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DEVELOPMENTS IN REGULATION: ADJUSTMENT CLAUSES

By John A. Carver, Jr.*

INTRODUCTION

Utility regulation is an arcane process which depends for its effective functioning more upon a large measure of public confidence in process and personnel than upon its intrinsic merit. Unfortunately, as the ingredient of confidence erodes among consumers, investors, legislators, the academic community, the media, and other segments of both the regulatory and regulated community, mechanisms which trigger recurrent and seemingly automatic rate increases come under special attack. Adjustment clauses are in this category.

Adjustment clauses have been known since 19171 and are currently in use in some form in most of the states.2 They are a regulatory device to adjust rates for cost changes without all of the procedures used for traditional rate cases. In economic terms, they are a form of “indexation” designed to counter the effects of inflation.

The full range of adjustments which qualify for analysis and discussion is large. Generally, this paper is concerned with rate adjustments authorized to become effective pursuant to the terms of an antecedent tariff. Some of these rate adjustments are “automatic”; others are subject to or require hearings, notice, audit, or other regulatory action which is definitionally short of

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2 Since most of the attention of legislatures and utility regulatory agencies has been directed to the workings of adjustment clauses for the electric and gas utilities, particularly the former, most of the data on the use of such clauses are on such utilities. State-by-state analyses have been compiled in this area. NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC., THE FUEL ADJUSTMENT CLAUSE: A SURVEY OF CRITICISMS, JUSTIFICATIONS AND ITS APPLICATION IN THE VARIOUS JURISDICTIONS (1975), reprinted as STAFF OF SUBCOMM. ON OVERSIGHT & INVESTIGATIONS OF THE HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, 94TH CONG., 1ST SESS., REPORT ON ELECTRIC UTILITY AUTOMATIC FUEL ADJUSTMENT CLAUSES, App. 1 (Comm. Print 1975); CONGRESSIONAL RESEARCH SERVICE, FUEL ADJUSTMENT CLAUSE ACTIONS IN THE ELECTRIC AND GAS UTILITY INDUSTRIES, 1973-74: A STATE-BY-STATE STATISTICAL ANALYSIS (1975), reprinted in 121 CONG. REC. S4963-67 (daily ed., Mar. 24, 1975).
that required in a full rate proceeding. The adjustments are dependent upon variables such as fuel costs and taxes. Some adjustments are called "tracking" or "pass-through" adjustments because the variable component is itself controlled by regulation, as where changes are tied to rates fixed by the same or another regulatory body. Rate adjustments may be tied to various general price indices,\textsuperscript{3} to return on equity,\textsuperscript{4} to taxes,\textsuperscript{5} and to the capital costs associated only with particular facilities such as environmental facilities.\textsuperscript{6}

Terminology should be viewed with suspicion, particularly the use of the term "automatic." Courts and commissions in the past have sometimes called all adjustment clauses "escalator clauses." The term "escalator clause" is more apt for incremental price increases\textsuperscript{7} at regular or fixed intervals. A true adjustment clause is designed to work both upward and downward as the base factor to which it is tied moves up or down.

In the main, the discussion in this paper is confined to adjustments in rates for the so-called fixed utilities, \textit{i.e.}, electric, gas, water, and combinations thereof, and it covers both federal and state action, wholesale and retail applications, and related rate design implications. Outside the scope of this paper are clauses which enable the downward adjustment of rates in order to meet competition,\textsuperscript{8} and fuel clauses negotiated by municipalities in states not having a regulatory commission.\textsuperscript{9}

A number of measures at the federal level have been pursued,

\textsuperscript{3} The New Jersey Board of Public Utility Commissioners allowed a telephone company an annual adjustment to the cost of salaries and wages determined by the national guideline increase of 6.2\textperthousand less productivity increase of 4.0\textperthousand or 2.2\textperthousand. \textit{In re Adjustment Clause in Tel. Rate Schedules}, 3 P.U.R.4th 298 (N.J. Bd. of Pub. Util. Comm'rs 1973).


\textsuperscript{7} Cf. Foy, \textit{Cost Adjustment in Utility Rate Schedules}, 13 VAND. L. REV. 663 (1960). For a recent example, see \textit{In re Commonwealth Water Co.}, 7 P.U.R.4th 456 (N.J. Bd. of Pub. Util. Comm'n 1974), wherein the New Jersey Board of Public Utility Commissioners rejected a proposed adjustment clause which provided for a 3.2\textperthousand annual increase in rates for water service.

