EXHIBIT 1

ARTICLE: Problems for Captive Ratepayers in Nonunanimous Settlements of Public Utility Rate Cases

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Author: Stefan H. Krieger *

* Associate Professor of Law, Hofstra University. B.A., University of Chicago; J.D., University of Illinois. I wish to thank James E. Hickey, Jr. and Stephen Fogel for their comments on this manuscript. I also wish to express my gratitude to my research assistants Joy Archer, David Fontana, Robin Chadwick, and Karen Nielsen for their help in preparation of this Article. Finally, I would like to thank Hofstra University for providing me with the research support that made preparation of this Article possible.

LexisNexis Summary

... These standards have been the essential basis for rate base regulation of public utilities. ... Three major statutory arguments have been raised against the nonunanimous settlement process: (1) that commission enabling acts do not permit commission staff to participate in settlement negotiations or, alternatively, do not allow settlement without the consent of governmental intervenors; (2) that statutory provisions allowing for settlements of administrative cases apply only if all parties consent; and (3) that, in the absence of unanimous settlement, enabling acts require full evidentiary hearings. ... But even if there is a lack of unanimity, it may be adopted as a resolution on the merits , if FPC makes an independent finding supported by "substantial evidence on the record as a whole" that the proposal will establish "just and reasonable" rates for the area. ... Edison conjured up the idea of informal, nonunanimous settlements of rate cases only after consumer groups used the formal ratemaking procedures to counterbalance Edison's power with the Commission. ... Even if the commission staff operates in good faith and refrains from any private negotiations with the utility, a commission faces great difficulty in avoiding the appearance of unfairness when it approves a settlement between its staff and the utility, excluding the representatives of a significant segment of ratepayers, such as captive customers, and failing to provide a full hearing on those issues important to the excluded parties. ... Several commissions now consider the range of interests represented by the parties in evaluating the reasonableness of nonunanimous settlements. ... In this age of deregulation, these lessons are significant for captive ratepayers, who seek protection through ratemaking proceedings from utility attempts to shift costs to captive ratepayers in a competitive marketplace.

Highlight

Professor Krieger discusses the recent tendency of public utility commissions to approve nonunanimous settlements of rate cases without full hearings. With the rising interest in alternative dispute resolution methods and the pressing demands of increasingly complex rate cases, a number of public utility commissions have encouraged negotiated settlement of rate cases. In many instances, commissions

have approved these settlements over the strenuous objections of consumer groups. Professor Krieger argues that in the current regulatory environment, the nonunanimous settlement trend poses significant dangers. The nonunanimous settlement process raises the risk that the burden of increased utility prices will be borne disproportionately by captive residential and low-income ratepayers. Professor Krieger concludes that requiring unanimous settlement is necessary to protect these less powerful groups.

Text

[*257] [*258] [*259] Introduction

During the past thirty years, scholars and practitioners have shown an increased interest in the development of alternatives to traditional litigation as a means for resolving disputes. [1] The literature is replete with discussions of various alternative dispute resolution (ADR) mechanisms. These mechanisms include negotiation, mediation, arbitration, mini-trials, and summary jury trials. [2] A number of commentators have noted the advantages these methods have over traditional adjudication. Among these benefits are the saving of time and money; [3] the flexibility and creative [*260] responsiveness of alternative processes; [4] the achievement of results that better serve the needs of the parties; [5] the enhancement of community involvement in the dispute resolution process; [6] the reduction of court caseloads; [7] and broader access to the justice system. [8] Given these purported benefits, proposals have been made suggesting the use of ADR to resolve a wide range of disputes that are

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1 STEPHEN B. GOLDBERG ET AL., DISPUTE RESOLUTION 3-7 (2d ed. 1992); Robert D. Raven, *Alternative Dispute Resolution: Expanding Opportunities*, ARB. J., June 1988, at 44; *see* Kathleen Sampson, Exploring the Issues in Private Judging, Panel Discussion at the American Judicature Society's Annual Meeting (Aug. 7, 1993) (edited transcript), in 77 JUDICATURE 203 (1994); *see also* Talbot D'Alemberte, *ADR Has Come Into Its Own*, ARB. J., Mar. 1991, at 3, 60; Robert B. McKay, *The Many Uses of Alternative Dispute Resolution*, ARB. J., Sept. 1985, at 12 (discussing the "dramatic expansion of ADR"); Richard A. Salem, *The Alternative Dispute Resolution Movement: An Overview*, ARB. J., Sept. 1985, at 3.

2 DONOVAN LEISURE NEWTON & IRVINE, ADR PRACTICE BOOK §§ 1.1-11.7 (John H. Wilkinson ed., 1990 & Supp. 1993); GOLDBERG ET AL., *supra* note 1, at 7-13; *see* SUSAN M. LEESON & BRYAN M. JOHNSTON, ENDING IT: DISPUTE RESOLUTION IN AMERICA (1988); LEONARD L. RISKIN & JAMES E. WESTBROOK, DISPUTE RESOLUTION AND LAWYERS (1987); *see also* JAY FOLBERG & ALISON TAYLOR, MEDIATION: A COMPREHENSIVE GUIDE TO RESOLVING CONFLICTS WITHOUT LITIGATION (1984). *See generally* THE POLITICS OF INFORMAL JUSTICE (Richard L. Abel ed., 1982) [hereinafter POLITICS OF INFORMAL JUSTICE].

3 DONOVAN LEISURE NEWTON & IRVINE, *supra* note 2, §§ 2.2-.3; *see* Tom Arnold, *Fundamentals of Alternative Dispute Resolution: Why Prefer ADR,* in 2 PATENT LITIGATION 1993, at 655 (PLI Pats., Copyrights, Trademarks, & Literary Prop. Course Handbook Series No. 376, 1993); David C. Bergmann, *ADR: Resolution or Complication?*, PUB. UTIL. FORT., Jan. 15, 1993, at 20; Richard M. Berman, Rate Regulation: Cable TV is Ready for ADR, ARB. J., June 1993, at 70, 71 (1993) (discussing the advantages of arbitration); Sampson, *supra* note 1, at 203; Lloyd N. Shields, *Why Attorneys Use ADR*, 41 LA. B.J. 222 (1993). *But see* Gail Bingham & Leah V. Haygood, *Environmental Dispute Resolution: The First Ten Years*, ARB. J., Dec. 1986, at 3, 12-13 (discussing environmental dispute resolution as not being comparable to litigation when evaluating cost and time savings).

4 DONOVAN LEISURE NEWTON & IRVINE, *supra* note 2, § 2.5; *see* Bergmann, *supra* note 3, at 20; Sampson, *supra* note 1, at 203; J. Walton Blackburn, *Environmental Mediation as an Alternative to Litigation*, 16 POL'Y STUD. J. 562, 563 (1988); Raven, *supra* note 1, at 44, 46.

5 GOLDBERG ET AL., *supra* note 1, at 5; *see also* Miriam K. Mills, *Overview and Implications of Alternative Dispute Resolution*, 16 POL'Y STUD. J. 493 (1988).

6 GOLDBERG ET AL., *supra* note 1, at 5; *see also* Alfred A. Marcus et al., *The Applicability of Regulatory Negotiation to Disputes Involving the Nuclear Regulatory Commission*, 36 ADMIN. L. REV. 213, 214 (1984).

7 GOLDBERG ET AL., *supra* note 1, at 5; Bergmann, *supra* note 3, at 20; Sampson, *supra* note 1, at 203.

traditionally adjudicated in the courts. These range from consumer cases [9] and housing disputes [10] to divorce [11] and domestic violence actions. [12] Authors have also called for the use of ADR processes in such complex fields as environmental [13] and nuclear energy regulation. [14] [*261] ADR has recently been touted as an answer to problems in public utility regulation. Traditionally, public utility rates are set in formal adjudicatory hearings in which all parties, primarily utilities and different classes of ratepayers, have the right to present their cases before utility commissions. [15] In the late 1970s and early 1980s, however, commentators began to argue that some provision for informal settlement was needed to address the regulatory delay inherent in the formal process. [16] In the middle and late 1980s, the problem of regulatory delay led state public utility commissions to experiment with informal alternatives to traditional adjudicatory proceedings. [17] By 1990, a commissioner in Colorado, a state that has experimented with ADR, praised informal settlement, observing that it "can provide all the fairness of legal due process and be a more effective means of building long-term relationships which reflect the underlying reality of American public utility regulation as a 'win-win' proposition." [18]

In the context of public utility regulation, however, a unique and disturbing practice has arisen: the nonunanimous or contested settlement. ADR mechanisms have rarely departed from the traditional concept of the litigation model in which all parties must either agree to the resolution of the dispute or at least to the procedures that will lead to that resolution. [19] While some states require unanimous

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[8] GOLDBERG ET AL., *supra* note 1, at 5-7.

[9] *Id.* at 389-91; *see* Ronald J. Adams, *Consumer Complaint Arbitration: The Corporate View*, ARB. J., Dec. 1988, at 41.

[10] *See* Lauren J. Resnick, *Mediating Affordable Housing Disputes* in Massachusetts: Optimal Intervention Points, ARB. J., June 1990, at 15.

[11] *See* Thomas E. Carbonneau, *A Consideration of Alternatives to Divorce Litigation*, 1986 U. ILL. L. REV. 1119; Joyce Hauser-Dann, *Divorce Mediation: A Growing Field?*, ARB. J., June 1988, at 15; Steven T. Knuppel, *Promise and* Problems in Divorce Mediation, 1991 J. DISP. RESOL. 127; David Singer, *Mediation -- A Growing Means for Settling Divorce Conflicts*, ARB. J., Dec. 1992, at 21.

[12] Karla Fischer et al., *The Culture of Battering and the Role of Mediation* in Domestic Violence Cases, 46 SMU L. REV. 2117 (1993).

[13] *See* Douglas J. Amy, *The Politics of Environmental Mediation*, 11 ECOLOGY L.Q. 1 (1983); Blackburn, *supra* note 4; Stephen Crable, *ADR: A Solution for Environmental Disputes*, ARB. J., Mar. 1993, at 24; Alfred Levinson, *Environmental Dispute Resolution and Policy Making*, 16 POL'Y STUD. J. 575 (1988); John P. McCrory, *Environmental Mediation -- Another Piece for the Puzzle*, 6 VT. L. REV. 49 (1981); Barry G. Rabe, *The Politics of Environmental Dispute Resolution*, 16 POL'Y STUD. J. 585 (1988); David Singer, *The use of ADR Methods* in Environmental Disputes, ARB. J., Mar. 1992, at 55; Bruce Stiftel & Neil G. Sipe, *Mediation of Environmental Enforcement: Overcoming Inertia*, 1992 J. DISP. RESOL. 303; Lawrence Susskind, *Environmental Mediation and the Accountability* Problem, 6 VT. L. REV. 1 (1981).

[14] *See, e.g.*, Marcus et al., *supra* note 6.

[15] *See infra* notes 65-89.

[16] *See, e.g.*, Thomas D. Morgan, *Toward a Revised Strategy for Ratemaking*, 1978 U. ILL. L.F. 21, 22, 76-78; *see infra* notes 115-116 and accompanying text.

[17] *See, e.g.*, In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660 (Ind. Pub. Serv. Comm'n 1986); In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23 (N.Y. Pub. Serv. Comm'n 1986); In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407 (Ohio Pub. Util. Comm'n 1989).

[18] Ronald L. Lehr, *Regulatory Negotiations*, PUB. UTIL. FORT., Sept. 13, 1990, at 20, 25.

[19] *See generally* WALTER A. MAGGIOLO, TECHNIQUES OF MEDIATION 95-103 (1985); PAUL PRASOW & EDWARD PETERS, ARBITRATION AND COLLECTIVE BARGAINING: CONFLICT RESOLUTION IN LABOR RELATIONS 1-16 (1970).

consent before allowing settlements of rate cases, [20] many public utility commissions have abandoned the traditional predicate for settlement, unanimity, and have approved rate [*262] case settlements to which several of the parties have not given their assent. [21] As long as the utility and perhaps one or two other parties reach an agreement with the commission staff, [22] these commissions are willing to approve the agreement and to forgo the requirement of a full evidentiary hearing. They reason that such a procedure is necessitated by the sheer number of parties involved in rate cases and the ability of a single party to obstruct an otherwise reasonable settlement. Accordingly, these commissions see the oxymoronic notion of a nonunanimous or contested settlement as the only realistic means of implementing the settlement process in these cases. [23]

The danger of such an approach is obvious. Parties with a substantial interest in a utility proceeding can be left out of the decision-making process. Although commissions that permit nonunanimous settlements require review of these settlements to determine their reasonableness, [24] these commissions often defer to the decision of the consenting parties. [25] The utility can come to the bargaining table with a proposal, walk away from negotiations whenever it finds the counterproposal of some other party objectionable, continue discussions with the commission staff, and then present to the commission an agreement with the staff as a settlement. Furthermore, in their zeal to reap the benefits of the nonunanimous settlement process, commissions shift the burden of proof to the nonconsenting parties by forcing them to prove the unreasonableness of [*263] the settlement. While both traditional regulatory hearings and the unanimous settlement process provide protection for all parties, the nonunanimous settlement process places some parties at a severe disadvantage.

Data on reported commission cases show an increase over the past decade in the use of the nonunanimous settlement mechanism to decide rate cases. A vast majority of those cases terminated in settlements to which consumer groups were nonconsenting parties. [26] Of the twenty-four reported general rate cases in which nonunanimous settlements have been approved by commissions, only one

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[20] Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693, 704-5 (Ill. 1989); Kentucky Am. Water Co. v. Kentucky ex rel. Cowan, 847 S.W.2d 737 (Ky. 1993); Missouri ex rel. Monsanto Co. v. Public Serv. Comm'n, 716 S.W.2d 791 (Mo. 1986); Missouri ex rel. Fischer v. Public Serv. Comm'n, 645 S.W.2d 39 (Mo. Ct. App. 1982).

[21] *See, e.g.,* In re Potomac Elec. Power Co., 81 Pub. Util. Rep. 4th (PUR) 587, 597-98 (D.C. Pub. Serv. Comm'n 1987); In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660 (Ind. Pub. Serv. Comm'n 1986); In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 352-53 (Ky. Pub. Serv. Comm'n 1989); In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23 (N.Y. Pub. Serv. Comm'n 1986); In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407 (Ohio Pub. Util. Comm'n 1989); In re El Paso Elec. Co., 101 Pub. Util. Rep. 4th (PUR) 405, 409-10 (Tex. Pub. Util. Comm'n 1988).

[22] The vast majority of states have three or four member commissions that are either appointed by the governor, selected by the legislature, or elected by popular vote. CHARLES F. PHILLIPS, JR., THE REGULATION OF PUBLIC UTILITIES 119 (1985). Commissions hire expert staff to advise them on technical ratemaking issues. *See infra* note 106.

[23] *See, e.g.,* In re Rules of Practice & Procedure Before the Comm'n, 112 Pub. Util. Rep. 4th (PUR) 215, 218 (Mich. Pub. Serv. Comm'n 1990).

[24] *See, e.g.,* In re Rules of Practice & Procedure Before the Comm'n, 112 Pub. Util. Rep. 4th (PUR) 215, 229 (Mich. Pub. Serv. Comm'n 1990); In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407, 450 (Ohio Pub. Util. Comm'n 1989); In re El Paso Elec. Co., 101 Pub. Util. Rep. 4th (PUR) 405, 409 (Tex. Pub. Util. Comm'n 1991).

[25] *See* cases cited *supra* note 17.

[26] These data were obtained by reviewing nonunanimous settlement cases reported in Public Utilities Reports and on Lexis and Westlaw. The research was restricted to general rate cases, those in which a commission considered the overall revenue requirement of the utility and the allocation of that requirement among the different customer classes. Although commissions have used the

was decided prior to 1980, four were decided between 1980 and 1985, and the remainder were decided after 1985. [27] A significant number of these settlements arose in the context [*264] proceedings addressing the rate treatment for expenses of recently constructed or canceled plants, particularly nuclear generating facilities. [28] In seventeen of the twenty-four cases, no consumer group was a signatory to the nonunanimous settlement; in three cases, one or more consumer groups did not agree to the settlement; and in only four cases other groups, such as industrial intervenors, were the sole nonconsenting parties. [29] To date, sixteen state commissions and the District of Columbia [*265]

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nonunanimous settlement mechanism in limited-issue rate cases, such as those involving the rate impact of changes in tax laws, the research encompasses only general rate cases because of their significant impact on ratepayers.

[27] For an explanation of general rate cases, see *supra* note 26. The twenty-four cases include the following commission proceedings: In re Arkansas La. Gas Co., 141 Pub. Util. Rep. 4th (PUR) 319 (Ark. Pub. Serv. Comm'n 1992), *aff'd* Bryant v. Arkansas Pub. Serv. Comm'n, 877 S.W.2d 594 (Ark. Ct. App. 1994); In re Pacific Gas & Elec. Co., 99 Pub. Util. Rep. 4th (PUR) 141 (Cal. Pub. Util. Comm'n 1988); In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660 (Ind. Pub. Serv. Comm'n 1986); In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348 (Ky. Pub. Serv. Comm'n 1989), *rev'd sub nom.* Kentucky ex rel. Cowan v. Kentucky Pub. Serv. Comm'n, 120 Pub. Util. Rep. 4th (PUR) 168 (Ky. Cir. Ct. 1991), *aff'd sub nom.* Louisville Gas & Elec. Co. v. Kentucky ex rel. Cowan, 862 S.W.2d 897 (Ky. Ct. App. 1993); In re Washington Gas & Light Co., No. 8545, Order No. 70658 (Md. Pub. Serv. Comm'n 1993); In re Detroit Edison Co., 39 Pub. Util. Rep. 4th (PUR) 107 (Mich. Pub. Serv. Comm'n 1980); In re UtiliCorp United, Inc., No. ER-93-37 (Mo. Pub. Serv. Comm'n June 18, 1993); In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23 (N.Y. Pub. Serv. Comm'n 1986); In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407 (Ohio Pub. Util. Comm'n 1989); In re Portland Gen. Elec. Co., 86 Pub. Util. Rep. 4th (PUR) 463 (Or. Pub. Util. Comm'n 1987); Pennsylvania Pub. Util. Comm'n v. Peoples Natural Gas Co., 1992 WL 315144 (Pa. Pub. Util. Comm'n 1992); In re Houston Lighting & Power Co., 134 Pub. Util. Rep. 4th (PUR) 303 (Tex. Pub. Util. Comm'n 1991); In re El Paso Elec. Co., 101 Pub. Util. Rep. 4th (PUR) 405 (Tex. Pub. Util. Comm'n 1988), *aff'd*, City of El Paso v. Public Util. Comm'n, No. D-3053, 1994 WL 278111 (Tex. June 22, 1994); In re Virginia Elec. & Power Co., 76 Pub. Util. Rep. 4th (PUR) 580 (W. Va. Pub. Serv. Comm'n 1986); In re Hope Natural Gas Co., 51 Pub. Util. Rep. 4th (PUR) 431 (W. Va. Pub. Serv. Comm'n 1983).

Information on the remaining cases was obtained from opinions involving judicial review of commission approval of nonunanimous settlements. *See* United States v. Public Serv. Comm'n, 465 A.2d 829 (D.C. 1983); Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693 (Ill. 1990); Kentucky Am. Water Co. v. Kentucky ex rel. Cowan, 847 S.W.2d 737 (Ky. 1993); Missouri ex rel. Monsanto Co. v. Public Serv. Comm'n, 716 S.W.2d 791 (Mo. 1986); Missouri ex rel. Fischer v. Public Serv. Comm'n, 645 S.W.2d 39 (Mo. Ct. App. 1982); Attorney Gen. v. New Mexico Pub. Serv. Comm'n, 808 P.2d 606 (N.M. 1991); City of Somerville v. Public Util. Comm'n, 865 S.W.2d 557 (Tex. Ct. App. 1993); City of Abilene v. Public Util. Comm'n, 854 S.W.2d 932 (Tex. Ct. App. 1993); In re New England Tel. & Tel. Co., 382 A.2d 826 (Vt. 1977).

[28] *See, e.g.*, Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693 (Ill. 1989); In re Pacific Gas & Elec. Co., 99 Pub. Util. Rep. 4th (PUR) 141 (Cal. Pub. Serv. Comm'n 1988); In re Public Serv. Co., 92 Pub. Util. Rep. 4th (PUR) 660 (Ind. Pub. Serv. Comm'n 1986); In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348 (Ky. Pub. Serv. Comm'n 1989); In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23 (N.Y. Pub. Serv. Comm'n 1986); In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407 (Ohio Pub. Util. Comm'n 1989); In re El Paso Elec. Co., 101 Pub. Util. Rep. 4th (PUR) 405 (Tex. Pub. Util. Comm'n 1991); In re Houston Lighting & Power Co., 134 Pub. Util. Rep. 4th (PUR) 303 (Tex. Pub. Util. Comm'n 1991).

[29] In the following cases, no consumer group was a signatory party to the nonunanimous settlement: Business & Professional People for Pub. Interest, 555 N.E.2d 693 (Ill. 1990); Kentucky Am. Water Co., 847 S.W.2d 737 (Ky. 1993); Attorney Gen. v. New Mexico Pub. Serv. Comm'n, 808 P.2d 606 (N.M. 1991); City of Somerville Public Util. Comm'n, 865 S.W.2d 557 (Tex. Ct. App. 1993); City of Abilene Public Util. Comm'n, 854 S.W.2d 932 (Tex. Ct. App. 1993); In re New England Tel. & Tel. Co., 382 A.2d 826 (Vt. 1977); In re Arkansas La. Gas Co., 141 Pub. Util. Rep. 4th (PUR) 319 (Ark. Pub. Serv. Comm'n 1992); In re Pacific Gas & Elec. Co., 99 Pub. Util. Rep. 4th (PUR) 141 (Cal. Pub. Util. Comm'n 1992); In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348 (Ky. Pub. Serv. Comm'n 1989); In re Detroit Edison Co., 39 Pub. Util. Rep. 4th (PUR) 107 (Mich. Pub. Serv. Comm'n 1980); In re UtiliCorp United, Inc., No. ER-93-37 (Mo. Pub. Serv. Comm'n 1993); In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23 (N.Y. Pub. Serv. Comm'n 1986); In re Portland Gen. Elec. Co., 86 Pub. Util. Rep. 4th (PUR) 463 (Or. Pub. Util. Comm'n 1987); In re Houston Lighting & Power Co., 134 Pub. Util. Rep. 4th (PUR) 303 (Tex. Pub. Util. Comm'n 1991); In re El Paso Elec. Co., 101 Pub. Util. Rep. 4th (PUR) 405 (Tex. Pub. Util. Comm'n 1991); In re Virginia Elec. & Power Co., 76 Pub. Util. Rep. 4th (PUR) 580 (W. Va. Pub. Serv. Comm'n 1986); In re Hope Natural Gas Co., 51 Pub. Util. Rep. 4th (PUR) 431 (W. Va. Pub. Serv. Comm'n 1983).

Commission have recognized the validity of nonunanimous settlement of rate cases. [30] Six of those commissions have gone so far as to adopt formal rules providing procedures for approval of such settlements. [31]

In those states in which the nonunanimous settlement of rate cases is allowed, use of the process is likely to continue. The recent deregulation of the electric and telecommunications industries will contribute to this trend. Commissions confronted with the very difficult ratemaking issues raised by deregulation may seek alternatives to traditional adjudication, as they did in handling the nuclear plant controversies.

With deregulation, commissions are faced with the complex issue of the allocation of costs between basic service customers, such as lowincome families, who do not have access to alternative sources of service (captive customers), and customers who do have such access. This problem is particularly severe for electric utilities with substantial sunk [*266] costs in generating plants. With the advent of retail wheeling, [32] utilities that wish to retain their large industrial customers will need to set prices for these customers that are competitive with lower cost alternatives provided by independent producers and other utilities. [33] They will thus attempt to shift as many costs as possible onto captive ratepayers in order to remain competitive. Similarly, in the telecommunications area, local companies may want to shift a large portion of shared costs onto captive customers in order to remain in competition for the business of large customers. Such cost-shifting may occur even though some of these costs are attributable to non-basic services, [34] from which the captive customers derive no benefit. The

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In the following cases, at least one consumer representative was a nonsignatory, but other consumer groups did agree to the settlement: Missouri ex rel. Fischer v. Public Serv. Comm'n, 645 S.W.2d 39 (Mo. Ct. App. 1982); In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660 (Ind. Pub. Serv. Comm'n 1986); In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407 (Ohio Pub. Util. Comm'n 1989).

In the following cases, the sole nonconsenting parties were nonconsumer groups: United States v. Public Serv. Comm'n, 465 A.2d 829 (D.C. 1983); Missouri ex rel. Monsanto Co. v. Public Serv. Comm'n, 716 S.W.2d 791 (Mo. 1986); In re Washington Gas Light Co., 84 MD PSC 274 (Md. Pub. Serv. Comm'n 1993) (No. 8545, Order No. 70658); Pennsylvania Pub. Util. Comm'n v. Peoples Natural Gas Co., 1992 WL 315144 (Pa. Pub. Util. Comm'n 1990).

[30] The states in which commissions have recognized the validity of nonunanimous settlements are Arkansas, California, Indiana, Illinois, Kentucky, Maryland, Michigan, Missouri, New Mexico, New York, Ohio, Oregon, Pennsylvania, Texas, Vermont, and West Virginia. *See supra* note 27.

[31] In re Commission's Rules of Practice & Procedure, 29 CPUC 2d 392 (Cal. Pub. Util. Comm'n Sept. 28, 1988) (Nos. 88-09-060, 84-12-0281); Rules of Practice & Procedure, Case No. 712, Order No. 10048, 1992 WL 548031 (D.C. Pub. Serv. Comm'n 1992); In re Rules of Practice & Procedure Before the Comm'n, 112 Pub. Util. Rep. 4th (PUR) 215 (Mich. Pub. Serv. Comm'n 1990); In re Rules of Practice & Procedure, No. 110, 1993 WL 562148 (N.M. Pub. Util. Comm'n Oct. 4, 1993); In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992); MO. CODE REGS. tit. 4, § 240-2.115; *see also* 15 Tex. Reg. 6101 (Oct. 19, 1990) (proposed amendment to TEX. ADMIN. CODE tit. 16, §§ 21.201-21.208 setting forth nonunanimous settlement procedures which were never adopted).

[32] Under retail wheeling a local utility is required to deliver the power of another utility or independent producer for a fixed transmission charge. *See* Phillip S. Cross, *Retail Wheeling -- Happy Motoring for State Regulators?*, PUB. UTIL. FORT., June 15, 1994, at 46.

[33] *See generally* Suedeen G. Kelly, *Overview,* in XVI PUB. UTIL. ANTHOLOGY xvii, xix-xx (Allison P. Zabriskie ed., July-Dec. 1993).

[34] *See generally* Mark E. Meitzen, *Shared Costs and the Cash Cow Debate: Who Gets Milked*, PUB. UTIL. FORT., Apr. 1, 1991, at 32, 33.

intensification of competition in the utility industry will make the allocation of costs between captive and noncaptive ratepayers one of the main issues at stake in ratemaking proceedings. [35]

The use of the nonunanimous settlement mechanism may have a significant effect on how these costs are allocated. Commissions, wishing to avoid contentious and lengthy hearings, may choose to defer to settlements reached among the utility, the staff, and large customers. However, if nonunanimous settlements which are opposed by representatives of captive ratepayers are approved without full adjudicatory hearings, the interests of many customers will be ignored.

This Article will examine the use of nonunanimous settlement procedures by public utility commissions in light of the problems inherent in such procedures, with particular regard to the plight of captive ratepayers. [36] First, the Article will present a brief history of the [*267] development of rate regulation by state public utility commissions. It will then describe the factors that led to the emergence of nonunanimous settlements in utility rate proceedings and examine the statutory authority for allowing such settlements. Next, it will analyze the benefits and deficiencies of nonunanimous settlement as a dispute resolution mechanism, with special attention to the problems of captive ratepayers. Finally, the Article will recommend that the courts and commissions reject the nonunanimous settlement process as a method for resolving rate cases.

I. The Historical Development of Rate Base Regulation

The history of rate base regulation -- the traditional method for setting utility rates -- is a saga of a search for workable procedures and standards to balance the power between regulated industries and their consumers. The early development of the independent regulatory commission movement in America was tied to problems of railroad supervision and control. The present public service and utility commissions are, for the most part, the outgrowth of railroad commissions established to deal with the problems of railroad power. [37] Initially, railroads wielded tremendous economic power over their customers. In response, customers sought relief from state legislatures. When these forums proved to

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[35] *See* Richard J. Rudden & Robert Hornick, *Electric* Utilities in the Future, Competition is Certain, the Impact is Not, PUB. UTIL. FORT., May 1, 1994, at 21, 23.

[36] Because of the different political contexts of federal and state ratemaking, this Article confines its analysis to nonunanimous settlements of rate cases in state public utility proceedings. The notion of nonunanimous settlements of rate cases originated in federal regulation of wholesale rates. *See* Mobil Oil Co. v. Federal Power Comm'n, 417 U.S. 283 (1974); Pennsylvania Gas & Water Co. v. Federal Power Comm'n, 463 F.2d 1242 (D.C. Cir. 1972); Lexington v. Federal Power Comm'n, 295 F.2d 109 (4th Cir. 1961). State commissions and courts have relied on federal cases to support their approval of such settlements. *See infra* notes 120, 162-186 and accompanying text. *But see* Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693 (Ill. 1990) (noting that the *Mobil* case "dealt with Federal law and a Federal agency; Federal procedures are not necessarily consistent with Illinois law and procedures.") Id. at 704. In the federal environment, because the consumers are usually large public utilities, the balance of power among the parties is much more even than in the state context.

The Article also limits discussion to rate-related cases. ADR procedures have also been encouraged in rulemaking and investigatory proceedings. *See* Evan van Hook, Note, *Conservation Through Cooperation: The Collaborative Planning Process for* Utility Conservation and Load Management, 102 YALE L.J. 1235 (1993). However, the impact of the use of those procedures on the balance of power in the commission has not been significant.

Finally, the Article does not address the issue of whether regulation, rather than the market, is the best method for setting public utility rates. *See generally* Bernard S. Black & Richard J. Pierce, Jr., *The Choice Between Markets and Central Planning* in Regulating the U.S. Electricity Industry, 93 COLUM. L. REV. 1339 (1993). The Article assumes that the regulatory system is the place in which rates are set and considers the proper use of ADR within such a system.

[37] HENRY C. SPURR, 1 GUIDING PRINCIPLES OF PUBLIC SERVICE REGULATION 9 (1924).

be inadequate for continuous regulation of railroads, legislatures created independent commissions to regulate the industry. However, when state legislatures and commissions began to assert significant control over railroads, the [*268] railroads sought in the federal courts to regain their power. As a result of these efforts, the Supreme Court ultimately balanced the competing interests of the industry and consumers by allowing commissions substantial authority to regulate railroads as long as they adhered to certain formal standards which protected the rights of railroad stockholders. These standards have been the essential basis for rate base regulation of public utilities.

A. *The Growth of Independent Regulatory Commissions*

Before the 1870s, railroads possessed substantial economic leverage over their customers, causing customers to respond by seeking legislative protection. The legislatures began to place sharp restrictions in railroad charters they granted. [38] As a result, numerous charters contained provisions fixing maximum rates, [39] and some even went so far as to determine rates by a sliding scale that varied inversely with railroad profits. [40] This form of regulation soon proved to be inadequate because of its inflexibility. Economic conditions were constantly changing as modern technology was being developed, necessitating a more dynamic regulatory response. Charter provisions could not easily be changed to meet new and unforeseen situations, making a dynamic regulatory process [*269] impossible. [41]

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[38] As early as 1836, the Massachusetts legislature reserved to itself the authority to modify railroad rates. PAUL RODGERS, THE NARUC WAS THERE: A HISTORY OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS 3 (1979). The legislature carved out the ratemaking power from the charters it granted to each railroad. The Massachusetts Legislature, for example, enacted a special statute to incorporate the Hartford & Springfield Rail-Road Corporation:

> The Legislature may, after the expiration of five years from the time when the said rail-road shall be opened for use, from time to time, alter or reduce the rate of tolls or other profits upon said road; but the said tolls shall not, without the consent of said corporation, be so reduced as to produce, with said profits, less than ten percent per annum.

1839 Mass. Acts. ch. 101, § 5.

[39] SPURR, *supra* note 37, at 2 (stating "maximum rate statutes were quite the rage at one time"); *see also* Rates of Fare & Freight, 1874 Iowa Acts 61 (setting reasonable maximum rates for the transportation of freight and passengers on the different railroads of the state).

[40] *See* Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

[41] *See* PHILLIPS, *supra* note 22, at 112. Maximum rate statutes were often passed without adequate consideration of the problems involved and without knowledge of the circumstances that the individual company faced. As a result, the statutes were often arbitrary and unfair. *See* SPURR, *supra* note 37, at 2.

Attempts at municipal regulation also proved ineffective. Municipalities relied primarily on franchise agreements as a means of exercising control over railroads. Before a company could commence operation, it had to acquire a franchise from the city council. The franchise usually set exact standards for service to be rendered and rates to be charged. *See generally* HERMAN H. TRACHEL, PUBLIC UTILITY REGULATION (1950); DELOS F. WILCOX, MUNICIPAL FRANCHISES (1910). However, a franchise had the status of a contract which a state could not impair without the grantee's approval. *See* Trustees of Dartmouth College, 17 U.S. (4 Wheat.) at 518. Therefore, it was often impossible for franchises to be changed regardless of how "ill-considered or antiquated with respect to current needs for regulation they might be." BURTON N. BEHLING, COMPETITION AND MONOPOLY IN PUBLIC UTILITY INDUSTRIES 24 (1938). Predictably, the companies resisted downward rate changes, and the municipalities resisted upward adjustments. As a result, especially where exclusive franchises were issued, municipalities "found themselves in the disagreeable situation of having bargained away their right to allow competition without having retained effective control over rates and service." *Id.* at 25. Furthermore, the agreements often failed to provide the administrative machinery needed to ensure that the company fulfilled the

When it became clear that the job of railroad regulation could not be handled effectively by the legislature, consumers demanded more stringent and continuous control to offset the power of the companies. In response, legislatures created independent commissions to regulate the industry. Under pressure from the Granger movement, a number of states, beginning with Illinois, enacted laws that fixed rates for transportation, grain elevators, and warehouses. [42] In 1869, the Illinois legislature passed the first of the Granger Laws, which required rates to be just and reasonable. However, this Act failed to provide an effective means for enforcement of its provisions. [43] Finally, in 1873, the Railroad and **[*270]** Warehouse Commission gained the power to issue a schedule of maximum rates and, more importantly, to prosecute violations of the Act. [44]

The companies fought back against this assertion of regulatory power, but initially they were unsuccessful. In *Munn v. Illinois*, [45] grain elevator owners charged that the Illinois legislature's attempt to set maximum rates was a violation of the Fourteenth Amendment. The Supreme Court rejected this challenge, observing:

> Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good. [46]

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terms of its contract. PHILLIPS, *supra* note 22, at 113. Thus, franchise regulation, like regulation by charter provisions, did not provide a flexible remedy for the problems of excessive railroad power.

