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COMMISSION

1. Reference Mr. Rubin's testimony at page 2, lines 21-23. Produce a copy of each article, section of a book, speech, and presentation referred to.

Answer:

The question was modified to request the following documents:

1. "Quality of Service Issues," a speech to the Pennsylvania Public Utility Commission Consumer Conference, State College, PA. 1988.

4. "How the OCA Approaches Quality of Service Issues," a speech to the Pennsylvania Chapter of the National Association of Water Companies. 1991.

6. "A Consumer Advocate's View of Federal Pre-emption in Electric Utility Cases," a speech to the Pennsylvania Public Utility Commission Electricity Conference. 1991.

19. "Zealous Advocacy, Ethical Limitations and Considerations," participant in panel discussion at "Continuing Legal Education in Ethics for Pennsylvania Lawyers," sponsored by the Office of General Counsel, Commonwealth of Pennsylvania, State College, PA. 1993.

52. Scott J. Rubin, "Effects of Electric and Gas Deregulation on the Water Industry," *Pennsylvania Public Utility Law Conference*, Vol. I, pages 139-146 (Pa. Bar Institute, 1998).

53. Scott J. Rubin, *The Challenges and Changing Mission of Utility Consumer Advocates* (American Association of Retired Persons, 1999).

54. "Consumer Advocacy for the Future," speaker at the Age of Awareness Conference, Changes and Choices: Utilities in the New Millennium, Carlisle, PA. 1999.

70. Janice A. Beecher and Scott J. Rubin, "Ten Practices of Highly Effective Water Utilities," *Opflow*, April 2001, pp. 1, 6-7, 16; reprinted in *Water and Wastes Digest*, December 2004, pp. 22-25.

73. Scott J. Rubin, Consumer Protection in the Water Industry, NARUC Annual Regulatory Studies Program, East Lansing, MI. 2001.

81. Scott J. Rubin, Legal Perspective on Water Regulation, NARUC Annual Regulatory Studies Program, East Lansing, MI. 2002.

85. Scott J. Rubin, "Thinking Outside the Hearing Room," *Pennsylvania Public Utility Law Conference*, Pennsylvania Bar Institute, Harrisburg, PA. 2002.

After a diligent and thorough search of his records, Mr. Rubin cannot locate copies of items 1 and 6. Mr. Rubin did not prepare any written remarks or paper for item 19; his hand-written notes for participating in the panel discussion are attached. All other items are attached.

Responsible witness: Scott J. Rubin

Two weeks ago, I had the pleasure of introducing Charlie Buescher at the national meeting of the National Association of State Utility Consumer Advocates. Now, I had never met Charlie before, and I'd never heard him speak, so I was a little concerned. I had asked him to speak to us on the industry's view of the Safe Drinking Water Act. But I've got to tell you, he didn't disappoint me -- he scared the hell out of us!

Now, I'm going to try to return the favor.

This is fun, isn't it Charlie? It's not exactly like preaching to the choir, is it?

When Rick Hugus asked us to speak on how the OCA approaches quality of service issues, I wasn't sure how I would respond. We don't have set technical criteria for evaluating whether water quality is adequate. For the lawyers in the group, it's a little bit like how the Supreme Court has approached pornography: I can't describe it for you; I can't give you a test to meet; it's sort of based on community standards; but I know it when I see it. And, by the way, once you've seen it, it's awfully hard to forget -- bad water service, that is.

At our urging, the PUC has adopted a quality of service standard for water companies which essentially defines adequate water service as that which is suitable for all household purposes for all customers almost all of the time. As I view it, that's the goal which every water supplier should have: Make sure that all of your customers can use the water for every household purpose all of the time.

Obviously, there will be exceptions. We do not expect a utility to provide perfect service. We recognize that there will be fires, main breaks, main flushing programs, natural disasters, and other sporadic instances when customers will not be able to use their water for all purposes. But such instances must remain sporadic, isolated, and well-explained in order for us to view these as exceptions rather than the norm.

There. I've told you what you already know. The PUC says your water has to be suitable for all household purposes. Now, how do I know it when I see it?

I don't. I'm a lawyer sitting in Harrisburg -- what do I know about your water. But your customers know and, boy, do they love to tell me about it. When we get calls from water utility customers, you can almost bet that it's either (1) you've requested a rate increase, (2) you've got a service problem, or (3) more often than not, both.

We don't go out and try to manufacture a quality of service case. We routinely look at records of customer complaints -- at the PUC, in our office, and sometimes in your own records. We'll often discuss your service record with a DER regional office. If there's no indication from your customers that there's a water quality problem, we won't try to create one.

So, our first quality of service criterion is: Do your customers think there's a quality of service problem?

If they haven't been complaining to you, the PUC, DER, or the OCA, then you don't have to worry. If they have been complaining, we're going to investigate and try to determine the nature of the problem. Frankly, at that point, our job is to try to force you to solve the problem.

We don't view quality of service issues as just another way to depriving you of the opportunity to earn what you think is a fair return -- we have lots of ways of doing that. When we encounter a quality of service problem, we want to give you a strong incentive to solve the problem. Some of you have been astute enough to realize this and, when a quality of service problem arises, you go out and fix it before the case is over. Terrific! The OCA will lose the issue in the case, you'll get some more money; but your customers will be receiving the safe and adequate service that they deserve.

When you don't voluntarily recognize the problem and act to correct it, it's time for the lawyers to fight it out. As some of you know, we tend to be <sup>pretty</sup> ~~very~~ successful in quality of service cases. It's very hard for the PUC to turn its back on customers who are not receiving adequate water service. When people bring in their soiled laundry, oozing water filters, and horror stories of what it's like to live with bad water <sup>or no water</sup> -- the PUC tends to pay attention.

At that point, our job is to attempt to verify the customers' complaints. Often, we will get water test results (either yours or our own) to show that the customers are not crazy. See, there's a lot of iron and manganese in the water. See, the water is corrosive, or has a lot of color, or is turbid, or whatever. We are not DER. We are not looking to enforce every primary and secondary standard. Our job is to determine if your water is suitable for all household purposes. If your customers say it isn't, we will try to prove them right, so that you will correct the problem.

Our second quality of service criterion, then, is: Is there objective evidence which shows that your customers are right and that there is a quality of service problem?

I should note that we've won quality of service cases based solely on the testimony of your customers. But we've also lost cases that way. When we can couple your customers' testimony with objective evidence: Test results, complaint records, water samples, and the like -- we will almost never lose (unless you correct the problem).

You know much better than I do what's important to your customers. From my experience, and from my discussions with <sup>customers,</sup> environmental regulators and industry officials, your customers are most concerned about the aesthetics of the water they receive. Almost no one will know if there's some obscure, odorless, colorless, potentially carcinogenic compound in your water. But everyone will know if it looks bad, smells bad, or tastes bad. DER might say that water with too much chlorine, or too much iron and manganese, or a strong odor is not a health hazard. But if your customers cannot stand to drink your water or wash clothes with it, it is not suitable for all household purposes and you've got a quality of service problem with the PUC.

By the way, I don't accept that aesthetically displeasing water is not a health hazard. If customers don't feel able to drink and cook with the water you provide them, they will look elsewhere for water to consume. Very often, as many of you know, they will look to less safe (but more aesthetically pleasing) sources of water -- like rural streams, untested private wells, and other potentially unsafe sources of water. At that point, your failure to provide water which is acceptable to your customers has potentially jeopardized their health.

Before I sit down, I would feel remiss if I didn't mention that the quality of your service does not end with the provision of safe, useable water. You still have the same obligations that all other public utilities have: to engage in sound billing practices, to have efficient management, to plan prudently for the future, and so on. Major defects in these areas may also lead to quality of service issues.



If I can leave you with a parting thought, it would be this: You should know your customers better than anyone in Harrisburg will ever know them. If you do, and if you respond to their needs, you should not have to worry about the OCA raising a quality of service issue. But if you don't know your customers or don't address their concerns, you should not be surprised when we raise a quality of service issue. Our job is to try to encourage you to know your customers, respond to their needs, and provide them with the type of service that we would all wish to receive from our public water suppliers.

Thank you for inviting us to be here today and for taking the time to listen to our point of view.

IV. Hypothetical Cases Involving Zealous Advocacy -

1. Pro Se Adversary - Agency has just ruled against pro se litigant. The pro se litigant calls your office, which handles agency appeals, to ask how the agency's decision can be challenged. What, if any, obligations do you have to provide a response to your potential adversary in Commonwealth Court? Should you advise that appeal alone will not stay the agency's order?

*Rule 4.3 - prohibits giving of advice to adversary  
Counsel should advise agency to include notice of  
appeal rights, etc. in its orders  
Advise to contact lawyer referral svc, etc.*

2. Pro se Adversary - Agency's prosecutory counsel in litigation against pro se opponent is aware of case law that would benefit pro se litigant's case. Does agency's prosecutory counsel have any obligation to address this case law before the tribunal or to bring it to attention of the pro se litigant?

*Mid-Penn  
Consumer  
Disputes  
Case and* → *Rule 3.3 - obligation to disclose controlling case  
law; no obligation to disclose non-controlling  
precedent  
no obligation to communicate w/ opponent*

3. Civil Litigation - Agency's prosecutory counsel in litigation against husband and wife in action to recover damages to state forest lands due to their negligence. The couple's insurance coverage will pay \$750,000 of \$1.2 million in damages sought by the government; judgment for full amount will result in bankruptcy for the couple. Does agency's prosecutory counsel have any ethical obligation to consider settlement of case, in lieu of pursuing full amount of damages?

*Ethical obligation to client - consider likelihood of recovery; time value of money; potential jury sympathy; etc.*

4. Brief Writing - In zealously advocating agency's position on appeal, can government lawyer make statements as to what is the controlling law and cite to cases, without any further qualification, that only arguably support the government lawyer's statement of the law?

*not unethical, but probably bad lawyering.*

*Rule 3.3 - don't make a false stmt. to tribunal*

5. Oral Argument - In seeking to overturn agency's adverse decision before an appellate court, private attorney is asked about the scope of review of the agency over the decisions of its hearing examiners. Without hesitation the private attorney states "abuse of discretion" - the answer that best serves his client's interest. The correct answer, however, is that agency review is de novo. Assuming that the private attorney did not know the correct answer, did the private attorney violate any ethical rules in answering as he did? What is appropriate response of the government's attorney?

Rule 3.3 → Knowingly make false stmt.

Atty has obligation to correct errors

Comment → Lawyer make make stmt only when knows to be true or believes true based on reasonable inquiry

Applies to facts

6.

Oral Argument - In seeking to overturn agency's adverse decision before an appellate court, private attorney states that agency's decision was made as a result of a "backroom deal" between agency and another private attorney - even though no direct evidence exists to support this claim. Assuming that the private attorney believes that this may have taken place, does private attorney violate any ethical rules in making this argument? Would the government's lawyer be going too far

Yes

by stating in rebuttal "that's a lie" and that the private attorney is fully aware of the fact that no evidence exists to support his argument?

Yes (2) True lie - keep respect  
 Rule 3.5 - don't engage in disruptive conduct  
 Refrain from abusive conduct

7. Agency Litigation - Agency's prosecutory counsel is asked by technical staff to bring prosecution against regulated entity. Upon analysis of facts and law, agency prosecutory counsel concludes that prosecution is not likely to succeed. Technical staff nevertheless presses for initiation of the prosecution. Does agency's prosecutory counsel have an ethical obligation to refrain from initiating or pursuing the prosecution? If agency head initiates the action and directs prosecutory counsel to participate, what are prosecutory counsel's ethical obligations in handling the matter?

Rule 3.1  
must be non-frivolous basis  
(Diff. from not likely to succeed and frivolous)

Agency head is client → client cannot order atty to take unethical action  
See comment to 3.1 re frivolous def'n

8. Agency Litigation - As agency's prosecutory counsel you are advocating an interpretation of law before a hearing examiner that has already been rejected orally by a different hearing examiner in a parallel proceeding. The agency decisionmakers have full power to overrule a hearing examiner's decision on matters of fact and law. Does agency prosecutory counsel have an ethical obligation to advise hearing examiner A that this issue has been decided adversely by hearing examiner B, even though the decision has not yet been reduced to writing?

Rule 3.3 no - not controlling

9. Agency Litigation - Agency has initiated new regulatory requirements on small businesses that will increase their cost of doing business considerably. Agency has issued orders to show cause why these entities should not be fined for failure to comply. In representing these entities, can private attorney raise claims and defenses with only arguable merit, knowing full well that the clients' major objective is to delay compliance with the new regulatory requirements?

*If claims not frivolous, OK.  
Comment to 3.2 → good faith - substantial  
purpose other than delay*

10. Agency Litigation - In major litigation against a large corporation before an agency tribunal, the government lawyer has propounded scores of interrogatories to obtain data deemed relevant to the proceeding. Ten of the interrogatories appear to require considerable efforts to answer. The private attorney representing the large corporation would like to object to all ten of these interrogatories as "unreasonably burdensome." To what extent must the private attorney investigate the burdensomeness of the interrogatory requests before he can ethically file an objection citing "unreasonable burden"?

*Rule 3.3 - can't lie  
Comment - must make reasonably diligent  
inquiry*

11. Agency Litigation - Agency's prosecutory counsel is involved in major litigation which is receiving a great amount of publicity. The press is anxious to determine what the agency's prosecutory counsel has to say about the case, especially if it is quotable. What can the agency's prosecutory counsel say without running afoul of the ethical obligations imposed by Rule 3.6? Does it make any difference that the case will be decided not by a jury, but by a hearing examiner?

R. 3.6 Substantial likelihood of materially prejudicing proceeding - civil matter triable to jury  
~~not~~ lists what can + can't be said  
Always safe to stick w/ what's in public record

12. Oral Argument - Private attorney represents a large corporation on appeal of agency's decision. At conclusion of oral argument on whether agency's decision should be enjoined, private attorney introduces his previously silent co-counsel, a former appellate judge newly added to the firm, to "take a bow" and greet the court. Is this an improper attempt to influence the presiding judge, sleazy practice, or just being friendly?

Rule 8.4 - prejudicial to administration of justice

# The Effects of Electric and Gas Deregulation on Water Industry Competition Issues

by Scott J. Rubin, Esq.



## I. INTRODUCTION

This chapter will address the potential effects of restructuring in the electricity and natural gas industries on water utilities. This chapter is a preliminary look at some of the ways in which water utilities might be affected by restructuring in other utility industries. There are currently several research projects in progress, by the author and others, that are examining these issues. Those projects should result in a much more comprehensive treatment of these issues than is possible at the present time.

## II. RESTRUCTURING IN THE ELECTRIC INDUSTRY

### A. Reasons for Restructuring

Historically, electric utilities were declining-cost companies. Each generation of power plants was more efficient than the earlier generation. The cost per unit of production declined and, as a result, prices fell. For example, from 1940 through 1970, the average price of electricity in the United States declined steadily from 3.84 cents per kilowatt-hour to 2.10 cents per kilowatt-hour. C.F. Phillips, Jr., *The Regulation of Public Utilities* (3<sup>rd</sup> ed. 1993) at 11.

All of this changed dramatically starting in the late 1960's and continuing through the late 1980's. Electric utilities invested in the next generation of power plants – primarily nuclear power plants – with the expectation that prices would continue to decline and that demand would continue to grow. The oil crisis and double-digit inflation of the 1970's, coupled with massive cost over-runs at nuclear power plants, the accident at Three Mile Island, and more stringent air pollution control requirements caused these predictions to dramatically miss the mark.

By the end of the 1980's, all of the nuclear power plants were either canceled or included in rates. By the mid-1990's, electric utility rate cases were becoming rare events, prices were stable and starting to decline again, and large consumers of electricity had competitive options available to them.

With the advent of combined cycle power plants that produce electricity at less than most utilities' average cost of production, it appears that we are back to "business as usual" in the utility industry. That is, it looks like we are again in a declining-cost era, where utility rates will be stable or decline as new technologies replace older, less-efficient plant and

equipment. However, instead of suggesting a return to the first 60 years of utility regulation (infrequent rate cases usually leading to a decline in rates), the industry and many consumers are seeking to deregulate portions of the industry.