\textsuperscript{8} Trigg, \textit{supra} note 1, at 978 n.79. These were in limited use when gas utilities sought to protect their business from unregulated competition.

\textsuperscript{9} \textit{Id.} at 987.
and a legislative definition for "automatic adjustment clauses" has been proposed. The attention given to electric utility fuel adjustment clauses by the House of Representatives Committee on Interstate and Foreign Commerce, Subcommittee on Oversight and Investigations, highlights the fact that adjustment clauses are being characterized by ratepayers, and by some legislators and regulatory commissions, as faulty policy and contrary to the public interest, and as a means of permitting "overcharges" by utilities. Speaking specifically of fuel adjustment clauses, the Moss Subcommittee's Report is flatly condemnatory:

Automatic fuel adjustment clauses, regardless of design, are inherently flawed and anti-consumer because of their tendency to seriously undermine the incentive of utilities to minimize fuel costs.

The subject has been considered by other committees of the Congress, including the Joint Economic Committee, and the Senate Committee on Government Operations under the continuing leadership of Senator Metcalf.

In the states, the activity concerning such clauses is principally reflected in the rate cases decided by the state commissions, but there has also been legislative reaction responsive to criticisms of the workings of the adjustment clauses. The Na-
tional Association of Regulatory Utility Commissioners (NARUC) has supported adjustment clauses tied to fuel costs, but opposed any mandatory federal legislation which would limit individual state determinations in one direction or the other. A study by a NARUC committee recommended that NARUC prepare a model fuel clause. Criticism of fuel adjustment clauses has been intense in consumer circles and consumer organizations presented much of the testimony considered by the Moss Committee. There are inconsistencies in the remedies proposed by critics of the regulation process. For example, the proposed Energy Independence Act would have required state utility regulatory agencies to permit fuel adjustment clauses; other measures considered by the 94th Congress would limit or prohibit fuel adjustment clauses.

Another complication presented to those responsible for reconciling the competing pressures is the activity of the Federal Power Commission, which is sometimes thought to “lead” the state commissions. The Federal Power Commission has taken a conservative position, adopting a rule on fuel cost adjustments for electric utilities which calls for a single base cost for fuel, and also permits only the inclusion of the charge for energy and not other charges associated with purchased fuel costs. It requires the filing of fuel purchase contracts as tariffs subject to suspension, unless the particular fuel is under general price regulation. However, taxes associated with fuel cost increases are permitted to be included, and the Commission mandates that adjustments for

16 Moss Comm. Hearings 3-32 (Testimony of Ralph H. Wickberg, President, NARUC).
19 Among the identified organizations were Save Our Cumberland Mountains, Environmental Action Foundation, Toward Utility Rate Normalization (TURN), and East Tennessee Research Corp. Moss Comm. Hearings, Index at iii-v.
21 See particularly H.R. 12461, 94th Cong., 2d Sess. (1976), known as the “Electric Utility Rate Reform and Regulatory Improvement Act.” Section 203 thereof would limit the kinds of adjustment clauses which could be approved by state agencies; section 305 similarly would control the Federal Power Commission.
fuel cost increases be spread among users on a consumption basis, that is per kilowatt-hour of energy.

The Commission in its notice of proposed rulemaking expressed its philosophy:

We recognize the need for a fuel adjustment clause. Properly administered fuel clauses can accomplish legitimate public interest objectives. Fuel clauses serve as a cost of service type mechanism to pass through changes in actual, reasonably and prudently incurred costs of fuel (decreases as well as increases), ensure appropriate and timely cash flow to electric utilities by eliminating "regulatory lag", and reduce regulatory expense, administrative processing costs and the number of formal rate proceedings. These features of the fuel clause inure to the benefit not only of the public utility but also the customer and taxpaying public. However, improperly administered or inadequately regulated by governmental authority, fuel clauses can be inequitable and unfair.23

The legal and economic literature is generally sympathetic to adjustment clauses. John W. Kendrick, has concluded that communications utilities can properly utilize adjustment clauses:

The public utilities generally have productivity performance records of which they can be proud. Hyperinflation threatens productivity advance through profit erosion. Automatic cost adjustments seem to be the answer, but only if combined with efficiency incentives which will motivate utility managements to continue to achieve at least as good a record of productivity advances in the future as in the past.24