[42] Between 1871 and 1874, Illinois, Iowa, Minnesota, and Wisconsin enacted Granger legislation imposing stringent rate and service regulations on railroads, grain elevators, and warehouses. Even though the Granger laws were eventually repealed in every state except Illinois, they established a pattern that other states followed. RODGERS, *supra* note 38, at 4; *see also* Charles F. Adams, Jr., *The Granger Movement*, 120 N. AM. REV. 394 (1875); Charles R. Dietrick, *The Effects of the Granger Acts*, 11 J. POL. ECON. 237 (1903); A.E. Paine, *The Granger Movement* in Illinois, 1 U. ILL. STUD. 335 (1905).

[43] Act of Mar. 10, 1869, §§ 1-7, 1869 Ill. Laws 309-12 (statute only provided for criminal penalties against officers, agents, or employees of the company who wilfully or knowingly violated the act); ROBERT E. CUSHMAN, THE INDEPENDENT REGULATORY COMMISSIONS 26 (1941). In 1871, Illinois created the Board of Railroad and Warehouse Commissioners, which was charged with enforcing the laws regulating railroads and grain elevators. Board of Railroad & Warehouse Commissioners Act of Apr. 13, 1871, §§ 1-19, 1871 Ill. Laws 618-24. This statute, however, provided no procedure to enforce the Commissioners' powers. *See generally* ALEXANDER DAVIDSON & STUVE BERNARD, COMPLETE HISTORY OF ILLINOIS FROM 1873 TO 1884 (1884) (discussing Granger railroad legislation and the political aspects of the Granger movement in Illinois).

[44] Act of May 2, 1873, 1873 Ill. Laws 136-60.

[45] 94 U.S. 113 (1876). In 1874, fourteen grain storage plants operated in Chicago. The plants were owned by approximately thirty people and were controlled by nine companies. The leaders of the nine firms periodically met in order to agree on grain storage rates. The defendants were convicted and fined for charging rates in excess of those fixed pursuant to the Act. The court concluded that the owners had a "virtual monopoly." Id. at 131.

For a description of the arguments against the Granger laws, see generally FRANK HENDRICK, RAILWAY CONTROL BY COMMISSIONS 161 (1900) (condemning Granger laws); W.M. Grosvenor, *The Communist and the Railway*, 4 INT'L REV. 585 (1877) (arguing that Granger legislation was communistic).

[46] 94 U.S. at 126.

In upholding the Act, the Court "laid the cornerstone of modern regulation" and "placed a powerful weapon in the hands of the states." [47] Between 1870 and 1890, a large number of states followed Illinois' lead and established railroad commissions with the power to fix rates and enforce orders. [48] These commissions had two types of powers. First, [*271] they had the authority to oversee railroads. This power allowed the commissions to ensure that the railroads complied with the law by inspecting railroads for safety, investigating accidents, examining company accounts, and compelling disputants and witnesses to testify under oath. More importantly, these commissions could set reasonable and nondiscriminatory railroad rates. By law, a rate established by the commission was prima facie reasonable in any suit between a railroad and any shipper. [49] Moreover, the attorney general and, in certain circumstances, the commission could bring suit to enforce the rates established by the commission. [50]

B. *Judicial Restraints on Regulation by Independent Commission*

In the political battle between railroads and consumers, the *Munn* decision gave state legislatures substantial power to regulate railroads and other companies "affected with the public interest." [51] The railroads, [*272] however, maintained their attacks in the courts on legislative regulation. In *Chicago, Milwaukee & St. Paul Railway Co. v. Minnesota*, [52] one railroad challenged a Minnesota statute establishing a railway commission with the power to determine "equal and reasonable rates." Under the statute, if a railroad refused to obey a rate reduction order, the Commission had the authority to seek a writ of mandamus from the state court. When the Commission sought the writ against a railroad, the

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47 RODGERS, *supra* note 38, at 4; *see also* Walton H. Hamilton, *Affectation with* Public Interest, 39 YALE L.J. 1089 (1930); Breck P. McAllister, *Lord Hale and the Business Affected with a* Public Interest, 43 HARV. L. REV. 759 (1930).

48 *See, e.g.*, Act of Mar. 2, 1889, ch. 192, 1889 Kan. Sess. Laws 284-86 (giving conditional powers to the Board of Railroad Commissioners); Railroads and Other Common Carriers, ch. 124, 1883 Kan. Sess. Laws 186-96; Act of Mar. 7, 1887, ch. 10, 1887 Minn. Carriers, ch. 124, 1883 Kan. Sess. Laws 186-96; Act of Mar. 7, 1887, ch. 10, 1887 Minn. Laws 49-66 (regulating common carriers and creating the Railroad and Warehouse Commission); Act of Mar. 11, 1884, ch. XXIII, 1884 Miss. Laws 31-44 (regulating railroad rates and creating a railroad commission); Act of Mar. 29, 1875, 1875 Mo. Laws 112-19 (regulating charges of railroad companies and providing for railroad commissioners); Act of Sept. 14, 1883, ch. 101, 1883 N.H. Laws 78-81 (establishing a Board of Railroad Commissioners). The financial panic of 1873 placed many railroads in financial difficulty. Because the panic occurred at the same time that the strong commissions were being established, public opinion turned against the commissions. As a result, many of the newlyformed commissions were abolished or converted to playing an advisory role. However, this trend was short lived. By 1887, ten states had established strong commissions with rate making and enforcement power. These states were: Alabama, California, Georgia, Illinois, Kansas, Minnesota, Mississippi, Missouri, New Hampshire, and South Carolina. *See* CUSHMAN, *supra* note 43, at 27; MARTIN G. GLAESER, PUBLIC UTILITIES IN AMERICAN CAPITALISM 64 (1957).

49 *See, e.g.*, Chicago B. & Q. R.R. v. Jones, 37 N.E. 247, 249 (Ill. 1894); St. Paul Ass'n of Commerce v. Chicago B & Q. R.R., 158 N.W. 982, 984 (Minn. 1916). *See generally* CUSHMAN, *supra* note 43, at 27.

50 CUSHMAN, *supra* note 43, at 27. While the strong commissions had the power to set rates and issue orders, they were dependent on the courts for the enforcement of those orders. *Id.* at 32.

51 Neil N. Bernstein, Utility Rate Regulation: The Little Locomotive That Couldn't, 1970 WASH. U. L.Q. 223, 231-32.

> The state had only to determine that the circumstances with respect to a particular business warranted the imposition of some form of price control and 'if a state of facts could exist that would justify such legislation,' the courts would assume that it did exist. Under those circumstances, *Munn* seemed to say, the property owner was at the mercy of the legislature. This was consistent relations, there was no limitation on the police power of the states.

Id. (footnotes omitted).

52 134 U.S. 418 (1890).

company attempted to defend itself by showing that the reduced rates were not equal and reasonable. The state court, however, held that the Commission's decision was unreviewable because the statute had made the Commission's decision "final and conclusive." [53]

The Supreme Court reversed, holding that the statute was unconstitutional:

> In the present case, the railroad alleged that the rate of charge fixed by the commission was not equal or reasonable, and [the Minnesota] Supreme Court held that the statute deprived the company of the right to show that judicially. The question of the reasonableness of a rate of charge for transportation by a railroad company, involving as it does the element of reasonableness both as regards the company and as regards the public, is eminently a question for judicial investigation, requiring due process of law for its determination. If the company is deprived of the power of charging reasonable rates for the use of its property, and such deprivation takes place in the absence of an investigation by judicial machinery, it is deprived of the lawful use of its property, and thus in substance and effect, of the property itself, without due process of law . . . . [54]

[*273] While in *Munn*, consumers had won a major victory which gave state legislatures the power to regulate public utilities, the *Chicago, Milwaukee* decision limited that power by affording companies the right to a full judicial hearing before they were required to comply with a rate order.

The power of state legislatures was further limited by the Supreme Court's 1898 decision in *Smyth v. Ames*, [55] in which it set constitutional standards for the reasonableness of rates. In that case, railroad stockholders challenged a legislative reduction in rates as confiscatory, resulting in an actual taking of their property without fair compensation in violation of constitutional due process. [56] The Court held:

> [T]he basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And, in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such

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[53] Id. at 457.

[54] Id. at 457-58. Three justices dissented, observing: "[The decision] practically overrules *Munn v. Illinois* . . . and the several railroad cases that were decided at the same time. The governing principle of those cases was that regulation and settlement of fares of railroads and other public accommodations is a legislative prerogative and not a judicial one." Id. at 461 (dissenting opinion).

[55] 169 U.S. 466 (1898).

[56] The doctrine that state rate fixing must not be confiscatory was originally pronounced in Stone v. Farmers' Loan & Trust Co., 116 U.S. 307, 331 (1886) (holding that "[u]nder 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 use without just compensation, or without due process of law.").

weight as may be just and right in each case . . . What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. [57]

[*274] This decision set the constitutional standard that a utility is entitled to a fair rate of return on its property. At the same time, the case created standards to counterbalance consumers' disproportionate political clout with state legislatures. The Court assumed that legislatures and their designees were subject to political pressure from the public and would safeguard the rights of consumers. [58] The Court hoped "to protect the utility owner whose voice was not heeded by the legislature and to ensure that the rates were not too low from his standpoint." [59]

With *Smyth*, a balance was struck between the power of the railroads and the power of their customers. While initially the railroads dominated their customers, consumers fought back and achieved direct statutory regulation and then the creation of commissions with authority to establish rates and to enforce them. Facing these consumer victories, railroad stockholders feared that unlimited control by legislatures could make their investments worthless. [60] Motivated by this fear, they counterattacked in the courts. Although the courts recognized the authority of state legislatures to regulate railroads and other public utilities, they also recognized the right of the railroads to a fair return.

The *Smyth* and *Chicago, Milwaukee* decisions set the standards from which the modern system of rate regulation developed. The *Chicago, Milwaukee* decision required that a utility be accorded a full hearing before it could be compelled to comply with a state rate order. Under *Smyth*, no state could confidently issue a rate order unless it could prove to a court that the rates provided the utility with a fair return on fair value. In order to arrive at a fair profit to be covered by rates for the use of the plant, the state needed to determine the value of the physical plant used by the utility. [61] The new mandate necessitated regulation by commission rather than by direct legislative action. [62] Commissions could implement the due process hearings mandated by *Chicago, Milwaukee*, and at the same time could provide an efficient forum for the valuation [*275] of property required by *Smyth*. [63] The requirements of full hearings and the adherence to particular constitutional standards for ratemaking assured

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[57] 169 U.S. at 546-47. The idea that a common carrier is entitled to a reasonable rate for his services has its roots in the English common law. *See* Bastard v. Bastard, 2 Shower 82 (K.B. 1679). By the same token, common law courts declared that common carrier rates must be reasonable. In his treatise *De Portibus Maris*, 1 Harg. Law Tracts 78 (1670), Sir Matthew Hale, Chief Justice to King James I of England, wrote that when private property is affected with the public interest, the rates for public use must be reasonable and moderate. Lord Hale's reasoning was relied upon by the Court in Munn v. Illinois, 94 U.S. 113, 126 (1876). The common law notion of reasonable rates can be traced back to the Church Fathers' doctrine of just price. GLAESER, *supra* note 48, at 196-197.

[58] FRANCIS X. WELCH, CASES AND TEXTS ON PUBLIC UTILITY REGULATION 236 (rev. ed. 1968).

[59] *Id.*

[60] *See generally* Bernstein, *supra* note 51, at 241-42.

[61] *Id.* at 243.

[62] *Id.* at 577. States began to establish independent regulatory commissions that had the authority to value property as the basis for setting reasonable rates. By 1915, every state except Delaware had established some kind of board to regulate utilities. *Id.* at 296; SPURR, *supra* note 37, at 12.

[63] Bernstein, *supra* note 51, at 242.

investors that they would receive a fair profit on their investments. [64] Thus, the modern system of regulation was developed to protect the rights of both consumers and investors.

C. *The Modern Process of* Rate Base Regulation

In response to the *Chicago, Milwaukee* and *Smyth* cases, legislatures inserted provisions into utility commission enabling statutes that provided for hearings in rate cases and established particular standards for ratemaking. [65] The current process for regulation of rates is essentially the same as that contained in the early statutes.

Consistent with *Chicago, Milwaukee*, statutes provide for full adjudicatory hearings on utility proposals to change rates. [66] Utilities must file proposed rate schedules with the commission and must publish notice of the proposed changes. [67] The commission then has a period of time, usually thirty to forty-five days, to decide whether or not to suspend the rates and to hold hearings on the proposed schedules. [68] If the commission does not suspend the new schedules, the utility puts them into effect after [*276] the waiting period. [69] If the commission does suspend the proposed rates, it holds hearings on the reasonableness of the schedules before the commissioners themselves, hearing examiners, or administrative law judges designated by the commission. [70]

At those hearings, the utility and "such persons or corporations as the commission shall allow to intervene" have a right to appear in person or through an attorney, to introduce evidence, and to cross examine witnesses. [71] Commissions have the power to hire expert staff, including attorneys, engineers, and accountants, who can testify at the proceedings. [72] In addition, commissions have the authority to issue subpoenas compelling the testimony of witnesses or the production of books and accounts. [73] Although commissions are not bound by technical rules of evidence or similar formalities when taking

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64 *Id.* at 241-42. A contemporary editorial on the *Smyth* decision observed: "Many observations might be made on this decision, but practically the most important point about it is that it makes the law perfectly plain, and makes railway property much more secure from attacks through State legislation than it has hitherto been." A.G. Sedgwick, *Nebraska Freight*-Rate Decision, 66 NATION 260, 261 (1898).

65 *See, e.g.*, N.Y. Public Service Law § 1 (McKinney 1916).

66 Although the act of prescribing rates for the future is considered a legislative function, the determination of whether a rate is reasonable is considered a judicial function. *See* ICC v. Cincinnati, N.O.T.P. Ry., 167 U.S. 479, 499 (1897).

67 *See, e.g.*, An Act to provide for the regulation of public utilities, 1913 Ill. Laws 459, § 35; ILL. ANN. STAT. ch. 220, § 5/9-201(a) (Smith-Hurd 1993); TEX. REV. CIV. STAT. ANN. art. 1446(c), § 43(a) (Vernon Supp. 1993). Rate cases can also be initiated by the commission itself or on the complaint by a ratepayer. *See, e.g.*, ILL. ANN. STAT. ch. 220, § 5/9-250 (Smith-Hurd 1993).

68 *See, e.g.*, 1913 Ill. Laws 459, § 36. *See generally* NATIONAL ASS'N OF REGULATORY COMM'RS, 1989 ANNUAL REP. ON UTIL. AND CARRIER REG. 849-52 (1990) (Table 209) [hereinafter NARUC REP.].

69 *See, e.g.*, 1913 Ill. Laws 459, § 35.

70 *See, e.g.*, *id.* § 60. *See generally* NARUC REP., *supra* note 68, at 910-13 (Table 228).

71 *See, e.g.*, 1913 Ill. Laws 459, § 65. *See generally* NARUC REP., *supra* note 68, at 269-302.

72 *See, e.g.*, 1913 Ill. Laws 459, § 3.

73 *See, e.g.*, *id.* § 65.

testimony, [74] a full record of the hearing is required. [75] At the conclusion of such a hearing, the commission must make findings of fact and enter an order based on the record. [76]

In addition to hearing procedures, and in accordance with *Smyth v. Ames*, the enabling statutes have also set standards for the ratemaking process. They require that commissions set rates that are "just and reasonable." [77] Consistent with *Smyth*, this phrase has been read to require that commissions allow the utility an opportunity to earn a reasonable return on its invested capital and to pay its reasonable operating expenses. [78] This requirement is reflected in the classic ratemaking formula: $R=O+B(r)$, where R is the revenue required by the [*277] company, O is the utility's operating expenses, B is the firm's rate base (invested capital), and r is the reasonable return allowed the company on its rate base. [79] The commission bases the precise amount for each of these elements on evidence obtained from the utility's books and records and from expert testimony. [80] Over the years, many different statutory and regulatory standards have been developed to guide commissions in determining, as precisely as possible, each of the terms in the ratemaking formula. [81]

In *Federal Power Commission v. Hope Natural Gas Co.*, [82] the Supreme Court rejected, as a constitutional matter, rigid adherence to the *Smyth v. Ames* fair value standard for ratemaking. Generally, however, states have not abandoned the rate base method for formulating rates. In *Hope*, the Court concluded that a commission is not required to use any particular method in determining rates as long as the end result is fair. Nevertheless, in interpreting commission enabling statutes, state courts have generally required commissions to follow the basic formula for rate fixing outlined in *Smyth v. Ames*. [83] Despite the end-result language of *Hope*, state courts have held that the commission must render findings of fact on each of the variables in the formula, and that any material error as to a particular variable renders the end result invalid. [84] As one court [*278] has observed: "If the Commission makes a material error, in considering the elements which make up the rate base, the rate

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[74] *See, e.g., id.* § 60. *See generally* NARUC REP., *supra* note 68, at 269-302.

[75] *See, e.g.*, 1913 Ill. Laws 459, § 65.

[76] *See, e.g., id.* § 65.

[77] *See, e.g., id.* § 36 ("On such [rate] hearing the commission shall establish the rates or other charges . . . which it shall find to be just and reasonable.").

[78] PHILLIPS, *supra* note 22, at 157-60; *see* TEX. REV. CIV. STAT. ANN. art 1446(c), § 39(a) (Vernon Supp. 1993) ("In fixing rates of a public utility, [the commission] shall fix its overall revenues at a level which will permit such utility a reasonable opportunity to earn a reasonable return on its invested capital used and useful in rendering service to the public over and above its reasonable operating expenses.").

[79] RICHARD J. PIERCE, JR., & ERNEST GELLHORN, REGULATED INDUSTRIES 89 (1987); *see* Citizens Util. Co. v. Illinois Commerce Comm'n, 529 N.E.2d 510, 512-13 (Ill. 1988).

[80] Even the earliest enabling statutes for utility commissions empowered them to establish a uniform system of accounts to be kept by utilities. *See, e.g.*, 1913 Ill. Laws 459, § 11.

[81] *See generally* Stefan H. Krieger, *The Ghost of Regulation Past: Current Applications of the Rule Against Retroactive Ratemaking* in Public Utility Proceedings, 1991 U. ILL. L. REV. 983, 995-96.

[82] 320 U.S. 591, 602 (1944).

[83] WELCH, *supra* note 58, at 284.

[84] *See, e.g.*, Keystone Water Co. v. Pennsylvania Pub. Util. Comm'n, 385 A.2d 946, 953-55 (Pa. 1978) (per curiam) (opinion in support of affirmance for a divided court rejects Commission's argument that it could give no consideration to a plant as an element of rate base as long as the end result was just and reasonable); Commonwealth Tel. Co. v. Public Serv. Comm'n, 32 N.W.2d 247 (Wis. 1948)

of return, the operating expenses or the operating income, the error will necessarily be reflected in its conclusion." [85]

Finally, the enabling acts provide standards for the distribution of rates among different customer classes and within particular classes. Generally, statutes proscribe "undue discrimination" in rates. [86] Beyond that proscription, commissions have broad discretion in designing rates. [87] However, most commissions focus on the cost of providing service to different customers as the basis for allocation of rates. [88] As with the revenue requirement, commissions have developed different methodologies to determine the "cost of service," [89] and expert evidence on this issue is presented at the rate hearings.

Although the rate regulation process initially began as a legislative attempt to rein in the power of utilities, over time the process has taken on many of the accoutrements of a judicial proceeding. Formal hearings are held, the utility has the burden of proof to show that its proposed rates are just and reasonable, expert witnesses are presented for cross examination, exhibits are introduced, and a record is preserved. As at a trial, the commission uses certain legal standards to assess the evidence used in determining each of the variables in the revenue requirement formula and to decide upon the proper rate design. The commission is then required to issue detailed findings of fact. If any material finding is [*279] erroneous, the order is invalid. This approach is an outgrowth of the political balance reached between the railroads and their customers during the late nineteenth century. The power to prescribe rates is considered a legislative function, but the determination of the reasonableness of those rates is regarded as a judicial function.

II. The Development of Nonunanimous Settlements of Rate Cases

The energy crisis of the 1970s contributed to the rapid increase in the number of rate cases brought before commissions. Burdened by a backlog of litigation, commissions developed new methods of resolving rate cases, including the use of nonunanimous settlements. Commissions have adopted two approaches to nonunanimous settlements. Some have used these settlements merely as evidence to be considered in the context of full evidentiary hearings. Other commissions have approved nonunanimous settlements without such hearings, thereby potentially ignoring the interests of groups which were not parties to the settlement agreement.

(rejecting Commission's order that failed to determine rate base or rate of return). *See generally* Francis X. Welch, *The* Rate Base Is Here to Stay, PUB. UTIL. FORT., Oct. 22, 1953, at 635, 641 (observing that despite the "end result" language in *Hope*, "the ghost of *Smyth v. Ames* is still doing business at the same old stand").

85 Southwestern Bell Tel. Co. v. State Corp. Comm'n, 386 P.2d 515, 525 (Kan. 1963).

86 *See, e.g.*, 1913 Ill. Laws 459, § 38 ("No public utility shall, as to rates or other charges, services, facilities or in any other respect, make or grant any preference or advantage to any corporation or person or subject any corporation or person to any prejudice or disadvantage. No public utility shall establish or maintain any unreasonable difference as to rates or other charges, services, facilities, or in any other respect, either as between localities or as between classes of service.").

87 *See, e.g.*, Wood v. Public Util. Comm'n, 481 P.2d 823, 827 (Cal. 1971); Texas Alarm & Signal Ass'n v. Public Util. Comm'n, 603 S.W.2d 766, 772 (Tex. 1980); City of West Allis v. Public Serv. Comm'n, 167 N.W.2d 401, 405 (Wis. 1969). Commissions may base the allocation of rates on any of the following factors: the cost of providing service to the different customers, the purpose for which the service is used, the quantity or amount of service received, the different character of service furnished, the time or season of use, the constancy or regularity of use, or "any other matter which presents a substantial difference as a ground of distinction." Texas Alarm & Signal Ass'n, 603 S.W.2d at 772.

88 *See* PIERCE & GELLHORN, *supra* note 79, at 181-82.

89 *Id.* at 182-93.

A. *Changes* in the Regulatory Environment

Until the late 1960s, the adjudicatory model for ratemaking was generally considered to be quite effective. Prior to that time, public utility regulation was a fairly placid affair, with little attention given to modifying the procedures of traditional rate base regulation. For example, during the first part of the twentieth century, the electric utility business required only minimal regulatory intervention. [90] Throughout this period, thermal efficiency gradually grew and the scale of power plants soared, resulting in a trend toward lower operating expenses and declining marginal costs. [91] In this environment, electric utilities filed rate cases infrequently because they generally felt they were receiving a satisfactory rate of return without formal regulatory proceedings. [92] Meanwhile, consumer groups were content because nominal prices were either constant [*280] or falling. [93] And with no complaints from consumer groups or requests for relief from utilities, utility commissions remained passive. [94] As Richard Hirsch describes:

> During much of the century . . . the stakeholders in the electric power matrix had formed an implicit consensus about the technological system and its management. Benefits accrued to all: consumers enjoyed electricity whose unit price declined gradually. Investors profited from steadily increasing dividends and share prices of utility stocks. Managers congratulated themselves for their aptitude in running a complex technological enterprise and for improving the financial picture of their companies. Manufacturers happily took new orders for the advanced technology that they pioneered. And regulators sat quietly on the sidelines providing little interference in what appeared to be one of the best examples of a natural monopoly. [95]

Then, in the late 1960s, a rise in energy prices caused the situation to change dramatically. The technological advances that had resulted in lower prices were no longer occurring at such a rapid rate. [96] Concurrently, inflation skyrocketed, and interest rates climbed steeply. [97] Then, in October of 1973, the country was hit by the Arab oil embargo, and the energy crisis began. In reaction to these events, electric utilities embarked on nuclear construction programs, and gas utilities sought alternative sources of fuel. [98]

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[90] *See* RICHARD F. HIRSH, TECHNOLOGY AND TRANSFORMATION IN THE AMERICAN ELECTRIC UTILITY INDUSTRY 176 (1989).

[91] *Id.* at 176.

[92] Paul L. Joskow, *Inflation and Environmental Concern: Structural Change* in the Process of Public Utility Price Regulation, 17 J.L. & ECON. 291 (1974).

[93] Id. at 299.

[94] *See* id. at 298-99.

[95] HIRSH, *supra* note 90, at 176-77.

[96] Stefan H. Krieger, *An Advocacy Model for Representation of Low-Income Intervenors* in State Public Utility Proceedings, 22 ARIZ. ST. L.J. 639 (1990).

[97] Id. at 639-40.

[98] Id. at 640; *see also* James E. Hickey, Jr., *Mississippi Power & Light Company: A Departure Point for Extension of the "Bright Line" Between Federal and State Regulatory Jurisdiction over* Public Utilities, 10 J. ENERGY L. & POL'Y 57, 63-64 (observing that the energy crisis reaffirmed "the reasonableness of planning decisions to build nuclear power plants").

With rising fuel costs and massive construction projects, utilities no longer felt that they were receiving an adequate price for their services. Consequently, they brought many more formal rate cases before public [*281] and by 1975, it had climbed to 114. [99] Rate cases became frequent occurrences for many utilities. Commissions discovered that utilities never seemed to be able to achieve the allowed rate of return set in a case, and, after the termination of one case, immediately filed new cases for further relief. [100] In addition, ancillary proceedings began to arise, addressing adjustments for fuel costs and other rate-related issues. [101] As a result of the rapid growth in rate proceedings, electric rates rose ninety percent nationally in the five years after 1970. [102]

As the number of rate cases grew and rates began to soar, consumer organizations became active in these proceedings. Some groups grew out of neighborhood and civic organizations whose members felt the crunch of higher utility rates and sought to put political pressure on commissions. Other groups addressed particular issues that they felt were important to the public interest, such as environmental concerns. Industrial and commercial consumer groups intervened to protect the pocketbooks of large and medium energy users. Finally, in reaction to political pressure from ratepayers, state legislatures began to develop offices of public counsel, and other proxy advocates, such as offices of attorneys general, sought to represent the interests of consumers in rate proceedings. [103]

Faced with increased rate filings and active consumer intervention, commissions felt overburdened. [104] Rate cases became lengthy [*282] proceedings, delayed in part by the sheer number of cases filed with commissions, the complexity of the issues involved, and the participation of intervenor groups. [105] Commission staffs, [106] strapped by limited resources, confronted the daunting tasks of evaluating and

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99 Krieger, *supra* note 96, at 640.

100 Joskow, *supra* note 92, at 313.

101 Krieger, *supra* note 81, at 986-87.

102 Krieger, *supra* note 96, at 640.

103 *Id.* at 643-44.

104 Joskow, *supra* note 92, at 313. "As a result of the changing economic and social environment in which they were operating, the 'satisfactory' balancing of different interestgroups that had characterized the procedural equilibrium of the 1950s and 1960s was now being quickly destroyed." *Id.* James Richardson quotes from a technical report to the Edison Electric Institute:

> Increases in energy prices, as well as public awareness and political organizing around consumer and environmental issues, have sharpened the conflict among utilities, consumer and environmental interest groups, and state utility regulatory authorities. Complex technical and financial issues are hotly debated in administrative hearings. With increasing frequency, parties dissatisfied with the results of hearings appeal decisions to state courts on procedural grounds. This further distracts from efforts to deal with the substantive issues at hand, and increases the costs and delays associated with operating the utility.

James R. Richardson, *Overcoming Obstacles to Negotiating Electric* Utility Industry Regulations, 7 NEGOTIATION J. 41, 41 (1991).

105 Morgan, *supra* note 16, at 24-25. This problem was not just an issue for energy regulation. In telecommunications, there has been significant uncertainty on all sides as a result of the deregulation of the telephone industry. Jonathan Brock, *Using Negotiation and Mediation as an Adjunct to* Utility Regulation and Rate Setting, in MEDIATION INST., DEVELOPING SYSTEMS FOR THE SETTLEMENT OF RECURRING DISPUTES: FOUR CASE STUDIES AND RECOMMENDATIONS 1, 2 (1984).

106 Staff members of most commissions are appointed by and report to the commission or its executive director to advise the commission on technical engineering, accounting, economics, and legal issues. *See, e.g.*, ILL. ANN. STAT. ch. 220, §§ 5/11-201 to

presenting testimony on the ever-expanding number of cases. [107] Rate orders in major cases began to run into the hundreds of pages, with thousands of additional pages of records of the testimony, exhibits, and briefs. [108] And, with extremely large rate hikes at stake, appeals of rate orders, especially by consumer groups, became a frequent occurrence. [109]

While most consumer intervenor groups were not particularly successful in these cases at first, they eventually had a significant impact. One early study found that in New York Public Service Commission gas and electric rate cases, "the presence of an intervenor will vary from no effect to a reduction of 0.40 percentage points in the allowed rate of return, depending on the degree of conflict between the [utility] and the intervenor." [110] While it is unclear whether the reductions were the result of effective advocacy by the intervenors or merely the consequence of political concessions by the Commission, [111] indisputably the presence of an intervenor had some effect in at least some cases. And even if consumer groups did not affect the ultimate decision in the case, their participation and demands for compliance with procedural requirements [*283] delayed the proceedings as long as possible, postponing the ultimate imposition of higher rates. [112] As time went on, a number of these groups refined their strategies, retained highly effective expert witnesses, and became quite successful at reducing the magnitudes of rate increases allowed by commissions. [113]

B. Nonunanimous Settlement as an Alternative to Traditional Rate of Return Regulation

Faced with active consumer participation in rate cases, commissions and utilities began to question the effectiveness of traditional rate base regulation. [114] Commissioners and some commentators began to describe the process as too "rigid" and "adversarial." [115] Furthermore, although adjudicatory processes were originally established to address the requirements of *Chicago, Milwaukee* and *Smyth*, some

5/11-208 (West 1993). In some states staff members have civil service or merit protections, while in others there is no such job security. *See generally* NARUC REP., *supra* note 68, at 307-12, 864-83 (Table 215).

[107] *See generally* Jonathan D. Raab, Consensus-Building in Electric Utility Regulation 89 (1992) (unpublished Ph.D. dissertation, Massachusetts Institute of Technology).

[108] Richardson, *supra* note 104, at 42-43.

[109] Krieger, *supra* note 81, at 988.

[110] Paul L. Joskow, *The Determination of the Allowed* Rate of Return in a Formal Regulatory Hearing, 3 BELL J. ECON. & MGMT. SCI. 632, 641 (1972).

[111] Morgan, *supra* note 16, at 50.

[112] *See id.* at 25.

[113] *See, e.g., infra* notes 243-248 and accompanying text.

[114] Raab, *supra* note 107, at 95-96 (author interviewed commission representatives in seven states, all of whom indicated a rise in settlements over the past five to ten years). In the third edition of Public Utilities Reports Digest, the first reference to reported settlements of cases occurs in the early 1960s in hotel, water, and telephone rates. Starting in the early 1980s, the number of reported cases raising settlement issues increased significantly. *See* 5 PUB. UTIL. REP. DIG. 3D *Procedure* § 31 (1983).

At the federal level, the Federal Power Commission (FPC), the precursor to the Federal Energy Regulatory Commission (FERC), originally adopted settlement procedures in 1949. Raab, *supra* note 107, at 95. It was not until the early 1960s, however, that the FPC began to actively foster settlements as a way of resolving cases. At that time, the Commission was faced with numerous requests for rate increases by gas pipeline companies. Because of the backlog in proceedings, the companies had collected over $ 1 billion subject to refund. *Id.*

[115] *See, e.g.*, Brock, *supra* note 105, at 20; *The Forum -- Question 2: Dispute Resolution*, PUB. UTIL. FORT., Nov. 8, 1990, at 28, 30-31 [hereinafter *Question 2: Dispute Resolution*].

commissions now challenged reliance on a judicial model for setting rates. [116] Proposals [*284] to develop methods for settlement of rate cases were made to expedite the process and ease the conflicts among parties. [117] Eventually some commissions even adopted formal rules for settling cases. [118]

In establishing these procedures, most commissions concluded that a requirement of unanimous agreement would undermine the settlement process. They assumed that the utility must consent to the settlement, [119] but recognized no requirement for agreement by all the intervenors. In supporting this position, a number of commissions pointed to language in federal cases construing the settlement provisions of the federal Administrative Procedure Act (APA):

> There is nothing in the Administrative Procedure Act which expressly requires unanimous consent of all the participating parties to an agreement of settlement; and to read such a contention into the statute in view of the countless state agencies, municipalities, and consumers who may be interested in an administrative proceeding would effectively destroy the settlement provision. [120]

While a unanimity rule would obviously make the achievement of settlements more difficult, these commissions fail to explain in any detail why such a requirement for state ratemaking cases would "effectively destroy" the settlement process. A few merely suggest that a requirement of unanimous consent would allow inactive or uncooperative parties to block any possible settlement. [121] [*285] Implicit in these decisions is the belief that some intervenors, especially public interest and consumer groups, have an interest in obstructing settlements. Such groups, some commentators argue, have a

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[116] *See, e.g.,* In re Commission's Rules of Practice & Procedure, 28 CPUC 2d 77 (Cal. Pub. Util. Comm'n Apr. 27, 1988) (Nos. 88-04-059; 84-12-028). Adopting a settlement rule, the Commission rejected a consumer intervenor's proposal that a rate case be fully litigated if the settlement is contested. The Commission noted:

> Once a stipulation or settlement is proposed, we wish to move quickly to examine it, receive parties' comments, hear parties' cases, and decide the matter, providing earlier certainty of outcome than would be possible under a year-long rate case schedule and freeing up parties' resources so that they might be used productively in other proceedings.

Id.

[117] *See, e.g.,* In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660 (Ind. Pub. Serv. Comm'n 1986).

[118] *See supra* note 31.

[119] Although no decision ever directly addresses this issue, commissions and courts apparently assume that because of the constitutional protections accorded utility investors in rate proceedings, a nonunanimous settlement cannot be approved without the utility's consent. *See supra* notes 52-57 and accompanying text.

[120] City of Lexington v. Federal Power Comm'n, 295 F.2d 109, 121 (4th Cir. 1961); *see* In re Iowa Elec. Light & Power Co., 46 Pub. Util. Rep. 4th (PUR) 130, 146 (Iowa Commerce Comm'n 1982) (citing *Lexington*); *see also* In re Pacific Gas & Elec. Co., 99 Pub. Util. Rep. 4th (PUR) 141, 176 (Cal. Pub. Util. Comm'n 1988) (citing Pennsylvania Gas & Water Co. v. Federal Power Comm'n, 463 F.2d 1242, 1250 (D.C. Cir. 1972)). The federal Administrative Procedure Act provides that all interested parties shall be given the opportunity for submission of "offers of settlement." 5 U.S.C. § 554(c)(1) (1988).

[121] *See* In re Rules of Practice & Procedure Before the Comm'n, 112 Pub. Util. Rep. 4th (PUR) 215, 218 (Mich. Pub. Serv. Comm'n 1990); *see also* In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407, 418 (Ohio Pub. Util. Comm'n 1989) (criticizing intervenors for failing to present testimony on revenue requirement when staff, industrial intervenors, city, and proxy consumer advocate were signatories to agreement).

strong ideological commitment to their causes and thus are less likely to compromise. [122] Additionally, some have asserted that these organizations seek media attention to gain political support for their causes and accordingly favor the public forum of litigation over the more private negotiation arena. [123] Finally, it is argued that "[b]ecause such groups sell advocacy rather than marketplace products, they often tend to be dominated by lawyers, with a preference for victory through litigation." [124] Faced with these notions about consumer groups, commissions assume that the settlement process will usually be successful only if unanimity is not required.

C. *Approaches to the* Nonunanimous Settlement Process

Commissions have adopted two general approaches to nonunanimous settlement procedures. A few regard settlement agreements merely as additional evidence to be considered in reaching a traditional rate base decision. [125] Under this approach, the utility presents its case-in-chief, and the settlement is introduced into evidence. Then, other parties and staff respond. The commission renders findings of fact on the entire record, including the settlement agreement, based on the traditional rate base formula. Because this approach maintains the requirement of a full evidentiary hearing, it deviates little from traditional ratemaking methods.

Most commissions, however, consider the merits of settlement agreements without holding a full adjudicatory proceeding. [126] These [*286] commissions will approve a settlement even without the development of a complete evidentiary record or findings of fact on each of the elements of the rate base formula. [127] The commission holds hearings on the settlement, takes evidence both in support of and against the settlement, and determines whether or not to approve it. [128] In making this decision, commissions do not use the traditional rate base method, but consider a number of other factors. These

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122 *See* Richard B. Stewart, *The Discontents of Legalism: Interest Group Relations* in Administrative Regulation, 1985 WIS. L. REV. 655, 674.

123 *Id.*

124 *Id.* Indeed, in the *LG&E* case, the Commission specifically criticized the intervenors for their demands in negotiations for attorneys' fees. In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 354 (Ky. Pub. Serv. Comm'n 1989).

125 In re Northern Indiana Pub. Serv. Co., 85 Pub. Util. Rep. 4th (PUR) 605, 614 (Ind. Util. Reg. Comm'n 1987) ("[I]t is our duty to make an independent decision of all relevant matters giving consideration to all evidence of record including the Stipulation between the parties.").

126 *See, e.g.*, In re Commission's Rules of Practice & Procedure, 29 CPUC 2d 392 (Cal. Pub. Util. Comm'n Sept. 28, 1988); In re Rules of Practice & Procedure Before the Comm'n, 112 Pub. Util. Rep. 4th (PUR) 215, 218-19 (Mich. Pub. Serv. Comm'n 1990); In re Rules of Practice & Procedure, No. 110, 1993 WL 562148 (N.M. Pub. Util. Comm'n Oct. 4, 1993); In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992). John M. Katko, Note, *Negotiated Ratemaking and the* Public Service Commission: Adjusting Its Present Structure to Ensure Fairness, 38 SYRACUSE L. REV. 1319, 1323 (1989).

127 At times, even after the development of a full evidentiary record, a commission will use the second approach, considering the reasonableness of the settlement rather than variables of the revenue requirement formula. *See, e.g.*, City of Somerville v. Public Util. Comm'n, 865 S.W.2d 557 (Tex. Ct. App. 1993). In *City of Somerville*, after extensive hearings and the issuance of a report by the hearing examiners, the utility entered into a nonunanimous settlement with several of the parties. The Commission held hearings on the settlement agreement and approved it. In its findings of fact, the Commission did not detail the underlying variables used to calculate the revenue requirement. Instead, the Commission merely found the settlement to be "reasonable and in the public interest." Id. at 562 n.14.

128 *See, e.g.*, In re Commission's Rules of Practice & Procedure, 29 CPUC 2d 392, Rule 51.6 (Cal. Pub. Util. Comm'n Sept. 28, 1988) (Nos. 88-09-060; 84-12-028); In re Rules of Practice & Procedure, No. 110, 1993 WL 562148, at *33-34 (N.M. Pub. Util. Comm'n Oct.

factors include whether the settlement is in the "public interest"; [129] whether the settlement comports favorably with the possible outcome if there were no agreement; [130] whether the negotiation process was reasonable; [131] whether a range of interests is represented by the parties who sign the agreement; [132] and whether the settlement is supported by substantial evidence. [133]

This approach to the nonunanimous settlement process is well illustrated by the 1989 decision of the Kentucky Public Service [*287] concerned the rate treatment for a new electric generating facility, Trimble County, constructed by Louisville Gas & Electric (LG&E). From the time the plant was originally authorized in 1978 through the next decade, intervenors including the Kentucky Attorney General, the county, and consumer groups had questioned in a number of cases the need for the new plant. [135] Finally, after construction was nearly complete, the Commission refused to allow the utility to collect rates to pay for twenty-five percent of the plant. [136] The utility appealed this decision, and the Commission opened a new docket to determine the rate treatment for the disallowed portion of the plant. [137]

LG&E and the parties to the case, including the intervenors and Commission staff, then began to engage in settlement negotiations. [138] LG&E made proposals for certain rate reductions and dismissal of its appeal, but the intervenors wanted not only a reduction in rates, but also refunds of rates paid for construction of the disallowed portion of the plant and payment of their attorneys' fees. [139] When LG&E would not consider payment of either refunds or attorneys' fees, the negotiations with the intervenors broke down. LG&E then continued in its discussions with the Commission staff and reached a nonunanimous settlement with the staff for a rate reduction and dismissal of the appeal. [140] LG&E then presented the agreement to the Commission, which held hearings on the reasonableness of the settlement. While professing to place the burden of demonstrating the reasonableness of the settlement on LG&E and the staff, [141] the Commission merely reviewed the events [*288] leading up to the settlement, compared the ratepayer benefits of the settlement to the maximum benefit it assumed ratepayers would otherwise receive, and concluded that the settlement was reasonable. The Commission

4, 1993) (No. 110); In re Procedures for Settlement & Stipulation Agreements, 1992 WL 487888, at *19 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992) (Nos. 90-M-0255, 92-M-0138). If the commission does not approve the settlement, it will allow the parties to renegotiate the agreement or litigate the case. *See, e.g.*, 1992 WL 487888, at *19.

129 *See infra* part V.A.

130 *See infra* part V.C.

131 *See infra* part V.D.

132 *See infra* part V.E.

133 *See infra* part V.B.

135 *See, e.g.*, In re Louisville Gas & Electric Co., No. 8924 (Ky. Pub. Serv. Comm'n May 16, 1984); In re Louisville Gas & Elec. Co., No. 8616 (Ky. Pub. Serv. Comm'n Mar. 2, 1983).

136 In re Formal Review of the Current Status of Trimble County Unit No. 1, No. 9934 (Ky. Pub. Serv. Comm'n April 20, 1989).

137 In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 350 (Ky. Pub. Serv. Comm'n 1989).

138 Id. at 354-55.

139 *Id.*

140 Id. at 355.

141 Id. at 358.

made no attempt to examine the reasonableness of the stipulated rates using the traditional standard. [142] Instead, it based much of its decision on what it perceived to be the unreasonable position taken by intervenors in the negotiation process. [143] As the trial court held in reversing the order:

> [T]he entire proceeding before the PSC regarding the settlement agreement can be considered nothing more than the most summary of proceedings with witnesses for LG&E and the PSC staff cheer-leading in favor of the agreement. The [Commission] clearly placed the burden upon the intervenors to demonstrate that the settlement agreement was unreasonable and/or unlawful. [144]

Because most commissions have a tendency to take this informal approach to approving settlements, an approach which represents a significant departure from traditional rate base ratemaking, this Article will focus primarily on the use of this method.

III. The Statutory Basis for Nonunanimous Settlement of Rate Cases

In examining the propriety of nonunanimous rate case settlements, the initial issue is whether there is statutory authorization for such a [*289] procedure. Three major statutory arguments have been raised against the nonunanimous settlement process: (1) that commission enabling acts do not permit commission staff to participate in settlement negotiations or, alternatively, do not allow settlement without the consent of governmental intervenors; (2) that statutory provisions allowing for settlements of administrative cases apply only if all parties consent; and (3) that, in the absence of unanimous settlement, enabling acts require full evidentiary hearings. A review of these arguments demonstrates that, although the first has little merit, the second and third raise serious doubts about whether nonunanimous settlements of rate cases are statutorily permissible under most enabling acts.

A. *The Role of Staff and Governmental Intervenors*

One court has held that because of the unique nature of the commission's staff, it cannot be a party to a settlement agreement. In In re New England Telephone & Telegraph Co., [145] the court noted that the Vermont Public Service Board's enabling act charged it only with the duty to assure adequate utility service at just and reasonable rates. Therefore, the court reasoned, the staff counsel lacked the authority

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[142] *See supra* notes 77-81 and accompanying text.

[143] In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 354 (Ky. Pub. Serv. Comm'n 1989). The Commission noted:

> Despite LG&E's firm opposition to paying the Intervenors' attorney fees, the Intervenor Group persisted in its efforts. The affidavits demonstrate that the Intervenor Group was so intent on recovering $ 1.6 million of attorney fees that the group proposed *increasing* future electric rates so that LG&E could recoup its payment from the ratepayers. The Intervenor Group's proposal would effectively transform LG&E into a mere conduit by which the Intervenor Group would recover its attorneys fees by taxing the ratepayers.

Id.

[144] Kentucky ex rel. Cowan v. Kentucky Pub. Serv. Comm'n, 120 Pub. Util. Rep. 4th (PUR) 168, 173-74 (Ky. Pub. Serv. Comm'n 1991), *aff'd*, 862 S.W.2d 897 (Ky. Ct. App. 1993). The court also expressed concern that the chairman of the Commission and a Commission member communicated at a luncheon meeting with LG&E's president prior to filing a formal settlement offer with the Commission. Id. at 170.

[145] In re New England Tel. & Tel. Co., 382 A.2d 826, 836 (Vt. 1977).

to enter into agreements because it was impossible for it to obtain authority from its client, the Board, to do so. [146]

This reasoning is overly formalistic and shows a misunderstanding of how an administrative staff functions. As the court recognized in *New England Telephone*, the staff regularly takes positions in cases, filing direct and rebuttal testimony and cross-examining witnesses. [147] The staff does not receive formal authority from the board to take particular positions in these cases. Rather, the staff operates as a bona fide party: investigating the facts and testifying in regard to its findings, hiring expert witnesses, and making arguments on both law and facts. [148] "[I]n none of its activities is Staff subject to direction by the Commission; Staff is instead an autonomous participant making its presentations to the [*290] Commission and eliciting rulings from it." [149] By their very nature, administrative agencies serve investigative, prosecutorial, and judicial functions. [150] If the staff, as the prosecutorial arm of the commission, decides to take a position in a rate case, it should not matter whether the staff presents this position through litigation or a proposed settlement. No provision of the traditional statutory schemes precludes such activity by staff. [151]

Some government intervenors make the converse argument that the relevant statutes preclude settlements without their participation. The standard enabling act for a legislatively created consumer representative [152] provides that it will represent the interests of residential and small business ratepayers in public utility proceedings. [153] Some of these representatives argue that this authority bars commissions from approving settlements which the representatives oppose. [154] This argument, however, ignores the function of these consumer offices. These representatives' legislative grant of power to advocate on behalf of a particular group of consumers is not equivalent to the authority to veto an agreement considered contrary to the public interest. [155]

B. *Statutory Authorization for* Settlement of Administrative Cases

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[146] Id. at 835-36. Although this case did concern a nonunanimous settlement, its holding would be applicable to unanimous settlements as well.

[147] Id. at 835-36.

[148] Attorney Gen. v. New Mexico Pub. Serv. Comm'n, 808 P.2d 606, 609 (N.M. 1991).

[149] Id. at 609-610 (noting problem that settlement would be impossible in case in which staff is only party besides the utility).

[150] *See generally* 1 KENNETH C. DAVIS & RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 2.3 (3d ed. 1994).

[151] Staff's participation in settlement discussions, however, may raise problems in regard to the balance of power in the negotiation process. *See infra* notes 236-239 and accompanying text.

[152] *See supra* note 103 and accompanying text.

[153] *See, e.g.*, FLA. STAT. ANN. § 350.061 (West 1980); MD. CODE ANN. art. 78, §§ 14, 15 (1991); TEX. CIV. STAT. ANN. art. 1446c, § 15A (West 1980 & Supp. 1994).

[154] Bryant v. Arkansas Pub. Serv. Comm'n, 877 S.W.2d 594, 597 (Ark. Ct. App. 1994); City of El Paso v. Public Util. Comm'n, 839 S.W.2d 895, 904-05 (Tex. Ct. App. 1992), *aff'd* in part, 883 S.W.2d 179 (Tex. 1994).

[155] Arkansas Pub. Serv. Comm'n, 877 S.W.2d at 597; City of El Paso, 839 S.W.2d at 904-905.

When a utility proposes new rates, the commission has the statutory authority to suspend rates and to hold hearings on their justness and reasonableness. [156] While most commission enabling statutes do not explicitly allow for the settlement of cases, many state administrative [*291] procedure acts, which are applicable to public utility commissions, have specific provisions that provide for settlements. [157] The Model Administrative Procedure Act (Model APA), for example, states: "Unless precluded by law, informal disposition may be made of any contested case by stipulation, agreed settlement, consent order, or default." [158]

Courts are divided in their interpretation of such language. Two courts have held that such a provision allows only unanimous agreements. [159] Reading the term "settlement" literally, they require consent of all parties. In construing language identical to the Model APA, for example, the Illinois Supreme Court observed: "In order for the commission to dispose of a case by settlement . . . all of the parties and intervenors must agree to the settlement." [160]

A number of other jurisdictions, however, read their enabling acts and administrative procedure acts to allow nonunanimous settlements without full adjudicatory hearings. [161] They contend that settlement in the regulatory context has a different meaning from settlement in traditional civil litigation. These jurisdictions base their interpretation not on the statutory language of the commission enabling acts or the administrative procedure acts but on a case that interpreted the federal Administrative Procedure Act (APA). In that case, *Pennsylvania Gas & Water Co. v. Federal Power Commission*, [162] the court rejected a customer's challenge to a nonunanimous settlement approved by the Federal Power Commission:

> [*292] "Settlement" carries a different connotation in administrative law and practice from the meaning usually ascribed to settlement of civil actions in a court. . . . [I]n agency proceedings settlements are frequently suggested by some, but not necessarily all, of the parties; if on examination they are found equitable by the regulatory agency, then the terms of the settlement form the substance of an order binding on all the parties, even though not all are in accord as to the result. This is in effect a "summary judgment" granted on "motion" by the litigants where there is no issue of fact.
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> . . . Only by exercising such "summary judgment" or "administrative settlement" procedures when called for can the usual interminable length of regulatory agency proceedings be brought

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156 *See supra* notes 68-71 and accompanying text.

157 *See, e.g.*, MODEL STATE ADMINISTRATIVE PROCEDURE ACT [hereinafter MODEL APA] § 9(d), 15 U.L.A. 207 (1981); *see also* 15 U.L.A. 137 (1981) (table of jurisdictions in which Model Act has been adopted).

158 MODEL APA § 9(d), 15 U.L.A. 207 (1981).

159 Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693, 700 (Ill. 1989); Kentucky Am. Water Co. v. Kentucky ex rel. Cowan, 847 S.W.2d 737, 740-41 (Ky. 1993).

160 555 N.E.2d at 700.

161 *See, e.g.*, In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660 (Ind. Pub. Serv. Comm'n 1986); In re Iowa Elec. Light & Power Co., 46 Pub. Util. Rep. 4th (PUR) 130 (Iowa Commerce Comm'n 1982); Attorney Gen. v. New Mexico Pub. Serv. Comm'n, 808 P.2d 606 (N.M. 1991); City of El Paso v. Public Util. Comm'n, 883 S.W.2d 179 (Tex. 1994); Bryant v. Arkansas Pub. Serv. Comm'n, 877 S.W.2d 594 (Ark. Ct. App. 1994); City of Abilene v. Public Util. Comm'n, 854 S.W.2d 932 (Tex. Ct. App. 1993).

162 Pennsylvania Gas & Water Co. v. Federal Power Comm'n, 463 F.2d 1242 (D.C. Cir. 1972).

within the bounds of reason and the agencies' competence to deal with them. [163]

Citing this language and relying on the public policy favoring settlement of disputes, a number of jurisdictions interpret their statutory schemes to permit nonunanimous settlements of cases. [164]

The basis for this interpretation is quite weak. The enabling acts require hearings on the record, and the administrative procedure acts allow for settlements. No court or commission that permits contested settlements without full evidentiary hearings cites any statutory language or legislative history to support this practice. Nor do they identify any textual basis in the relevant statutes that suggests that settlement in the regulatory context connotes something different than settlement of civil litigation. [165] Indeed, even the court in *Pennsylvania Gas & Water* acknowledged that, while the federal APA allows for the settlement of cases, it does not, by its terms, allow for nonunanimous settlements. [166] Instead of examining the language of the applicable enabling or administrative procedure acts, the courts permitting nonunanimous settlements merely rely on conclusory assertions about public policy [*293] favoring expeditious resolution of cases. [167] But as one court has observed in rejecting the concept of nonunanimous settlements, public policy concerns, such as the exigencies of a rate case, do not constitute grounds for a commission to exceed its statutory authority. [168]

More importantly, most cases allowing nonunanimous settlements do not recognize the limited nature of the *Pennsylvania Gas & Water* holding. The court in that case likened contested settlements to summary judgments. It approved the contested settlement precisely because the Commission had accepted as true all of the factual allegations of the customer challenging the settlement. The court observed: "If the Commission were required in a case such as this one to hold a full and formal evidentiary hearing despite the fact that it accepted all of a participant's factual allegations as true and still found their conclusions to be wanting, the settlement procedure would be rendered meaningless." [169] Most state commissions that have approved contested settlements, however, do not use a summary judgment standard. Instead, they forgo full hearings even when there are contested issues. [170] Even

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163 Id. at 1246.

164 *See, e.g.,* In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660, 683-84 (Ind. Pub. Serv. Comm'n 1986); *see also* Attorney Gen. v. New Mexico Pub. Serv. Comm'n, 808 P.2d 606, 610 (N.M. 1991); In re Iowa Elec. Light & Power Co., 46 Pub. Util. Rep. 4th (PUR) 130, 146 (Iowa Commerce Comm'n 1982).

165 Nor do they explain the reason the utility must be a party to the settlement if settlement means something different in the regulatory context.

166 Pennsylvania Gas & Water Co., 463 F.2d at 1247.

167 *But see* In re Iowa Elec. Light & Power Co., 46 Pub. Util. Rep. 4th (PUR) 130, 145-46 (Iowa Commerce Comm'n 1982) (suggesting that intervenor has burden to show that Administrative Procedure Act's use of "settlement" language means unanimous agreement, although acknowledging that statutory scheme does not expressly allow for nonunanimous settlements).

168 Missouri ex rel. Fischer v. Public Serv. Comm'n, 645 S.W.2d 39, 43 (Mo. Ct. App. 1982).

169 Pennsylvania Gas & Water Co., 463 F.2d at 1251.

170 *See, e.g.,* City of El Paso v. Public Util. Comm'n, 883 S.W.2d 179 (Tex. 1994); In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23 (N.Y. Pub. Serv. Comm'n 1986).

those that purport to apply a summary judgment standard often ignore it when faced with contested facts. [171]

[*294] C. *Requirement* in Enabling Statutes of Full Evidentiary Hearings

Three courts have held that, in the absence of unanimity, commission enabling acts require full evidentiary rate base hearings. [172] However, several other courts and commissions have ruled that the enabling statutes do not require full evidentiary hearings before approval of nonunanimous agreements. [173] Courts that permit nonunanimous settlements without full hearings disregard the enabling acts' traditional requirement of findings in regard to the justness and reasonableness of approved rates. In the absence of unanimous consent, the statutes require full evidentiary hearings in every case.

A number of the courts which allow nonunanimous settlements cite the Supreme Court decision in *Mobil Oil Corp. v. Federal Power Commission,* [174] another Federal Power Commission (FPC) rate case, in support of the proposition that the enabling acts allow such settlements. [175] In *Mobil*, after an extensive record had been made in hearings, a settlement proposal agreed to by a large majority of all interests was approved by the Commission. [176] The State of New York challenged this settlement because it lacked unanimous support. [177] The Court rejected this challenge. It held first that the Commission clearly had the power to admit the agreement into the record. [178] The Court then adopted the holding of the court of appeals affirming the Commission decision:

> No one seriously doubts the power -- indeed, the duty -- of FPC to consider the terms of a proposed settlement which fails to receive unanimous support as a decision on the merits. . . . We [*295] agree with the D.C. Circuit that even "assuming that under the Commission's rules [a party's] rejection of the settlement rendered the proposal ineffective *as a* settlement, it could not, and we believe should not, have precluded the Commission from considering the proposal *on its merits*." [179]

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[171] *See, e.g.,* In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660, 687 (Ind. Pub. Serv. Comm'n 1986). Using the summary judgment standard in the rate case context, the test would be whether there is any genuine issue of fact as to the utility's revenue requirement provided by the agreement, assuming all the facts as presented by parties opposing the settlement to be true. *See* Pennsylvania Gas & Water Co., 463 F.2d at 1252. In Public Service Co., although the Commission professed to use such a standard, it instead applied the test of whether "issues of material fact remained in conflict and whether adoption of the terms of the settlement proposal would be in the public interest." Public Serv. Co. at 687. There is a significant difference between these two standards. The first focuses on the elements of a traditional rate case; the second ignores those elements and replaces them with a vague public interest test.

[172] Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693, 704 (Ill. 1989); Kentucky Am. Water Co. v. Kentucky ex rel. Cowan, 847 S.W.2d 737, 740-41 (Ky. 1993); State ex rel. Monsanto Co. v. Public Serv. Comm'n, 716 S.W.2d 791 (Mo. 1986); State ex rel. Fischer v. Public Serv. Comm'n, 645 S.W.2d 39 (Mo. Ct. App. 1982).

[173] Bryant v. Arkansas Pub. Serv. Comm'n, 877 S.W.2d 594, 599-600 (Ark. Ct. App. 1994); Attorney Gen. v. New Mexico Pub. Serv. Comm'n, 808 P.2d 606, 610-11 (N.M. 1991).

[174] Mobil Oil Corp. v. Federal Power Comm'n, 417 U.S. 283 (1974).

[175] Bryant, 877 S.W.2d at 599-600; New Mexico Pub. Serv. Comm'n, 808 P.2d at 610-11.

[176] 417 U.S. at 296-98.

[177] Id. at 312.

[178] Id. at 312.

[179] Id. at 313-14 (quoting Michigan Consolidated Gas Co. v. Federal Power Comm'n, 283 F.2d 204, 224 (D.C. Cir. 1960)).

> If a proposal enjoys unanimous support from all of the immediate parties, it could certainly be adopted as a settlement agreement if approved in the general interest of the public. But even if there is a lack of unanimity, it may be adopted as a resolution *on the merits*, if FPC makes an independent finding supported by "substantial evidence on the record as a whole" that the proposal will establish "just and reasonable" rates for the area. [180]

Relying upon the "independent finding" language of *Mobil*, a number of commissions and courts read the decision as allowing commissions to forgo full hearings in rate cases and to approve nonunanimous settlements if they make independent findings that the agreements are in the public interest. [181] While these courts acknowledge that in *Mobil* the FPC held traditional rate hearings and made its decision on an extensive evidentiary record, they contend that the case does not require full-blown rate hearings, but allows flexible procedures for considering nonunanimous settlements. [182] They assert that as long as the record contains sufficient evidence to support the settlement, the agreement strikes a fair balance between the ratepayers and the utility, and the contesting parties have had [*296] an opportunity to present their positions, the requirements of *Mobil* have been met. [183]

This reading of *Mobil* is incorrect. The *Mobil* Court in no way rejected the requirement of traditional rate hearings in nonunanimous settlement cases. By observing that unanimous agreements should be approved if they are "in the general interest of the public," [184] the Court indicated that such hearings were not required when all parties are in agreement. But, in regard to nonunanimous settlements, the Court noted that they "may be adopted as a resolution *on the merits*, if FPC makes an independent finding supported by 'substantial evidence on the record as a whole' that the proposal will establish 'just and reasonable' rates for the area." [185] By using the language "on the merits," the Court did not merely envision approval of the settlement agreement under some nebulous public interest standard, but endorsement reflecting an independent determination "on the merits" that the settlement established "just and reasonable" rates. [186] Such approval necessarily requires the development of a full case record. [*297] The phrase "just and reasonable," which is contained in public utility commission

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180 *Id.* at 314, (quoting Placid Oil Co. v. Federal Power Comm'n, 483 F.2d 880, 883 (5th Cir. 1973) (emphasis in original)).

181 *See, e.g.*, Bryant v. Arkansas Pub. Serv. Comm'n, 877 S.W.2d 594, 599-600 (Ark. Ct. App. 1994); In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660, 685 (Ind. Pub. Serv. Comm'n 1986); In re Iowa Elec. Light & Power Co., 46 Pub. Util. Rep. 4th (PUR) 130, 146 (Iowa Commerce Comm'n 1982).

182 *See, e.g.*, United States v. Public Serv. Comm'n, 465 A.2d 829, 833 n.3 (D.C. 1983) (rejecting argument that *Mobil* is inapplicable unless a full administrative record has been established); In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660, 685 (Ind. Pub. Serv. Comm'n 1986) ("Although an administrative settlement must be approved on the basis of an adequate record, the procedures from which this record is derived are quite flexible.").

183 *See, e.g.*, City of Akron v. Public Util. Comm'n, 378 N.E.2d 480, 483 (Ohio 1978) (although no testimony presented on rate of return, court affirmed order approving nonunanimous settlement, noting that "the commission afforded appellants full opportunity to present evidence with respect to all contested issues"); City of Abilene v. Public Util. Comm'n, 854 S.W.2d 932, 939 (Tex. Ct. App. 1993) ("[t]he procedure used in this case offered adequate opportunity for all parties to present their positions for the Commission's consideration"). *See generally* In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *12 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992).

184 Mobil Oil Corp. v. Federal Power Comm'n, 417 U.S. 283, 314 (1974).

185 Id. at 314.

186 Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693, 704 (Ill. 1989). In that case, the court reversed a Commission order approving a nonunanimous settlement because the order was based on the settlement agreement, not on the merits. The court observed that "[a]bsent statutory law to the contrary, we have no quarrel with the Commission's ability to

enabling acts, is a term of art. [187] It was incorporated into public utility statutes in response to *Smyth v. Ames*. Although the constitutional fair value standard established by *Smyth* has been abandoned, its requirement of a full examination of the utility's rate base, operating expenses, and reasonable rate of return as a basis for setting rates has become an essential component of ratemaking statutes. [188] Traditional rate base ratemaking requires an evidentiary record as well as findings of fact based on this record. [189] In other words, under these statutes, when confronted with a nonunanimous settlement, the issue for a commission is not whether the settlement proposal reasonably balances the interests of ratepayers or whether substantial evidence supports that particular agreement. [190] Instead, as in any rate case, a commission must make findings on the merits regarding rate base, operating expenses, rate of return, and rate design.

For these reasons, the flexible hearings approach adopted by most commissions in reviewing nonunanimous settlements is prohibited by traditional statutes. While such hearings might expedite the process and allow for more efficient processing of cases, commissions do not have statutory authority to use such a process in the absence of unanimous consent. [191] In their attempts to handle the complexity and demands of these cases, the commissions, with the blessing of a number of courts, have ignored the previously recognized requirements of traditional rate base hearings.

IV. Nonunanimous Settlement of Rate Cases as a Dispute Resolution Mechanism

Even if the enabling statutes permit commissions to approve nonunanimous settlements without traditional rate hearings, it is unclear whether such a process is a valid dispute resolution mechanism. While commentators and commissioners have preached the value of [*298] nonunanimous settlement as a means of expediting the processing of cases, [192] they have failed to examine in-depth all the issues raised by this departure from traditional ratemaking methods. [193]

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consider a settlement proposal not agreed to by all of the parties and the intervenors as a decision on the merits, as long as the provisions of such a proposal are within the Commission's power to impose, the provisions do not violate the [Public Utilities] Act, and the provisions are independently supported by substantial evidence in the whole record." *Id. See also* City of Somerville v. Public Util. Comm'n, 865 S.W.2d 557, 562 (Tex. Ct. App. 1993); In re Idaho Power Co., 102 Pub. Util. Rep. 4th (PUR) 139, 148 (Idaho Pub. Util. Comm'n 1989) (Miller, Comm'r, separate opinion).

[187] *See supra* notes 55-64 and accompanying text. *See generally* PIERCE & GELLHORN, *supra* note 79, at 100-101.

[188] *See supra* notes 65-85 and accompanying text. *See generally* PIERCE & GELLHORN *supra* note 79, at 101.

[189] Business & Professional People, 555 N.E.2d at 700.

[190] Id. at 702; State ex rel Fischer v. Public Serv. Comm'n, 645 S.W.2d 39, 43 (Mo. Ct. App. 1982).

[191] 645 S.W.2d at 43.

[192] *See, e.g.,* In re Commission's Rules of Practice & Procedure, No. 87-11-053 at *4 (Cal. Pub. Util. Comm'n Nov. 25, 1987) (Westlaw, PUR Database); In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *2 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992); Morgan, *supra* note 16, at 76-78; Marilyn O'Leary, *Negotiated* Settlements in Utility Regulation, PUB. UTIL. FORT., Aug. 21, 1986, at 11.

[193] *But see* Katko, *supra* note 126 (addressing problems of nonunanimous settlement in a particular case before the New York Public Service Commission).

In recent years, a significant amount of literature has developed concerning the functioning of different dispute resolution systems and the selecting of a process for dispute resolution. [194] Although few of these commentators have addressed the area of public utility regulation, [195] their insights can be very helpful in identifying general principles for evaluating the benefits and weaknesses of the nonunanimous settlement process. While rate cases differ in some respects from environmental, civil rights, domestic relations, and other civil controversies, these disputes all raise some common issues. These issues include the equity of the process, the legitimacy of the system, and the administration of justice. Rate cases are not entirely sui generis. Therefore, it is useful to expand any examination of the propriety of nonunanimous settlements beyond the narrow issues of the arcane world of rate regulation.

The literature on dispute resolution has identified a number of factors for evaluating the quality of dispute resolution mechanisms. [196] Five of [*299] the most significant factors are: (1) the efficiency of the process; (2) the balance of power among the parties in the process; (3) the legitimacy of the process; (4) the effect of the process on human relationships; and (5) the role of the process in clarifying fundamental policy issues. [197] In this part, the Article will describe each of these factors, reviewing the dispute resolution literature on each of them. The Article will then examine the nonunanimous settlement process in light of each factor, comparing this process with traditional rate base regulation and the unanimous settlement process. Throughout this discussion, the Article will focus on the problems that representatives of captive ratepayers face as intervenors in rate proceedings.

A. *The Efficiency of the Process*

The first factor which needs to be evaluated in judging a dispute resolution mechanism is the efficiency of the process. As one commentator has observed:

> Minimizing the cost of administration of social enterprises, although rather pedestrian by comparison to the other goals . . ., is a well established and independent societal goal. Even where action must be undertaken in the public interest to achieve desired goals the action should itself be conducted so as to consume as few resources as possible in administrative costs. [198]

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194 *See, e.g.*, POLITICS OF INFORMAL JUSTICE, *supra* note 2; DOUGLAS J. AMY, THE POLITICS OF ENVIRONMENTAL MEDIATION (1987); JEROLD AUERBACH, JUSTICE WITHOUT LAW: RESOLVING DISPUTES WITHOUT LAWYERS (1983); Richard Delgado, *ADR and the Dispossessed: Recent Books About the Deformalization Movement*, 14 L. & SOC. INQUIRY 145 (1988); Richard Delgado et al., *Fairness and Formality: Minimizing the Risk of Prejudice* in Alternative Dispute Resolution, 1985 WIS. L. REV. 1359; Harry T. Edwards, *Alternative Dispute Resolution: Panacea or Anathema?*, 99 HARV. L. REV. 668 (1986); Owen M. Fiss, Comment, *Against* Settlement, 93 YALE L.J. 1073 (1984); Philip J. Harter, *Dispute Resolution and Administrative Law: The History, Needs, and Future of a Complex Relationship*, 29 VILL. L. REV. 1393 (1983-1984); David Luban, *The Quality of Justice*, 66 DENV. U. L. REV. 381 (1989); Lawrence Susskind & Gerard McMahon, *The Theory and Practice of Negotiated Rulemaking*, 3 YALE J. ON REG. 133 (1985); Sally E. Merry, *Disputing Without Culture*, 100 HARV. L. REV. 2057 (1987) (reviewing STEPHEN B. GOLDBERG ET AL., DISPUTE RESOLUTION (1985)).

195 *See* Morgan, *supra* note 16; van Hook, *supra* note 36; Raab, *supra* note 107.

196 *See, e.g.*, Robert A. Baruch Bush, *Dispute Resolution Alternatives and the Goals of Civil Justice: Jurisdictional Principles for Process Choice*, 1984 WIS. L. REV. 893; Luban, *supra* note 194; Frank E.A. Sander, *Alternative Methods of Dispute Resolution: An Overview*, 37 U. FLA. L. REV. 1 (1985).

197 Bush, *supra* note 196, at 908-21; Luban, *supra* note 194, at 401-17; Sander, *supra* note 196, at 13-15.

198 Bush, *supra* note 196, at 920.

In the rate regulation context, because of the time and resources devoted to rate cases by commission staff, utility managers, intervening parties, and the commissioners themselves, administrative costs can be quite significant. Accordingly, it is often argued that the settlement process, especially with respect to nonunanimous settlements, contributes to process-related savings.

Commissions assert that settlement of rate cases conserves public and private resources. Nothing the increasingly complex nature of some rate **[*300]** cases, commissions urge settlement as a means to remove the burden of the procedural formalities of adjudicatory hearings from their staffs. [199] They also contend that settlement avoids the risks to the commissions of appellate litigation. [200] Further, commissions point to the savings of time and money for utility management and staff which would otherwise be involved in the full litigation of a case. [201] Moreover, they assert that settlement expedites the process of information-gathering for both the parties and the commission. [202] Commissions contend that formal litigation fosters extreme posturing by the different parties and the coloring of information presented as evidence, both of which obstruct an expeditious exchange of ideas and data. [203]

Some commissions have suggested that a nonunanimous settlement rule is required to achieve these benefits. Without such a rule, it is feared, an inactive party or obstructionist consumer intervenor may boycott any negotiations, arbitrarily blackball a reasonable settlement, and force full-scale hearings. [204] As a result, any savings of time and resources derived from the settlement process would be wasted. **[*301]** The limited empirical research on the settlement of rate cases does not wholly support the claims of its proponents in regard to process-related savings. While no study of the time savings of the nonunanimous settlement process has been made, the few studies addressing unanimous settlements show that the process of negotiating these settlements takes substantial time. For example, Jonathan Raab's study of the unanimous settlement of the Pilgrim Nuclear Plant case found that the settlement process required considerable expenditures of time and money. [205] Settlement discussions in that case

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199 *See, e.g.,* In re Commission's Rules of Practice & Procedure, No. 87-11-053 at *4 (Cal. Pub. Util. Comm'n Nov. 25, 1987) (Westlaw, PUR Database); In re Chesapeake & Potomac Tel. Co., 84 Pub. Util. Rep. 4th (PUR) 364, 369 (D.C. Pub. Serv. Comm'n 1987); In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 364-65 (Ky. Pub. Serv. Comm'n 1989); In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *2 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992); In re Cincinnati Gas & Elec. Co., 52 Pub. Util. Rep. 4th (PUR) 304, 306-307 (Ohio Pub. Util. Comm'n 1983); In re El Paso Elec. Co., 101 Pub. Util. Rep. 4th (PUR) 405, 409 (Tex. Pub. Util. Comm'n 1988). *See generally* Brock, *supra* note 105, at 2, 20; Morgan, *supra* note 16, at 24-42; Raab, *supra* note 107, at 66, 88-92.

200 In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23, 29 (N.Y. Pub. Serv. Comm'n 1986).

201 *See, e.g.,* id. at 30; In re Chesapeake & Potomac Tel. Co., 84 Pub. Util. Rep. 4th (PUR) 364, 369 (D.C. Pub. Serv. Comm'n 1987); In re El Paso Elec. Co., 101 Pub. Util. Rep. 4th (PUR) 405, 409 (Tex. Pub. Util. Comm'n 1988).

202 *See Question 2: Dispute Resolution, supra* note 115, at 35.

203 *See id.* at 34 (quoting Pennsylvania Commissioner William Smith stating "[f]ormal litigation is expensive, time consuming, and tends to foster extreme positions on the part of the litigants").

204 *See supra* notes 121-124 and accompanying text.

205 Raab, *supra* note 107, at 133, 143 (concluding that settlement of the Pilgrim generating plant case in Massachusetts, after conclusion of hearings, could not be credited with significant resource savings).

began only after the evidentiary hearings were completed. All the parties interviewed were skeptical about the usefulness of negotiations any earlier in the process. [206] As one participant stated:

> A settlement would not have made sense either prior to or early in the hearings. We needed to get all the information out on the table. Otherwise, the settlement would have become a back room deal, and not a creative solution based on the evidence and the parties' different expectations of the future. Until we had developed the case on paper, we would not have known how to set all the parameters in the settlement, and it would have been rather arbitrary. [207]

Although, as Raab notes, it is possible that this exchange of information could have been more expeditiously accomplished without formal evidentiary hearings, [208] even informal, technical information meetings would have required considerable commitments of time.

While it can be argued that studies such as Raab's support a nonunanimous settlement rule, there is no indication in any of these cases that the cause of delay was an obstructionist intervenor. In the cases analyzed, there were only limited process-related savings, which were due [*302] to the complex and technical nature of rate disputes, rather than to an arbitrary blackballer. Undoubtedly, a requirement of unanimous consent lengthens the negotiation process to some extent. Studies of negotiating groups have found that a unanimous decision-making rule usually lengthens the negotiation process and creates a greater probability of group impasses. [209] However, serious negotiations of rate cases require substantial outlays of time and money regardless of the decision-making rule used. While nonunanimous settlements of rate cases unquestionably save some time and money, the extent of these savings is unclear and may be overestimated by proponents of such settlements.

B. *The Balance of Power Among the Parties* in the Process

A second factor to be considered in evaluating the propriety of the nonunanimous settlement process is the balance of power among the parties in the process. Many commentators assert that one of our societal goals is distributional justice -- "the attainment of equity in the distribution of society's resources, including all forms of wealth and power." [210] For the dispute resolution system, this goal translates into procedures that protect the have-nots and counterbalance the power and wealth of the haves. [211] In other words, distributional justice is achieved when a dispute resolution mechanism gives all parties equally valued input into the decision-making process. [212]

1. *The Importance of a Balance of Power* in Negotiation

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[206] *Id.* at 143.

[207] *Id.* at 143. In Jonathan Brock's study of an independent telephone utility's unanimous settlement of a rate case, he found that the negotiation process shaved time off the proceedings, even though he also determined that a serious exchange of information required substantial expenditures of time and resources by the parties and commission staff. Brock, *supra* note 105, at 8-10.

[208] Raab, *supra* note 107, at 143.

[209] Leigh L. Thompson et al., *Group Negotiation: Effects of Decision Rule, Agenda, and Aspiration*, 54 J. PERSONALITY & SOC. PSYCHOL. 86, 92 (1988).

[210] Bush, *supra* note 196, at 911.

[211] *Id.* at 911-12; Luban, *supra* note 194, at 407-13.

[212] *See* Luban, *supra* note 194, at 411.

Settlement mechanisms do not exist in a vacuum. As Sally Engle Merry has observed:

> No [dispute resolution] process exists separately from its place in the unfolding sequence of stages, which gives it meaning and force. If parties are aware that a more coercive process will ensue if mediation fails, the dynamics of the mediation will differ sharply from "pure mediation," because the expectation [*303] of an imposed settlement will inevitably alter the meaning of the event for all the actors. [213]

Therefore, the ability of each participant in any ADR process to wield its power, through litigation, political clout, physical strength, or psychological pressure, is an essential factor which must be considered in determining the appropriateness of the use of that process to resolve a particular problem.

Most commentators conclude that a relative balance of power among the parties is a necessary component in socially just negotiations. [214] Without such a balance, there will be little incentive for good faith negotiations by all parties. [215] The party with the superior power will not be motivated to engage in serious dialogue if it knows that it can achieve its goals outside of the negotiation process. In addition, even if discussions take place, it is unlikely that they will lead to optimal solutions if there is no balance of power. When a balance of power is established, the parties are less able to use coercion and manipulation to achieve their ends, and it is more likely that they will share information and reason together in designing a settlement that addresses each party's interests. [216]

Finally, without a balance of power, it is unlikely that the result will be equitable. As Jerold Auerbach has observed: "Compromise only is an equitable solution among equals; between unequals, it inevitably reproduces inequality." [217] For example, a party with greater financial resources and technical expertise will often attempt to intimidate weaker [*304] parties into settlement. [218] Faced with this pressure, parties with fewer resources are likely to feel constrained to accept less than fair

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213 Merry, *supra* note 194, at 2066.

214 *See* AMY, *supra* note 194, at 80 (in the context of environmental mediation, author contends that mediation tends to be viewed as appropriate only when there is a relative balance of power between the disputants); Amy, *supra* note 13, at 8; Brock, *supra* note 105, at 15; Susskind, *supra* note 13, at 14 (In regard to environmental mediation, the author asserts that "a mediator should probably refuse to enter a dispute in which the power relationships among the parties are so unequal that a mutually acceptable agreement is unlikely to emerge."). *But see* Susskind & McMahon, *supra* note 194, at 154. Susskind and McMahon found that EPA demonstrations of negotiated rulemaking disprove the hypothesis that such rulemaking will fail if one party has inordinate power goals without having to deal with others. They found that environmental groups with less power were effective because they were able to form coalitions with more powerful allies. In the nonunanimous settlement context, however, such coalition formation is difficult for less powerful groups. *See infra* notes 233-238 and accompanying text.

215 *See, e.g.*, Brock, *supra* note 105, at 17.

216 *See generally* AMY, *supra* note 194, at 92-93; Bob Rosin, *EPA* Settlements of Administrative Litigation, 12 ECOLOGY L.Q. 363, 370 (1985).

217 AUERBACH, *supra* note 194, at 136.

218 *See* AMY, *supra* note 194, at 143-45; *see also* Amy, *supra* note 13, at 9 ("instead of avoiding mediation or seeking to exclude other groups from the process, powerful interests may actively embrace mediation as a way of co-opting their weaker opponents"); Susskind, *supra* note 13, at 15 (commenting on the effects of leverage in mediation).

outcomes. [219] Such an outcome is especially likely when the negotiation process is forced on the parties, as in situations of compulsory mediation. [220]

2. *Formalism as a Tool of Power* in Dispute Resolution

Formal adjudication is one instrument that can be used by less powerful parties to protect their interests against more powerful opponents. [221] The procedural safeguards afforded by adjudication serve several functions. First, they create certain internal constraints on the decision-maker. They require her to apply existing rules and standards to the particular case. In addition, because of the repetitive nature of most caseloads, they encourage her to consider a case in terms of the relevant legal and factual issues, not the parties involved. [222]

Second, these safeguards provide external constraints on the decision-maker. For example, disqualification, ex parte communication, and recusal rules all help in controlling bias. [223] While some of these procedures are infrequently used, their mere existence creates an institutional check on improper influence in the decision-making process.

Finally, these safeguards establish controls on the parties "by defining the scope of the action, formalizing the presentation of evidence, and reducing strategic options." [224] Rules of procedure, for example, [*305] require notice at each stage of a case, provide a formal schedule for the litigation process, allow for an open exchange of information among the parties, and mandate explicit findings of fact by the decision-maker. [225] Similarly, rules of evidence limit the power of the parties in the presentation of their cases, establish exclusions for irrelevant and prejudicial evidence, provide an agenda for production of proof, require foundations to establish the competency of witnesses and the reliability of testimony, and limit the admissibility of prejudicial evidence. [226]

The limitations that formal rules impose upon the decision-maker and the parties help to provide a level playing field for all of the parties. As Owen Fiss has observed, "[j]udgment aspires to an autonomy from distributional inequalities." [227] Although imbalances of power can distort the

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219 *See generally* Fiss, *supra* note 194, at 1076 ("the poorer party may be less able to amass and analyze the information needed to predict the outcome of the litigation and thus be disadvantaged in the bargaining process"); Susskind, *supra* note 13, at 15. Additionally, informal processes open the door for decision-maker prejudices to influence the decision-making. *See generally* Delgado et al., *supra* note 194, at 1374, 1402.

220 AMY, *supra* note 194, at 146 ("A lack of voluntariness may undermine much of the integrity and legitimacy of the mediation.").

221 *Id.* at 106; Richard L. Abel, *Introduction* to POLITICS OF INFORMAL JUSTICE, *supra* note 2, at 1, 11 (arguing that formalism protects powerless such as defendants in criminal cases and tenants in eviction actions). *See generally* Delgado et al., *supra* note 194.

222 Delgado et al., *supra* note 194, at 1368.

223 *Id.* at 1368-69.

224 *Id.* at 1374.

225 *Id.* at 1371-73.

226 *Id.* at 1373-74.

227 Fiss, *supra* note 194, at 1078.

adjudication process, the procedural safeguards of that process can restrict the undue influence of parties with superior power. [228]

The significance of formal procedures as tools for balancing power in dispute resolution is well illustrated by the historical development of the rules of traditional rate base regulation. As described earlier, in the early nineteenth century consumers sought protection from legislatures to counteract the superior economic power of railroads. [229] As a result of these efforts, legislatures established strong commissions that possessed considerable power over railroads. [230] Fearing unlimited control by legislatures and commissions, railroads themselves sought relief in the courts, and the Supreme Court created formal procedural protections to counterbalance what it saw as the superior power of consumers. [231] With the formal requirements of notice, hearings, findings of fact, and substantive standards, the Court attempted to strike a balance between the power of railroads and their consumers.
[*306] 3. *The Balance of Power and* Nonunanimous Settlements

The balance of power in negotiations is certainly a key concern in public utility disputes. Many conflicts among utilities, consumer groups, and government intervenors are not merely the result of failures in communication that can be resolved through improved dialogue. [232] In many rate cases, a battle over strong political interests lies underneath the technical data and expert opinions. Issues such as the allocation of the costs of new generating facilities, the rate treatment of cancelled nuclear plants, the determination of rate design, and the proper rate of return require the balancing of different political, social, and economic interests. [233] Given the importance of the balance of power among the parties in the negotiation process, any assessment of the impact of negotiated settlements on distributional justice must not ignore the relative power of each party.

The nonunanimous settlement mechanism tends to give utilities superior bargaining power in the negotiation process, especially in relation to weaker intervenors. The utility has a power to which no other party is entitled: the power to veto a settlement. In any negotiation, the utility knows that the discussions end as soon as it walks away from the bargaining table. If any other party withdraws, however, the negotiations can continue, and the commission can approve a contested agreement in a flexible hearing. Because representatives of groups such as captive ratepayers fear that they may be left out of a settlement agreement, they may be coerced and manipulated into an agreement they would otherwise not accept.

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228 *Id.* at 1077-78.

229 *See supra* notes 40-41 and accompanying text.

230 *See supra* notes 42-43 and accompanying text.

231 *See supra* part I.B.

232 *See generally* AMY, *supra* note 194, at 228:

> The fundamental flaw underlying any attempt to rely on [alternative] dispute resolution to resolve public policy conflicts is that such well-meaning efforts ultimately rest on a false understanding of what politics is all about. Politics is not simply about communication, it is about power struggles. It is not only about common interests, but also about conflicting interests. And it not only involves horse-trading, but competition between conflicting values and different moral visions.

233 Krieger, *supra* note 96, at 648.

The tendency of nonunanimous decision-making to foster coalition formation aggravates this problem. One general study of coalition formation found that, in three-person negotiation groups that followed majority rule decision-making, two members usually formed a coalition "to prevent the remaining negotiator from achieving his or her most [*307] important interests and to ensure that the two colluding members achieved their most important interests." [234] The study also found that colluding members tended to stick together for the duration of the negotiations because they feared that a new coalition might be formed against them. [235]

Coalition formation in rate cases may lead to a detrimental manipulation of the negotiation process. Rate cases usually involve multiple issues, and each party has varying degrees of interest in regard to each of these issues. For example, an industrial intervenor might be very interested in certain rate design issues and less concerned about the amount of the rate hike. Because the utility must be a signatory to the agreement, the nonunanimous settlement process may give intervenors the incentive to ally themselves with the utility and to agree to provisions demanded by the utility in which they have only moderate interest. In return, the utility might accept their conditions. In this hypothetical, the industrial intervenor might agree to the amount of a utility rate hike in order to persuade the utility to agree to the intervenor's rate design proposal. While that intervenor might have an interest in addressing the rate hike issue, it will likely forgo that interest rather than endanger its alliance with the utility. Although all the remaining intervenors may strongly contest the amount of the rate hike, the agreement will be presented to the commission as a settlement of all issues between the utility and the industrial intervenor. Because the utility has a superior capacity to form coalitions, the balance of power in negotiations becomes even more distorted.

Participation of the commission staff in the nonunanimous agreement may accentuate the power imbalance. The staff, as an arm of the commission, wields significant power. [236] Indeed, if the staff allies itself with the utility, a bandwagon effect may be created, swaying other parties [*308] to join the agreement, albeit reluctantly. [237] As one court that recognizes the concept of nonunanimous settlements has noted:

> [Nonunanimous agreements create] the possibility of an unintentional shift of the burden of proof from the utility to the opponents of the stipulation. There is a danger that when presented with a ready-made solution, the Commission might unconsciously require that the opponents refute the agreement, rather than require the utility to prove affirmatively that the proposed

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[234] Thompson et al., *supra* note 209, at 92. These groups also used an issue agenda for decision-making. *Id.*

[235] *Id.*

[236] *Cf.* AMY, *supra* note 194, at 150 (observing that in context of environmental mediation the presence of governmental representatives maximizes power imbalances).

[237] *But see* In re Commission's Rules of Practice & Procedure, No. 87-11-053, at *9 (Cal. Pub. Util. Comm'n Nov. 25, 1987) (Westlaw, PUR Database) (rejecting bandwagon effect argument in approving rule allowing for nonunanimous settlements and stating: "We wish to assure parties that it is the Commission and not the stipulating parties which must make the decision in any matter. We are not bound to approve a stipulation or settlement simply because it is offered.").

> rates are just and reasonable. This danger is increased when the Commission staff is a signatory party and is in a position of advocating the stipulation. [238]

The vast majority of nonunanimous settlements include the utility and commission staff but exclude consumer groups. [239] While most commission staff members attempt to represent the public interest in good faith and while some consumer groups adamantly object to all rate increases, this coalition-building phenomenon raises serious distributional justice questions. With the pressures of limited time and resources, the commission staff might in good faith ally itself with the utility in order to expedite negotiations and resolve a case.

The nonunanimous settlement process significantly affects the ability of consumer groups to use the legitimate threat of formal hearings as a weapon in negotiations. In most rate cases, the utility has significantly more power than most intervenors. It has most of the technical information regarding the relevant issues in the case within its control, it usually has a permanent staff of experts, and it has the resources to hire additional expert consultants. [240] Usually, however, it does not have unlimited time to litigate cases and, like most litigants, it is concerned [*309] with the risk of losing the case. Besides obtaining its requested rate relief, the utility is interested primarily in an expeditious hearing of its case. On the other hand, many consumer groups, especially those representing the interests of low-income and other captive customers, rely on the formal procedural protections of the hearing process to offset the power of the utility. By insisting that the utility defend its prima facie case and meet statutory standards for each of the elements of the rate-making formula [241] and demanding that the commission render detailed findings of fact on each of the elements, these consumer groups attempt to create a more level playing field with their adversaries.

In some cases, the nonunanimous settlement process has the potential to deprive consumer intervenors of the protections of formal procedures. With a requirement of unanimous agreement, all parties would know that they must negotiate within the shadow of the law. [242] If these negotiations fail, these parties would have the right to have their case heard at a traditional rate base hearing. If the utility faces lengthy hearings, presentation of numerous witnesses, difficulties with meeting certain statutory standards, or the possibility of extended delays and appeals, consumer intervenors may hold some power over the utility. The effectiveness of these weapons becomes more limited with the use of nonunanimous settlement. If the utility can obtain consent from staff and perhaps one or two other intervenors, such as industrial customers, consumer groups may be left out of the settlement and may have no opportunity for a full-blown hearing.

The importance of formalism for power balancing is not merely hypothetical; it is exemplified by the recent successes of consumer groups in rate cases, and by the attempts of some utilities and commissions to use the settlement process to offset these accomplishments.

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238 City of Abilene v. Public Util. Comm'n, 854 S.W.2d 932, 938-39 (Tex. Ct. App. 1993). The court, however, approved the settlement without addressing whether or not the commission had incorrectly shifted the burden of proof in that case. *Id.*

239 *See supra* note 29 and accompanying text.

240 Utilities also wield significant influence with commissions. *See infra* notes 261-265 and accompanying text.

241 *See supra* notes 77-85 and accompanying text.

242 This term is used in the dispute resolution area to refer to the notion that negotiations occur against the backdrop of possible full-scale litigation. *See generally* Robert H. Mnookin & Lewis Kornhauser, *Bargaining* in the Shadow of the Law: the Case of Divorce, 88 YALE L.J. 950 (1979) (introducing and discussing term).

A prime example is the Illinois Commerce Commission's handling of Commonwealth Edison rate cases in the 1970s and 1980s. In the early 1970s, Edison embarked upon an ambitious construction program to add six nuclear generating units. [243] Forecasting increased load growths, [*310] Edison persuaded the Commission to approve certificates for these plants. [244]

Throughout the 1970s and the early 1980s, consumer groups and other intervenors aggressively challenged rate increases resulting from the construction program in the Commission and the courts. These earlier challenges, however, were largely unsuccessful. [245] Finally, in 1985, various consumer and government intervenors challenged a Commission order granting a $ 494.8 million rate increase for costs associated with one of these plants. [246] These intervenors appealed the order, arguing that the Commission erred by presuming that the costs of the plant were reasonable, rather than requiring an affirmative showing of reasonableness. [247] In April 1986, the trial court held in favor of the intervenors and remanded the case to the Commission. [248]

After the trial court's decision, Edison proposed negotiations and, shortly thereafter, entered into an agreement with a number of governmental parties to settle rate issues concerning three additional nuclear plants. [249] Consumer groups attacked this nonunanimous settlement, and in July 1987 the Commission, by a four to three vote, rejected the settlement. [250] Undeterred, Edison filed a new rate case and entered into a new settlement with the Commission's staff and industrial [*311] intervenors. After expedited proceedings, the Commission approved the nonunanimous settlement. [251]

The Commonwealth Edison saga illustrates consumer intervenors' use of formal procedures to attempt to balance the power in dispute resolution. [252] After the Commission approved Edison's construction program, the Commission continued to grant the utility's requests for rate increases. But after Edison completed the new plants, consumer groups effectively raised a procedural argument, the erroneous

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243 *See* In re Commonwealth Edison Co., 84 Pub. Util. Rep. 4th (PUR) 469 (Ill. Commerce Comm'n 1987).

244 Id. at 477. Consumer, environmental, and "public interest" groups, as well as governmental intervenors, objected to the construction of these plants, challenging Edison's optimistic forecasts for increased load. *See* In re Commonwealth Edison Co., 50 Pub. Util. Rep. 4th (PUR) 221, 222-25 (Ill. Commerce Comm'n 1982). In 1978, the commission initiated its own investigation into the efficacy of this construction program, and, in 1980, it directed Edison to complete its construction program in as timely and economic a manner as possible. In re Commonwealth Edison Co., 84 Pub. Util. Rep. 4th (PUR) 469, 476 (Ill. Commerce Comm'n 1987).

245 *See, e.g.*, People v. Illinois Commerce Comm'n, 448 N.E.2d 986 (Ill. App. Ct. 1983); In re Commonwealth Edison Co., 50 Pub. Util. Rep. 4th (PUR) 221, 222-25 (Ill. Commerce Comm'n 1982).

246 In re Commonwealth Edison Co., 71 Pub. Util. Rep. 4th (PUR) 81 (Ill. Commerce Comm'n 1985).

247 People ex rel. Hartigan v. Illinois Commerce Comm'n, 510 N.E.2d 865 (Ill. 1987).

248 People ex rel. Hartigan v. Illinois Commerce Comm'n, 85 CH 1097, slip. op. (Cir. Ct. of Cook County Apr. 29, 1986).

249 Carol McHugh, *The $ 1.34 Billion* Utility Bargain: Shedding Light on the Edison Case, CHI. LAW., Dec. 1993, at 16.

250 *Id.* at 17; In re Commonwealth Edison Co., 84 Pub. Util. Rep. 4th (PUR) 469 (Ill. Commerce Comm'n 1987).

251 *See* In re Commonwealth Edison Co., 117 Pub. Util. Rep. 4th (PUR) 401 (Ill. Comm. Comm'n 1988); McHugh, *supra* note 249, at 17.

252 The Edison case is not an isolated attempt by a utility to use the nonunanimous settlement process after consumer successes. In In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348 (Ky. Pub. Serv. Comm'n 1989), the utility entered into such a settlement after the commission had disallowed twenty-five percent of a newly constructed generating plant, and in In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23 (N.Y. Pub. Serv. Comm'n 1986), the utility and the commission staff used the nonunanimous settlement process in response to strong consumer challenges to the Shoreham nuclear plant.

presumption of reasonableness by the Commission, to attack a rate increase associated with one of the plants. Just as the formal procedures of rate base ratemaking established in *Chicago, Milwaukee* and *Smyth* protected utilities from the power of commissions perceived to be overly-sympathetic to ratepayers, consumer groups now used these same types of procedures to counterbalance the power of the utility. [253]

The *Edison* cases also demonstrate the use of the nonunanimous settlement process to thwart the use of formal procedures as a tool of power. In other contexts, several commentators have suggested that one of the reasons for the current upsurge in ADR has been the increased use of the judicial process during the 1960s to expand entitlements for disadvantaged groups who had not previously used those processes: for example, women in domestic violence cases, low-income consumers in credit and collection actions, and poor tenants in eviction proceedings. [254] Indeed, commentators argue that these disadvantaged groups have used [*312] the formal mechanisms of adjudication to balance power against their opponents. In response, their opponents have proposed more informal dispute resolution mechanisms to thwart this newly-gained power. [255]

The history of the *Edison* case supports this hypothesis that recent interest in ADR has been fueled by a desire to upset the balance of power created by formal procedures. For over a decade, intervenors had challenged Edison's nuclear construction programs. Although many of these cases were lengthy proceedings involving complex issues, neither the utility nor the Commission requested the use of the settlement process and the abandonment of traditional rate base ratemaking. Throughout this period, however, Edison was relatively successful in obtaining relief. Edison conjured up the idea of informal, nonunanimous settlements of rate cases only after consumer groups used the formal ratemaking procedures to counterbalance Edison's power with the Commission. Without the constraints of formalism, the utility obtained the Commission staff's assent to a nonunanimous settlement and eventually the Commission's blessing for the agreement. The utility, therefore, used the nonunanimous settlement procedure to deprive intervenors of the power they had gained through formal processes.

Admittedly, the *Edison* cases are unusual: they arose out of the bygone era of nuclear plant construction and involved hundreds of millions of dollars of rate increases. Commentators may argue that the desire of the Commission and staff to approve the nonunanimous settlement resulted from the unique exigencies of those cases and times. Without any evil intent, commissions tried to address a difficult situation not entirely of their making. It is also possible that, in situations less critical than those in the *Edison* case, the settlement process might actually help to level the playing field for less advantaged intervenors. Indeed, given the technical complexity of rate cases and the limited resources of such intervenors, the less formal setting of the bargaining table might give these intervenors more

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253 Unlike utilities, ratepayers may not have a constitutional right to particular rates. *Compare* State ex rel. Jackson County v. Public Serv. Comm'n, 532 S.W.2d 20, 31 (Mo. 1975) (rejecting argument that ratepayers have a vested right in existing rates) *with* Nebraska ex rel. Spire v. Northwestern Bell Tel., 445 N.W.2d 284, 297-98 (Neb. 1989) (recognizing consumers' right to reasonable rates). The requirements for rate hearings contained in the enabling statutes, however, give both utilities and ratepayers the rights to procedural protections in those hearings.

254 *See* POLITICS OF INFORMAL JUSTICE, *supra* note 2, at 3; Merry, *supra* note 194, at 2072.

255 POLITICS OF INFORMAL JUSTICE, *supra* note 2, at 3; Merry, *supra* note 194, at 2072.

power. [256] This type of setting actually might help intervenors become more powerful by organizing their own coalitions with the utility or with other intervenors. [*313] On the other hand, there are lessons to be learned from cases such as *Edison*. In the current climate of increased deregulation, commissions will face serious conflicts between the rights of large ratepayers with access to alternative sources of service and captive customers with no such access. [257] The balance of power issues in rate cases that have arisen over the past twenty-five years will remain, and many representatives of captive ratepayers may rely on the formal process in good faith to protect their rights. In their desire to expedite the resolution of rate cases, it is important that commissions and their staffs not lose sight of the impact of nonunanimous settlements on the relative balances of power of the parties in the dispute resolution process. Distributional justice requires a level playing field, and the nonunanimous settlement process can have the tendency to tip the balance in favor of the utility.

C. *The Impact on the Legitimacy of the System*

The effect of nonunanimous settlements on the legitimacy of the ratemaking system is the third factor that should be considered when evaluating the appropriateness of the settlement processes. As Baruch Bush observes:

> Every society strives to ensure that its governing institutions and structures appear legitimate in the eyes of its members. Note that the goal is defined in terms of appearance and perception, not some objective standard of fairness or political economy. Even if the society denies certain citizens the right to participate in decision-making, it may nevertheless achieve legitimacy in the eyes of its members, if it appears that this is an appropriate thing to do. Indeed, even the victims of the denial may accept it as legitimate. [258]

Thus, a determination of whether the nonunanimous settlement mechanism enhances or diminishes the legitimacy of the regulatory system requires an examination of the perceptions of fairness held by both the parties to the proceeding and others who are affected by the decisions. [259] [*314] When examining the legitimacy issue, it is important to note that the regulatory system is not simply the unidirectional assertion of authority by a commission over its regulated industries. Rather, it is a process of ongoing interactions and relationships among the different participants -- commissioners, commission staff, utility personnel, and intervenors -- played out against the backdrop of the different legal and political methods available to these parties. [260]

A number of political scientists and economists assert that most commissions are dominated by the industries they regulate. [261] They argue that, although agencies are frequently created in response to a call for reform, over years of regular contact a subtle relationship begins to develop between the

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256 In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *2 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992).

257 *See supra* notes 32-35 and accompanying text.

258 Bush, *supra* note 196, at 918.

259 Raab, *supra* note 107, at 77.

260 Krieger, *supra* note 96, at 656.

261 *Id.* at 651.

regulator and the regulated company. [262] Eventually, the commission, looking for safety in all its decisions, surrenders its power to the regulated companies. [263] Other commentators contend that regulators become overly sympathetic to the regulated industries, either because they previously worked for the companies or because they have plans for such employment in the future. [264] And still others assert that well-organized utilities buy power from political parties that have electoral and financial resources. Rational self-interested government officials strive to maximize their wealth by adopting policies consistent with the interests of the regulated company. [265]

Commentators have challenged all these versions of the so-called "capture theory" on both historical and empirical bases, [266] but few question the fact that, at the very least, companies tend to exert significant influence in the regulatory process. Regulators and regulated companies develop a relationship of close mutual dependence. The companies rely upon regulators for their revenues and profit. Most regulators by nature are risk averse. Wishing to avoid blatant failures, regulators rely upon the regulated companies to provide reliable and high quality service. [267] "An [*315] agency will be reluctant to push too hard with regulatory directives that may cause, or plausibly be claimed to cause, service failures. Regulators are similarly reluctant to enforce measures that may seriously impair the financial health of the regulated industry." [268]

Given these tendencies toward capture or, at the least, mutual dependence of commissions and utilities, the legitimacy of the decision-making process in the regulatory system can often be a subject of significant contention. [269] Unanimous settlement of regulatory cases enhances the legitimacy of the dispute resolution process. When traditional adversaries work together to reach a consensus and the commission eventually approves the settlement, the legitimacy of the process is strengthened. [270] When all parties have worked out a decision together, they tend to be more willing to commit themselves to it. [271]

Unfortunately, however, the nonunanimous settlement process may exacerbate legitimacy problems. Settlement discussions often involve ex parte communications among the parties at unannounced and sometimes secret meetings. [272] There is nothing nefarious in such contacts. Indeed, the closed dispute resolution process purportedly encourages parties to be candid in the exchange of information, discourages the posturing of more public procedures, and fosters frank discussions of respective

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262 *See* MARVIN BERNSTEIN, REGULATING BUSINESS BY INDEPENDENT COMMISSION 74-84 (1955).

263 *Id.* at 86-95.

264 George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 11 (1971).

265 *Id.*

266 *See* Krieger, *supra* note 96, at 653-54.

267 *See* James Wilson, *The Politics of Regulation,* in THE POLITICS OF REGULATION 357, 376-77 (James Wilson ed., 1980).

268 Stewart, *supra* note 122, at 663.

269 *See, e.g.*, Katko, *supra* note 126, at 1320 (discussing Nine Mile Point Two project).

270 Raab, *supra* note 107, at 340.

271 *See* Rosin, *supra* note 216, at 368.

272 *Id.* at 392.

positions. [273] In the public utility commission context, however, closed processes may increase the dangers raised by the already mutually dependent relationship of staff and company officials. In fact, these kinds of settlement discussions may expose commission staff to persistent pressure to go along with a settlement or face the consequences of the adverse effects that lengthy hearings may have on the financial health of the company. Failure of commission staff to go along with a settlement may also negatively impact their professional careers. [274] [*316] All ADR processes in commissions run the risk of fostering private or secret meetings with commission staff. It is only natural for utility managers to cooperate with agency officials with whom they have an ongoing close relationship. The nonunanimous settlement procedure, however, strengthens this tendency. Because utilities do not have to obtain the consent of all the parties and because the commission staff has significant influence over the commission, [275] the nonunanimous settlement procedure encourages utilities to reach an agreement with the staff. The procedure fosters closed back room meetings with staff, without the participation of other parties. [276] And, once the commission staff has signed the agreement, without a unanimity requirement, other parties will either be forced to join the settlement or face the uphill battle of challenging the agreement in a flexible hearing before the commission. The nonunanimous settlement system diminishes the perception of fairness of commission decision-making.

A good illustration of this problem is the New York Public Service Commission's proceedings in the mid-1980s concerning the rate base allowance for the Nine Mile Point Two Nuclear Generating Facility. [277] Throughout the construction of that plant, the most expensive nuclear generating facility in the history of the United States, consumer groups challenged the need for its construction. [278] As the plant neared completion, the Consumer Protection Board (CPB), the state-funded consumer advocate, [279] requested a Commission inquiry into the cost overruns at the plant and the alleged mismanagement or imprudence of the co-owners. [280] In response, the Commission instituted a proceeding [*317] to investigate the prudence of all expenditures at the plant. [281] But before hearings began, the Commission staff and the utilities stunned intervenors by submitting a proposed settlement to the Commission. This agreement, reached in private negotiations, the record of which was kept secret, required ratepayers to pay over $ 4.45 billion of the plant's costs and contained the assurance

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273 *Id.*

274 *See id.* at 372.

275 *See generally* Lehr, *supra* note 18, at 23 ("While it is often said that regulators are captured by the industries they regulate, it is often more true that they are captives of their staff.").

276 The recently adopted New York settlement guidelines attempt to address this problem by requiring notices of all negotiation meetings to all parties. In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *17 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992). The commission recognized that meetings without notice are "too susceptible of impropriety to be tolerated." *Id.* at 6.

277 *See* In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23 (N.Y. Pub. Serv. Comm'n 1986); Katko, *supra* note 126.

278 Katko, *supra* note 126, at 1319 (noting that the original price tag for the plant was $ 400 million while its final cost was in excess of $ 6 billion); *see* Burstein v. Public Serv. Comm'n, 470 N.Y.S.2d 698 (N.Y. App. Div. 1983).

279 *See* N.Y. EXEC. LAW art. 20, §§ 550-53 (Consol. 1983).

280 Katko, *supra* note 126, at 1325.

281 In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23, 25 (N.Y. Pub. Serv. Comm'n 1986).

that no investigations would be held in regard to the prudence of the plant's construction costs. After expedited hearings, the Commission approved the settlement. [282]

In response to attacks on the secret nature of the negotiations, the Commission found that "in the circumstances of this case such confidentiality may have been necessary to the development of the settlement proposal." [283] But the Commission failed to recognize the effect of this closed process on the perception of legitimacy of its decision-making process. As the dissenting commissioners observed in their opinion:

> The intervenors were forced to react to a fait accompli instead of being permitted to have a voice in shaping an agreement. Therefore, the record in this case is but poorly developed. For example, the question of the cost impact of delays in commencing construction was raised by intervenors early in the prudency proceedings but was settled without adducing evidence. . . . As it is, serious doubt remains as to whether or not the construction duration on which the settlement is based is appropriate. The same could be said for the other issues which affect the cost of the plant. [284]

[*318] Again, it can be argued that the Commission opted for this closed process solely because of the unique issues involved in the case. The Commission in fact has recently adopted stronger rules precluding ex parte contacts between its staff and other parties in the negotiation process. [285] Nevertheless, as commissions confront difficult issues raised by a competitive environment in the future, the legitimacy issues raised by this case will be very real. Participants in collaborative decision-making processes, such as negotiation, consider the process to be legitimate only if they perceive that their interests were better served by that process than by traditional adjudication. [286] Even if the commission staff operates in good faith and refrains from any private negotiations with the utility, a commission faces great difficulty in avoiding the appearance of unfairness when it approves a settlement between its staff and the utility, excluding the representatives of a significant segment of ratepayers, such as captive customers, and failing to provide a full hearing on those issues important to the excluded parties. Even open proceedings can be perceived as illegitimate if some participants are considered mere bystanders. The lesson to be learned from the *Nine Mile Point Two* case is that there is a possible adverse effect of nonunanimous settlements on process legitimacy.

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282 The original agreement established a rate base allowance of $ 4.45 billion. Id. at 25. The commission initially rejected the settlement, advising the parties that $ 4.16 billion would be a sounder basis for a rate allowance for the plant. When the utilities agreed, hearings were held on the revised settlement. Id. at 27.

283 Id. at 46. Although the commission had guidelines prohibiting negotiation without notice to other parties, the commission approved the agreement because the guidelines were not "legally binding rules" and "departure from the guidelines did not substantially impair any party's right to be heard on the proposed settlement . . . ." Id. at 46-47.

284 Id. at 51-52. The commission's decision was motivated by its prior experience of lengthy hearings on the Shoreham nuclear power plant. Apparently the Commission did not want to undergo drawn-out prudence hearings in this case. Id. at 28-29.

One answer to the problem of a closed process is that staff can be precluded from the settlement process. *See generally Question 2: Dispute Resolution, supra* note 115, at 34 (The Commissioner expressed the opinion that "by keeping the staff out of negotiations, we have tried to prevent any appearance of commission involvement in 'back room' deals."). The problem with this approach is that staff, with its technical knowledge, has an important role to play in negotiations. *See* Raab, *supra* note 107, at 197.

285 In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *4-5 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992).

286 Raab, *supra* note 107, at 340.

D. *The Effect of the Process on Human Relationships*

A fourth factor to be considered in evaluating the quality of a dispute resolution process is its impact on human relationships. An important societal goal is that members of the society cooperate as much as possible at individual and group levels. [287] As David Luban notes, one criterion of justice is reconciliation, "transforming the disputants and their mutual relationships so that they come to acknowledge each other's point of view and common humanity." [288] This transformation is desirable because it [*319] can lead to more efficient resource utilization and inspire creative problem solving. [289]

Commissions argue that negotiations, even those that lead to nonunanimous settlements, promote peaceful relations among the parties and ultimately result in a cooperative resolution of the case. [290] As one court noted: "The law has no interest in compelling all disputes to be resolved by litigation." [291] Negotiation, it is argued, can bring public interest groups with limited resources into a process from which they might otherwise be excluded. [292] At the bargaining table, parties have the opportunity to share technical information and to understand each other's interests "faster than the highly contentious and positional hearings allow . . . ." [293] And then the parties and staff can work together to shape solutions "without the rigid formality of litigation." [294]

Commissions assert that traditional rate base regulation is not a perfect system for resolving complex ratemaking issues. [295] Because the regulatory process is inherently ambiguous, especially in areas that require forecasting, proponents of settlement argue that any attempt to arrive at a single correct solution through litigation is pointless. [296] As the commission in the *Nine Mile Point Two* case observed in the context of a prudence challenge: "[I]t is not possible to quantify directly the cost [*320] implications of each specific act of imprudence in an extremely complex construction project that extended over more than a decade." [297] Negotiation, on the other hand, gives the parties the

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[287] Bush, *supra* note 196, at 916.

[288] Luban, *supra* note 194, at 413.

[289] Bush, *supra* note 196, at 916.

[290] *See* Attorney Gen. v. New Mexico Pub. Serv. Comm'n, 808 P.2d 606, 610 (N.M. 1991); In re Cincinnati Gas & Elec. Co., 52 Pub. Util. Rep. 4th (PUR) 304 (Ohio Pub. Util. Comm'n 1983); In re El Paso Elec. Co., 101 Pub. Util. Rep. 4th (PUR) 405, 409 (Tex. Pub. Util. Comm'n 1988).

[291] Utah Dep't of Admin. Serv. v. Public Util. Comm'n, 658 P.2d 601, 613 (Utah 1983).

[292] In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *2 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992).

[293] Raab, *supra* note 107, at 143.

[294] *Question 2: Dispute Resolution, supra* note 115, at 31.

[295] *See, e.g.,* In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23, 28 (N.Y. Pub. Serv. Comm'n 1986); In re New England Tel. & Tel. Co., 106 Pub. Util. Rep. 4th (PUR) 343, 347 (R.I. Pub. Util. Comm'n 1989). *See generally* Morgan, *supra* note 16, at 71 ("Ambiguity is an inherent characteristic of the ratemaking process . . . . The most that can be hoped of any process, whether formal or compromised, is that the result will fall within a range of reasonableness.").

[296] Morgan, *supra* note 16, at 70-71; Raab, *supra* note 107, at 92.

[297] In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23, 28 (N.Y. Pub. Serv. Comm'n 1986).

opportunity to devise creative solutions not easily achieved through litigation. [298] For instance, one commentator points approvingly to the creative practicality of the unanimous settlement of the *Pilgrim Nuclear Power Plant* case. [299] In that case, the parties agreed to tie the utility's cost recovery directly to the plant's future performance in order to avoid the necessity of traditional litigation over the prudence of the plant's costs. [300]

Despite the benefits of the negotiation process in general, the nonunanimous settlement procedure has several deficiencies in fostering cooperative relationships. Such a procedure may discourage the players from developing collaborative relationships over time. Because nonunanimous settlement procedures do not require unanimous consent, participants in the process may be drawn into alliances against each other and are not encouraged to seek solutions that address the interests of all the parties. [301] The process may stimulate collaboration between two or among three of the parties, but other parties may be left out entirely. Unfortunately, in most commissions the nonunanimous settlement process has resulted in ongoing utility and commission staff coalitions against consumer intervenors. [302] When a significant segment of ratepayers, such as captive customers, consistently has the status of nonconsenting party, cooperation among parties is not enhanced.

It also is questionable whether the nonunanimous settlement process promotes creative brainstorming and problem-solving. Social scientists have found that:

> [*321] Integrative strategies require that group members learn other members' preferences and find ways to expand the pie of resources to accommodate these preferences. Encouraging negotiation groups to reach unanimous decisions may help them to accomplish these goals by forcing them to consider nonobvious alternatives that increase the amount of resources to be divided and the goals of all group members. Consequently, participants in a unanimous group may be more committed to the group's final decision, have more control over the process of reaching agreements, and be more satisfied with the group's decision. [303]

Without the unanimity requirement, the parties in a commission settlement negotiation may not feel pressure to approach the issues creatively. Rather, they may merely seek to develop alliances, especially with commission staff, in order to gain quick approval by the commission. The *Trimble*

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298 In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *2 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992) (contending that negotiations may provide the opportunity to address issues that might result in regulatory innovations); Brock, *supra* note 105, at 20.

299 Raab, *supra* note 107, at 137-38.

300 In re Boston Edison, D.P.U. 88-28, 48, 89-100 (Mass. Dept. Pub. Util. Oct. 3, 1989).

301 *See supra* notes 235-239 and accompanying text. *See generally* In re Idaho Power Co., 102 Pub. Util. Rep. 4th (PUR) 139, 148 (Idaho Pub. Util. Comm'n 1989) (Miller, Comm'r, separate opinion) ("[I]f the future is going to be characterized by consensus rather than by confrontation, there has to be a genuine effort to obtain consensus from all interests.").

302 *See supra* note 29 and accompanying text.

303 Thompson et al., *supra* note 209, at 87. *See generally* Raab, *supra* note 107, at 142 ("Parties needed the opportunity to present their own and probe each other's cases. This ventilating was probably necessary to get numerous facts and opinions on the table and to allow the parties to more realistically assess their relative strengths in the cases.").

County, [304] *Nine Mile Point Two,* [305] and *Edison* cases [306] all support this hypothesis. In all three cases, without the constraints of a unanimity rule, the utility did not feel compelled to work with consumer groups to develop creative solutions, but rather primarily sought to reach agreements with commission staff, to the detriment of consumer intervenors.

E. *The Effect of the Process on Clarifying Fundamental Policy Issues*

A final factor that should be evaluated in considering the propriety of the nonunanimous settlement process is the impact of that process on clarifying fundamental policy issues. Public hearings and decisions on fundamental policy issues are valuable to society. They help guide our behavior on matters of public concern. [307] As Judge Harry Edwards observed: "One essential function of the law is to reflect the public [*322] resolution of . . . irreconcilable differences [in disputes about fundamental public values]; lawmakers are forced to choose among these differing visions of the public good." [308] Public airing of disputes clarifies for the disputants, and society as a whole, the conflicting moral and philosophical values at stake in a particular case. Some problems are not just about interpersonal disputes or failures to communicate, but are instead about basic disagreements about society's direction. [309] Formal adjudicatory proceedings do not attempt to avoid these controversies. They provide a public forum for these debates. [310] Finally, public pronouncements on fundamental policies help make officials and agencies politically accountable. When officials make public decisions on these difficult issues, those affected may have some recourse through the democratic process. [311]

For these reasons, most commentators have recognized that disputes about fundamental policies are poor candidates for ADR processes. [312] In his seminal article, *Against* Settlement, [313] Owen Fiss notes:

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304 *See supra* notes 134-143 and accompanying text.

305 *See supra* notes 277-284 and accompanying text.

306 *See supra* notes 243-251 and accompanying text.

307 *See generally* Blackburn, *supra* note 4, at 571.

308 Edwards, *supra* note 194, at 678-79; *see also* Frank H. Easterbrook, *Justice and Contract* in Consent Judgments, 1987 U. CHI. LEGAL F. 19, 26 ("Resolving disputes is only one of the two principal functions of the legal system. The other is shaping legal rules to use in the future. . . . If every case were settled, there would be no ongoing process of elucidation.").

309 *See generally* AMY, *supra* note 194, at 172-187 (noting that conflicts may be about fundamental principles or conceptions of society and, consequently, not amenable to negotiation).

310 *See generally* Delgado et al., *supra* note 194, at 1394 (pointing out that informalism ignores conflicts about basic social tensions); Edwards, *supra* note 194, at 678 (noting that settlement techniques may never be able to reconcile disputes about fundamental public values).

311 Edwards, *supra* note 194, at 677 ("[e]nvironmental mediation and negotiation present the danger that environmental standards will be set by private groups without the democratic checks of governmental institutions"). *See generally* Rosin, *supra* note 216, at 372-73 (noting that settlements make it difficult for public to monitor agency conduct).

312 Raab, *supra* note 107, at 54-55. *See generally* AMY, *supra* note 194, at 172-76 (noting that mediation can distort environmental conflict); Amy, *supra* note 13, at 15-16 (observing, in the context of environmental mediation, that mediation of controversies over nuclear power plants is inappropriate).

313 Fiss, *supra* note 194.

> Adjudication uses public resources and employs not strangers chosen by the parties but public officials chosen by a process in which the public participates. These officials, like members of the legislative and executive branches, possess a power that [*323] has been defined and conferred by public law, not by private agreement. Their job is not to maximize the ends of private parties, not simply to secure the peace, but to explicate and give force to the values embodied in authoritative texts such as the Constitution and statutes: to interpret those values and to bring reality into accord with them. [314]

The danger with ADR is that it can replace the rule of law on basic policy issues with privately bargained-for deals. [315] Even fervent supporters of ADR acknowledge that certain disputes involving questions of fundamental rights should be decided through formal dispute resolution mechanisms. [316]

In the public utility context, not all ratemaking issues concern fundamental public values. Issues such as the setting of the utility's allowed rate of return or the allowance or disallowance of minor operating expenses are not generally questions that call for official elucidation. [317] They usually raise technical issues with few policy implications. On the other hand, questions relating to the methodologies for the treatment of imprudent construction costs of new plants, the performance standards for new plants, and the allocation of costs between captive customers of a utility and customers who have market alternatives are controversial issues that generally require public debate and official decision. [318] These are issues which have a major impact on both the utilities and ratepayers. They either address significant issues of future rate increases or of cost [*324] allocation among different customer classes. Without such determinations, utilities have little direction for long-term planning, and ratepayers have little guidance as to the amounts of future rate increases.

The nonunanimous settlement mechanism has the potential for permitting settlements under circumstances in which they are inappropriate. By definition, the more controversial a case, the more difficult it will be to reach agreement among all parties. Indeed, one study has shown that collaborative dispute resolution on utility issues is much more successful on smaller technical issues than on larger policy matters. [319] The failure to obtain unanimity on a policy issue may not reflect unreasonable intransigence on the part of non-settling parties, but instead may show that the issue should be resolved through the formal hearing process rather than through the settlement process. As an Ohio commissioner observed in a dissent from a decision that approved a nonunanimous settlement stipulating nuclear plant performance standards:

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314 *Id.* at 1085.

315 *See* Edwards, *supra* note 194, at 676-77; David Schoenbrod, *Limits and Dangers of Environmental Mediation: A Review Essay*, 58 N.Y.U. L. REV. 1453, 1466 (1983) (reviewing ALLAN TALBOT, SETTLING THINGS (1983)).

316 *See* Raab, *supra* note 107, at 54-55.

317 *See* Harter, *supra* note 194, at 1411 ("No one would seriously contend that a disagreement over how much postage should be placed on a package should be made by means of a trial.").

318 *Cf.* Daniel Joseph & Michelle L. Gilbert, *Breaking the* Settlement Ice: The Use of Settlement Judges in Administrative Proceedings, 3 ADMIN. L.J. 571, 590-91 (1989-1990) (discussing 1 C.F.R. § 305.86-3(D)(11) (1993) and recommending that "[s]ettlement procedures may not be appropriate for decisions on some matters involving major policy issues"). *See generally* Raab, *supra* note 107, at 55-56 (observing that ADR may be inadvisable for extremely controversial cases or where there is need for public illumination on details of public utility's actions or proposals).

319 *See* Raab, *supra* note 107, at 204.

> Unfortunately, the more complex the policy consideration, the less likely a consensus position is to produce policy coherence in all areas. In this case, the Commission clearly needs to establish plant performance standards which promote economic efficiency, which assess penalties when standards are not achieved, [which] reward[] when they are exceeded, and most importantly, which promote[] safe operation of plants.
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> The Stipulation [however] establishes nuclear performance standards which supersede any other such standards that may be adopted by the Commission during the time that the Stipulation is in effect. [320]

Commissions should be wary of using nonunanimous settlements to avoid hard decisions that might in the long run be beneficial to the regulatory process and the public at large, especially as significant deregulation begins. The utilities, large customers, and captive ratepayers should receive clear signals from commissions in regard to the [*325] commissions' policies. Without such direction, participants will be unable to plan reasonably for the future. Nonunanimous settlements, therefore, should not be used to avoid hard decisions.

V. Safeguards Against the Dangers of Nonunanimous Settlements

As this discussion shows, significant problems exist with the nonunanimous settlement process for resolving rate cases. While this process is more efficient than traditional rate adjudication and the unanimous settlement process, it raises serious questions concerning the furtherance of social justice, the legitimacy of the process, the advancement of human relationships, and the protection of fundamental rights. Commissions have attempted to address some of these problems by adopting certain procedures and standards for review of nonunanimous settlements. Most commissions require an independent assessment to determine whether the settlement is in the public interest. Others require that substantial evidence support the settlement. Certain commissions compare the settlement with the possible outcome of the case if it had been litigated. Some commissions evaluate the reasonableness of the negotiation process itself. Finally, some examine the range of interests represented by the parties who signed the agreement. In this part, the Article will evaluate how well each of these procedures addresses the problems raised by the nonunanimous settlement process.

A. *Independent Assessment by the Commission to Determine if the* Settlement is in the Public Interest

Before approving a nonunanimous settlement, most commissions require an independent assessment of the agreement to determine if it is in the public interest. [321] Commissions emphasize that settlements are not binding upon them and that they, not the parties to the case, have the [*326] ultimate responsibility to determine the validity of a rate order. [322] Commissions analogize the situation to the approval of settlements in class action cases, where "the details of a resolution can probably best be

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[320] In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407, 461 (Ohio Pub. Util. Comm'n 1989).

[321] *See, e.g.,* In re Potomac Elec. Power Co., 81 Pub Util. Rep. 4th (PUR) 587, 597 (D.C. Pub. Serv. Comm'n 1987); In re Rules of Practice & Procedure Before the Comm'n, 112 Pub. Util. Rep. 4th (PUR) 215, 229 (Mich. Pub. Serv. Comm'n 1990); In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407, 450 (Ohio Pub. Util. Comm'n 1989); In re El Paso Elec. Co., 101 Pub. Util. Rep. 4th (PUR) 405, 409 (Tex. Pub. Util. Comm'n).

[322] *See, e.g.,* In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 352 (Ky. Pub. Serv. Comm'n 1989); In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407, 417 (Ohio Pub. Util. Comm'n 1989).

understood and worked out by the parties themselves, but the court must assure that the public interest . . . does not go unrecognized." [323]

Although this approach is well-intentioned, its major flaw is the amorphous nature of the public interest standard. In another context, Owen Fiss observes that the Tunney Act, [324] which allows a court to approve an antitrust settlement proposed by the Department of Justice if it is in the public interest, "provides the judge with virtually no guidance in making this determination or in deciding whether to approve the settlement. The public-interest standard in fact seems to invite the consideration of such nonjudicial factors as popular sentiment and the efficient allocation of prosecutorial resources." [325]

In fact, in applying the public interest standard to approve nonunanimous settlements, some commissions have been prone to consider factors having little relation to the reasonableness of the rates. For example, one commission noted that "it does not serve the public interest for this Commission to continue to review past mistakes and postures [of the utility]; it is in the public interest that this Commission and the Company's management both focus on the future . . . ." [326] This same commission found that a settlement was in the public interest because it avoided the risk of an adverse ruling from the state supreme court. Another commission concluded that it was not in the public interest to require a cost-of-service study or an expanded-load research program before its approval of a settlement because the studies requested were too complex and would delay the proceeding. [327] Still another commission [*327] found that a settlement was in the public interest because the benefits to ratepayers under the agreement were substantially equivalent to those that would be reaped if the utility filed for a threatened additional rate increase. [328]

Contrary to the suggestion by some commissions that the public interest standard is equivalent to the just and reasonable criteria in traditional rate base ratemaking, [329] the two are quite different. As described previously, the traditional standard requires an examination of each element of a utility's revenue requirement -- the rate base, rate of return, and operating expenses -- and then a separate consideration of the reasonableness of rate allocation among customer classes. [330] In contrast, the public interest standard is merely a rough appraisal as to whether the settlement "strikes a fair balance among the interests of ratepayers and investors . . . ." [331] Instead of looking at each of the variables

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323 Morgan, *supra* note 16, at 74; *see also* In re San Diego Gas & Elec. Co., Decision No. 92-12-019, Application No. 91-11-024 I.92-02-004, 1992 WL 465296, at *1 (Cal. Pub. Util. Comm'n Dec. 3, 1992).

324 Antitrust Procedures & Penalties Act, 15 U.S.C. § 16(e) (1988).

325 Fiss, *supra* note 194, at 1081.

326 In re Idaho Power Co., 102 Pub. Util. Rep. 4th (PUR) 139, 146 (Idaho Pub. Util. Comm'n 1989).

327 In re Iowa Elec. Light & Power Co., 46 Pub. Util. Rep. 4th (PUR) 130, 146 (Iowa Commerce Comm'n 1982).

328 In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 359 (Ky. Pub. Serv. Comm'n 1989).

329 *See* In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23, 43-44 (N.Y. Pub. Serv. Comm'n 1986).

330 *See supra* notes 77-89 and accompanying text.

331 In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *13 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992).

in the ratemaking formula, the commission need only consider whether the agreement, as an integrated whole, is fair or whether it comports with some vague notion of regulatory policy. [332]

The *Nine Mile Point Two* rate case reflects the distinction between these two approaches. [333] The nonconsenting parties to the agreement, the consumer intervenors, asserted that the New York Public Service Commission had to determine the prudence of the utility's actions during the construction of the plant in order to decide the just and reasonable rate base. The majority summarily rejected this argument and implicitly suggested that the just and reasonable standard is equivalent to a public interest test. [334] The majority, however, failed to recognize that the [*328] expression "just and reasonable" is a term of art in traditional ratemaking, not just a general statement of policy. As the dissent pointed out, the determination of justness and reasonableness required the consideration of two key issues: the value of the enhancements to the plant and the reasonableness of the construction delays. A prudence review was essential to such a determination. [335]

An independent assessment under a public interest standard provides little protection against abuses of the nonunanimous settlement process. While some commissions use the public interest standard to engage in a serious review of ratemaking issues, [336] others unfortunately do not. The latter commissions balance the interests in any way they see fit. Motivated by concerns of delay and risk aversion, some commissions simply approve the settlement. [337] Therefore, the independent assessment mechanism provides limited protection against imbalances of power or unfair commission staff-utility alliances in the negotiation process of nonunanimous settlements. Nor does the assessment place limits on the commission's authority to approve such agreements and to avoid decisions on significant policy issues. Quite simply, the independent assessment mechanism can permit a commission to clothe an unprincipled decision in the ostensibly acceptable attire of the public interest.

B. *Fact-Finding Hearings to Determine if the* Settlement is Supported by Substantial Evidence

Some commissions require a fact-finding hearing to determine if substantial evidence supports a nonunanimous settlement. [338] These hearings are not full-blown rate case hearings but rather are flexible [*329] hearings to determine the propriety of the settled rates. [339] Like the problems with the independent assessment process, this procedure fails to provide adequate protection against the dangers

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332 *See id.* at 12-13; Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693, 702 (Ill. 1989) (rejecting a nonunanimous settlement because commission looked at decision as an "integrated whole," and did not decide each issue on the merits).

333 In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23 (N.Y. Pub. Serv. Comm'n 1986); *see supra* notes 277-284 and accompanying text.

334 In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23, 43-44 (N.Y. Pub. Serv. Comm'n 1986).

335 Id. at 52.

336 *See, e.g.,* In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407 (Ohio Pub. Util. Comm'n 1989).

337 *See supra* notes 326-328 and accompanying text. *See generally* Rosin, *supra* note 216, at 368.

338 *See, e.g.,* Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693, 704 (Ill. 1989); In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660, 684-87 (Ind. Pub. Serv. Comm'n 1986); In re Rules of Practice & Procedure Before the Comm'n, 112 Pub. Util. Rep. 4th (PUR) 215, 218-19 (Mich. Pub. Serv. Comm'n 1990). *But see* In re Idaho Power Co., 102 Pub. Util. Rep. 4th (PUR) 139 (Idaho Pub. Util. Comm'n 1989) (rejecting hearing requirement).

339 *See supra* notes 182-183 and accompanying text.

of nonunanimous settlements. If the commission does not have precise standards for evaluating the reasonableness of its decisions, a fact-finding hearing does little to prevent the commission from abusing its discretion. The phrase "substantial evidence" only has meaning if the commissions evaluate the substantiality of the evidence under a specific standard.

Without the requirements that the parties present evidence on each variable of the traditional ratemaking formula and that the commission make findings of fact on each of those variables, fact-finding hearings on nonunanimous settlements can become simply the presentation of canned testimony in favor of the settlement. [340] The predisposition of commissions to favor settlements as a means of conserving resources and expediting cases can give rise to window-dressing hearings in which the outcome is essentially predetermined. As the reviewing court in the *LG&E* case observed: "[The] entire proceeding before [the commission] regarding the settlement agreement can be considered nothing more than the most summary of proceedings with witnesses for LG&E and the [commission] staff cheer-leading in favor of the agreement." [341] In one Texas Commission case, the attorney for one of the agreement's supporters even acknowledged on the record that accounting data had been fabricated for the purpose of justifying the settlement. [342]

Allowing opposing parties to cross-examine witnesses for the signatories and to present evidence in opposition to the agreement does [*330] little to make these hearings more fair. While commissions profess to place the burden of proof on those favoring the settlement, [343] such declarations are not helpful without a substantive standard for decision-making. [344] Some commissions would rather approve agreements than face lengthy hearings and may saddle opponents with the burden of showing the unreasonableness of the agreement. [345] This procedure does little to rectify the possible power imbalances between utilities and captive ratepayer intervenors that result from the nonunanimous settlement process. Further, this procedure does not contribute to the perception of a legitimate decision-making process.

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[340] *See generally* Rhode Island Consumers' Council v. Federal Power Comm'n, 504 F.2d 203, 210 (D.C. Cir. 1974) (warning in federal context against pro forma hearings).

[341] Kentucky ex rel. Cowan v. Kentucky Pub. Serv. Comm'n, 120 Pub. Util. Rep. 4th (PUR) 168, 173 (Ky. Ct. App. 1991); *see also* United States v. Public Serv. Comm'n, 465 A.2d 829, 834 (D.C. 1983) (Terry, J., concurring) ("In my judgment the procedure by which a settlement was imposed in this case on an unwilling [intervenor] reeked of unfairness. The Commission's decision to limit [the intervenor] to the presentation of one witness, in particular, strikes me as arbitrary and capricious. . . .").

[342] In re Gulf States Util. Co. (Nos. 8702 et seq.) Transcript of proceedings at 160 (Tex. Pub. Util. Comm'n) (One of settling parties acknowledges that "there has been some talk about these numbers being fill numbers or backed-into numbers. Of course, a lot of them are backed into. Let's not kid anybody on that.").

[343] *See, e.g.,* In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 358 (Ky. Pub. Serv. Comm'n 1989); In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *18 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992) ("The burden of proving that a proposed settlement is in the public interest rests on the parties proposing the settlement.").

[344] *See* City of Abilene v. Public Util. Comm'n, 854 S.W.2d 932, 938-39 (Tex. Ct. App. 1993) ("There is a danger that when presented with a ready-made solution, the Commission might unconsciously require that the opponents refute the agreement, rather than require the utility to prove affirmatively that the proposed rates are just and reasonable.").

[345] Kentucky ex rel. Cowan v. Kentucky Pub. Serv. Comm'n, 120 Pub. Util. Rep. 4th (PUR) 168, 173-74 (Ky. Ct. App. 1991). *See generally* Morgan, *supra* note 16, at 76 (discussing that a federal Administrative Conference recommends that objectors be allowed to present objections to nonunanimous settlements and noting that "[t]he hearing under such circumstances may seem to be less than wholly objective; [the objector] seems in effect forced to prove the others wrong. Assuming the agency has the data well in hand and has previously resolved many of the underlying policies, however, the actual detriment to the objector is relatively slight, while the benefit to the expeditious flow of cases through the agency seems significant indeed.").

C. *Comparison of the* Settlement with the Possible Outcome

Some commissions compare the nonunanimous settlement agreement with the possible outcome of litigation to evaluate the reasonableness of the nonunanimous settlement. [346] For example, the New York settlement guidelines provide that one of the factors to be considered in reviewing [*331] a settlement is "whether the result compares favorably with the likely result of full litigation and is within the range of reasonable outcomes." [347] If the parties reach a settlement before they develop a full record in a case, the commission holds mini-hearings on the settlement during which supporters of the agreement present testimony predicting the outcome of a fully-litigated case and contrasting those projections with the settlement amounts. Opponents can then attempt to contest these predictions.

Like the other two methods for reviewing nonunanimous settlements, this method is subject to abuse. As Owen Fiss observes in his critique of the comparison with judgment approach for evaluating class action settlements under Rule 23 of the Federal Rules of Civil Procedure:

> [T]he judgment being used as a measure of settlement is very odd indeed: *It has never* in fact been entered, but only imagined. It has been constructed without benefit of a full trial, and at a time when the judge can no longer count on a thorough presentation promised by the adversary system. The contending parties have struck a bargain, and have every interest in defending the settlement and convincing the judge that it is in accord with the law. [348]

In the nonunanimous settlement context, commissions have to face the opponents to the agreement. But, given the summary nature of the approval hearings, the lack of standards for reviewing evidence, and the usual alliance between staff and the utility, opponents frequently have a difficult time persuading the commission that the settlement agreement is not within the range of possible outcomes. As long as the supporters of the agreement present some credible basis for their predictions, the commission is likely to give its approval. [349]

[*332] D. *Examination of the Reasonableness of the Negotiation Process*

A few commissions also examine the reasonableness of the negotiation process itself to determine whether to approve a nonunanimous settlement. [350] They consider whether any parties have been excluded from settlement discussions, whether any parties were precluded from participating in the

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346 *See, e.g.,* In re Potomac Elec. Power Co., 81 Pub. Util. Rep. 4th (PUR) 587, 604-05 (D.C. Pub. Serv. Comm'n 1987); In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 359 (Ky. Pub. Serv. Comm'n 1989); In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *12 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992).

347 In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *12 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992).

348 Fiss, *supra* note 194, at 1082.

349 *See, e.g.,* In re Nine Mile Point Two Nuclear Generating Facility, 78 Pub. Util. Rep. 4th (PUR) 23, 30-31 (N.Y. Pub. Serv. Comm'n 1986). In that case, concerning rate base allowances or disallowances for the Nine Mile Point Two nuclear generating plant, supporters of the settlement compared the allowances for the Shoreham plant, which resulted from a previous fully-litigated proceeding. While the Commission accepted this comparison, the dissenters observed that, "[t]o use the Shoreham disallowance as the basis for the Nine Mile Point Two disallowance is to base a decision on the shadow of a shadow." Id. at 54.

350 *See e.g.,* In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 354-56 (Ky. Pub. Serv. Comm'n 1989); In re Rules of Practice & Procedure Before the Comm'n, 112 Pub. Util. Rep. 4th (PUR) 215, 229 (Mich. Pub. Serv. Comm'n 1990).

drafting of the agreement, and whether the negotiation process was tainted with any irregularities. [351] If the commission concludes that the parties conducted the negotiations at arm's-length and in good faith, the commission can approve the settlement. [352] For example, in the *LG&E* case, the Kentucky Public Service Commission approved the settlement after reviewing affidavits and reply affidavits describing the bargaining process. It found that all the parties had the opportunity to participate in negotiations, that the conduct of the discussions was proper and regular, and that the intervenors opposing the deal had taken unreasonable positions in these discussions. [353]

The examination of the negotiations, however, may inhibit the very kind of open and informal exchanges that are helpful in facilitating negotiation. Indeed, some commissions address this problem by adopting confidentiality rules prohibiting disclosure of the substance of settlement discussions without the consent of all parties. [354] In adopting such a rule, the California Public Utilities Commission stated that its "intent was to [*333] create a forum where free and open discussions could take place during the settlement discussions themselves." [355] Without such protection, parties may refrain from the kind of free-wheeling discussions that lead to creative solutions to problems. Their goal may merely be to make a record of their purported good faith efforts to negotiate. [356]

This approach also suffers from a lack of standards. Commissions simply have not developed, and would be hard pressed to develop, workable criteria for reviewing the reasonableness of the negotiation process itself. The fact that intervenors have an opportunity to participate in settlement negotiations does not, by itself, indicate that the utility and staff negotiated in good faith. Any party can go through the motions of bargaining without any intention of budging from its original position. Likewise, given

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351 In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 354-56 (Ky. Pub. Serv. Comm'n 1989); *cf.* In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *6 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992) (prohibiting caucuses between utility and non-utility parties without notice because private meetings between such parties fail to give the impression of an open process).

352 In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 356 (Ky. Pub. Serv. Comm'n 1989).

353 *See* id. at 354-56.

354 *See, e.g.,* In re Commission's Rules of Practice & Procedure, 29 CPUC 2d 392, Rule 51.9 (Cal. Pub. Util. Comm'n Sept. 28, 1988) (Nos. 88-09-060, 84-12-028) ("No discussion, admission, concession or offer to stipulate or settle, whether oral or written, made during any negotiation on a stipulation or settlement shall be subject to discovery, or admissible in any evidentiary hearing against any participant who objects to its admission."); In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *19 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992).

355 In re Commission Rule of Practice & Procedure, No. 88-09-060, at *35 (Cal. Pub. Util. Comm'n Sept. 28, 1988) (Westlaw, PUR Database).

356 In In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348 (Ky. Pub. Serv. Comm'n 1989), the commission rejected the argument that a review of the reasonableness of the negotiation process violated the prohibition against admitting evidence of settlement offers in a trial. The commission reasoned that this prohibition

> is based on the reasoning that "the law favors settlement of controversies out of court, and will not permit an offer of compromise to be used as a weapon against the party making the offer." . . . That reasoning, however, has no application to the determination of the issue of whether the proceeding leading to the Settlement Agreement is tainted. This issue addresses not a trial of the merits of the Settlement Agreement, but rather the conduct leading up to that Agreement.

Id. at 353. This argument, however, misses the point. The policy preventing use of settlement offers as a weapon against another party is itself based on the belief that such use would inhibit free and open negotiations among the parties. Whether evidence of settlement offers is admitted on the merits of the case or for a review of the reasonableness of the negotiations, its admission has a chilling effect on settlement discussions.

the informal nature of the negotiation process, it is a difficult task for a commission to distinguish between a party's posturing in negotiations and its actual position on a particular issue. It is odd for commissions to accept settlement as a means to avoid the rigorous requirements of traditional regulation while they embrace the additional obligation of reviewing affidavits and counter-affidavits from participants to evaluate the reasonableness of the bargaining process itself.

E. *The Range of Interests Supporting the* Settlement

In assessing the propriety of a nonunanimous settlement, some commissions consider the range of interests held by the parties that [*334] support the settlement. [357] If a broad spectrum of intervenor interests supports the agreement or if traditionally adversarial parties are signatories to the agreement, these commissions will give the nonunanimous settlement careful consideration. The concern is the legitimacy of the settlement process. As the New York Public Service Commission observed in adopting settlement guidelines: "To avoid any appearance of impropriety in settlements, every effort must be made to ensure that potentially interested parties have an adequate opportunity to participate in negotiations." [358] To provide an incentive for such participation, commissions notify the parties that the commission will consider the breadth of interests represented by signatory parties. Through this inclusionary process, commissions hope to address the problems of power imbalance inherent in nonunanimous settlements.

This approach, however, does not completely remedy those problems. While the New York Public Service Commission's approach commendably recognizes the need to include as many parties as possible in the agreement, it provides little protection for representatives of captive ratepayers. Given the variety of interests represented in major rate cases, it is difficult, if not impossible, to develop a workable definition of the term "range of interests." For example, if all industrial and commercial intervenors, as well as the commission's staff, support the agreement, a commission may find that the participation criterion is satisfied. Similarly, if most residential and governmental intervenors are signatories, but lowincome customers oppose the agreement, a commission also may reasonably conclude that a broad spectrum of the interests are included.

Like the phrase "public interest," the phrase "range of interest" is subject to ad hoc interpretations. When the Michigan Public Service Commission recently approved a nonunanimous settlement, it suggested [*335] that the commission staff itself can represent a range of interests because the staff's role "is to promote the public interest, including the interests of ratepayers." [359] Given this vague notion of the range of interests, some commissions may conclude that a broad range of interests is represented simply to avoid the delay caused by disapproval of nonunanimous settlements.

The large number of issues raised in rate cases compounds this problem. When negotiation involves two or more issues, "majority rule is subject to numerous methods of strategic manipulation and

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[357] *See, e.g.,* In re Rules of Practice & Procedure Before the Comm'n, 112 Pub. Util. Rep. 4th (PUR) 215, 229 (Mich. Pub. Serv. Comm'n 1990); In re Detroit Edison Co., 39 Pub. Util. Rep. 4th (PUR) 107, 111 (Mich. Pub. Serv. Comm'n 1980); In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *19 (N.Y. Pub. Serv. Comm'n Mar. 24, 1992); In re Cleveland Elec. Illuminating Co., 99 Pub. Util. Rep. 4th (PUR) 407, 417, 449 (Ohio Pub. Util. Comm'n 1989). *But see* In re Louisville Gas & Elec. Co., 107 Pub. Util. Rep. 4th (PUR) 348, 352 (Ky. Pub. Serv. Comm'n 1989).

[358] In re Procedures for Settlement & Stipulation Agreements, Nos. 90-M-0255, 92-M-0138, 1992 WL 487888, at *4 (N.Y. Pub. Serv. Comm'n Mar. 24 1992).

[359] In re Midland Cogeneration Venture Ltd. Partnership, 141 Pub. Util. Rep. 4th (PUR) 127, 159 (Mich. Pub. Serv. Comm'n 1993).

paradoxes of voting," the result of which may not reflect the optimal outcome desired by the consenting parties. [360] In rate cases, some parties may have aligning interests on some issues, but conflicting interests on others. [361] For instance, industrial intervenors may agree with residential groups on disallowances for certain utility expenditures, but may differ with regard to the methods of allocating rates among customer classes. Disagreements may even arise within the same customer class. Moreover, each party may assign different weights and priorities to a particular issue. The fact that a range of intervenors supports a nonunanimous settlement does not necessarily mean that those intervenors represent a wide spectrum of positions on all issues in the case.

Assent to the nonunanimous settlement by the Office of Public Counsel or another proxy advocate does not alleviate these definitional problems. [362] Although such advocates are charged with the task of intervening on behalf of large numbers of ratepayers, the advocate cannot practically represent all of those consumers' conflicting interests. As one judge noted in an appeal from a case in which the utility's largest customer opposed a nonunanimous settlement entered into with the District of Columbia's Office of People's Counsel: "I seriously doubt whether the [*336] Office of People's Counsel, which purports to represent all consumers in the District of Columbia, can ever adequately represent the interests of [that customer] which are likely to be at odds with the interests of its other 'clients.'" [363] In a similar vein, a dissenting commissioner lamented the fact that although the state's attorney general and most other intervenors agreed to a nonunanimous settlement, they failed to address issues raised by a community organization. He observed that "[t]he lesson to be learned is that if the future is going to be characterized by consensus rather than by confrontation, there has to be a genuine effort to obtain consensus from all interests." [364]

VI. The Unanimity Rule for Settlement of Rate Cases

As the above analysis indicates, there are significant questions regarding whether public utility commission enabling acts authorize nonunanimous settlements of rate cases. Regardless of the issue of statutory authority, serious policy questions exist as to the propriety of the process. Finally, although laudable, commission efforts to remedy these problems through independent assessments of nonunanimous settlements are not completely effective. These independent assessments are seemingly standardless, providing little protection to weak parties, such as captive ratepayers.

A. *Advantages of a Unanimity Rule*

A rule requiring unanimity before commission approval of settlements addresses many of these problems by helping to maintain the balance of power in negotiation. Because all parties, not just the utility, have veto power, consumer groups may use the threat of formal hearings as a bargaining

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360 Thompson et al., *supra* note 209, at 87.

361 *See supra* notes 235-236 and accompanying text.

362 *See* In re Public Serv. Co., 72 Pub. Util. Rep. 4th (PUR) 660, 685 (Ind. Pub. Serv. Comm'n 1986) (noting that when proxy advocate participates in drafting proposed settlement agreement, commission has responsibility to scrutinize merits of agreement more carefully).

One commentator has suggested that the proxy advocate should be the chief negotiator for the various consumer concerns. Katko, *supra* note 126, at 1335-37. He does not, however, address the issue of possible conflicting concerns of consumer groups.

363 United States v. Public Serv. Comm'n, 465 A.2d 829, 834 n.1 (D.C. 1983) (Terry, J., concurring).

364 In re Idaho Power Co., 102 Pub. Util. Rep. 4th (PUR) 139, 148 (Idaho Pub. Util. Comm'n 1989) (Miller, Comm'r, separate opinion).

weapon. Utilities cannot avoid negotiating in the shadow of the law simply by forming alliances with some parties against others. [365]

[*337] Because all parties have more or less an equal role in the negotiation process, the public perceives the process as legitimate. [366] A unanimity rule will also promote commission decisions on fundamental public issues. [367] Although all participants to a proceeding can consent to an agreement on public issues, unanimity increases the likelihood that a commission will render a formal determination on an issue when a significant segment of the public desires it. Finally, unanimous consent encourages parties to develop creative, nonobvious solutions for the issues in a case. [368] As a result, a unanimity rule may actually increase participation in the bargaining process in the long term. [369]

Admittedly, the formal adjudicatory process has significant limitations. The process neither encourages innovative solutions to long-term policy issues nor fosters cooperative relationships among the parties. It may also have the tendency to become bogged down in protracted disputes. A unanimity rule, however, affords the benefits of ADR without jeopardizing the rights of any of the parties.

The contrast between the use of unanimity and nonunanimity rules is starkly illustrated by the two rounds of negotiations in the *Edison* cases. [370] In the first round, the utility entered into a nonunanimous settlement with several governmental parties. Edison presented the agreement to consumer intervenors as a fait accompli. As an Edison vice president put it: "The agreement is not negotiable; that's the way it was put together. That doesn't mean we won't talk to people, and have, but changing the terms of the agreement, no. We've given our absolute best on this agreement now and we just can't change it." [371] When consumer intervenors pushed for negotiations, Edison did not budge. The Illinois Commerce Commission, in its desire to approve the settlement, held hearings on the agreement seven days a week, often starting at eight a.m. and ending at two a.m. the next morning. [372] The attorney for one [*338] consumer intervenor commented that the agreement "was supposed to be a done political deal . . . Edison, with the support of the hearing examiner, was trying to drive us into the ground." [373] When the Commission rejected this settlement by a four to three vote, Edison allied with the Commission staff and entered into a new nonunanimous settlement for a $ 480 million rate increase. [374] The Commission held another "around the clock proceeding" and eventually approved the settlement. [375]

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[365] *See supra* notes 235-239 and accompanying text.

[366] *See supra* notes 261-268 and accompanying text.

[367] *See supra* notes 312-320 and accompanying text.

[368] *See supra* notes 290-306 and accompanying text.

[369] *See* Thompson et al., *supra* note 209, at 87.

[370] *See supra* notes 243-251 and accompanying text.

[371] Mark Eissman, *Edison Won't Negotiate on its* Rate Plan, CHI. TRIB., Dec. 25, 1986, at 1.

[372] McHugh, *supra* note 249, at 16.

[373] *Id.*

[374] *Id.* at 17.

[375] *Id.*

The Illinois Supreme Court reversed the Commission's decision, holding that the Commission's enabling statute did not authorize nonunanimous settlements. [376] Thereafter, the second round of negotiations took place, under the court's requirement of a unanimity rule. During these negotiations, Edison did not approach consumer intervenors with a "done deal," but recognized the balance of power. Edison's attorney observed:

> As these cases went on, there were times when the consumer . . . parties might have thought they had the upper hand . . . And then there were times . . . when Edison might have thought it had the upper hand. But, no one consistently had the upper hand. It seemed like there ought to be a way, to use somewhat of a cliche, 'to cut through the Gordian knot.' [377]

Initiated by Edison's president, the bargaining took place over several months, with numerous confidential settlement conferences among all the parties with "hard bargaining on an almost daily basis." [378] Negotiated line-by-line, word-by-word, settlement papers were "extensively edited and marked up by all the attorneys." [379] The final agreement settled six large rate cases. [380] [*339] Regardless of the merits of the settlement agreements, the two rounds of negotiations clearly illustrate the difference between negotiations under a unanimity and under a nonunanimity rule. The nonunanimous settlement process substantially favored the utility. Edison forged alliances with governmental parties and presented the settlement to the other parties on a take-it or leave-it basis. To gain Commission approval, Edison allied with the Commission staff. To expedite the case, the Commission held accelerated hearings. Then, in reviewing this settlement, the Commission failed to use the traditional ratemaking standards, but applied a vague balancing test, considering the agreement as an integrated whole. [381]

Negotiations under a unanimity rule, however, reflected a more legitimate process. Edison approached consumer intervenors as equal partners in the discussions. Settlement provisions were negotiated issue by issue. Collaboration was encouraged. Even with the large number of involved parties and the variety of interests represented, [382] the parties reached a final resolution.

A unanimity rule clearly has the drawbacks of expanding the time devoted to negotiations and increasing the probability of group impasse. [383] Expeditious processing of cases, however, cannot be a goal unto itself. The legitimacy of the decision-making process and the final result is a vital factor that should be considered in evaluating the success of any dispute resolution mechanism. Most studies of administrative ADR show that negotiation is not a panacea for all problems of the adjudicatory system. Indeed, administrative ADR has been found to be a successful process for dispute resolution

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376 Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693 (Ill. 1990).

377 McHugh, *supra* note 249, at 20 (quoting Dale E. Thomas, attorney for Edison).

378 *Id.* at 22.

379 *Id.* (quoting Howard A. Learner, litigant for consumers' group).

380 *Id.* at 15.

381 Business & Professional People for Pub. Interest v. Illinois Commerce Comm'n, 555 N.E.2d 693, 702 (Ill. 1990).

382 McHugh, *supra* note 249.

383 *See generally* Thompson et al., *supra* note 209, at 92.

only in a limited number of such cases. [384] When there are multiple parties and issues, and when some of those issues concern fundamental values or beliefs, informal settlement of a dispute [*340] may be impossible. [385] Even if possible, settlement may require expenditures equivalent in time and resources to those in traditional formal processes. [386] In other words, there is no quick fix to the problems of delay in public utility rate cases.

B. *The* Problem of the Intransigent Intervenor

The difficulty of the intransigent intervenor does not warrant the abandonment of a unanimity rule. As described above, some commissions reject a requirement of unanimous consent because they assume that inactive or uncooperative parties would have the ability to block any possible settlement. They fear that the consumer groups will unreasonably hold out solely for their own political purposes. [387] The problem with this argument is the assumption that a party's intransigence necessarily reflects unreasonable behavior. A consumer group may choose not to agree to a nonunanimous settlement because the group adheres to certain fundamental beliefs about a particular issue, because it feels that a public hearing would help to build collective action on an issue, or because it believes that a formal pronouncement of policy by the commission is necessary. None of these motives are per se unreasonable and they should not be grounds for abandoning a unanimity requirement. Intransigent utilities are not treated in this manner. When Edison presented its nonunanimous settlement to consumer intervenors and refused to negotiate its terms, [388] the Commission did not propose a process which would permit the staff and other intervenors to reach a nonunanimous settlement to the exclusion of the utility. [*341] Even if a party is intransigent and a full settlement cannot be reached, the process of negotiation itself may aid the eventual resolution of the dispute. As one commentator observed in regard to negotiated rulemaking in the environmental context: "In some respects, negotiated rulemaking cannot fail. At the very least, conflicts can be clarified, data shared, and differences aired in a constructive way. Even if a full consensus is not achieved, the negotiation process may still have narrowed the issues in dispute." [389] In contrast to the divisiveness created by the nonunanimous settlement process, a unanimity rule encourages a process in which collaboration is a goal. At the very least, those parties who have reached an understanding on certain issues may present at the hearings joint positions for the commission to formally consider. Even after negotiations break

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384 *See generally* AMY, *supra* note 194, at 215 (noting that mediation tends to work only in certain circumstances); Stewart, *supra* note 122, at 677 (observing that prospects for negotiated litigation alternatives are greater in certain types of cases); Susskind & McMahon, *supra* note 194, at 152-53 (concluding that parties will not participate in negotiations if their alternatives elsewhere will produce better results).

385 *See generally* Stewart, *supra* note 122, at 677 n.81 (quoting an estimate that only ten percent of environmental controversies can be successfully negotiated); Susskind, *supra* note 13, at 152 (Commenting on the EPA's experience with negotiated rulemaking, the author observes that "parties are unlikely to make the necessary concessions to reach consensus if the only way to reach agreement is to compromise fundamental values or beliefs.").

386 Raab, *supra* note 107, at 133-34 (concluding that the settlement of the Pilgrim generating plant case in Massachusetts could not be credited with significant resource savings).

387 *See supra* text accompanying notes 122-123.

388 *See supra* text accompanying note 371.

389 Susskind & McMahon, *supra* note 194, at 159.

down, discussions may continue in the shadow of formal hearings, possibly leading to an eventual unanimous agreement. [390]

Many commissions already have rules to protect the process from intervention by parties who represent no cognizable interest or who have no intent to participate. The procedural rules of many commissions provide that an intervenor must have or represent "a justiciable interest which may be adversely affected by the outcome of the proceeding," require the timely submission of specific position statements by intervenors on issues in the case, and compel them to accept the status of the record at the time of the intervention. [391] Such rules may be used to exclude any latecomer whose primary purpose is to scuttle a negotiated settlement.

If these rules prove to be insufficient, there is certainly no impediment to the adoption of reasonable regulations limiting intervention to parties who will "fairly and adequately" represent the interests of particular customer classes. [392] Several commissions now consider the range of interests represented by the parties in evaluating the reasonableness of nonunanimous settlements. [393] This same kind of [*342] analysis could be conducted at the intervention stage of the case without as significant a danger that the decision will be tainted by the unprincipled desire for a speedy settlement of the case. [394]

Finally, even if intervention rules will not effectively address the problem of the intransigent intervenor, the potential for delay is not that great. In twenty-four reported decisions, the holdout party was never a lone discontented ratepayer or disgruntled utility employee. Not one empirical study of settlements in the public utility ratemaking area has identified blackballers. Although such parties certainly exist, commissions should balance the danger of an intransigent intervenor against the numerous problems of nonunanimous settlement. Unless blackballers pervade commission proceedings, the advantages of an inclusionary process through the unanimity rule outweigh its disadvantages.

Conclusion

In the late nineteenth century, the formal procedures of traditional rate base ratemaking were established to protect the rights of utility investors. Nearly a century later, consumer groups have used these same procedures to safeguard their own interests. Relying on traditional ratemaking procedures, consumer groups actively intervened in cases, pressed commissions to conduct serious inquiries into the prudence of utility expenditures, sought equitable allocation of rates, and appealed adverse decisions to the courts. As a result, cases that were once relatively simple proceedings became lengthy endeavors, taxing commission time and resources.

Commissions then began to experiment with negotiated settlements. Faced with strong consumer participation, many commissions decided that the only practical way to expedite cases was to allow

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390 *See* Richardson, *supra* note 104, at 45-46 (describing New Mexico rate case where parties settled after pre-hearing negotiations failed).

391 *See, e.g.*, IND. ADMIN. CODE tit. 170, r. 1-1-9 (1994); TEX. ADMIN. CODE tit. 16, § 22.103 (1994).

392 *Cf.* FED. R. CIV. P. 23(a).

393 *See supra* notes 357-364 and accompanying text.

394 Although commissions could be prone to limiting intervention for the purpose of expediting the cases, intervenors would have more protection under this approach than under the present nonunanimous settlement process. The issue on judicial review of a denial of a motion to intervene would not be the broad issue of the reasonableness of the settlement, but the narrow one of the validity of the denial. Faced with the potential for judicial review of its intervention decisions, commissions would most likely continue a liberal intervention policy for legitimate intervenors.

nonunanimous settlements, even if consumer intervenors objected. To protect against abuse, commissions held hearings on these settlements, reviewing their reasonableness under a public interest standard. They have supplemented traditional rate base ratemaking with a new kind of flexible ratemaking.

[*343] This divergence from formal procedures, when all parties have not consented to the settlement, creates problems, especially for less powerful consumer groups. Formalism has helped to protect the rights of ratepayers in recent years and has been an effective tool in reining in utility power in commission proceedings. By allowing only the utility to veto an agreement, the nonunanimous settlement process dilutes the force of the threat of formal proceedings. No longer must the utility bargain entirely in the shadow of the law. Consumers run the risk that the utility will form alliances with the commission staff, industrial intervenors, or large commercial intervenors and then gain commission approval. Indeed, in over eighty percent of the reported nonunanimous settlement decisions, a consumer group was not a signatory.

Although many of these cases arose in the context of rate treatment for large utility construction projects, a number of lessons for future cases can be drawn from them. While the nonunanimous settlement process is more efficient than traditional adjudication, the process has the potential for accentuating power imbalances in negotiations and creating a perception of unfairness in decision-making. This process may not necessarily advance cooperative relationships among the parties and may not promote formal declarations of policy on fundamental issues.

In this age of deregulation, these lessons are significant for captive ratepayers, who seek protection through ratemaking proceedings from utility attempts to shift costs to captive ratepayers in a competitive marketplace. A unanimity rule protects against some of the problems of the nonunanimous settlement process. It helps to maintain a balance of power among the parties. It promotes a perception of fairness in the decision-making process of commissions and utilities. It increases the possibility that commissions will render significant policy decisions. Most importantly, a unanimity rule helps to establish an environment where collaboration is promoted. Although compared to formal adjudication, a unanimity rule may not significantly decrease the time and resources expended on a case, and in some cases may allow an intransigent intervenor to block an agreement, in the long run it may foster cooperation among the parties. Faced with the reality that they are required to muster unanimous consent and that they may be involved in other proceedings in the future, parties will be encouraged to brainstorm creative solutions to their problems. Unlike the nonunanimous settlement process, which has the potential for creating power imbalances and harmful alliances, a unanimity rule provides commissions with a legitimate ADR mechanism.

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EXHIBIT 2

RATE CASE AND AUDIT MANUAL

Prepared by:

NARUC Staff Subcommittee on Accounting and Finance

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INTRODUCTION TO THE MANUAL

This manual has been prepared by the National Association of Regulatory Utility Commissioners (NARUC) Staff Subcommittee on Accounting and Finance as a guideline for state, territory, and federal regulatory utility commission personnel.[1] It is not our intent to provide a checklist for use by commission auditors, accountants or analysts[2]. Rather, it is our intent to set forth the most common, basic regulatory principles, processes, and procedures used by many regulatory commissions to examine and investigate general rate applications. We anticipate that each regulatory jurisdiction will have areas of uniqueness and specific areas of differences when it comes to examining a utility's revenue requirement and operating earnings. Recognizing that these differences exist, we have tried to present the basic steps of the rate case investigation in such a way that revisions and changes can be made by the individual jurisdictions while maintaining the overall usefulness of the more general guidelines.

An example of a common difference among the jurisdictions is the test year used. Some states use an average historic test year, others use a year-end historic test year, and others use projected, future test periods. Yet, this difference does not generally change the nature or importance of the test year, nor does it change the basic list of elements that are included in the rate base or the operating income statement.

We offer one caution to those who are concerned about the use of the phrase "audit manual." We make use of the word "audit" as it is commonly referred to in regulatory circles. We do not mean it in the purist sense of the word, where one might assume a verification of booked numbers to source documents and a strict sampling of accounts. Instead, we use it to mean a regulatory review, a field investigation, or a means of determining the appropriateness of a financial presentation for regulatory purposes. Clearly, the reader should distinguish a regulatory audit from financial audits performed by independent certified public accountants.

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[1] The term "Commission" used throughout this document refers to the individual state, territory, or federal regulatory commission that is examining and investigating the general rate application.

[2] The term "auditor" used throughout this document refers collectively to auditors, accountants, and analysts.

PRELIMINARY PROCEDURES

Determining the Scope and Purpose of the Audit

The auditor should fully understand the scope of the audit that is about to be performed. This manual focuses on steps most commonly used for audits related to general rate cases wherein the regulator is looking at the reasonableness of the presented revenue requirement or operating earnings.

Other types of regulatory audits tend to focus on one isolated expense category (e.g., fuel and purchased power) or a specific investment (e.g., costs of recently completed construction project.) Yet, other audits may focus on management processes or compliance with specific commission directives. This manual is not intended to provide a comprehensive walk-through of these regulatory examinations.

In addition, the auditor should be aware of the resource constraints that exist at the time of the audit or rate case. Limited time and staff may require the auditor to focus on larger impact items (i.e., those having more impact on the revenue requirement) rather than allowing oneself the luxury of a comprehensive review of all rate base and income statement items. To limit travel costs, copies of many documents can be provided for review at the Commission office. When limited resources exist, and a more narrow focus is required, a risk analysis should be performed early in the process. (See Focusing the Audit discussion below.)

Understanding the Utility's Accounting System

The auditor should become familiar with any regulatory requirements mandating the use of a particular accounting system, such as the Commission's uniform system of accounts and system of accounts from other regulatory agencies including, as applicable, Part 32 from the Federal Communications Commission (FCC) and the uniform system of accounts from the Federal Energy Regulatory Commission (FERC). In familiarizing oneself with the mandated system, the auditor should become familiar not only with the account descriptions and numbering system, but also with the instructions accompanying the accounting requirements.

The auditor should gain a basic understanding of how the utility's accounting and reporting for financial purposes differs from accounting and reporting for regulatory purposes. The auditor should become familiar with what is driving these differences, and the types of items included in regulatory assets and regulatory liabilities that comprise these differences. In this regard, the auditor should have a basic familiarity with Statement of Financial Accounting Standard 71, Accounting for the Effects of Certain Types of Regulation.

The auditor should gain a basic understanding of the utility's accounting system and the Chart of Accounts that is used in the day-to-day implementation of the accounting system. The auditor should also gain a basic understanding of what queries can be performed to retrieve information

from the utility's accounting system and how extensive the process would be to develop new queries needed to meet the auditor's information needs. In gaining this general understanding, the auditor should also inquire into the comprehensiveness of the accounting system and related matters. For example, is the payroll system an associated system, or is it unique unto itself? How are work orders and construction estimates incorporated into the overall system, or are they created manually?

Analyzing Historical Financial Data

The auditor should prepare a spreadsheet of historic financial data or otherwise obtain such an analysis from the utility. This type of spreadsheet analysis generally contains three to five years of data for the most recent historic years for which data is available. The level of detail contained in the spreadsheet is dependent on the data availability and the needs and comfort level of the auditor. In general, the spreadsheet would include line items for each element of rate base, each category of revenue, and each category of expense (or each expense account). Additional detail may be prepared on each plant account, each accumulated depreciation and depreciation account (by type of plant), and additional expense account detail. When determining the level of detail, the auditor should consider the items most necessarily examined in rate proceedings, and those accounts most likely to have the largest impact on revenue requirements. These spreadsheets will provide the auditor with a starting point for identifying the most significant changes in investment, revenues, and expenses, and thus, assist in identifying areas for which additional detail may need to be obtained during the field visit or through the informal or formal discovery process. While several sources may be available for obtaining this data, common sources include FERC Form No. 1 and FERC Form No. 2, Automated Reporting and Management Information System (ARMIS) Reports filed with the FCC, or state commission annual reports by the utility.

In addition to preparing a spreadsheet with the above described data, the auditor will want to consider preparing a similar spreadsheet containing unit sales data (e.g., sales in kilowatt hours or cubic feet), number of customers by type (e.g., residential, commercial, irrigation, etc.), and other information that is deemed to provide general background or useful information (e.g., number of employees, miles of installed cable, etc.).

To the extent that it can be obtained through Commission records, trial balances, or informational requests to the utility, it is also useful to prepare a side-by-side spreadsheet of similar financial and operational monthly data for the twelve months of the test year. The month-by-month analysis will allow the auditor to visualize anomalies in any revenue trends (e.g., declining sales), to view seasonal expenses (e.g., tree trimming) or expense anomalies (e.g., storm damage), or to view lumpy changes in investment (e.g., plant retirements). This again will allow the auditor to create a list of items to be further examined by obtaining invoices, payroll records, work orders, or other source documents.

Focusing the Audit

The auditor may want to prepare an analysis, in order to better focus one's time and resources on portions of the expenses, revenues, and investment that are most likely to impact customers' rates. For instance, it would be easy to get lost in the political sensitivities of trying to eliminate donations and political expenditures that regulators may consider to be offensive, but in doing so, one could overlook the larger expense of special pensions for the Board of Directors that may also be inappropriate. By identifying the big ticket items – those that really matter to the overall level of rates – one can determine the issues about which to inquire first, and those that can wait or move to the bottom of the list.

The spreadsheets of historical data and trends can be very useful in identifying the more significant items. One may want to focus on those costs that have changed the most from historical levels. Regardless of the change from historical levels, the auditor may want to focus on those few items that make up the most significant portion of the operating costs (e.g., salaries, depreciation, and purchased power costs).

Another approach to focusing the audit is to compute ranges of change that would have to be incurred to impact rates. What percentage change in rate base would have to occur in order to change the earned return by one percentage point (or 100 basis points)? In another instance, a utility could be asking for less than its fully authorized return in order to mitigate rate impacts on customers. If so, what dollar level of expense or rate base adjustment would be required in order to exceed the requested authorized return level? These boundaries can assist the auditor in deciding whether to pursue a more difficult or questionable adjustment.

There is another area related to focusing the audit of which the auditor will want to be aware: What limitations or constraints exist regarding the areas to review? If the auditor believes that it is important to review affiliate transactions, it is useful to know early in the process whether one might be overstepping the Commission's authority to review such transactions, or whether the Commission has broad powers of review in this area. Similarly, if the auditor wants to review not only the minutes of the Board of Directors' meetings for the utility, but also for the Board of the parent company, may he/she do so? When looking at these sensitive areas, the auditor should have thought through answers to questions of relevance to the utility operations and Commission authority.

Reviewing Federal Regulatory Reports, Shareholder Reports, and SEC Filings

Reports filed by the utility with the Securities and Exchange Commission (SEC), the FCC, the FERC, and other regulatory bodies may contain a host of information over and above the traditional financial information that becomes the mainstay of an auditor's work. This information will reveal everything from lawsuits pending against the utility to the significant accounting practices, if the auditor takes the time to read the footnotes. The perspective provided to shareholders in these reports is often significantly different than the outlook provided to regulators, and may provide the auditor insights into management's views.

These reports also provide an independent source against which to verify the figures contained in the utility's application or submission. However, this comparison may be difficult if the filing to the federal agency or shareholders contains consolidated information for regulated and unregulated operations or consolidated operations for multiple jurisdictions.

Reviewing SEC Audit Reports, Federal Utility Audit Reports, and Other Audit Reports
A review of audit reports from other regulatory agencies or taxing authorities will also provide useful background information to the auditor. Audit reports from these various governmental authorities will provide different sets of information, depending on the jurisdiction of that agency. The SEC's audit reports may provide insight into allocations from service companies to the state utility operations or may look at larger corporate relationships. An FCC audit report may look at specific property, plant and equipment accounts and provide a view of the appropriateness of a utility's continuing property records. A taxing authority's audit report may indicate whether the utility has properly maintained its sales and tax records. If a problem is indicated, it could be indicative of other record keeping problems of the utility. Often, a problem in one record keeping area warrants inquiries into other accounting practices.

Reviewing Prior Orders of One's Own Jurisdiction
One of the best indicators of items to examine in a regulatory audit comes from prior orders of that jurisdiction. The orders can provide two distinct messages. In one case, if a very recent audit of the utility focused on officer salaries and compensation upon termination, there may be no need to do the same level of in-depth audit. Upon learning that there has been no change in the policy from the prior case, assuming that the practice had previously been acceptable, the auditor could pick a different large item upon which to focus. This new issue area could be anything from purchasing practices to expense/capitalization practices. The second message gleaned from prior cases may be to look at recurring problem areas. Were inconsistent deferral practices an issue in previous cases? If so, the auditor may wish to again look at deferral practices to see if they continue as a problem or if corporate policies and practices have changed.

As difficult as it is to admit, rarely does an auditor – either individually or as a team – have the opportunity or resources to look at every aspect of the utility in each and every case. Additionally, issues ebb and flow. The Commission may be interested in the cost of consolidated service centers one year, and in the next case be more interested in the cost of maintaining equipment. It is up to the auditor to not only present audit findings that are useful, but also information that is relevant to the times and the circumstances of the case.

Reviewing Prior Audit Reports and Prior Workpapers
The auditor may also review files, reports, and workpapers from previous regulatory audits, if such records are available. Reviewing these documents may provide one with a better understanding of what to expect during the field visit. What should one expect the work orders to look like? What was a primary focus on the prior audit, and can some of that information

simply be updated, rather than recreated? What information should one expect to see on the customer bills? Are prior organizational charts available so that a comparison can be made of the current organizational structure to those of the past (perhaps allowing one to ask about the cost of the reorganization)?

Reviewing External and Internal Audit Reports and Workpapers

The auditor may wish to obtain a list of internal and external audits performed in recent history by the utility's internal and external auditors. These audits by internal audits may include a variety of topics, and the auditor may wish to select the audit topics to review that are most relevant to the issues of the case. Once selecting some or all of the audits to review, one will wish to obtain (or review) a copy of the audit report and then determine whether it is important to follow-up with a review of the workpapers. Examples of the types of things the internal auditors may look at include everything from the handling and deposits of payments to allocations of officers' compensation among subsidiaries.

The auditor may also wish to review the reports, recommendations, and workpapers of the utility's external auditors. These reports and recommendations would normally include the annual financial audit with the testing procedures and testing results with supporting workpapers. One should expect that much of this may be available electronically. While the types of audits being performed by the external and regulatory auditor are very different, there will likely be information useful to the regulator in the external audit report (e.g., level of deferrals of expenses and any concern about recoverability). One should not limit a review of audit reports to that of only the annual financial audit, as external auditors may have been hired to look into specific other items (e.g. cost allocation manuals or property records). Furthermore, one may also wish to inquire if any consultants performed reviews or audits that might be of interest. An example of something that might have been done by a consultant, rather than an auditor per se, would be an evaluation of fuel procurement practices.

Contacting Other States about Common Cases or Common Issues

If the utility has operations in multiple jurisdictions, it would be helpful for the auditor to have some familiarity with colleagues or counterparts in the other jurisdictions. The auditor might already be familiar with issues that have arisen in the other jurisdiction, and may want to explore similar issues during the audit. If one does not have such a relationship, it may be useful to contact the other jurisdiction(s) to determine if there are common concerns and/or solutions. Furthermore, orders of other regulatory bodies are commonly available for review, either through the internet, through direct requests to the other state, or by asking the utility to provide copies of the desired documents.

Coordinating with Complaint Personnel and Commission Engineers

Utility regulators generally focus on two categories of regulation: rates and service. These two items go hand in hand and therefore, service is an important consideration when considering the

reasonableness of expenses and investment to be included in rates. In this regard, it would be useful for the auditor to have a discussion with other Commission personnel, such as facility (or safety) engineers and customer complaint representatives, to get a feel for the level of service problems that are associated with the utility being examined. For example, if there are numerous complaints about closing local customer offices, and consolidations into regional service centers, one might want to ask about the savings associated with such a restructuring, in order to see that those savings from the office closing are reflected in the adjusted earnings, and to see that any one-time costs of the offices from the restructuring are properly addressed in the case (e.g., perhaps they should be amortized and not reflected in the one year of the test year). Similarly, if there are complaints about noise on the telephone line in the rainy season, or voltage drops in high winds, the auditor may want to ask about maintenance practices, and examine whether expenditures (either in the form of new investment or operating maintenance) have been reduced in recent years.

Determining the Appropriateness of the Test Year

The test year is a period of measurement for a recent, consecutive twelve-month period consisting of a full year of operations where data is readily available. While many jurisdictions have traditionally used, and continue to use, historical test year data, some commissions either allow or mandate the use of a projected or future test year. In either case, the test year is used to examine earned returns compared to either previously authorized earnings levels (based on approved rates of return) or compared to requested earnings levels (based on requested or recommended rates of return). Whether using a future or historic test year, the auditor should judge the appropriateness of the test year that has been proposed. Is it representative, after adjustments, of the period in which rates take effect?

When looking at an historic test year, one of the first questions asked is whether the test year is too stale to make it a reasonable basis upon which to establish rates for a future period. In looking at the appropriateness of the test year (and whether it might be too old), one should look at what has happened since the end of the test year and the current time. Are the historic costs and revenues normal or recurring? Has extraordinary growth occurred during the intervening time (e.g., has a new industrial customer come on line)? Or, has there been a negative impact on revenues through shift reductions at the local foundry? In looking at the months beyond the end of the test year, have the growth rates for rate base, expenses, and revenues all remained fairly close and constant, maintaining the test year relationship among these three elements, or has one element changed dramatically, making the test year out of kilter with current operations? If so, can this situation be resolved through adjustments to the test year?

When looking at a future test year, one will want to examine the test year selected for reasonableness. Is this period mandated by rules, statute, or Commission directive? Is the test year founded on a historical base or documented figures, such that its projections are readily understandable and traceable?

Checking Schedules and Supporting Documents for Mathematical Accuracy

While this may seem like an obvious step, or even an unnecessary one in the age of computers, one might be surprised at the number of cases in which a number has been added instead of subtracted, a column or row has been hidden in a spreadsheet, a formula has been overridden, or a number has been transposed when being carried from one schedule to the next. The auditor should be able to recreate and verify the computations contained within the utility application or submission.

COORDINATING THE AUDIT

Determining Time and Place

In today's age of consolidations and mergers, many utilities have multiple corporate offices that are located in multiple states. It would not be uncommon for the accounting department and the regulatory department to be in different cities, or even in different states. Thus, it is important to determine where the site visit will take place, or whether it will take place in multiple locations. Will not only the records be available at the location selected, but will the people who can explain the records and answer questions about the adjustments also be available at that location?

Has adequate time been set aside for the site visit? When determining the answer to this question, the auditor should consider time not only for document and record review, but also a walk-through and explanation of the adjustments, and a tour of warehouses (or service territory or customer service centers or the like).

Scheduling Discussions with Utility Personnel

To the extent known, it is useful to provide at least a general list of topics of interest to be discussed during the site visit. Perhaps one will want to devote much of the audit time reviewing invoices, ledgers, and other financial records. However, in other cases (often cases for larger companies), more time may be spent in conversations with utility personnel discussing policies, processes, specific adjustments, budgeting, forecasting, and other similar topics. In those cases, it is wise to provide a list of topics you want to discuss (allowing the utility contact to line up the proper personnel) or a list of specific people that you would like available during your visit. For planning purposes, it is helpful to have the schedule for these interviews arranged prior to the beginning of the field visit. However, it is also practical to build in some non-specified time that can be used to read proprietary reports or have follow-up discussions to earlier listed topics. It is also useful to make arrangements if the auditor wishes to meet with the independent auditor or review his/her workpapers.

Arranging for Field Visits and Review of Property

Many auditors prescribe to the theory that it is more meaningful to deal with the financial aspects of a case when one has a basic understanding of the facilities and operations being discussed, or when the equipment that cost millions of dollars to purchase and install can be visualized. Thus, many auditors use the field visits as a time to do more than examine invoices and read Board of Directors' minutes. This may be a time to listen in on how well customer service representatives handle customer complaints. It may be a time to visit a power plant and see the size of a boiler or a coal plant. It may be a time to see the service territory and the size of the new refinery that has been added during the test year.

The auditor may also want to walk around the warehouse or the corporate offices in order to determine the reasonableness of the costs. It is difficult to know if the cost of an office is

appropriate without visualizing. Are the offices opulent? Are there original Picasso paintings on the wall (and included in rate base)? Are employees generally busy? Are garages full of extra vehicles during the day, or are they all out being used? Are warehouses full of utility equipment and supplies, or are they being used for non-utility purposes?

Listing Information to be Available

The auditor should prepare a list of the items that should be waiting and available during the field visit, since the utility coordinator will likely ask for this in preparing for the audit. Are there specific accounts that have been identified for which you would like invoices so that you can better understand why the expenses are higher than in prior years? Do you want copies of Board minutes to take with you, or are you willing to read them there, if they are ready and waiting? Perhaps a list of internal audit reports could be made available, and then the auditor could indicate early during the visit which of the reports he/she would like to read or have copied.

Determining Confidentiality Procedures

The auditor does not want to get to the site visit, or rate case audit, and find that much of the work is stalled because of an inability to review confidential (or propriety) data. Thus, the auditor should have made arrangements (in consultation with the assigned attorney) with the utility relative to treatment and review of confidential data.

RECORDS TO BE REVIEWED

The following is a list of records that the auditor may consider obtaining or reviewing during the audit or site visit:

- Affiliate Agreements for Inter-affiliate Transactions
- Audit Committee Minutes
- Billing Records (registers, etc.)
- Board of Director Minutes
- Chart of Accounts and Accounts Manual
- Construction Work Orders
- Construction Budgets
- Continuing Property Records
- Depreciation Studies
- External Independent Audit Reports and Workpapers (looking especially at the adjustments that the company chose not to make in spite of the auditor's recommendations)
- Franchise Fee Records (collection and payment)
- General Ledger and Subsidiary Ledgers
- Income Tax Returns
- Internal Audit Reports and Workpapers
- Invoices
- Lead-Lag Studies
- List of Property Units
- Monthly or Quarterly Operating/Financial Reports
- Monthly or Quarterly Trial Balances
- Organizational Charts (one showing the corporate (parent and affiliate entities) and one showing internal reporting lines and internal departments)
- Payroll Records
- Property Tax Statements
- Risk Committee Minutes and Documentation
- Sample of Customer Bills (to verify rates and information)

REVIEWING PROPOSED ADJUSTMENTS

A utility's rate filing commonly begins with test year booked numbers, which are then adjusted to represent anticipated, normalized operations for the period, that the rates will take effect. (See Revenue Requirement Computation example toward the end of this document.) Several types of adjustments may be included, and these adjustments may be referenced by different names in different jurisdictions. Commonly, these adjustments will include correcting adjustments (e.g., the removal of prior period items from the test year), normalizing adjustments (e.g., adjusting revenues for normalized weather conditions or for a normalized level of expenses), and pro forma adjustments (e.g., the reflection of authorized salary increases into the test year figures). In general, the pro forma adjustments can be viewed as a ratemaking attempt to transform the relationship that exists between the elements of cost of service (revenues, expenses, taxes, and investment) during the test year to one that would take place during the period that the rates resulting from the rate proceeding take effect. One is trying to identify circumstances during the test year, or beyond the end of the test year, that impact the on-going expenditures or revenues of the utility.

The adjustments proposed by the utility are generally listed and described in the exhibits and testimony contained within or accompanying the filing or submission being reviewed. If not provided up-front, the auditor should obtain the workpapers and electronic files that lay out the computations and supporting documents used to develop the adjustments.

In reviewing the prudence and reasonableness of the adjustments proposed by the utility, the auditor should ultimately keep in mind that the ultimate purpose of the review is to determine a revenue requirement and customer rates that are just, fair, reasonable, and sufficient.

The auditor should look for an application of the matching principle. For example, if plant is proposed to be removed from rate base, is there a matching adjustment to the depreciation expense and/or accumulated depreciation reserve, and should deferred taxes be adjusted? If expenses are changed, is there a matching adjustment to the cash working capital figure? If the adjustment adds new equipment (rate base) will it generate additional revenues or reduce expenses? Have the proper adjustments been made to revenues, expenses, and taxes?

The auditor should not only review the utility's proposed adjustments, but should also look for the adjustments that have *not* been made. Are there adjustments missing that if made would make the test year more reflective of normal, on-going operations?

RATE BASE ITEMS

General Principles

The utility's rate base is the total of the investor funded or supplied plant, facilities, and other investments used by the utility in providing utility services to its customers. The rate base is the investment base to which a fair rate of return is applied to arrive at the net operating income requirement (i.e., the amount of authorized return).

Many jurisdictions have adopted the concept of using the original cost of the plant or equipment to determine the value for the purposes of computing rate base. Under the original cost concept, the cost of the item at the time that it was first put into utility service is the cost that remains with that item throughout its life. If the asset is purchased during its life from another utility, the original cost carries with it, and any difference between it and the purchased price is booked as an acquisition adjustment (known as goodwill in non-utility industries). However, some jurisdictions have adopted other valuation methods, such as fair value, reconstruction costs, or replacement costs. The audit guidelines listed below presume the use of original cost and do not specifically address auditing based on other valuation methods.

When examining the balances of the various rate base items, the auditor will want to determine his/her jurisdiction's policy, if any, regarding the use of average or year-end balances. While the proper matching of booked investment, expenses, and revenue would argue in favor of an average test year, many jurisdictions have moved toward the use of year-end balances. One rationale for using year-end balances is to offset regulatory lag, and to make the plant more reflective of the time that rates are to be placed into effect. The auditor will want to verify that the utility's submission is consistent with Commission policy, if any. Some states have no policy on this matter and leave the matter to the discretion of the utility. In other instances, year-end balances may be used for items such as plant in service (e.g., accounts with less month to month volatility) but may use 13-month averages or other monthly average data for items such as prepayments, materials and supplies, and other similar accounts that have a lot of variability throughout the course of a year.

In reviewing specific rate base items, the auditor will want to continually be considering the concept of *used and useful*. This principle is widely adopted by regulatory commissions and requires that plant be functioning and necessary to be included in the revenue requirement. Plant that is considered to be excessive may not be appropriate for inclusion in rates at this time. However, the auditor should be aware that utility investment is often lumpy in nature, such that it may be cost ineffective to add small increments of plant and equipment each year, rather than building to meet a longer growth horizon.

Plant in Service

In addition to the used and useful concept described above, the auditor should be aware of any Commission policy and state laws regarding plant being in-service prior to its inclusion in rates. For example, one jurisdiction may have a policy of allowing plant to be included as long as it is in service prior to the time the rates go into effect, whereas another jurisdiction may not allow plant that is not in service by the end of the test year to be included in the revenue requirement. Other jurisdictions may look at the issue on a case-by-case basis. The auditor should become familiar with past decisions on this matter.

Another concept that is common when looking at plant in service is that there should be no *gold-plating* of facilities. In other words, the facilities should be reliable and adequate to the needs of providing service (and need not be Spartan) but should not be extravagant or extreme (e.g., no need for Taj Mahal-like facilities). Some analysis of this can be done by looking at the cost per square foot of office space, or the cost per installed megawatt (MW) of capacity, or the like. However, the auditor will also be required to use judgment in these areas.

The auditor will want to examine the major additions in the facilities that have occurred since the last rate proceeding. This examination can start with asking the utility to identify the major plant additions by year (with the auditor stating, for instance, projects that exceeded a specific dollar value or percentage of total plant), specifying the type of project, the need for the project, total cost of the project, and the project start and completion dates. Once this list is received, the auditor may wish to follow-up on specific projects, by examining the detailed work orders and the specific expenditures that were incurred. It may also be useful to compare the ultimate cost of the project to the initial projects submitted when the project was initially authorized or approved by management. It is also important to identify any plant that is replaced so as to verify that it is retired properly.

The auditor may also use this review as an opportunity to look at current and historic net plant balances to determine a trend in plant investment. If net plant balances are increasing, is there an explanation for the new investment or the slower depreciation rate? If net plant is generally decreasing, is that a reasonable expectation based on the circumstances of the service area (e.g., growth rates, economic conditions, etc.) Or, is the decline in investment an indication of new corporate policies (e.g., purchasing power rather than constructing power plants)? Is there a risk that the reduction in net plant, and reduction in investment, will put service quality or reliability at risk? Is adequate investment being budgeted to maintain appropriate service levels?

The auditor will also want to review any sales of plant or equipment that have occurred since the last rate case, and determine if any gains or losses from the sale are being properly treated. Other items to look at with a sale include whether the cost of the plant was properly removed not only from the plant in service, but also from accumulated depreciation and depreciation expense. Additionally, have any deferred taxes associated with the plant been removed from the books, and have the continuing property records been updated?

The auditor will also want to look at plant in service that is leased rather than owned. In addition to making sure that it is used, useful, and prudent in its provision of service, one will want to make sure that it is properly recorded either as a capital lease or an operating lease. (For example, if a subsidiary builds a power plant on behalf of its sister utility company, and the utility then leases the power from that plant, one should examine the proper accounting and treatment of that power cost.) Furthermore, the auditor should examine lease transactions for arms length transactions (e.g., is the transaction cost priced at the affiliate's cost, at market price, or at the lower of cost or market? Does the jurisdiction have a policy on the pricing of affiliate transactions?)

The auditor may also want to look at land, as it is included in plant in service. One would want to look at whether land balances have changed, as well as verifying deeds on land purchases and verifying sales prices using county records for any purchases and sales. Finally, one may wish to examine land transactions between the utility and affiliates or subsidiary entities.

Plant Held for Future Use

This category of plant generally contains plant that is owned and held for a future purpose, and thus not yet in active service. Many jurisdictions require that the property held in this account have a definite plan for use (e.g., the FERC) or even specify a time frame by which the property must be actively used (e.g., the FCC). Therefore, the auditor should specifically examine the list of items within this account and determine if there is a definite plan for use related to the provision of utility service. Some states completely disallow any inclusion of plant held for future use in rates, while others may allow some or all to be included in rate base. This is a jurisdictional specific decision.

Construction Work-in-Progress

The auditor should become familiar with any existing policy on construction-work-in progress. Some states completely disallow any inclusion of construction work-in-progress (CWIP) in rates, while others may allow some or all to be included in rate base. This is a jurisdictional specific decision. However, to the extent that a jurisdiction does permit construction-work-in progress to be included in rate base, the auditor should make sure that allowance for funds used during construction (AFUDC) has stopped being accrued. To the extent that CWIP is not allowed to be included in rates, it is likely that AFUDC will be accrued until the property is completed and put into service.

The auditor should become familiar with the formula used by the utility to compute AFUDC (sometimes referred to as Interest Used During Construction, or IDC), and make sure that the utility has computed the rate correctly. The auditor should especially make sure that the proper return has been used in computing the rate.

Acquisition Adjustments
Under the concept of booking all plant-in-service at original cost, any difference between the price paid for the utility plant and the original cost of that plant is booked as an acquisition adjustment. It is at the discretion of each jurisdiction as to whether or not the acquisition adjustment is included in rate base, and often, that decision is made by the jurisdiction on a case-by-case basis. The auditor should look at each acquisition adjustment transaction and determine the circumstances for its existence. Why did the utility pay above book for the property, and is there some benefit to ratepayers as a result of that transaction? Will customers have better service as a result of the purchase by the utility, even if the utility did pay above book value for the property? As another option, some jurisdictions have allowed the amortization of the acquisition adjustment above the line, but have not allowed the unamortized balance to be included in rate base – thus splitting the risk of that transaction between ratepayers and the utility's shareholders.

Cash Working Capital
In its simplest form, it is broadly recognized that, when a new business starts up, it requires some of the investors' money in the cash drawer to cover expenses until the business can sell its merchandise and receive payment for it. As the business matures, the need is the same, but there is confusion about whose money is in the drawer. Another way to look at it is that cash working capital is the measure of investor funding of daily expenditures and a variety of non-plant investments that are necessary to sustain on-going operations of the utility until those expenditures can be recovered through revenues.

There are several methods commonly used by regulators to measure the amount of cash working capital required for inclusion in a revenue requirement computation. Some jurisdictions prefer one method over another, while sometimes the decision of which method is used is dependent upon the size and resources of the company. The three methods, each described in more detail below, are: the formula method, the balance sheet approach, and the use of a lead-lag study.

1. Formula Method. The formula method is also known as the 45-day rule, and was established by the FERC (formerly, the Federal Power Commission) in a 1939 decision. At that time, the working capital was computed as 45/365 of operating costs, but excluded taxes (which did not require initial outlays of capital) and depreciation (which is a non-cash expense). In a 1949 case, the FERC modified the formula so that not only were taxes and depreciation excluded from the formula, but purchased power was also excluded (based on the contention that purchased power is paid for after revenues are received.) This is the key point for the auditor. Even when the jurisdiction adopts the formula approach, the actual elements of the formula may be different form the formula used in other jurisdictions, or even from that used in other cases. For example, at one time, a particular jurisdiction modeled its formula after that used by FERC, but allowed 15/365 of purchased power to be included. Other jurisdictions have had debates over whether taxes (specifically, income and property taxes) should be included in the formula. These are all legitimate points for discussion, although the auditor should look to previous cases for guidance.

Under this method, the auditor should also be aware of changes made to the allowed operating expenses, since changes to those expenses will also change the overall result of the formula based cash working capital.

2. Balance Sheet Method. Two unique balance sheet approaches have been noted in practice. In one, often referred to as the *net current asset method*, the average current and accrued assets are compared to the current and accrued interest free liabilities. This is the method that is generally discussed in accounting circles. This method focuses on the fact that all of the current assets must be financed, and is less concerned with how long any particular asset must be financed. If adopting this method, the auditor should look at the nature of the current assets and current liabilities to see if they are reasonable and prudent.

Another balance sheet approach is sometimes referred to as the *overall balance sheet* approach. It is based on the premise that a utility's return should be equal to the carrying cost of outstanding securities including common equity, noting that capital devoted to non-utility ventures is removed, as are investments on which no return is allowed for ratemaking purposes. If the rate base exceeds the return bearing capitalization then the difference between the two quantities is the cost free source of capital. If the capitalization exceeds the rate base, the difference is the requirement for cash working capital. The auditor should be aware that under this method, capital will be difficult to allocate between utility and non-utility uses. Additionally, under this computation, either a positive or negative cash working capital may result. The balance sheet method is the working capital method that attempts to determine if the utility actually funds the working capital.

3. Lead-Lag Study. While the lead-lag study can be more time consuming and costly than other more simplistic methods, the results tend to be more individualized to a specific company. Under this method, one is attempting to measure the actual time between a utility's out-of-pocket payment of expenses to provide service and the collection of revenues for service. The weighted average of the net lag days times the average daily expense yields a positive or negative requirement for cash working capital. As with other methods, the result may be either a positive or negative cash working capital requirement. (For example, if a utility bills service at the beginning of the period for which service is being provided, as many of the telecommunications companies do, then one should not be surprised at a result of negative cash working capital.) As with other methods, there continue to be debates as to which expenses to include in the calculation. For instance, should non-cash items be included or excluded? How should items such as long-term debt interest, stock dividends, and deferred taxes be treated in this computation? Once again, these questions are best answered both by looking at the theory of what is attempting to be measured (e.g., the measurement of *paid* expenses may argue against the inclusion of depreciation) and what treatment these items have been given in previous cases in a particular jurisdiction or for a particular utility.

Customer Deposits

Customer deposits are shown as a liability on the utility's balance sheet and represent a source of non-investor supplied capital. Customer deposits are generally treated one of three ways.

The first method does not reduce rate base by the customer deposits balance and classifies any interest accrued or paid on those deposits as a below-the-line (or non-operating) expense. This method allows the utility to earn a return on a rate base that has not been reduced by the amount of customer deposits, and then allows it to use that return to pay the interest that is required to be returned to customers with the return of that deposit. One consideration in using this method is whether the return allowed on rate base is higher than the return that the utility is required to pay on its customer deposits. If so, the utility may be allowed to earn more than is necessary, and return that difference to shareholders.

The second method reduces rate base by the customer deposits balance, and classifies any interest accrued or paid on those deposits as an above-the-line (or operating) expense that is included in the revenue requirement computation. The interest that the utility must pay is generally deemed to be a legitimate expense that must be recovered in one form or another.

The third method includes the liability for customer deposits in the utility's capital structure at a zero cost, reducing the overall rate of return. If interest is paid on the customers' deposits, the utility can recover that interest expenses as an above-the line (or operating) expense.

When examining this item, the auditor may want to become familiar with the utility's deposit policies, to make sure that the amount of deposits it holds is consistent with any rules of the particular jurisdiction on the matter. One wants to make sure that the proper amount is being held, not only for the sake of customers who paid the deposits, but also to assure that too much interest expense is not being included in rates to be paid by the general body of ratepayers. One may want to look not only at the policy of how much is collected from any individual customer as a deposit, but whether deposit policies are consistent with minimizing uncollectibles. One may also wish to review policies of when deposits are returned to customers.

Prepayments

The auditor should examine the nature of the prepayments as well as the amounts of each type of prepayment. In looking at these items, one should look to see that they relate to the provision of utility service, and are the type of expense that is normally lumpy in nature, and therefore, paid periodically and then amortized over some number of months. An example of a commonly included prepayment is insurance. Watch the allocation of insurance as it often covers not only the regulated utility, but also affiliates and deregulated activities. Since the prepayment balance will vary during a period, the auditor may wish to consider using an average balance in order to reach a more normalized level for inclusion in rate base.

Contributions-in-Aid of Construction/Customer Advances

Contributions-in-Aid of Construction (CIAC) and Customer Advances reduce the rate base as a source of non-investor supplied capital. CIAC and Customer Advances are payments made by customers generally to fund plant additions for new or expanded service. CIAC are generally non-refundable, whereas Customer Advances often have a provision allowing for refunds under specified circumstances. For certain of the utility industries (e.g., water and wastewater), it is common for the CIAC and Customer Advances to be contained in its own rate base account, whereas for other industries (e.g., electric and gas) it is common for these items to be netted against the plant costs associated with their payment. For telecommunications utilities, CIAC and Customer Advances are generally not an issue. Therefore, the auditor should be familiar with the accounting policy for the utility involved.

Additionally, the auditor should be familiar with the utility's line extension policy and any other tariffs that relate to the CIAC and Customer Advances and the level to which the utility may still have an obligation to refund these amounts. Furthermore, the auditor should determine whether any taxes or amortization expenses are associated with either the CIAC or Customer Advances, such as whether any of the funds are considered to be taxable income, or whether any of the funds include a gross-up for taxes.

Materials and Supplies and Purchasing Practices

The auditor should look for ways to determine the reasonableness of the materials and supplies (inventories) balance. For instance, one might ask for the utility's policy on spare parts inventory, and its ability to obtain materials and supplies on short notice. One might also ask about the purchasing practices of the utility, to determine whether it is using reasonable care in keeping its material and supply costs low. Additionally, the auditor may wish to look for anomalies in the month end balance during the period, to see if there is a need to normalize the balance included in rate base.

For utilities with fuel stocks (such as electric utility coal piles or natural gas storage), one may want to ask about balances and policies on determining the most efficient and effective inventory levels. For example, is it generally the policy to keep a certain number of days of coal stock on hand, with a review of that level if a strike is pending? Is the amount of natural gas stored dependent upon the price of that natural gas?

Accumulated Deferred Income Taxes

Accumulated Deferred Income Taxes are also treated as a reduction to rate base. See Income Taxes discussion below.

Regulatory Assets and Other Deferrals

The auditor should become familiar with the specific items in this account, including the nature of the entries, the dollar amounts, the reason for the deferrals, and whether or not regulatory approval has been obtained (or is needed) for the deferrals. In looking at the nature of the

deferrals, the auditor should consider whether the deferral is appropriate for inclusion in rate base. For instance, is the utility deferring certain fuel or purchased power expenses under a mechanism that is approved by the Commission allowing for dollar-for-dollar recovery of those costs? Or, is the utility deferring controversial costs that are outside of any regulatory mechanisms that have previously been approved? The auditor should also look at the amortization period for these deferrals. What is the rationale for that amortization period? How was it determined? Is the utility simply waiting to begin amortizing the deferral until it is in rates, or did it begin the amortization consistent with some other action or situation? Finally, the auditor should be familiar with Statement of Financial Accounting Standard 71 when looking at these potential rate base items.

Suspense and Clearing Accounts

Suspense or clearing accounts are auxiliary accounts that exist for technical reasons and which are repeatedly cleared. Postings may be made to a clearing account due to a time gap between accounting transactions, organizational task distribution, or accounting transactions requiring clarification. The auditor should examine the utility's reasons for using clearing accounts and its method for clearing them. The auditor should verify that these accounts are routinely cleared and that the method used for clearing is appropriate. If not cleared in the appropriate time period, costs may not be adequately reflected in rates for these expenditures. Be sure the account is not routinely over or under amortized.

INCOME TAXES

Accumulated Deferred Income Taxes

Under Statement of Financial Accounting Standards (SFAS) 109, Accounting for Income Taxes, companies must recognize changes in tax rates when they occur and use deferred tax accounting. The resulting comprehensive interperiod tax allocation, or income tax normalization, causes a rate base adjustment that is amortized over the tax life of the timing difference. The option is cash-basis accounting, which "flows through" the timing difference to the income statement.

Deferred income taxes (DIT) arise when income tax amounts provided for book purposes differ from the amount of taxes currently due and payable. The primary cause of the tax differences is the straight-line depreciation rates used for rate making purposes versus the accelerated depreciation rates used for federal and state income tax purposes. Under this method, there is higher depreciation expense for tax purposes than for regulatory book purposes, causing the taxes computed for regulatory books (and thus, included in revenue requirement) to be more than the taxes actually payable to the Internal Revenue Service and state taxing entities, in the early years of the asset's life. In later years, the situation reverses itself, such that the revenue requirement will reflect a lesser amount of income tax than that which is actually due and payable. This difference then becomes a source of interest-free funds, provided by ratepayers and not investors. This accumulated balance of interest-free funds (ADIT) is available to the utility to further invest until it is then needed to fund the taxes due and payable in the later years. This is shown by the following example:

$3,000 Asset
Tax Life = 3 Years ($1,000 per year depreciation expense)
Book Life = 5 Years ($600 per year depreciation expense)
Tax Rate = 40%

INCOME TAX EFFECT OF DEPRECIATION EXPENSE[3]			
IRS TAXES	BOOK TAXES	CURRENT YR. DIT	DIT BALANCE
$1,000 x 40% = $400	$600 x 40% = $240	$400 - $240 = $160	$160
$1,000 x 40% = $400	$600 x 40% = $240	$400 - $240 = $160	$160 + $160 = $320
$1,000 x 40% = $400	$600 x 40% = $240	$400 - $240 = $160	$320 + $160 = $480
$ 0 x 40% = $ 0	$600 x 40% = $240	$ 0 - $240 = ($240)	$480 - $240 = $240
$ 0 x 40% = $ 0	$600 x 40% = $240	$ 0 - $240 = ($240)	$240 - $240 = $ 0

These differences are generally caused by both differences between IRS/State and regulatory allowed asset depreciation lives, and differences in the depreciation method (e.g., straight line versus accelerated). Other differences in IRS versus regulatory income taxes, which do not

[3] In this table, credits are shown as positive amounts, and debits are shown in parentheses.

become part of the DIT computation per se, are permanent differences, and not just timing differences. An example of a permanent difference is the fact that business meals are not generally deductible for IRS purposes but are often included as a legitimate operating expenses for ratemaking. Finally, there may be basis differences, in that the total amount of the capitalized asset may be different for IRS and regulatory purposes. For example, certain items that are capitalized as plant in service for regulatory purposes (e.g., depreciation on vehicles used during construction) may not be allowed to be capitalized for IRS tax purposes.

The auditor should generally be aware of the two methods of treating the timing differences reflected in accumulated DIT. The timing differences related to life and method differences are required by the federal tax code to be *normalized.* Pursuant to normalization, the timing differences are accumulated in the DIT account and used to spread the benefits of the IRS tax policies over the economic life of the asset. This will be the bulk of the dollars involved in DIT. The remaining items, related to basis differences, may be either normalized or *flowed-through* to customers. Under the flow-through method, income tax savings resulting from IRS tax methods are immediately used to reduce rates (i.e., revenue requirements) instead of recording the difference as a liability in the deferred tax accounts.

In looking at accumulated DIT, the auditor should look at the Schedule M of the federal (and possibly state) tax return, to determine the types of items that are different between the IRS/State computed taxes and taxes computed for regulatory purposes. One should then follow these items through the records and adjustments to determine that they have been properly reflected in the accumulated DIT. One should look for large changes in the accounts and determine why these significant changes occurred, and whether they match other items reflected on the income statement.

There are several unique circumstances for which to watch, including sale of assets and changes in tax rates. If an existing utility asset is sold, there should be a transfer of not only the asset but there should also be a reduction of the associated accumulated DIT balance. Similarly, with a purchase of an asset (for example, from a sister company), one should watch to see if deferred taxes are transferred with the asset. It is important to review current tax regulations to understand when DIT balances can be transferred and when they cannot.

Several of the reductions in federal income tax rates in recent history have caused a unique circumstance, where DIT were computed using a rate that no longer exists. In the example in the table above, if the tax rate were reduced to 35% from 40%, there would be a balance remaining in the account at the end of the five year life, even though the asset were now retired. To address this, a special amortization of the DIT balance must be made. The auditor should examine these circumstances and work with the utility personnel to understand the method by which these special adjustments are reflected in the income tax expense and in revenue requirement. Furthermore, the auditor will want to examine the treatment of those *excess deferred income*

taxes if that asset is sold or transferred before the ratepayers have the full benefit of that tax reduction correction.

There are two ways of treating DIT in the revenue requirement computation. In the first, the accumulated DIT is deducted from rate base. This appropriately recognizes that these are interest free funds upon which the utility should not earn a return. In the second, the accumulated DIT is not deducted from rate base, but instead, is treated as a zero cost element of the capital structure. In doing so, a lower average authorized rate of return is applied to a higher rate base. In concept, the methods should derive similar results. The auditor should become familiar with the jurisdiction's policy and practice on this matter, so it is properly reflected in the rate computation.

Investment Tax Credits

Ending about 1986, a reduction in income taxes was provided as part of the federal tax code for those who constructed plant during this period. The investment tax credit (ITC) was generally required to be amortized in equal increments over the economic life of the asset. Some of the assets constructed during that period are still in service, and thus, the current revenue requirement may reflect a remaining balance related to earlier ITCs.

Utilities were generally required to make a selection of one of two options for regulatory treatment of ITCs. These options generally are:

Option One: For ratemaking purposes, the rate base may be reduced by the unamortized ITC, but the net operating income may not be increased by the amortization of the ITC.

Option Two: For ratemaking purposes, the net operating income may reflect the amortization of the ITC, but the rate base may not be reduced by any portion of the unamortized ITC.

There was a third option that expired in 1980 that allowed for the flow through of credits immediately as a reduction of current tax expense. Most of the utilities have chosen either option one or option two. The auditor should determine the option that was chosen (and cannot be changed) and make sure that the case properly reflects that choice in the rate base or income statement computation. The auditor should also make sure that the amortization period for investment tax credits matches with the life of the asset, and that the amortization period is adjusted if the depreciation life is adjusted. The auditor should be familiar with state tax laws and determine if state ITCs are properly reflected.

Income Tax Expense

Income tax adjustments (additions and deductions) for the test year are affected by ratemaking adjustments. Generally, all ratemaking changes to revenues, expenses, and other taxes would be fully includible or deductible for calculating the tax effects of test year adjustments.

The auditor should look at the Federal and State Schedule M items/adjustments to see what differences exist between the tax return computation and the book tax computation, and inquire about any of the items that appear to be out of place or that are not understood. The auditor should also review and understand the timing and payment schedule of income taxes.

The auditor should verify that the depreciation rates for book purposes and those for tax purposes are appropriate.

The auditor may consider obtaining a copy of the most recent IRS audit report and determine the treatment of any follow-up requirements from that audit.

The auditor should be aware that the marginal tax rate will affect the net to gross factor. This not usually an issue for large utilities, but it may be for small utilities.

Revenue Conversion Factor (Net to Gross Factor)

The revenue conversion factor/multiplier, or net to gross factor/multiplier, converts a net income deficiency into a gross revenue deficiency. This recognizes that a utility would need to collect from the customers more than one dollar in gross revenue for each dollar of net operating income it wants to keep for itself, due to the imposition of taxes on those earnings.

In general, the revenue conversion factor/multiplier is computed using the following formula:

$1 / (1 - \text{Tax Rate})$

Thus, if the tax rate was 40%, the computation would be:

$1 / (1 - 40\%) = 1.667$

This means that for every additional (or reduced) dollar of net income that the utility is being granted, 1.667 dollars should be added to (or reduced from) rates. This will allow the utility an actual opportunity to earn that additional dollar while also allowing the utility to pay the additional income taxes on that one dollar of income.

While the above represents the basic formula, many additional items may be added to the formula to reflect revenue driven expenses. For example, it is common for the utility to modify the formula to reflect additional uncollectible revenue. In theory, for each additional dollar of revenue billed, there will be a portion that is uncollectible, and this may be appropriate to include in rates. Similarly, some utilities may wish to reflect other revenue based expenses, such as franchise fees and regulatory commission fees, in the revenue conversion factor/multiplier, since these fees are often tied directly to the level of revenues billed.

The auditor will want to become familiar with the individual utility's or individual jurisdiction's policy or practice on what to include or exclude from the formula.

Inter-company Tax Allocation Agreements

A regulated utility that is a member of an affiliated group of companies may participate in the filing of a consolidated income tax return. Typically, the allocation of consolidated income tax liabilities is governed by an inter-company tax allocation or tax sharing agreement that specifies, among other things, the allocation of tax losses and credits among member companies. Such agreements may be subject to SEC and IRS rules and regulations as well as federal/state regulatory approval. Tax sharing agreements are generally structured to provide immediate tax benefits to those entities that generate income tax losses and credits, but only to the extent that no member of the consolidated group is allocated more income tax than what its liability would be on a stand-alone basis. From a ratemaking standpoint, the primary issue is to determine whether any of the benefits derived from the filing of a consolidated tax return are properly allocable to regulated operations. The auditor should ensure that the per book allocation of the consolidated income tax liability is consistent with the provisions of the tax sharing agreement, and also whether this allocation methodology is consistent with the regulatory policies of the state commission.

DEPRECIATION AND AMORTIZATION EXPENSE AND ACCUMULATED RESERVES

Depreciation Expense

The auditor should obtain or prepare a schedule looking at beginning and ending plant balances, the cost of removal rate, estimated lives, and plant retirements. This will provide the auditor a basis for examining the depreciation rates and plant balances that are used to compute the depreciation expense reflected in the utility's filing. The auditor should verify that the depreciation rate in use has been approved by the Commission (or that approval is not required). In this regard, the auditor may also want to look at the last time depreciation rates were reviewed by either the company or the Commission for appropriateness. Some utilities have been known to go a decade or more without reviewing the continuing reasonableness of its depreciation rates, even though the type of plant or technology in use has changed during that time frame without a depreciation rate review.

The auditor will also want to become familiar with SFAS 143, Accounting for Asset Retirement Obligations. If a company has a legal obligation to incur costs to remove an asset at its retirement, the net present value of those costs is part of the ultimate cost of the asset and should be recovered in charges to deprecation expense over the life of the asset. For those assets for which there is a legal obligation of removal, a liability is recorded at fair value. Each accounting period, the liability is increased to its present value. The asset is also increased to reflect the asset retirement obligation, and this is depreciated over the life of the associated tangible asset. With the implementation of this statement, transitional entries may also have been required in order to reflect catch-up transactions such that the transaction would reflect the liability and asset as if they had been recorded at the beginning of the asset's life. The auditor will want to fully understand how the implementation of SFAS 143 impacts the use of more traditional depreciation rates, and especially the previous practice of reflecting cost of removal as an expense over the life of the asset. It will be particularly important to understand which assets carry a legal obligation of removal, as these are the only assets impacted by this particular accounting standard.

Accumulated Reserve for Depreciation

The auditor should generally be able to tie changes in the accumulated reserve for depreciation to other parts of the filing, especially the depreciation expense and plant in service balances. The auditor should look for large or unusual changes to the depreciation reserve and seek explanations of those changes, if any. The auditor should also look to assure that retirements of plant have also been reflected in plant in service. It is most utilities' general accounting practice to remove the original cost of the retired plant from both plant in service and accumulated depreciation – whether or not that retirement was planned or unexpected. (In other words, whether or not the plant was fully depreciated.)

Amortization Expense

Amortization expense is the equivalent to depreciation expense for assets that are not plant in service. Capital leases are an area to investigate to assure that the amortization expense corresponds with the capitalized amount and it is amortized over a reasonable life at the proper rate. Additions or remodeling of capitalized leases (i.e., buildings) should be evaluated to determine if they were properly booked to the asset or expense.

OPERATING REVENUES

Retail Revenues and Sales

The auditor should begin by looking at an analysis of the test year revenues, such as the one recommended above where monthly balances are compared to look for anomalies, seasonality, or other oddities. Additionally, one will want to look at a multi-year comparison of annual revenue to obtain a view of the trend for the utility. Is it growing and if so, is the growth relatively consistent? Is the growth related to new customers or additional usage of existing customers? (The answer to this question may help explain whether the growth in revenue is consistent or inconsistent with growth in plant.) Are revenues and expenses growing together? It will also be useful to look at any anomalies or trends in the data by customer class or type of service to determine if one class or another is a significant driver of the change in income.

The auditor will want to look for seasonality in the revenue data. If seasonality exists, it may be important to then determine whether the data has been normalized, or whether normalization is needed. If usage is seasonal or driven by weather (e.g., changes with the use of air conditioning), then any unusual weather patterns that occurred during the test year will skew the data to either under or over report revenues. This can be corrected by adjusting the usage to reflect normal weather patterns, based on historical weather data and either heating degree days or cooling degree days. The period of historical data used in these normalization adjustments tends to vary by state, with some states using 50 years of data, and others using only ten or twenty years of data.

The auditor will also want to make sure that any other rate changes that occurred during the test year are reflected in the adjusted revenues. Was there a rate change authorized part way through the test year? If so, then the early months of the test year need to be adjusted as if that rate change had been in effect for the entire test year. This should be done not only with major rate case changes, but also with changes in non-recurring charges (e.g., late fees, non-sufficient check charges, etc.).

The auditor will want to examine the actual losses that are occurring on the system. Is the loss reasonable for a system of its size, recognizing density, the age of the plant, and other physical characteristics of the system? If losses have been increasing over time, what has the utility done to try to reduce that line loss or to investigate the cause of the increasing loss? (These system losses could be electric line losses, gas losses, unaccountable water losses, or infiltration into a sewer utility.)

Special contracts are another area of interest in examining revenue. Are there any special retail contracts (generally used to serve larger customers)? Have these been approved by the Commission, or do they require Commission approval? Do the contractual rates continue to recover at least variable costs and is there a contribution to the fixed costs of the system, even if

not at a fully embedded cost level? Why did the utility feel the need to enter into a special contract with this customer, rather than charging the usual tariffed rate?

The auditor may find it useful to spot check some actual customer bills, and verify that the bills comply with any billing rules and regulations of the Commission. Additionally, one would spot check the bills to the approved rates, to assure that customers are being billed at the proper rate.

Other (Miscellaneous) Revenues and Special Charges

In looking at miscellaneous and other revenues, the auditor will first want to determine the nature of these charges. Are they non-recurring charges for utility service? Or, are they for the sale of appliances or other non-regulated services? If non-regulated services have been included in operating revenues and are to be removed through adjustments, one will want to coordinate these revenue adjustments with the expenses, to assure that any related expenses for non-utility services have also been removed from the regulated income computation.

Unbilled Revenues

The purpose of unbilled revenue is to match the period's (e.g., test year's) revenues with expenses applicable to that same period. In other words, this recognizes that service may be provided and expenses may be incurred and recorded before service is billed and revenue is recorded or received. Thus, unless the proper revenue is recorded, there will be a mismatch between revenues and expenses.

The auditor should examine the revenues to determine if unbilled revenues have been reflected, and if not, why not? Additionally, one will want to examine how unbilled revenues are reflected in the adjusted revenues. It is common practice for the unbilled revenues to be accrued at the beginning of a period (or in some cases, each month) and then reversed when the actual revenues are billed. The auditor should examine the records for these accruals and reversals.

Unregulated Revenues

The auditor should examine how the utility has recorded unregulated revenues to keep them separate from regulated revenues. Are they in separate accounts? Are they in subaccounts? Additionally, there should be an examination to make sure that there is a clear understanding of the items that are considered to be regulated versus unregulated by the particular jurisdiction. Also, as noted above, if there are unregulated revenues that are removed from the revenues reflected in the filing, the auditor should make sure that any expenses associated with the unregulated revenues are also removed from the filing.

Uncollectibles

To start the examination of uncollectibles, the auditor should obtain a general understanding of the utility's policy of determining that an account is no longer likely to be recovered. What determines that an account is uncollectible? What attempts are made to recover the funds? How large did the utility allow the account to become before service was disconnected, and is this

consistent with the jurisdiction's policies and rules on disconnections and deposits? What is the actual write-off for the year, versus the amount being accrued for uncollectible revenues? Is the uncollectible rate appropriately reflected in the net to gross factor?

In addition to understanding the utility's practices about this issue, the auditor may also wish to look at the pattern of uncollectibles that has occurred over the past few years. Is there a particular year in which uncollectibles have been particularly large such that it is not representative of on-going operations? If such an anomaly exists, the auditor may wish to consider normalizing this expense through the use of a multi-year average of data.

Sharing Mechanisms

The auditor should become familiar with any sharing or incentive mechanisms that have been approved for the utility being examined. Examples of this might include the opportunity for a utility to keep a portion of the savings if it is able to reduce certain operating costs (e.g., fuel costs). In these instances, the auditor will want to assure that the revenues directly assignable to shareholders have been properly recorded and removed from the regulated income statement. Alternatively, if there was an agreement for a level of cost cutting that was not met, the auditor may need to compute the difference in savings that are not reflected in the actual results of operation.

Additionally, the auditor will want to verify the computation of the sharing amounts, to assure that the proportion of revenues (or cost savings) is being appropriately allocated between ratepayers and shareholders.

Deferred Cost Recovery Mechanisms

The most common type of deferred cost recovery mechanism that exists is a fuel adjustment mechanism or a gas cost adjustment mechanism. (These are known in different jurisdictions by different names and have different formulas associated with them, but mostly have similar principles underlying them. That is, the utility will recover all or a portion of its specified costs on a more expedited basis and in a more singular way than the remaining rate case elements.) Often, these mechanisms have a true-up provision, measuring the difference between anticipated costs and actually incurred costs, and then allowing for future recovery (or refund) of that difference.

Aside from fuel or gas cost recovery mechanisms, utilities are occasionally allowed to defer other costs that would otherwise have been expensed. Examples include: early retirement program costs, early plant closure costs, or demand-side management costs.

The auditor should become familiar with the types of costs that have been permitted to be deferred, and whether or not any recovery mechanism was stated or authorized at the time of the deferral. One should then look for consistency between the previously authorized plan and the current accounting entries relative to that recovery. One might also look at whether the amount

to be recovered is consistent with the original deferral balance, or whether the amount has unexpectedly (and without Commission approval) changed.

Federal Funds and Support Mechanisms

The auditor should be aware of any federal or state support that is provided to a utility and/or its customers. An example of this kind of revenue stream is high cost support (or universal service funding) to support local telecommunications service. The auditor should reach an understanding of the accounting treatment of these funds, since some may be treated as revenue, and others may be treated as negative expenses. The auditor should have a basic understanding of how these funds are derived, and whether the amount tends to vary or remain stable from year to year. Finally, one should understand and verify whether these support mechanisms are intrastate or interstate in nature, such that they are properly reflected in rates and operating income.

OPERATING EXPENSES OTHER THAN DEPRECIATION AND INCOME TAXES

General Review

In reviewing operating expenses, the auditor may wish to begin by again turning to the historical analysis of expenses that was prepared during the preliminary procedures and the analysis of the month by month test year data. An examination of these spreadsheets will assist one in identifying the initial areas upon which to focus during the audit. It will assist in pinpointing anomalies in the expenses, as well as trends in the expenses. Besides the list of hot topics that might be particular to one's individual jurisdiction, one will want to focus on the oddities indicated by the data.

In looking at the numbers that stand out of the analyses, one will want to gather background on the events that occurred during the test year that may have caused unusual expense levels. Was there a major storm that would have caused the need for unusual levels of maintenance and repair? Was there a labor strike that would have impacted salaries and wage levels? Did a new switch (or power plant) come on line that will change the overall operating costs?

One of the overriding principles to remember when reviewing expense related adjustments is the concept of *known and measurable*, particularly when dealing with adjustments to historic test periods. It is widely accepted that adjustments should have a strong degree of certainty associated with them, and that there should be a reasonable ability to measure the item underlying the adjustment. For example, there might be different mindsets about including an adjustment for additional personnel in the administrative expenses if the job descriptions for the people had been prepared and a classified help wanted ad were being run, compared to simply indicating that additional people were needed but they had not yet been included in corporate budgets. Similarly, there might be a world of difference between indicating that it is the utility's general policy to grant cost of living increases to employees and the situation where one can view the Board of Directors' minutes showing that a specific percentage increase has been approved.

Maintenance and Repair Expenses and Practices

The auditor will want to look at general maintenance practices of the utility and determine whether the expenses incurred appear reasonable based on those practices. Has there been an increasing or decreasing trend of maintenance expenses? Is there an indication that maintenance is the victim of cost cutting measures in order to maintain shareholder dividends?

One may also wish to consider whether those maintenance practices are consistent with Commission expectations as well as the provisioning of safe, adequate, and reliable service. For example, does the utility have a practice or policy relative to the testing of meters? How often is it done and how does this compare to the manufacturer recommendations? Does it test them

itself or does it use an outside contractor? What is the cost effectiveness of this decision? Have there been an increasing number of complaints relative to inaccurate meter readings?

Similar questions could be asked of any number of maintenance related items. What is the utility's tree trimming policy? What is the average period between major and minor generating plant overhauls? What policy exists relative to testing for leaks in water lines?

Insurance and Security Costs

Nationally, the utility industry is incurring increased costs for insurance and security of its facilities and operations. However, the auditor should still inquire as to what the utility is doing in an attempt to mitigate these increases. Has self-insurance been considered? Has there been a review of historically incurred costs, to see if current reserves for property damage can be reduced? Have higher deductibles or a different level of coverage been considered?

Furthermore, the auditor should inquire into the general proactive measures that have been instituted by the utility in order to limit damages or problematic situations. The cost of these measures should also be examined for reasonableness and to make sure that the additional actions are warranted. Examples of items to examine include: additional screening of employees, additional security equipment at critical facilities (e.g., central offices, water treatment facilities, dams, or substations), or the creation or major revision of emergency management procedures. Quite often one insurance policy will extend coverage to utility operations, headquarters, affiliates, and deregulated operations. The auditor should review the policies, determine who and what is covered, and evaluate how the costs are assigned. Even if there is no incremental insurance or security cost to cover non-utility operations, evaluate the benefits received and determine the proper sharing and allocation of costs to all entities covered by the policy/security.

Fuel, Purchased Power, and/or Natural Gas Costs

For many electric utilities, the cost of fuel and purchased power can be the largest single expense and in some cases, well exceeds fifty percent of a utility's total operating expenses. Therefore, these costs warrant some special attention either in general rate proceedings or separate proceedings related to the review of costs included in fuel, purchased power, and natural gas cost recovery rate mechanisms.

To begin, the auditor will want to become generally familiar with the utility's general operation. Does the utility have its own natural gas wells used for providing retail gas service, or does it purchase its natural gas on the open market? What is its policy for purchasing contract gas versus using gas from storage versus buying spot market gas? Or, for an electric utility, is all of the power purchased in the open market, or does it own its own power plants, or is there a mix? Are purchase contracts long term or, as for many cooperatives, all requirement contracts?

After reaching a basic understanding, the auditor will want to explore specific cost aspects of not only contracting for the fuel or purchased power, but also issues of transport of the fuel or power (i.e., wheeling costs, pipeline transport, train tariffs); inventory costs and arrangements (i.e., gas storage or coal inventory levels); and measurement (e.g., where is the power metered, who reads and maintains that meter – the buyer or seller; how often are scales calibrated, etc).

From there, the auditor may wish to examine some of the actual contracts and billings from the utility's wholesale suppliers. Do these match the entries in the utility's ledgers and expense accounts? Is the fuel being provided within the heat content and moisture content specifications contained in the contract? One might want to look at reports on the testing of samples of the delivered fuel to verify that tests are being done to assure that the utility is receiving the quality of fuel for which it pays. In another area, one might want to see if any escalators in the contracts have been properly computed and documented. If the fuel or generation is purchased from an affiliate, determine if the purchase price is appropriate. Should it be priced at cost plus a return or at market price? Could it be purchased less expensively from a non-affiliated entity?

Salaries and Benefits

Salaries and benefits are a major expense for most utilities, and there are many aspects of salaries and benefits that can be explored during an audit.

To start, the auditor may wish to discuss with the utility general policies of the company relative to salaries. Are there automatic increases annually? Are increases merit based or cost of living based? How do the salary policies for management differ from those of non-management? What are the general benefits provided to employees (e.g., health care, 401K, pensions)? These discussions will provide some background to then look at more specifics of the costs. It is also useful to understand how the compensation plan has changed, if it has, compared to recent periods. For example, many utilities have in recent years implemented incentive plans wherein a portion of an employee's salary is tied to performance (e.g., bonuses). One would want to ask when this incentive was developed, and how the performance standards are determined. The auditor should find out whether his/her Commission has allowed incentive costs to be included in setting rates. Are cost savings from the condition that created the incentive included in the test year?

Once one has obtained a background of how the compensation plan for the utility works, it then behooves the auditor to find out how reasonable this plan is and one way to start is to ask the company how it determines that salaries remain in a reasonable range. Are salary surveys of others in the industry used to benchmark ranges of salaries? Are general salary surveys used to look at the regional salaries for various employee classifications (e.g., linemen, accountants, drafters, etc.)? Another more broad way to look at salaries is to do some comparison of costs on a per customer basis among utilities of similar characteristics, and see if anything appears to be out of place and worth investigating. Perhaps one company will have more employees at lower

salaries than another with fewer, higher paid employees, but it may be that if the costs are similar, the ratepayers are indifferent.

As to the actual expenses in the filing or utility submission, the auditor could assure that the filing reconciles with various payroll records, such as quarterly tax reports. Also, the auditor will want to look for supporting documentation for any payroll adjustments that are proposed. Is there a union contract denoting the increase reflected in the case? Is there a minute of the Board of Directors' authorizing salary changes? Are there payroll records verifying the number of employees during the test year? The auditor should also remember that as salaries and wages are adjusted, so are payroll taxes.

Another area often examined relates to overtime. One will want to determine if the amount of overtime included in the test year is reasonable and more importantly, typical. Therefore, the auditor may wish to look at the percentage of overtime worked during the past few years (generally three to five years) and compare it to the percentage of overtime in the test year. If there is a large difference between the historical numbers and the test year numbers, one will want to obtain an explanation. Additionally, one may wish to consider using a multiple year average percentage of overtime to use in the computation of the revenue requirement in order to normalize any test year anomalies. One may wish to look at capitalization versus expense ratios, and contract labor levels in a similar manner to that just described for overtime.

The auditor may also find it informative to look at severance costs (e.g., for recent changes of top management) and stock options in terms of the overall reasonableness of compensation packages. It is important to remember that through the audit, the auditor is not trying to manage the company, or even tell the company what the utility policies are to be. Rather, one is attempting to determine what is a reasonable level to be included in revenue requirement for inclusion in customer rates. The auditor should find out whether his/her Commission has allowed severance costs and stock options to be included in setting rates.

Pensions

A basic understanding of SFAS 87, Employers' Accounting for Pensions, will want to be held by the auditor. This accounting standard requires that pension plans be accounted for on an accrual basis rather than on a cash basis. In other words, the cost of an employee's pension is recognized over that employee's approximate service life, and the books reflect those expenses over that life, rather than basing it on the amount the employer decides to contribute to that plan for any particular period. The statement also requires immediate recognition of a liability when the accumulated benefit obligation exceeds the fair value of plan assets. This later provision of recognizing an additional liability may have ratemaking relevance with continued dramatic movements in stock values and thus, the value of pension plans. The auditor will want to see what has transpired with the pension plan relative to recent changes in the stock market.

The auditor will also want to gain some understanding of where the pension plan stands relative to the actuary's view of pension funding requirements. Is the plan over or under funded? Is there a provision or adjustment in the utility's filing for some catch-up funding to recognize current under funding?

Postretirement Benefits Other than Pensions

Before 1993, most companies recognized the cost of providing postretirement benefits other than pensions when they actually made the payments. When health care costs were not thought to be very significant, this "pay-as-you-go" method was considered to be in accordance with generally accepted accounting principles. As health care costs escalated, Financial Accounting Standards Board (FASB) reconsidered how to account for postretirement benefits other than pensions.

In December 1990, FASB issued SFAS 106, Employers' Accounting for Postretirement Benefits Other than Pensions. FASB concluded that companies should stop cash accounting and begin accruing retiree welfare benefits (medical, dental, and life insurance) just as they accrue pensions; and they should recognize the accumulated postretirement benefit obligation not recorded during prior periods (i.e., transition benefit obligation). SFAS 106 required companies to amortize the transition benefit obligation over 20 years or less. Many commissions objected to making these changes because of the rate impact.

The auditor should be familiar with SFAS 106, Employers' Accounting for Post Retirement Benefits Other than Pensions, and SFAS 112, Employers' Accounting for Postemployment Benefits. One will want to make sure that any interplay of these standards with the payroll entries is fully understood.

Customer Sales Expense

The auditor will want to look at customer sales expense, which includes not only labor costs, but also costs of operating service centers, advertising and customer information expenses, merchandising costs, and other related items. These costs include a mix of the more routine with items that can and do become controversial.

Advertising is an item that warrants a look based on the individual jurisdiction's current regulatory stance. In the past, many regulators disallowed any promotional advertising from rates, since there was a common belief that a monopoly service did not require promotional advertising. However, regulators did commonly allow the cost of informational advertising (e.g., conservation) and safety ads to be included in revenue requirement. Thus, it was common practice to obtain a break out of advertising costs by category, such as legal notices, promotional ads, safety ads, and other, such as ads of new programs that might be put into effect. It was also common for the auditor to obtain copies of the ads in order to check the categorization and make sure that they actually related to the provision of utility service.

However, there is a new twist to this whole issue of advertising with the introduction of competition, or customer choice, in some jurisdictions. In a competitive world, there may be more of a need for companies to advertise to obtain and keep customers. However, many jurisdictions have required the competitive service to be offered by an affiliate or separate division. Thus, the auditor should determine if there are reasons to allow competitive advertising in the case, or whether those costs should be being separately tracked by a separate entity of the company.

Another item that has warranted considerable discussion is the replacement of local customer offices with regional service centers. While much of the transition to regional service centers has already occurred for many utilities, there are still questions about their effectiveness and efficiency. In other words, are customers being served as well or better, and what indicators or documentation exists to make that comparison? Additionally, are there cost savings that have occurred with the establishment of a service center and the closure of local offices, and if so, are those savings properly reflected in rates?

Billing and Collection Expense

Much of the detail used in analyzing this account has been described earlier relative to looking at uncollectibles and meter maintenance. Overall, the auditor should fully understand the utility's policies on shut offs, determining late fees, and the nature of its billing format (and the customers' ability to understand the billing format). Otherwise, the numbers should be verified for reasonableness and accuracy.

Dues and Donations

The auditor should focus on identifying those dues and donations that are reasonably included in rates relative to the provision of service. Dues to trade organizations may assist in the provision of service. However, one might look to question whether donations to a political candidate are necessary for the provision of service. Are charitable donations or golf club memberships necessary? Again, it is not the intent to direct where the utility can spend its money, but rather, to decide how much of that expense should be paid by ratepayers rather than shareholders. Do ratepayers benefit in some way from the expenditure?

One source of information on breaking out these expenses is the Audit Report on the Expenditures of the Edison Electric Institute (for electric) or Audit Report on the Expenditures of the American Gas Association (for natural gas). These reports break out the utilities' payments to these trade associations, and assist in identifying the portion of the expense that may be troubling to a particular jurisdiction. One should also examine the invoices for the dues paid, since these invoices often indicate what portion of the dues is for the support of political activity.

Outside or Contract Services

The auditor will first want to identify the types of costs contained in this account. Is it primarily legal fees for outside counsel? Is it consulting fees related to a rate case or other regulatory

matters? Are the fees related to the local jurisdiction? Is it independent audit fees? Once there has been some identification of the types of costs included in this account, then one can begin to question and explore the need and reasonableness of the various expenses. Review of professional fees, such as legal and accounting, may also provide insight into issues not previously disclosed, such as condemnation proceedings or lawsuits by customers.

The auditor may also find it useful to verify some of the monthly transactions to invoices, in order to assure that the expense is reasonably associated with the jurisdiction's activities. For instance, there could be legal or consulting expenses associated with corporate restructuring that appear would be more appropriately assigned to an unregulated subsidiary.

Regulatory Expenses

The auditor will want to identify the type of expenses included in this account, since the account may include everything from salaries to filing fees to annual regulatory assessments fees. The auditor will want to verify the costs to invoices or other supporting documentation. Additionally, one will want to verify whether these costs are included in rates as an operating expense, or whether some or all of them are treated as separate line items on customers' bills and simply passed through without impacting the income statement. (This might be the case with a municipal franchise fee or a public utility commission assessment.)

The auditor may also wish to determine the appropriateness of any adjustment that is made in a rate filing tying payments in this account to the level of revenues. In other words, one will want to determine the appropriateness of increasing this expense as a function of increasing rates, assuming that some of the expenses may be based on a percentage of revenue.

Taxes Other than Income Taxes

This account may contain a variety of items including property taxes, franchise fees, and sales taxes. Each of these items may have a different rate or regulatory treatment than the others. The auditor will want to identify the major categories of items included in this account, and understand the regulatory treatment of each of the major categories. For example, sales taxes may be treated as a pass through to customer rates as a line item on the bill, and therefore, have no impact on the utility's earnings. On the other hand, property taxes may be treated as an operating expense, and be subject to adjustments in rate proceedings as plant is added.

In looking at any adjustment for property taxes, the auditor will want to determine if the adjustment is being caused by the addition of plant or a change in the assessment rate. The auditor will want to generally understand the formula used to derive property tax expense, which will then assist in determining whether any adjustment to property taxes is reasonably computed.

If there are any adjustments proposed to plant, the auditor should consider the effects on property tax expense. If the jurisdiction's property taxes are based primarily on original cost net book value, then one would expect that the property tax assessment base roughly equal the utility's

total state net cost (the jurisdiction's plant in service less accumulated depreciation) at the beginning of the fiscal year times the average tax rate. Thus, one could look to an adjustment to tax expense based on:

Property Tax = (Average Tax Rate) x (Plant in Service – Accumulated Depreciation)

However, each jurisdiction's assessment may consider other factors, such as economic obsolescence or a measurement of capitalized earnings. This is why the auditor should become familiar with the general computation of property taxes for his/her jurisdiction.

CAPITAL STRUCTURE

Debt and Associated Interest Rates

The auditor will want to find resources (such as the C.A. Turner Utility Reports) to determine if the proportion of the capital structure associated with debt is similar to that for the industry being examined as a whole. Additionally, one will want to look at the pieces of the portfolio. Why has the debt been issued (e.g., is it all to finance utility plant or are there cash flow needs or other non-utility plant investments)? Has debt been called and refinanced, and if so, why? Has the utility refinanced its higher cost debt? Similarly, one will want to look at the interest rate, and determine whether it is consistent with the interest rates seen for other, similar utilities. One will want to look for resources that might assist in these comparisons (such as Mergent Bond Record).

If the utility's proportion or cost of debt is significantly different than that indicated as industry averages, the auditor may wish to consider using a *hypothetical* capital structure, in lieu of the actual capital structure. In doing this, one would look to base the capital structure on industry averages for similarly situated utilities, in effect, using a more normal capital structure for rates than that indicated by the actual capital structure. This is sometimes done when either the proportion of debt or proportion of equity is an unusually large portion of the capital structure.

Another item to examine is the treatment of the debt issuance costs. Have these costs been included in the overall cost of the debt, and if so, has this been done in a way that amortizes that cost over the life of the debt? Or, has some other means (such as expensing) been used to reflect the cost of the debt in rates, and if so, has that been done on a normalized basis?

Finally, if the jurisdiction has over authority for approval of debt issuances, have all of the issuances received the proper approval from regulatory bodies?

Preferred Stock

Similar to the analysis done on debt issuances, the auditor will want to examine the proportion of, and cost of, preferred stock relative to general industry average comparisons.

Equity

The auditor will want to again look at the reasonableness of the proportion of equity contained in the capital structure. Additionally, one may want to look at the pattern of issuances – how often is equity issued and for what purposes (e.g., as part of stock options for employees or officers, to finance non-utility operations or payroll, other). Are the company's policies on dividends and its earnings retention policy such that it is able to do a reasonable amount of internal financing for new projects and capital needs?

The auditor may also find it helpful to read comments and materials issued by securities and Wall Street analysts, such as Value Line, along with Reports to Shareholders. Reading these kinds of items may offer an insight to what is going on in the business and can lead to further questions for the company. Furthermore, the auditor may find it useful to look at ratios such as market to book, price to earnings, the change in price of the stock in question versus the change in price of other stocks within the peer group, and other similar items.

AFFILIATE TRANSACTIONS

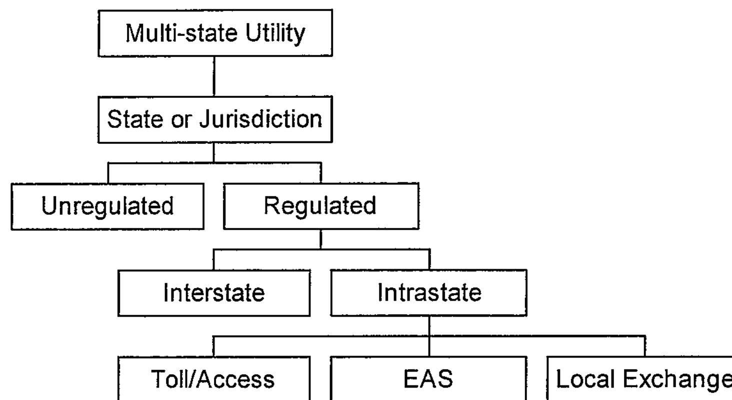
Many state jurisdictions have laws, rules, and policies about affiliate transactions and transfer pricing. The auditor should determine whether the utility needs approval for its affiliated interest transactions and transfer prices, and whether it has met its legal obligation.

ALLOCATIONS

Cost allocations are used to determine:

(1) The level of total state costs for multi-state utilities;
(2) The regulated (versus unregulated) component of total state costs,
(3) The intrastate (versus interstate) regulated component of total state costs, and
(4) The revenue requirement by category of service.

An example of how the allocation process may work is shown below:



Interjurisdictional Allocations

For multi-state utilities, it is necessary to allocate the common costs of headquarters and other centralized operations to the various state jurisdictions. Where common facilities cross state boundaries or provide service outside the state in which they are located, the utility must make allocations to develop state-basis rate base and expenses. There are no uniform procedures for these allocations. During the rate case investigation, the auditor should review the utility's allocation procedures. For telecommunications utilities, the FCC has extensive rules for jurisdictional separations.

Regulated/Unregulated Allocations

FERC, FCC, SEC, and state rules and laws govern the allocation of costs between regulated and unregulated operations. Part of the general rate case investigation is to review the utility's cost allocation procedures and associated financial results to ensure that unregulated costs are properly allocated to unregulated (non-operating) accounts. The auditor will also want to look for "incidental" uses of regulated plant to determine whether a proper assignment of costs has been determined. For instance, the utility may propose that regulated operations could pay for new fiber, when the fact is that the new fiber will be used to generate substantial revenues for unregulated operations or unregulated services.

JURISDICATIONAL ALLOCATIONS

The Commission may require utilities to record certain events differently than the FCC or FERC allow, due to state laws or Commission policies. Because some utilities must follow the federal system of accounts, they must track the Commission's requirements through jurisdictional side records. A common accounting difference is when the FCC and state do not authorize the same depreciation rates. Another example of a difference that may occur relates to a jurisdiction's imputation of directory (yellow page) revenue, due to affiliated publishing arrangements that do not comply with the jurisdiction's affiliated interest rules. Side records generally create temporary tax differences that result in deferred income taxes for ratemaking purposes.

FINAL PROCEDURES

It is normal for the auditor to have a closing discussion with the utility representatives at the end of the on-site visit or audit. During this discussion, one can recap some of the concerns that might exist, items that the utility has agreed to change as a result of found errors, and review items that are still in the follow-up process. As to the follow-up items, it is important to review what one believes the utility has agreed to provide, and to establish an estimated (or actual) date by which the information is to be provided.

The auditor may have also created a separate list of to-do items that will require follow-up back in the office. For instance, during a discussion, it may have been mentioned that the utility followed a certain procedure because of direction that it received in a case from the past. The auditor might look up that order and see if the utility is interpreting the Commission's action in the same manner that the auditor does. In other instances, one might have been told that this was the understanding received from discussions with others at the Commission. Again, it might be worthwhile for the auditor to verify that discussion point.

The auditor will want to identify the documents that it would like copies of from the audit, and make sure that those are provided either at the exit interview or as follow-up in the mail. The auditor will then want to review and study those documents and ask any further questions that arise after the close of the site visit.

Lastly, the auditor will want to follow the jurisdiction's practice for completing the documentation and recommendations. Perhaps, this step involves compiling workpapers that are then used by others in preparing recommendations. Perhaps it involves preparing a report to staff management or the Commission. In other instances, it may culminate in filing testimony and exhibits. During the step the auditor may also wish to separately flag any information received that may be of interest in future cases such that it can be stored or filed separately.

REVENUE REQUIREMENT COMPUTATION

The *rate base, rate of return* approach to ratemaking measures a utility's revenue requirement using the following basic formula:

R = E + (V x r)
R = Total revenue requirements
E = Total operating expenses, including deprecation and taxes
V = Value of rate base
r = rate of return

Therefore, as the auditor looks at the impact that any particular adjustment will have on revenue requirement, he/she should take into account the income tax impact, as well as the impact of the revenue conversion factor. For example, the revenue requirement impact of a rate base adjustment would be computed as:

(Adjustment to Rate Base x after-tax rate of return on rate base[4]) x net to gross factor

A revenue requirement impact of a change in revenues would be computed as:

[Adjustment to Revenues – (Adjustment to Revenues x Income Tax Rate)] x net to gross factor

In computing the revenue requirement of an expense change, one would use the same formula as that designated above for a revenue change.

The following tables provide examples of the computation of rate base, rate of return on rate base, net operating income, and revenue deficiency. They are meant to be illustrative only.

[4] When interest synchronization is used, the revenue requirement impact of a rate base adjustment would be computed as: [(Adjustment to rate base x **after tax** rate of return on rate base) x net to gross factor].

Rate Case and Audit Manual Prepared by NARUC Staff
Subcommittee on Accounting and Finance (2003)

Example Computation of Revenue Deficiency

	Company Adjusted	**Staff Adjusted**
Rate Base	$792,534,826	$775,266,347
Recommended Return on Rate Base	9.79%	9.49%
Calculated Allowed Return	$77,589,159	$73,572,776
Net Operating Income	$57,006,682	$59,995,491
Income Deficiency	$20,582,477	$13,577,286
Net to Gross Tax Multiplier	1.61	1.61
Revenue Deficiency	$33,137,789	$21,859,430
Deficiency as Percent of Retail Revenue	15.3%	9.94%

Example Computation of Rate of Return

	Dollar Amounts	**Percentage of Total**	**Cost of Capital**	**Weighted Cost**
Debt	$400,987,632	47.15%	7.93%	3.74%
Preferred Stock	$20,009,700	2.35%	8.65%	0.20%
Equity	$429,453,568	50.50%	11.00%	5.55%
Total / Overall Rate of Return	$850,450,900	100%		9.49%

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Example Computation of Rate Base

	Company Books	Company Adjustments	Company As Adjusted	Staff Adjustments	Staff As Adjusted
Plant in Service	$1,018,148,893	$178,432,801	$1,196,581,694	($7,163,680)	$1,189,418,014
Plant Held for Future Use	930,274	0	930,274	(678,985)	251,289
Misc. Deferred Debits	13,770,053	142,108	13,912,161	(8,014,433)	5,897,728
Acquisition Adjustment	23,758,411	0	23,758,411	0	23,758,411
Prepayments	4,717,479	0	4,717,479	(874,544)	3,842,935
Fuel Stock	6,838,332	879,042	7,717,374	0	7,717,374
Materials and Supplies	14,772,467	0	14,772,467	270,502	15,042,969
Working Capital	2,909,838	578,401	3,488,239	(230,872)	3,257,367
Rate Base Additions	$1,085,845,751	$180,032,352	$1,265,878,103	($16,692,012)	$1,249,186,091
Accumul. Depreciation	379,123,702	$1,764,842	380,888,544	(175,566)	380,712,978
Accumul. Amortization	12,311,595	0	12,311,595	0	1,2311,595
Accumulated DIT	67,390,960	678,421	68,069,381	(66,469)	68,002,912
Unamortized ITC	5,896,865	0	5,896,865	0	5,896,865
Customer Advances	6,176,892	0	6,176,892	0	6,176,892
Customer Deposits	0	0	0	818,502	818,502
Rate Base Deductions	$470,900,014	$2,443,263	$473,343,277	$576,467	$473,919,744
TOTAL RATE BASE	$614,945,737	$177,589,089	$792,534,826	($17,268,479)	$775,266,347

Example Computation of Net Operating Income

	Company Books	**Company Adjustments**	**Company As Adjusted**	**Staff Adjustments**	**Staff As Adjusted**
Operating Revenues	**$300,758,598**	**$14,792,403**	**$315,551,001**	**($3,309,272)**	**$312,241,729**
Production Expenses	$144,432,920	$8,428,074	$152,860,994	($6,215,353)	$146,645,641
Transmission Expenses	7,128,703	1,987,043	9,115,746	(135,513)	8,980,233
Distribution Expenses	4,565,278	988,804	5,554,082	(11,571)	5,542,511
Customer Account. Exp.	2,792,364	1,980,432	4,772,796	0	4,772,796
Customer Service Exp.	173,923	150,043	323,966	0	323,966
Sales Expenses	123,047	0	123,047	0	123,047
Admin. and General Exp.	14,342,433	4,010,092	18,352,525	(255,164)	18,097,361
Depreciation	26,614,782	1,764,842	28,379,624	(175,566)	28,204,058
Amortization	4,132,364	0	4,132,364	(110,335)	4,022,029
Taxes Other than Income	11,594,559	689,741	12,284,300	(696,000)	11,588,300
Income Taxes	24,145,852	(1,500,987)	22,644,875	1,301,422	23,946,297
Investment Tax Credit Adjust.	0	0	0	0	0
Total Operating Expenses	**$240,046,235**	**$18,498,084**	**$258,544,319**	**($6,298,081)**	**$252,246,238**
NET OPERATING INCOME	**$60,712,363**	**($3,705,681)**	**$57,006,682**	**$2,988,809**	**$59,995,491**
Return on Rate Base	**9.87%**		**7.19%**		**7.74%**