1954 in Case No. T-252-54.10, inasmuch as the MPSC determined that net earnings for the test period were in excess of 6.5% and such a return was deemed to be adequate.

Subsequently, on June 10, 1954, Michigan Bell filed a petition for rehearing, setting forth new evidence regarding its need for increased revenues. Michigan Bell noted that the value of its telephone plant had increased about $25,000,000 since the last rate case; expenses had increased

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[32]Opinion and Order of the Michigan Public Service Commission issued on June 5, 1952, Case No. T-252-52.13, 18.

about $6,800,000; but, that intrastate operating revenues had increased only $5,600,000.

By order dated July 28, 1955 in Case No. T-252-55.15, all three commissioners of the MPSC approved a rate increase for Michigan Bell of $2,802,000. This rate increase was less than one-tenth of the $22,282,481 rate increase requested by Michigan Bell on June 9, 1953. The rate increase was justified by the MPSC on the basis that Michigan Bell had experienced a decline in its earnings whereas its telephone plant had increased in value. This increase in the telephone plant was based on the utilization of the original cost method. All three of the commissioners felt that the use of an original cost rate base was appropriate since this was the valuation method employed by Michigan Bell in its application. Thus, the issue of the original cost rate base versus fair value rate base did not need to be addressed in this particular proceeding. The MPSC concluded that a rate increase of $2,802,000 would produce a rate of return of 6.22% or better, and that such a rate of return was well "within the regulatory zone of reasonableness."

SOME COMMISSIONERS ADOPT AN ORIGINAL COST RATE BASE APPROACH AND HYPOTHETICAL CAPITAL STRUCTURES TO MINIMIZE MICHIGAN BELL RATE INCREASES

In November 16, 1956, Michigan Bell filed another application for a rate increase with the MPSC, requesting

additional annual revenues in the amount of $12,542,000. On August 6, 1957, the MPSC issued an Opinion and Order in Case No. T-252-57.26, which authorized a rate increase of $2,835,000, or approximately one-sixth of the amount sought by Michigan Bell. This rate increase was approved by two of the three commission members: Democrats Otis M. Smith and James H. Lee. The third member of the MPSC, Republican Maurice E. Hunt, dissented from the Opinion and Order of his colleagues on the basis that the evidence demonstrated that Michigan Bell was entitled to a much larger rate increase. The majority opinion written by the two Democrats, utilized an original cost rate base whose value was determined to be $445,711,535. Republican Hunt thought that a larger rate base value was warranted, based on a fair value approach. Hunt was of the opinion that legal precedent required the use of a fair value rate base, while the Democrats were of the opinion that an original cost rate base was appropriate since this was the approach used by Michigan Bell in this proceeding. The Democrats determined that a 6.4% rate of return was necessitated from the evidence introduced at the hearings, which was an increase from the 6.22% that had been authorized in 1954. Republican Hunt thought that economic factors indicated that an even higher rate of return would be appropriate.

As a final reason for providing less of a rate increase than was sought by Michigan Bell, the Democratic majority

reviewed the income taxes that Michigan Bell was paying with regard to its existing capital structure, and concluded that Michigan Bell could have avoided a certain amount of these income taxes if it had a more appropriate capital structure. At page 15 of the order issued in Case No. T-252-57.26, the MPSC observed that Michigan Bell's actual capital structure at the end of 1956 consisted of the following:

TABLE 5
CAPITAL STRUCTURE FOR MICHIGAN BELL - 1956

Ratio		
Long Term Debt	$105,000,000	21%
Notes	5,000,000	1%
Equity	383,235,000	78%

Because the long term debt ratio was only 21%, the MPSC noted that Michigan Bell had paid greater amounts of income tax than it would have if the long-term debt ratio had been higher. Thus, the MPSC employed the accepted regulatory practice of adopting a hypothetical capital structure, increasing the debt ratio when it was clearly low and decreasing it when it was too high. The MPSC concluded that a 40% long term-debt structure would be appropriate for Michigan Bell, and made a determination as to what the avoidable income tax expense would have been in 1956 if such a long-term debt ratio had in fact existed. Republican Hunt dissented from the use of a hypothetical capital structure, and thought that Michigan Bell was entitled to recoup all of

the income taxes it had paid on the basis of a 21% long-term debt ratio.

From an analysis of the rate cases for Michigan Bell through the year 1957, one might be tempted to conclude that the Democratic members of the MPSC were more inclined to approve smaller rate increases for Michigan Bell than were their Republican colleagues. This observation would be correct through 1957, but with the advent of Otis M. Smith as Chairman of the MPSC, this pattern was to change slightly with the next rate case decided in 1958. Smith was the first Black to be a member of the MPSC. He tended to be a moderate conservative Democrat, whose interests were more aligned with the protection of the financial interests of utility companies than with the interests of residential rate payers for the lowest possible rates. Thus, with the alignment of Smith with his Republican colleagues in some of the rate cases, the analysis must move from Democrat versus Republican, to political liberals versus political conservatives.

JAMES H. LEE: ADVOCATE FOR RESIDENTIAL RATE PAYER INTERESTS AND RATE REDUCTIONS FOR MICHIGAN BELL

As a follow up to the rate increase approved by the MPSC on August 6, 1957 in Case No. T-252-57.26, Michigan Bell filed a petition with the MPSC on September 11, 1957, for a reopening and rehearing of the case. This petition was granted by the MPSC, and additional hearings were held.

On June 26, 1958, the MPSC issued an Opinion and Order in Case No. T-252-58.23, wherein it concluded that although it had previously granted a rate increase in Case No. T- 252-57.26 in the amount of $2,835,000, a review of the record on rehearing indicated that such a rate increase was not totally adequate and that Michigan Bell was entitled to additional revenues on an annual basis. Thus, the MPSC approved an additional rate increase for Michigan Bell in the amount of $2,212,000.

This particular rate increase was approved by two commissioners, with one commissioner dissenting. Approving the rate increase were Chairman Otis M. Smith, a Democrat, and Thomas M. Burns, a Republican. Dissenting was Commissioner James H. Lee, a Democrat. The majority opinion adopted a fair value rate base, valued at $506,693,000. Smith and Burns also adopted an increased rate of return on telephone plant investment of 6.60%. When the 6.60% rate of return was applied to a rate base of $506,693,000, the result was an income requirement of $32,379,886, the majority calculated that Michigan Bell was experiencing an income deficiency of $1,061,852. Such a deficiency, when adjusted for the effect of Federal Income Taxes, resulted in an additional revenue requirement of approximately $2,212,000. As previously discussed, a Republican and a moderate Democrat, evidenced a conservative approach to utility rate making by giving primary concern to the

financial growth of Michigan Bell. To provide additional revenues to Michigan Bell, the majority members were willing to utilize the more liberal financial concept of fair value rate base and to approve rates of return in excess of those recommended by the Staff of the MPSC.

The more politically liberal member of the MPSC, Democrat James H. Lee, revealed in his dissenting opinion that his primary concern was the effect that the increased rates would have on the residential users of telephone services, rather than with the financial improvement of Michigan Bell.[33] Lee was of the opinion that the evidence demonstrated that Michigan Bell should be required to reduce its revenues by approximately $3,000,000 per year. The Staff of the MPSC recommended that Michigan Bell be limited to a 6.50% rate of return on rate base, not 6.60% as adopted by the other two commissioners. Lee supported the Staff on this issue.

The MPSC Staff also supported the use of an original cost rate base, rather than a fair value rate base. Staff valued the original cost rate base at $518,805,588. Commissioner Lee supported the use of the original cost rate base. Applying a 6.50% rate of return to a rate base of

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[33]In the late 1970's and early 1980's, Commissioners Willa Mae King and Edwyna Anderson would issue a series of important dissenting opinions in various Detroit Edison and Consumers Power Company rate increase cases stating that substantial portions of the approved rate increases were unwarranted when evaluated against the detrimental financial impact on the majority of residential users of electric utility services.

$518,805,962, Lee calculated that Michigan Bell was entitled to annual revenues of $30,855,962, or approximately $3,000,000 less than it was presently earning. Thus, the more liberal member of the MPSC was willing to utilize conservative financial concepts of original cost rate base and a stable rate of return as recommended by the Staff of the MPSC.

A review of the various Michigan Bell rate cases decided by the MPSC in the 1950's indicates that Michigan Bell requested rate increases totaling $77,270,481; but, that it was granted only $28,931,882, or approximately slightly less than 40% of the amount sought by Michigan Bell. The financial data for Michigan Bell for the 1950's indicates continued growth for Michigan Bell, particularly with regard to the continued construction of new telephone facilities to meet a growing demand for services. For instance, the 1957 Annual Report for Michigan Bell states:

> Michigan Bell backed its faith in the economic future of the state with a record $105 million expansion and improvement program in 1957, which was $19 million greater than in 1956.
>
> In the dozen years since the end of the war, Michigan Bell has spent nearly $674 million in new construction.
>
> .....
>
> Fifty-seven new buildings, building additions, or major alterations were completed during the year, including major structures at Detroit, Dearborn, Flint, Jackson, Lansing, Pontiac, and Wyandotte, and work was started on 59 others . . .

> Nearly $32 million was spent on new central office equipment to provide more and better service. Thousands of miles of aerial and underground wire and cable were installed, along with additional carrier circuits and micro-relay channels . . .[34]

Despite a record of continued growth in both gross and net income, and record breaking construction programs to meet the increased demands for telephone service, Michigan Bell contended in its Annual Reports for 1957 and 1958 that it needed additional rate increases.[35] Due to the recession in Michigan in 1958, Michigan Bell did experience a decline in demand for telephone service, which only lasted until the commencement of 1960. Although earnings did decrease in 1958, Michigan Bell was still a very profitable utility company. In its Annual Report for 1958, Michigan Bell utilized the untypical financial data of 1958 to try to illustrate the validity of its tenuous position that the rate increases approved by the MPSC throughout the 1950's had been inadequate and unjustifiably low:

> A continuing postwar problem of this company has been to obtain adjustments in the price of its service more closely related to the heavy increase in the costs of doing business. In June, the Public Service Commission granted the company authority to increase revenues, through rate adjustments, by $2,212,000 a year - an increase of

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[34]1957 Annual Report of the Michigan Bell Telephone Company, 5 & 6.

[35]Ibid., 14-16; and Michigan Bell Telephone Company, Annual Report ([Detroit, MI]: Michigan Bell Telephone Company, 1958).

only one percent. The amount was less than a quarter of what the company asked.

Since 1940, increased revenues to this company, through adjustments in the price of its service, have amounted to only 32 percent while the price of most things the public buys has more than doubled.

In allowing the rate increase, the Commission has determined the company was entitled to a return of 6.6 percent on net plant investment. The company does not regard such a return as sufficient to permit it to undertake the improvements that, in the long run, would provide the best service for our customers while keeping down its costs. It is significant, moreover, that Michigan Bell was unable to earn even the 6.6 percent return to which the Commission said it was entitled.

Through the postwar inflationary year, the company has been faced with a constantly increasing investment per telephone in addition to rising costs of doing business.

The average investment for all telephones in service rose to a new record of more than $300 at the end of the year against $288 a year ago and $230 in 1948.

.....

The company earned only a 6.08 percent on the investment in 1958 - the approximate level of its earnings throughout the postwar era. In contrast, the postwar profit performance of typical industrial firms has been far above this company's, even including the recession.

A company with the year-after-year financial results in the low area of 6 percent return on investment hardly can assume risks and heavy outlay of funds on projects that can be postponed. That's true because heavy expenditures, even though leading to improvements and lower costs in the long run, temporarily depress the return on investment that is already too low.[36]

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[36]1958 Annual Report of the Michigan Bell Telephone Company, 5 & 6.

This plea by Michigan Bell in its 1958 Annual Report for increased rates that would provide an adequate return on investment from Michigan Bell's perspective, and hence the borrowing power to finance new facilities, appears to be somewhat exaggerated. As previously stated, a review of the financial performance for Michigan Bell in the 1950's, appears to indicate a company that had been provided sufficient monies available to attract new investment funds to construct additional telephone plant facilities. Throughout the 1950's, the Republicans on the MPSC, together with the moderate Democrat, Otis M. Smith, in the late 1950's, approved rate increases for Michigan Bell with the primary purpose of facilitating the construction of additional telephone facilities. It wasn't until the appearance of the Democrat James H. Lee on the MPSC in the late 1950's that one can discern a member of the MPSC who was primarily concerned with the financial impact of the rate increases on the existing residential users of telephone services. Even Chairman McCarthy, a Democrat in the early 1950's, who dissented against certain rate increases approved by the MPSC, did so not so much from the viewpoint of the impact of the rate increases on the residential customers, as on the basis that the financial condition of Michigan Bell did not warrant the particular rate increase that had been approved. Thus, from the perspective of the eventuality that there would be

consideration given to the financial interests of residential customers as well as the financial integrity of Michigan Bell, one can discern a movement in the rate orders for Michigan Bell in the 1950's of the financial impact of the rate increases on the residential customers.

BRIEF HISTORICAL REVIEW OF THE DEVELOPMENT OF CONSUMERS POWER THROUGH THE 1950'S[37]

Consumers Power is one of the nation's ten largest investor-owned operating utilities, and is the third largest utility company in the country that sells both electricity and gas.[38] The roots of Consumers Power go back to the mid-19th century when gas was first used for public lighting purposes in Michigan. Gas had first been used for public lighting purposes in Baltimore, Maryland in 1816, when the Baltimore city council passed an ordinance authorizing the Gas Company of Baltimore to go into business. However, this

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[37]The material for this portion of the dissertation was obtained from George Bush, Future Builders: The Story of Michigan's Consumers Power Company (New York: McGraw-Hill Book Company, 1973).

[38]It is interesting to note that during the New deal, the Public Utilities Holding Company Act was enacted, which required utility companies that were part of holding company systems and which conducted both gas and electric operations to divest themselves of one or the other of these utility functions. This divestiture requirement was an attempt to prevent companies from monopolizing sister utility industries. Although Consumers Power did not ultimately become independent of the Commonwealth & Southern holding company system until 1949, it was permitted to remain both a combination gas and electric utility company.

new invention was very slow to spread, and as late as 1850 only 30 American communities had gas plants.

In western Michigan, Kalamazoo was the key city in the early history of the Michigan utilities industry. On May 8, 1856, 20 individuals and business firms subscribed to $27,000 of a proposed $30,000 capital stock issue of a firm known as the Kalamazoo Gas Light Company. Sometime in 1856, the village council for Jackson, Michigan granted to Edward Coen the right and privilege to erect and maintain the gas works and conduits for public distribution. Kalamazoo Gas Light Company and Coen's company were the two earliest predecessor companies of Consumers Power. Five additional gas companies were formed in Michigan before 1870 and were also predecessor companies of Consumers Power in the gas field: (1) Pontiac Gas Light Company - 1856; (2) East Saginaw Gas Light Company - 1863; (3) Saginaw Gas Light Company - 1868; (4) Bay City Gas Light Company - 1868; (5) City of Flint Gas Light Company - 1870. Even more important were the electric company predecessors of Consumers Power: (1) Grand Rapids Electric Light and Power Company - 1880; (2) The Swift Electric Light Company in Saginaw, Michigan - 1881; (3) Peoples Electric Light Company in Flint, Michigan - 1882; (4) Jackson Electric Light and Power Company - 1884; (5) Kalamazoo Electric Company - 1885; (6) Battle Creek Electric Light and Power Company - 1887; and (7) Edison Electric Light & Motor Company in Pontiac, Michigan - 1888.

Often during this period, competing companies were organized to render the same services in the same territory. By 1900, Grand Rapids had four competing utility operations. This competition, coupled with technological change, made this period one of great financial danger linked at best to a very small monetary reward. At this time there was no regulatory agency designed to supervise the entrance of competitors into a geographical territory. It wasn't long, however, before competition was eliminated through the process of consolidation. The result was a period of phenomenal growth for the utility industry coupled with rising profits.

The leader of this early period of consolidation in the utility industry was William Augustine Foote, who was the founder of Consumers Power. His younger brother was James Berry Foote, and he provided the financial expertise that was necessary to put together the various gas and electric companies that eventually formed Consumers Power. W. A. Foote built his business reputation as a promoter of electric light companies within the state of Michigan. In 1887 he organized the Battle Creek Electric Light and Power Company, and the Albion Electric Light Company. In March of 1888, he organized the Jackson Electric Light Works as a corporation, based on a capitalization of $100,000. In 1878, W. A. Foote and his associates bought the controlling interest in the Kalamazoo Electric Company; and in 1900,

Foote became a one-third partner in the Grand Rapids - Muskegon Power Company.

Between 1905 and 1910, the demand for power increased significantly. The biggest factor in this increased demand was the traction business. Electric streetcars were then called traction lines, and they played an important role in the development of the early electric companies, including Foote's Jackson Electric Light Company. While the early traction lines in the southern part of Michigan had no actual corporate relationship with Consumers Power or its predecessor companies, they were affiliated organizations and later became part of the same holding company. Electric companies had been started primarily for public street lighting purposes, but it wasn't very long before their most important function became that of providing electricity for trolleys. For a significant period of time, this was their most stable business, and it was often impossible for them to obtain bond financing unless they could show that they had traction contracts. W. A. Foote first became involved in the electric railway business when the Jackson street line went bankrupt, and Foote as its major creditor became the receiver for the defunct firm. When the electric railroads started to boom, they soon constituted the financial backbone of the electric utilities business.

In 1907, Foote had gained effective control of the electric business in five major Michigan cities: Jackson,

Albion, Battle Creek, Kalamazoo and Grand Rapids, as well as several smaller communities including Big Rapids, Grandville and Coopersville. Foote also had a substantial position in the Muskegon utilities market. Foote's business operations were affected by the depression that hit the country in 1907. The answer to his money problems was to be found in the company named Hodenpyl-Walbridge & Company, with headquarters on Wall Street in New York City. What made Hodenpyl-Walbridge unique as a money house in New York was that it had started business in 1889 in Grand Rapids, Michigan as the Michigan Trust Company with $200,000 in capital. Anton Hodenpyl and Henry D. Walbridge were to form a partnership in 1903 that eventually grew into one of the nation's most important utility companies. When Hodenpyl-Walbridge moved their offices to New York, the fulcrum of Michigan's utilities was shifted to New York and remained there until the end of the holding company period. The Hodenpyl-Walbridge move initiated a period of time when Consumers Power would no longer be a local business, but would be the principal operation of a utilities complex that would cover many parts of the nation.

Hodenpyl and the E.A. Clark Company of Philadelphia cooperated in 1903 to form the Saginaw-Bay City Railway & Light Company, a consolidation of all the utilities and traction lines then operating in Saginaw and Bay City. Hodenpyl-Walbridge soon controlled most of eastern

Michigan's power outside of Detroit. At the same time Foote's utilities empire was taking shape in western Michigan in the form of Commonwealth & Southern Company. The Foote and Hodenpyl-Walbridge interests were merged in 1909. Eventually these interests were transformed into the Commonwealth & Southern Corporation, one of America's utility giants in the coming holding company days. The Commonwealth & Southern Corporation would ultimately have utility interests in the eastern, middle western and southern parts of this country.

The legal consolidation of the Foote and the Hodenpyl-Walbridge interests was completed in 1910 by the incorporation of Consumers Power in Maine as a holding company for all the electric operations in Michigan. Consumers Power remained a Maine corporation until 1968, when it became a Michigan corporation. The Michigan Light Company was organized as a holding company for the various gas operations. In 1915, the Michigan Railroad Commission permitted both Consumers Power and the Michigan Light Company to become electric and gas operating companies in the state. Both Consumers Power and the Michigan Light Company were subsidiaries of the mamouth multi-state holding company, Commonwealth Power, Railway & Light Company. The birth of Consumers Power was complete on June 24, 1922, when the gas properties of the Michigan Light Company were conveyed to Consumers Power.

During the second decade of the 20th century, Michigan was rapidly developing into an urban, industrial state. Its population had grown from 2.4 million in 1900 to nearly 3.7 million in 1920. This growth was also marked by a shift of the population from rural areas to the emerging automobile cities. In 1890, when Michigan had about 2 million inhabitants, only 35% of them lived in towns of 2,500 or more population. By 1920, this situation was practically reversed, with 61% of the state's more than 2.2 million people living in towns and cities. The population growth and shift in the living situation created an increased demand for electric service.

During World War I, Consumers Power's capacity soon became inadequate. Staggering amounts of capital were needed for new construction. The cost of money increased with inflation. The price of labor, fuels and materials doubled, and in some cases tripled, without commensurate increases in electric and gas rates. Prior to the war years, the financial position of Consumers Power between 1910 and 1914 had been sound. Its income, both gross and net, had increased rapidly, and so had its capitalization - from $12 million to $23 million. Because that state regulatory commission would not increase electric rates during the war years, Consumers Power could not earn enough from its electric rates to cope with inflation and earn an adequate return on its investment. The low rates also

contributed to Consumers Power's troubles by inducing people to purchase increased amounts of electric energy. Persons at this time were encouraged to use more energy by the utilization of flat rates, which was necessitated by the fact that no equipment existed for measuring service.[39] During the 1920's, meters were developed and measured rate service was implemented.

With a complex of hydro and steam generators feeding a single transmission system for distribution in the various localities, costs became state wide rather than local. Consequently, it seemed logical that rates should also be state wide rather than differ from community to community. The Michigan Railroad Commission authorized the use of state wide rates.

Inasmuch as rates were not deemed by Consumers Power as being sufficient to provide the necessary capital to finance the construction of additional generating facilities, after World War I, Consumers Power tapped a new source of capital by selling investment bonds to its customers, with its employees acting as the sales force. Thus, Consumers Power

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[39]When equipment was developed for measuring the use of electrical service, utility companies adopted a step rate structure, which encouraged customers to increase their useage of electricity by offering reduced rates as more energy was used. In the 1970's, in an effort to encourage customers to reduce their use of electricity, the MPSC approved inverted rate structures which increased rates as more energy was used.

was in the process of becoming, to a small degree, a customer owned utility.

The 1920's was a period in which Consumers Power grew in terms of assets and number of customers served. A significant part of this expansion was due to the acquisition of a large number of municipally owned utilities in the state. The earnings of Consumers Power also grew. Starting in 1922, Consumers Power's earnings grew every year. Even in 1929, the year of the stock market crash, there was a rise in revenues. Gross earnings grew from $15 million in 1922 to $33.4 million in 1929, and Consumers Power's net income rose from $4.2 million to $14.3 million over the same period.

During the 1920's, the era of competition amongst rival utility enterprises ceased. More often than not, companies competing for new territory worked out an informal gentlemen's agreement that carved up territorities between them. This was the situation whereby it was agreed that with regard to the provision of natural gas, Consumers Power would be permitted to supply Oakland County while the Detroit Gas Company (later Michigan Consolidated Gas Company) would supply Wayne County. With the tremendous expansion of population in subsequent years, this became a significant agreement for Consumers Power since Oakland County became the most lucrative service area for gas sales.

In 1921, Consumers Power's gas customers had numbered 60,590. By 1929, they totaled 162,590. Over the same period, the number of electric customers increased from 130,421 to 296,036. In the period 1921 to 1932, kilowatt sales rose from 294,408,610 to 979,542,316. Gas sales in cubic feet increased from 2,289,078 to 6,786,105. During the 1920's, Consumers Power's holding company, the Commonwealth Power, Railway & Light Company, grew to such an extent that at the conclusion of the decade its utilities properties operated in Michigan, Illinois, Indiana, Tennessee, Alabama, Georgia, Mississippi and Florida. In 1922, Commonwealth acquired the Tennessee Electric Power Company. This acquisition was significant because this particular company would later become the direct target of President Franklin Roosevelt's attack on privately owned public utilities. The Tennessee Valley Authority would eventually provide the impetus to the federal government to break up the utilities complex initiated by Foote and Hodenpyl-Walbridge at the turn of the century. With the break up of the Commonwealth empire, Consumers Power would become, in 1949, a totally independent operating company, functioning wholly within the state of Michigan.

On May 23, 1929, the Commonwealth & Southern Corporation was formed under the laws of the state of Delaware. This corporation absorbed all of the utilities properties of the Commonwealth Power, Railway and Light

Company; and consequently, became the holding company for Consumers Power. Although the utilities industry came under extensive government scrutiny during the 1930's, Consumers Power was fortunate to be part of the Commonwealth holding company system. Congressional hearings in the 1930's severely criticized the utility holding company system developed by Samuel Insull in the Chicago area. The congressional investigations ultimately led to government regulation of the utility holding company systems with the adoption in 1935 of the Public Utility Holding Company Act. In the era of customer ownership of utilities, Insull had sold shares in his holding companies rather than the operating companies. This had the unfortunate effect of separating his shareholders from the actual source of income and involved them in several speculative gambles on the part of the holding companies.

Consumers Power and Commonwealth had no relations with the Insull group. In essence, Commonwealth was innocent of the three cardinal sins charged against utility holding companies. The first, was overcharging operating companies for the functions performed by the holding company for the particular group. Commonwealth avoided this evil by distributing the shares in the holding company to the operating companies in proportion to their gross earnings. The second, was that holding companies arranged for "upstream loans" from the operating companies, so that, in

effect, the underlying utility properties financed the parent company instead of the other way around, as was supposed to be the basic purpose of the structure. Commonwealth did not engage in this practice. The third sin was that holding companies frequently wrote up the asset values of the operating companies, commonly called "loading the rate base", which made it possible to charge exaggerated rates to customers. The congressional hearings eventually exonerated Commonwealth of engaging in this practice. Despite the fact of this exoneration, and the fact that Commonwealth charged some of the lowest rates for utility services in the country, Wendell Wilkie as Chairman of the Board of Directors of Commonwealth was to eventually lose his battle with Roosevelt to keep the Commonwealth system intact.

During the 1930's, Wilkie did win another legal and political battle on behalf of the Commonwealth interests. In that era, the J.P. Morgan Co., along with several other investment banking houses, formed the United Corporation. The United Corporation was designed to be a super holding company for utilities, and attempted to take over the Commonwealth operating companies. Wilkie was able to utilize his political acumen to frustrate this attempt by the large investment banking houses to take over the Commonwealth complex. The only purpose of such a take over would have been to enable the investment houses to charge

double commissions on the issuance of utility bonds, a practice which had been criticized in the congressional hearings.

In 1933, when Wilkie became President of Commonwealth, Consumers Power was caught in the depression which affected all of the country. Michigan was particularly hard hit by the depression. For several weeks the company was forced to operate on a cash basis; and not much cash was coming in, and wouldn't for several years. Between 1929 and 1933, gross revenues dropped 22%, from $33,420,000 to $26,000,000. Over the same years, common stock earnings dropped 66%, from slightly over $8 million to less than $3 million, and most of this had to be held in reserve. Strict economies were enforced within the company, including a 10% pay cut for all employees and officers.

The bleak year of 1933 was the turning point. In 1934, revenues were almost back to the 1929 levels, although net income still lagged far behind. During Wilkie's reign, the number of electric and gas customers for Consumers Power increased steadily; and the amount of its electric and gas sales also increased, except for a small dip in 1938. During the 1930's, electric and gas sales increased because Consumers Power promoted the use of more appliances in the household. One reason appliance sales were so important, especially in the early years of slow economic recovery, was that the company's generating equipment and its gas and

electric transmission and distribution systems had been built for the prosperity demands of 1929 and 1930. Thus, Consumers Power found itself with excess capacity. The overriding consideration was to generate sufficient sales volume so that rates could be drastically reduced, so as hopefully to avoid government dissolution of the Commonwealth system. To this end, Consumers Power promoted the "objective rate". If a householder was using a certain number of kilowatt hours in an average month, under the objective rate, he could add electric cooking and still not pay more for several months. After a time, the total bill he paid was raised, but the unit cost was lowered. From the standpoint of Consumers Power, the objective rate permitted putting into effect immediate rate reductions without decreasing sorely needed revenues; from the point of view of the consumer, it allowed the use of more electrical energy without a corresponding increase in the bill.

Total revenues per customer did increase as expected. In the seven years from 1935 to 1942, despite a drastic drop in the price per Kilowatt hour, the average customer's monthly power purchase rose nearly 35%, from $28.52 to $38.41. While the customer's bill was higher by one-third, his use of electricity nearly doubled.

In 1936, the Battle Creek division was the first at Consumers Power to achieve the goal of 1,000 kilowatt hours per customer per month. By 1937, the average for the whole

Consumers Power's system was 1,004 and in 1939 it reached 1,150, almost double what it had been in 1933. During this period, Consumers Power's kilowatt hour sales per household rose far more sharply than national consumption, while the average rates charged by Consumers Power fell faster than the national norm. In 1939, Consumers Power's rates averaged 3.01 cents, as compared with the national average of 4.05 cents. In terms of percentages, this meant that company sales exceeded the national utility average by 28% and at a price that gave Consumers Power's customers a 26% break.

Wilkie's drive to lower the rates of the operating companies in the Commonwealth system almost got Consumers Power into serious financial trouble. Wilkie pushed the rates so low that despite an increase in total revenues, there was too little income in relation to expenditures. With the increasing use of electricity it was necessary to expand generating and transmission facilities, and as a result, the company found itself in a cash squeeze. Consumers Power did not completely recover from this situation until after World War II, and then only because Michigan's population increased, which resulted from defense production and the growth of the automotive and chemical industries that came with the postwar boom. Meanwhile, much of the necessary expansion had to be halted, especially during the recession which hit in 1929.

No action was taken on the government divestiture of the Commonwealth & Southern Company during World War II. As soon as the war ended, the government made it clear that Commonwealth & Southern wouldn't be permitted to survive, and in 1949 Consumers Power became an independent entity. One of the immediate and grave monetary concerns for Consumers Power was how the MPSC would treat the wartime excess profits tax for rate making purposes. Between 1936 and 1942, the tax total rose from about $2.5 million per year to $16 million, a sum greater than the company's annual payroll. In 1942, taxes amounted to about $37 for every home supplied with electricity, and consequently, practically consumed the entire year's electric revenue.

The excess profits tax created a peculiar situation with respect to customer charges in both 1944 and 1945. In the case of City of Detroit v. MPSC, a divided Michigan Supreme Court held that the MPSC had the right to exclude in whole or in part "excess profits" of the character defined in the Revenue Act as constituting operating expenses which would place unnecessary burdens on the consumer.[40] As a consequence, the MPSC ordered reductions in revenues for Consumers Power in avoidance of amounts which otherwise would be paid to the federal government in the form of so-called excess profits tax. Similar orders were issued in proceedings against other utilities in the state, including

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[40]City of Detroit v. MPSC, 308 Mich 706, (1944).

Michigan Bell. These reductions were ordered without any investigation on the part of the MPSC as to whether or not the companies were earning a reasonable return on the value of their properties. The nature of the reduction was a 75% credit on the December, 1944 bill. Similar reasoning was employed in December, 1945, when a 20% reduction was ordered. The principal reason for the smaller credit in December, 1945 than in 1944, was the reduction in 1945 in taxable income resulting from expenses relating to redemption of bonds in that year.

By the 1950's, Consumers Power's service territory covered most of the Lower Peninsula. Consumers Power experienced significant growth in the 1950's. Population growth and general prosperity kept pace with industrial expansion. The state's census, 5.3 million in 1940, rose to 6.4 million by 1950, and rocketed to nearly 8 million by 1960. Most of this growth took place in Consumers Power's service territory. Consumers Power itself participated in stimulating the state's growth. It was a particular concern of the company's industrial development department to stimulate economic progress in areas that had not yet benefited from industrialization. Consumers Power brought in Corning Glass to Albion, General Electric to Edmore, Hooker Chemical to Montague, and U.S. Plywood to Gaylord.

By 1955, Consumers Power was serving nearly 788,000 electric customers, an increase of more than 50% since the

end of the war, and nearly 427,000 gas customers, up from 253,880 at the end of WWII. Even more impressive was the increase in the number of gas space-heating purchasers, up from 25,640 to 198,005 in the same period. Moreover, each customer demanded far more service than he had ever before. Kilowatt hour sales nearly doubled, and gas sales quadrupled between 1945 and 1955.

The expansion of customers created additional problems. Generating capacity had to be increased to meet demand. Existing plants had to be enlarged, and three new steam generating plants went into construction. Meanwhile the costs of such construction continued to go up due to inflation. Consumers Power now had to face the challenge of raising new capital, a problem that previously had been dealt with by its holding company, Commonwealth & Southern.

Consumers Power raised the additional capital by marketing for the first time its common stock, a significant portion of which was sold to its employees on a payroll deduction plan. The first two Consumers Power common stock offers were made even before the Commonwealth & Southern dissolution was complete. The initial sale in 1946, involved 500,000 shares at $36 per share. Then in November, 1948 another 400,000 shares of common stock were sold at $33 per share. Additional shares were brought out in later years.

Nearly one-fifth of the employees of Consumers Power and its subsidiary, Michigan Gas Storage Company, took advantage of the stock purchase opportunity. Stock subscriptions were signed by 1,304 employees, or about 19% of the full time regular employees. The subscription covered 21,287 shares. At the price of $34.25 per share, the total amount subscribed was $729,080, of which nearly half was paid in cash. In 1951, a similar type of offer was made to the employees. After this offer, nearly one-fourth of the employees emerged as shareholders of Consumers Power, and of those purchased at the time of the February, 1950 plan, 706 again purchased stock in October of 1951. In January, 1954, some 679,000 shares were offered to stockholders and employees. With this sale, more than 38% of the employees became stockholders.

A major event in the 1950's was the decision of Consumers Power to go into nuclear generation. This decision was based on the fact that it was becoming apparent that coal had become an expensive generating fuel. In 1959, contracts were signed for the $25 million construction of Consumers Power's Big Rock Point nuclear plant near Charlevoix. Big Rock was the fifth investor owned nuclear reactor in the country and started producing electricity on December 8, 1962.

REVIEW OF THE REGULATORY ORDERS ISSUED BY THE MICHIGAN PUBLIC SERVICE COMMISSION DURING THE 1950'S WITH REGARD TO THE CONSUMERS POWER COMPANY

In the 1950's, Consumers Power experienced increased sales and profits for both its electric and gas operations. Although rate increases were granted to Consumers Power in this period for its gas operations, a review will only be provided as to the impact of the two general rate orders issued by the MPSC relating to Consumers Power's electric service offerings.

Before reviewing these orders, it is of some interest to note that on November 12, 1948, the MPSC issued an order permitting Consumers Power to amend its fuel cost clause for certain electric service offerings, so as to increase its annual revenues by approximately $220,000. The increase granted was only about one- tenth of the $2,000,000 increase requested by Consumers Power. Mention is made of this case because it involved Consumers Power's fuel cost clause, a subject which was of great concern in the 1970's and 1980's, particularly with the enactment by the Michigan legislature in 1982 of a new act concerning the procedures to be utilized by the MPSC for approving fuel cost adjustment clauses.[41] A fuel cost clause is important to electric and/or gas utilities because it permits these utilities to automatically pass on to their rate payers increases or

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[41]Opinion and Order of the Michigan Public Service Commission, Case No. D-2916-48.4.

decreases incurred by the utilities in the purchase of generating fuels without the need for awaiting specific MPSC approval in a general rate case, which could involve other complicating issues to be considered simultaneously by the MPSC. A review of the order issued in Case No. D-2916-48.4, indicates that a fuel cost clause was first approved for use by Consumers Power in 1939. However, this automatic fuel cost clause did not apply to electric service provided to residential customers; it applied only to certain classes of industrial and municipal customers. In 1948, Consumers Power sought to have its fuel cost clause applied to residential customers, but the MPSC denied this request.

On January 4, 1950, the MPSC issued an order in Case No. D- 2916-50.1, regarding a request by Consumers Power to increase its rates for electric services. This case was decided on the basis of financial data for the years 1948 and 1949. The application was originally filed by Consumers Power on December 30, 1948, and in it Consumers Power requested an increase in electric rates designed to produce additional annual revenues in an amount of approximately $6,600,000. The final order by the MPSC authorized increased rates that were designed to produce an annual increase in electric rates of $4,180,000, or approximately two-thirds of the amount requested by Consumers Power in its 1948 application. In this rate case, one can discern the possibility of certain differences in political philosophies

between the three commission members, and its effect upon the approach to be taken with regard to the utility rate increases. Although the MPSC authorized an electric rate increase of $4,180,000, such an increase was approved by only two of the three commissioners. The two commissioners who approved the increase were Republicans: Schuyler L. Marshall and Stuart B. White. The Chairman of the MPSC was John H. McCarthy, a Democrat, who wrote a dissenting opinion wherein he stated that the evidence submitted in the hearing demonstrated that Consumers Power did not need an increase in its electric rates.

The written majority opinion in Case No. D-2916-50.1, specifies the economic conditions that Consumers Power was facing in 1948/49:

(1) a period of unprecedented inflation;

(2) an unprecedented demand for electric service;

(3) the general ability for a company to obtain equity funds for new construction was difficult and costly;

(4) the demand for electricity had increased at a more rapid rate than Consumers Power's construction program, with the result that Consumers Power did not have customary adequate reserve generating, transmission and distribution capacity to assure continuation of uninterrupted service;

(5) in order to meet present demands and anticipated increased demands for electric service, Consumers Power needed additional monies for new construction of electric facilities.

Other than Consumers Power and the Staff of the MPSC, the only other parties to be represented in this proceeding

were the AG for the state of Michigan and thirty three municipalities located throughout the Lower Peninsula. Since the municipalities were customers of Consumers Power for their own street lighting needs, it is apparent that they didn't participate in this proceeding for the purpose of advocating the financial interests of residential users of electric energy. Although the AG on many occasions has represented the interests of residential customers in various rate proceedings, his office apparently didn't do so in this proceeding, inasmuch as he failed to present any witnesses at the hearing. A review of the majority order and the dissenting opinion fails to indicate that the Staff of the MPSC presented a position at the hearing on behalf of residential users of Consumers Power's electric energy. Thus, in this proceeding, residential customers were not formally or informally represented by any party participating in the hearing. Another important interest which was unrepresented in this proceeding was that of the industrial users of electrical energy. In the years subsequent to the decade of the 1950's, parties representing the interests of residential and industrial customers of electrical energy would become important participants in rate proceedings.

The majority opinion in Case No. D-2916-50.1, discussed at some length the rates charged by Consumers Power for its services in the past. Starting in 1915, the average rates

paid by customers of Consumers Power declined until 1918; subsequently increases were incurred, reaching a peak in 1921, followed by a period of declining rates which extended to 1950. The period of increases between 1918 and 1921 was due to World War I which caused inflationary pressures and Consumers Power sought increases in its general rates until 1921. During the period from 1921 to 1924, there was a reduction in the average rate paid by residential customers due principally to the increased use of energy. Since 1924 there were forty seven separate reductions in general rate schedules; and of this number, eight separate reductions were made in residential service. These reductions were brought about by Consumers Power either voluntarily or as a result of conferences with the MPSC or its predecessors.

The majority opinion also noted that Consumers Power had continued its policy of charging uniform rates throughout its entire territory except in two areas. In one area, the city of Bay City, it had municipal competition, while in the other area, the city of Pontiac, rates were by agreement with the city.

Evidence introduced in this proceeding indicated that for the years 1920 through 1948, the average annual use of electricity per customer increased, and that these increases had an impact upon the reduction of the average rate paid for the same corresponding period of time:

TABLE 6
AVERAGE ELECTRIC RATES BILLED TO
CUSTOMERS OF CONSUMERS POWER COMPANY

Year	Annual Revenue Per Customer	Annual Kwh Per Customer	Average Electric Rate Billed
1920	$21.31	281	7.65 cents
1925	22.40	334	7.00
1930	28.65	578	5.10
1935	28.52	726	4.10
1940	36.35	1238	3.36
1945	43.49*	1640	3.03
1948	50.90	2080	2.45

* Disregarding 20% rebate in December 1945 bills

The biggest factor relating to the MPSC granting a rate increase of $4,180,000 instead of the $6,600,000 sought by Consumers Power, was the approach adopted with regard to the proper valuation for the rate base of Consumers Power. There was a difference of opinion between the majority opinion and the written dissent as to the approach to utilize. Three competing philosophies regarding the proper value to be placed on the rate base were considered: (1) original cost; (2) reproduction cost; or (3) fair value. Under the capital cost method, the rate base would be valued at the dollar amount actually expended on the utility plant, less depreciation. The reproduction cost method would value the rate base at the current dollar amount it would take to rebuild the utility plant if it were destroyed. The fair

value approach would reach a value for the utility plant somewhere between the low extreme of the original cost method and the high extreme of the reproduction cost approach. The fair value method would consider such items as original investment, reproduction cost, depreciation, and the value of the service to the customer as exemplified by a comparison of rates with other electric utilities in the state and throughout the nation.

All members of the MPSC rejected the reproduction cost approach, even though the evidence submitted by Consumers Power utilized this concept to reach a valuation of its electric utility plant of $412,721,000. The Staff of the MPSC took the position that the proper approach to rate base valuation would be to use original cost, less depreciation, plus reasonable working capital requirements. Using this approach, the Staff concluded that a proper rate base would be $247,955,000, based on a weighted average rate base for the year 1949. Chairman McCarthy adopted the Staff's approach, and in his dissenting opinion noted that if the Staff's original cost rate base were adopted, and a 6 1/4% rate of return were applied to it, Consumers Power would only be entitled to total net annual revenues in the amount of $15,500,000. Since Consumers Power had a net revenue from electric operations in 1949 of $16,222,000, it clearly wasn't entitled to any rate increase. Chairman McCarthy was of the opinion that prior decisions of the Michigan Supreme

Court or the recent decision of the U.S. Supreme Court in Hope Natural Gas Company, 320 US 591 (1944), did not require the rejection of the original cost rate base in this proceeding.

The majority opinion was of the belief that legal precedent, both at the state and federal levels, precluded the utilization of an original cost rate base. Consequently, they used a fair value approach, and determined that the value of the Consumers Power's rate base should be $330,000,000. Applying a 5.7% rate of return to this rate base, the majority opinion noted that this would yield net earnings of approximately $18,810,000, or the need of additional increased net revenues in the amount of $2,588,000. So as to produce these additional net revenues, the majority authorized a rate increase which would produce additional annual gross revenues in the amount of $4,180,000.

One can speculate that the Republican majority adopted a fair value rate base approach so as to justify providing Consumers Power increased electric rates. In the recent past, Consumers Power had a close identification with the Republican Party, as evidenced by the fact that its previous Chairman of the Board, Wendell Wilkie, had been that party's presidential nominee against Franklin D. Roosevelt. Moreover, this was a period of inflation, coupled with the growth in customers for Consumers Power, and the Republicans

on the MPSC sought to justify a rate increase to Consumers Power on the basis of providing attractive returns on utility plant investments so as to enable Consumers Power to obtain additional funds from investors for the construction of new utility facilities.[42] The MPSC stated the following in its order:

> The Commission is cognizant of the need for expansion and takes into consideration the fact that there is a backlog of approximately 9,000 customers awaiting service; that the stand-by margin of generating capacity of this company serves a very important territory in Michigan, comprising 53 counties with a population in excess of 2,250,000 people and includes such industrial centers as Pontiac, Flint, Saginaw, Bay City, Muskegon, Grand Rapids, Kalamazoo, Battle Creek and Jackson and scores of smaller cities which have, in recent years, become industrialized because of a decentralization policy . . . [43]

Again, it should be borne in mind that no party to this Consumer Power electric rate increase proceeding claimed to be representing the direct interests of residential rate payers. The Republican members of the MPSC appeared to be exclusively concerned with the financial needs of Consumers Power and expressed no concern in their written majority

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[42]Beginning in the late 1960's, and continuing thereafter on a regular, uninterrupted basis, consumer advocates emerged who vigorously argued that alternatives to traditional rate base regulation needed to be adjusted by regulatory commissions, since rate base regulation had encouraged utility managers to continually build larger and more costly generating facilities so as to continue to earn additional revenues based on the earned return on the new investment.

[43]Opinion and Order of the Michigan Public Service Commission issued on January 4, 1950, Case No. D-2916-50.1, 23.

opinion as to the impact the increased rates would have on residential rate payers. Although Chairman McCarthy in his dissent expressed the opinion that Consumers Power was not entitled to any increase in rates, his dissent was based solely on the legal issue of the proper methodology to be used in determining the value of the rate base and gave no consideration to what the interests of the residential rate payers might be in this proceeding.

On May 22, 1959, the MPSC issued an order in Case No. D-2916-59.2, authorizing Consumers Power to again increase its annual revenues from the sale of electric energy by $6,788,485. The majority opinion in this case was written by two members of the MPSC: Otis M. Smith, Chairman of the MPSC, a Democrat; and Thomas M. Burns, a Republican. The third member of the MPSC, Democrat James H. Lee, wrote a dissenting opinion wherein he expressed the view that Consumers Power was not entitled to any rate increase. This particular case is significant because one of the parties to this proceeding, the Michigan Rate Payers Association, was a voluntary coalition representing the specific interests of residential users of electric energy. In addition, it should be noted that Commissioner Lee in his dissent attempted to assess the impact of this rate increase on residential rate payers. No party was present in this proceeding to represent the interests of any industrial users of electric energy.

The primary area of dispute between Lee and the other two commissioners revolved around the proper methodology to determine the value of the electric rate base. This was the same issue of contention a decade earlier in Case No. D-2916-50.1, between Chairman McCarthy and the remaining two members of the MPSC. Another major area of controversy in Case No. D-2916-59.2, was how to treat for rate making purposes the tax effect of accelerated depreciation. In addition to the issues of rate base value and the proper treatment of accelerated depreciation, Commissioner Lee disagreed with his colleagues on the MPSC on a number of other issues which involved relatively small amounts of money: (1) how to treat employee discounts; (2) the proper treatment of money contributions to industrial development groups; (3) the proper allocation of management salaries and expenses to merchandise operations; (4) the proper treatment of the advertising program; and (5) how to treat the 1959 wage increase.

The application in Case No. D-2916-59.2, was filed by Consumers Power on January 28, 1958, and was amended on April 7, 1958 to reflect a request for increased electric rates in the amount of $15,300,000. Parties to this proceeding, in addition to Consumers Power, were the Staff of the MPSC, the AG, and the Michigan Rate Payers Association. Unlike the earlier rate case in 1950, in this

case the Michigan Rate Payers Association represented the interests of the residential users of electric energy.

In its Opinion and Order, the MPSC made note of the substantial growth of Consumers Power in the 1950's. The electric service area of Consumers Power included almost 2,700,000 people. Within this area, Consumers Power served some 828,000 customers in 1,498 communities. In 1957, approximately 67% of Consumers Power's operating revenues were derived from sales of electricity; most of the remaining 33% came from sales of natural gas. Growth in both population and business activity had been very substantial in the electric service area. The record showed that kilowatt hour sales had increased from 3.85 billion in 1949 to 8.02 billion in 1957, and over the same period the number of electric customers increased from 623,000 to 828,000. In meeting these substantial additional demands for electric service, Consumers Power invested about $402,000,000 in capital additions to its electric plant and applicable common plant in the years 1950 through 1957.

A major component of this rate case was how to treat, for rate making purposes, the tax effect of accelerated depreciation. On this issue the positions of Consumers Power and the Staff of the MPSC were the same, while the Michigan Rate Payers Association took a stand in substantial opposition to Consumers Power and the Staff. The position of the Michigan Rate Payers Association was that even though

the federal tax law permitted Consumers Power to utilize an accelerated method of depreciation, and thus, receive a more liberal tax benefit in the early years of the operating life of its electric utility plant, that for rate making purposes Consumers Power should be required to use straight line depreciation. The position of Consumers Power and the Staff was that the difference between income taxes calculated by the use of straight line depreciation and the income taxes calculated by the use of an accelerated method of depreciation is a legitimate part of the cost of electric service and should be reimbursed by the rate payers. Since straight line depreciation, if used as the sole basis of rate making, would result in a lower rate increase than originally sought by Consumers Power, the Michigan Rate Payers Association was of the opinion that the use of accelerated depreciation resulted in a permanent tax saving rather than a deferral of taxes. Commissioner Lee agreed with the position taken by the Michigan Rate Payers Association, and in his dissent characterized the rate increase justified by the use of accelerated depreciation as a "phantom" tax charge:

> The use of accelerated depreciation provisions of the tax code results in a tax saving rather than in a tax deferral. Utility property generally has a long life, and for this reason the claiming of depreciation for tax purposes extends over a lengthy period. It has been demonstrated conclusively in testimony before this Commission that the accumulated tax saving for a growing utility continues to rise over a long period and, once it has reached a peak, very probably will

> remain at that high level permanently. The gross amount of this accumulation therefore becomes a permanent windfall to the utility at the expense of the utility's customers. The permanence of this amount indicates clearly that the utility experience a tax saving rather than a tax deferral.
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> Capital for the use in utility operations should, without question, be provided by investors. By permitting the phantom income tax, the Commission forces the customers of the utility to contribute to its capital funds. It was pointed out in the previous paragraph that the accumulated funds generated through provisions for "future" taxes are a permanent windfall to the utility. Therefore the amount of this fund is clearly a permanent involuntary contribution of capital by the customer.[44]

Chairman Smith and Commissioner Burns agreed with Consumers Power and the Staff that the difference between income taxes calculated by the use of straight line depreciation and income taxes calculated by the use of accelerated depreciation should be included in the cost of service in this case. Whereas Commissioner Lee was of the opinion that the use of accelerated depreciation resulted in an over-all tax saving, Smith and Burns stated that accelerated depreciation merely resulted in a deferral of tax liability. More importantly, whereas Commissioner Lee believed the use of accelerated depreciation resulted in the rate payers of Consumers Power making a contribution to the capital of Consumers Power, Chairman Smith and Commissioner Burns reached exactly the opposite conclusion. Commissioner

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[44]Dissenting Opinion of James H. Lee, Commissioner, issued on May 22, 1959, Case No. D-2916-59.2, 5&6.

Lee's dissenting opinion is significant in a historical context, since he conjectured that the federal tax policy of permitting a utility company to take accelerated depreciation on its construction projects would provide encouragement to the utility management to undertake continual construction projects in the future, regardless of their need. Thus, the analytical framework was presented in the late 1950's that many observers would use in the 1970's to argue that the management of Consumers Power was persuaded to continue with the construction of the Midland Nuclear Project beyond its direct cost benefits to ratepayers by the prospect of obtaining significant tax benefits through accelerated depreciation.[45]

The other major issue in this proceeding that needed resolution was the valuation of the electric rate base. This issue, as in the prior rate case, revolved around the concept of the original cost valuation versus the fair value concept. Whereas in the earlier rate case, Consumers Power had submitted a rate base valuation based on reproduction cost, in this proceeding Consumers Power offered a rate base which it identified as a fair value rate base. The rate

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[45]Another federal policy added in the 1950's designed specifically to encourage electric utilities to build nuclear generating facilities was the enactment of a statute limiting the liability of an electric utility for a nuclear accident. Without such a limitation in liability, it has been speculated that no privately owned electric utility would have been willing to construct a nuclear facility with the associated risk of unlimited liability.

base was determined in large part through the use of a procedure generally referred to as the trending of original cost. Consumers Power's calculations, which also included working capital requirement, resulted in a fair value rate base of $650,000,000. Chairman Smith and Commissioner Burns in their majority opinion adopted for purposes of this case a fair value rate base. Their fair value rate base varied from that of Consumers Power in some small particulars, and consequently, they determined a rate base value of $516,500,000. These two members of the MPSC, as did their predecessors who wrote the majority opinion a decade earlier in Case No. D-2916-50.1, felt that a reading of prior state law precedents, together with the applicable federal law contained in the Hope Natural Gas Company case, required the use of a fair value rate base and not an original cost rate base.

The Staff presented evidence as to an original cost rate base, with certain minor modifications. The Michigan Rate Payers Association developed a net original cost depreciated rate base, which was also an average base for the year 1958. Commissioner Lee felt that state and federal legal precedents required that the rate base be determined on original cost, less depreciation, with no inclusion of any amount for working capital.[46] Under this approach, his

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[46]It is interesting to note that while public interest groups and regulatory commissioners sympathetic to rate payer interests, such as James Lee, have historically argued for the

rate base valuation was $495,162,000. Commissioner Lee then applied a rate of return of 6% to his rate base calculation to arrive at an annual revenue requirement of $29,710,000 for Consumers Power. Other evidence introduced at the hearing had demonstrated that Consumers Power's adjusted electric operating revenues for 1958 were $27,731,475. Under Lee's calculations, Consumers Power's actual adjusted revenues for 1958 exceeded its required income requirements by some $470,000. Therefore, Consumers Power did not need a rate increase, and for other reasons stated in his dissenting opinion, Lee believed that the evidence indicated the need for a substantial rate reduction.

Another reason given by Commissioner Lee for concluding that Consumers Power did not need an increase in its electric rates was that throughout the 1950's Consumers Power's net earnings per share of common stock had steadily increased:

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appropriateness of using an original cost rate base since this generally results in a reduced rate of return to the utility company and reduced rates for the rate payers, in the late 1970's and early 1980's when construction costs of nuclear projects soared beyond the limits of economic viability, public interest groups then argued that a fair value rate base approach should be used for rate making purposes rather than an original cost approach, since in these circumstances fair value would be less than original cost, and therefore, the rate of return to the utility company on a fair value rate base would be less than on an original cost rate base, and correspondingly rates for utility users would be less.

TABLE 7
NET EARNINGS PER SHARE OF COMMON STOCK
OF CONSUMERS POWER COMPANY

Year	Net Earnings	Per Share
1950	$19,000,000	$2.78
1951	19,500,000	2.61
1952	20,700,000	2.80
1953	24,900,000	3.17
1954	26,600,000	3.12
1955	29,200,000	3.11
1956	31,200,000	3.33
1957	32,760,000	3.30

Thus, Commissioner Lee was able to conclude: "Despite the so-called higher costs and the constant addition to the number of shares outstanding, the earnings per share show an upward trend with slight occasional interruptions. This refutes the claim of the company that it needs higher rates."[47]

In Commissioner Lee's dissenting opinion, one can discern the first expression of concern about the effect that the approved rate increases would have on the residential users of electrical energy. Lee's concluding remark on this subject was expressed as follows: "even if the increase would amount to 'only three or four cents per day for the typical household customer', the total amounts to a hugh and unwarranted raid on the collective pocketbook of the company's customers."[48]

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[47]Lee, Case No. D-2916-59.2, 12&13.

[48]Ibid., 13.

A review of the two Consumers Power electric rate cases decided by the MPSC in the 1950's, Case No. D-2916-50.1 and Case No. D-2916- 59.2, reveals certain divergences of political philosophy and opinion among the members of the MPSC. In each case, one member of the MPSC dissented from the majority members of the MPSC and wrote opinions stating that Consumers Power was not entitled to any rate increase. In each instance, the dissenting member of the MPSC was a Democrat. In the first electric rate case, the majority opinion approving an increase in electric rates for Consumers Power was written by two Republicans. In the second rate case, the increase was approved by a Democrat and a Republican. Thus, one cannot simply state that Democrats opposed the rate increases sponsored by the utility companies, and the Republicans supported the rate increases. Rather one can speculate that Democrats who were liberally oriented in their politics and embraced government regulation of utilities, opposed the rate increases, and the more moderate to conservative Republicans and Democrats approved substantial increases in rates since they generally believed in minimal government regulation of utility companies. Although Chairman Otis M. Smith was both a Democrat and a black, he was basically conservative in his political philosophy as evidenced by the fact that eventually he became a Vice President and General Legal Counsel for General Motors. Thus, Chairman Smith supported

a significant increase in electric rates for Consumers Power in 1958.

It is of some interest to note that the more moderate or conservative members of the MPSC who approved the rate increase for Consumers Power did so by applying liberal accounting and financial concepts to the financial data introduced into evidence at the hearings. They utilized such concepts as fair value rate base and accelerated depreciation to approve rate increases that were designed essentially to provide additional monies to Consumers Power to construct new electric utility plant for an expanding customer base. Their primary concern was to protect the financial integrity of the utility company, rather than examine the impact of the increased rates on residential customers. The more politically liberal members of the MPSC utilized more conservative financial concepts to conclude that Consumers Power should not be granted any rate increases. Their opinion was that if Consumers Power wanted to construct new facilities to meet new demand, such monies should come from investors rather than rate payers.

Finally, at the conclusion of the 1950's, one can discern the emergence of a political concern as to how the rate increases granted to Consumers Power would impact on the financial condition of the residential customers of Consumers Power. This consumer concern is evidenced in the

dissenting opinion of Commissioner James Lee and the participation of the Michigan Rate Payers Association.

CONCLUSIONS

The 1950's were a decade of initial inflationary pressures in the state of Michigan, followed by a brief two year period of recessionary trends in 1957-1958. Throughout the 1950's, both Michigan Bell and Consumers Power experienced substantial economic growth, while the budget allocations made by the Michigan legislature to the MPSC to perform its regulatory functions remained relatively stable. Thus, although the number of rate cases increased in the 1950's, and correspondingly the responsibilities of the MPSC in this area grew in importance, the budget of the MPSC did not increase in a commensurate degree. That the Staff of the MPSC was beginning to need to be enlarged in order to properly perform audits of the major utilities in rate cases is evidenced by the comments made the state budgetary reports for the latter half of the 1950's. In addition, the need for increased sums of money to be expended on expert witnesses in rate cases indicates that rate cases for public utilities were becoming a regular part of the yearly activities of the MPSC. Rate cases were no longer a relatively infrequent occurrence as in prior decades.

The rate increases granted to Michigan Bell and Consumers Power in the late 1940's and the early 1950's were supported by the Republican members of the MPSC. Any proposal for the refusal of the rate increases requested by these utilities was submitted by the Democratic members of the MPSC, principally Chairman James H. McCarthy. A review of the written orders issued by the MPSC in the late 1940's and the early 1950's approving rate increases for these utilities indicates that neither the Republicans in the majority nor the Democrats that dissented from the rate increases were concerned principally with the effect that the rate increases would have on the financial interest of the residential users of their utility services. Both the Republicans and the Democrats confined their analysis to the protection of the financial position of the utility company.

With regard to an analysis of the rate orders issued by the MPSC in the late 1950's, one discerns the development of rate increases supported by both Republicans and Democrats. The Democrat who supported rate increases for Michigan Bell and Consumers Power in the late 1950's was Chairman Otis M. Smith. In essence, Smith was a moderate, black Democrat, who sided with Republicans in approving rate increases so as to promote the financial integrity and growth of utility companies. The Democrat who opposed rate increases for Michigan Bell and Consumers Power was James Lee. Lee's dissenting opinions with regard to the rate increases

granted to these utility companies in the late 1950's are very important since they evidence for the first time a concern by a commissioner on the MPSC with the impact these rate increases would have on the financial interests of the residential rate payers of these utilities. That the late 1950's were the initial period of consumer concern with the increasing utility rates is evidenced by the fact that the Michigan Rate Payers Association was a participating party in the hearings concerning the last rate case of Consumers Power in the 1950's.

In the late 1950's, the analysis of which members of the MPSC supported rate increases for utility companies cannot simply be done on the basis of party affiliation. A more relevant criteria is the political philosophy of the various members of the MPSC. It appears that liberal Democrats, namely Commissioner Lee, were inclined to argue that Michigan Bell and Consumers Power were entitled to no rate increases and perhaps should have their rates reduced by the MPSC, while moderate to conservative Republicans and Democrats (Chairman Otis M. Smith) approved substantial rate increases for these utilities. It is important to note that those moderate to conservative members of the MPSC who approved rate increases for the utility companies did so by employing liberal accounting and financial concepts such as fair value rate base and accelerated depreciation. The liberal members of the MPSC who disapproved the rate

increases for the utilities and sought to protect the financial interests of the residential rate payers, did so by employing conservative accounting and financial concepts such as original cost rate base and straight line depreciation. In particular, the Democrat James Lee in his dissenting opinion, objected to the use of accelerated depreciation for rate-making purposes as an unwarranted inducement to encourage utility companies to construct unneeded facilities on a regular basis in order to benefit from increased depreciation.

The members of the MPSC who supported substantial rate increases for Michigan Bell and Consumers Power were of the opinion that such increases were necessary if these utility companies were to be able to induce persons to invest in the construction of new facilities to provide service to new customers. The regulatory policy underlying the rate increases to Michigan Bell and Consumers Power was the promotion of expanding utility services which would generate additional revenues for these utility companies.

While the evidence from the 1950's would hardly establish that the MPSC had been "captured" by the regulated utilities, it does indicate that a regulatory preference was given to the financial integrity of the utility companies. Only James Lee thought that regulatory policy should consider the impact of rate increases on utility customers. Lee was a prophet to some extent in that he vigorously

argued that the MPSC should not adopt accelerated depreciation for rate making purposes since to do so would only encourage utilities to overbuild their generating and transmission plant, with the result being higher than necessary rates being charges to the customers of the utility companies.

CHAPTER III

MICHIGAN UTILITY REGULATION IN THE 1960'S: EMERGENT CONFLICT

INTRODUCTION

Since the early 1970's, public utility regulation has been seen as increasingly complex and conflictual in nature. William T. Gormley, Jr., an academic analyst of regulatory issues, has maintained that solutions to the current problems in public utility regulation are seldom obvious and that decisions by public utility commissions are seldom consensual.[1]

It was not always so, Gormely continues. For over half a century prior to the early 1970's, state public utility regulation was relatively tranquil. In this period, state public utility commissions were virtually ignored by the public, the press, and the academic community. For the most part, the interests of utility companies and their customers coincided. The consensus of interest was largely the result of the fact that utility companies filed a number of requests for rate decreases in this era.

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[1]William T. Gormley, Jr., The Politics of Public Utility Regulation (Pittsburgh: University of Pittsburgh Press, 1965).

The 1960's are generally viewed as a period of great social unrest and turbulence.[2] But according to most scholars, minimal conflict marked state public utility regulation. With unit costs decreasing as larger plants were built, utility companies offered low rates to encourage consumption. Generally business and residential customers were happy with this result. This cycle of decreasing costs and lower prices was to end in the late 1960's and early 1970's. With remarkable suddenness, utility issues became much more complex and conflictual.

This chapter analyzes the issue of consensual versus conflictual politics in public utility regulation in Michigan during the 1960's. During the 1960's, the total operating revenues for Michigan Bell increased by approximately 85.3% and its net operating income by 99.8%.[3] During the 1960's, Consumers Power's total operating revenues for electric service increased by 71.5% and its net operating income by 63.9%.[4] Its total operating revenues for gas service increased by 138.7% and net operating income

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[2]During the presidency of Lyndon B. Johnson, 1963-1968, the country was involved in two wars: one war on the domestic front (The War Against Poverty), and the second war in the international arena (The Viet Nam War). The War Against Poverty was a response to the social unrest of the 1960's, while the Viet Nam War contributed to the social turbulence of the late 1960's.

[3]Annual Reports filed with the Michigan Public Service Commission, 1960-1969. Cited below as Annual Reports.

[4]Moody's Public Utility Manuals (New York: Moody's Investor Services, Inc., 1961-1970).

almost tripled (196.1%).[5] Much of the growth in earnings in this decade for Michigan Bell and Consumers Power was due to an increase in the number of customers served and the addition of new service offerings rather than because of rate increases approved by the MPSC.[6]

This chapter develops the thesis that although the 1960's were indeed a period of consensus politics in Michigan utility regulation, as evidenced by the MPSC favoring the positions advanced by the utility companies on a number of significant issues, it was also a period of rising conflict in regards to the participation in a number of rate proceedings of various groups whose interests were in opposition to the utility companies. The intervention of the Michigan Utility Rate Payers Association and the Attorney General in rate proceedings provided an element of conflict to those proceedings. Conflict in the rate-making area is further evidenced by the fact that, at the beginning of the 1960's, Commissioner James Lee issued dissenting opinions which argued that rate decreases should have been ordered rather than rate increases as endorsed by the other members of the MPSC.

The Staff of the MPSC added additional conflict by arguing on numerous occasions that more significant rate decreases were required than were ultimately agreed to by

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[5]Ibid.

[6]Annual Reports; Moody's Public Utility Manuals.

the MPSC and the utility companies. The Staff of the MPSC is composed of professional accountants, engineers, and financial experts who are employees of the State of Michigan. The primary function of the MPSC Staff is to independently review the financial and operating status of the regulated utility companies and make recommendations to MPSC members about the appropriate rates to be charged by the utility companies. These recommendations are usually presented in the form of testimony offered in utility rate-making proceedings.

It has been commonly accepted that the state utility regulatory issues became much more complex in the early 1970's. While this is generally true, this chapter presents evidence that a number of issues facing the MPSC in the 1960's were already fairly complex in nature. The issue of how to handle liberalized depreciation for rate-making purposes was very complex and controversial, as evidenced by the fact that a special "generic" hearing was held at the request of the MPSC to provide a uniform and final resolution of this problem. Additional issues of a complex nature handled by the MPSC involved the separation of common expenses between interstate and intrastate telephone service, the appropriate rate base valuation to utilize, the rate of return on invested capital, and the utilization of hypothetical rate-based structures.

THE MICHIGAN BELL RATE INCREASE ORDER

On February 18, 1960, the MPSC approved a rate increase of $4,014,223 for Michigan Bell.[7] This order was approved by two of the three commissioners: Chairman George F. Hill and Thomas M. Burns. A Dissenting Opinion was issued by Commissioner James H. Lee. Lee maintained that the evidence introduced at the hearing indicated that the rates for Michigan Bell should be reduced by a least $4,151,525 per year. The major issues dividing the commissioners in the majority and Lee in the minority were in the areas of the proper level of operating income, the appropriate size of the rate base, and the magnitude of the justifiable rate of return.

Before examining the financial results of this rate case, it is important to note that there was disagreement in this proceeding about the appropriate principle to apply in separating the intrastate telephone services from the interstate telephone services. Michigan Bell provided local exchange service in various areas in Michigan as well as toll services between various points within Michigan. In conjunction with other telephone companies, it also provided interstate operations. Because some facilities and some employees were utilized in carrying out both the interstate

[7]Opinion and Order of the Michigan Public Service Commission issued on February 18, 1960, Case No. T-252-60.1 (cited below as T-252-60.1).

and the intrastate operations, it was necessary to make allocations of these jointly used facilities and the expenses associated with them to each of the two types of service.

The majority on the MPSC supported Michigan Bell's cost-separation formula. This method was called the "actual use" basis and utilized the procedures set forth in the Separations Manual prepared jointly by the National Association of Railroad and Utilities Commissioners and the Bell System.[8] Commissioner Lee objected to the utilization of the "actual use" method, claiming that it was based on the unrealistic theory that the time the telephone is used on a local call was just as valuable as the time the telephone is used on a toll call.[9] Lee stated that this conclusion could not be true since the telephone company derived substantially more revenue from toll calls than from local calls. Thus, in his opinion, the toll call service should be weighed more heavily than local call service in making the separation allocations. By adopting the Bell methodology of making these various cost separations, the MPSC opted to apportion more of the common expense factors to intrastate service than to interstate service. Such an apportionment method had the unfortunate result of requiring

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[8]T-252-60.1, 3.

[9]Dissenting Opinion of James H. Lee, February 18, 1960, Case No. T-252-60.1, 2 & 3 (cited below as Dissenting Opinion, T-252-60.1).

residential customers to pay a greater share of the common expenses than would have been true if another method allocating more of the common expenses to business subscribers had been adopted by the MPSC.

The majority on the MPSC determined that the income earned by Michigan Bell on a yearly basis was $3,632,799 based primarily on an assumed debt ratio of 35%.[10] Commissioner Lee believed that a 40% debt ratio would be more appropriate.[11] Although Michigan Bell did not advocate a 35% debt ratio in this proceeding, the majority opinion noted that Michigan Bell had supported such a debt ratio in previous rate proceedings before the MPSC. The importance of this determination for rate-making purposes is that a capital structure containing 40% debt would entitle Michigan Bell to greater interest deductions for tax purposes than a 35% debt ratio. Such an increase in deductible interest would bring about a reduction in Michigan Bell's income requirements, and hence, the need for a rate increase of reduced magnitude. Commissioner Lee noted that, historically, the MPSC (since at least 1950) had concluded that the amount of federal income tax paid on a debt structure containing less than 40% debt capital was an avoidable expense and that a proper adjustment was required. This position had been developed by MPSC staff

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[10]T-252-60.1, 6-7.

[11]Dissenting Opinion, T-252-60.1, 5-13.

witness Tom Hancock whose testimony emphasized the fact that Michigan Bell could, and in fact did, finance most effectively when the system's debt ratio was near or exceeded 40%.[12] Despite the MPSC Staff position as to the proper debt ratio, the majority opinion found that a 35% debt ratio was more appropriate than 40%. Such a finding by the majority of commissioners on the MPSC resulted in the approval of higher rates for Michigan Bell.

Another area of major disagreement between the majority opinion and Lee's position was the proper rate base for Michigan Bell. During the presentation of testimony in the 1960 rate increase case, Michigan Bell submitted data on two distinct types of intrastate rate-base structure. One intrastate rate base amounted to $588,390,534 based on an average net telephone plant at original cost plus an allowance of $13,000,000 for case, materials, and supplies, and prepaid accounts. The second intrastate rate base amounted to $720,807,000 based on an average net telephone plant trended to a "current cost" figure, plus $13,000,000 for working capital. The MPSC Staff based its case on an average capitalization base of $542,925,897, which contained funded debt, advances from the parent company, common stock, and retained earnings (surplus).

The majority opinion of the MPSC determined that a proper rate base structure should embrace the first rate-

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[12]T-252-60.1, 8-12.

base presentation of Michigan Bell.[13] Thus, the majority determined that it would approve a total intrastate rate base of $585,472,164 comprised of an average net plant of $575,472,164 added to an allowance of $7,000,000 for working capital.

Commissioner Lee in his dissenting opinion indicated that he would have approved the MPSC Staff rate base of $542,925,897.[14] Such a rate base structure was termed an "average capitalization rate base." Lee noted that the use of such a rate base automatically insured that the investor would receive a return on every dollar devoted to the company by the investor for every day the company had the use of such investment. Thus, Lee noted that this approach was the most preferable since it excluded from the rate base monies classified as "working capital," but which were transferred to AT&T from Michigan Bell for a short period of time. AT&T invested these monies in governmental securities. Thus, to include these monies in Michigan Bell's rate base would, according to Lee, permit the Bell System to earn two rates of return on the same money. Moreover, Lee was of the opinion that these particular monies could not have come from "investors," and consequently, should not be subject to earning a rate of return by being included in the rate base. Thus, of the

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[13]Ibid.

[14]Dissenting Opinion, T-252-60.1, 5-13.

three commissioners, only Lee would have given credence to the MPSC's Staff recommendation in this area.

The final area of disagreement between the majority of the MPSC members and Lee was on the appropriate rate of return. The majority determined that a rate of return of 6.62% was reasonable.[15] The MPSC Staff recommended a rate of return of 6.47%, assuming a 40% debt ratio. Commissioner Lee supported the Staff recommendation.[16] This finding was significant because Lee thought the proper rate of return should give consideration to the financial interests of the rate payers as well as to the financial position of Michigan Bell:

> Much has been said of the attrition suffered by Michigan Bell, but very little consideration has been given to the inflationary effect of unwarranted price increases upon its customers, many of whom must live on fixed incomes such as pensions. I doubt if a claim of confiscation could be maintained if the average earnings were 5 1/2 to 6% on invested capital.[17]

Finally, Lee would have adopted a reduction of $4,000,000 in Michigan Bell's rates as advocated by the MPSC's technical staff. In the opinion of Lee, such a reduction in rates was warranted because Michigan Bell was experiencing decreased expenses through reductions in its payroll. The payroll deductions were the result of a

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[15]T-252-60.1, 6-7.

[16]Dissenting Opinion, T-252-60.1, 4-5.

[17]Ibid. 18-19.

reduced number of Michigan Bell employees per 1,000 telephones served by Michigan Bell before 1950. Lee noted that the reduction of 2.72 employees per 1,000 telephones between 1955 and 1959 was due to technological developments in the industry which were expected to continue. Lee included the following: "The adoption of electronic computers in the detailed clerical accounting, inventory and billing operations of the company, and high speed electronic switching of calls, local and toll, will act to continue the reduction in manpower." For Lee, this trend in the reduction of manpower due to technological displacement warranted a rate reduction for Michigan Bell rather than a rate increase.

What is apparent in an analysis of this case is that the majority of the MPSC commissioners in approving a $4,000,000 rate increase adopted the positions developed by Michigan Bell on several controversial issues, while Lee was the only commission member to agree with the Staff positions. Lee's perspective on utility regulation was shaped in large part by his prior legal experience as a utility consumer advocate for the City of Detroit between 1940 and 1955. Lee's specific position before becoming a commissioner on the MPSC was assistant deputy attorney for the City of Detroit for utility matters. In that capacity, he frequently represented the interests of Detroit before the Federal Power Commission in opposition to rate increases

requested by interstate gas pipeline companies.

The fact that the majority of the MPSC commissioners adopted the positions developed by Michigan Bell on virtually all of the major controversial issues is strong evidence that there was a consensus of opinion between the MPSC and the utility company. However, there is evidence of the emergence of conflict in rate proceedings, as indicated by the vigorous dissenting opinion of Commissioner Lee based on the findings of the MPSC Staff.

It should also be noted that the other parties to this proceeding were the cities of Detroit and Grand Rapids, Wayne County, and the Michigan Utility Rate Payers Association. However, none of these parties were considered important participants in this rate proceeding since none of the commissioners discussed in either the written majority or minority opinions, the positions developed by these parties on the various issues related to the rate increase.

The participation of the Michigan Utility Rate Payers Association in this and other rate proceedings is important since it was a forerunner of vigorous rate payer participation in utility rate increase cases in the 1970's. The Michigan Utility Rate Payers Association was based in Kalamazoo, Michigan and initiated by Paul Todd, Sr. No written evidence remains in the files of the MPSC about who actually constituted its membership, but most persons who remember this entity claim it was funded primarily by Todd

to promote his opinions on various utility issues of the day.[18] Todd was a wealthy business executive in Kalamazoo who had been chairman of the Public Utilities Commission in the 1930's. It is acknowledged that Todd gave Consumers Power Company a difficult time in the rate cases in the 1930's.[19] In the late 1950's, Todd formed the Michigan Utility Rate Payers Association to intervene primarily in the rate proceedings of Consumers Power. In the late 1950's he had opposed the acquisition of the Kalamazoo Municipal Power Company by Consumers Power. When the issue was put up for a referendum, he campaigned against the acquisition. The voters, however, approved this purchase.[20] One can speculate that Todd may have been an advocate of public power because of his opposition to Consumers Power in the 1930's and later to the buy out of the Kalamazoo Municipal Power Company by Consumers Power in the 1950's.

On April 5, 1962, in Case No. U-927, Michigan Bell filed an application with the MPSC for authority to reduce certain of its intrastate long-distance telephone service rates. It was alleged by Michigan Bell that such rate reductions would result in a revenue loss to Michigan Bell of approximately $1,600,000. This application was approved

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[18]Interview with Tom Hancock (Former Chief of Staff of the MPSC), March 10, 1987; and telephone conference with Hugh B. Anderson, Assistant Attorney General, May 6, 1987.

[19]Ibid.

[20]Telephone conference with Hugh B. Anderson, May 6, 1987.

unanimously by the MPSC on the very same day that the application had been filed.

Although on the surface of things it appeared that Michigan Bell would have lost approximately $1,600,000 in yearly revenues from the reduction in its intrastate long-distance telephone rates, in reality Michigan Bell did not lose these monies since it received approximately $1,600,000 from its parent company, AT&T. The receipt of these funds from AT&T was the result of the transfer of certain of AT&T's interstate long-distance revenues to its various subsidiaries, including Michigan Bell. The transfer of revenues from AT&T to its subsidiary companies was known as "separations" and was approved by the Federal Communications Commission. Thus, the MPSC in its order of April 5, 1962, noted that the Committee on Communications Problems of the National Association of Railroad and Utilities Commissioners (NARUC) had reached an accord with the FCC relative to certain changes in the separation procedures and practices used by the Bell System companies in settlement for interchanged message toll telephone business. The effect of these changes in separations procedures and practices would be a net transfer of an estimated $46,00,000 in revenue requirements from intrastate to interstate operations for the entire Bell System.[21]

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[21]Opinion and Order of the Michigan Public Service Commission issued on April 5, 1962, Case No. U-927, 1 & 2.

On May 26, 1964, Michigan Bell filed a second rate decrease application with the MPSC for authority to reduce its operating revenues by approximately $7,500,000 annually. On June 4, 1964, this rate reduction application was unanimously approved by the MPSC.[22]

A third rate reduction was approved by the MPSC on August 12, 1965. This was the last major rate decision involving Michigan Bell in the 1960's. The order in Case No. U-2056 stated that the rate reductions in services would have the result of reducing Michigan Bell's annual net operating revenues by approximately $8,386,000.This particular case was initiated by a request made by the MPSC to Michigan Bell. The MPSC Staff proposed that studies be made of Michigan Bell's rates of return with regard to certain classes of service, with the intent of reducing rates where the revenue for the type of service warranted it or where overall revenue would justify such a reduction.[23] As a result of these various rate studies, the MPSC ordered rate reductions among various classes of service.[24] The order issued in Case No. U-2056 is reflective of a period of time in the 1960's when inflation had not impacted the

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[22]Opinion and Order of the Michigan Public Service Commission issued on June 4, 1964, Case No. U-1634.

[23]Opinion and Order of the Michigan Public Service Commission issued on August 12, 1965, Case No. U-2056, 2.

[24]Toll message service, rural residential service, two-party and four-party flat rate residence service, semi-public coin telephone service, metropolitan service, and econo-unit service.

Michigan economy in a significant manner. With an increasing customer base contributing additional revenues to a fairly stable rate base, the MPSC was compelled under commonly accepted rate-making formulas to order reductions in various rates.

An analysis of the rate-reduction cases involving Michigan Bell and other utilities in the 1960's might initially lead to the conclusion that on the surface this was a period of consensus. The rate reduction orders do not mention that the Staff of the MPSC had any disagreement with the amount of rate decreases announced. As previously mentioned, William T. Gormley, Jr., in The Politics of Public Utility Regulation, has stressed that the 1960's were marked by few conflicts over public utility regulation. However, participants in the rate reduction cases of the 1960's maintain that conflict did indeed occur, and in the form of differing positions by the Staff of the MPSC versus the positions taken by the commissioners. Hugh Anderson, who was legal counsel to the MPSC from 1962 to 1985, has indicated that conflict occurred in several rate reduction cases in the mid-1960's.[25] Generally, the MPSC Staff would recommend large rate reductions based on the fact that the utilities were earning in excess of their authorized rates of return. However, the major utilities would "back door"

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[25]Hugh B. Anderson to James R. Anderson, February 2, 1987. It should be noted that the author is not related to Hugh B. Anderson.

the MPSC Staff by negotiating much smaller rate reductions with the commissioners. These observations have also been expressed by Tom Hancock, a member of the Staff of the MPSC from 1955 through the 1970's.[26]

THE GENERIC HEARING

A major proceeding in the mid-1960's which illustrates the emerging conflictual nature of public utility issues concerned the proper rate case treatment of liberalized depreciation. Section 167 of the Internal Revenue Code of 1954 permitted business concerns to utilize various liberalized schedules as alternatives to the customary straight-line approach. Liberalized depreciation provided for the deduction of larger amounts of depreciation in the early years of property life and progressively smaller amounts in later years.

Beginning in 1954, Michigan utilities had petitioned the MPSC for special accounting authority relating to the use of liberalized depreciation. Through the early part of 1962, the MPSC had issued orders to thirteen utilities permitting specific accounting treatment. Although a utility may have elected to use liberalized depreciation for federal income tax purposes, the MPSC generally ordered that the utility employ normalized federal income taxes for state rate-making purposes. The MPSC would utilize expense data

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[26]Interview with Tom Hancock, March 10, 1987.

assuming the use of straight line depreciation by the utility. The end result of normalization was higher utility rates than if the MPSC had employed liberalized depreciation for rate-making purposes. Several intervenors in utility rate cases (including the Michigan Utility Rate Payers Association) had consistently advocated that the MPSC employ liberalized depreciation for rate-making purposes by adopting the flow through accounting method as opposed to the normalization accounting method. The use of flow through accounting would have resulted in reduced rates for utility companies.

On March 22, 1962, the MPSC issued an order directing all utilities and other interested parties to participate in a generic hearing to review the prior handling of liberalized depreciation. In this order, the MPSC noted that as of December 31, 1961, the use of liberalized depreciation had enabled Michigan utilities to defer federal taxes in the amount of approximately $142,000,000. The large amounts of deferred taxes prompted the MPSC to investigate its treatment for rate-making purposes.

On June 13, 1963, the MPSC issued its order confirming its previous policies concerning the treatment of liberalized depreciation in rate cases. This result supports the conclusion of the continuation of consensus politics in Michigan utility regulation. Fifteen utility companies and the Staff of the MPSC argued vigorously in

this proceeding for the continued use of normalized accounting treatment for depreciation.

However, this case also is an indication of emerging conflictual politics in the state regulatory arena in the 1960's. The Michigan Utility Rate Payers Association and other intervenors presented testimony of various expert witnesses and argued for the utilization of "flow-through" accounting treatment of depreciation. The fact that their position on this complex public utility issue did not prevail does not negate the fact that parties participated in the rate-making process with positions contrary to the utility companies, the MPSC, and its Staff.

THE CONSUMERS POWER CASES: THE EARLY 1960'S

In mid-June 1960, Consumers Power filed an application with the MPSC seeking authority to increase its rates for gas services. Parties who took an active part in this case were Consumers Power, the Staff of the MPSC, the County of Wayne, and the Michigan Utility Rate Payers Association.

On May 4, 1961, the MPSC issued a unanimous order wherein it approved a rate increase of $7,925,307 for gas service, based on a 1960 test year.[27] In analyzing the proper expenses for operating the gas business, the MPSC determined that expenses should be reduced by $1,454,636 for

[27]Opinion and Order of the Michigan Public Service Commission issued on May 4, 1961, Case No. U-291.

rate-making purposes from the level proposed by Consumers Power as reasonable and just.[28] Adjustments which were made for the reduction in operating expenses included nonrecurring expenses in connection with merchandising operations, and amounts for deferred federal income tax.

With regard to the proper value to be assigned for the rate base, the MPSC agreed with the Staff that the value should be $217,483,580 based on average net plant rather than a "fair value" basis of $260,000,000 as proposed by Consumers Power.[29] The concept of a fair value rate base was developed by Consumers Power largely through the use of trending techniques founded in substantial measure on the contention that original cost does not correctly measure value because a considerable portion of its plant was installed in years when installation costs were lower than at present. The MPSC objected to the use of the fair-value trending technique in this proceeding as too conjectural. The MPSC agreed with the position taken by its Staff. In regard to working capital requirements, Consumers Power proposed that the allowance should be $9,258,886.[30] The Staff agreed that an allowance of $2,014,749 would be adequate. The majority of Commissioners on the MPSC noted that the current liabilities of Consumes Power normally

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[28]Ibid., 3.

[29]Ibid, 16 & 18.

[30]Ibid., 18 & 21.

exceeded its current assets, and therefore determined, that the allowance for working capital should be $4,943,391. Thus, the value of the total rate base was found to be $222,426,971 for purposes of this proceeding.

On the important issue of the appropriate rate of return, Consumers Power presented testimony regarding the reasonableness of a figure of 7.38%.[31] The MPSC Staff took the position that 6.03% was an acceptable figure. The MPSC members basically supported the Staff position by adopting 6.34% as the rate of return in this proceeding.

In this rate case, the MPSC paid virtually no attention to the position taken by the Michigan Utility Rate Payers Association. On most issues, the MPSC adopted the positions taken by the Staff. However, on several important issues, such as the allowance for working capital and the allowance for charitable contributions, the MPSC disagreed with the Staff and supported Consumers Power. Although conflict over fairly complex regulatory issues did take place among various parties to the hearing process, the resolution of these issues in favor of Consumers Power is an indication of regulatory preference towards that utility company.

It should be noted that during the mid-1960's, the MPSC issued several orders which had the effect of directing Consumers Power to issue refunds to gas customers totaling $7,745,282 because the estimated cost of purchasing gas

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[31]Ibid., 21 & 25.

supplies from interstate suppliers was less than had been projected as an annual expense in the prior rate case (U-291).[32] Of particular importance is that on May 7, 1964, in Case No. U-1616, the MPSC issued a unanimous order which approved a reduction in annual gas revenues of approximately $1,700,000. This reduction was the result of an agreement reached between Consumers Power and the MPSC Staff as to various changes which had occurred since the prior rate case in 1962.

THE ATTORNEY GENERAL INTERVENES

Near the end of the 1960's, the MPSC approved a significant rate increase for Consumers Power for both gas and electric services. The participants in this proceeding were Consumers Power, the MPSC Staff, and the Attorney General. Based on financial data for 1968, the MPSC issued a written order on September 29, 1969, wherein all three commissioners approved an increase in Consumers Power's existing rates to provide additional gas operating revenues of $21,308,000 and additional electric revenues of $16,514,000.[33] The commissioners noted that Consumers Power

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[32]See Order Approving Gas Refunds issued by the Michigan Public Service Commission on August 9, 1962, Case No. U-291; and Order Directing Refunds To Customers Of Consumers Power Company issued by the Michigan Public Service Commission on August 8, 1963, Case Nos. U-291, D-2948-52.5, and Case Nos. U-3110 and U-3179.

[33]Opinion and Order of the Michigan Public Service Commission issued on September 29, 1969, Case Nos. U-3110 and U-3179.

had sustained growth in demand for both gas and electric service in the 1960's.[34] In the five years, 1964-1968, Consumers Power had attracted approximately 200,000 additional space-heating customers to its system, increasing its total to 641,000. Annual requirements for gas had increased from 87,500,000 million cubic feet in 1968. In the five years, 1964-1968, Consumers Power's annual kilowatt hour sales increased from 11.6 billion to 17.4 billion.

Consumers Power's gas rates had been last increased by the MPSC in May, 1961. Its gas rates had been reduced twice between May, 1961 and May, 1964. The MPSC had taken no action concerning the gas rates between May, 1964 and September, 1969. Consumers Power's electric rates had been increased by the MPSC in June, 1959. Its electric rates had been reduced three times between June, 1959 and June, 1966. The MPSC had taken no action concerning the electric rates between June, 1966 and September, 1969.

Despite the fact that Consumers Power had experienced a steady growth in the number of its gas and electric customers throughout the 1960's, the MPSC voted to approve substantial increases in the gas and electric rates in 1969 because Consumers Power had to make substantial capital expenditures for its electric and gas facilities to provide service to its expanding customer base.

With regard to virtually all of the contested major

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[34]Ibid., 3 & 4.

issues in this rate proceeding, the three commissioners substantially agreed with the position taken by the Staff of the MPSC.[35] These issues included the appropriate standard for determining the value of the rate base; the various adjustments to be made to the operating income; and the amount to be allocated for working capital requirements. For determining the value of the rate base, Consumers Power had advocated the use of the fair value method.[36] The MPSC rejected this method, and instead, approved the Staff's approach based on the use of the average utility net utility plant as evidenced by actual historical costs listed on the company's books. The MPSC stated that the latter approach complied with the legal precedents previously developed by itself and the U.S. Supreme Court.

The one major area where the MPSC failed to adopt the position developed by the Staff involved the determination of an appropriate rate of return. The Staff argued that the appropriate rate of return on assets was in the range of 6.42% to 6.51%. The MPSC approved an overall rate of return of 7.15%, which resulted in a rate of return on common equity of 12.12%. This was acceptable to the MPSC because it had earlier adopted the capital structure presented by the Staff which has assigned 38.7% to common equity.[37]

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[35]Ibid., 53.

[36]Ibid., 5-13.

[37]Ibid., 21-31.

The participation of the AG in this rate increase proceeding is important inasmuch as the Attorney General has participated in all subsequent rate proceedings for the major utility companies. The participation by the AG indicates an additional movement toward conflictual politics in rate proceedings as opposed to consensual politics. Prior to the 1968-69 rate filings of Michigan Bell, Consumers Power, the Michigan Consolidated Gas Company and the Detroit Edison Company, the AG had participated in a very limited number of rate cases in the late 1940's. The AG continued to intervene and actively participate in utility rate cases because, in 1961, the MPSC granted a rate increase to Michigan Bell without holding a public hearing on the issue as required by Michigan statutory law. When Frank Kelly, the Attorney General learned of this development, he contacted the three members of the MPSC and indicated that the approved rate order was unlawful. The MPSC issued an order rescinding the rate increase. Subsequent thereto, the AG concluded that his participation in all subsequent rate increase cases for major utility companies would be appropriate.[38]

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[38]Hugh B. Anderson to James R. Anderson, February 2, 1987, and telephone conference with Hugh B. Anderson, May 6, 1987.

CONCLUSIONS

The decade of the 1960's established a pattern of small rate increases for utilities at its beginning, a series of rate reductions in the middle, and more significant rate increases at the end. The operating revenues and net profits of utilities companies showed substantial growth throughout the decade due, in part, to a steady increase in customers.

In the 1960's, the most vigorous participants in utility rate- making proceedings were the utility companies and the MPSC Staff. On many significant issues in these proceedings, the majority of the commissioners relied heavily on the positions taken by utility companies. This evidence supports the impression that the 1960's represent a period when consensus in favor of utility companies tended to be the final result of the rate-making process.

Although the 1960's were in fact a period of favorable results to utility companies, the evidence also indicates that the 1960's were a period of emerging conflict in utility rate proceedings. This view is substantiated for rate proceedings before the MPSC in the 1960's by (1) the dissenting opinions of Commissioner James Lee advocating rate reductions for utility companies rather than rate increases; (2) the participation of the Michigan Utility Rate Payers Association, a residential activist group; (3) a generic hearing held on the issue of the proper rate

treatment of liberalized depreciation in which residential rate payer groups actively participated putting forth positions in opposition to those of the utility companies; (4) the Staff of the MPSC advocating larger rate decreases than those eventually negotiated between the utility companies and the commissioners of the MPSC; and (5) the active participation of the AG in rate matters at the end of the 1960's on behalf primarily of residential rate payers.

Further evaluation of the evidence concerning the regulatory activities of the MPSC in the 1960's seems to justify the conclusion that the MPSC pursued a policy of preferential treatment in setting rate levels for these companies. For instance, the MPSC generally granted less in the way of rate reductions to these utility companies than was usually recommended by its own Staff. Moreover, the MPSC usually resolved all major issues arising in a rate case in favor of the utility company, including the matter of liberalized depreciation. Thus, while it is possible to discern the roots of conflictual politics in utility regulation in the 1960's, in the broad perspective of evaluating the end results of regulation, it must be concluded that it was still a period of consensus between utility commissioners as regulators and the utility companies as the regulated enterprises.

CHAPTER IV

THE EARLY 1970'S: FROM CONSENSUS TO CONFLICT

INTRODUCTION

Before the 1970's, utility proceedings were basically limited to the narrow, but extremely important, issue of the level of the authorized rates. Business and residential customers were generally happy with utility rates, which tended to be low. Inasmuch as unit costs decreased as larger plants were built, utility companies offered low rates to encourage consumption. Dramatic changes, however, began in the late 1960's and early 1970's. One factor inducing change was inflation, a consideration which weighed heavily in the utilities' requests for sharp rate increases.[1] New litigants, such as the AG, various municipalities, consumer groups, and business concerns

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[1]Inflation contributed to dramatic expense increases for both Michigan Bell and Consumers Power. Michigan Bell's expenses increased 65.4%; the gas expenses for Consumers Power 110.1%, while its electric expenses increased 147.5%. Also, the rate bases for both companies and the associated debt levels increased. The telephone plant for Michigan Bell increased 65.8% and its long-term debt 64%. The electric plant for Consumers Power increased 55.2%, the gas plant increased 35.4%, and the long-term debt for the utility was increased by 51.9%.

Inflation contributed to a substantial increase in total and net operating revenues for both companies. Total operating revenues for Michigan Bell increased approximately 67.3% and its net operating income by 68.8%. Total operating revenues for Consumers Power electric service increased by 85.1% and its net operating income by 20.2%. Its total operating revenues for gas service increased by 76.6% and the net operating income increased by 11.7%.

became involved in rate cases, adding appreciably to their complexity.

In the early 1970's, the issues addressed in rate proceedings broadened, in part as a result of a wave of massive capital outlays by the utilities. Understandably, the utility companies asked for substantial rate increases. Various customer groups questioned the expediency of these large capital outlays and the resultant rate increases. In telephone hearings, customer groups protested rate differentials between geographical areas of the state. Another issue was whether business or residential customers should bear the primary burden of the massive rate increases approved in this period. Although the period prior to the 1970's was generally one of consensus politics in Michigan utility regulation, by the mid-1970's there was a clear divergence of interests between most utility companies and their customers which evidenced the transition to a politics of conflict in utility regulation.

The early 1970's was a period in which the regulatory process became highly adversarial. In part this was due to the fact that regulatory agencies found themselves involved in areas once considered the prerogative of utility management, especially capacity expansion and financing. Although the times were difficult for the utilities, regulators continued to show a bias in their favor. New regulatory concepts were developed to aid in providing more

money to utilities than was perhaps merited under traditional rate base regulation. These new regulatory concepts included earnings erosion allowances, normalization factors, and the use of projected test years instead of strictly historical test year data. One commissioner on the MPSC characterized the use of the new concept of an earnings erosion allowance as nothing less than a financial "gift" to the utilities. Further evidence of utility preference was the use of the highly unusual procedure of reopening a closed rate case to take additional testimony from utility companies to justify approving revised, higher rates. The MPSC finally questioned the prudence shown by Consumers Power when it ordered an independent study of the cost over-runs in constructing the Marysville Synthetic Gas Production Facility.

Finally, the early 1970's framed in a modern context the still unresolved conflict as to what is the "public interest" to be served by utility regulation. Commissioner Willis Ward held that public-interest group intervention in the utility rate making process should not be permitted because rate making was a task for experts. Rate making was intended to be technical process, one not subject to political pressures. The "public interest" would be served by maintaining the financial health of the utility companies, regardless of the amount of the rate increase imposed upon the rate payers. That the financial health of

the utility companies was of paramount concern to Willis Ward is evidenced by the fact that he did not approve of the use of negotiated settlements, even if they were endorsed by the utility companies themselves.

A different perspective of utility regulation was provided by Commissioner William R. Ralls, who believed that utility regulation should protect the interests of the ratepayers, rather than safeguarding the financial health of the utility companies. Ratemaking, Ralls believed, was essentially political in nature, and was not really a technical financial exercise. Accordingly, utility regulation served the public interest when it focused on ratepayer concerns, as well as those of the utility companies.

WILLIS WARD AND THE MISSION OF REGULATION

On August 1, 1968, Michigan Bell petitioned the MPSC for authority to increase its rates by $20,000,000 annually. On May 13, 1970, the MPSC authorized a rate increase of $14,799,000, a figure which represented a substantial portion of the amount requested by the company.[2]

A significant factor with regard to this case is that at least five parties were active participants: Michigan Bell, the MPSC Staff, the City of Detroit, the AG, and the

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[2]Opinion and Order of the Michigan Public Service Commission issued on May 13, 1970, Case No. U-3204.

United States Defense Department as well as several other federal agencies. The participation of these various parties heightened the conflict over the several issues that were litigated in this proceeding. Increased conflict in individual rate cases resulted in growing public controversy in the late 1970's as to the feasibility of continuing traditional rate base regulation.

An important issue concerned the prices charged by Western Electric for telephone equipment sold to Michigan Bell. The Staff took the position that since Western Electric and Michigan Bell were affiliated companies by virtue of being subsidiary companies of the American Telephone and Telegraph Company (AT&T), the prices charged by Western Electric were probably excessive and not competitive. The MPSC rejected the Staff position on this important issue, and agreed with Michigan Bell that these prices were not excessive.[3]

One of the most vigorously contested issues concerned the rate of return to be authorized for the common stock of Michigan Bell.[4] In order to determine the rate of return,

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[3]The issue of the proper accounting treatment for affiliated companies of a utility holding company system so as to avoid "improper" cross-subsidization of services continues to be an issue of growing importance for regulation in the 1990's.

[4]In rate cases, the rate of return to be authorized on common equity is usually one of the most hotly contested issues due to the large sums of money involved. If it is assumed that a utility has $16 billion in common stock, and a rate of return of 8% is authorized, the utility will be entitled to $80 million. If, however, a return of 8.5% is approved, the return on the investment will be $85 million. Thus, a rate difference of only .5% will result in the significant sum of $5 million.

the MPSC first decided what was the appropriate distribution or mix of capital for Michigan Bell. The Staff and Michigan Bell presented positions on capital structure which were essentially the same. Both parties supported a capital structure with a mix of approximately 38% debt and 62% common equity. The evidence showed that Michigan Bell conformed closely to the total AT&T system insofar as capital structure was concerned. The total AT&T system had a capital structure which consisted of 37.2% debt and 62.8% common equity, and it was anticipated that in the near future the consolidated structure would be 40% debt and 60% common equity.

The AG also presented evidence as to Michigan Bell's capital structure figures which were quite close to those of Michigan Bell and the Staff. On a pro forma basis, the AG stated that the average 1969 structure for Michigan Bell would be 36.5% debt, 61.5% common equity, and 2.0% deferred tax reserves. However, the AG sought to revise Michigan Bell's capital structure for purposes of determining a rate of return on common equity by supporting a position that the MPSC should adopt the "double leverage" concept for capital structure. In effect, this concept presented the claim that a portion of the outstanding debt of AT&T should be assigned to Michigan Bell. If this action were taken, the AG stated that Michigan Bell's revised capital structure

would be 48.8% long-term debt, 49.2% common equity and 20% deferred tax reserves.

The MPSC concluded that while the double leverage concept had certain positive points, it also presented serious problems. The MPSC was of the opinion that to assign debt of AT&T as the principal or exclusive source of Michigan Bell's common stock investment, implied a rigid, clearly traceable flow of funds, which in reality was not possible of accomplishment. The funds which AT&T obtained from outside sources were fully co-mingled with other funds AT&T had internally generated as a corporation. As a stockholder in Michigan Bell, AT&T may have used many sources of funds both internal and external for its subsequent investment in Michigan Bell's stock. In such circumstances, the MPSC had serious reservations about the valid application of the double leverage concept in the context of this rate proceeding, and therefore rejected its use in determining a proper rate of return for Michigan Bell.

Other parties to this proceeding presented evidence as to the appropriate rate of return on common equity for Michigan Bell. The proposals ranged from a recommendation of 10.5% to 11.5% put forth by Michigan Bell, to a low of 8% to 8.25% advocated by the AG. Two out of the three commissioners determined that 9.3% would be an acceptable rate of return.

It is significant to note that Chairman Willis Ward thought that a rate of return of 9.3% on common equity was too low, and that the authorized rate of return should be 9.6%.[5] If Chairman Ward's position had been adopted, it would have resulted in Michigan Bell receiving an additional $20,169,000 in revenues on an annual basis.

Willis Ward was a black Republican from Detroit and was appointed to the MPSC by Governor George Romney. Ward had been a track and football star at the University of Michigan and had graduated from its law school. Ward was noted as having had an imposing presence about him.[6]

Ward espoused a very definite philosophy on utility rate proceedings. He believed that the law required that these proceedings be limited to the determination of utility rates, and should not become legal forums about the management policies of the utility companies. Utility rate hearings, Ward insisted, should be limited to technical and financial issues. Thus, he believed that the only proper parties to utility rate proceedings were the utility companies and the Staff of the MPSC, since they were the ones who had the experts who could make appropriate recommendations on the technical, financial issues. He would have preferred that no other parties participate in

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[5]Dissenting Opinion of Chairman Willis F. Ward, Concurring In Part, August 31, 1970, Case No. U-2304.

[6]Interview with William R. Ralls, a former member of the MPSC.

these proceedings since entities such as the AG or the city of Detroit, etc., only added emotion-filled arguments to the proceedings and really did not assist the MPSC in its challenging task of determining fair and equitable rate levels.[7]

In contrast to the traditional, restricted regulatory philosophy of Willis Ward, was the more expansive philosophy of William R. Ralls, a Democrat who had been appointed to the MPSC by Governor William Milliken. When one reads Ralls' dissenting opinions, one can discern a belief that utility rate hearings were appropriate proceedings not only to determine rates, but also for the exploration of the social ramifications of the utility companies' management policies. Therefore, it was appropriate to permit the participation of public interest groups in utility rate hearings, as well as the utility companies themselves and the Staff. Many of Ralls' dissenting opinions cited evidence which had been introduced in rate proceedings by the AG or by public interest group intervenors. The evidence was used to support the sometimes controversial positions advanced by Ralls in his dissenting opinions.

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[7]Ibid.

THE EFFECT OF INFLATION AS SEEN THROUGH THE MICHIGAN BELL RATE INCREASE ORDERS

On December 10, 1970 in Case No. U-3838, Michigan Bell applied to the MPSC for authority to increase its rates to produce additional annual revenue of $59,663,000. The company also requested the MPSC to authorize partial and immediate rate relief in the amount of $19,854,000 annually.

On April 28, 1972, Chairman Rosenberg and Commissioner Sculthrop issued the final rate order in this proceeding which granted Michigan Bell a rate increase of $43,779,000. The final rate order included the prior interim rate increase of $18,000,000 that had been previously approved on December 1, 1971. Thus, Michigan Bell was awarded slightly more than two-thirds of its original request for an increase of $59,663,000. Commissioner Ralls dissented with regard to the amount of the final rate increase. He argued that the evidence entitled Michigan Bell to an increase of only $30,317,000, which was approximately half the amount ordered by the MPSC majority. This dissent was among the first of many Ralls would issue during the 1970's. Ralls' dissents were generally cogent and well reasoned. Not since James Lee in the late 1950's had a commissioner regularly dissented from rate-increase orders. Ralls' dissents dealt not only with the difficult issue of the proper amount of rate increases, but also presented both legal reasoning and precedents as grounds for rejecting the rate increases.

The issues which divided Ralls from his colleagues on the MPSC were: (1) the amount of the increase in the authorized rate of return that would be necessary for Michigan Bell to attract new investment dollars; (2) Michigan Bell's corporate relationship with Western Electric; and (3) the treatment of various adjustments to the income statement of Michigan Bell. Ralls also had significant observations to make in his dissenting opinion on the important issue of rate structure.

A number of intervenors participated in this proceeding and presented testimony. Intervenors in this case included the AG, the City of Detroit, the County of Wayne, the UAW-Michigan CAP, and the United States Defense Department on behalf of a number of federal agencies. The active participation of such a large number of intervenors indicates that the economic consequences of utility rate cases were becoming more significant to the general public in the early to mid 1970's.

In this proceeding there were substantial differences among the parties as to the appropriate rate of return to be earned by Michigan Bell on its common equity. This issue was very important in Michigan Bell rate cases because virtually all of its common stock was held by its parent company, AT&T, rather than being publicly traded on the New York Stock Exchange. Thus, there existed no basis to readily determine an objective price for Michigan Bell

common stock. In addition to differences regarding the proper rate to be earned on common equity, there also existed substantial disputes as to the appropriate method to use in determining the fair rate of return.

Michigan Bell presented two expert witnesses concerning the appropriate rate of return. Mr. Robinson argued that 12% was fair and Mr. Straton maintained that a range of 12% to 12.5% was appropriate. Mr. Robinson's evidence consisted mainly of an analysis of the earnings or market-price performance of AT&T, while Mr. Straton emphasized data concerning relative risk.

Mr. Bernstein was the expert witness presented by the AG. Bernstein used as his principal measure the Bell System operating companies which had some of their common stock in the hands of the general investing public and concluded that Michigan Bell should be awarded an equity earnings range of 8.75% to 9.0%.

Thomas Hancock, on behalf of the Staff, took a position that was between the theories put forth by Michigan Bell and the AG, and argued that the equity earnings range should be 9.0% to 9.3%. Commissioners Ward and Sculthrop, the two Republicans on the MPSC, determined that the rate of return on common equity should be 9.3%. Chairman Ward approved this position, even though he noted that an even higher rate of return on common equity might be appropriate. In arriving at this particular rate of return, the MPSC looked

at comparable earnings rates for other regulated telephone companies, regulated electric companies, and unregulated manufacturing companies.

Commissioner Ralls, the Democrat on the MPSC, thought that greater weight should be given to the earnings performance of regulated telephone companies than was done by his two other colleagues on the MPSC. Therefore, Ralls concluded that a 9% rate of return on common equity was sufficient for Michigan Bell. Ralls noted that Michigan Bell had to build new facilities to meet the growing demand for telephone service, but that the spiraling cost of building such facilities was a significant problem for the utility. Thus, to attract new investment dollars to meet the needs of the required building program, Michigan Bell needed to be provided the opportunity to earn a higher rate of return on its common equity. However, Ralls believed an increase to 9% in the authorized rate of return on common equity would prove to be sufficient to attract the required new investment dollars, and that the 9.3% authorized by the MPSC was excessive. What is important to note is that the 9% adopted by Ralls and the 9.3% adopted by the other two commission members, were both figures advocated by Mr. Hancock, the expert witness for the MPSC.

Another major area of disagreement between Ralls and the Republican majority concerned the reimbursement of equipment expenses charged to Michigan Bell by the Western

Electric Company. Both Michigan Bell and Western Electric were subsidiaries of AT&T, and the question raised by Ralls was whether the expenses were inflated by Western Electric due to the corporate family relationship with Michigan Bell. If such expenses had been inflated and full reimbursement were authorized by the MPSC, then the ratepayers, rather than the shareholders of Michigan Bell, would be paying for the excessive costs.

Michigan Bell maintained that Western's prices were generally the lowest obtainable for the quality of equipment and supplies provided. The MPSC Staff urged, as it had in previous Bell rate cases, that the MPSC should adjust the profits on Western Electric's sales to Michigan Bell to the same level as the rate of return allowed on Michigan Bell's common equity by the MPSC. Michigan Bell argued in response to the Staff position that Western was a manufacturing company and not a utility. In such a situation, Michigan Bell asserted that to use the same rate of return for Western Electric as authorized for Michigan Bell would be inappropriate. Commissioners Ward and Sculthrop professed to see no evidence that Western Electric's prices to Michigan Bell were unreasonable, and accordingly, rejected the Staff position.

Ralls, however, believed that the Staff position which maintained that the earnings level for the Western sales to Michigan Bell, should be adjusted to the same level as the

rate of return allowed on Michigan Bell's common equity by the MPSC. To Ralls, the issues were whether Western had earned a fair rate of return on its sales to Michigan Bell, and what benchmark should be used to make this determination. Ralls noted that an objective benchmark couldn't be used in this case because proper evidence had not been introduced by Michigan Bell as to the earnings being obtained by Western. The FCC had only recently admitted that it was incapable of conducting a through analysis of the prices and profits of Western Electric and the amount claimed by the Bell System operating companies for investment and operating expenses.

Ralls also observed that if AT&T should view as inadequate the profit levels established by state regulatory commissions for telephone companies under their jurisdiction, then AT&T could still earn the profits it determined as being adequate by increasing its profits from Western Electric since Western Electric was unregulated at the state and federal levels. Since the Staff had offered testimony that Western Electric should only be allowed the same rate of return as the MPSC had allowed Michigan Bell to earn on its common equity, Ralls felt compelled to approve this position in this case since this was the only credible evidence introduced as to the proper benchmark standard for the level of earnings.

Ralls also disagreed with his colleagues as to whether to allow Michigan Bell to recover certain expenses reflected in the income statement. Those items were state income tax rate increases and newly negotiated wage increases. Basically, Ralls objected to the full allowance of these expenses in this case because his other two colleagues allowed these expenditures to be projected beyond the test year. The position Ralls took as to these projected expenses was that if, for instance, the tax increase to Michigan Bell was to be fully reimbursed although occurring outside the test year, then the tax benefits Michigan Bell received outside the test year (which reduced the costs of serving the consumer) should also be fully reflected. Since the MPSC hadn't done this, Ralls believed that Michigan Bell shouldn't be able to fully recover all of these expenses. Thus, Ralls would have adopted the Staff position that there should be a cut-off at the end of the agreed upon test year for recognition of both expenses and savings, rather than utilizing projections beyond the test year.

One area of this rate case where all three commissioners were in agreement was the rejection of the request by Michigan Bell that the MPSC grant it an increase in rates to compensate for an "earnings erosion." The earnings erosion allowance was intended to compensate for the recent downward trend in earnings that some utilities had experienced due to inflation. This in turn had made the

regulation of rates and charges more difficult. The MPSC noted that Michigan Bell had proposed a more "formalistic basis" for determining the impact of the earnings erosion factor than it anticipated. The MPSC rejected this approach in this case since it concluded that the techniques employed by Michigan Bell to determine the extent of the earnings erosion had introduced an element of "double allowance" for the indicated past revenue deficiency.

Finally, Ralls disagreed with Ward and Sculthrop with regard to the important area of the appropriate rate structure for Michigan Bell. Basically, at the beginning of the 1970's, Michigan Bell's rates for residential telephone service had been higher in urban areas than in rural areas. The majority of the MPSC distributed the $44,000,000 rate increase so as to continue this discrepancy in rates. For instance, residential customers in the Detroit area paid a flat rate for basic telephone service that was 75 cents to $1.50 per month more than what rural customers paid for the same service. Originally, this rate discrepancy had been justified on the basis that usage of the telephone by residential customers was greater in communities with a large number of telephones in the calling area. Accordingly, it was speculated that basic residential service had a greater "value" to customers in urban areas than in rural areas. Thus, rates for basic residential telephone service were based on "value of service" concepts

rather than on cost data related to providing the same service in rural versus urban areas.

Ralls noted that no credible evidence had been presented which would support the conclusion that the cost to serve a residential customer in such larger communities was higher than to serve a customer in the smaller communities. Ralls observed that the rates of privately-owned telephone companies in outstate Michigan were usually higher than Michigan Bell's outstate rates, and also higher than Michigan Bell's Detroit rates, suggested that the cost of business was higher, if anything, in smaller communities than in Detroit. Although intervenors like the UAW supported immediate rate equalization between urban and rural areas, Ralls believed that Michigan Bell's rates in the Detroit metropolitan area should not be raised at all, and only a modest increase should have been applied to rural areas with the goal being to equalize rates in the next rate case.

RATE STRUCTURE AND COMPETITIVE SERVICES IN THE CONTEXT OF THE MICHIGAN BELL RATE CASES

Approximately one year after the conclusion of U-3838, Michigan Bell on February 15, 1973 applied for an additional rate increase of $29,700,000.[8] A number of intervenors actively participated in this case: the AG, the United

[8]Case No. U-4293.

States Department of Defense, Business Telephone Systems, MICA, Michigan Telephone Answering Service Association, and the City of Grand Rapids. On December 21, 1973, Rosenberg and Sculthrop issued a majority opinion approving a rate increase of $27,768,000, which was substantially all of the rate increase requested by Michigan Bell. Ralls issued a dissenting opinion in this case.

On many important issues, the positions taken by Michigan Bell prevailed. For instance, the MPSC accepted Michigan Bell's arguments as to the proper test year, the composition of the capital rate base, acceptance of newly negotiated labor wage increases, and the non-use of accelerated depreciation prior to 1970.

On a number of contested issues the positions taken by the Staff or the AG found favor with the MPSC. This resulted in reducing the figures urged by Michigan Bell for its rate base and its operating expenses. The Staff position supporting an average rate base was accepted. Evidence submitted by the Staff and the AG prevailed as to the proper price adjustments for Western Electric's sales of equipment to Michigan Bell.

All parties to this proceeding agreed on a rate of return on common equity of 9.3%, and the appropriate cost to be assigned to Michigan Bell's debt.

The fact that many of the positions taken by the AG as to reductions that should be made in operating expenses and

the total elimination of a recovery for an alleged earnings erosion shows that the intervention by outside parties was having some impact on the results of utility rate increase proceedings. This was a change from rate cases in the 1950's and the 1960's, when there was no participation by intervenors, or, if there was such participation, little or no weight was given to their positions.

In his dissent, Ralls noted with pleasure that his MPSC colleagues had adopted a position which he had advocated in a dissent in an earlier case on price adjustments for sales by Western Electric to its sister company, Michigan Bell.[9] The adoption of the proposal sponsored by the Staff and the AG in this area resulted in a reduction to Michigan Bell's rate base and operating expenses of $3,991,000 and $381,000 respectively. The Staff and AG proposal was a reflection of the reduction in rate base and expenses of Michigan Bell that would occur if Western Electric sold its products and services to Michigan Bell at prices that would yield the same rate of return on common equity. Thus, the position advocated by Ralls in his dissenting opinion in Case No. U-3838 was now adopted by the full commission.

Ralls, however, dissented from his fellow Commission members on the key issue of rate restructuring. This issue concerned the rates to be charged to residential customers

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[9]Dissenting Opinion of Commissioner William R. Ralls, December 23, 1973, Case No. U-4293, 1.

throughout the state for basic local telephone services. In the prior case, U-3838, the MPSC had decided to continue the original practice of authorizing higher rates for this particular service in metropolitan areas than the rural areas. Ralls, however, dissented from this finding on the ground that residential rates should immediately be equalized throughout the state. In this particular case, however, the majority of the MPSC decided it would not be prudent to immediately equalize rates for residential telephone services throughout the whole state, but that a more gradual approach should be implemented. Therefore, the MPSC approved a greater rate increase for less populated rural areas than for the urban areas of the state.

But the MPSC stopped short of uniform statewide rates for basic residential telephone services. The commission majority did not renounce the principle of "value of service", which had figured in earlier telephone rate cases. Under this notion, urban customers could easily access more adjacent telephone numbers, and their service was on that account more "valuable". On this issue Ralls maintained that there no longer existed a valid reason for urban-rural rate disparity. He asserted that he would not increase residential rates in the Detroit area, and would have a smaller increase in rates in the Detroit suburbs than in other areas of the state.

An even more important issue concerning rate structure involved the appropriate rates for telephone services provided to businesses, such as Key, PBX and Centrex. The issue of restructuring these services covered over 1,600 pages of testimony and included numerous exhibits. The majority of the MPSC commissioners adopted the position taken by Michigan Bell, as modified by the Staff, relating to the rates to be charged for these services. The MPSC adopted rates for these services that were slightly above those recommended by Michigan Bell, but below those advocated by competitors of Michigan Bell who were selling similar services to the public. The MPSC in this proceeding adopted an overall return requirement on net plant rate base of 7.87%. The MPSC, however, adopted the Staff's proposed return requirement of 8.75% on KEY, PBX and Centrex equipment as being reasonable and argued that such rates would be fully compensatory and not a burden on other services. The testimony of the intervenors as to the justification for other rates for these services was not accepted because such testimony was not supported by any cost of service studies.

Michigan Bell's cost-of-service studies supported its requested rates. In addition, the justification put forth by Michigan Bell for its rates for these business services was that its present rate structure was established in 1959 and was out of date. Although the MPSC partially approved

of the proposed rates put forth by Michigan Bell in this proceeding, it noted that this rate proposal really wasn't supported by adequate cost of service studies since Michigan Bell had adopted a "packaging concept" whereby in many cases one item of service was being priced to cover the cost of several items of services and equipment. The MPSC ordered Michigan Bell to do more adequate cost of service studies for these services, but adopted the rate proposals put forth in this proceeding so as to afford Michigan Bell the opportunity to more effectively compete in the newly emerging competitive market with the unregulated suppliers of business telephone equipment (i.e. the "interconnects").

Commissioner Ralls dissented on the pricing of business telephone equipment. In his opinion, the order issued in this case gave clear recognition of the emergence of competition within the telephone industry. Services such as PBX, Centrex and Key were known to be "commercial vertical services" and bore the brunt of the new competition in the industry. In the past, when there was no competition, Michigan Bell had priced these services substantially above costs on the basis of the "value of service" concept. With the recent emergence of competition, Michigan Bell felt compelled to bring rates closer to costs. Commercial users of services would no longer be charged more than residential customers under the policy that business services could subsidize the services provided to residential users. Thus,

while Ralls supported this first step toward cost justified rates, he thought the MPSC needed to require better data from Michigan Bell to support such rates. Ralls noted that Michigan Bell's current approach was a dramatic break with past practice where over time, Michigan Bell had been able to earn varying rates of return on different product lines and services while still earning its overall rate of return within regulatory restraints. Now, competition would force Michigan Bell to lower rates on those telephone services that were being offered by competitors since they were price elastic, while increasing rates on the nonelastic basic residential telephone services.[10] While this would correct the prior situation of subsidizing residential services by commercial services, the problem facing the MPSC in the future would be the temptation to Michigan Bell to increase rates above cost considerations in the noncompetitive residential market while lowering rates below costs in the competitive business service classifications.

The dissenting opinions of Commissioner Ralls in this case and the prior case of U-3838 are significant in that

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[10]Elasticity is defined in general terms as a measure of degree of responsiveness of one variable to change in another. Thus, price elasticity of demand is the degree of responsiveness of the quantity demanded of a good to change in its price. The resulting elasticity measure is a pure number, independent of units. If the measured price elasticity is greater than 1, it is deemed that the good has "elastic demand"; if the elasticity is equal to 1, the good is said to be of unit elasticity; and if the elasticity is less than 1, the good has "inelastic demand". The importance of the measure of price elasticity to demand is that it tells us what will happen to total expenditure on a good if its price should change. See Auld, et al, editors, American Dictionary of Economics (New York: Facts on File, Inc., 1983), 91-93).

they address issues that were not previously part of the rate making process. The economic effects of competition in the utility field were issues considered for the first time in this case and in Case No. U-3838. Ralls was very perceptive in discerning that these issues would complicate the rate making process in the future. Issues of this type were destined to be given serious consideration because these were issues that were of greatest concern to the many new intervenors in the utility rate making process of the 1970's.

It is in this period that the issue of the cross-subsidization of services began to rise to the forefront of utility regulation. This study has already explored two of these subsidization issues: (1) the subsidization of rural residential telephone services by metropolitan area subscribers and (2) the subsidization of residential telephone services by business telephone services. Another area of subsidization involved the transfer of certain equipment costs from long-distance telephone services provided by AT&T to local telephone services provided by Michigan Bell. AT&T wanted to transfer these equipment costs to local telephone companies such as Michigan Bell so as to lower interstate telephone rates to compete with the then newly emerging interstate microwave telephone companies such as MCI. Since the interstate telephone market was price elastic, AT&T believed it was in its business interest

to transfer these costs to the inelastic local residential services. Thus, the competitive pressures to AT&T in the interstate telephone market ultimately resulted in a greater percentage of the telephone rate increases authorized in the mid-1970's being applied to the monopolized local residential telephone services than to competitive interstate telephone services.

UTILITY RATEMAKING BECOMES MORE COMPLEX

On April 23, 1974, in Case No. U-4575, Michigan Bell filed an application requesting authority to revise its rates so as to increase its intrastate revenues by $11,400,000 annually. The company argued that it needed an increased return on its common equity, and additional revenues to compensate for "earnings erosion" and to offset anticipated increases in labor costs. On the afternoon of that same date, the AG took the unprecedented step of filing a Motion to Dismiss the total rate application of Michigan Bell. A hearing was held on the AG's Motion to Dismiss on May 22, 1974. On June 13, 1974, the two Republican Commissioners on the MPSC, William G. Rosenberg and Lenton G. Sculthrop, issued an opinion and order wherein they granted part of the AG's Motion to Dismiss.

The AG had requested that Michigan Bell's entire application be dismissed on the basis that since Michigan Bell's rates had last been determined by the MPSC in Case

No. U-4253 on December 21, 1973, this application filed on April 23, 1974 was clearly premature in that the rates approved in the prior rate case had been in effect only three months.

In the Motion to Dismiss, the AG also alleged (1) that Michigan Bell's request for a 34% increase in the rate of return on common equity representing approximately $62,000,000 was unreasonable in light of the then prevailing economic conditions; and (2) that Michigan Bell's request for an earnings erosion allowance which represented approximately $40,000,000 had been twice rejected by the MPSC (Case Nos. U-3838 and U-4253). The AG asserted that this application was merely another attempt to relitigate previously decided issues. The AG also contended that the request for additional rates of approximately $14,000,000 to cover anticipated increased wage costs was speculative and premature in that no additional costs had in fact occurred and would not occur until the expiration of Michigan Bell's then current wage agreement in July of 1974.[11]

Michigan Bell urged the MPSC to deny the AG's Motion to Dismiss on several grounds. Michigan Bell stressed that the MPSC had the legal duty to permit it to present its entire case in a full rate proceeding, and that the failure to

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[11]See Opinion and Order of the Michigan Public Service Commission issued on June 13, 1974, Case No. U-4575.

proceed in this manner would violate Michigan Bell's rights to due process of law.

All parties to the proceeding other than Michigan Bell supported the AG's Motion to Dismiss. The MPSC determined that under the circumstances of this particular case, due process requirements wouldn't be violated if it granted this motion, even though it wouldn't consider Michigan Bell's evidence on the merits of each and every issue present in Michigan Bell's application.

The MPSC decided that it should approve only a portion of the AG's motion. With regard to that part of the Michigan Bell application seeking an increase in the rate of return on common equity from 9.3% to 12.4% in the amount of approximately $62,000,000, the MPSC granted the Motion to Dismiss. However, as to the remaining portion of this application seeking a rate increase in the amount of $49,400,000, the MPSC ordered that this case should proceed to be heard.