I. RECENT DEVELOPMENTS

Foy25 and Trigg26 have documented regulatory commission consideration of adjustment clauses from about 1917. Disapproval of requested clauses has usually been for the asserted reason that the adjustment clause technique is incompatible with the spirit and purpose of regulatory law and confusing to the consumer.27

The most significant recent development is the decision by the New Mexico Public Service Commission to allow an adjust-

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24 Kendrick, Efficiency Incentives and Cost Factors in Public Utility Automatic Revenue Adjustment Clauses, 6 Bell J. of Econ. 299, 312 (1975).
25 Supra note 7.
26 Supra note 1.
ment in rates based upon the utility's return on equity falling above or below a range of 13.5% to 14.5% in the preceding annual period.\textsuperscript{2}

In Texas, where utilities are not yet generally under statewide commission regulation, the city of Houston has agreed that Houston Lighting & Power should have a "cost-of-service adjustment clause" that will lead to increases in rates whenever the costs of labor (excluding executive salaries), depreciation and the interest requirement of bonds go up faster than revenues.\textsuperscript{29}

Illinois Bell submitted an adjustment clause which, although it was rejected by the Illinois Commerce Commission,\textsuperscript{30} reflects a recognition of the interrelationship between cost increases and productivity increases. As proposed, the clause would assign weights to changes in both costs and productivity to keep the company reasonably whole at the rate of return level authorized by the commission.

A different twist in the recent developments concerning adjustment clauses is presented in the rejection by an FPC administrative law judge of a proposal by United Gas Pipe Line which would allow its purchased gas tracking adjustment tariff to reflect declining sales volumes.\textsuperscript{31} There is now pending before the Federal Power Commission a proposed rule to deal with purchased gas cost adjustments. It would limit the number of purchased gas adjustments to two a year, prescribe the semi-annual adjustment dates, and would cover both pipeline and producer supplier costs.\textsuperscript{32}

Schiffel concludes that the use of automatic fuel rate adjustments "is a useful regulatory tool that has probably not been abused," but, reflecting the more conservative of the views of generally approving commentators, he thinks the "extension of such clauses to costs over which the company has some control and which are relatively stable would appear to be inappropriate as well as unnecessary."\textsuperscript{33}
II. THE LEGAL BASES OF ADJUSTMENT CLAUSES

One theory supporting adjustment clauses is that the rate adjustment when made has already been subjected to appropriate procedural and substantive requisites. An adjustment clause enables the utility to recover its costs more rapidly than under orthodox rate proceedings but not to increase its rates above allowable costs. Adjustment clauses also save the regulatory agency from becoming bogged down with rate cases. The legal standards of regulation remain unchanged. The regulatory agency definitionally is without lawful power to turn its regulatory responsibility over to the company, so when a rate is increased "automatically," the theory is that the company is acting pursuant to a tariff which has been fully considered.

A utility is constitutionally entitled to have the opportunity to recover the costs of rendering service to the public, and such costs include a fair rate of return on the rate base. The "prudence" of the costs incurred is subject to regulatory supervision. Consequently, an adjustment clause usually takes the form of a fixed rule, determined to be just and reasonable in the underlying rate proceeding, accompanied, at least by implication, with the finding that it does not become less so by reason of its provision for subsequent changes in rates, upward or downward, based upon the occurrence of future events. In a word, adjustment clauses are not per se illegal. Some state cases have involved the issue of compliance with statutory requirements, but few of the illegality contentions have been sustained.


North Carolina ex rel. Utilities Comm'n v. Edmisten, 27 N.C. App. 171, 217 S.E.2d 201 (1975); City of Norfolk v. Virginia Elec. & Power Co., 197 Va. 505, 90 S.E.2d 140 (1955). The Virginia court's language has been frequently cited:

The proposed escalator clause is nothing more or less than a fixed rule under which future rates to be charged the public are determined. It is simply an addition of a mathematical formula to the filed schedules of the Company under which the rates and charges fluctuate as the wholesale cost of gas to the Company fluctuates. Hence, the resulting rates under the escalator clause are as firmly fixed as if they were stated in terms of money.

197 Va. at 516, 90 S.E.2d at 148.


In some states, all adjustment clauses are prohibited.37 Thus far no state seems to have mandated them. Between these extremes, the state laws on the subject vary in their requirements on shortened proceedings before an adjustment clause-triggered increase in rates may become effective. Notice, and the filing of specified information, may be mandated.38

Adjustment clauses which take effect without some hearing procedure, however shortened, are not for that reason freed from continuing regulatory supervision. Complaint procedures are almost universally available to challenge the rates of a utility which do not conform to the standard of being just and reasonable.39 In addition, the audit and inspection function of the regulatory agency may be directed particularly to the workings of adjustment clauses by explicit provisions in the order approving the rule.

The more complex the factors prescribed to trigger rate adjustments, the more complex becomes the task of regulatory surveillance. But even the very simple fuel adjustment or "pass-through" situations can present legal questions. One recent example of this involved an adjustment in rates based upon an increase in the price of Canadian gas carried by Pacific Gas Transmission Co. (PGT) to its parent, Pacific Gas & Electric (PG&E). The Federal Power Commission had approved a tariff under which fluctuations of the price of Canadian gas, as fixed by Canadian regulatory authority, would be reflected in the monthly billing arrangement between the transmission company and the customer utility, without prior Commission approval.40

In a proceeding which arose out of a filing of a new contract between PGT and a Canadian affiliate, the Federal Power Commission instituted proceedings to determine whether PGT’s tariff

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37 See note 33 supra. But note the pendency of State ex rel. Florida Power Corp. v. Pfeiffer, Civil No. 46,384.
38 Moss Comm. Hearings 92; Schiffel, supra note 33, at 27.
39 In Pacific Gas Transmission Co. v. FPC, 536 F.2d 393 (D.C. Cir. 1976), the United States Court of Appeals for the District of Columbia upheld the use of section 5(a) complaint authority to require that before increasing its wholesale rates as authorized by an approved tariff, the company must file an application and seek approval under section 4, the rate filing section.
40 Id.
should be modified to redefine the elements includible on pur- 
chased gas costs in PGT's rates, and thereafter required that prior 
filings be made with the Federal Power Commission before any 
increases in the cost of Canadian gas could be passed on to the 
U.S. purchaser.

The Commission's position was upheld by the Court of Ap- 
peals for the District of Columbia Circuit in an opinion written 
by retired Supreme Court Justice Tom C. Clark. Justice Clark 
said that any other procedure would make the Federal Power 
Commission a rubber stamp for Canadian authority, since such 
action would subject gas consumers "to unjust and unreasonable 
rates fixed by the Canadian authority ipse dixit."

Since neither the Commission nor the Court of Appeals can 
control Canadian governmental authority which sets gas rates at 
the border, only the existence of cheaper domestic alternatives to 
supply the particular market should justify denying entry of the 
gas. Judge Bazelon, not always sympathetic to natural gas sup- 
pliers complaining about FPC regulation, suggested that the 
FPC might have conditioned its original grant of import author- 
ity, rather than amending the particular tariff in a procedure he 
called "peculiar." His comment on the majority's reasoning is 
cogent:

The fatal flaw in this reasoning is that it falsely assumes the 
tariff somehow disabled the Commission from responding to Cana-
dian imposed price increases. In truth, the only measure the tariff 
precluded the FPC from taking was that the FPC could not tempo-
rarily or permanently prohibit PGT from recovering costs incurred 
because of the increases. The Commission has failed to explain why 
imposing a prohibition on cost recovery ever would be an appropri-
ate or even plausible response to Canadian price increases. After all, 
PGT, not the Canadian government or Canadian producers, would 
bear the brunt of such a prohibition; the FPC concedes that had 
PGT been required to absorb even the initial 32 cent price increase 
for a short period of time it would have been driven out of business, 
and 2,000,000 consumers would have been deprived of 40% of their 
gas supply. Yet PGT plainly has no responsibility for or control over

\[\text{Id.}\]
\[\text{Id. at 396.}\]
\[\text{Id. at 397 (Bazelon, C.J., dissenting). Judge Bazelon began his dissent in this case by saying, "There is a certain attractiveness, I must admit, to the FPC's decision in this case..."}\]
price increases mandated by the national Canadian government. PGT cannot even mitigate the impact of those increases by expanding production of non-Canadian gas since PGT's sole operations are in Canada. