# Economic Inequality: Does Utility Regulation Contribute?

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In a democratic society built on a capitalist economy, some economic inequality is inevitable. But current levels of inequality threaten both democracy and capitalism. As the *New York Times* recently reported: "Officially the economy is surging again. But the winnings have gone predominantly to the wealthy. And the middle class is never coming back."[1] What is regulation's responsibility?

Regulation's purpose is performance—the economic performance of the industries we regulate. The regulator's job has four main components: (1) define the public interest in performance; (2) identify whose private behavior, if unregulated, will conflict with that public interest; (3) design standards that align that private behavior with the public interest; then (4) set and enforce rewards and penalties for those who satisfy or fail the standards.

For utility regulators, the "public interest" is defined and confined by their statutes. The typical utility statute requires "reliable" service, offered without "undue preference or discrimination" at "just and reasonable" rates. Reliable service means service available to all customers at all times. Just and reasonable rates give the utility a reasonable opportunity to earn a fair return on prudent investment, while not imposing wasteful costs on customers. Nondiscrimination means treating similar customers similarly and dissimilar customers dissimilarly—by assigning costs to the cost-causers and awarding benefits to the benefit-creators.

Because utility statutes focus only on economic performance, the "public interest" addressed by those statutes does not include broad societal objectives. So said the Supreme Court, holding that the Federal Power Commission had no authority to issue a rule prohibiting utilities from racially discriminating. Racial equality, while certainly core to humanity's public interest, was not part of the Federal Power Act's public interest.[2]

What about economic inequality? Do regulatory decisions contribute to it? If so, what is regulation's responsibility? Consider six examples.

**Utility acquisitions:** Since the Great Recession, stock values have risen while wages have stagnated. Stock ownership is distributed unequally. So inequality has increased. "[T]he people who possess tradable assets, especially stocks, have enjoyed a recovery that Americans dependent on savings or income from their weekly paycheck have yet to see."[3] When commissions allow a target utility's acquirer to pay a billion-dollar premium (the excess of purchase price over market value) to the target's shareholders, that gain goes to a small, unrepresentative, stock-owning segment of our society. Inequitable? Not if the target stockholders actually created the value reflected in the gain they get. So who created that value? Most of that value—the value the acquirer sees in controlling a monopoly franchise—comes from three sources: (1) captive customers, who have no choice but to buy from the utility

the service they need to survive; (2) the government's decision to protect the utility from competition, because that protective decision is what makes customers captive; and (3) the utility's statutory and constitutional right to charge government-set rates calculated to provide the utility a reasonable return on its prudent investment. None of those three values were created by the target stockholders.

Another frequent reason for the premium? The acquirer expects the regulator, when setting the target's rates, to allow an equity-level return on target equity purchased by the acquirer with debt. Since equity-level returns nearly always exceed the interest on acquisition debt, the acquirer receives extra profit—profiting coming not from target utility's performance but from what Wall Street calls "financial engineering." Still more value comes from the efforts of the utility's workers—whose skills and experience are paid for by ratepayers. So in a utility acquisition, the regulator's approval lets gain go to the target's stockholders, for value created by utility workers and captive utility customers. That's inequality.[4]

**Home weatherization:** In summer 2017 I had my 1950s-era house weatherized—new attic insulation, new attic fan, total cost $9000. Now the house gives more comfort at lower cost. Under a regulator-approved program, Pepco rebated me $2000. That $2000 comes from Pepco's ratepayers, most of whom have less wealth and less house than I do. That's inequality. Yes, my $7000 benefits others, by reducing pollution and lowering future capacity costs; but I made the decision to spend it; the ones forced to pay the $2000 did not.

**Rooftop solar:** Under early net-metering rules, producing your own electricity made your meter run backwards. The arithmetic result? Though your solar production allowed the utility to avoid only variable cost, the meter running backwards allowed the homeowner to avoid both variable and fixed costs (because the rates you avoided on the "uncharged" kilowatt hours recovered both variable and fixed costs). The fixed costs you avoided then shifted to non-producing customers—likely less affluent than you. (Warning to utilities tempted to scissor these sentences from their context: The solarizing homeowner, like the weatherizer just discussed, shelled out big dollars—dollars that will benefit the non-solarizers by reducing pollution and deferring utility capacity. And those benefits mean a lot to children whose asthma worsens when power plants land in their neighborhoods, as the NAACP has courageously documented.[5]) But the cost-shift risk remains: Solar panel policy, incorrectly designed, can contribute to inequality.

**Rate discounts for mobile industries:** Regulators give large industrial and commercial customers discounts from the fully allocated rate (the rate necessary to cover the customer's pro rata share of the utility's variable and fixed costs), if the customer makes a credible threat of leaving the system. To cover the discounts, rates rise for the less mobile. Yes, if the customer left, rates would rise even more, so courts regularly uphold these discounts as "duly discriminatory."[6] But still—shifting costs from the more mobile to the less mobile contributes to inequality.

**Undergrounding distribution lines:** Some neighborhoods want undergrounding to improve their aesthetics. Charging undergrounding costs to all, while benefitting only some, increases inequality.

**High-tech requirements:** High-tech companies in the new economy want power at a quality higher than normal users require. Cost-causers must be the cost-bearers. Otherwise, we have inequality.

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Regulators can solve some of this inequality with the standard statutory solution to undue discrimination—assigning costs to the cost-causers and benefit-recipients. But some types of inequality—like low-income apartment dwellers paying above-average energy bills for below-average energy comfort, because their landlords don't weatherize—fall outside the regulators' statutory domain of utility performance. This statutory constriction should not let regulators off the hook. When the cold facts of industry performance cause inequality, regulators should not say "It's not my department." They should bring those cold facts to the political decisionmakers—the executive and legislative leadership—and press them to act. When we marry regulatory expertise with political responsibility, we leave no one behind.

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[1] *New York Times*, Business Section p.3 (Sept. 16, 2018).

[2] *National Assoc. for the Advancement of Colored People v. Federal Power Commission*, 425 U.S. 662 (1976). I have argued that the NAACP opinion does not preclude commissions from requiring utilities to shape their services and workforces to reflect their customers' diversity, because that shaping can affect utilities' performance. See "Promoting Diversity and Prohibiting Discrimination: Is There a Regulatory Obligation to Society?"

[3] *New York Times*, Business Section p.3 (Sept. 16, 2018).

[4] For a detailed dialogue on this issue, see the testimony and briefs leading to the Maryland Public Service Commission's approval of Exelon's acquisition of Pepco Holdings, Inc., Case No. 9361. In that proceeding, I was a witness for the Office of People's Counsel. The Maryland Court of Appeals recently upheld the Commission decision rejecting OPC's position that the premium must be shared with customers. Fixing the Commission's error now will require statutory change.

[5] *See* National Association for the Advancement of Colored People, *Just Energy Policies: Reducing Pollution and Creating Jobs* (2014) (finding that 68 percent of African Americans throughout the country live within a 30-mile radius of coal-power plants, leading to more asthma and lung disease among African-American children).

[6] *See* Scott Hempling, *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* at Chap. 8.B.3 (Amer. Bar Assoc. 2013).