The sole Democrat on the MPSC, William R. Ralls, issued a dissenting opinion, wherein he stated that the AG's Motion to Dismiss the Michigan Bell application should be denied. In support of his conclusion on this issue, Ralls stated:

> At first glance, my colleagues' decision today to dismiss Michigan Bell Telephone Company's request for an increased rate of return to its shareholders appears only to deny the Company's desire for higher profits. In reality, this decision prevents the public, the Commission Staff, and the Commission itself from any deliberations on this issue. The majority have denied each of us the opportunity to vote profit levels up or

> down. Today's Order, in my opinion, is premature. The Commission majority's decision could cost Michigan Bell customers millions of dollars in higher-than-justified profits the Company would be allowed to earn. The larger public good demands observance of the fundamental right guaranteed to all of a fair and open hearing on the issues. Without either factual or legal support my colleagues have arbitrarily terminated all inquires into this matter, and by their action they have prevented not only a decision on the record, but making any record at all.[12]

Michigan Bell appealed the decision of the MPSC to grant a portion of the AG's Motion to Dismiss to the Ingham County Circuit Court. On July 24, 1974, Judge Jack W. Warren granted a temporary injunction which ordered the MPSC to give full consideration to all issues raised in Michigan Bell's rate application, including the rate of return issue and the evidence offered by Michigan Bell in support of the request to increase its rate of return on common equity. Thus, the dissenting opinion of William R. Ralls stating that the AG's Motion to Dismiss should have been denied in its entirety by the MPSC was ultimately affirmed on appeal by Circuit Judge Jack W. Warren.

On December 19, 1974, the Republican Commission members (Rosenberg and Sculthrop) issued an order granting partial rate relief to Michigan Bell in the amount of $27,471,000. This amounted to slightly more than 1/3rd of the $63,900,000 sought by Michigan Bell for partial rate relief.

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[12]Dissenting Opinion of Commissioner William R. Ralls re Attorney General's Motion to Dismiss, June 13, 1974, Case No. U-4575.

The amount of interim rate relief that was approved by the MPSC was intended to cover increased labor expenses which Michigan Bell was expected to immediately experience due to newly negotiated labor contracts.

Commissioner Ralls again dissented against the award of interim rate relief in this case. Ralls maintained that the record in this case did not demonstrate the existence of extraordinary circumstances with regard to Michigan Bell's financial situation.

The most significant legal issue surrounding the issuance of the order for partial and immediate rate relief was the fact the administrative law judge did not permit the AG or the City of Detroit the opportunity to introduce and present evidence in opposition to the Michigan Bell motion for an interim rate increase at the November 1, 1974 hearing on the motion. Thus, the only evidence that was considered by the administrative law judge on this motion was the evidence filed by Michigan Bell and the MPSC Staff. The AG and the City of Detroit offered to present evidence on this motion at the hearing, but the administrative law judge determined he would exclude this evidence on the basis of his reading of the requirements of section 6a of 1939 PA 3, as amended. The AG and the city of Detroit appealed this ruling to the MPSC, but this appeal was denied, even though in two other recent cases (Case No. U-4576 involving Consumers Power decided on September 16, 1974 and Case No.

U-4570 involving Detroit Edison decided on September 19, 1974) the MPSC had considered evidence of the AG on a motion for interim rate relief when put on a separate record at the hearing. Ralls dissented on this issue and stated that he believed such evidence of the intervenors (the AG and the City of Detroit) should have been received at the hearing and considered by the administrative law judge in determining whether to approve interim rate relief. In this regard, Ralls noted that the MPSC had never before denied an intervenor the opportunity to present evidence in opposition to a motion for an interim rate increase. Also, Ralls observed that the MPSC had previously accepted testimony of intervenors on the issue of interim rate relief as long ago as 1948 in the Detroit Edison interim proceeding, Case No. D-1722; and more recently in Consumers Power's gas and electric interim hearings, Case Nos. U-4331 and U-4332 respectively.

The refusal of the MPSC to consider the evidence of the AG and the City of Detroit on the issue of interim rate relief is a strong indication of a bias of the MPSC under Chairman Rosenberg in the mid-1970's in favor of positions taken by utility companies and to discount the participation of intervenor groups in these proceedings. A similar bias was at work in the late 1960's and early 1970's under Chairman Willis Ward. Such a bias would prove to be a very pivotal factor at this point in time in the history of

utility regulation because rate increase applications were being filed by utility companies on a yearly basis. Each application involved increases in record dollar amounts, and each application was intended to alleviate cost pressures resulting from inflation and the accelerated expansion of utility generating facilities.

The final order in this proceeding was issued on February 20, 1975. A rate increase of $59,655,000 was approved by the two Republican commissioners on the MPSC (Rosenberg and Sculthrop). Democrat William R. Ralls dissented and stated that only an increase of $28,129,000 was merited in this case. The final rate increase was approximately one-half of the amount requested by Michigan Bell and was less than the increase of $84,397,940 recommended by the administrative law judge. The increase basically conformed to the recommended rate increase of $51,428,000 put forth by the MPSC Staff.

Ralls maintained that the award by the other two commissioners was "extravagant". Approximately one-half of this award would have been appropriate in Ralls's view since it represented Michigan Bell's proven higher costs of $28,129,000. The remainder of the approved rate increase was inappropriate in the estimation of Ralls since it permitted Michigan Bell to increase its profit margin by $22,574,000 and granted an additional bonus of $8,952,000 to "boot". Thus, Ralls concluded "in my opinion Michigan Bell

is entitled to no more than $28,129,000 which would make them whole by covering all the higher costs experienced by the Company".

Ralls disagreed with the decision of his other two colleagues to award for the first time to Michigan Bell an increase in rates to compensate for an erosion in earnings. In prior rate cases, Michigan Bell had asked for approval of such an erosion allowance and the request had been rejected by the MPSC. In this case, under the leadership of Republican William R. Rosenberg, an erosion allowance of $8,952,000 was approved. This erosion allowance was intended to compensate for a continuing decline in economic activity coupled with unabated rising inflation that threatened the earnings stability of Michigan Bell. Ralls maintained that the approval of this erosion allowance was nothing more than a "gift" to Michigan Bell. To Ralls, the whole concept of an earnings erosion was fatally flawed, and couldn't be justified on the record compiled in these proceedings. The Michigan Bell study of its own performance covered the years 1970 through 1973 in an attempt to show the need for an earnings erosion allowance amounting to over $30,000,000. The AG pointed out, however, that in December of 1973 the MPSC had denied Michigan Bell an earnings erosion allowance even though it did authorize a rate increase based on other factors. Thus, Ralls noted that the bulk of the period covered by the Michigan Bell study

presented in this case had been available for review by the MPSC when it had last considered and rejected the requested allowance. Furthermore, the Staff had presented extensive testimony showing that a earnings allowance was not justified by Michigan Bell's performance. The Staff demonstrated that when previous rate increases granted to Michigan Bell had become fully effective, the total authorized rate of return had been realized. Finally, Ralls concluded that the earnings erosion allowance operated to place Michigan Bell in a privileged position as compared to firms in the competitive marketplace.

Another major area where the Democrat Ralls disagreed with his Republican counterparts concerned the determination of a fair rate of return on Michigan Bell's common equity. Three basic positions were presented on this issue: (1) Michigan Bell argued that the rate of return should be a range from 13.3% to 14.5%; (2) the Staff advocated a rate of return of 10.19%; and (3) the AG argued for a rate of 8.67% for the portion of Michigan Bell's common equity capital determined to have been supplied by AT&T.

The administrative law judge as well as the majority of the MPSC found the Staff methodology presented by Michael Holmes was the most appropriate approach and adopted his proposed equity return of 10.19%. Basically the MPSC Staff utilized the traditional approach for determining the fair rate of return for a particular utility company by allowing

the utility a rate of return on its common equity which was consistent with the returns expected or experienced by other companies similar to the utility. Ralls, however, objected to this approach because he felt that the majority made a "fatal mistake" in failing to realize that Michigan Bell did not sell its stock on the open market. Instead, all of its stock was purchased and owned by AT&T. By failing to trace the true source of funds used to purchase Michigan Bell's common stock, Ralls noted that the majority of the MPSC overstated the return required by Michigan Bell by $22,574,000. For Ralls, the proper approach to use to determine a fair rate of return for Michigan Bell was the approach advocated by the AG, namely, the double debt leverage concept of determining cost of capital. Thus, Ralls concluded that a 8.67% return would be appropriate for Michigan Bell, which would reduce the rate increase awarded to Michigan Bell by $22,574,000.

In his dissenting opinion, Ralls again reiterated his previously expressed concern that due to Michigan Bell's intercorporate relationship with AT&T, it was being overcharged for materials and services provided by AT&T, and these excessive charges were being borne by Michigan Bell ratepayers in the form of excessive charges. This was the same position endorsed by the AG and the City of Detroit with regard to the following expenses: (1) a contract with Bell Laboratories known as the Business Information System

program (BIS); (2) certain license contract fees paid to AT&T as the parent company of Michigan Bell; and (3) the process used by Michigan Bell for separating intrastate from interstate operations. All these expenses were allowed in total by the two Republican members of the MPSC.

By the mid 1970's, with regard to the regulation of Michigan Bell, several interesting phenomena were beginning to appear. First, the rate increase applications were becoming more frequent and involved substantially greater amounts of money. There was more vigorous participation in the rate cases by the AG on behalf of consumers, and by other public interest groups such as municipalities. For the first time in decades, the MPSC was granting interim rate increases to the utility companies prior to final rate orders being issued. With regard to a significant number of issues, the Republican members of the MPSC tended to vote against the positions presented by the AG. During this period, the AG was Frank Kelly, a Democrat. Perhaps, the most important issue where the Republican members of the MPSC disagreed with the Democrat AG was when the AG was not permitted to put testimony on the record concerning the interim rate increases requested by Michigan Bell. Other important issues where this split occurred concerned the granting of an earnings erosion allowance in the final rate order issued in 1973 when this same issue had been considered and rejected in prior rate cases, and the

granting of substantial increases for the rate of return on common equity without giving recognition to the economic benefits received by being a subsidiary company of AT&T. Only the vigorous and informed dissents of William R. Ralls gave proper weight to the positions taken by the AG. The results in the Michigan Bell rate cases during this period of time lead to the conclusion that the MPSC favored the positions argued by Michigan Bell and was not predisposed to give much credence to the positions advanced by consumer groups. Finally, on a wide range of issues involving proper expenses to be allowed for equipment and services provided by AT&T or its affiliate companies to Michigan Bell, the MPSC generally permitted all of these expenses to be included in the rates to be paid by ratepayers and rarely required Michigan Bell to substantiate the reasonableness of these expenses or to require that a portion of these expenses be borne by shareholders in the form of reduced dividends.

THE FIRST CONSUMERS POWER RATE INCREASE CASE OF THE 1970'S

On August 13, 1970, Consumers Power applied to the MPSC to increase its electric rates. The MPSC on December 14, 1971, authorized an increase of $10,559,400 in annual revenues. The two Republican members of the MPSC, Willis Ward and Lenton G. Sculthrop, approved the rate increase.

The Democrat on the MPSC, William R. Ralls, did not participate in the case.

The MPSC noted that throughout the 1960's, Consumers Power had sustained growth in the demand for its electric services. In the years 1965 through 1969 its annual kilowatt-hour sales had increased from 14.3 billion to 18.5 billion. Capital expenditures in Consumers Power's Electric Department amounted to $82,052,000 in 1966 and increased to $177,257,003 in 1970.

The parties to this case disagreed on the appropriate value to be assigned to Consumers Power's rate base. One determination was a net original cost rate base; and the other was a fair value basis determination. The MPSC adopted Consumers Power's net original cost rate base presentation, but rejected the fair value basis determination on the basis that it had previously rejected this position in Consumers Power's 1959 electric rate case, D-2916, and Consumers Power's 1969 electric rate case, U-3179.

With regard to the critical issue of the appropriate rate of return on common equity, Consumers Power contended that it should be in the range of 13.5% to 15%. The AG argued that it should only be 10%. The MPSC Staff argued that the equity return rate could reasonably be in the range of 11.5%, and it further stated that a rate of return of 12.12% (the rate authorized by the MPSC in Consumers Power's

last rate case), would represent an ample equity earnings rate. The MPSC came to the conclusion that the Staff's position was the most reasonable, and therefore adopted a 12.12% rate of return on common equity in this proceeding. The MPSC would continue to maintain that a 12.12% return on common equity figure should be used in all Consumers Power electric rate cases throughout the mid-1970's.[13]

The most interesting aspect of this case was a proposal set forth by the AG to increase the jurisdictional net operating income to Consumers Power by $4,999,000 to recognize increased efficiency of operations when the Palisades Nuclear Plant came on line. The MPSC rejected the position taken by the AG on this issue primarily for the reason that the MPSC didn't believe that Consumers Power would experience an increase in efficiency of the magnitude asserted by the AG. The MPSC noted that the difficulties faced by Consumers Power in getting the Palisades Nuclear Plant on line were well known to the MPSC and that for this reason Consumers Power had just recently received authorization to operate this plant at only 20% of its capacity.

Based on the evidence produced in this proceeding, the MPSC authorized a rate increase of $10,559,400, which was substantially similar to the recommendation put forth by the

[13]In this case, the MPSC adopted an adjusted operating inome for the elect5ic operations of Consumers Power of $78,718,000 which was substantially similar to the figure proposed by the Staff.

MPSC Staff in its presentation. This case is of interest because at the beginning of this decade, the MPSC had indicated that with regard to the Palisades Nuclear Plant, Consumers Power was at that time experiencing construction difficulties which would result in a facility that would operate at less efficiency than originally planned. As the 1970's progressed, the ability of Consumers Power to complete the Midland Nuclear Project would become the major issue in the electric rate cases involving Consumers Power.

CONSUMERS POWER USES THE NEGOTIATION PROCESS TO TO OBTAIN RATE RELIEF; MORE OBSERVATIONS ON THE REGULATORY PHILOSOPHY OF CHAIRMAN WILLIS WARD

On August 2, 1972, Consumers Power applied for an increase in its retail electric rates of about $56,000,000.[14] Consumers Power also filed a Motion for Partial and Immediate Rate Relief which sought authority to amend its rate schedules so as to increase its retail electric revenues during the pendency of this case by approximately $34,000,000 on an annual basis.

In addition to Consumers Power and the Staff, other participants in this case were the AG, Michigan UAW-CAP, the United States Department of Defense, Brown Paper Company, Owens-Illinois, Inc., and the city of Wyoming, Michigan. The participation of Michigan UAW-CAP is strong evidence of

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[14]See opinion and order of the Michigan Public Service Commission issued on November 24, 1972, Case No. U-4174; also Dissenting Opinion of Willis F. Ward, Chairman, November 24, 1972, Case No. U-4174.

the increasing importance of utility rate increase cases to the public.

What is significant about this rate case is that it was resolved by negotiation rather than litigation. On September 12, 1972, the scheduled hearings in this proceeding were temporarily recessed at the request of certain parties so that they could enter into negotiations. At the adjourned hearing held on September 26, 1972, it was announced on the record that an agreement had been entered into, subject to the review and approval of the MPSC, for resolution of the issues in the proceeding. The parties executing the agreement were Consumers Power, the AG, the Michigan UAW-CAP and the U.S. Department of Defense. The Staff did not take a position on the negotiated settlement. At the hearing on September 26, 1972, testimony and exhibits in connection with the agreement were presented. The intervenor parties to the agreement presented no testimony whatever bearing on the agreement. The Agreement to Settle Proceeding was proposed and submitted on the record for the MPSC's consideration. The hearing was then closed, subject to any further action by the MPSC.

The evidence presented in support of the proposal by Consumers Power, as well as the evidence presented by the MPSC Staff concerning such proposal, was described by the MPSC as a "pricing out" of Consumers Power's financial results for the test year selected (the twelve months ending

April 30, 1972) in terms of the principles adopted by the MPSC in its most recent Consumers Power electric rate order (U-3749). The evidence presented by Consumers Power had not been subjected to cross-examination by the other participants. The Staff had not presented a full and independent case based on an audit of the books of Consumers Power, and the intervenors had presented no evidence whatsoever.

On October 5, 1972, the MPSC issued a further Order and Notice of Hearing reopening the record and scheduling further public hearings on October 16, 17, 18 and 19, 1972. The reasons the MPSC issued its Order reopening this case were as follows:

1) The MPSC decided it did not have before it sufficient evidence. In fact, the evidence of the Staff based upon a complete audit had not yet been submitted, upon which the MPSC could make an independent and meaningful judgment as to whether or not the proposal was, in fact, in the public interest.

2) In order to properly enable the MPSC to discharge its obligations and responsibilities in this case it was essential that the MPSC have before it, on the record, the complete Staff case based upon its audit of the books of Consumers Power, and the position of the Staff as to the sufficiency and propriety of the various features of the proposal.

3) It was in the public interest that a public hearing be held, at which hearing all interested parties, including the general public, having any stake in the issues involved in the proposal would be heard.[15]

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[15]Opinion and Order of the Michigan Public Service Commission issued on November 24, 1972, Case No. U-4174, 4.

The MPSC, then, reopened the matters which had been settled by negotiation. At the reopened hearing, the direct case of Consumers Power was received into evidence and cross-examined by the various parties. In addition, the Staff presented a report and audit of the books of Consumers Power, as well as its recommendations concerning the proposed settlement agreement.

A significant part of the majority Opinion and Order in this case was devoted to resolving differences between the Staff case and the direct case as presented by Consumers Power. Most issues dividing the Staff and Consumers Power as to the value of the rate base, the appropriate level of expense items, and the rate of return values, were determined in favor of the Staff position. Based on the strict reconciliation of the Staff and Consumers Power cases, the MPSC determined that a rate increase of $28,605,000 would be appropriate. This was slightly more than one-half of the rate increase originally requested by Consumers Power.

The majority of the members of the MPSC went on to note, however, that in this rate proceeding, Consumers Power, the AG, Michigan UAW-CAP, and the United States Department of Defense had proposed that a rate increase of $27,994,000, plus an additional $1,018,000 that Consumers Power would charge its electric customers to partially offset the revenue impact from reduction of late payment

discounts and the extension of the time for payment, or a total of $29,012,000 should be granted to Consumers Power. In addition, the Staff testified that the proposed amount was reasonable. Although the analysis of the Staff and Consumers Power proofs indicated that $28,605,000 was the appropriate level of the rate increase, the MPSC majority approved a rate increase of $29,012,000 as agreed to in the proposed settlement agreement by the various parties to the proceeding. Basically, the MPSC majority felt that the difference between a rate increase of $28,605,000 and $29,012,000 was not significant. Of course, what induced the MPSC to approve the rate increase of $29,012,000 was that this was the amount agreed to by the parties in the settlement agreement reached as a result of the informal negotiation process as opposed to the formal adversarial rate case approach. Thus, the most important dynamic to this particular case was that the amount of the rate increase was the result of an informal negotiation process rather than the traditional adversarial rate case approach.

A significant portion of the majority opinion of the MPSC was devoted to defending a rate increase based on a negotiation, particularly since Chairman Willis Ward issued a vigorous dissenting opinion questioning the legality of the informal negotiating process. The philosophical differences between Willis Ward and the other two members of the MPSC (Lenton G. Sculthorp and William R. Ralls) as to

the appropriate rate making process revolved around the specific issue of whether rate of return on common equity for Consumers Power should be 12.2% (the majority position) or should be increased above that level (the Ward position).

Willis Ward has been portrayed by some participants in the regulatory process in the late 1960's and the early 1970's as being merely a "lackey" of the utility companies, primarily because he tended to support most of the positions espoused by utility companies in rate cases while ignoring the positions developed by opponents of utility rate increases. Such a characterization of Ward is somewhat misleading. His dissenting opinion indicates a person who had a firm regulatory philosophy and who was not merely an unthinking servant of the utility companies. Consumers Power had argued in the proposed settlement agreement that a rate of return of 12.2% on common equity was acceptable. Ward disagreed with this position of Consumers Power in his dissenting opinion, and stated that his review of the financial status of Consumers Power indicated that a higher rate of return should be approved:

> I disapprove of the tendered settlement between the intervenors and the company. I do so reluctantly because it is clearly indicated that the company is in serious need of regulatory relief in the form of rate increases if it is to maintain its financial health. . . . There is also testimony clearly establishing that this utility is not earning the rate of return determined as reasonable by our prior order. This is a most disturbing situation to me. Also, our files indicate that the other large utilities are not coming reasonably close to the earnings that are allowed in our findings of a lawful and reasonable rate of

> return. I have reason to believe that this Commission is the only entity in the State of Michigan capable of treating the conditions causing this undesirable result. The Commission can only do so by expeditious and thorough examination of the afflicted utility. Short cuts and hastily contrived settlements not aimed at the heart of the malady of inadequate return on common equity, as is suggested in the instant settlement proposal, will not restore the health of this utility or any other of our utilities.
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> The aforementioned ominous downtrend of this utility's interest coverage ratios and its failure to render its stocks attractive to investors by reason of its flat dividend over the past several years has resulted in a downgrading from a AAA to a AA by certain security analysts. The direct result of this downgrading is an increase in the cost of debt. Obviously, this increased cost must be borne by the ratepayer. Therefore, both the investor and the ratepayer suffer.[16]

From the comments of Ward, we can discern that he had a limited perspective of the rate making process. It was intended merely to maintain the financial health of the utility company. Little or no concern was expressed with regard to the management practices of the utility company. Thus, for Ward, if rate of return on common equity was falling, the only solution was for ratepayers to pay higher rates to maintain the approved rate of return. An option that Ward was not prepared to accept was that lower returns on common equity might have to be borne by shareholders in the form of lower dividends if poor management practices was the factor most responsible for a declining rate of return on common equity.

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[16]Dissenting Opinion of Willis F. Ward, Chairman, November 24, 1972. Case No. U-4174, 1, 9 & 10.

More importantly perhaps, the dissenting opinion of Ward indicated that he believed the law did not sanction rate determination by informal negotiations by utility case participants. For Ward, utility rates could only legally be determined as a result of a statutorily mandated rate case proceeding, with the final result of the MPSC being subject solely to review by the law courts. Thus, Ward stated his position in an unequivocal manner:

> The proofs convincingly establish that the applicant is in dire need of relief in the form of interim and partial rate increases as well as substantial relief in a final order. This settlement agreement does not meet their problem. My difficulty with the settlement proposal arises by reason of the fact that the applicant, in spite of experienced counsel and verbal admonition from the Commission as a result of meetings with the Commission and higher ranking officers, persisted in abandoning its presentation along the lines of established procedures for rate relief but resorted to off-the-record, out-of-court, settlement negotiations with the intervening Attorney General. The Commission had no part whatsoever in these deliberations. . . . The gravest problem is whether it is in the public interest for this Commission to deviate from its established procedures pursuant to enabling statutes and Commission rules of procedure to approve a settlement between certain interested parties with respect to a rate increase affecting all of the customers of this applicant. . . . The only supervisory control over the Commission in carrying out this legislative function of setting utility rates is in the form of statutory appeal to the courts whose charge is to ascertain that the Commission has not abused its authority or violated the law in denying due process or acted outside legislative expression. . . . I do not believe that the legislature intended to have the power of the Commission circumscribed even though the Administrative Procedures Act encourages settlements with respect to administrative bodies. . . . This settlement is not in the public interest for the reason that it was arrived at

> beyond and outside of the procedures approved by the legislature. . . . It is morally wrong to let expediency govern a principle such as is involved here.[17]

Thus, according to Ward, the traditional adversarial rate case mechanism was the only vehicle permitted by law to determine utility rates. Informal settlement procedures were not permitted by law and were a usurpation of the MPSC's rate making function.

Finally, Ward was of the strong opinion that the participation of the AG in utility rate case proceedings was an impermissible conflict of interest and tended to permit the intrusion of "politics" into a process that was intended to be technical and non-political in nature:

> When it created the Public Service Commission and vested it with legislative powers to fix rates with respect to charges a utility could impose upon its customers, I do not believe that the legislature intended the further grant of an implied right to any customer or any public official, whether elected or appointed, to fix rates or in any way interfere with the discretion vested in the Commission to discharge this mandated function. We have here a case in which an elected official, in this case the Attorney General of the State of Michigan, has seen fit to appear on the record in a rate proceeding conducted by this Commission and declare himself to represent the public and, as such, proffer a purported agreement with a regulated utility with regard to its charges and the quality and the nature of the service that utility will render to the state. Clearly, this is an invasion of the powers vested in the Public Service Commission by the legislature. I have grave doubts as to whether the Attorney General can legally appear

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[17] Ibid., 1-5, 9.

and thereby invade the province of the Public Service Commission.[18]

If Willis Ward had been merely interested in catering to the interests of the utility companies, he would have approved the settlement agreement entered into by Consumers Power in this case which specified a rate of return on common equity of 12.2%. Instead he had a perspective that as a commissioner of the MPSC he had an obligation to review the financial health of the utility companies appearing before him, and if the data indicated a need for a higher rate of return than agreed to by a utility company, it was his duty to advocate such higher rate of return. In truth, his position as to the narrow and restricted function of the role of the MPSC was no longer appropriate to the turbulent times of the 1970's. Cases were going to be settled through the negotiation process involving the parties to the rate case rather than requiring a full-blown adversarial rate proceeding in every instance. The AG would have a pivotal and positive contribution to make in utility rate proceedings on behalf of the public, and the narrow perspective of Willis Ward as to the participation of the AG in such proceedings would be rejected.

Commissioners Sculthrop and Ralls were prepared to take a more forward-looking perspective as to the participation of public interest groups in rate case proceedings. They

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[18]Ibid., 2-3.

were also prepared to accept the validity of the negotiation process in settling these highly complicated and emotionally charged proceedings. However, they were acutely aware that there was a legal obligation to have a proper factual record before them upon which to judge the appropriateness of any proposed settlement agreement. Therefore, they ordered a reopening of the hearings in this matter to receive into evidence the full case of Consumers Power, have it cross-examined by all parties to the proceeding, and to have the Staff submit its technical report on the financial status of the company. Thus, the same minimal procedural requirements were adhered to in this negotiated case as would have been applied in a contested case where an interim rate order and then a subsequent final rate order would be issued. In its analysis of the case, the majority of the MPSC noted:

> The only question to resolve is whether or not it is in the public interest for the Commission to approve the proposal submitted by the Applicant and the Intervenors in this case. . . . The Commission is charged by law with the responsibility for setting rates which are neither so low as to be confiscatory nor so high as to be unjust. . . . The Commission must set such rates upon its own independent and meaningful judgment to produce the proper level of earnings required to maintain a viable utility, able to raise capital sufficient to maintain its service and to meet the growing demands of its customers. . . . The critical and necessary procedural requirement of this Commission has been satisfied; i.e.,the complete Staff case based upon its audit of the books of the

> Applicant has been submitted and cross-examined on the record.[19]

Thus, to counter the argument of Willis Ward that the MPSC was permitting private parties to set rates for public utilities when the MPSC accepted the proposed settlement agreement, the MPSC majority noted that it had determined that a 12.2% rate of return was acceptable based on two independent standards or guidelines; namely:

1) The utilization of the MPSC's last rate order for Consumers Power electric rate proceeding, Case No. U-3749, dated December 14, 1971, as the basis by which Consumers Power, with the assent of the Intervenors, to determine a reasonable revenue deficiency and rate of return for settlement purposes; and

2) The presentation in evidence of the complete Staff case after an audit of Consumers Power's books.[20]

Finally, the majority of the MPSC sanctioned the method of negotiated settlements as opposed to the need in every case to have a fully contested and adversarial proceeding:

> Certainly, the Commission is not being bypassed when its most recent rate order is considered the basis or yardstick for reaching a proposal. . . . The Commission observes that Applicant and Intervenors, in accepting a proposal figure within a close range of the Commission's updated case, have quite drastically changed their positions since

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[19]Opinion and Order of the Michigan Public Service Commission issued on November 24, 1972, Case No. U-4174, 19-20.

[20]Ibid., 24.

> the proceeding in Case No. U-3749. In that case, Applicant alleged its revenue needs to be approximately $18,000,000 more than the order and the Intervenor Attorney General's position on revenue requirements was approximately $26,000,000 to $36,000,000 less than the order. Therefore, it appears to the Commission that only through a negotiated approach will highly adversary parties agree upon figures that are within a range of reasonableness and which, in effect, support a prior Commission order. Apparently only because of long drawn out, highly contested prior rate cases is a foundation laid upon which to make a proposal to the Commission. [21]

Because this rate case was determined primarily through the use of off-the-record discussions between Consumers Power and the Intervenors, the MPSC felt compelled for the first time to include a number of public disclosure requirements in a rate order. The rate order required Consumers Power to file with the MPSC its proposed financing plans for the next five years (1972 through 1976). This was apparently done because Consumers Power requested this rate increase shortly after announcing a proposed major financing for the Midland Nuclear Project. The MPSC felt that it had not been provided adequate time to review the proposed financing:

> For the Commission to be confronted, as it was in this case, with a rate request just before a major financing, as though the need for financing was just discovered, is not conducive to the orderly growth of the utility. [22]

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[21] Ibid., 33.

[22] Order Requiring Additional Testimony and Evidence issued by the Michigan Public Service Commission on July 9, 1973, Case Nos. U-4331 and U-4332.

Consumers Power was also ordered to disclose data as to its efficiency, employment practices, construction program and environmental compliance. Thus, this rate order discloses the beginning of a trend for the MPSC to be concerned not only with the financial data by which to set rates, but also with a number of issues concerning the overall operations of the utility companies it regulated.

SIMULTANEOUS FILING OF GAS AND ELECTRIC RATE CASES: THE MPSC INTERCEDES TO AID THE UTILITY COMPANY

On April 18, 1973, Consumers Power filed two significant applications to increase its electric rates (U-4331) by $36,100,000 on an annual basis and to increase its gas revenues (U-4332) by $50,400,000 annually. In both cases, Consumers Power asked the MPSC to grant partial and immediate rate relief, prior to approving a final rate increase. Much of the testimony and proposed exhibits attached to each of the rate applications by Consumers Power were applicable to each of the two rate cases.

By the end of 1972, Consumers Power's electric service area included all or parts of 61 counties in the lower peninsula of Michigan in which it served more than 1,150,000 electric customers in 1,542 municipalities or townships. Consumers Power also provided gas service to approximately 911,000 customers in 790 municipalities or townships in the lower peninsula of Michigan. The gas system was completely

integrated and interconnected. Consumers Power purchased, produced, stored, transmitted, distributed and sold natural gas to customers within its system at uniform rates. In 1973, Consumers Power placed in service a gas reforming plant at Marysville, Michigan.

In both the gas and electric cases, the MPSC issued orders on July 9, 1973 requiring Consumers Power to provide additional testimony and evidence to supplement that which had been originally filed by the utility company with its application. In these cases, the lone Democrat on the MPSC, William Ralls, filed vigorous dissents to the issuance of these orders. The two commissioners approving these orders were both Republicans. Chairman William Rosenberg was a new member of the MPSC. These orders were important in that they signified a pro-utility preference to his regulatory philosophy. These regulatory orders were innovative since the MPSC on its own motion ordered Consumers Power and Detroit Edison to provide testimony to help their rate cases. This testimony was in addition to the testimony these utilities on their own had determined they should file to support their own rate increase applications. With regard to Consumers Power, these orders directed it to file answers to supplemental inquiries relative to: (1) an Earnings Erosion Factor (beyond the test year); (2) Rate Struc-

ture; (3) Advertising, Public Relations and Related Areas; and (4) Regulatory Commission Expenses for 1972.[23]

The additional testimony filed by Consumers Power as to the Earnings Erosion Factor for a period of time extended beyond the approved test year helped to provide a factual basis on the record for a greater rate increase in these rate cases, than would otherwise have probably been granted without the supplemental testimony. Ralls objected to using evidence as to an earnings erosion beyond the test year since this involved "projected" data rather than actual historical costs. Thus, by order of the MPSC, Consumers Power had been commanded to predict future events. Ralls argued that if more recent data than had been originally submitted by Consumers Power was required for these cases, it would have been more appropriate to select a new test year rather than engaging in speculation as to future events. Ralls also noted that for the MPSC to require this additional testimony was a procedural irregularity since Consumers Power had submitted its own testimony and had already been cross-examined on it. Moreover, Consumers Power had also fully completed its case in this matter. Equity required Consumers Power to file a new case rather than having the MPSC order the utility company to provide

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[23]Dissenting Opinion of Commissioner William R. Ralls, July 9, 1973, Case Nos. U-4331 and U-4332.

evidence which the MPSC deemed to be appropriate.[24] Thus, the orders issued in the Consumers Power's cases and a similar order in the Detroit Edison case evidenced a pro-utility bias on the part of the MPSC in this era of growing inflation and increasing shortage of gas supplies.

THE MARYSVILLE GASIFICATION PLANT BECOMES THE CENTER OF ATTENTION

On November 9, 1973, the MPSC issued orders in both the electric and gas cases granting partial and immediate rate relief to Consumers Power. In the electric case (U-4332), Consumers Power was granted interim rate relief in the amount of $25,000,000. This was approximately two-thirds of the requested total rate increase of $36,100,000.

Of particular interest was the interim rate order concerning the gas rate case. Consumers Power was granted a rate increase on an interim basis of $25,000,000, which was about one-half of the $50,400,000 of the final rate increase originally requested by Consumers Power. The Staff supported the granting of the interim rate relief in a slightly greater amount than was finally authorized by the MPSC on the basis that a gas revenue deficiency did in fact exist and that to delay granting rate relief until a final order

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[24]Order Granting Partial and Immediate Rate Relief issued by the Michigan Public Service Commission on November 9, 1973, Case No. U-4331, 10-13.

was issued would cause unreasonable and harmful loss of revenue to Consumers Power.

The Michigan Industrial Energy Users Group took no position as to whether the MPSC should or should not approve an interim rate increase for Consumers Power. The failure to take a position on the amount of the rate increase to grant a utility company was a common practice for the Michigan Industrial Energy Users Group at this time. The extent of the participation of the Michigan Industrial Energy Users Group was limited to insuring that if a utility company was granted a rate increase that industrial customers wouldn't bear a greater percentage increase in the cost of their energy than they were accustomed to paying in the past in relation to the commercial and residential customer classes.

The AG opposed the granting of any interim rate relief. The AG claimed that the then current rates for Consumers Power's gas division were excessive based on a 12.12% rate of return on common equity. The AG maintained that Consumers Power was (1) meeting all of its financial obligations, (2) had cash in the bank of $11,000,000, (3) had increased its cash flow by approximately 39% in the first 7 months of 1973 on an annualized basis compared with 1972, and (4) had paid its usual dividends on common stock. The AG also contended that Consumers Power's earned rate of return on common equity was 9.8% in 1972, had increased to

10.28% by the year ending July 31, 1973, and for the first 7 months of 1973 as annualized had further increased to 11.86%. Finally, the AG questioned the unexpectedly high construction costs of the Marysville project and asserted that its inclusion in the rate base amounted to a "cost-plus" rate making approach with the rate payers footing the bill.

It is interesting to note in this case that all three commissioners on the MPSC approved the award of interim rate relief to Consumers Power. One of the major aspects to the interim rate relief in the gas case was the fact that most of the rate increase was due to cost overruns in the construction of the Marysville I gasification plant.[25] The MPSC noted that Consumers Power was experiencing difficulty at this time in attracting capital from external sources under favorable terms. At one time Consumers Power bonds were Triple-A, sinking fund debentures were Double-A, and common stock was A-plus, but now were only Double-A, Single-A and A, respectively. Interest coverage on bonds was only 2.34 times and it would be impossible for Consumers Power to issue and sell additional first mortgage bonds if it fell below 2.0 times average. Finally, the MPSC argued that revenue relief had to be granted to Consumers Power to help complete construction of the Marysville I plant despite the

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[25]Opinion and Order of the Michigan Public Service Commission issued on November 9, 1973, Case No. U-4331.

existence of significant cost over-runs in order to permit needed gas supplies to be available for the upcoming 1974 heating season.

Of particular concern to the MPSC was the fact that a capital expenditure originally estimated to cost $40,000,000 in 1971 was now estimated to cost $155,000,000, an increase of 288%. The record reflected that the initial planned cost of $40,000,000 had increased to $80,000,000 in October, 1971, $119,999,999 in November, 1972, and was further revised to $155,000,000 in August of 1973, all with the approval of Consumers Power's Board of Directors. The record further reflected that during this two-year period of major cost revisions, the Board of Directors of Consumers Power had failed to make an independent inquiry into the decision-making process of the management team responsible for the planning, purchasing and construction of Marysville, even though estimated costs had redoubled again. Only when the rate increase application had been filed with the MPSC did the Board of Directors decide to order a special audit of the Marysville project.

The MPSC made note that the entire planning and construction process of the Marysville plant was exclusively under Consumers Power's control. Consumers Power had not filed an application with the MPSC requesting approval of the project prior to the commencement of its financial commitments. The MPSC also observed that Marysville would,

based on then current estimates, result in an increase in the cost of gas service by at least 20% to all of Consumers Power's customers because of the plant investment costs and the projected fuel, feedstock and operating expenses. Finally, the MPSC ordered its own independent investigation of the Marysville project since it felt that explanations would be forthcoming concerning the feasibility of decisions to build the plant and the cost overruns which would have significant adverse effects on customers of Consumers Power. Thus, we begin to discern that the MPSC itself is finally making slow progress towards a recognition of the need to do more than merely evaluate the financial condition of a utility company as part of its regulatory function, but must also evaluate the performance of management with regard to innovative, but very costly construction projects.

THE ELECTRIC RATE ORDER ALSO ACCEPTS THE NEED TO ELIMINATE PROMOTIONAL RATES

On January 18, 1974, the MPSC issued final rate orders in both the electric and gas cases. In the electric case, the MPSC authorized final rate relief in the amount of $5,975,773. This amount, when coupled with the $25,000,000 interim rate increase, produced a total increase in electric rates in the amount of $30,975,000. Since Consumers Power originally requested a rate increase of $36,100,000, the

MPSC basically awarded Consumers Power the total amount of its request for an increase in rates.

On the majority of issues in the electric rate case, the MPSC agreed with either Consumers Power or the Staff. The MPSC rarely agreed with the positions taken by the AG or other consumer oriented intervenors. For instance, the MPSC rejected the positions taken by the AG concerning the proper value of the rate base, the rate of return to be allowed on common equity, the overall rate of return, and certain expense items, such as employee fringe benefits, charitable contributions and donations, advertising expenses, profits on reacquired securities, etc.

Commissioner Ralls agreed with substantially all the positions taken by his Republican counterparts on the MPSC, and voted to award Consumers Power a final rate increase of $30,197,773, only $784,000 less than that of the Republicans on the MPSC. Ralls basically would have disallowed $784,000 of advertising and consultant expenses incurred by Consumers Power. In this case the positions of Consumers Power versus the positions taken by the other participants concerning allowance of advertising expenses within the cost of service were diametrically opposed. Consumers Power believed all of its advertising expenses should be recognized as benefiting its customers, and therefore, being a legitimate cost of service. The Staff, the AG and the West Michigan Environmental Action Council, Inc. opposed the recognition

of such expenditures, maintaining that the sums showed an absence of concrete assistance to the ratepayer.

The types of advertising expenditures questioned by the intervenors related to the content of materials Consumers Power had chosen to communicate to the public: (1) a continuing increase in electric demand over the balance of the 1970's, requiring additional generating capacity; (2) the impossibility of building future coal- fired plants due to environmental requirements; and (3) unreasonable delays in the construction of nuclear plants caused by unenlightened environmentalists. Ralls maintained that in order for advertising expenses to be recognized as reasonable expenditures to be paid by ratepayers, rather than by shareholders, it had to be demonstrated that the advertising was of real benefit to the customer and reasonable in cost. Ralls concluded that it was inequitable for ratepayers to have to pay for the advocacy of controversial environmental issues. This type of advertising should be paid by the shareholders.

As with gas rates, the MPSC in this proceeding determined that "declining price" rate structures for residential users of electric service should be eliminated, and that a flat rate structure should be instituted. This decision to eliminate the quantity discount rates was made because such rates (1) were not cost justified; (2) discriminated against low-income customers; (3) wasted

scarce fuel resources; (4) subsidized the deterioration of water and air resources; and (5) contributed to the erosion of a utility's earnings. Thus, flat rates were approved as being "conservation" rules.

Finally, there was some disagreement between Ralls and the other two members of the MPSC as to the proper method for determining the amount of the final rate increase. Ralls stated that the rate increase he approved was not based on allowing for an earnings erosion factor, but upon "normal accounting and ratemaking methods, as applied to a year-end test period". However, the majority of the MPSC did allow for a rate increase of $24,000,000 for an earnings erosion based upon year-end levels of expenses, rather than a yearly average level of expenses. In the final rate order, the MPSC expressed its concern that electric utility companies in Michigan had been unable to earn the authorized rate of return on common equity after a rate order had been put into effect. Rising costs for fuel and new plant investment for electric utilities had resulted in them earning less than the rate of return the MPSC had found reasonable and had authorized. The MPSC noted that frequent rate increases for electric utilities in recent years had been the result of inflation and higher costs of new productive facilities. Thus, earnings erosion had been due in large measure to the addition of expensive new plant at a rate not offset by economies of scale or increased sales to

either existing or new customers. So that electric utilities would be able "to attract billions of dollars of new capital to Michigan to provide the State with adequate electric supplies", the MPSC felt compelled to raise rates to compensate for the earnings erosion.

In the electric rate case, the response of the MPSC to the problem of earnings erosion was to use an updated test year by calculating the test year at year-end levels rather than average 1972 levels. The Staff and Consumers Power both recommended a year end approach. The intervenors opposed this approach. The MPSC estimated that the use of the year-end approach compared with the average test year method increased Consumers Power's revenue requirements by about $24,600,000.

In the gas rate case (U-4331), the MPSC had dealt with the earnings erosion problem by looking at facts "beyond the test year" to 1973 and 1974 so as to take into account the cost impact of the Marysville synthetic gas facility which would go into partial service in the spring of 1973 and would go into full service during the first several months of 1974.

Earnings erosion for electric utilities resulted from building larger generating facilities at a cost per unit of capacity that greatly exceeded the per unit costs of older generating units. The new generating plants were more costly to operate due to their tremendous size and

complexity. The MPSC noted that whether the new units were operating below their designed capability because of faulty design, poor decisions by management in deciding to purchase a particular unit, or for any one of numerous other reasons, it was management's responsibility to see that the situation was corrected to achieve full utilization of the new units. To help the management of Consumers Power to control rising costs of new capacity, the MPSC directed Consumers Power and the Staff of the MPSC to establish mutually acceptable performance goals, particularly in the areas of construction, planning and management, full utilization of plant capacity, and other critical items of general operation. Further, Consumers Power and the Staff were directed to prepare a report of their findings to submit to the MPSC.

Finally, to help electric utilities recover revenues for costly new generating facilities that were in the process of being constructed, the MPSC continued the practice of including construction work in progress (CWIP) in the rate base, and therefore, reflecting the related allowance for funds used during construction (AFUDC) as an increase in net operating income. By including the AFUDC as a part of net operating income for rate making purposes, it was assumed that when the plant under construction went into service it would earn a rate of return sufficient to cover

the earnings requirements that would no longer be provided by the allowance.

On January 18, 1974 in Case No. U-4331, the MPSC entered its order authorizing final rate relief for Consumers Power in the gas case. This order was unusual in that it authorized two sets of rates, one that would be immediately effective and would only include Marysville I, and the other to become effective at such time as Marysville II became fully and commercially operable. Since interim rate relief in the amount of $25,000,000 had already been authorized, the MPSC approved final rate relief for Marysville I in the additional amount of $7,045,000, and for Marysville II in the additional amount of $14,571,000. Thus, approximately 80% of Consumers Power's original rate relief of $50,400,000 was authorized for the Marysville II project. In this proceeding, most of the positions advanced by the AG were rejected by the MPSC, in favor of the positions advanced by either Consumers Power or the Staff. For instance, the AG argued that the Marysville investment should be excluded from the rate base as being an investment necessitated by imprudent management in that Consumers Power had secured additional pipeline sources of gas. The MPSC rejected this position on the basis that the record was void of any proofs to substantiate this claim. Indeed, the decision had been made to build Marysville because Consumers Power wanted to avoid gas supply pipeline curtailments from

suppliers in an era of dwindling gas supplies and increasing supplies.

Ralls only reluctantly went along with his fellow commissioners to approve the final rate increase. He thought that it was poor regulatory practice to grant increases based on projected future plant expenses or operating expenditures, rather than actual historical costs. His position was that the actual operating expenses of Marysville could be passed on to customers when they were incurred through the use of an adjustment clause. He noted that a similar mechanism to pass on to gas customers the increased cost of purchased gas through a Purchased Gas Adjustment Clause had already been approved by the MPSC in Case No. U-4263 on August 13, 1973. Moreover, on the same date in Case No. U-4262, the MPSC had approved a Fuel Cost Adjustment Clause to pass on to electric customers on a monthly basis the increased costs of purchasing fuel to operate electric generating facilities. Thus, Ralls thought the operating expenses could be passed on to the customers of Marysville gas as it was actually used by utilizing an adjustment clause, rather than through increased rates based on projections of the future operating expenses of Marysville.

THE MPSC AIDS THE UTILITY BY REOPENING THE CASE TO RECEIVE ADDITIONAL TESTIMONY FAVORABLE TO THE UTILITY

In the rate increase case for gas service, the MPSC on March 27, 1974 took the highly unusual step of issuing a supplemental order which granted a partial rehearing. The MPSC noted that since the closing of the record in this proceeding on November 13, 1973, subsequent events had taken place which gave the MPSC reasonable cause to believe that certain findings and determinations in its order of January 18, 1974 and the effects thereof should be examined.

Although not a part of the record in these proceedings, the MPSC found it appropriate to take notice of the imposition and the effect, directly or indirectly, of the oil embargo against the United States. In addition, the enactment of legislation and promulgation of regulations at the federal level to allocate and price petroleum products had resulted in fundamental changes in the relative cost and availability of fuels.

Moreover, on December 1, 1973, the Government of Canada had increased its export tax on petroleum products from 40 cents to $1.90 per barrel. Since Consumers Power directly relied upon Canadian sources for the feedstocks necessary to synthetically produce natural gas at its Marysville plant, the cost of that gas was directly affected. Also on February 1, 1974 the Canadian government had announced a further increase on the export tax to $6.40 per barrel. These dramatic events had all occurred subsequent to the

close of the record in U-4331. Thus, the MPSC noted that principally due to the increases in the Canadian export tax by approximately 1600%, Consumers Power's cost of gas had increased literally "overnight" in an unprecedented manner. In these circumstances, the MPSC felt compelled to order a rehearing in this matter.

The rehearing itself revolved around the issue of management of the operations at Marysville. Consumers Power had alerted the MPSC to the importance of the Marysville gas in order to avoid the curtailment of service to its firm commercial and industrial customers. The extraordinary cost increases in Marysville gas, subsequent to the close of the record in this case directly called into question the assignment of the costs of Marysville to all classes of Consumers Power's customers. This situation emphasized the need to consider the necessity to reexamine the traditional methods of allocating Consumers Power's revenue requirements among its various customer classes. With regard to Marysville, two fundamental inquiries required the attention of the MPSC:

(1) Did all of Consumers Power's customers equally benefit from gas produced at Marysville?, and

(2) If not, should the costs thereof be assigned in accordance with the benefit derived?

With respect to the traditional method of revenue allocation, the rate schedules approved in the final order

demonstrated differentials in customer price per Mcf depending upon the end use of the gas. For example, the rate for residential usage was currently $1.30 per Mcf, while large volume commercial and industrial usage was at 88.6 cents per Mcf.

Further inquiry had to be made of Consumers Power's then current cost of gas relative to current rates for residential, commercial and industrial use. Consumers Power also had been provided questions regarding the cost and availability of alternative fuels, and the ability of and cost to various classes of Consumers Power's customers to obtain alternative energy sources in the market place.

The MPSC therefore found that the public interest required the proceedings in Case No. U-4331 to be reopened for the limited purpose of redetermining, based upon additional testimony and evidence, the most equitable distribution of Consumers Power's gas costs among its various classes of service in view of the costs of incremental gas supplies; the benefits derived therefrom; the limited availability of this resource; the availability of and price of alternative fuels; and the feasibility of conversion thereto.

In addition, the MPSC found it necessary to reexamine the costs associated with Consumers Power's gas adjustment clause. This inquiry was limited to a determination as to the appropriate manner in which the clause operated to pass

through changes in the calculated cost of gas to the various classes of Consumers Power's customers, and what effect, if any, changes in the design of Consumers Power's rates would have upon the various classes.

In a separate opinion, Commissioner Ralls objected to the actions taken by the other two commission members in reopening the case. He believed that an order should be issued which froze the gas rates of Consumers Power at their present levels inasmuch as the investigation report concerning the performance of management at Marysville hadn't been completed and submitted to the MPSC for its review. Until the independent audit of Marysville had been performed, it was the opinion of Ralls that no additional rate increase through the use of adjustment clauses should be permitted.

Ralls further noted that prior approval by the MPSC of adjustment clauses would enable Consumers Power to raise its rates by about $70 billion dollars annually on or about April 1, 1974. Thus, gas rates for the average Consumers Power residential customer would increase by approximately 40% as a result of actions taken by the MPSC in August of 1973 and January of 1974. Commercial and industrial rates would increase by more than 80%.

Ralls noted that these were shocking figures. They were all the more shocking when a person considered that homes of nearly one out of three Michigan residents were

heated by Consumers Power gas, and that Consumers Power provided gas service in the counties hit hardest by the energy crisis - such as Genessee, Saginaw, Ingham and Oakland - where major automotive assembly and supply plants were located and where there was exceptionally high unemployment. Ralls concluded that the MPSC had an opportunity to make a significant contribution in the fight against inflation by stopping the largest rate increase to go into effect at one time in the history of Michigan. To Ralls, this should have been the MPSC's finest hour - instead it was a dark day for nearly 3,000,000 Michigan residents who lived in homes that would experience gas rate increases of approximately 40%.

Ralls further asserted that the majority of the MPSC proposed to respond to the unprecedented price increases, the continuing uninvestigated allegations of imprudence and mismanagement of Consumers Power, and demonstrable failures to supply needed volumes of natural gas by merely reopening the case. The scope of the reopened proceeding would be limited to determining whether the costs placed upon residential customers by the conduct of the management of Consumers Power and the orders of the MPSC should be shifted instead to commercial and industrial customers--who would then pass these costs back to Michigan's customers through increases in the prices of their own products. The logic of such a course of action in the light of the fact that the

residential increases of 40% per year were accompanied by industrial increases of more than 80% escaped Ralls. Before such rate increases should be passed on to its gas users, Ralls maintained that the investigative report into the management of the Marysville project should first be completed. Ralls concluded that "it is in the best interests of Consumers Power customers, shareholders, and the general public to get to the bottom of the problem once and for all".[26]

On November 19, 1974, the MPSC issued its Opinion and Order wherein it approved the allocation of the increase in gas revenues among the various customer classes. The MPSC determined that while all classes of Consumers Power customers directly benefitted from the synthetic natural gas production at the Marysville plant, all classes did not presently benefit on an equal basis. Commercial and industrial customers had benefitted in the past and continued to receive benefits in the present from Marysville production beyond those currently available to residential customers. To insure that commercial and industrial customers paid rates that were commensurate with the greater benefit they received, the MPSC ordered a reduction in residential rates by five cents per Mcf. Moreover, since residential customers had been ordered to pay for gas on a

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[26]Separate Opinion of Commissioner William R. Ralls, March 27, 1974, Case Nos. U-4331 and U-4332, 4.

flat-rate charge basis in order to encourge conservation in the use of natural gas, the MPSC ordered the elimination of a declining block-rate structure for commercial and industrial customers and substituted a flat-rate charge structure for conservation progrms. Flat rates would result in commercial and industrial customers paying greater sums for gas, and so the industrial intervenors opposed this action. Despite the opposition of industrial customers, the MPSC determined that commercial and industrial customers needed to be encouraged to become more conservation-oriented in their use of natural gas.

CONCLUSIONS

In looking at the first half of the 1970's, the relatively recent conflictual nature of utility proceedings comes into full bloom. In addition to the usual participation of utility companies and the Staff of the MPSC in these proceedings, the active participation of the AG, municipalities and consumers groups also became common place. Most importantly, business concerns also became significant participants in these proceedings. For industrial users of energy to participate in the rate proceedings of other business concerns (i.e., utilities) was an unprecedented development. It should be noted, however, that the participation of these business concerns was not so much in opposition to the total amount of the rate increase

requested by the utility company, but to ensure that of the total rate increase finally approved by the regulatory commission, the industrial users would not bear more than their perceived fair share of the approved rate increase in relation to the residential and commercial users of the same energy.

In the early 1970's, the issues that were litigated in utility rate proceedings broadened considerably. Rather than merely applying traditional mechanical formulas to determine the proper amounts of rate increases, the MPSC in a number of instances was forced to evaluate the social implications of their decisions. For instance, in the area of telephone regulation, the MPSC was forced to focus on substantial cross-subsidization issues in two areas: (1)higher rates for services in urban and suburban areas subsidizing lower rates in rural areas, and (2)residential rates being increased to subsidize lower business rates to meet emerging competition in the business related services. This was a period of large expenditures for replacements to the physical facilities of the utilities and for new additions thereto. For some electrical generating utilities, it was a period of expansion into nuclear generation. For both Michigan Bell and Consumers Power, the value of their physical facilities increased by 65.8% over that at the beginning of the decade. Of course, the value of the debt associated with these facilities increased just

as dramatically. The increase in debt provided one of the primary basis for the requested rate increase. Similarly, operating expenses were also increasing by 65% or more, largely due to inflation, and had to be met through rate increases.

The rate increase cases that were decided in the first part of the 1970's were characterized by the vigorous participation of various intervening groups with a public interest perspective. Thus, utility rate proceedings in the 1970's were a forum for deciding not only financial issues related to rate increases, but the social desirability of various costly generating projects that were being constructed by the utilities. In particular, controversy surrounded Consumers Power with regard to cost overruns at the Palisades Nuclear Project and the Marysville Synthetic Gas Plant. In order to meet the extensive cost overruns of these projects, the MPSC was forced to go from historically cost based rate regulation to the use of future estimated costs by the use of a concept called an "earnings erosion allowance".

At the beginning of the 1970's, the MPSC awarded Michigan Bell substantially all of the rate increase it requested in its application (U-3204). This would be one of the last rate cases in the 1970's where a utility company would be awarded close to the full amount of the requested rate increase. The practice that would subsequently develop

in the 1970's would be for the MPSC to award a utility approximately one-half of its requested rate relief. Thus, the practice emerged in Michigan of utility companies inflating their rate increase requests with the knowledge that the MPSC would be inclined to award substantially less than they had originally requested.

Traditional issues still were litigated in rate cases. These included the appropriate value of the rate base; the proper rate of return; the level of reasonable expenses; etc. However, even a traditional issue such as the appropriate test year took on new significance. For instance, due to inflationary factors, Michigan Bell in Case No. U-3204 advocated an "year-end" rate base, rather than an average year rate base.

Probably the most interesting aspect of Case No. U-3204 was the dissenting opinion of Chairman Willis Ward expressing his belief that the majority opinion in this case failed to approve a sufficiently large rate increase for Michigan Bell, despite the fact that Michigan Bell had agreed that the MPSC should award the rate increase as sanctioned by the majority of the MPSC. In particular, Chairman Ward presented a regulatory philosophy that opposed the intervention of public interest groups in utility rate hearings. Ward also opposed the new innovation of negotiated settlements in rate cases.

Opposed to the traditional rate base philosophy of Willis Ward was the perspective of William R. Ralls in his vigorous dissenting opinions that the regulatory approach of the 1970's had to be expanded to include a review of management decisions, as well as the mere review of financial data, to ensure that a utility company earned a fair return on its investment. The inflation of the early 1970's required public interest groups to participate on an increasing basis in rate proceedings and for the MPSC to consider the social implications of its decisions. A newly emerging issue of central importance for telephone regulation concerned the appropriate rates for competitive services. Competitors of Michigan Bell frequently offered unregulated services to business customers at rates that were generally less than offered by Michigan Bell for identical services. In order to retain these business customers, Michigan Bell frequently was required to seek regulatory approval from the MPSC to lower its rates for competitive business services. To make up for expected losses from the business customers, Michigan Bell was suspected of requesting larger rate increases for residential telephone services than would normally be justified on traditional cost of service principles. This phenomenon was an important factor for the increasing participation of consumer based public interest groups to ensure that residential telephone rates weren't

increased in such an amount as to subsidize the proposed reduction in rates for business services.

Finally, even though regulatory trends in the early 1970's indicated that traditional rate base regulation would be expanded by the MPSC, the rate cases of this period still evidenced a regulatory bias in favor of the utility companies. William Rosenberg advocated the use of an earnings erosion allowance to aid utilities in obtaining larger rate awards in this period. Rosenberg expanded the use of interim rate relief to provide more monies to utilities without having to permit intervenors in these interim rate proceedings the ability to put rebuttal testimony on the record. Moreover, Rosenberg utilized the unprecedented procedure of reopening a closed rate case so as to permit utilities to put new and additional testimony on the record of financial events occurring after the closing of the record. It is the dissenting opinions of William R. Ralls in this period that focuses attention on the need for utility companies to redirect management procedures and directions in the 1970's, and not to expect the MPSC to continually award financial "gifts" to cover poor decision making by utility managers.

CHAPTER V

THE LATE 1970'S: RATE BASE REGULATION BEGINS TO BE QUESTIONED; AND COMPETITION INVADES THE MONOPOLY MARKETS OF THE UTILITY COMPANIES

INTRODUCTION

The competition between various interest groups in the regulatory arena that began to emerge in the mid-1970's resulted in significant developments in the legislative and judicial spheres in the late 1970's and the early 1980's. New rate design proposals emerged in the regulatory arena in the early 1970's. Prior to the 1970's, competition had been virtually nonexistent in the various utility industries due to the monopoly franchises granted to utilities by the law. In the 1970's, legislative and judicial initiatives sought to introduce more competition into utility markets. For instance, proposals in the electric utility industry that encouraged regulators to adopt inverted rate structures, time-of-day pricing, and other innovative rate theories eventually resulted in the passage of the Public Utility Regulatory Policy Act of 1978 (PURPA) at the federal level, and the adoption of Public Act 304 in 1982 at the state level. Moreover, theories justifying rate reductions for

business users of telephone services resulted in a significant restructuring of the national telephone industry as a result of the U.S. government's anti-trust lawsuit against AT&T. The competition of economic ideas in the legislative, judicial and regulatory arenas would eventually result in increased competition for utility firms in the economic marketplace. A number of economists argued that competition would make utility firms more efficient, and correspondingly, prices for utility services would be reduced to the benefit of ratepayers.

The financial situation for an intrastate telephone company such as Michigan Bell was complicated by the fact that the U.S. government in 1974 filed an anti-trust lawsuit against AT&T seeking the divestiture of certain of its subsidiary companies. In the 1970's, AT&T was facing intensified competition from Microwave Communications, Inc. (MCI) in the interstate telephone market with regard to the provision to business customers of various lucrative long-distance services. Thus, certain pressures were applied to the local operating companies to maintain or increase rates for local exchange residential telephone services so that AT&T might be able to meet the reduced prices that competitors were offering in the long-distance business telephone market. Since local exchange service is a natural monopoly and long-distance service was beginning to lose its monopoly characteristics as competition entered the market

arena, the temptation within the larger Bell system was to attempt to subsidize the lower than cost justified rates for long distance services by higher than cost justified rates for monopolized local exchange services. Economic competition would foster the birth of new pricing theories in the regulatory arena.

In 1969, MCI initiated a private anti-trust lawsuit against AT&T seeking damages for alleged anti-competitive practices in failing to permit MCI to interconnect with AT&T's long-distance facilities so that MCI could provide a competitive alternative service. In 1974, the U.S. government filed its anti-trust lawsuit against AT&T. When the government and AT&T finally reached agreement on the mechanics of settling the anti-trust suit in early 1982, AT&T was permitted to retain legal ownership of Western Electric and Bell Laboratories, but was required to divest itself of all 22 of the local operating companies, which in turn would become subsidiaries of seven newly created regional telephone companies. In the Federal Circuit Court Judgment, AT&T was permitted to enter the lucrative field of providing computer equipment and services to the public. The local operating companies were restricted to providing intrastate telephone service and could not provide interstate long-distance telephone services, manufacture and/or sell telephone equipment, or sell computer equipment or services to the public. Thus, the local operating

companies could only provide local telephone services, essentially to residential customers. These were the least lucrative of the telephone services, but perhaps the most costly to provide. Local exchange service still retained its monopolistic characteristics, and so residential customers were restricted to one source for local telephone services. However, AT&T was able to get rid of the costly local exchange companies, continue to provide lucrative long-distance services to businesses, and enter the potentially lucrative computer market.

When the Federal Anti-Trust Consent Decree was issued, the fear was expressed that rates for long-distance business services would decrease, but that rates for local exchange services would probably increase beyond the limits that would be cost justified due to the absence of competition. It was argued that residential customers might pay higher rates for local services to subsidize the purchase of telephone plant that would primarily benefit long-distance business users, whose rates would decrease.

By the late 1970's, the regulation of public utilities had moved beyond the exclusive domain of regulatory commissions, into the judicial and legislative forums. This movement into other forums is indicative that rate making had become a highly politized topic that involved the vigorous participation of residential and industrial rate payer groups in the rate making process.

As competition began to surface in the various utility industries, regulators became interested in the issue of the cross-subsidization of various utility services. The introduction of incentive regulation proposals was an attempt to promote competition, while maintaining some regulatory oversight over utility companies.

Utility companies and intervenors entering into settlement negotiations as to the magnitude of rate increases became very prevalent. Although the use of the projected test year approach became more accepted by regulators, the utilization of earnings erosion allowances and normalization factors was rejected.

THE MICHIGAN BELL RATE ORDERS

(A) THE USE OF A PROJECTED TEST YEAR AS A MEANS OF AVOIDING THE AWARD OF AN EARNINGS EROSION ALLOWANCE

In the mid to late 1970's, Michigan Bell litigated two rate increase cases before the MPSC (Case Nos. U-4820 and U-5125). On April 24, 1975, in Case No. U-4820, Michigan Bell filed an application seeking a rate increase of $88,100,000.

On May 4, 1976, the MPSC authorized a rate increase of $52,172,000. This represented about two-thirds of the total rate increase it had requested.

There were several intervenors in this case, representing both business interests and residential consumer interests. One of the issues in this case was

whether the amount of requested rate increase was cost justified. Some intervenors speculated that Michigan Bell was seeking an abnormally high rate increase to be paid by its local exchange customers in order to provide increased sums of monies to AT&T, thereby permitting AT&T to maintain low long distance rates to meet competition from MCI.

The main issue of this case was whether Michigan Bell was entitled to an earnings erosion allowance. In the prior rate case, the MPSC had determined that it would approve an earnings erosion allowance if a utility had demonstrated its inability to earn the allowed and appropriate rate of return due to economic conditions beyond its control, such as inflation.[1] In that case, the MPSC had authorized a rate of return on common equity of 10.19%. In this case, all parties agreed that 10.19% would continue to be the authorized rate of return on common equity. Michigan Bell argued that due to inflation it had failed to meet its authorized rate of return, and therefore, was entitled to an earnings erosion allowance of approximately $25,800,000. The Staff proposed an allowance of $4,418,000. The AG opposed any earnings allowance.

In the prior rate case, the MPSC had requested that Michigan Bell use a projected test year (as well as data for an historical test year), so as to alleviate the need to use

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[1]Opinion and Order of the Michigan Public Service Commission issued on February 15, 1975, Case No. U-4575.

an earnings erosion allowance in times of inflation. In this case, Michigan Bell and the Staff submitted financial data based on a 1974 historical test year and a 1975 projected test year. However, none of the other parties submitted financial information based on a projected test year. Therefore, the MPSC used the 1974 historical test year data, and awarded $12,936,000 as an earnings erosion allowance. The MPSC mandated, however, that in future rate cases, projected test year data were to be used by all parties so as to avoid having to use an earnings erosion allowance.

William R. Ralls dissented to the award of $52,172,000 as final rate relief. He would have disallowed the earnings erosion allowance of $12,900,000, and therefore, would have approved final rate relief in the reduced amount of $39,272,000. Ralls noted that the MPSC had made adjustments to the 1974 historical test year data for anticipated adverse future events. Ralls went on to reason that if the MPSC's findings as to the proper level of future rates were correct based on the adjusted 1974 period, then it necessarily followed that the so-called earnings erosion allowance of $12,900,000 was excessive and should be disallowed.

Ralls observed that Michigan Bell would have a reasonable opportunity to earn its authorized rate of return

in the future with a rate adjustment of only $39,200,000. Ralls concluded:

> If, . . . the "earnings erosion allowance" is not in fact what it is purported to be, that is an allowance for past failures to earn the authorized rate of return, but is instead an added correction for adverse future circumstances, then it is a distinctive and costly response to unquantified potential negative developments affecting Michigan Bell's operations. The nature of these negative factors remains mere speculation.[2]

On June 6, 1976, a mere one month after the issuance of the final order in Case No. U-4820, Michigan Bell filed a new rate increase application in Case No. U-5125 for the then record setting amount of $178,200,000. The Staff recommended final rate relief in the amount of only $31,409,500.

On April 4, 1977, the MPSC awarded Michigan Bell a rate increase of $58,984,000. This was approximately one-third of the amount requested by Michigan Bell in its application. Michigan Bell provided financial data both on an historical test year basis (1975) and a projected test year basis (1976). The projected test year data were submitted in compliance with the previous order of the MPSC in Case No. U-4820. Since the MPSC decided to use the projected test year data, no earnings erosion allowance was approved as had been done in prior Michigan Bell rate cases. In its order, the MPSC noted its use of projected

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[2]Dissenting Opinion of Commissioner William R. Ralls, issued on May 4, 1976, Case No. U-4820, 3.

test year data for 1976 would benefit Michigan Bell since 1975 was an economically poor year. Therefore, financial data for 1975 would not be reflective of the period in which the rates set in this proceeding would be effective. To further help Michigan Bell financially, the MPSC decided it would make adjustments to the 1976 projected data for events that were anticipated to occur in 1977, such as changes in AT&T's depreciation rates which would apply also to Michigan Bell, and major wage increases to take place in 1977.

William R. Ralls issued another dissenting opinion in this matter. He took the position that the $58,980,000 rate increase was more than twice the amount justified by the evidence in this case. For Ralls, a rate increase of only $28,870,000 was justified; and therefore, the other two commissioners on the MPSC had awarded Michigan Bell $30,110,000 in excess revenues. Ralls noted that the award made to Michigan Bell for executive salaries should have been reduced by $3,310,000; and the award for license payments made to AT&T should have been reduced by $8,140,000.

(B) RALLS ARGUES THAT THE CONCEPT OF LEVERAGE HAS RESULTED IN AN EXCESSIVE RATE OF RETURN AWARD TO MICHIGAN BELL

Most importantly, Ralls' analysis of the evidence indicated that the increase for Michigan Bell's rate of return on common equity approved by the MPSC in this case was excessive and should have been reduced by $21,930,000.

The MPSC had previously approved a rate of return of 10.19% on common equity for Michigan Bell. In this case, the AG recommended that the rate of return remain the same. Michigan Bell presented testimony which would have justified a rate of return between 13.4% and 15.2% for the AT&T system as a whole. The U.S. Government advocated a rate of return of 11.5% to 12.5%; and the MPSC Staff presented testimony for a rate of return of 12.44% to 13.5%, with a specific recommendation of 12.97% for the total AT&T system. The MPSC determined that a 12.75% rate of return on common equity for the total AT&T system would be appropriate, and that this would actually result in an 11.35% return on Michigan Bell's equity.

Commissioner Ralls dissented and maintained that a 12.50% return on common equity for AT&T was justified, and that this would result in a 10.44% required return for Michigan Bell. If the Michigan Bell rate of return were reduced from 11.35% to 10.44%, this would mean the rate increase approved for Michigan Bell in this proceeding should have been reduced by $21,930,000.

In his dissenting opinion, Ralls addressed the problem of leverage due to Michigan Bell's being a subsidiary of AT&T. A holding company such as AT&T may employ "leverage" by investing funds under its control bearing a fixed cost, into projects of a subsidiary company such as Michigan Bell that earn a higher rate of return. For example, if a

holding company could borrow funds at 8% and put the funds to work in a subsidiary company at 12%, the earnings on the holding company's investment would be increased. Ralls went on to observe that the Staff had originally proposed using a double debt leverage approach in this case. This approach is based on the concept that nothing greater than the overall cost of capital to the holding company can be a fair return on the funds supplied to the subsidiary by the parent. Therefore, the rate of return on common equity for the subsidiary would be lower than the rate of return on common equity for the holding company. Thus, the rate of return of 12.50% for AT&T should result in a rate of return on common equity for Michigan Bell of only 10.44%. If the double debt leverage approach had been used by the MPSC in this case, the rate increase for Michigan Bell would have been reduced by $21,930,000.

(C) RATE DESIGN ISSUES, INCLUDING THE ALLEGATION OF CROSS- SUBSIDIZATION OF BUSINESS SERVICES BY RESIDENTIAL CUSTOMERS

An important issue addressed in this case was how the approved rate increase was to be distributed among the various classes of telephone service. Instead of applying an identical percentage increase to the existing rates for business and residential services, the MPSC approved a higher percentage rate increase for business services as opposed to residential services. A number of intervenors in

this case represented business interests: Michigan Business Telephone Users Committee (MBTUC); ADT Security Systems; Michigan Burglar Alarm Systems, Inc.; and Midnight Burglar Alarm Systems, Inc. The primary interests of the business concerns was to make sure that the percentage of rate increase for business related telephone services didn't unjustifiably exceed the percentage rate increases for basic exchange services used primarily by residential customers. Although it has been maintained by telephone companies that rates have historically been higher than cost justified for business services so as to maintain lower than cost justified rates for residential services, this assertion had been disputed by consumer interest groups.[3] The interim rate order in this case did in fact place a higher percentage of the interim rate increase on business related services, rather than residential related services. In the final order there again were substantial increases authorized for both certain business related services, and for residential local service.

As to the transfer of funds from Michigan Bell to AT&T under license agreements or through rate of return on common

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[3]This issue of cross-subsidization of rates between business and residential customer categories has never been conclusively resolved. For instance, during hearings held as recently as 1991 by the Michigan Legislature to adopt a new telephone regulatory statute, residential consumer groups claimed that residential services were priced too high and business services too low, thereby resulting in residential customers providing an unjustified subsidy to business interests. The business groups and the telephone companies took exactly the opposite perspective during these legislative hearings. Representatives of the MPSC stated that currently used cost allocation criterion would not prove whether residential customers were subsidizing business related services, or vice versa.

equity, Commissioner Ralls thought that about $30,000,000 of the rate relief for Michigan Bell that would eventually go to AT&T was excessive and should be denied.[4] It can be surmised that AT&T put pressure on Michigan Bell and other local operating companies to obtain substantial rate increases not only to cover increased costs of inflation, but to provide funds to keep long distance rates lower to meet competition from new interstate carriers like MCI. Again these funds would come to AT&T from increasing rates for local residential service which was monopolistic in nature.[5]

Early in 1982, the AT&T anti-trust settlement agreement was executed between AT&T and the U.S. Government. Michigan Bell was legally separated from AT&T and became a subsidiary company of a newly formed company, Ameritech. After the dissolution of the AT&T system, it was predicted that local operating companies such as Michigan Bell would be filing rate applications for significant increases in residential local service rates to subsidize less than cost justified

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[4]Dissenting Opinion of Commissioner William R. Ralls issued on April 4, 1977, Case No. U-5125, 1-5 and 7-8.

[5]On August 23, 1977, Michigan Bell filed an application with the MPSC to reopen Case No. U-5125 to consider the revenue effects of the wage contract negotiated after the final order had been issued on April 4, 1977. On August 7, 1977, Michigan Bell had entered into a three year contract with the Communications Workers of America, which provided for wage and benefit increases for nonmanagement employees. After reviewing this financial data, the MPSC issued an order on January 23, 1978 in Case No. U-5125R awarding an additional rate increase of $27,427,000 to Michigan Bell. Thus, Michigan Bell was eventually awarded $86,411,000 in additional annual revenues in Case No. U-5125, slightly less than one-half of its initial request of $178,200,000.

access charges for AT&T to provide long distance telephone services in the highly competitive business market. This particular phenomenon has not occurred in the almost 10 years since the anti-trust settlement agreement was executed. In this time period, residential telephone rates have remained relatively stable.[6]

THE CONSUMERS POWER RATE CASES

With regard to Consumers Power and its provision of natural gas services, the main issue that concerned the MPSC for the balance of the 1970's was the unanticipated increased costs of constructing the Marysville synthetic gas facility. On November 27, 1974, Consumers Power filed an application for a total rate increase of $54,157,000 in Case No. U-4717, which included a request for interim rate relief in the amount of $39,559,000.

The importance of the issues involved in this proceeding is indicated by the number and types of intervenors:

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[6]This conclusion is subject to considerable differences of opinion. For instance, a recent study by a New York based telecommunications consultant claims that phone charges have increases an average of 315 percent since the court ordered divestiture of AT&T in 1984. That hugh increase included the cost of basic phone service plus a number of other monthly charges that show up on monthly phone bills for things like wire maintenance plans, 911, directory assistance and numerous local, state and federal taxes. With regard to monthly phone service charges only, the Federal Communications Commission has stated that this cost has increased 53 percent since the breakup of AT&T. Also, it has been calculated that toll calls handled by the local Bell Operating Companies can run 25 percent to 250 percent more for a one-minute call than if a long distance carrier had handled it, adding up to $5.9 billion in extra charges for consumers annually. Lansing State Journal, Section B, August 10, 1992.

(1) General Motors Corporation
(2) Dow Chemical Company
(3) Owens-Illinois, Inc.
(4) Michigan Sugar Company
(5) SWS Silicones Corp.
(6) Holiday Park Towne Houses Cooperative
(7) Detroit Metropolitan Growers Association
(8) Michigan State Florists Cooperative
(9) Grand Valley Growers Cooperative
(10) Great Lakes Mushroom Cooperative Association
(11) Michigan Plant Growers Cooperative
(12) Kalamazoo Valley Plant Growers Cooperative
(13) John H. King - individually

The MPSC granted interim rate relief to Consumers Power on June 2, 1975 in the amount of $29,194,000, approximately $10,500,000 less than requested by Consumers Power. In its interim rate order, the MPSC highlighted the fact that the financial position of Consumers Power was now fairly precarious:

(1) Dividends on common stock had been reduced from $2/share to $1.34/share.

(2) Return on common equity was less than 5%, substantially below the 12.12% presently authorized by the MPSC.

(3) Securities of Consumers Power had been down rated by Moody's, due to poor earnings.

(4) In 1975, Consumers Power needed to generate $337,300,000 for the following purposes:

(a) $251,000,000 for construction projects ($30,000,000 was for gas construction projects); and
(b) $86,300,000 to refinance its 2 7/8ths first mortgage bonds.

Only $67,000,000 of these funds could be generated internally by Consumers Power, while $270,000,000 had to come from external sources. This was the

> largest amount of money Consumers Power ever had to finance externally in a single calendar year.[7]

On March 8, 1976, the MPSC issued a final order in Case No. U- 4717. The MPSC found that Consumers Power was experiencing a revenue deficiency of only $881,401, and therefore authorized no additional rate relief in this proceeding beyond the $29,194,000 of interim relief previously authorized on June 2, 1975. The major issue addressed in the final order was whether rate payers should bear any of the construction costs of the Marysville Plant.

As previously noted, the final cost of constructing the Marysville Plant was $155,000,000. This amount greatly exceeded the original budget estimates. Prior to this case, the MPSC in Case No. U-4331 had approved ratepayer responsibility for only $119,700,000 of the construction costs. Thus, in this case Consumers Power was seeking approval to assess ratepayers an additional $35,000,000 in construction costs. The Staff of the MPSC basically supported the position of Consumers Power. The AG presented evidence that none of the Marysville construction costs should be included in the rate base, including the $119,700,000 previously authorized by the MPSC. The AG stated that Consumers Power had built the Marysville Plant to "pad" its rate base. The AG vigorously argued that Marysville should never have been built.

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[7]Order Granting Partial and Immediate Rate Relief issued by the Michigan Public Service Commission on June 2, 1975, Case No. U-4717, 13 & 14.

In order to help resolve the dispute over what construction costs should be included in the rate base, the MPSC hired the Stanford Research Institute (SRI) as an independent consultant. SRI prepared a written report entitled "Marysville SNG Plant - An Investigative Case Study". SRI presented 13 principal findings, 4 of which were of particular interest:

1. The Marysville SNG plant, the first of its kind in the United States, produces a reliable supply of supplemental gas for Consumers' customers.

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4. The original decision by Consumers to build a light hydrocarbon SNG plant was based on the fact that this would be the only way to meet traditional gas demands in the mid-1970's. This decision was reasonable in terms of conditions prevailing in 1971.

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11. The actual engineering and construction costs greatly exceeded the original estimates because of a combination of interrelated factors including:

    - First-time application of this technology in the United States

    - Complicated design situation in terms of feedstock combinations and properties

    - Underestimation of the cost impact of the compressed construction schedule

    - Design changes during the engineering phase to ensure plant reliability and ease of operation

    - Overestimation of labor productivity

    - The first job by Lumus under new occupational health and safety (OSHA) standards

    - Accounting and cost control practices during construction, which were ineffective given the large and complex nature of the project.

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13. SRI has found no wilful wrongdoing on the part of Consumers, Lumus, or any other organization involved in the Marysville project.[8]

The report also "recommended" that the MPSC include all of the construction costs of Marysville in Consumers Power's rate base. This "recommendation" engendered a great amount of controversy. The testimony of Dr. A. James Moll, the Project Director, indicated that at an informal meeting, William Rosenberg, chairman of the MPSC, had asked SRI include such a recommendation in the report. The AG argued that such a "recommendation" was inappropriate because the SRI study was supposed to be limited to making findings as to whether the cost overruns in constructing Marysville had been reasonably incurred by Consumers Power. It was not within the purview of the SRI Report to make recommendations as to the inclusion of Marysville construction costs in Consumers Power's rate base, since that was clearly the legal prerogative of the commissioners comprising the MPSC. Thus, the AG tried to argue that Chairman Rosenberg had clearly overstepped his authority in requesting that such a "recommendation" be included in the report and that such a request had fatally flawed the SRI Report.

In this case, the MPSC found that Consumers Power's decision to construct the Marysville Plant was a prudent

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[8]Opinion and Order of the Michigan Public Service Commission issued on January 23, 1978, Case No. U-4717, 16 & 17.

investment decision in light of the circumstances that existed at the time the decision was made. However, the MPSC then went on to find that only $119.7 million of the $155 million expended by Consumers Power to construct the plant had been reasonable expenditures, and the remaining costs of construction of $35.3 million were unreasonable and should not be included in the rate base.

William R. Ralls issued a concurring opinion wherein he supported no rate increase for Consumers Power. In the concurring opinion, he stated that he was particularly appalled by Consumers Power's attitude that all of the construction costs of Marysville should be included in its rate base and passed on to its rate payers, regardless of whether some of the construction costs had been unreasonably incurred or were even wasteful. Since gas utility companies were natural monopolies functioning without the constraints of competition, it was the duty of the MPSC to approve only reasonable and non-wasteful construction costs.

One of the procedural irregularities of this case, was that by order dated March 8, 1976, the proceeding was remanded by the MPSC for new hearings to permit Consumers Power to present new evidence regarding the construction costs for Marysville. Shortly before this, Consumers Power had filed a new application in Case No. U-5110 for an increase in gas rates. This new application was dismissed by the MPSC on June 28, 1976, partially due to the fact that

this case had been remanded for further evidence. In the reopened hearings, Consumers Power was permitted to present new financial data based on an updated test year. At the conclusion of the reopened hearing, the MPSC issued an order on March 21, 1977 wherein it approved a second interim gas rate increase of $4,928,000. William R. Ralls wrote a dissenting opinion stating that the MPSC should not have approved a second interim award in this case, particularly since a final rate order was expected to be issued by the MPSC within a matter of a few short weeks.

A final order was approved in this case by the MPSC on January 23, 1978. William Rosenberg had been replaced as chairman of the MPSC by Daniel Demlow; and William R. Ralls had been succeeded as a MPSC commissioner by Willa Mae King. In addition to the cost increases approved by the previous two interim rate orders, this final rate order approved an additional increase of $10,994,655 for Consumers Power. The major component of this final rate increase in gas service was the inclusion in rate base of an additional $5,330,531 for the construction of the Marysville Plant. Prior to 1970, Consumers Power had estimated that it would cost $40,000,000 to construct Marysville. When Marysville was finally completed in 1979, the cost of construction had nearly quadrupled to $156,000,000. Of this $156,000,000, the MPSC had previously approved the inclusion of $119,700,000 in Consumers Power's rate base. Thus,

approximately 300% of the original construction cost estimates had to be paid by Consumers Power's ratepayers pursuant to MPSC authorization. When the $5,330,531 of construction costs approved in this particular rate order were added to the $119,700,000 previously approved by the MPSC, the rate payers of Consumers Power were required to pay over 3/4ths of the construction costs for a plant that cost more than four times the original cost estimates to build.

The MPSC did not approve the full inclusion of $156 million of construction costs in the rate base, because even though the plant itself was deemed to be a prudent investment, not all of the construction costs were reasonably incurred by Consumers Power's management. The MPSC was of the opinion that it had to approve a substantial portion of the construction costs in the rate base, since not to do so might lead to a "chilling effect" on utility decisions to enter into large-scale construction projects.

The issue of whether it was the fault of management or of the regulators for the high cost overruns experienced in the 1970's for the construction of nuclear generating facilities will be reviewed later in this paper. However, this issue on a much smaller financial scale was clearly present in the construction of the Marysville Gas Processing Plant. The cost of constructing this facility was nearly four times that of the original cost estimates. The rate

payers of gas service were required to pay for 2/3rds of the cost overruns. The MPSC at one point in time, sought to avoid assessing blame on Consumers Power's management for the significant cost overruns by relying on a special report prepared by SRI that recommended all construction costs to be included in the rate base. This recommendation by SRI engendered a large amount of controversy, since the recommendation was included at the request of Chairman William Rosenberg at an informal conference with SRI officials. The MPSC did eventually conclude that it wasn't bound by the recommendation, since it was clearly "outside the scope of the study". In addition, the MPSC eventually concluded that many of the cost overruns were unreasonably incurred by Consumers Power, and failed to approve approximately $35,000,000 in construction costs in Consumers Power's rate base.

Although it took over 3 1/2 years to conclude rate case U- 4717, Consumers Power never really claimed that a major portion of the cost overruns was due to regulatory lag or was the fault of inaction by regulators to approve rate increases on a timely fashion. From the public record, it clearly appears that the significant cost overruns for the Marysville project were the fault of Consumers Power. Its ability to oversee the construction of large scale construction projects so as to minimize construction costs for ratepayers was clearly called into question, and should

be kept in mind when evaluating the issue of who was responsible for the vastly more significant construction cost overruns of the Midland Nuclear Facility.

EROSION ALLOWANCES AND PROJECTED TEST YEAR PERIODS

With regard to the electric operations of Consumers Power, financial difficulties became more and more apparent in the late 1970s, essentially due to the problems associated with the Midland Nuclear Generating Facility. On April 23, 1974, Consumers Power filed in Case No. U-4576 an application for authority to increase its electric rates by $72,159,000. On September 16, 1974, the MPSC issued an interim rate order, authorizing Consumers Power to increase its rates by $27,624,000; and on January 23, 1975, a final order was issued permitting an additional rate increase of $38,606,642. Thus, the interim and final rate orders increased electric rates by $66,230,642, which was almost the total amount of rate relief originally requested by Consumers Power.

Several parties intervened in this proceeding, essentially to offer testimony on the issue of innovative rate design proposals. This case was interesting from a number of perspectives. For the first time in many years, Consumers Power experienced a decrease in electric sales. The testimony of Consumers Power did indicate that it

anticipated growth in sales to continue after 1974, but at a lesser rate than in the past. Although investment in construction had decreased, Consumers Power still needed to issue new securities to finance new construction to meet increased demands for electricity. The previously authorized rate of return on common equity for Consumers Power had been 12.12%; but, Consumers Power for the last few years had been unable to earn this return. In this proceeding, the MPSC decided to continue an authorized rate of return on common equity of 12.12% for Consumers Power. However, it did direct the Staff of the MPSC to prepare and present a study on the appropriate level of return on common equity for Consumers Power to be presented in the next rate case, with particular attention being paid to the significant changes that had taken place in capital markets since the completion of the Staff's last full investigation.

In this case, an historical test period was utilized for the 12 month period ending December 31, 1973. To some extent it had become accepted by the mid 1970s that in a period of rapid inflation, rate increases based on historical rest years would soon prove to be inadequate for utility companies. In an effort to alleviate frequent rate cases, utility commissioners began to consider the use of projected test years, so that increased rates could be based on projected expense increases. However, in this case, no testimony was presented with regard to a projected test

year. Thus, in an effort to help the deteriorating financial position of Consumers Power, the MPSC approved the use of an earnings erosion allowance. Consumers Power requested an earnings erosion of $35,000,000; but, the MPSC authorized an earnings erosion of $10,930,640. The primary basis for granting an earnings erosion allowance in this case was the "precarious" financial situation of Consumers Power:

(1) Consumers Power's interest coverage had in 1974 either fallen below or been dangerously close to the 2.0 times factor, thus prohibiting or endangering the issuance of new bonds.

(2) Consumers Power was not currently issuing new preferred stock as its after-tax preferred ratio was well below the 1.5 times requirement contained in its Articles of Incorporation.

(3) Its earnings per share for the 12 month period ending September 30, 1974 was $1.43 per share.

(4) Reported earnings had fallen to $1.37 per share for the 12 months ending October 31, 1974 and to $1.16 per share for a similar period ending November 30, 1974.

(5) Consumers Power's common stock until very recently had traded at less than $10.00 per share, thereby precluding the issuance of additional common shares due to the provisions of the MBCA restricting the sale of common stock at a price below par value.

(6) In December, 1974, Consumers Power's securities were further down rated in several respects.

    (a) Preferred stock was down rated from A to Ba by Moody's on December 23, 1974, and from AAA to BBB by Standard & Poor's on December 14, 1974.

    (b) Consumers Power's bonds were similarly reduced from A to Baa by Moody's and from A

to A- by Standard & Poor's on the same date, respectively.

(c) Consumers Power's Commercial Paper rating of A2 had been withdrawn by Standard & Poor's which also downgraded Consumers Power's Pollution Control Revenue Bonds from A to BBB- on December 21, 1974.

Thus, Consumers Power had impaired ability to issue any new securities at reasonable costs.

(7) For some time, Consumers Power had failed to earn its dividend requirements on common stock of $2.00 per share. It had continued to pay the dividend, however, in view of the consequences inherent in either suspending or reducing the quarterly payout of 50 cents per share. Realistically, however, it was clear that Consumers Power could not continue to pay the current dividend unless earnings per share improved significantly in the near future.

(8) Consumers Power's financial difficulties and the resultant inability to issue new securities had taken a severe toll upon its construction program.

(9) In 1974, Consumers Power had begun to reduce all construction expenditures to the bare minimum and had extensively curtailed planned expenditures for the next several years.

(10) In a similar period, it had reduced its employment levels and laid off hundreds of construction workers.

(11) The costs of its new generating plant had and were likely to come on line at much higher costs per unit than the costs that had previously been incurred for its existing generating capacity.[9]

Having evaluated the various factors contributing to the deteriorated financial condition of Consumers Power, the MPSC felt compelled to grant an earnings erosion allowance to Consumers Power, which was described as an "additional

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[9]Opinion and Order of the Michigan Public Service Commission issued on January 23, 1975, Case No. U-4576, 50 & 51.

return factor" to be applied to Consumers Power's previously established rate base. The MPSC also mentioned that another reason for approving an earnings erosion allowance was to give recognition to the fact that the historical test year approach didn't recognize all changes causing future earnings erosion in an inflationary economy.

William R. Ralls issued a vigorous dissent in Case No. U-4576, which noted that Consumers Power was a "sick company" despite having had rate increases approved in 1972, 1973, and 1974.[10] Ralls perceived that the problems of Consumers Power had not been treated in a fundamental way by the MPSC, and therefore no additional final relief should be provided to Consumers Power over and above that previously provided on an interim basis. Ralls maintained that the evidence before the MPSC could not serve as a basis for a rational decision as to the actual amount of Consumers Power's needs since it was based on an historical test year. Adequate rates should be based on relevant future projections.

Ralls maintained that the MPSC was using a mistaken regulatory approach, since it was merely treating symptoms. Rather than providing Consumers Power an unwarranted $10,000,000 in increased rates through an earnings erosion allowance, Ralls discerned that there needed to be a reform

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[10]Dissenting Opinion of Commissioner William R. Ralls issued on January 23, 1975, Case No. U-4576, 4 & 5.

of the whole rate evaluation process. Ralls asserted that the only viable solution for bringing public and private interests back into harmony was to have a drastic and immediate reform of public investor utilities.

Ralls felt that reform was needed because Consumers Power had faced a continuing crisis in the mid to late 1970s. Consumers Power had cut $138,000,000 from its 1975 construction program. Over a billion dollars of cutbacks in construction expenditures had been projected through 1981 by Consumers Power. This would have a devastating effect on the Michigan economy. Consumers Power's bonds had been downgraded. Common stock couldn't be sold at reasonable prices. Thus, Consumers Power had to rely on high cost, short term money to operate; and even this source was drying up.

In Case No. U-4840, the MPSC approved on April 12, 1976 a rate increase of $33,977,000 for the electric operations of Consumers Power based on the use of a partially projected test year, rather than an historical test year.[11] Thus, the MPSC did not need to resort to the use of an earnings erosion allowance so as to maintain some semblance of financial health for Consumers Power in an era of inflationary costs.

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[11]William R. Ralls issued a dissenting opinion which disputed the need for an almost $34 million rate increase for Consumers Power.

AS EARLY AS 1977 THE COST OF BUILDING THE MIDLAND NUCLEAR FACILITY IS VIGOROUSLY QUESTIONED BY PUBLIC INTEREST INTERVENORS

In Case No. U-5331, the MPSC utilized a fully projected test year in approving a rate increase of $70,210,000 for Consumers Power electric service. The application in Case No. U-5331 had been filed on January 31, 1977 seeking a rate increase of $164,200,000. Thus, Consumers Power was awarded slightly half of the rate increase it sought. The MPSC used a fully forecasted 1978 test year in this case, based on actual financial results for the years 1976 and 1977.

Since forecasted operating results for 1978 were used as the test period, the MPSC adopted an average 1978 forecasted rate base. The issue of the proper amount of money to be allocated to this rate base was hotly contested in this case. The first consideration was whether any of the construction costs for the Palisades Nuclear Plant should be excluded from the rate base since it had cost significantly more to construct than had been originally projected. Second, the issue of the cost overruns associated with the construction of the Midland Nuclear Facility began to become sharply focused in this proceeding.

The Public Interest Research Group in Michigan (PIRGIM) had intervened in this proceeding and argued that all future construction costs of the Midland Nuclear Project should be excluded from Consumers Power's approved rate base. Further, PIRGIM noted that to date, $1,065,647,000 had

already been spent on Midland. This figure was more than double the original cost projections, and PIRGIM argued that new proceedings should be initiated by the MPSC to determine how to allocate the construction costs already incurred on an equitable basis between the electric rate payers of Consumers Power and its shareholders.

PIRGIM further argued that the MPSC should develop a plan for Consumers Power to contract with customers for the construction and operation of cogeneration facilities; and to encourage Consumers Power to utilize coal-fired facilities in order to fill any generating gap in the foreseeable future.[12] As to the proposal for coal-fired facilities, there appears to have been no discussion in this proceeding as to detrimental environmental impacts from this type of electric generation.

PIRGIM proposed the exclusion of the Midland Nuclear Facility costs from the rate base because:

(1) Consumers Power's energy demand forecast was inaccurate and unreliable; and Consumers Power had failed to take into account the impact of energy conservation programs and the development of alternative energy sources.

(2) Consumers Power's plans to meet future demand did not include reasonable and prudent energy conservation measures, and Consumers Power's proposed construction program did not rely upon the most energy-efficient and least expensive alternatives, including the construction of coal-

[12]Opinion and Order of the Michigan Public Service Commission issued on July 31, 1978, Case No. U-5331, 16.

> fired plants designed to cogenerate industrial process steam.[13]

Consumers Power vigorously opposed the exclusion of the Midland costs from the rate base. The utility maintained that its demand forecast was reasonable and indicated the need for the construction of a generating plant the size of Midland's to meet Michigan's anticipated energy needs for the 1980's and the 1990's. Consumers Power also maintained that it had taken into sufficient account the reasonably expected effects of conservation measures and other reasonably foreseeable energy developments.

Although PIRGIM claimed that the Midland project should be excluded from the rate base because the evidence indicated the plant would not be needed, the MPSC determined that at this time, all construction costs should be included in Consumers Power's rate base. The MPSC noted that although Consumers Power's past demand forecasts had tended to be too high, Consumers Power's present demand forecast was not unreasonable. Some growth in demand for electric energy could reasonably be expected. Therefore, even assuming that Consumers Power's forecasts were somewhat high, it did not follow in the opinion of the MPSC that the Midland Project was not needed nor that it was an imprudent investment that should be totally excluded from the rate base.

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[13] Ibid.

The MPSC cited significant reasons as to why it believed the Midland Project should not be excluded from the rate base:

> (1) Abandoning Midland would have serious and catastrophic results for the supply of electricity in the 1980's and 1990's, not only for Consumers Power's retail customers, but also for the whole state of Michigan.
>
> (2) The forced abandonment of Midland would be a financial disaster for Consumers Power and would seriously compromise Consumers Power's ability to finance any additional construction, including coal-fired and cogeneration facilities.
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> (3) To the extent the financial community perceived the MPSC as acting irresponsibly by enforcing the abandonment of the Midland Project, all other utilities in Michigan would have increased difficulty in financing their construction projects. However, the MPSC would inquire into the reasonable expense of specific aspects of the Midland Project in the future.[14]

Thus, the MPSC argued that the costs of abandoning the Midland Plant would be significant in light of the fact that it perceived the Plant would have many benefits once it was completed. The bottom line conclusion for the MPSC was that it believed the Midland Project was designed to be a major baseload plant and that if in the future it ran properly it should provide power at a price which was comparable to many other units. In the final analysis, however, the Midland Project could only be constructed at a cost that would result in the production of power at a price that would

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[14]Ibid., 18 & 19.

greatly exceed energy prices of other comparable generating units.

The inclusion of the Midland Plant in the rate base was even more significant when viewed in the light that the authorized rate of return on common equity was increased from 12.75% to 13.5%. The authorized rate of return for Consumers Power had increased from 12.12% to 13.5% in only three years time.

The Midland Project eventually cost over $4 billion to construct, a figure substantially above the original cost estimate of approximately $256,000,000. It appears that the management of Consumers Power must bear a substantial part of the responsibility for the enormous cost overruns. The ability of Consumers Power's management to undertake and complete projects such as this at that time is called into question when one considers that there were also significant cost overruns for the Palisades Nuclear Plant and the Marysville Gas Processing Plant. Management efficiency studies were ordered by the MPSC for each of these projects. Although each project, in reality, appeared to be a prudent investment at the time of its planning and in the initial construction phase, eventually costs significantly escalated due in substantial part to what appears to have been lack of proper oversight by management. The MPSC in reality was hard pressed to stop a project such as this once it was commenced, since the law recognizes that it is the

legal responsibility of the officers of a utility company to make management decisions for that company, not the regulators. The regulators are left with only the legal authority to evaluate the reasonableness and prudence of decisions already made and implemented by utility management as to whether a particular expense was reasonable and should be included in allowable operating expenses or in the rate base. In view of the fact that some other utilities at this time were able to build nuclear plants at close to original cost estimates, one needs to place blame for the extraordinary cost overruns involving the Midland Nuclear Facility primarily on the management of Consumers Power.

NEW RATE DESIGN PROPOSALS AND THE PUBLIC UTILITY REGULATORY POLICY ACT OF 1978 (PUPRA)

Case Nos. U-4576, U-4840 and U-5331 challenged the MPSC to consider a number of new rate design proposals presented by both residential public advocacy groups and industrial users of electric energy. In the 1970's, electric utility companies in the United States began to experience major problems: declining load factors[15]; increasing fuel costs; rapidly rising costs for constructing new generating capacity; lower than expected power plant reliability; and a

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[15]A utility load factor is the ratio of its average load or production to its highest or peak generation level. A low load factor, a modest average load relative to the high peak periods, is inefficient because the peak capacity seldom is used. A high load factor, average load approximately equivalent to the highest peak period, is more efficient because most of the generation capacity is used continuously. See Bonbright, Principles of Public Utility Regulation, 357.

virtual end to the economies of scale associated with increasing sizes of generating plants.[16]

Lowered efficiency coupled with the tremendous increase in costs, resulted in a dramatic increase in electric utility bills, particularly for poorer families. A larger percentage of the disposable income of poorer families had to be apportioned for utility bills. In response to this development, various public interest groups and the AG increased their advocacy in rate hearings on behalf of the poor. Decreased efficiency resulted in the unnecessary expansion of utility generation facilities. These particular developments created a controversy as to the economic validity of the rate design theories that justified the actual rates consumers paid for electricity.

Once the MPSC had determined the total amount of the rate increase, the second step of the process was to allocate this figure among the various classes of customers. Historically, this apportionment between the customer classes had resulted from a block pricing structure that provided additional electricity at a decreased price in a step manner. The resulting declining block rate provided for consumption of additional electricity at successively lower charges than for the initial consumption. Declining block rates were originally justified by economies-of-

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[16]"Title 1 of PURPA: The Effect of Federal Intrusion into Regulation of Public Utilities", 491; and H.R. Rep. No. 496 (Part IV), 95th Cong., 2d Sess. 127, reprinted in (1978) U.S. Code Cong. & Ad. News 8454.

scale; and were cost-based in that as more production was concentrated in a utility plant with large fixed costs, the per unit cost decreased. Declining block rates promoted the consumption of electricity, which maximized the utility's profits by using excess capacity in the generation plant. The large rate increases requested by the utility companies in the 1970's reflected both the enormous increase in fuel costs as well as diminishing excess capacity in the then existing generating facilities. As a result of the rate increases, controversy arose concerning the continued economic justification of the declining block rate structure, given its promotional effect on electric power consumption. Experts began to propose several alternative rate structures designed to discourage the wasteful consumption of electricity through the use of price incentives.

In electric rate cases prior to U-4576, the MPSC had made some adjustments to the use of traditional inverted rate structures by adopting a flat rate structure for residential customers.[17] Thus, commercial and industrial customers continued to enjoy the cost benefits of declining rates, without the encouragement of savings derived from less energy usage. In U-4576 some intervenors urged the MPSC to adopt an inverted rate structure for all customer

[17]Opinion and Order of the Michigan Public Service Commission issued on January 23, 1975, Case No. U-4576, 64-66.

classes to replace the declining block and flat rate structure then currently in place. The inverted rate is the converse of the declining block rate. The initial block is the lowest priced, and each succeeding block is priced higher. Proponents of this rate theory argued that the inverted rate structure was cost justified. They also maintained that the growth in peak demand and the exhaustion of economies of scale in production had resulted in the need for new generation facilities, leading to increased rate base values and higher rates. Therefore, placing utility costs in the higher priced, high volume, later blocks was justified in that large consumers were responsible for the costly peak demand. Opponents of this pricing method, however, argued that growth in electrical consumption occurred over the entire range of the rate structure and not solely in the later blocks.

In Case No. U-4576, the Environmental Defense Fund and the West Michigan Environmental Action Council, Inc., advocated the adoption of inverted, graduated rates for residential customers. The MPSC Staff and PIRGIM supported a proposal for the adoption of inverted, graduated rates for residential customers only. The MPSC stated in its final order that it had previously asserted that innovative, equitable, and practical approaches to rate design were imperative for modern utility regulation. However, the MPSC went on to determine that immediate adoption of inverted,

graduated rates was not warranted at that time for any of the various customer classes. Thus, for the time being, the present flat rate structure for residential customers was continued, as well as the traditional declining block rate for commercial and industrial customers. Underlying the analysis of the MPSC was the concern that if inverted, graduated rates were adopted and they accomplished their intended purpose by discouraging energy consumption, then the utility company would suffer a decline in its total revenues which would necessitate the later implementation of very high rates in the early blocks of energy usage. Therefore, careful study needed to be given to the revenue implications of these innovative conservation measures, particularly since Consumers Power was experiencing extreme financial instability.

In his dissenting opinion, William R. Ralls discussed an issue that has continued to stir controversy in the field of public utility regulation: whether the rates charged for energy usage as approved by regulatory commissions reflect a subsidization of rates by industrial customers for residential users, or whether residential users subsidize lower than cost justified rates for commercial and industrial users?[18] Ralls believed that the MPSC failed to address this issue by refusing to adopt energy saving

[18] Dissenting Opinion of Commissioner William R. Ralls issued on January 23, 1975, Case No. U-4576, 1, and 9-11.

proposals such as inverted rates or to address the issue of how rate increases should be allocated among the various classes of customers. Ralls maintained that small residential customers continued to pay higher prices per unit of energy than large users of energy, and therefore, subsidized large industrial users. Ralls concluded that the rate increase approved in this case was passed on to customers who were not themselves responsible for the increased costs experienced by Consumers Power. For Ralls, industrial customers were the primary cause of utilities building more costly generating facilities, and residential customers should benefit from lower per unit energy prices through the use of inverted, graduated rates.

General Motors, as an industrial user of energy, advocated in this proceeding several proposals which showed a variance with the thinking of both the MPSC and Consumers Power:

> (1) The MPSC should use an average cost approach for setting rates and continue the declining block rates for commercial and residential customers.
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> Declining block rates reflected, according to General Motors, declining average costs of energy production as more energy was produced and this reduction was reflected in declining block rates. This approach would primarily benefit large industrial users, and clearly conflicted with the views of Ralls.
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> (2) The MPSC should begin to take steps to more nearly equalize the rates of return to Consumers Power from the various classes of

> customers. General Motors maintained that rates had traditionally been set higher for industrial customers than were cost justified so as to provide lower than cost justified rates for residential users. Thus, rates had been set on a value of service concept, rather than solely on cost considerations. General Motors argued that rates for each class of electric customer should reflect the cost of providing service to that class. Cost reflective rates would give customers a price signal upon which they could choose between paying the increased price parallel to the cost they imposed on the system or deferring their consumption to a time when consumption posed a lesser burden on the system.
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> The perspective of this philosophy clearly differed from Ralls, since Ralls believed residentials subsidized industrials. The MPSC, while advocating in theory the benefit of cost justified rates, traditionally had no problem with implementing higher percentage rate increases for industrials than for residentials based on a value of service concept.
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> (3) Any rate increase should be allocated to the various classes of customers on the basis of class revenue which recovers costs other than fuel, an approach known as the "zero fuel" method.[19]

None of General Motor's positions were adopted in this proceeding by the MPSC. In the opinion of General Motors, the method of allocating the rate increase awarded in this proceeding continued to perpetuate a system that had fundamentally deviated from cost-of-service principles, and which should have been immediately abandoned by the MPSC.

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[19]Opinion and Order of the Michigan Public Service Commission issued on January 23, 1975, Case No. U-4576, 62.

In Case No. U-4576, the MPSC also considered proposals submitted by the Environmental Defense Fund and the West Michigan Environmental Action Council, Inc. to implement time-of-day pricing based on marginal pricing principles. This particular proposal was opposed by General Motors and other industrial intervenors. The MPSC decided that this innovative rate design proposal shouldn't be implemented at that time, until further studies of the economic impact on Consumers Power could be conducted by the MPSC Staff.

Time-of-day rates are a specific type of peak-load pricing. Peak-load pricing allocates higher costs and correspondingly higher rates to consumption that occurs during peak generation periods when the utility is generating near capacity.[20] Electricity produced during a peak period is more expensive than non-peak electricity because inefficient peak production facilities must be operated in order to handle demand. Utility policy has been to purchase facilities with low capital costs for peak periods, even though these plants have less energy efficiency and require oil or natural gas to operate. Therefore, growth in peak demand requires utilities to build new generation plants that are operated by scarce oil or gas.

Premised on consumer willingness to respond to price changes in electricity, the peak-load pricing system attempts to persuade consumers to defer their electrical usage to non-peak periods,

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[20]"Title 1 of PURPA: The Effect of Federal Intrusion Into Regulation of Public Utilities", 502 & 503.

thereby decreasing the need for new generation facilities and the wasteful use of oil. In addition, the peak-load pricing scheme is more equitable in that consumers responsible for the rising peak-load costs would be given a choice between paying the increased costs they are imposing on the system or paying lower the power non-peak price and avoiding burdening the system with new construction requirements and the expensive use of fossil fuels. Time-of-day rates implement a system of peak-load pricing during the daytime and the non-peak period at night. Customers should respond to the increased price during the day by shifting their consumption to the lower-priced night time, non-peak period, thereby reducing the generation peak of the utility and minimizing the necessity of new construction.

Opponents of peak-load pricing theory presented two countervailing arguments in an effort to persuade the MPSC not to modify the then approved rate structures. First, additional costs would be incurred because of the new meters required to measure time-of-day usage. Second, some customers would be unable to shift their demand regardless of the magnitude of the price increase. For example, large industrial users (such as General Motors) who were required to operate their plants continuously, or commercial users who supplied a daytime service such as subway transportation, would be unable to react to a daytime price increase by shifting their demand to the night time.

In the next electric rate case for Consumers Power (U-4840), the MPSC did adopt some modified versions of inverted, graduated rates and time-of-day pricing. With regard to the inverted rates, the Staff and Consumers Power recommended the continuation of flat rate structures for residential customers, and declining block rates for commercial and industrial users. The MPSC adopted the PIRGIM proposal for a graduated rate design, with three consumption blocks for residential customers only:

0 - 500 Kwh/month

501 - 1,000 Kwh/month

1,000 or more Kwh/month

The MPSC decided that these were reasonable blocks and fairly represented typical categories of residential electrical usage within Consumers Power's service area. In particular, the MPSC found that the existing flat rate structure did not in and of itself provide sufficient incentives to residential customers to intelligently conserve electrical energy.[21]

The MPSC was very impressed by the arguments put forth by PIRGIM to reject flat rate structures for residential customers, and move to inverted, graduated rate structures. PIRGIM noted that Consumers Power had experienced steady growth in residential consumption, especially in the higher consumption blocks, and that consumption increased at a faster pace in these

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[21]Opinion and Order of the Michigan Public Service Commission issued on April 12, 1976, Case No. U-4840, 48-53.

blocks. PIRGIM further maintained that it was residential customers in the higher consumption blocks that put a strain on the system that required additional construction for generation, which in turn produced the need for higher rate levels. Because this pattern produced increasing marginal costs, the frequency of rate applications could be expected to continue, and such a pattern would continue to be disastrous to those residential customers who were not the ones creating the need for increasing marginal costs. Finally, low consumption blocks would be subsidizing the growth in consumption by high-use customers who were increasing their number of luxury appliances.

With regard to time-of-day pricing, the MPSC adopted a modified time-of-day pricing scheme for larger commercial and industrial customers. The modified time-of-day pricing scheme was proposed by the Staff and continued the existing rate schedules, while establishing differential energy charges between on-peak and off-peak periods of 2 mills per Kwh. The Staff witness claimed that the on-peak and off-peak energy charge differential appropriately recognized time related cost differences of supplying energy to the primary commercial and industrial classes of customers. The MPSC felt that the moderate time-of-day rates put forth by the Staff constituted a reasonable and necessary approach to this complex problem. The MPSC stated that the proposal was a necessary first step toward the eventual full implementation of time-of-day pricing in those situations

where it was administratively feasible and where costs did not outweigh potential benefits.

The MPSC concluded that the adoption of moderate forms of inverted rates and time-of-day pricing were conservative modifications to the existing rate structures of Consumers Power. The MPSC was now persuaded that it had to explore alternative pricing mechanisms which gave recognition to the fact that the continued availability of electrical energy at reasonable costs was an assumption that could no longer be taken for granted. The MPSC perceived that there no longer existed the possibility of returning to the energy demand growth levels that existed prior to the 1973 oil embargo in view of the ever-increasing cost of constructing utility generation plants and for fuels used to run such plants.[22]

The adoption of these new rate structure proposals by the MPSC in 1976 was a preview of the passage by the Congress of the Public Utility Regulatory Act of 1978 (PURPA). The legislation was the federal government's response to the financial difficulties being experienced by many of the country's utility companies. PURPA required state regulatory commissions to determine whether certain rate structure standards should be adopted for each of the covered utility companies. In addition to inverted rates and time-of-day pricing proposals, state commissions were also required to consider the possible implementation of seasonal rates.

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[22]Ibid., 53-57.

Seasonal rates are a form of peak-load pricing. Seasonal rates permit higher rates for electricity during a seasonal peak period than for consumption during a seasonal non-peak period. Anticipating this price modification, customers could choose to defer or decrease their consumption of electricity. Customers, however, would find deferral of consumption more difficult in a seasonal rating scheme than a time-of-day scheme because a seasonal rate design requires a customer to defer his usage several months whereas the time-of-day structure encourages customers to defer consumption only a few hours. An interruptible rate is a reduced rate available to a customer willing to have his consumption decreased or terminated during a peak demand period, thereby minimizing the necessity of using the wasteful peak generation facilities.[23]

The implementation of PURPA in 1978 is an important milestone in the regulation of electric companies. With regard to the issue of federalism, the regulation of rates and the design of rate structures had traditionally been viewed as an area of exclusive state jurisdiction with regard to direct sales of energy to the ultimate consumer. PURPA attempted to superimpose a layer of federal standards over state regulatory commissions so as to provide national uniformity. More importantly, it was a clear recognition that energy production

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[23]"Title 1 of PURPA: The Effect of Federal Intrusion Into Regulation of Public Utilities", 512.

and the prices related thereto had finally transcended local concerns and had assumed national dimensions.[24]

PURCHASED POWER AND FUEL COST ADJUSTMENT CLAUSES, AND ACT 304 OF THE PUBLIC ACTS OF 1980

Case No. U-4621 was a Fuel Cost Adjustment Clause (FCAC) proceeding filed by Consumers Power on July 8, 1974.[25] Consumers Power sought approval to amend its existing FCAC so as (1) to include the costs of purchased power and interchange power, and (2) to include a cost estimation factor for fuel, and purchased and interchange power, thereby eliminating the two month lag between the time the costs were incurred and the time corresponding revenues were received.

FCAC's had been in general use in Michigan since the 1940's. During the period from 1940 to 1973, statutory law provided that FCAC's were only applicable to billings of commercial and industrial customers. The Michigan legislature by Act 300 of the Public Acts of 1972 removed this statutory prohibition of incorporating such clauses in the electric rate schedules for service to residential customers.[26]

Consumers Power applied a fuel cost adjustment factor to residential customers' billings after the MPSC decided Case No.

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[24]Ibid., 519.

[25]By Order issued on July 21, 1975, the Michigan Public Service Commission consolidated hearings on this particular case with the hearings scheduled to be held on Case No. U-4840, a request by Consumers Power for authority to increase its electric rates.

[26]Opinion and Order of the Michigan Public Service Commission issued on April 12, 1976, Case Nos. U-4621 and U-4840, 69 & 70.

U-4262 on August 13, 1973. It was the opinion of the MPSC that an FCAC was intended to provide the best matching of revenues received and expenses incurred for the fuels used to generate electrical energy.

In Case No. U-4576, the MPSC in its final order issued on January 23, 1975 approved a FCAC for Consumers Power which provided for automatic adjustments, both upward and downward, of Consumers Power's rates to reflect increases or decreases in the costs of nuclear as well as fossil fuel, and to eliminate the lag in the collection of increased fuel expenses which existed in the previous clause.

In Case No. U-4621, the MPSC determined that the FCAC should be modified because the existing FCAC had a 2 month lag time period between the incurring of fuel expenses and the recovery of revenues for these fuel purchases. In a period of high inflation, such a lag was very detrimental to a company like Consumers Power, where 40 to 70% of its operating expenses involved fuel costs. Consumers Power had proposed to modify the existing FCAC to automatically pass through to customers 100% of the increased costs of fuel, with no time lag in billing.

The MPSC concluded, however, that a FCAC that passed through 100% of the increases or decreases in monthly fuel costs did not provide sufficient incentives to assure that Consumers Power would on a continuous basis exercise its most diligent efforts to both purchase fuel at the lowest possible price and generate or purchase power at the lowest prices available. The MPSC accepted

the proposal of the AG that it was in the public interest to permit Consumers Power to recover only 90% of the costs incurred by Consumers Power for fuel or power purchases.[27] An FCAC which only recognized 90% of such costs would provide Consumers Power with real incentives to minimize every cost in any way associated with the process of supplying electrical energy to its customers.

When monthly costs escalated, Consumers Power would be required to bear a portion of the increase until regular rate relief proceedings could be held at a later date. When monthly costs decreased, Consumers Power would realize a portion of the benefits inherent in the cost savings. The MPSC anticipated that the 90% incentive provision would deter management decisions to operate generating equipment on a non-economic fuel burn basis, particularly with respect to contracts for fuel supplies which were on a take or pay basis. Finally, the MPSC was persuaded that the 90% provision would provide explicit incentives to management to negotiate and renegotiate fuel contracts at the lowest possible costs.

In Case Nos. U-4840 and U-4621, the MPSC approved for the first time the use by Consumers Power of Purchased and Net Interchange Power Cost Adjustment Clauses (PPAC). The PPAC was designed to recognize 90% of the increases or decreases in the cost of electrical power purchased or sold on a monthly basis. According to the MPSC, the 10% disallowance would severely

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[27]Ibid., 70 & 71.

penalize management for poor planning regarding the availability or nonavailability of generating units. Unlike the FCAC, the MPSC included a 3 month lag feature in the PPAC between cost incurrence and revenue recognition for billing purposes.

Commissioner Ralls issued a defiant dissenting opinion in Case Nos. U-4840 and U-4621 with regard to the adoption by the MPSC of the modified FCAC and the PPAC. Ralls cited the need for reform of the existing FCAC. He referred to the recent introduction of PPAC's as a "backward step".[28]

Ralls went on to observe that the inflationary pressures of the times created a need for more exacting scrutiny of utility companies' financial data, including a need for more vigilant auditing of the data, before the MPSC could be deemed to have met its obligations to prevent unnecessary costs being passed on to the public. He observed that such costs had been recovered historically through the normal rate making process, under intense scrutiny within the context of a general rate case. He argued that hearings established for the newly adopted PPAC's would be a meaningless formality at a time when there should be greater public scrutiny and understanding of utility decisions.

Rall's main objection to the new PPAC's was that the monthly hearings would be hearings in name only, in which no one representing the public interest would be able to effectively participate. He maintained that there would be no proper

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[28]Dissenting Opinion of Commissioner William R. Ralls, issued on April 12, 1976, Case Nos. U-4621 and U-4840.

analysis of outside power purchases and internal generating capability, which required the mastering of voluminous data and possession of considerable technical skill and experience.

Ralls further questioned the statutory authority on which the MPSC relied for such a variable charge for the retail sale of electricity, stating that this procedure was a failure to observe statutory requirements for alteration of rates on a one-time basis. Ralls concluded that there was no support for such a notion of open-ended, unlimited continuing jurisdiction applicable to such a major item of increased cost to customers that could be found in either the statutes or case law.

By mid-1977, Ralls had left the MPSC. His successor, Willa Mae King, began in August, 1977 to also question the use of FCAC's and PPAC's. In 1980, Edwyna G. Anderson succeeded Willa Mae King as the Democratic commissioner appointed to the MPSC and continued to advocate the position taken by Ralls and King on the issue of FCAC's and PPAC's. In addition, lawsuits were filed by the AG challenging the legality of the PPAC's. Legislation, both pro and con, was introduced in the State Senate regarding PPAC's.

In a decision rendered on September 30, 1980 in Consumers Power's Case No. U-5979, Commissioner Edwyna G. Anderson issued a dissenting opinion to the majority opinion of Daniel J. Demlow and Eric J. Schneidewind.[29] In her dissenting opinion,

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[29]See Dissenting Opinion of Commissioner Edwyna G. Anderson issued on September 30, 1980, Case No. U-5979. (The Matter of the Purchased and Net Interchange Power Adjustment of Consumers Power in Rule 16.B, Original Sheet No. A-27, MPSC No. 9 - Electric). It should be noted that the author is not related to Edwyna G. Anderson.

Commissioner Anderson objected to the use of FCAC/PPAC's in their then current form by the MPSC. She noted that the MPSC had stated that the current FCAC/PPAC package could account for 40% to 70% of the total costs of operating an electric energy company. This large percentage of fuel and purchased power costs of the total business costs of an electric company provided the basis, according to FCAC/PPAC supporters, for allowing the company to recoup those expenses quickly and without the requirement of a lengthy hearing procedure. It was argued that this would assure the company's financial integrity and keep it solvent. Supporters also claimed that it was a means of keeping consumer rates down, since the company did not have to borrow money to finance costs from one general rate increase to another.

Edwyna Anderson was disturbed that this massive expense of 40% to 70%, had escaped the scrutiny of a full-blown hearing, and was allowed to be passed through to Consumers Power's customers with virtually no challenge to its validity in relation to overall revenues, the revenue requirement, costs of service and other pertinent factors bearing on the company's financial condition. Anderson went on to note that utility companies reaped the major benefits of the use of FCAC/PPAC's. According to Anderson, utilities got customers' money immediately, saving millions of dollars in capital expenses, which kept their earnings up and enhanced their ability to borrow money with little regulatory review of the necessity for such transactions.

In her dissent, Anderson stated that FCAC/PPAC's were an ill-advised abandonment of the traditional regulatory responsibility for rate-making by formula. The FCAC/PPAC's made the MPSC a mere "rubber stamp" for utility company decisions with regard to a massive portion of their yearly spending decisions. Anderson had reviewed the PPAC monthly hearing transcripts and found that the hearings generally were only 15 minutes in length, with a company witness putting forth the company financial data followed by a cursory review and recommendation by a MPSC Staff person. Anderson further observed that PPAC's and FCAC's simply passed through high amounts of money to the rate paying public with little investigation by the Staff or review by the MPSC itself. Anderson asked rhetorically, shouldn't expenses involving millions of dollars warrant more than a perfunctory 15 minute monthly or bimonthly hearing.

The proponents of FCAC/PPAC's claimed they would save customers money because they would eliminate regulatory lag. In response, Anderson noted that since their authorization by the MPSC, utility rates had not declined, but had increased substantially. Thus, the argument revolving around FCAC/PPAC's concerned those persons who believed that they would result in management efficiency, and those persons who believed they would have a detrimental impact on the pocket books of the utility customers. Anderson believed the FCAC/PPAC's represented a cavalier approach to the public trust. To her, utility companies were not entitled, any more than any other business entity, to

all of their money up front. She noted that when utility companies over recovered expenses (such as through the use of FCAC/PPAC's), no refund policy had been developed that would assure that every person who had paid for the purported fuel costs in advance would get his or her money back in full that they might be entitled to for overpayment. Rarely did a customer whose actual consumption provided the basis for a refund get what he or she was entitled to.

The criticism of FCAC/PPAC's voiced by Commissioners Ralls, King and Anderson in their various dissenting opinions, resulted in the passage of Public Act 304 in 1982 by the Michigan legislature. This act provided specific statutory authority for the MPSC to incorporate fuel, purchased gas or purchased power adjustment clauses into the tariffs of Michigan utilities provided certain procedural requirements were adhered to. However, in order to incorporate such a PPAC into its tariffs, the utility had to file a 12 month power supply cost recovery plan, a 5 year forecast of the power supply requirements of its customers, its anticipated sources of supply, and projections of power supply costs, in light of its existing sources of electrical generation and the sources of electrical generation under construction. Approval of the 12 month and the 5 year projections could be given only after a public hearing in which interested parties could submit their evidence on the reasonableness of the plans. At the end of the 12 month period, a reconciliation hearing had to be held to determine if the

utility had overcharged for its purchased power and should make refunds to customers.

Significantly, the act provided for the establishment of a utility consumer representation fund. The board was authorized to make disbursements from the fund to qualifying groups to represent the residential customer interests in the purchased power plan hearings and the reconciliation hearings. Thus, Act 304 incorporated several of the procedural safeguards for purchased power clauses discussed by Edwyna Anderson in her dissenting opinion in Case No. U-5979 on September 30, 1980.

SYSTEM AVAILABILITY INCENTIVE CLAUSES AND OTHER OPERATION AND MAINTENANCE EXPENSE RECOVERY CLAUSES

Beginning in the late 1960's, increasing inflation and decreasing utility productivity were the primary causes of the rise in the cost of utility services. The traditional rate making process of using cost plus pricing principles was severely questioned in the late 1970's. Customers began to complain about utility companies spending whatever they wanted and then submitting the bills to their customers to be paid in full.

Regulators in Michigan and other states perceived that they had no effective means of influencing utility decision making in a timely manner. During the tenure of Chairman Daniel J. Demlow, Michigan embarked upon a new regulatory approach which emphasized the use of incentives.[30] Such a system attempted to address the

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[30]See Daniel Demlow, "Incentive Regulation," in Issues in Public Utility Regulation (East Lansing, MI: MSU Public Utility Papers, 1979), 531-547.

public's concern for cost minimization, while also endeavoring to provide a means for utility management to be rewarded for introducing cost reduction practices. Incentive regulation requires that a utility commission set general performance targets, and management is then free to meet these targets and to receive the credit for success or accept responsibility for failure.[31]

In 1976, the MPSC took the first step toward instituting incentive regulation. Fuel and purchased power cost adjustment clauses were approved for Detroit Edison, and as previously discussed, were approved for Consumers Power in 1977.

A second step toward incentive regulation was taken in 1977 when the MPSC authorized a "system availability" incentive clause for Detroit Edison and Consumers Power. Availability is a

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[31]The most important task for incentive regulation is to determine those measures of performance associated with and affecting the cost of doing business. The incentive provisions developed by the MPSC generally contained six features or terms to guide future regulatory actions: (1) the evaluation time frame; (2) the target or neutral zone in which there will be no incentive or disincentive; (3) the action trigger points; (4) the incentive-disincentive bandwidth; (5) the incentive-disincentive amount; and (6) the implementation mechanism. The first two factors are concerned with the expected accomplishment to be realized with a given performance dimension. Basically, the evaluation period used by the MPSC was either one calendar month or twelve continuous calendar months. The target or neutral zone was that range of values in which the reward - penalty factors would not be operative. The range was such as not to penalize management unjustly for performance in the lower range. Careful attention was given to what level of performance justified the activation of the reward mechanism at the upper end of the performance scale.

Once the neutral zone had been established, reasonable trigger points were determined for incentive and disincentive action and the bandwidth for the incentive - disincentive measures. It was necessary to develop policies that would continue to be effective over a long period of time. A means for determining reasonable targets or yardsticks, such as the nationwide increase in productivity or cost of living, that were external to the operations of the utility was approved by the MPSC. The external yardstick and the utility performance measure was allowed to fluctuate as the result of events reasonably common to both. To operate properly, it was concluded that it was critical that incentive provisions had to be developed which recognized routinely expected performance and then rewarded or penalized deviation from it.

quantitative measure of the ability of a number of electric generating machines to serve customer needs. The best measure is megawatts per hour. Between 1973 and 1976, system availability for Detroit Edison and Consumers Power progressively deteriorated, and then dramatically rebounded in 1977. This happened to be the year that the incentive availability provision was implemented for Detroit Edison (U-5108) and Consumers Power (U-5331), and the first year for reward-penalty review of the performance of utility companies in this area.

In the mid-1970's, management had spent a great deal of money on availability problems. Expenditures by Detroit Edison for production maintenance increased from almost $30 million in 1973, or about 0.9 mills per Kwh sold, to approximately $65 million in 1977, or 1.8 mills per Kwh sold. Even so, availability remained at roughly the same unacceptable low level. The situation was similar for Consumers Power. From a regulatory perspective, this low availability seriously affected costs passed through to the consumer under the fuel and purchased power clauses. Since increased maintenance expenditures had failed to solve this problem for either Detroit Edison or Consumers Power, the MPSC sought to rectify the problem by approving system availability provisions for both companies.

The MPSC noted that the implementation of a system availability provision sought to address a number of relationships among productive maintenance expenditures, availability levels, and fuel and purchased power expenses. An

improvement of five percentage points in availability can reduce fuel and purchased power expenses by several millions of dollars. Increased availability significantly reduces fuel and purchased power expenses. Production maintenance expenditures are very significant, amounting to about four percent of a utility's revenue dollar. These expenditures have a paradoxical quality. Inadequate expenditures can impair availability by increasing the possibility of forced outages. Excessive expenditures can impair availability by increasing the downtime needed for scheduled maintenance. Given these parameters, the MPSC concluded that an optimization potential exists between scheduled maintenance for generators and forced outage rates.

In U-5331, the MPSC sought to improve unit availability for Consumers Power by providing for an adjustment of the utility's rate of return on common equity either up or down depending upon the relationship of the average system availability to prescribed availability standards. The scale adopted by the MPSC was as follows:

TABLE 8
RATE OF RETURN RELATED TO AVERAGE SYSTEM AVAILABILITY

ANNUAL AVERAGE SYSTEM AVAILABILITY	EQUITY RETURN INCENTIVE ADJUSTMENT
0 - 70%	- .25%
70.1 - 80%	- 0 -
80.1 - 85%	+ .25%
85.1 - 100%	+ .50%

The MPSC believed that the availability incentive provision, by offering a bonus of 25 or 50 basis points to common equity rate of return, depending upon the availability in a calendar year, should motivate management to continue higher levels of availability and minimize maintenance costs.

Under the incentive system, stockholders benefitted through an increase in earnings per share, and customers received a lower billing. The provision effectively meant that what was profitable to the public was also profitable to the shareholder, a paralleling of interests often thought to be mutually exclusive.

The system availability incentive program worked well for Detroit Edison and Consumers Power. In accordance with the provision, Detroit Edison received two rate increases, one of approximately $6 million as a result of its performance during 1978, and one of approximately $12 million for 1978. The MPSC Staff estimated that Edison's customers had saved substantially more than $18 million in purchased power costs as a result of Edison's increased availability between 1977 and 1979.

In 1978, the MPSC approved for Consumers Power in Case No. U-5331 a third incentive program. The clause tied the allowable level of "Other Operation and Maintenance" expense (O&M Expenses) to the base level determined for calendar year 1978, adjusted for inflation as represented by annual charges in the national all-items consumer price index. The provision also acted to increase

rate levels promptly in response to the impact of inflation on such expenses.

The O&M Expense item accounts for about one-sixth of a utility's revenue dollar. With the 1978 provision in place, in combination with the system availability clause and the fuel and purchased power clause, the Michigan incentive program addressed almost two-thirds of a utility's cost of doing business.

The MPSC Staff noted that under traditional rate case procedures, rate levels were ultimately changed to the same extent that "Other O&M" changed. In other words, as "Other O&M" expenses increased, revenue requirements increased by a similar amount. Under the method adopted by the MPSC, the revenue requirement increase was based instead on the increase in the Consumer Price Index (CPI). By making the increase contingent on retail cost changes in the economy rather than the utility incurred costs, management was subjected to outside cost pressures. Thus, utility management had to perform as well as the average of numerous other businesses as recognized by the CPI, or its stockholders would suffer a reduction in earnings. Correspondingly, if management thought cost control efforts could contain "Other O&M" expenses so as to outperform the CPI, then the stockholders would enjoy an increase in earnings. In this manner then, the proposal acted to reward efficiency and to punish inefficiency in the same manner as would occur in a competitive market.

The MPSC believed that this proposal would subject Consumers Power's management to pressures for economy which would be analogous to the cost pressures which existed in the private sector. If Consumers Power's management was to allow costs to increase at a faster rate than the CPI, Consumers Power's stockholders would pay the bill. However, if Consumers Power's management was to keep other O&M expenses below the increase in the CPI, then Consumers Power's earnings would be increased. In the long run, if earnings were increased, the rate payers would benefit through the resulting lower cost of capital.

In a dissenting opinion issued in U-5331, Commissioner Willa Mae King opposed the adoption of the Other O&M Expense provision. She indicated that she thought this provision was dangerous and unwise because it gave unjustified rate increases to Consumers Power. Moreover, Commissioner King stated that she was uncertain as to whether Consumers Power's administrative and general expenses responded as directly or as quickly to changes in the CPI as the other two commissioners seemed to assume. King further believed that the majority might be establishing a system that would have the unfortunate result of recognizing future expenses in present automatic annual rate increases.[32]

The results of the Other O&M Indexing System were mixed. Into the early 1980's, the actual levels for the O&M expenses were greater than the allowed levels of the Other O&M Expenses

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[32]Dissenting Opinion of Commissioner Willa Mae King issued on July 31, 1978, Case No. U-5331.

under the incentive clause. The utility companies argued that the gap between allowed and actual levels of O&M expenses was due to the MPSC's failure to adopt a reasonable base level of allowable expenses in the orders adopting this system. The utilities further argued that an unrealistically low base level resulted in adequate yearly adjustments, depriving the utilities of a fair opportunity to earn their authorized overall rates of return.[33]

The MPSC disagreed with the perspective presented by the utilities. The MPSC maintained that the significant feature of both the Power Plant Availability System and the Other O&M Indexing System was the use of an index external to and beyond the control of the utility as a means both to set rates and to provide target incentives for managers. Rates would not be determined and performance would not be measured simply by the utility's past performance.

Subsequent to the inception of incentive regulation, it was suggested that the framework could be further perfected and expanded to provide a comprehensive system that would reduce regulatory lag, reduce or eliminate the most objectionable cost-plus and disincentive aspects of the traditional regulatory approach, and encourage utilities to operate efficiently.

Essentially, the proposed new system would adjust rates periodically by applying an index or adjustment factor to a set base with respect to those costs that were significantly within

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[33]Ibid.

the control of the utility. Special provisions were to be made for certain expenditures, such as fuel, purchased power, and purchased gas, and for adding new generating capacity to an electric utility's rate base.

The MPSC would have to first determine what costs were to be indexed and then set an adequate base. Basically, the costs to be indexed should be those the utility could control, at least within certain limits. The base level of costs to be indexed would be established using traditional rate base techniques. Next, the MPSC would determine a proper index by which to adjust the base rates periodically. Such indices could be those measuring national or regional changes in costs of labor, materials, or other items related to operations. Productivity growth could also be considered in setting the index.

The indexing system for setting rates to cover certain expenses has several advantages. It is simple and quick, allowing relatively rapid adjustments for inflation and greatly reduced regulatory lag. The system should also produce revenues adequate to ensure the ability to finance new construction at reasonable cost. Revenue adjustments that are relatively predictable in timing and amount allow greater long-range planning than the traditionally uncertain system. The indexing system provides relatively long-range incentives for efficient operations, and should result in the elimination of the most objectionable cost-plus aspects of the traditional system. Indexing provides targets for utility managers and measures of

performance that aid everyone concerned with assessing utility firms.

In view of the tremendous cost over-runs involved in such projects as Marysville and Midland, it is important that a system be adopted for monitoring generating plant construction expenses. Incentive provisions for utility plant construction projects should be considered, which would reward utility management for constructing a plant at costs which are below an accepted national industry standard, and clearly penalize management for construction that is too costly. In this regard, it is important that the state consider the adoption of siting legislation. This type of legislation would allow the MPSC to review an electric utility's proposals to construct new generating plant before construction begins. This type of review would partially eliminate the present difficulties of using rate case disallowance after construction as a policing mechanism. Siting legislation and incentive regulation with regard to the construction of new electric power generating facilities could cure some of the cost over-run problems experienced in the 1970's by the use of the traditional rate case approach.

CHAPTER VI

EPILOGUE: REGULATED COMPETITION OR UNREGULATED MONOPOLY? AND THE SEARCH FOR ALTERNATIVES TO RATE BASE REGULATION

In the 1980's, many telecommunications utilities experienced a diminishing monopoly position due to increased competition in a number of service markets where they had previously enjoyed a monopoly status. For the state of Michigan, the issue involving utility regulation that dominated public debate was whether Consumers Power should abandon the construction of its giant generating plant at Midland as a nuclear facility, and convert it to a gas fired generation unit. If the Midland unit was abandoned as a nuclear generating facility, how would the construction cost over-runs be allocated between ratepayers and shareholders by the MPSC?

The large construction cost over-runs experienced by Consumers Power at its Marysville Synthetic Gas Plant and at its Midland Nuclear Project were symptomatic of substantial construction cost over-runs incurred by many utility companies across the country in the 1980's. In the case of Consumers Power, this dissertation concludes that such imprudently incurred cost over-runs evidenced a need for

firmer regulation of public utilities. The emergence of competition in the utility field in the 1980's provided the justification for managers of public utilities to press government officials for deregulation. Utility companies claimed that the new competitors were permitted by law to engage in unfair price practices. It is the basic conclusion of this author that where public utilities enjoy a monopoly in providing utility services they should be subject to very firm regulation based on traditional rate of return principles. However, in markets where services provided by utility companies are subject to price pressures from competitors, perhaps some limited form of incentive regulation should be considered as an alternative to traditional rate base regulation.

Although this dissertation notes the need for stricter public oversight with regard to large scale construction projects undertaken by public utilities, the conclusion is inescapable that the main responsibility for the Midland debacle must rest with the management of Consumers Power. Therefore, a major portion of the cost overruns of the Midland project must be shouldered by the shareholders of Consumers Power, and not its ratepayers. This was the basic decision rendered by the MPSC some six years subsequent to the date the MPSC stated it would have been prudent for Consumers Power to have abandoned the construction of Midland as a nuclear facility. Although a case can be made

that it was legislatively provided benefits, such as accelerated depreciation, tax credits, etc., that made the construction of such large generating facilities financially feasible, such an assertion begs the question of why some major electric companies in the country were able to avoid getting trapped in the dilemma generally associated with the construction of mammoth nuclear generating facilities. The Midland situation is a strong argument for stricter regulatory control of utilities, rather than the trend of relaxed regulatory oversight. If the regulatory agencies fail to exercise their legislatively mandated oversight duties, then either the courts, the legislature or the people will ultimately perform this function.

In the telephone industry, one of the major issues that emerged in the 1980's was the cross-subsidization of residential customers by business customers (or vice versa), and interstate services by intrastate services with regard to the cost allocation for the use of commonly utilized equipment. This dissertation supports the proposal that in order to help minimize the cross-subsidization of some utility customer classes by other customer classes, the allocation of costs associated with commonly used telephone equipment to the various customer classes should in general be on the basis of the percentage of the usage of the common equipment by each of the various customer classes.

For Michigan Bell, January 1, 1984 stands as both the end of an era and the beginning of another in its corporate existence. This is the date established by federal judge Harold Greene for the divestiture of the 22 Bell Operating Companies (BOC's) from the parent company, AT&T.[1] AT&T would retain ownership of Western Electric, the Bell Laboratory Co., and its long distance telephone operations. AT&T, however, would no longer be permitted to provide basic exchange telephone service since it would no longer retain control of the BOC's. Michigan Bell would become one of the seven regional telecommunications companies established by the anti-trust decree, namely American Information Technologies Corp. (AMERITECH).

As of January 1, 1984, Michigan Bell was basically prohibited from:

(1) Offering Interstate, Long-Distance Telephone Services;

(2) Offering Intrastate, InterLATA Services;

(3) Manufacturing customer premises equipment; or

(4) Providing any telecommunication services, except monopoly services actually regulated by tariffs approved by a federal or state regulatory agency.

For all practical purposes, Michigan Bell was restricted to providing local, basic exchange telephone services, which are of a monopoly nature, and are often referred to as

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[1]See Modified Final Judgment (MFJ) in United States v. AT&T, 552 F Supp 1341 (DDC, 1982), affirmed by the United States Supreme Court at 103 SCt 124, 75 LEd2d 472 (1983).

"Plain, Old Telephone Services" or "POTS". Judge Greene prohibited Michigan Bell and other BOC's from entry into the more lucrative telephone service markets, which are essentially competitive in nature. Examples of the types of competitive services that Michigan Bell was not permitted to provide include long distance services, the manufacture of telephone equipment, and enhanced services.[2]

On November 30, 1982, Michigan Bell filed a rate application with the MPSC in Case No. U-7473. This rate case was filed primarily to ensure that Michigan Bell would not experience a decrease in its revenues after January 1, 1985 upon the completion of the divestiture process. Michigan Bell alleged that it would need an increase in its annual intrastate revenues of $451,000,000 due to divestiture. A stipulation was entered into on May 18, 1983 by all the parties to this Access Charge case which authorized an increase of only $182,275,000 in Michigan Bell's annual revenues.

Due to the requirements of the MFJ, Michigan Bell sought to establish rates for services in two very broadly defined areas: (1) telephone service offerings within their local exchanges; and (2) access charges to be assessed to

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[2]Enhanced services are also referred to as information services. Enhanced services generally means the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information that is conveyed by telecommunications. This would include, but not be limited to, data processing and other computer-related services, and electronic publishing services.

other telecommunications carriers for the ability to have access to the local telephone exchange (Access Charges). It was imperative for Michigan Bell to have revised rates established before January 1, 1984, because without such an order from the MPSC, Michigan Bell as a telephone exchange provider would lose significant amounts of money it had previously received from long distance interLATA carriers through separations and settlements contracts.[3]

The MFJ had terminated the previously approved separations and settlements contracts, and Michigan Bell had to have the MPSC approve access charges assessed to long distance interLATA carriers. The Staff concurred with the Michigan Bell approach that the revenue deficiency be made up from an interim surcharge placed on the Common Carrier Line rate, and that the revenue to be obtained from various customer classes would be determined by the MPSC in the main rate case. The MPSC endorsed and adopted this proposal.[4]

On April 26, 1984, the MPSC issued its final rate order in U- 7473. The MPSC noted that the parties had agreed on a revenue deficiency for Michigan Bell of $182,275,000, based on a 13.83% return on common equity. Thus, the basic issue

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[3]See Chapter 3 for a discussion of the separations process; General Accounting Office, Telephone Communications: Controlling Cross-Subsidy Between Regulated and Competitive Services. ([Washington, D.C.]: U.S. General Accounting Office, 1987), 15-17; and also, Richard Gabel, Development of Separation Principles in the Telephone Industry (East Lansing, MI: Michigan State University Press, 1967).

[4]Order Granting Motion for Partial and Immediate Rate Relief of the Michigan Public Service Commission issued on December 22, 1983, Case No. U-7473, 7 & 8.

addressed in the final rate order was the proper rate design. In resolving this issue, the MPSC proceeded to assess part of the revenue deficiency to access charges to be received from interexchange carriers. The balance of the revenue deficiency had to be assessed to the residential and commercial customers using various local exchange services. The MPSC evidenced some inclination to try to not increase residential rates for local exchange services. This goal could not be accomplished without assessing very substantial rate increases to business customers. While the MPSC was not hesitant to assess higher rates to business customers, it did not want to approve extremely substantial rate increases for these services within one rate proceeding. Thus, the MPSC approved somewhat lower rate increases for business services than advocated by the Staff, and the difference was assessed to the residential customer class. For instance, the MPSC approved in the final order a rate increase for private line services that was one-third of the amount advocated by the Staff.

In addition, the MPSC addressed two other very important issues in this case: (1) whether to adopt timed measured telephone service for residential and business customers; and (2) how to maintain affordable basic exchange telephone service, so as to ensure that Michigan Bell couldn't charge higher than cost justified rates for this monopoly service and then transfer the excess profits to

subsidize lower than cost justified rates for Michigan Bell's services rendered in competitive markets.

One of the business related intervenors in this case, Association of Businesses Advocating Tariff Equity (ABATE), advocated the adoption of timed measured local telephone service for business and residential customers. Basically, measured telephone service involves a set monthly fee, plus an additional price per call within the local service area. However, the time duration of any particular call can be unlimited. Under a timed measured service plan, there would continue to be a set monthly fee, but there would be an additional charge for each minute of time used in making a local telephone call. The ALJ recommended the adoption of timed measured local service for business users, but not for residential users. ABATE objected that the approval of the ALJ was inconsistent, as the nature of telephone usage by residential and business customers was identical, and to have different rates for the same service would result in discriminatory treatment of business and residential messages.

The MPSC rejected the concept of timed measured local service for either business or residential customers. Basically, the MPSC was of the opinion that to charge telephone customers on the basis of a per minute fee, would result in low income users not being able to afford local telephone service in the future. Thus, the opinion of the

MPSC in this particular case presents one of the most hotly contested issues in the post-divestiture era: the maintenance of affordable universal telephone service for low income users of telephone services. In this case, the MPSC stated that the adoption of the timed measured service proposal would be a "radical transformation" of standard historical telephone service and would not result in affordable local service. The MPSC stated its opposition to this concept by stating that "timed measured service is not a viable option for Michigan".[5] In order to keep basic local service rates affordable, the MPSC noted that any revenue deficiency in this service could be made up from other revenue-producing services, and, if necessary, from contracting extended local service areas into truly local exchanges. In the past, rates for measured business service had been consistently set above cost levels in order to keep measured residential service at affordable levels. Thus, in this area, the MPSC had acknowledged subsidization of telephone services based on a Value of Service concept for measured business service as opposed to the use of a Cost of Service approach. Statutory proposals considered by the Michigan legislature in 1991 continued to evidence a concern of lawmakers that in the post-divestiture era it was

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[5]Opinion and Order of the Michigan Public Service Commission issued on April 26, 1984, Case No. U-7473, 50.

important to maintain affordable local exchange services for residential customers.

The crucial issue of subsidization in the post-divestiture era has to do with setting rates for local exchange services which continue to be provided in a monopoly environment and the setting of rates for long-distance services through access charges which are now provided in a semi-competitive environment. After the MFJ, many commentators postulated that access charges might be set too low to cover costs for the BOC's and that BOC's such as Michigan Bell would seek to retain their customary income levels by raising rates for local exchange services higher than would be justified on cost-of-service principles. In discussing this issue, the MPSC stated that its final order in U-7473 was the culmination of two years of effort to preserve Universal Telephone Service in the face of legal and economic events which threatened to price such services beyond the reach of many Michigan citizens.[6]

The MPSC went on to note that the "access charge" mechanism initially proposed by the FCC, as well as federally imposed depreciation practices, could very likely have resulted in the institution of a number of larger rate increases which potentially could have led to a doubling of the cost of providing basic exchange service. Therefore, the MPSC noted that in association with other state utility

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[6]Ibid. 55-57.

commissions it had helped in the lobbying effort with the federal Congress, which resulted in the passage of legislation to preserve affordable telephone service. Although it is true that this federal legislation did increase the amount of the access charges, which in turn permitted a reduction in the rate increases proposed for local exchange service, it has been argued that the access charges set by Congress were still lower than cost justified for long-distance telephone services in comparison to the costs associated with providing local telephone services.

According to the MPSC, the challenges facing it in U-7473 were:

> I. To continue the tradition of affordable basic service rates which had allowed over 95% of Michigan's citizens to possess telephone service in their homes; and
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> II. At the same time, to be sensitive to technical and financial developments which would have resulted in bypass of the local exchange, absent some restructuring of long distance rates.[7]

The MPSC concluded that in trying to solve this dilemma, it could not tolerate a high level of bypass to occur because the loss of such telecommunications traffic would drastically reduce the revenues of the local exchange carrier and require significant rate increases to replace lost revenue.

Finally, the MPSC claimed that the final order issued in U-7473 provided a solution to the problem of maintaining

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[7]Ibid., 55 & 56.

Universal Telephone Service, while still giving full recognition of the development of changed technical and financial circumstances. The concept adopted in this final order limited the increases allocated to basic exchange service while raising required additional revenue from increases to short haul toll rates on intrastate long distance calls. This approach provided increased revenues by increasing the number and cost of long distance calls within the state. It is important to note that while rates for short haul intrastate long distance calls was raised substantially, the increase in rates for long haul intrastate long distance calls was minimal. With regard to intrastate long distance calls, the MPSC in the 1980's, chose to discriminate in rates with regard to short haul and long haul intrastate telephone traffic. This type of rate disparity goes back to the original outcry for regulation of railroad rates in the 1880's, when many individuals complained about very high rates for short haul railroad traffic in monopoly markets, versus lower rates for long haul railroad traffic in the more competitive markets. Whereas, in the 1880's, the need for regulation of railroads prevailed based on its monopoly position in long distance markets, in the 1980's proposals have surfaced for deregulation of long haul telephone traffic even though many services offered by BOC's are monopolistic in nature.

A very important issue facing the telephone industry in the 1990's is the proper allocation of costs between long distance carriers and local exchange carriers using telephone equipment in common, so that proper cost related rates can be determined for these two types of services. Proper assignment of costs between long distance carriers and local exchange carriers should help to insure that monopoly services provided by local exchange carriers are not set artificially high so as to subsidize lower than cost justified rates in the more competitive long distance market. Prior to divestiture, the assignment of common costs between AT&T and the BOC's was determined by a negotiation process called "separations", which was essentially political in nature. After divestiture, the assignment of such common costs continued to remain an essentially political decision in that Congress set the level that could be charged to interexchange carriers by BOC's for access to the local exchange telephone network. BOC's, such as Michigan Bell, in the past had advocated various cost allocation methods for assigning common costs among various classes of customers. Basically, however, none of these cost allocation methods had utilized the principle that the costs of the telephone system used in common should be assigned to the various customer classes based on the usage of the common telephone plant by each customer class. Such a concept is premised on the idea that

each of the customer classes should pay for telephone service based on its usage of the service.

The basic common cost factors that need to be assigned between long distance interexchange carriers (such as AT&T) and the BOC's (such as Michigan Bell) are related to the telephone loop. Loop costs consist of expenditures for the telephone of the subscriber, drop lines, telephone poles and cables, and related equipment at local telephone offices. The allocation of loop costs to either the local or long distance carriers has historically been based on formulas approved by the FCC. At the time of divestiture, a minor portion of the loop costs were allocated to local carriers inasmuch as the then existing FCC formulas imposed a significant portion of the loop costs on long distance carriers. After divestiture, however, very little of these "loop costs" would allocated to the long distance carriers because of judicial orders issued in the federal anti-trust case. This change in the allocation of loop costs after divestiture reflected, in part, the fact that the industry itself had traditionally viewed telephone costs as falling into two categories: either "access" or "usage". "Access" was thought of as a loop and its related expenses because these expenses appeared to be directly attributable to each customer who requested the loop. The judicially mandated divestiture process, however, altered this perspective and required that these access costs be placed in the local

customer charge. In contrast, "usage" had traditionally been viewed as the costs most directly related to the volume of calls and the related variable costs such as toll costs.

To reiterate, the FCC process had historically recognized that a substantial portion of the loop costs should be allocated to the toll services offered by long distance carriers. The FCC then changed this position to conform with the directives of the judicially created divestiture process which required local subscribers to pay "access charges" which were intended to cover substantially all of the loop costs.

The perception that the loop should be viewed exclusively as a "local" charge is inappropriate. For instance, assume that a telephone subscriber in Chicago installs a telephone for the sole purpose of talking with a relative who lives in Boston. In this illustration, the loop is installed only for the purpose of providing long distance service. The costs of the loop, however, end up in the local service charges paid by the subscriber in Chicago. Moreover, his neighbors may contribute to the costs of the loop in their local service charges if an average loop cost is assigned to each subscriber by telephone regulators, whereas the marginal installation cost for a particular telephone may be higher than the assigned average loop cost.

The result of the mandates of the judicial orders arising from the divestiture process has been that long distance carriers have been able to escape their legitimate responsibilities for loop costs. A more realistic analysis of the telecommunications network would give recognition to the fact that the loop is installed to enable the subscriber to communicate both in the local exchange network and in the long distance network. Subscribers have different preferences with respect to their use of the local and/or the long distance communications network. Thus, it seems appropriate to recognize that the loop and its related costs are as necessary for long distance services as long distance services are for the loop.

New methodologies need to be fully developed and adopted, which recognize the discrepancy of allocating all loop costs to local carriers, so as to alter the significant and inappropriate financial advantage long distance carriers enjoy with regard to the local exchange carriers. Additional analysis of the telecommunications industry is needed to trace loop costs to those who have peak responsibility for the enlargement of the telecommunications network due to their usage of the network during peak periods. Cost allocation based on peak responsibility has been an approach that has long been recognized within other utility industries.

The National Regulatory Research Institute (NRRI) published a report in April, 1985 entitled, "Cost-Of-Service Methods For Intrastate Jurisdiction Telephone Services."[8] This report gives recognition to the fact that a portion of the loop costs should be attributed to those services which are responsible for the costs that are incurred, rather than assigning all of these costs to the telephone exchange where the loop is physically located. This concept results in the attribution of costs to those subscribers who cause a system to be enlarged. The peak responsibility concept has been used in other types of utility services, but has not been previously utilized by the telephone industry.

The peak responsibility approach should be seriously considered by regulators as a method to allocate costs between interstate and local exchange carriers; and as a method of assigning costs to the various service categories of the local exchange carriers. Assigning future telephone costs between residential and business users based on peak usage responsibility would go a long way toward resolving the traditional dispute as to whether business users subsidize residential users of local exchange services through higher than cost justified rates. This historical dispute remains unresolved because cost allocation methods that are currently used by telephone companies and by

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[8]Cost-Of-Service Methods For Intrastate Jurisdiction Telephone Services," (Columbus, OH: National Regulatory Institute, April, 1985).

regulators do not take into consideration the usage of the telephone network by the various telephone classes of customers.

The peak responsibility approach to the allocation of costs could conceivably be used to demonstrate that local carriers are subsidizing long distance carriers, and that there should be a more equitable sharing of the loop costs. Such a study could be used to possibly convince the FCC, Congress, or the federal courts to reverse the current trend of imposing all the loop costs on local carriers. Generally speaking, the local telephone companies which are currently experiencing expensive loop additions should want all such costs fully recognized and attributed to the appropriate telephone carrier.

THE SAFETY AND WELL-BEING OF THE CITIZENS OF THIS STATE REQUIRE THAT ALL HAVE ACCESS TO CERTAIN ESSENTIAL TELECOMMUNICATIONS SERVICES AT AN AFFORDABLE RATE[9]

The statement cited above is reflective of a concern of certain members of the public that rates associated with local exchange services will be increased to such an extent as to result in "plain old telephone service" being priced beyond the means of large numbers of citizens to pay. It has also been noted that "access to certain essential

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[9]Statement contained in a proposed bill submitted to the Michigan Legislature in 1991. The proposed bill concerned a plan to modify the regulation of the telecommunications industry in Michigan. A new telecommunications regulatory statute was approved by the Michigan legislature and the governor in 1992, but did not contain the language cited in the text of this Dissertation.

telecommunications services is necessary to prevent a society of information haves and have-nots."[10] Thus, it has been argued that one of the purposes of public policy in Michigan should be to keep basic local service rates as low as possible, since basic local telephone services are provided in a monopoly market and are perceived to be price inelastic. Coupled with this purpose is the aim of enabling telecommunications carriers to enter into highly competitive markets to offer new and enhanced services to the public. This second purpose has been stated as the attempt "to create an environment that will place Michigan on the leading edge of telecommunications technology, provide incentives to develop new products and services, improve the quality of Michigan telecommunications infrastructure, (and) provide viable alternatives to national and international penetration."[11]

The recently enacted Michigan telecommunications statute mandates price caps for local exchange services, and provides no rate regulation standards for enhanced telecommunications services provided in competitive markets. In some ways this legislation can be viewed as "regulated competition", and some commentators feel that

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[10]Ibid. This language was originally included in a telecommunications bill debated in the Michigan legislature in 1991, but was eventually deleted from the new Michigan telecommunications regulatory statute which went into effect in 1992.

[11]Ibid.

"regulated competition" is a contradiction in terminology. The basic issue is whether permitting one carrier to provide both monopolistic local exchange services and competitive enhanced services can be accomplished without local rates in the monopoly market being raised to such an extent that they produce excessive revenues which are used to subsidize lower than cost justified rates in the competitive enhanced services market.

Conceptually, one of the problems in the area of cross-subsidization between monopolized local exchange services and competitive enhanced services revolves around the fact that commonly used telecommunications plant is utilized to provide both monopoly and competitive services. Thus, the best method of assigning these common costs may be the same method that was proposed to assign common plant costs between interstate and the local exchange services. To help solve this allocation problem in the latter area, it was proposed to assign costs on the peak responsibility theory. This same method can also be used to assign common costs between local exchange services and enhanced telecommunications services. However, the problem becomes more difficult if the same carrier is providing both basic local exchange services and enhanced services. The temptation to subsidize enhanced services with revenues derived from local exchange services is a very real one.

Over the past two decades, advances in technology have increasingly brought about a merger of the nonregulated data processing and the traditionally regulated telecommunications fields. AT&T and the seven regional BOC's have diversified into many unregulated, competitive fields. The FCC has maintained that the telephone companies and telephone users could potentially benefit from the use of the telephone network to provide new nonregulated competitive telecommunications services.

Until recently, the FCC's response to the desire of the carriers to enter nonregulated markets has been to use both structurally separate subsidiaries and accounting separation as a means of controlling any attempt to shift costs from nonregulated to regulated activities. Under structural separation a carrier conducts nonregulated business activities in a subsidiary separate from its regulated telephone operations. With accounting separation, a carrier can conduct nonregulated activities without setting up a subsidiary, but is required to keep separate accounting records to track nonregulated revenues and expenses. These accounting controls provide the means to determine that the carrier's regulated telephone rates are not affected.

As advances in technology made it more difficult to distinguish between "data processing" and "communications", the FCC initiated its Second Computer Inquiry (Computer II) in 1976. The Computer II decision created a regulatory

distinction between "basic" and "enhanced" services. It deregulated enhanced services, as well as customer premises equipment (CPE). The FCC decided that the enhanced services and CPE markets were competitive, making regulation unnecessary, but required that these carriers offer these services through separate subsidiaries. In addition, the Computer II decision contained several provisions designed to ensure the proper allocation of certain costs between the regulated and nonregulated operations. Immediately after Computer II, questions were raised as to the adequacy of the cost allocation provisions in preventing subsidization of nonregulated services.[12]

State public utility commissions also began to express concerns about intrastate telephone revenues being used to subsidize carriers' nonregulated activities. In 1984, NARUC initiated audits by state public utility commission staffs of the intrastate operations of each of the seven regional BOC's. NARUC was concerned that the regulated telephone companies were subsidizing the holding companies' nonregulated subsidiaries and that regulators would not be given access to the holding companies' records to monitor nonregulated activities. NARUC issued a summary report citing the following common concerns: (1) access to records of nonregulated operations; (2) the effect on the ratepayer

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[12]"Telephone Communications: Controlling Cross-Subsidy Between Regulated and Competitive Services," 18-20.

of using profits from regulated operations and/or borrowing to finance nonregulated ventures; and (3) moving profitable services from regulated to nonregulated control.[13]

In 1986, the FCC reversed a portion of its Computer II decision and determined that separate subsidiaries were both inefficient and restricted the advance of technology. It adopted a new program of nonstructural safeguards to promote technology and efficient network use, while still addressing ratepayer and competitive concerns. A key nonstructural safeguard that the FCC adopted is a process of allocating telephone company costs shared by both regulated and nonregulated operations. Elements of this process included (1) cost allocation standards and accounting procedures, (2) company cost allocation manuals, and (3) annual certified public accountant reports attesting that the allocations accurately reflect procedures in the cost manual. The FCC would oversee the entire process and use its own auditors to periodically examine the cost allocations.

The Federal General Accounting Office, however, concluded that the level of oversight the FCC was prepared to give to its cost allocation standards would not provide telephone ratepayers or competitors positive assurance that the FCC cost allocation rules and procedures would properly control cross-subsidization. The basis of this conclusion was that the FCC didn't have sufficient audit staff or

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[13]Ibid., 23.

travel funds to perform the required periodic audits of the records of the telephone company.[14]

It is unlikely in Michigan that a regulatory commission will have sufficient staff or funds available to properly audit the books of Michigan Bell to insure that cross-subsidization of competitive service offerings by the local exchange services won't take place in the future. Despite the historic problems of rate base regulation of a monopoly in a business environment that seeks to promote competition, the conclusions arrived at over a hundred years ago regarding short haul subsidization of long haul railroad traffic still holds true today for the potential of subsidization of competitive enhanced telecommunications services by monopoly local exchange services. If a company like Michigan Bell desires to move into the competitive enhanced telecommunication services market in search of higher profits, it should be required to divest its monopoly exchange telephone facilities that have inelastic demand characteristics to either a public corporation or a private corporation chartered by the state for the specific purpose of only providing the monopoly local exchange services. Thus, as Michigan Bell moves into the more competitive telecommunications markets, it can avoid potential anti-trust problems resulting from its retention of the monopolistic local exchange services.

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[14]Ibid., 51-55.

A century ago, the public was properly concerned with the economic consequences of monopoly power. The public today should be as concerned, if not more so, with these very same issues in the telecommunications industry. One hundred years ago a public policy dilemma faced law makers in that it was persuasively argued that economies of large scale production that were available to monopoly or near monopoly enterprises had economic advantages to the public through lower per unit manufacturing costs, which resulted in lower prices to the public for the final product. For many policy makers it was possible to conclude that the price advantages that monopoly power provided through economies of large scale production outweighed the perceived evils of reduced competition in markets dominated by large corporations. Today, no economic advantages accruing to the public have been substantiated for permitting Michigan Bell to get into the competitive enhanced services market while retaining a government granted monopoly in the local exchanges.

THE MPSC HAS CONTINUED ITS ALL TOO COMMON PRACTICE OF ESTABLISHING HOW MUCH MONEY IT WANTS TO PROVIDE A COMPANY AND THEN RESORTING TO WHATEVER APPROACH IS NECESSARY TO AUTHORIZE THESE DOLLARS, AT THE EXPENSE OF LEGAL AND ECONOMIC REASONING[15]

The above statement was written by Commissioner Edwyna G. Anderson in her Separate Concurring and Dissenting Opinion issued in Case No. U-6923 on May 18, 1983. Anderson then went on to present the following conclusions: "The MPSC must remove its blinders and regulate the companies it oversees .... If the MPSC fails to regulate the companies under its jurisdiction, then the courts, the legislature and the people will do this."[16]

In the 1980's, the pressing issue for large investor owned utility companies and their regulators was in many instances how to deal from a public policy perspective with the significant costs of building very large nuclear power generating facilities. These nuclear projects generally took much longer to construct than originally projected, and the costs to build them far exceeded their original cost estimates, resulting in much higher rates to consumers. As a result of these skyrocketing costs and potential losses to the utility companies, the issue arose as to who properly should pay for these particular nuclear projects that far exceeded cost projections: the rate payers or the

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[15]See page 8 of the Separate Opinion of Commissioner Edwyna G. Anderson, Concurring in Part and Dissenting in Part, issued on May 18, 1983, Case No. U-6923.

[16]Ibid.

shareholders of the utility companies. Related to the cost responsibility issue, was the issue of who was responsible for letting such a situation arise: the utility companies or the state regulators. This latter issue is not easily resolvable, and has only recently been answered tentatively for a company such as Consumers Power and its Midland Project. Part of the difficulty in answering this issue is that some utility companies built nuclear plants at close to original cost projections; and such successes have been generally attributed to sound utility management practices.[17] However, nuclear projects of other utility companies have far exceeded costs, and a portion of the blame for this has been focused on state regulatory policies and federal policies.[18]

As previously noted, in 1967 Consumers Power announced its plans to build a two-unit nuclear power plant in the City of Midland, immediately across the Tittabawassee River from the chemical manufacturing complex of the Dow Chemical Company.[19] Unit #1 was to consist of 500 MW of electric generating capacity and the equivalent of 300 MW of process steam capacity, the steam output to be delivered to Dow.

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[17]Cook, "Nuclear Follies," 82-100.

[18]Ibid.

[19]The material in this part of the Dissertation that is related to the history of the Midland Nuclear Project was obtained from an unpublished report prepared by Hugh B. Anderson, Assistant attorney General for the State of Michigan, entitled "Midland Power Plant Project: A Case History in Legal and Regulatory Incentives to Economic Waste," dated October 1984.

Unit #2 was to be an all-electric plant of 800 MW capacity. The estimated cost of the combined units was $256,000,000, with Unit #1 to be completed in 1974 and Unit #2 in 1975.

Actual construction at the site began in 1971, and continued in one form or another until July 16, 1984, when the project was shut down. Over the course of the 17-year period between project announcement and shut down, numerous revisions in cost estimates and completion schedules were announced. By 1977, the cost estimates had grown to $1,670,000,000, which caused Dow to express a desire to cancel its contract for process steam from the facility. In 1978 Dow obtained a revision of the steam contract, permitting it to withdraw from the contract in the event that Unit #1 could not be completed by December 31, 1984, provided Dow paid a termination penalty equal to about half the sunk costs in the steam portion of the plant.