The Energy Policy Act of 1992, P.L. 102-486, 16 U.S.C. §§ 824j-824o, went a long way to opening up the wholesale electricity market to competition. Subsequent orders of the Federal Energy Regulatory Commission (FERC) all but deregulated that market. *See Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities*, 61 *Fed. Reg.* 21,540 (1996), modified on reconsideration, 62 *Fed. Reg.* 12,274 (1997).

In Pennsylvania, the restructuring of the electricity industry is moving forward rapidly. With the enactment of the Electricity Generation Customer Choice and Competition Act, 66 Pa. C.S. §§ 2801, *et seq.*, in November 1996, Pennsylvania is at the forefront of attempting to allow all consumers to choose their supplier of electricity.

#### B. Status of Restructuring

Restructuring refers to the process of making a portion of the electricity market competitive. Neither Pennsylvania nor any other state is considering the possibility of deregulating the distribution of electricity. So, for the foreseeable future, it appears that the electricity industry will consist of two distinct markets: the generation of electricity which may become largely unregulated and the distribution of electricity (the wires, transformers, and substations that are needed to get electricity to the consumer) that will remain regulated. It is for this reason that most people are referring to the “restructuring” of the electric industry, rather than to its deregulation.

For the past 20 years, there has been a national and state policy to encourage the production of electricity by independent companies rather than by the local utility. *See, e.g.*, 16 U.S.C. § 824a-3; 18 C.F.R. §§ 292.101, *et seq.*; 52 Pa. Code §§ 57.31, *et seq.*; *Pennsylvania Electric Co. v. Pa. Public Utility Commission*, 544 Pa. 475, 677 A.2d 831 (1996). That policy has given rise to many independent power producers throughout Pennsylvania, as well as many large commercial and industrial consumers that generate at least some of their own electricity. Further, since the passage of the Energy Policy

Act of 1992, there has been widespread competition in the wholesale electricity market, making it easier for utilities to buy power from the lowest-cost source.

The latest step in this process is giving these diverse generating companies direct access to retail consumers. Rather than being required to sell only to large utilities, electricity generating companies would be allowed to sell directly to consumers. In addition, companies (and even cities and non-profit organizations) are being encouraged to buy electricity at wholesale and resell it to retail consumers, as a way of further broadening the electricity market. The hope is that by giving consumers direct access to the electricity generator, consumer choice will increase, the quality of service will improve, and prices will decline.

Restructuring the electricity industry is not a simple task. The Pennsylvania Public Utility Commission (PUC) has conducted at least two dozen separate proceedings to address everything from the licensing requirements for electricity suppliers to the precise rates that electric utilities will charge for distributing power to their customers. *See Appendix A* for a partial list of generic orders.

The market in Pennsylvania is scheduled to open on January 1, 1999, when one-third of the electricity customers in Pennsylvania will be able to choose their generation supplier. Another one-third of consumers will be able to choose their supplier on the next day, with the remaining one-third getting the right to choose one year later. Thus, on January 2, 2000, every electricity consumer in Pennsylvania will be able to choose their generation supplier.<sup>1</sup>

### III. RESTRUCTURING IN THE NATURAL GAS INDUSTRY

#### A. Reasons for Restructuring

Many states are considering restructuring the natural gas industry in conjunction with restructuring the electric industry. In Pennsylvania, large consumers have been able to purchase their own gas supplies for

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<sup>1</sup> This schedule reflects the effect of the restructuring orders issued by the PUC. It differs from the phase-in schedule set out in the statute, which envisioned full customer choice on January 1, 2001. 66 Pa. C.S. § 2806(b).

more than a decade, but small consumers do not have that ability. It is believed by some that if the natural gas industry is restructured, small consumers will be offered packages of energy services, including a combination of electricity and gas. This could make it both easier and more cost-effective to purchase energy services.

#### B. Status of Restructuring

The restructuring of the natural gas industry began in the mid-1980's, when FERC issued Order 436 (50 *Fed. Reg.* 42,437 (1985)) and, later, Order 636 (57 *Fed. Reg.* 13,267 (1992)); see 18 C.F.R. Part 284. After several years of litigation, those orders and subsequent orders issued by the Pennsylvania PUC, gave all large natural gas consumers the ability to choose their gas supplier. In many instances, the gas was delivered to a large industrial consumer directly from an interstate pipeline, completely bypassing the local gas distribution utility. In other cases, the local gas utility continues to transport the gas from the interstate pipeline to the customer. When this occurs, the local utility receives a fee for transporting and distributing the gas, but has no role in procuring the gas itself.

Some of Pennsylvania's natural gas utilities have started programs to allow smaller consumers to purchase gas directly from other suppliers. See, e.g., *Pa. Public Utility Commission v. Equitable Gas Co.*, 1997 Pa. PUC LEXIS 92 (1997); *Pa. Public Utility Commission v. Columbia Gas of Pennsylvania, Inc.*, 1996 Pa. PUC LEXIS 140 (1996). While legislation has been introduced to require the restructuring of the natural gas industry (S.B. 943 (Printer's No. 1037) and H.B. 1068 (Printer's No. 1193)), efforts to develop consensus legislation have been unsuccessful so far. It appears unlikely that natural gas restructuring legislation will be enacted during the 1998 session of the General Assembly; however, that should not affect the ability of utilities to implement and expand their pilot programs for small gas consumers.

### IV. EFFECTS ON THE WATER INDUSTRY OF RESTRUCTURING IN OTHER UTILITY INDUSTRIES

#### A. Water Utilities as Energy Utility Customers

Water utilities use a great deal of electricity. Nationwide, approximately

78 million kilowatt-hours are consumed **each day** in the production and distribution of water. H. Arora and M.W. LeChevallier, "Energy Management Opportunities," 90 *Journal American Water Works Association*, 2:40 (Feb. 1998). One water utility system estimates that electricity costs represent 9% of its total operating and maintenance expenses. *Id.*

In a restructured energy market, water utilities will need to change the way in which they purchase energy services. New energy options, including real-time metering and pricing, will be made available. This will place an increased emphasis on the ability of water utilities to manage both the timing and magnitude of their energy consumption. Energy-efficiency measures, such as the installation of variable-speed pumps, should become increasingly cost-effective.

In addition, water utilities will face increased choices about the type of energy that they use. Electricity and natural gas will become more interchangeable, particularly as new technologies are developed. Fuel cells and micro-turbines are being tested in several parts of the country and look like they will become commercially viable in the near future. M.L. Wald, "Fuel Cell Will Supply All Power to a Test House," *New York Times* (June 17, 1998). As this occurs, smaller energy users will have options similar to those available today for larger energy users (who can install on-site combustion turbines). These options allow energy consumers to purchase natural gas in order to produce their own electricity. Thus, many water utilities will be faced with options that include the purchase of electricity from various sources, improving the utilization and efficiency of electricity, and purchasing natural gas – either to use directly or to produce electricity on-site.

It can be expected that the utilities' customers and the PUC will look more carefully at water utilities' energy costs and the measures that the water utility is taking to minimize the level of those costs. Water utilities will need to document their energy-utilization decisions and ensure that they are maximizing the benefit from each energy dollar that they spend.

#### B. Water Utilities as Potential Acquisition Candidates

The energy and water industries are both undergoing major consolidations. Several energy-industry mergers have been announced during the past two years, including the proposed merger between

DQE, Inc. (the parent of Duquesne Light Co.) and Allegheny Power System, Inc. (the parent of West Penn Power Co.). In addition, there are numerous mergers taking place in the water industry, including the proposed merger between PSC Corp. (the parent of Philadelphia Suburban Water Co.) and Consumers Water Co. (the parent of Consumers Pennsylvania Water Co.).

Importantly, energy utilities are becoming more interested in the water utility business and mergers will become more common between those two industries. For example, DQE, Inc., in addition to owning Duquesne Light Co., also owns AquaSource, Inc., a growing water utility. AquaSource currently operates in six states, serving more than 95,000 water customers. "Liquid Gold: Consolidation Sweeps Texas' Small Town Water Utilities," *Texas Journal* (Aug. 5, 1998). In fact, that company is currently the largest investor-owned water utility in Texas and it expects to continue to grow considerably during the coming years. *Id.* Similarly, Enron Corp. (a major electricity and natural gas marketing company, as well as the parent company of an electric utility in Oregon) recently announced the acquisition of Wessex Water, PLC, a British water utility. "Enron to Acquire Wessex Water for \$2.2 Billion," *Wall Street Journal* (July 24, 1998). That energy company has announced plans to enter the water business both in the United States and throughout the world. "Enron Names Mark a Vice Chairman, Putting Her in Firm's Top Echelon," *Wall Street Journal* (May 7, 1998).

As the energy industry restructures, some energy utilities (such as GPU, Inc., in Pennsylvania and New Jersey) will be reshaped into distribution utilities. Distribution utilities will seek opportunities to maximize the return on their distribution expertise and infrastructure. These include their customer service operations, call centers, billing, metering, field operations, and other areas of expertise.

As a consequence, water utilities will become potential acquisition candidates. As with any acquisition, this will place increased pressure on the utility's management and employees to become more efficient and enhance the value that they provide for their investors and customers. It also will raise new issues for the PUC and other regulators, who need to receive assurances about the capabilities of the new owners to operate a water utility safely and reliably.

### C. Water Utilities as Potential Competitors

The restructuring of the energy industry also presents opportunities for water utilities to provide new services and increase their profitability. With appropriate regulatory approvals, water utilities could become energy service providers. This could take many forms, including the purchase and resale of energy, the provision of billing and metering services, or some combination of these activities.

Opportunities also may exist for joint projects that might involve, for example, performing metering for energy and water by the same personnel or even through a common billing system. Similarly, water utilities and energy utilities might team up to provide new types of equipment or services to consumers (such as appliances that use hot water more efficiently, reducing a consumer's water and energy bills simultaneously).

## V. PROSPECTS FOR RESTRUCTURING THE WATER INDUSTRY

### A. Reasons for Restructuring

It does not appear that the water industry is facing the same pressures as the energy industry. Restructuring in the energy industry is primarily a function of the declining costs being experienced on the production side of the business. That is, new power plants can produce electricity at less than utilities' current average cost of production. Further, the economies of scale in the electric industry are declining rapidly and may soon be non-existent (such that small, distributed generation may prove to be more cost-effective than large, central-station power plants).

The same is not true in the water industry. The water industry continues to be an industry with increasing costs of production (newer treatment plants are more costly than the plants they are replacing) and substantial economies of scale (larger treatment plants have a much lower unit cost of production than smaller treatment plants). Thus, the underlying technological factors that are giving rise to the restructuring of the electric industry are not present in the water industry.

In its simplest terms, this means that increasing competition in the water industry would not result in a cost savings to consumers. Cost savings are potentially available in the electric industry only because new,

smaller energy sources can be constructed at less than the average cost of existing sources. Precisely the opposite is true in the water industry: in order to reduce costs, production must be centralized as much as possible, and new plants are more expensive than the average cost of existing plants.

In addition, there is the practical problem of the physical differences between water supplies, even after they have been treated. While electricity and natural gas are fungible commodities, the same is not true for water. Different water sources have different characteristics (taste, color, odor, chemical composition, etc.). This makes it very difficult to “wheel” water from one water system to another.

In summary, both the technology of water production and the characteristics of water itself make it very unlikely that the water industry will be restructured in the same way as the energy industries. Multiple water suppliers serving a single market and competing for consumers is very unlikely.

It is more likely that the water industry structure may change by separating the ownership of production plants from the transmission and distribution of water. In several communities, new water treatment plants are being built by companies that are independent of the utility that distributes water to consumers. These types of arrangements can improve the economies of scale (by having a central treatment plant serve more than one water utility) and increase the financing options that are available to smaller utilities and publicly owned water utilities. However, this type of change in ownership does not lead to consumer choice; it simply opens up different options for the water utility itself.

#### B. Status of Restructuring

There have not been any meaningful proposals to restructure the water utility industry in Pennsylvania. While mergers and consolidations, as well as other types of regional water supply solutions, can be expected in the future, it is very unlikely that individual water consumers will have the ability to choose their water supplier.



## VI. CONCLUSION

The restructuring of the energy industry presents opportunities for water utilities to reduce their energy costs and improve the efficiency of their operations. It also might present opportunities for water and electric utilities to merge or otherwise combine certain aspects of their operations. Some water utilities may use these opportunities to provide a wider range of services, including energy services, to their customers. It is unlikely, however, that water customers will have the ability to choose their water supplier. The economies of scale and physical characteristics of water make such customer choice neither likely nor desirable, unless there is a dramatic change in the technologies that are available to produce potable water.

Appendix A

**Partial List of  
Pennsylvania Electric Choice Generic Orders**

Advanced Meter Deployment for Electricity Providers; 52 Pa. Code §§ 57.251-57.259, L-00970128, May 14, 1998.

Amend 52 Pa. Code Chapter 57 to Ensure Electric Service Reliability, L-0970120, April 24, 1998.

Electric Generation Customer Choice and Competition Act - Customer Information, M-00960890, F. 0008, 180 P.U.R.4th 61, July 10, 1997; entered July 11, 1997.

Electronic Data Transfer and Exchange, M-00960890F.0015, June 19, 1998.

Establishing Standards for Changing a Customer's Electric Supplier, L-00970121, July 07, 1998.

Final Rulemaking Order Establishing Customer Information Disclosure Requirements for Electricity Providers 52 Pa. Code, Chapter 54, L-00970126, May 01, 1998.

Licensing Requirements for Electric Generation Suppliers; 52 Pa. Code, Chapter 54 and § 3.551, L-00970129, April 24, 1998.

Proposed Enrollment Procedures Applicable to Electric Distribution Companies, M-00960890F.0014, April 24, 1998.

Quality of Service Benchmarks and Standards, L-00970131, May 21, 1998.

Regulations Regarding Adjustment of Electric Distribution Company Bills, L-0970127, April 24, 1998.

Regulations Regarding the Perfection of Security Interests in Intangible Transition Property, 52 Pa. Code Ch. 74, L-00970122, July 11, 1997.

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Universal Service and Energy Conservation Programs 52 Pa. Code Chapter 54, L-00970130, May 01, 1998.

# **The Challenges and Changing Mission of Utility Consumer Advocates**

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**for  
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AARP is the nation's leading organization for people age 50 and older. It serves their needs and interests through information and education, advocacy, and community services which are provided by a network of local chapters and experienced volunteers throughout the country. The organization also offers members a wide range of special benefits and services, including Modern Maturity magazine and the monthly Bulletin.

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## **Abbreviations used in this report**

<b>CAB</b>	<b>Civil Aeronautics Board</b>
<b>CFA</b>	<b>Consumer Federation of America</b>
<b>CLEC</b>	<b>Competitive Local Exchange Carrier</b>
<b>CUB</b>	<b>Citizens Utility Board</b>
<b>DOT</b>	<b>Department of Transportation</b>
<b>FCC</b>	<b>Federal Communications Commission</b>
<b>FERC</b>	<b>Federal Energy Regulatory Commission</b>
<b>FTC</b>	<b>Federal Trade Commission</b>
<b>GAO</b>	<b>General Accounting Office</b>
<b>ICC</b>	<b>Interstate Commerce Commission</b>
<b>LTL</b>	<b>Less-than-truckload</b>
<b>NAAG</b>	<b>National Association of Attorneys General</b>
<b>NACAA</b>	<b>National Association of Consumer Agency Administrators</b>
<b>NASUCA</b>	<b>National Association of State Utility Consumer Advocates</b>
<b>NRRI</b>	<b>National Regulatory Research Institute</b>
<b>OCA</b>	<b>Office of Consumer Advocate</b>
<b>OCC</b>	<b>Office of Consumers' Counsel</b>
<b>OPC</b>	<b>Office of People's Counsel</b>
<b>PUC</b>	<b>Public Utilities Commission</b>
<b>PULP</b>	<b>Public Utility Law Project</b>
<b>TURN</b>	<b>The Utility Reform Network</b>

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# Executive Summary

Many organizations that represent the interests of utility consumers were created during the 1970s. These consumer advocacy organizations include agencies within state government, independent consumer groups (ranging from local groups to nationwide alliances representing millions of consumers), and legal services organizations representing low-income consumers. For the past 20 years, participating in state and federal cases involving all aspects of regulating electric, gas, and telecommunications utilities has been a major focus for these consumer advocates.

Now, there is an increasing trend toward the partial deregulation of, and the introduction of competition in, these utility industries, and numerous questions arise from these massive structural changes in the industry: What is the role of consumer advocacy organizations in this new utility market? How do they need to change to respond to these forces in the utility industry? What types of expertise do they need? What should be the source of their funding?

This report is based on in-depth interviews with representatives of ten consumer advocacy organizations from throughout the United States and on research into the effects of deregulation on other industries. In addition, the report has been guided by a project advisory committee, consisting of researchers and utility consumer advocates from across the country.

Deregulation in the airline, trucking, and savings and loan industries gives some indication of what may lie ahead for utility consumers. Deregulation in these industries has led to increased choices and lower prices for large consumers and large communities, but in some cases, it has led to decreased choices and higher prices—or even the complete elimination of service—for some smaller communities and consumers.

Deregulation also has produced confusion over who protects consumers. The federal and state governments have not always seen eye to eye on who has the responsibility to protect consumers from fraud, unfair trade practices, or other improper practices. This confusion has raised concerns about public safety and the quality of service that consumers receive.

Thus far, none of the efforts at deregulation have been able to ensure the availability and quality of service to all consumers. Some communities and consumers have lost service as a result of deregulation; others continue

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to receive service but at higher prices or lower levels of quality. At the same time, some consumers benefit from new services and lower prices. The challenge is to find a balance between price deregulation and the continued regulation of safety and service.

### ***Telecommunications***

On paper, the market for long-distance telecommunications services is highly competitive. Hundreds of companies sell long-distance service to consumers. A closer look at the industry, however, reveals that just three companies—AT&T, MCI, and Sprint—provide most of the service within the industry.

The transition from a monopoly (AT&T) in 1984 to an oligopoly in the late 1990s has had some advantages for consumers. Long-distance prices have fallen, and pricing options have increased. At the same time, though, the average cost of residential local telephone service nationwide has increased by about 64 percent. The net effect has been a sustained price reduction for consumers who make a large number of long-distance calls and a net price increase for consumers who make relatively few long-distance calls. Overall, the average total residential phone bill increased by about 60 percent from 1983 to 1994.

Meanwhile, local phone service for residential consumers and for most business consumers remains a virtual monopoly everywhere in the United States. In fact, the local phone monopolies are getting larger through mergers.

### ***Electricity***

Several states with high electricity costs are embarking on efforts to open their electricity markets to competition. In the electric industry, restructuring refers to the process of making the generation and/or the supply of electricity competitive.

The biggest single issue pertaining to electricity restructuring is the recovery of “stranded costs” (or above-market costs) by electric utilities. Stranded costs are the difference between the market value of the utility’s assets and the amount that the utility has been including in its regulated rates (typically, the actual cost of the assets). In the case of some very expensive assets, like nuclear power plants, the actual cost of the asset is much higher than its market value. It appears that until these stranded costs are recovered, substantial reductions in electric rates will be difficult to achieve.

## ***Natural gas***

A few states are beginning the process of restructuring the natural gas market. In the mid-1980s, the wholesale market for natural gas was deregulated on the federal level. Since that time, large gas consumers have had the ability to buy gas directly from gas producers and have it transported directly to their place of business. Current efforts to restructure the gas industry are aimed at giving smaller consumers, including individual residential consumers, that same right. Large-scale test programs are underway or will begin shortly in several states to give consumers the right to buy gas from their supplier of choice.

## ***Effects of restructuring on utility consumer advocates***

The movement toward deregulation is changing the traditional role of consumer advocacy organizations. Where utility industry restructuring is occurring, consumer organizations are dealing with new challenges, particularly in the areas of consumer education, consumer complaint handling and consumer protection, market oversight and merger review, and coalition building. The changing focus of consumer advocates is a function of changes in the utility industry and the need for consumers and policy makers to ensure that this transition does not adversely affect consumers. These roles are in addition to continuing regulatory responsibilities for the distribution of electric and gas service, ensuring the provision of universal telephone service, and other ongoing regulatory issues.

The complexity of utility industry restructuring should not be underestimated. It is not simply a matter of enacting legislation or changing commission policy and watching a free market develop. The process is extremely complicated and time-consuming, and it can seriously strain the resources of a consumer organization.

Utility consumer advocacy organizations tend to rely on their own expertise, coupled with outside consultants who regularly work for consumer advocates. Most of these consultants have experience on the more traditional issues involved in utility regulation. While many are developing the expertise needed to help consumer advocates deal with restructured utility industries, many gaps still remain in the available expertise. The lack of readily available expertise makes it more difficult for them to participate in negotiations or litigation involving these highly complex issues.

Consumer advocacy organizations will need to develop new ways to explain the benefits that they provide and encourage the continued funding of the organization. Historically, these organizations relied on their success in saving money for consumers to justify their budget requests or to encourage consumers to join their organizations. During the 1970s and

1980s when utilities were filing for unprecedented, multi-million dollar rate increases, the need to fund a consumer advocate was clear. However, the issues involved in utility industry restructuring are much more amorphous than the dollars and cents involved in a rate case.

Most state agencies that perform a utility consumer advocacy function are funded through an assessment on each utility that operates in the state, though some receive funding from the state's general fund. Legal services organizations receive funding from several sources, including the federal government, state governments, the United Way, or Interest on Lawyer Trust Accounts (IOLTA) programs. Nonprofit consumer organizations receive most of their funding from the contributions of individual consumers, sometimes supplemented by grants from foundations and other private charities. The restructuring of the utility industry could have a major impact on the funding of all types of consumer advocacy organizations.

As the structure of the utility industry changes, traditional relationships among consumer advocacy organizations will need to change as well. It will be increasingly important to recognize shared interests, keep open the lines of communication, and develop coalitions and working groups to ensure that scarce resources are being used in the most effective way possible.

Consumer advocacy organizations can increase their effectiveness by better coordinating their efforts on a national level. There are several organizations that work on a national level to represent the interests of utility consumers, but they do not always coordinate their efforts or pool their resources.

Many consumer advocates are not just waiting to see how utility industry restructuring will affect their organizations. Instead, they are actively transforming their organizations to deal with the new structure of the utility industry. Throughout the country, advocacy organizations are finding ways to do more with their existing resources. Organizations are redefining their mission, putting more emphasis on consumer education, working with other organizations that have different expertise, and finding ways to assist consumers that do not involve litigation before the utility commission.

The transition from the current, regulated utility industry to a less-regulated industry structure will be complex and difficult. Consumer advocates are needed to ensure that the new industry structure contains protections for consumers and that educational programs allow consumers to become smart shoppers in the new market. The workload will be enormous, the issues will be complex, funding sources will change, and coalitions will shift. There can be little doubt, however, that strong consumer advocates will be needed to make sure that the new utility industry continues to provide safe and reliable service to all consumers at affordable prices.

## **Conclusions**



# Chapter 1: Introduction

Throughout most of the history of the public utility industry, utilities were declining-cost companies. Each generation of equipment—whether telephone switching equipment, natural gas production equipment, or electric utility power plants—was more efficient than the earlier generation. The cost per unit of production declined, and as a result, prices fell. For example, from 1940 through 1970, the average price of electricity in the United States declined steadily from 3.84 cents per kilowatt-hour to 2.10 cents per kilowatt-hour.<sup>1</sup> (20).

Starting in the late 1960s and continuing through the late 1980s, this trend has reversed. Electric utilities invested in the next generation of power plants—nuclear power plants and fossil-fuel plants—with the expectation that prices would continue to decline and that demand would grow by several percentage points each year. The oil crisis and double-digit inflation of the 1970s, together with massive cost overruns at nuclear power plants, the accident at Three Mile Island, and more stringent air pollution control requirements, caused these predictions to dramatically miss the mark. During the 1970s and early 1980s, telecommunications utilities continued to improve their efficiency as the next generation of equipment—microwave transmission—became available. Neither the telecommunications industry or regulators apparently realized that this new, lower-cost technology, would enable competitors to enter the market for long distance telecommunications service at much less than the average embedded cost of the existing service. It was easy to think of AT&T as “the phone company,” but large telecommunications consumers were looking for alternatives, and new market entrants, like Microwave Communications, Inc. (now known as MCI), were looking for opportunities to compete against AT&T. Presumably, if AT&T had realized the very real threat that was posed by this new technology, it could have taken action to better serve its large customers and possibly avert the threat from new entrants. Its failure to do so led to the eventual development of a competitive market for long distance communication services. Natural gas utilities improved their efficiency as well and were forecasting rapid increases in the demand for gas. This industry, too, was deeply affected by the oil crisis and massive inflation of the 1970s, coupled with federal price controls which made new drilling uneconomical.

In general, the 1970s were a time of turmoil in the utility industry. For example, during the last five years of the 1960s the total amount of rate increases awarded to electric utilities nationwide was just \$200 million. In the first five years of the 1970s, electric rate increases totaled more than

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<sup>1</sup> These figures, taken from *Moody's Public Utility Manual*, are expressed in nominal dollars. After accounting for the effects of inflation, the result would be an even more dramatic decline in utility prices during this period.

<sup>2</sup> These figures are expressed in nominal dollars. If they were adjusted for inflation, the difference would become smaller but still would show dramatically higher levels of rate increases during the later 1970's and early 1980's than had ever existed in the history of the utility industry. Further, these figures *exclude* rate increases that were caused by automatic fuel adjustment clauses, where much of the impact of inflation was reflected in utility rates.

\$5.5 billion. The second half of the 1970s saw total electric rate increases of about \$15 billion throughout the United States. That level of rate increases was then equaled in just the next two years: 1980 and 1981 combined saw nationwide electric utility rate increases of another \$15 billion.<sup>2</sup> (20) The same type of trend is apparent in the natural gas industry, where total nationwide rate increases totaled less than \$200 million from 1965 through 1969, while in 1979 alone rate increases exceeded \$2 billion. (20)

By the late 1960s and early 1970s, utility rates were increasing, large consumers were asking for special rates to alleviate the impact of the overall increases, and utility commissions were coming under increased scrutiny. Utilities' construction plans and rates were becoming front-page news, open and accountable government was being advocated, and state legislatures were coming under increased pressure to do something about the rising cost of utility services. Open meeting laws were passed, which required government to make decisions in public, many utility commissions were required to hold formal hearings on rate increase requests; and utility commissioners were made full-time employees and their professional staff grew by several orders of magnitude. For example, between 1967 and 1983, many state utility commissions saw their budgets increase by anywhere from 400 percent to 1000 percent or more. (25)

In order to deal with these massive changes in the utility industry and in order to respond to the needs of consumers, many states created an agency within state government to represent the interests of consumers before the utility commission. These agencies, typically known as a public counsel, public advocate, or consumer advocate, became widespread. By the mid-1970s, more than 40 states had appointed state-authorized consumer advocates, and the District of Columbia had established a similar office. Most of the public advocates are funded, either directly or indirectly, by utility consumers, often through an annual assessment on each utility that is then passed on to consumers through the utility bill. (19)

These public advocates hired or contracted with attorneys, accountants, economists, and other analysts to participate in utility rate cases and other matters. Public advocates and their consultants became an integral part of the regulatory process and helped to give consumers a voice during the turbulent period when all of the major utility industries were undergoing tremendous pressure.

At the same time, independent consumer groups also became much more involved in utility issues. Ranging from local consumer groups with a few members to nationwide alliances representing millions of consumers, numerous organizations arose to represent specific segments of the popula-

tion in utility cases — environmental activists, advocates for low-income consumers, groups focused on the process of government, and small business alliances, to name just a few.

The 1980s and early 1990s saw the resolution of many highly contentious issues. By the end of the 1980s, all of the nuclear power plants were either canceled or included in rates; natural gas prices had been deregulated at the wellhead, and large gas users could purchase gas directly from producers; and the AT&T monopoly had been broken up into separate companies to provide local, long-distance, and equipment services. By the mid-1990s, utility rate cases were becoming rare events, prices were stable and starting to decline again, and large consumers of utility services had competitive options available to them. These options include cogeneration technologies that provide electricity and heat, direct purchases of natural gas from dozens of suppliers, and hundreds of companies that sell long-distance telecommunications services. In addition, during the 1990s, several utility commissions adopted alternative regulation plans designed to keep rates stable without requiring periodic rate cases.

With the ever-decreasing cost of computer technology (leading to greatly reduced costs in telecommunications and increased efficiency in all utility industries), advances in natural gas drilling equipment, and combined cycle power plants that produce electricity at less than most utilities' average cost of production, it appears that we are back to "business as usual" in the utility industry. That is, it looks like we are again in a declining-cost era, where utility rates will be stable or decline as new technologies replace older, less-efficient plant and equipment.

Yet, all is not normal in the utility industry. Rather than settling back and watching rates decline, the utility industries are seeing new issues emerge: competition and deregulation. Instead of suggesting a return to the first 60 years of utility regulation (infrequent rate cases usually leading to a decline in rates), the industry and many consumers are following the path of other previously regulated industries—trucking, airlines, railroads, savings and loans—and seeking to deregulate portions of the utility industries.

The Energy Policy Act of 1992 went a long way to opening up the wholesale electricity market to competition. Subsequent orders of the Federal Energy Regulatory Commission (FERC) all but deregulated that market. The price of natural gas at the wellhead was deregulated in the late 1970s. By the mid-1980s, FERC had restructured and deregulated nearly all portions of the wholesale gas market, allowing large consumers to purchase their own gas and have it transported to their business. The interstate long-distance telecommunications market has become increasingly competitive during the past ten years and is now largely deregulated. The Telecommunications Act of 1996 encourages states to follow suit and



bring competition to and deregulate intrastate, and even local, telecommunications services. The utility industry in the late 1990s looks very different than the industry of the 1970s and 1980s. The purpose of this report is to investigate the role of utility consumer advocacy in this new era of deregulation and competition. Specifically, this report seeks answers to the following questions: What are the roles of consumer advocacy organizations in this new utility market? How do consumer advocacy organizations need to change to respond to these new forces in the utility industry? What types of expertise do they need? What should be the source of their funding?

## **Organization and Methodology**

This report is based on in-depth interviews with representatives of ten consumer advocacy organizations from throughout the United States and on research into the effects of deregulation on other industries. In addition, the report has been guided by a project advisory committee, consisting of researchers and utility consumer advocates from across the country.

Chapter 2 of this report reviews deregulation in the airline, trucking, and savings and loan industries, focusing on consumer-protection issues that arose as a result of deregulation in these industries and the effect of deregulation on consumer groups. This section of the report is based on a review of relevant economic, public policy, and legal literature.

Chapter 3 provides an overview of competition and deregulation activities in the telecommunications, electricity, and natural gas industries, based on interviews with representatives of consumer advocacy organizations in several states. This section examines what restructuring means in each industry, what has happened so far, and what activities can be anticipated during the next few years.

Chapter 4 focuses on utility consumer advocacy organizations and the impact utility industry restructuring may have on these organizations. Chapter 4 also discusses ways in which these organizations have been changing to meet the different needs of a partially deregulated utility industry. It includes a discussion of a number of issues that consumer advocates will confront as the nature of the industry and regulatory process change over the next several years. This section is based primarily on in-depth interviews that were conducted with representatives of ten consumer advocacy organizations throughout the United States.

Chapter 5 discusses the implications for the future of utility consumer advocacy. More specifically, this section addresses a number of changes that consumer advocacy organizations will need to undertake to assure that the new utility industry provides safe and reliable service to all consumers at affordable prices.

## Chapter 2: Deregulation of Previously Regulated Industries

A brief review of deregulation in three industries—airlines, trucking, and savings and loans—is a useful starting point for examining potential issues in utility deregulation. The focus in reviewing these industries is on the impact of deregulation on consumers and the way in which consumer protection and consumer advocacy have changed as a result of deregulation. In attempting to assess what the experiences of the airline, trucking, and savings and loan industries mean for the coming deregulation of the utility industries, it is first important to recognize that most utility deregulation proposals involve the *partial* deregulation of an industry. This leads to a series of issues that were not present in other industries (such as concerns with cross-subsidization and unfair dealing between regulated and unregulated portions of the same corporation).

Beginning in 1975, the Civil Aeronautics Board (CAB) began lessening restrictions on the airline industry. In this regard, the CAB focused on regulations pertaining to route changes, the review of airline fares, and the entry of new carriers into the market. The movement toward deregulation was a function of many factors, including economic theory about the benefits of competition, and pressure from entrepreneurs who saw an opportunity to provide better service at lower cost than the existing airline companies.

### Airline Industry

Since 1978, the effects of deregulation in the airline industry have been studied by dozens of economists and policy analysts (1, 2, 4, 7, 12, 16, 23-24, 26-28, 34, 35, 39). With 20 years of experience under deregulation, the airline industry offers an interesting case study of the impact of deregulation on consumers and the ways in which consumer protection and consumer advocacy change when a previously regulated industry becomes deregulated.

At the outset, it is important to note that the airline industry was not fully deregulated in 1978. Concern for the immediate impact of deregulation on small communities prompted the U.S. Congress to include special provisions to subsidize and protect air service to small communities. (2) In addition, the federal government continues to regulate safety, some aspects of consumer protection (such as deceptive advertising), and mergers within the industry.

Analysts disagree about the effect of competition on airline consumers. In the aggregate, it appears that deregulation and increased competition was beneficial for many consumers. Average airfares have declined in most

parts of the country, the number of people flying has increased tremendously, and most measures of the quality of service show that service is improving. (1, 16, 26) However, these results are not true for *all* consumers. Some small communities have lost air service completely, while in many other communities, prices have increased, and the frequency of service has declined. (2, 32, 34) In fact, in the first six years after deregulation, 114 small communities lost all air service. (34) While average fares throughout the country declined between 1979 and 1994, several communities saw average fares increase by more than 20 percent (as measured in constant dollars) during this same period. (1, 32) During the first ten years after deregulation, some of the fare changes were even more dramatic. Although fares were generally falling, the fares on several routes—even those involving some large cities—doubled or tripled during this period. (2) Moreover, these calculations do not consider the dramatic decline in fuel prices since 1978, which would have resulted in fare decreases, even under regulation. (7)

The results of deregulation have also varied significantly by region of the country. Areas of the country experiencing high levels of growth tend to see benefits from competition: more airlines providing service, more flights, and lower fares. In contrast, those parts of the country declining in population or economic activity are not benefiting from deregulation: fewer airlines provide service and fares tend to be higher. (1, 32) As the General Accounting Office (GAO) concluded in 1996: “the largest decreases [in fares] occurred at airports serving communities of various sizes in the West and Southwest. In contrast, . . . the airports serving several communities—particularly small and medium-sized communities in the Southeast and Appalachian region—have experienced sharp increases in fares since deregulation.” (32)

One public opinion expert has stated the problem succinctly: “For the American public, the litmus test of deregulation is a pragmatic one: Has deregulation produced the benefits it promised? The standard used to judge is, frankly, self-interest: have lower prices, more choices, and greater convenience been the outcome? According to these criteria, the verdict on deregulation is a mixed one. Americans perceive both successes and failures . . .” (14) Indeed, while the public originally supported airline deregulation, by 1988, 45 percent of the public thought that deregulating airline routes was working against the public interest, and only 51 percent believed that the deregulation of airline fares was working. (14) Similarly, a 1995 study revealed consumers’ express concern about the “reduction in services, or higher costs, to smaller cities and rural areas” as well as concerns about airline safety. (9)

The deregulation of the airline industry provides useful information about the effect of deregulation on consumer protection in general and on the process of protecting the consumers' interest in particular. When airlines were deregulated, nothing was done to ensure that the consumer protection functions previously performed by the CAB would be carried on by the federal government. The 1978 legislation gradually phased out the responsibilities of the CAB and completely abolished the CAB effective January 1, 1985. In fact, it was believed by some analysts that "consumer protection may actually improve with less regulation." (24) This was based on replacing airline tariffs with more traditional consumer protection activities such as lawsuits. Airlines' tariffs, similar to the tariffs of public utilities, often limited the airlines' liability or imposed conditions on consumers, such as requirements to reconfirm flights several hours before departure. It was believed that these kinds of restrictions would not survive in a free market and that consumers would receive more protection as a result.

By 1984, however, it became apparent that this approach would not work. In June of that year, the GAO recommended that Congress enact legislation that would clearly provide for a continuation and transfer of the CAB's consumer protection functions. (35) The GAO concluded that the failure to provide for a strong consumer protection function within the government "could well lead to an increase in expensive and unnecessary litigation and a reduction in consumer protection." Specifically, it concluded that in the absence of Congressional action, "a decline in consumer protection is likely to occur," and increased litigation would result "as consumers and airlines attempt to determine their respective rights and obligations."

Congress responded by passing the CAB Sunset Act of 1984, which transferred the consumer protection responsibilities of the CAB to the Department of Transportation (DOT). (31) These responsibilities include policing fraud and other deceptive trade practices as well as reviewing mergers.

In subsequent reports, GAO reviewed consumer protection issues resulting from airline deregulation. (30, 31) Those reports found that several new kinds of consumer protection issues arose from deregulation. Among the most significant were misrepresentations and outright fraud in the tour industry (essentially resellers of airlines' services) and misleading advertising. The GAO found that the federal government was ill-equipped to deal with some of these abuses and other consumer advocates—primarily state attorneys general—were attempting to resolve some of the concerns. Airlines were arguing, however, that the states did not have the legal authority to deal with these issues. The airlines asserted that Congress had given the federal government the exclusive right to regulate these aspects

of the airline industry. For example, several state attorneys general challenged airline advertising that quoted very low fares between cities but in fine print stated that the fares covered the price of a one-way ticket and were available only if a round-trip ticket were purchased. The airlines successfully challenged the states' authority to review their advertising because DOT had some authority in this area. (15, 30) GAO also found that DOT's enforcement efforts were lax in some areas, particularly in regulating tour operators. Coordination between the federal and state governments, and even between DOT and the Federal Trade Commission (FTC), also were noted as enforcement problems in this area. In several areas, it was unclear whether the state or federal governments had jurisdiction to resolve a consumer complaint, and the communication between DOT and states was very poor. (30) In other cases, particularly in the area of telemarketing of tours, the FTC was exercising jurisdiction, even though federal auditors later found that DOT should have been made aware of the problems and taken action to resolve them. (31)

## **Trucking Industry**

The interstate trucking industry was deregulated by the Motor Carrier Act of 1980. The interstate trucking industry is really two separate industries: the truckload industry (that is, shipments where the shipper fills an entire truckload) and the less-than-truckload, or LTL, industry (where numerous small shipments must be aggregated to fill a truck). The truckload industry provides for point-to-point shipping — that is, a truck is loaded in one location and delivers the load directly to its destination. The LTL industry takes the shipment to a terminal, where it is consolidated with other shipments bound for a nearby location. The effects of deregulation on large (truckload) and small (LTL) shippers have been very different.

While deregulation has increased competition within the truckload industry by allowing small, independent businesses to enter this segment of the industry, competition in the LTL industry has all but disappeared. (8, 22) The key difference between these segments of the industry appears to be the amount of infrastructure that is required. To compete successfully in the LTL market, a company must have a large network of trucks and terminals so that shipments can be aggregated efficiently. In the nearly two decades since deregulation, it has become increasingly difficult for new companies to enter this market. Before deregulation, the four largest LTL carriers controlled about 20 percent of the market. Within five years of deregulation, they controlled 35 percent of the market, and by the early 1990s, they had roughly 40 percent of the market. (22) In fact, in the first six years after deregulation, "more than 54 percent of the LTL trucking companies went out of business," and there have been no new entrants into this market. (22) Another study of the industry summarizes the effect of deregulation in the LTL market in this way: By 1986, "the ten largest LTL

carriers accounted for 60 percent of LTL shipments and 90 percent of its profits.” (8)

While the truckload market appears to be very competitive, that industry has problems as well. Excess capacity in the market (that is, too many trucks) has created a large disparity between the prices paid by very large shippers (such as large factories that ship thousands of truckloads per year) and those paid by smaller shippers (such as small factories that might ship a few truckloads per week). In fact, some analyses show that very large shippers are demanding, and getting, below-cost rates just so that trucking companies can generate some cash and keep their fleets in business. (8) The result is that many smaller truckload shippers pay higher rates than they would otherwise so that trucking companies can recover some of the losses they incur on the business from large shippers. (8)

Evidence of rising safety concerns within the industry is also mounting. The truck fleet is aging, maintenance is being deferred, and drivers are pressured to drive for long hours. (8, 13) Since deregulation, accident rates are increasing, and the overall level of safety is decreasing. (8, 13)

The savings and loan crisis of the 1980s was caused, at least in part, by the relaxation of regulations over the financial integrity of those institutions, coupled with incentives for them to pay higher interest rates to depositors. This, in turn, led them to lend money to riskier enterprises that would pay higher interest rates. Many of those riskier loans involved real estate development. When the recession of the early 1980s led to a decline in demand for real estate and a decline in real estate values, many savings and loans saw the value of their assets decline enough to put them in partial or total default. (22, 37)

## **Savings and Loan Industry**

It would be improper, though, to blame deregulation for the entire problem. Deregulation of interest rates and the costs of financial services was designed to provide more choices to consumers and to help savings and loans retain business that they were losing to brokerage firms that could sell “money market” accounts. Up until the late 1970s, savings and loans were prohibited from paying interest on checking accounts and were strictly regulated in the amount of interest they could pay on other accounts. With interest rates reaching 15 percent or more, brokerage firms were attracting savings and loan customers by offering “money market” accounts that paid market interest rates and worked very much like checking accounts. Deregulation of interest rates and other services was seen as a way to keep savings and loans viable by allowing them to compete more effectively with brokerage accounts. (22, 33, 37)

Deregulation did have the intended effect. It enabled savings and loans to retain business and compete more effectively for deposit accounts. The downside, however, was that savings and loans engaged in riskier activities in order to generate enough funds to pay those higher interest rates. When those riskier investments failed, a crisis resulted.

It is too easy to say that deregulation was a failure. Savings and loans might have failed in even greater numbers had they been unable to attract and retain depositors. What is clear, however, is that the combined deregulation of interest rates and relaxation of regulatory controls on safety (the adoption of more lenient rules for valuing assets, among other factors) created an unstable business environment. The relaxation of controls on safety also made it more difficult to detect outright fraud and other criminal activities.

Another important question about savings and loan deregulation, and one that is often overlooked, is the impact on consumers. Before the crisis occurred, the GAO examined the effect of deregulation on the prices that consumers paid for banking services. (33) In 1987, the GAO concluded that low-income consumers (those with annual incomes under \$10,000 per year) were paying significantly more for banking services than they were before deregulation. In contrast, higher-income consumers (those with annual incomes above \$50,000) were receiving much higher interest rates on deposits, which more than offset any fee increases. (33)

The results of the GAO study and other studies led many to seek federal legislation to require financial institutions to offer "lifeline" services to low-income and older consumers. (33) Efforts to adopt legislation were not successful, but they did draw attention to the concern that some segments of the population were having trouble affording basic financial services.

There is every indication that since the GAO study in 1987, the problem is worsening. Banks are reporting ever higher earnings from the fees that they charge, while interest rates on basic accounts have declined to under 2 percent. (17)

## **Lessons Learned**

Consumers and consumer advocates can learn from the experiences of other industries. Obviously, if there is deregulation in an industry, it means that rates and the other terms of service will no longer be regulated. For large consumers and large communities, choices are likely to increase and prices to decline, but for small communities and small or low-income consumers, choices may decrease and prices rise; some areas have suffered the complete elimination of the service.

Once there is deregulation, the typical consumer protection function in a regulated industry (trying to keep rates low and ensuring that the terms of service are reasonable) no longer apply. Fraud and misrepresentation will become important issues, not only among resellers and other new entrants into the industry but also among established industry participants. The federal and state governments have not always seen eye-to-eye on who has the responsibility to protect consumers from fraud, unfair trade practices, or other improper practices. At least in the case of airline deregulation, Congress did not make it clear who has the responsibility to provide needed services to low-income consumers, small communities, and others whom the market may not protect. Further, even within the federal government, there has been some confusion over which agencies have the responsibility to perform some of these functions. Similar confusion has occurred in some states over the jurisdiction of state agencies to deal with consumer protection concerns.

If the utility industries follow the path of other once-regulated industries, major mergers among large utility companies will continue, and some large companies will seek protection from the bankruptcy courts or even go out of business completely. These actions raise additional consumer protection concerns, such as the consumers' recourse when a supplier defaults on a promise to deliver a certain service.

Finally, deregulation also can lead to additional concerns about public safety and the quality of service that consumers receive. Airline deregulation has been handled in such a way that the safety of service has been retained or even enhanced, in large measure because the federal government continues to regulate the safety of airline service. On the other hand, deregulation in the trucking and savings and loan industries has led to very serious concerns about safety and quality of service within those industries.

Thus far, none of the efforts at deregulation have been able to ensure the availability and quality of service to all consumers. Despite promises at the outset that consumers would benefit and that neither public safety nor the quality of service would decline, deregulation has, in fact, led to increased concerns about public safety and a diminution in the quality or availability of service for at least some customers. Some communities and consumers lost service as a result of deregulation; others continue to receive service but at higher prices or lower levels of quality. At the same time, some consumers benefit from new services and lower prices. (5)

The complete deregulation of an industry does not appear to be consistent with the protection of public safety. The experience in the airline industry shows that it is possible to deregulate an industry financially while main-



taining regulations over the safety of the service that is provided. The result can be the provision of enhanced levels of service for many consumers.

The challenge is to strike an appropriate balance between price deregulation and regulation of safety and service. (5) This challenge has been described as follows: “If deregulation is not carried out carefully, disaster—such as the savings and loan crisis—will result. On the other hand, regulatory reform can unleash a torrent of creativity, innovation, and increased competition. The challenge for regulators is to craft regulations that will yield these outcomes.” (22)

## Chapter 3: Deregulation of the Utility Industries

Efforts to deregulate portions of the telecommunications, electricity, and natural gas industries are well underway throughout the United States. A complete review of the status of deregulation is beyond the scope of this report and would be out of date before the report could be printed. Instead, this chapter will provide a brief overview of the ways in which deregulation is being pursued in these industries and how consumers may be affected by deregulation within the next few years.

The telecommunications industry is really two industries: interstate long-distance service and local service. Interstate long-distance service is under the jurisdiction of the federal government, while local service is regulated by each state Public Utilities Commission (PUC). The federal government has largely deregulated long-distance service, while local service remains a regulated monopoly in all states.

### Telecommunications

#### **Long Distance**

The market for long-distance telecommunications services, on paper, is highly competitive. Hundreds of companies sell long-distance service to consumers. Different pricing plans, “dial around” services, on-peak rates, off-peak rates, flat rates, and week-end discounts are just some of the options offered to consumers.

A closer look at the industry, however, reveals that just three companies — AT&T, MCI-WorldCom, and Sprint — provide most of the service within the industry. Depending on the measure used (revenues, number of minutes, or number of telephone lines), AT&T controls between 55 percent and 70 percent of the market. (11) Collectively, the “big three” control between 82 percent and 91 percent of the long-distance market.<sup>3</sup> (11) Thus, while the market for long-distance telecommunications appears to be a highly competitive, in fact, the market is an oligopoly, dominated by three large firms.

Much of the apparent competition within the long-distance industry is the result of companies’ buying services at wholesale prices from the big three and then reselling those services to retail customers. There are hundreds, perhaps even thousands, of telecommunications resellers, but in reality nearly every consumer in the United States is purchasing long-distance service from one of three companies.

It does not appear likely that a fourth major provider of residential long-distance service will develop any time soon. While companies

<sup>3</sup> These figures are based on market shares before the merger of MCI and WorldCom. That merger is expected to slightly increase the share of the combined company, but MCI was required to divest its Internet assets before the merger, which could lead to a loss of some long-distance customers.