At the end of 1979, the cost estimate of the plant took a leap upward to $3,100,000,000. At that time, $1,000,000,000 had been invested in the plant, leaving a "to go" cost of $2,100,000,000, the largest "to go" cost in the history of the project. At this juncture, the AG intervened in proceedings before the MPSC in opposition to Consumers Power's request that the issuance of additional securities be approved for financing the continued construction of the plant. The Michigan Citizens Lobby (MCL), the largest consumer organization in the state, also intervened in

opposition to the Midland financing. During the course of a 20-month contest at the MPSC, the AG and the MCL took the position that the Midland plant would ultimately cost $3,500,000,000-$4,500,000,000, and that the "to go" cost of $2,500,000,000-$3,500,000,000 was in excess of the cost of reasonable alternatives such as the construction of coal-fired plants of equivalent capacity. Consumers Power stressed the view that the plant would probably not be economical at a completed cost in excess of $3,500,000,000, but that it was confident that a $3,100,000,000 estimate was realistic. The MPSC Staff took the view that the plant would probably be uneconomic at a completed cost in excess of $3.4 billion, and was prepared to recommend to the MPSC that Midland costs be capped at that level, as the maximum amount that could be recognized for rate making purposes upon completion of the plant. At the same time, in 1980, Consumers Power's management undertook a serious review of the economics of the project, but elected to continue.

On August 4, 1981, the MPSC authorized continued financing of the Midland project, declining to make findings concerning the need for or cost effectiveness of the Midland plant. The MPSC said that it was impractical for it to review the economics of a construction project once the project had been commenced. On appeal to the Michigan Supreme Court, the MPSC was affirmed. The Court held that the MPSC had no power under the utilities securities statute

to consider need or cost effectiveness in approving the issuance of securities to finance construction projects, whether or not the project had begun.

In February, 1982, the estimated cost of the Midland project rose to $3,390,000,000. On March 31, 1983, the estimated cost was revised to $4,490,000,000, and the completion schedule was extended to 1985, thus giving Dow the option to terminate the steam supply contract. Dow exercised this option in July, 1983, but rather than paying the $460 million contract termination penalty, filed suit to set aside the contract.

By the fall of 1983, Consumers Power was aware that a revised cost estimate under preparation by it and its general contractor, Bechtel Power Corporation, would substantially exceed the existing $4,430,000,000 estimate. In December, Consumers Power retained bankruptcy counsel.

On April 10, 1984, Consumers Power announced a new, and what proved to be final, cost and completion schedule estimate for Midland. Unit #2 was to be completed in December, 1986 at a cost of $4,100,000,000; and cogeneration Unit #1, in which $1,500,000,000 had been invested, would be indefinitely suspended.

During the first week of January, 1984, a coalition was formed for the purpose of putting the Midland plant out of its misery. The "coalition" consisted of the MPSC Staff, the AG, the MCL, and ABATE, an informal association of 31

industrial firms. Working continuously throughout the first quarter of 1984, the coalition developed a written proposal that was formally presented to Consumers Power on March 28th, which offered a 6% rate increase to remain in effect for 25 years to defray a portion of a Midland abandonment loss. Even before the March 28th proposal was presented, representatives of Consumers Power, the MPSC Staff and the AG began on March 15th a weekly series of discussions concerning the fate of the Midland plant. The discussion group was expanded in mid-April to include MCL and ABATE representatives. Discussions continued on a weekly basis and sometimes on a more frequent basis through July 16th, when the project was shut down. Consumers Power found that it was not possible to obtain the agreement of the AG, ABATE or MCL to a set of rate making guarantees that would inspire sufficient confidence in the investing public to raise the capital necessary to complete Unit #2. The MPSC staff had, however, agreed to a proposal that $2,900,000,000 of the cost of Unit #2 be included in rate base upon completion.

Consumers Power common stock closed on October 12, 1984 at $4.50/share, down from $21 a year earlier. The total market value of the 88 million outstanding common shares was $396,000,000, compared to a book value of $2,300,000,000. Quarterly dividends on the common stock were cut from 63 cents to 35 cents/share in April; to 10 cents in July; and eliminated in October. The Board of Directors of Consumers

Power had deferred until December a decision on whether to pay out the next installment of dividends on the preferred and preference stock, which ordinarily would have been declared at the Board's October meeting. The market price of the preferred and the preference stock declined more than 40% during 1983/1984, to a level where the dividend yields were about 24% and 25%, respectively. Consumers Power sold a $100,000,000 first mortgage bond issue, ten-year term, in October, at a cost of 17.03%.

By the mid-1980's, the Midland Project was only one of many numerous nuclear projects in the United States facing significant financial difficulties, which led many persons and interest groups in the country to question the feasibility of nuclear power as source of energy for the country in the immediate future. It was noted that outside the United States, nuclear power development was low- cost, reliable and environmentally safe; while within the United States it was high cost, unreliable and possibly environmentally not safe. One analysis of the situation even concluded that nuclear power was killed, not by its enemies, but by its friends.[20]

The problems with the nuclear power industry revolved around the intersection of competing interests involving utility regulators, utility company management, nuclear contractors, and anti-nuclear obstructionists. Cost-plus

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[20]Cook, "Nuclear Follies".

contracts offered nuclear contractors few incentives to minimize construction costs. Thus, of the major nuclear projects, the costs of the plants differed widely, ranging from $932 per kilowatt for Duke Power's McGuire 2 station to a whopping $5,192 per kilowatt for Long Island Lighting's Shoreham project. The average cost of construction was $2,134 per kilowatt, with the Midland plant coming in substantially above the average at $4,899 per kilowatt.[21]

At the beginning of the nuclear era, the perception was that state utility commissions and the regulated utility companies had reached a "community of interest", generally favorable to utility companies. High inflation and high interest rates substantially increased the costs of the nuclear program and ultimately dissolved this community of interest between the regulators and the utilities. In addition, after the Three Mile Island incident, some commentators suggested that the balance of decision-making power had sifted sharply from utilities to the regulators. If there was such a shift in decision-making power, it was partially due to the perception in some areas of the American political spectrum that the principal underlying cause of the failure of the American nuclear power program was "poor utility and project management".[22]

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[21] Ibid.

[22] Opinion and Order of the Michigan Public Service Commission issued in Case No. U-7830 Step 3B, dated May 7, 1991.

Some observers concluded that management was the factor that made the difference between a financially successful nuclear project and an unsuccessful project. If a utility failed to involve itself directly in every aspect of the nuclear project, a mismanaged project was likely to result. This partially happened when Consumers Power hired the Bechtel Corporation to oversee construction management of the Midland plant. In June of 1984, Consumers Power was forced to halt Midland #2 when it was 85% complete, due to financial difficulties that threatened to send Consumers Power into bankruptcy.

For much of the 1980's, most members of the MPSC failed to address in rate cases the issue of the extent of mismanagement by Consumers Power of the construction of the Midland plant, and what portion of the increased construction costs should be borne by the shareholders as opposed to the rate payers. The true extent to which the MPSC avoided for a substantial period of time the determination of the degree of responsibility Consumers Power should bear for the cost overruns at Midland was highlighted by the fact that the MPSC didn't make a final decision on this issue until May 7, 1991, when it rendered its final order in Case No. U-7830, Step B.

As initially conceived in early 1967, the Midland plant was to be in commercial operation by April, 1973 at a total cost of $255 million. In late 1967, Consumers Power

announced that the plant was to be in commercial operation in February, 1975 at a cost of $349 million. The plant was to consist of two units and was intended to provide electric power for Consumers Power's customers as well as process steam for The Dow Chemical Company. In July, 1984, Consumers Power abandoned efforts to complete the plant after spending approximately $4.1 billion. At that time, construction was estimated to be 84% complete and engineering 82% complete. The issue was what portion of the $4.1 billion expenditure should be borne by the rate payers by being placed in the rate base of Consumers Power.

In Case No. U-7830 Step 3B, the MPSC majority, consisting of Commissioners William E. Long and Ronald E. Russell, concluded that by July 2, 1980 Consumers Power should have decided not to continue construction of the plant as a 2-unit cogeneration facility, since that particular construction plan held out little, if any, prospect of success. The majority also found that by July 2, 1980 Consumers Power had subordinated the interests of its ratepayers to the utility's interest by maintaining a contract with Dow.

In a separate opinion concurring in part and dissenting in part, MPSC Chairman Steve Fetter concluded that Consumers Power's actions were imprudent after February 11, 1981, because by that date Consumers Power was directing Bechtel to maintain two sets of construction schedules, an

unrealistic one for public consumption showing that a completion date was rapidly approaching, and a more accurate but later completion date for the internal use of Consumers Power. Thus, Fetter found that Consumers Power was no longer acting in the public interest, but rather was pursuing its purely private goals while avoiding public scrutiny. By February 11, 1981, it should have been completely clear to Consumers' management that its publicly announced completion date couldn't be met.

After disallowing imprudently incurred costs and removing the cost of facilities intended for service to Dow transferred to the Midland Cogeneration Venture, the MPSC determined that Consumers Power should be allowed to recover only $760 million of the $4.1 billion of the construction expenses as prudently incurred costs. After adjusting for tax loss benefits and revenues that Consumers Power had previously received, the MPSC found that Consumers Power should be allowed to recover $347 million over a 10-year period. Had Chairman Fetter's February 11, 1981 finding been adopted, it would have resulted in $862 million of prudent costs and a recovery of $504 million over a 10-year period.

As previously noted, many critics of high cost nuclear projects have concluded that a substantial portion of the cost increases were due to poor performance by utility management. A slightly different perspective was offered by

Commissioner Edwyna Anderson in her dissenting opinion issued in Case No. U-6923 involving Consumers Power. In that dissenting opinion, Commissioner Anderson (a Democrat), appeared to place a substantial portion of the responsibility for large cost overruns at Midland on the Michigan regulators, particularly Commissioners Eric J. Schneidewind and Matthew E. McLogan (both Republicans), the writers of the majority opinion in U-6923. Commissioner Anderson noted that for the years 1980 - 1982, the pattern of the majority on the MPSC had been to grant utility companies millions of dollars in (1) unrealistic profits; (2) unrealistic expense allowances; and (3) unjustified incentives.[23] She noted that this had happened despite the State's serious economic decline in that period. She argued that nuclear plants were the source of the then recent downgrading of many electric companies and a general weakening of the electric utility industry. Repeated requests for rate hikes would no longer solve the problem faced by the electric utilities in her opinion. Investment costs in nuclear projects had exceeded reasonable limits.[24]

Edwyna Anderson argued that the majority opinion in U-6923 ignored the following facts:

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[23]Separate Opinion of Commissioner Edwyna G. Anderson, Concurring in Part and Dissenting in Part, issued on May 18, 1983, Case No. U-6923, 1.

[24]Ibid., 2.

(1) utility company managers must assume responsibility for their problems;

(2) the rate increase authorized by the majority created a financial burden for rate payers; and

(3) it increased shareholder risk more than ever through a patchwork of rate relief that addressed symptoms and disregarded fundamental sicknesses of Consumers Power.[25]

In addition, Commissioner Anderson carried on a tradition found in dissenting opinions of objecting to large rate increases granted to utility companies that ignored their adverse economic impact to a utility's ratepayers, while maintaining that the majority of the MPSC concerned itself almost exclusively with the financial condition of the utility company, but didn't consider the financial circumstances of the rate payers. In the late 1950's, Commissioner James Lee had issued a number of perceptive dissenting opinions criticizing his colleagues for not looking at the economic impact on rate payers of large rate increases granted to Michigan Bell and Consumers Power. In U-6923, Edwyna Anderson took exception to the majority's exclusion of evidence from the record relating to the economic conditions of the State of Michigan and its citizens. Anderson noted that the law required a balancing of the interests of rate payers, the utility company, and its investors.

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[25]Ibid.

As to the Midland project, Edwyna Anderson noted that it was an albatross around Consumers Power's neck. Edwyna Anderson challenged her colleagues to open an immediate and comprehensive investigation into the problems of the Midland construction. She found it inconceivable that a project of this magnitude and with its serious fiscal problems for Consumers Power and the State had never been the subject of a specific investigation by the MPSC. For Edwyna Anderson, the MPSC inaction surrounding the construction of Midland was clearly indicative of a form of "regulator neglect".[26]

With regard to the Midland plant, an active participant in the Michigan regulatory process came to develop a position that was between the utility mismanagement concept and the regulatory neglect hypothesis. Hugh Anderson, an Assistant Attorney General, representing the office of the Michigan Attorney General in many of the rate proceedings, placed the blame for the Midland debacle on specific legal and regulatory policies which he claimed created an incentive for economic waste. His written analysis of the situation was prepared in October of 1984.[27]

When Midland was canceled on July 16, 1984, $4,100,000,000 had been spent on the project, with no net salvage value anticipated by Consumers Power. The loss at

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[26]Ibid., 3 & 5.

[27]Anderson, "Midland Power Plant Project: A Case History in Legal and Regulatory Incentives to Economic Waste."

that time was equal to $3,000 for each of Consumers Power's 355,000 electric customers. Although it had been claimed that the Midland Nuclear Project had been terminated because Consumers Power could not attract sufficient investment capital or internal cash flow to cover the cost of continued construction, Hugh Anderson concluded that Midland was abandoned because the project no longer had economic value.

According to Hugh Anderson, one of the fundamental federal policies contributing to Midland was federal income tax incentives provided by the Job Development Investment Tax Credit (JDITC). The JDITC provided a strong incentive for the allocation of resources into capital goods. The 8% tax credit, with generous carryback and carryforward provisions, had generated about $220,000,000 in tax credits from the Midland project. The great majority of the economic benefits of those tax credits were required to be retained by utility stockholders under the JDITC provision of the Internal Revenue Code, which did not permit tax credits to be used as a reduction to the rate base or the cost of capital. Anderson determined that only 22% of the value of the tax credits benefited ratepayers, with the other 78% going to the shareholders. Thus, Anderson concluded that the more expensive Midland became, the tax credits also became proportionately larger, and the gain to the stockholders became greater. Such financial benefits to

Consumers Power itself and to its shareholders assured that the full cost of the project would ultimately be rate based.

Other provisions of the Internal Revenue Code, relating to accelerated depreciation, and the deductibility of interest, property taxes and construction overheads on construction work in progress, contributed to Consumers Power's cash flow, thereby facilitating the financing of this major project.

Hugh Anderson also cited various Michigan laws as contributing an inducement to utilities to build larger generating facilities, regardless of their documented need. Section 7 of Act 106 of the Public Acts of 1909 permitted an electric utility a "reasonable return on the fair value of all property used in the service". Fair value has been equated with original cost. Although the original cost concept was initially used to cut dollars from an inflated replacement cost rate base and to eliminate "going concern" value, it is now often used to justify inclusion in rate base of the entire cost of a project upon completion, although evidence may exist that its market value and replacement costs were far lower.

Act 69 of the Public Acts of 1929 prohibits a privately owned utility from entering into competition with another utility in the latter's service territory, without a Certificate of Public Convenience and Necessity from the MPSC. Hugh Anderson argued that anti-competitive statutes

such as this gave comfort to utility managers embarked on high cost construction projects that whatever the rate consequences of those projects, there would be little, if any, potential competition from a low -cost producer. Further, because there was no specific statutory authorization in Michigan, or most other states, for plant abandonment losses to be charged to ratepayers, the incentives provided by the statute currently are in the direction of completing, rather than abandoning CWIP.

Hugh Anderson in his study also criticized specific policies adopted by the MPSC. He noted that the policy of the MPSC as to abandoned generating plants, or completed plants that were no longer being used was to permit the utility to recoup its entire investment over a period of 5 - 10 years, with no return on the investment. This policy, with respect to generation projects abandoned before their completion, was applied in the case of Consumer Power's Quanicassee nuclear plant and the Detroit Edison Company's Fermi 3 and Greenwood 2 and 3 nuclear plants. In the case of Greenwood 1, an 800 MW oil-fired generating plant completed in 1979, whose fuel, operating and maintenance costs made it uneconomical to operate from its inception, the MPSC permitted full ratebasing of the plant.

Hugh Anderson then observed that a regulatory policy that charged current customers for part or all of the financing cost on CWIP would provide substantial additional

cash flow to pour into a major construction project, when that cash might not be available from skeptical investors. Michigan is a "partial-CWIP" state. CWIP is included in rate base, but offset by a credit to income for AFUDC at a rate equal to the authorized rate of return. However, AFUDC accrued in prior periods is included in rate base without offsetting AFUDC. This became very significant in the case of the Midland project, where about $1,000,000,000 of its cost at the time of abandonment represented accumulated AFUDC, generating in excess of $100,000,000 annually in revenues through inclusion in the rate base.

Hugh Anderson went on to note that another regulatory policy, common to virtually every jurisdiction, that generated cash from ratepayers for major construction projects was the inclusion of the high cost of new money in the cost of capital computation, for determining the authorized rate of return to be applied against the rate base. The new money was more costly than the old money because the cost of all types of capital had increased in recent years, and a growing risk premium had been attached to investments in utilities with major nuclear plant projects under construction. Dr. John W. Wilson, an economist employed by the AG had estimated that the average embedded cost of capital to Consumers Power had been driven upwards by three percentage points as a result of the Midland project financing.

For Hugh Anderson, the upshot of the MPSC's regulatory policies was to provide strong incentives for the commencement of large construction projects, and the continuation of such projects long after they could no longer be economically justified.[28] Anderson believed that utility management's knowledge that on a worst case scenario, where a project must ultimately be aborted, it would probably be permitted to recover its investment from ratepayers, although without interest, encouraged the commencement of a project. The knowledge that the cost of a project would be fully ratebased upon completion, regardless of value, was a powerful incentive to continue construction, rather than abandoning the construction in mid-stream and accepting the return of capital without future interest thereon.

With regard to the huge cost over-runs experienced by a number of nuclear projects, utility companies have generally blamed regulatory delay for the unanticipated cost increases. Hugh Anderson provided a powerful argument to refute this position. First, he specifically observed that Consumers Power and other electric utilities had often cited the changing and expanding regulations of the Nuclear Regulatory Commission (NRC) as a principal cause of delays and cost escalations for nuclear plant projects, particularly since the May, 1979 accident at Three Mile

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[28] Ibid., 14.

Island (TMI). Changes in the regulations governing nuclear projects by the NRC did make a contribution to the adverse economics of many nuclear plant projects. However, the estimated cost of the Midland plant had originally been scheduled to be completed by 1975, four years before the TMI accident. Hugh Anderson observed that if Midland had not been so far behind schedule, it would have been essentially immune from post - TMI changes in regulatory requirements.[29]

Hugh Anderson also thought that the actions of investors and banks had significantly contributed to the follies experienced by the Midland Project. Anderson observed that the Midland plant could not have been continued as long as it had been, had it not been for the willingness of investors and banks to advance funds in the face of overwhelming evidence that the Midland project was not economically viable. In the first half of 1983 a large group of banks led by Chase Manhattan granted term loans of $600,000,000 to finance the continued Midland construction, even though the estimated cost of the plant had shot up by $1,000,000,000 over the previous year's estimate, and the completion schedule had been revised so that Dow had a right to terminate the steam supply contract. Even after Dow pulled out of the contract in July, and immediately filed a law suit to avoid payment of the $460,000,000 termination penalty, investors snapped up a common stock offering in

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[29]Ibid., 15.

November, 1983 at in excess of $20 per share. In January, 1984, after Consumers Power had already retained bankruptcy counsel, Consumers Power was able to sell $50 million of preference stock at a yield of 17.6%; and in March was able to sell an $80 million bond issue yielding 15%. In October, 1984, Consumers Power sold a $100 million bond issue with a yield to maturity of 16.6%, despite almost daily pronouncements by Consumers Power officials that bankruptcy proceedings would be commenced by the end of the year in the absence of emerging anti-bankruptcy rate relief. Anderson estimated that the funds raised in January probably prolonged the life of the Midland project for an additional six months, at the cost of about $22,000,000 per month, not including financing costs.

Finally, Hugh Anderson placed a significant portion of the blame for the Midland construction failures on Consumers Power's management. Anderson opened his remarks in this area by stating that it was "obvious" that management's performance significantly contributed to the escalation of Midland's costs from $256,000,000 for two generating units to $4,100,000,000 for one unit, and a $1,500,000,000 loss on the other unit.[30] Obvious examples of poor management performance included the construction of the Midland plant in a swampy area, on top of 30 feet of improperly compacted

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[30]Ibid., 17.

fill material, thereby requiring a $400,000,000 tunneling project to shore up the foundations.

Another example of poor management performance, was electric load growth projections which continued to project sales growth at the 1963 - 1973 rate of 7.5% compounded annually, long after sales growth had been brought to a halt by sharp increases in the price of electricity and economic dislocations occasioned in large part by the Arab states' oil embargo of 1973. For the 1973-1983 period, Consumers Power's sales growth dropped by a factor of 10, to .7% annually. It was only on August 27, 1984 that Consumers Power had brought its long-term load growth forecast into line with the reality of the 10 previous years: a forecasted compound annual rate of 1.86%.

Anderson also observed that Consumers Power's avoided cost analysis had been seriously flawed since they purported to justify the economics of the Midland plant on the basis of assumed long-range stability of nuclear fuel costs, while at the same time assuming escalation rates in the real cost of fossil fuels of 5% or 6% compounded annually over the life of the plant. Moreover, Consumers Power was in error when it exhibited unwillingness to consider lower cost alternatives of purchasing long- term firm capacity from other utilities in Michigan, surrounding states and the province of Ontario, on the ground that these sources of supply would be "unreliable".

Anderson drew the unique conclusion that the above-mentioned management errors were not in his opinion "independent" factors in the Midland economic disaster, but the predictable and probable result of the regulatory and tax law incentives to the continued construction of uneconomic power plants. Anderson also put forth the controversial conclusion that the economic failure of the Midland and the other large nuclear power plant projects in the United States did not militate in favor of greater involvement of regulatory agencies and the public in the management of utility companies.[31] Anderson speculated that there was no reason to believe that regulators, with maximum public input, would have managed the utilities from 1973-1983 any more effectively, on average, than did utility management. The managers of the Bonneville Power Administration, the Washington Public Power Supply System, and the Tennessee Valley Authority were all public officials, presumably motivated to provide adequate service at the lowest possible cost. Yet, these public agencies created some colossal power plant failures.

In criticism of the MPSC, Anderson noted that it had made load growth projections that were higher than those issued by Consumers Power in the period 1973-1983. The MPSC was supportive of the continued construction of the Midland plant at least through 1981, and the MPSC Staff continued to

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[31]Ibid., 19 & 20.

advocate completion of both Midland units as late as July 16, 1984, when Midland was completely shutdown, even though Consumers Power had long ago abandoned any pretense of completing cogeneration Unit #1. Anderson observed that even as late as October 5, 1984, the MPSC Staff recommended that the Midland project only be mothballed (not abandoned) and maintained in its existing state, at the ratepayers' expense, for possible future completion.

One of Anderson's more novel conclusions was that even if Michigan had a power plant siting statute, he had no doubt that the MPSC would have approved the Midland project at its inception and whatever construction work had been approved thereafter.[32]

Anderson further maintained that utility management had not appeared to have learned very much from power plant construction failures. It believed that it was the victim of bad luck, changing NRC regulatory requirements, unforeseeable events such as the 1973 oil embargo, the 1979 TMI accident, and basely motivated politicians. Anderson argued the real lesson of the power plant debacles was that incentives to wasteful construction needed to be eliminated. The most significant steps towards that end would include:

(1) Repeal of the JDITC, or at least repeal of the prohibition giving customers the full economic benefit of the tax credits.

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[32]Ibid., 20 & 21.

(2) By statute or regulatory agency policy, requiring investors to finance the full cost of construction. This would mean no CWIP in rate base, and no "averaging up" of the cost of capital for ratemaking purposes to reflect the high cost of new capital invested in work in progress.

(3) Prohibit by statute or regulatory policy the pass - through of any portion of power plant abandonment losses to customers.

(4) Prohibit by statute or regulatory policy the inclusion in rate base of that portion of the cost of completed power plants which exceeded the economic value of the plants.

(5) Eliminate legal impediments to competition within utility service territorities.

(6) Require by both federal and state statutes that utilities wheel power at reasonable rates.[33]

Blame for the Midland construction fiasco can be shared by the utility company, the regulator, and the policies of state and federal governments. However, under our present system of utility regulation, primary responsibility must be borne by the management of Consumers Power, rather than the MPSC. Other electric utility companies in this era were able to construct substantial nuclear projects at one-half or less the cost per KW than the costs associated with the Midland project.[34] Moreover, Consumers Power has argued, and the courts have accepted such argument, that the regulators do not have the authority to manage utilities, but are merely responsible for determining the

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[33]Ibid., 21 & 22.

[34]Cook, Nuclear Follies," 82-100.

reasonableness of the business costs incurred by a utility company.

Having abandoned the Midland project as a nuclear generating facility in 1984, Consumers Power set out to avail itself of the perceived benefits of PURPA by converting a portion of the facility to a cogeneration unit to be operated as a natural gas-fired plant. As passed by Congress, PURPA contains measures designed to encourage increased efficiency in the generation and use of energy by electric utilities and their customers. PURPA is designed to encourage cogeneration and small power plant production, and to increase the use of renewable energy sources. Cogeneration facilities are characterized by the sequential production, from one fuel source, of both electric energy and steam that can be used for industrial or commercial purposes. Small power production facilities are defined as those that produce electric energy by the use of biomass, waste or renewable resources that have a generating capacity of 80 MW or less.

To encourage development of such facilities, Congress created a class of qualifying facilities that were to be exempted from the bulk of federal and state regulations. However, subsection 210(b) of PURPA requires that the rates paid by electric utilities for purchases of energy produced by cogeneration facilities shall be just and reasonable to the customers of the electric utility. Thus, state

regulatory agencies, such as the MPSC, have jurisdiction over rates paid by Michigan electric utility companies for energy purchased from cogeneration facilities.

After Consumers Power canceled the Midland project as a nuclear generation plant, it decided to convert part of the facility to a cogeneration plant. This plant was to be owned by a limited partnership with CMS Midland, Inc. and two other Consumers Power subsidiaries as general partners, and a subsidiary company of Dow Chemical as one of several limited partners. The newly formed limited partnership would be known as the Michigan Cogeneration Venture (MCV). Consumers Power would basically own 49% of the cogeneration facility.

On September 10, 1987, the MCV filed an application with the MPSC in Case No. U-8871 for approval pursuant to MCLA 460.6j(13)(b) of capacity charges for the sale of electricity by the MCV to Consumers Power as contained in a power purchase agreement between those parties. MCV stated that it intended to construct and operate a gas-fired cogeneration plant with the design capacity of approximately 1,350 MW to supply steam and electricity to Dow and to sell electricity to Consumers Power. The cogeneration plant at Midland was completed in 1990 and is currently providing steam to Dow and electricity to Consumers Power. The purchase power agreement between MCV and Consumers Power has a term of 35 years and an average rate of 4.5 cents per Kwh.

Eventually, some 40 other cogeneration facilities, other than Consumers Power, filed applications with the MPSC for approval to sell electricity to Consumers Power. These additional applications were consolidated with the application filed by the MCV in U-8871 for a joint hearing process, so that the MPSC could more easily determine which cogeneration facilities would sell electricity to Consumers Power and at what rates. While the MPSC at this time has not made a final determination in Case No. U-8871, it has stated that of the over 40-some cogeneration facilities seeking to provide electricity to Consumers Power that the MCV plant is by far the largest to seek MPSC approval. The MCV plant would substantially affect utility rates for 35 years. The MCV itself projects a 14% rate increase if the MPSC approves its application. Case No. U-8871 and the other consolidated cogeneration cases are very important to the issue of competition in the field of electrical energy production in Michigan for the next several years. Clearly, if the MCV application were approved in its entirety by the MPSC, few if any of the other cogeneration producers in Michigan would be able to sell electrical energy to Consumers Power, even though they might be able to do so more cheaply than MCV.

At the end of the 19th century, America had basically adopted a public policy of turning to regulation by independent commission of the prices charged by monopolistic

utility companies. Although competition had marked the very early years of the national utility industry, eventually the trend toward monopolizing in the various utility fields prevailed, and the American public expressed concern about excessive prices and profits. Much of the initial thrust toward legislative activity to set up regulatory commissions came as a result of political agitation by the users of utility services, who were unhappy with the monopolistic prices of these companies. The Granger Movement was an early example of consumerism with regard to the railroad industry and the establishment in 1887 of the Interstate Commerce Commission.

In the late 20th century, the American public has expressed concern about excessively high prices in various utility industries, which are perceived not to be the result so much of monopolization of markets per se, as due to improper influence over utility regulators by the utility companies. Opposed to this generalized and vague public concern, has been the perspective of the utility companies that they have been precluded by regulatory agencies from earning appropriate levels of profits and unduly stifled by public agencies from entering into newly emerging technological fields where profit potentials are greater than currently exist in traditional utility activities. Whereas in the late 19th century, utility companies were seeking to solidify their monopoly positions within a single

market, in the late 20th century utility companies are seeking to diversify their activities into competitive markets where they won't be burdened by rate regulation limitations. Thus, AT&T acquiesced in the divestiture of its regulated operating companies, so that it could freely engage in those competitive activities that it had previously been legally precluded from entering by the 1956 antitrust consent decree. In turn, the BOC's were limited by the divestiture order to offering monopolistic exchange telephone services by the MFJ, and they now believe that they are the victims of unjust legal restrictions which preclude them from entering into potentially very lucrative telecommunications data transmission markets. BOC's, such as Michigan Bell, now want to get into these fields.

Similarly, electric utilities such as Consumers Power which have a monopoly on the distribution of electricity, now would like to be active participants in the emerging competitive field of electricity production. One of the purposes of PURPA was to provide incentives for small power production companies to be formed, and thereby diversify the number and types of companies engaged in the production of electricity in this country. Consumers Power, through the MCV, has sought to maintain and diversify its own position as to the production of electricity. If Consumers Power is able to only purchase its excess electricity needs from the MCV, to the exclusion of other newly formed small power

producers, it will have frustrated the policy of PURPA that seeks to diversify the sources of electricity production in this country. It appears that it wouldn't be in the public interest to permit Consumers Power to use its monopoly power in the distribution of electricity to discourage the formation of new small power producers because Consumers Power had determined to purchase all its excess energy requirements from the MCV, in which it is a 49% owner. The issue of a electric utility firm using its monopoly position in the distribution of electricity to gain unfair advantage in a competitive electric generation market is similar to the issue of Michigan Bell using its monopoly position in the provision of local exchange services to possibly subsidize the provision of various competitive services, and thereby sell the competitive services to the public at prices below those of their competitors.

Thus, a number of utility companies are presently seeking to diversify into a number of new service markets which are competitive in nature, while retaining their monopoly privilege in their established markets. Such a situation has the potential of lessening the competition in the competitive markets, since the utility companies can seek to earn lucrative profits in the monopoly sector of their business, and transfer a portion of these profits to the competitive services so as to lower the selling prices of these services below those of the competition, with the

eventual result of driving the competition out of business.

With utility companies providing both monopolistic and competitive services concurrently, three possible alternative solutions present themselves for addressing the issue of improper subsidization of the competitive services by the captive users of monopoly services. First, would be the possibility of permitting the monopoly provider of utility services to continue to provide these services on a monopoly basis, while permitting them to entering competitive markets as they desired. At a minimum, this should be done through separate subsidiary corporations, with vigorous traditional rate of return regulation remaining in place as to the monopoly services.

A second alternative, would require utilities to completely divest themselves of their monopoly operations if they desire to enter competitive markets. The potential for unfair subsidization of competitive services by profits derived from the monopoly services demands such a divestiture of the monopoly services before the BOC's can enter into competitive markets. Such a divestiture would probably prevent the potential violation of the anti-trust laws by removing the possibility of a monopolistic business unfairly subsidizing its ventures into competitive markets when its competitors could not have the equivalent advantage of using profits from monopolized services to subsidize their competitive services.

Perhaps, the preferable alternative is to preclude the utilities from having monopoly licenses or franchises, while at the same time permitting entry into competitive markets. If this approach is adopted, then it is appropriate to look at various types of incentive regulation to replace traditional rate of return regulation with regard to the services provided in the market that was traditional monopolized in structure. Incentive regulation needs to encourage utility management to maximize efficiency in providing services directly to the public and provide sufficient inducements for the continued construction of production facilities which enable the provision of these utility services.

CONCLUSIONS

For the telephone industry in Michigan, the 1980's were a momentous period. As a result of the federal anti-trust lawsuit filed against AT&T, Michigan Bell was separated from AT&T and became a subsidiary of Ameritech Corporation, based in Chicago. Upon completion of the divestiture process in 1984, Michigan Bell was essentially limited to providing local exchange telephone service. By court order, Michigan Bell and the other former AT&T operating companies, were precluded from manufacturing telephone equipment or providing data transmission services. The MPSC issued an order in Case No. U-7374 which indicated a concern with the

problems that might potentially result from the divestiture process.

The first problem that concerned the MPSC was the fear that "bypass" might occur and financially harm Michigan Bell in an irreparable manner. Bypass relates to the phenomenon that competitors of Michigan Bell who only provide communications services to business customers, might be able to provide such services at lower rates than Michigan Bell. Michigan Bell claimed that it had to provide communications services to residential customers at lower than cost-justified prices while its competitors were not legally required to provide the more costly residential services. Since Michigan Bell's competitors might be able to skim the cream (i.e. the more profitable business subscribers) of the communications services from Michigan Bell, the result for Michigan Bell would be a tremendous loss of revenues.

Potential loss of business revenues for Michigan Bell due to bypass, gave rise to a second issue for the MPSC in U-7473 that Michigan Bell might substantially raise its rates for residential communications services that are provided in monopoly markets in order to lower rates for its business services offered in the competitive market environment. It was speculated that divestiture might result in the monopolized residential service market subsidizing lower than cost justified rates for competitive business services. Some experts in the telecommunications

field have argued that rates for residential exchange telephone services have not escalated to the extent that was originally feared. However, the basic issue of whether business related communications services subsidize residential telephone services, or vice versa, has never been conclusively resolved. Advocates for both types of users of telephone services vigorously argue for their respective positions, without having adequate cost data at their disposal to justify their respective positions.

It has been argued that the resolution of this dispute is imperative in an era that is moving increasingly toward price deregulation of all services, including, monopoly services. It has been further argued that it would be inappropriate to completely deregulate monopoly services, particularly where the same company provides services in competitive markets and might be tempted to lower its rates in the competitive markets by cross-subsidization of revenues from the monopoly services. A specific proposal for the resolution of this cost allocation controversy has been put forth in this study. The proposal is to measure the amount of telephone calls made by all residential customers and by all business customers on the telephone system at peak calling times. Costs of the existing telephone plant and of future telephone plant would be assigned to the various telephone classes in direct relation to the proportion of the number of telephone calls each

class makes during peak hour calling times. Rates for each telephone user class would be set according to such usage. Such a proposal should be fair and equitable to all telephone users

If monopoly services are to be relieved from traditional rate base regulation, it has been argued that as a matter of public policy incentive regulation should be implemented, rather than complete rate deregulation. It is the position of this writer that historical evidence from the initial years of monopoly services in the late 19th century and the early 20th century support the conclusion that as long as utilities receive a public benefit by being able to provide service in a monopoly market, there should be some scrutiny of the operations of the utilities by the public in the form of rate review. Incentive regulation is a way to provide financial rewards or penalties for utility management for its performance in the marketplace, and yet, not completely abandon the ability for rate review by public officials. Bottom line, incentive regulation means that in return for management flexibility, utility companies must be willing to have their performance evaluated with reference to companies that do business in the competitive marketplace.

The appropriateness of permitting incentive regulation in the energy industry is evidenced by the events surrounding the construction of the Midland nuclear

facility. The energy industry is developing into an industry where energy generation is gradually becoming more competitive, while the distribution of energy remains essentially a monopoly enterprise. Competition in electric generation was one of the goals of PURPA as passed in 1978, which essentially encouraged the development of cogeneration facilities. Electric utilities have essentially fought competition in the area of electric generation by refusing to buy electricity generated by new cogeneration facilities.

Electric utilities are seeking to free themselves from rate regulation in the area of electric generation by taking advantage of PURPA provisions and setting themselves up as cogeneration facilities. Thus, traditional electric utility companies are engaging in the generation of electricity in competitive markets, while providing electricity directly to consumers in legally monopolized service areas. If electric utilities are to be freed of the constraints of traditional rate base regulation, they should not be permitted to enjoy complete deregulation of rates in markets where they have been granted legal monopolies to provide electricity directly to business and residential customers. Again, the alternative of incentive regulation may prove to be the best regulatory tool for the electric utility industry and the public.

This study has provided a review of the history of the rate regulation of Consumers Power in an attempt to arrive

at tentative conclusions as to who should bear the responsibility for the astounding escalation of Midland's construction costs from $256 million for two generating units to $4.1 billion for only one unit, and a $1.5 billion loss on the uncompleted unit. This study is based on the belief that one of the best ways to understand the development of regulatory policy as to the Midland Nuclear Project is to review the perceptive and penetrating dissenting opinions of James Lee, William R. Ralls, Willa Mae King, and Edwyna Anderson. The dissenters were all Democrats, two of which were black females.

Although James Lee was a commissioner in the late 1950's and the early 1960's, and had retired before the commencement of the Midland Nuclear Project, his dissents were to prove to be prophetic regarding the incentives that existed for utility management to build continually larger and more costly generating facilities, regardless of the economic viability of such projects. In his dissenting opinions, Lee analyzed the probable effects of then recently enacted federal tax policies permitting utilities to take accelerated depreciation. Lee projected that the use of accelerated depreciation would induce utility management to continually build larger and larger generating facilities, without necessarily giving proper analysis to the need for or the economic viability of such larger generating facilities. The attitudes of Consumers Power management to

continue to press ahead with the construction of Midland as a nuclear project despite unprecedented cost increases for construction substantiates Lee's predictions expressed twenty years earlier.

Lee's dissenting opinions as to the inappropriateness of permitting utilities to utilize accelerated depreciation for new construction projects is related to the observations made by Hugh Anderson in the early 1980's that large scale generating plants were primarily the result of ill-advised federal and state regulatory policies, rather than the direct result of imprudent utility management decisions or regulatory neglect by the regulators. Accordingly, Anderson proposed certain changes in regulatory policies which he believed would remove the currently existing strong incentives to commence extremely large scale construction projects and to then continue the construction of such projects long after they could no longer be economically justified. With regard to adjustments in regulatory policies, Anderson advocated (1) the repeal of the JDITC, (2) requiring investors rather than ratepayers to finance the full cost of construction, (3) prohibiting the inclusion in rate base of that portion of the cost of completed power plants which exceeded the economic value of the plants, (4) fostering competition within utility service areas, and (5) requiring utilities to wheel power at reasonable rates. While it is true that regulatory policies encouraged the

construction of economically unreasonable and unfeasible generation plants such as Midland, blame for the extraordinary escalation in construction costs of such a project must be borne by utility management, or the regulators, or some combination thereof.

Except for the commissioners who wrote dissenting opinions, the MPSC must bear a portion of the responsibility for the large cost overruns incurred at Midland. At the end of the 1980's, the MPSC basically concluded that Consumers Power management should have abandoned construction at Midland as a nuclear facility in 1981, or possibly no later than 1983. However, it was not until the end of the 1980's that the MPSC voiced the conclusion that the continued construction of Midland into 1984 was an imprudent management decision which the ratepayers of Consumers Power should not have to bear the financial responsibility. If in the late 1970's and early 1980's, the majority of the MPSC had heeded the advice of the dissenters (Ralls, King and Anderson), perhaps much wasteful construction at Midland would have been avoided, to the financial benefit of both the ratepayers and shareholders of Consumers Power. Certainly the dissenters had concluded in the late 1970's and early 1980's that Midland had become a financial albatross around the neck of Consumers Power.

However, under current regulatory law, utility management has the sole responsibility for decisions

regarding the commencement and continuation of utility plant construction, and under traditional rate base regulation procedures the regulators can only evaluate the prudence of construction expenses in later rate cases. In view of these realities, the management of Consumers Power must bear the ultimate responsibility for the financial fiasco at Midland. At the end of the 1980's, traditional rate base regulation has proved to be inadequate for public control of the construction decisions of private utility companies. If privately owned utilities are to continue to enjoy the benefits of monopoly power, regulation to protect the interests of ratepayers is required. In the new energy environment, incentive regulation provides utility management flexibility in decision making and opportunities to be rewarded for success, as well as penalties for poor performance, while enabling regulatory officials on a more frequent basis to keep a closer scrutiny on decisions affecting operations and construction.

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ORAL SOURCE MATERIAL

Interview with Tom Hancock on March 10, 1987. Mr. Hancock is the owner of his own public utility consulting firm. Previously, Mr. Hancock was employed on the staff of the Michigan Public Service Commission from 1955 through the late 1970s. In 1973, Mr. Hancock assumed the position of Chief of Staff of the Michigan Public Service Commission.

Interview with Albert J. Thorburn on August 21, 1984. Mr. Thorburn was engaged in the private practice of law and represented the legal interests of numerous utility companies before the Michigan Public Service Commission from the late 1940s through the late 1980s.

Telephone conference with Hugh B. Anderson, former Assistant Attorney General, May 6, 1987.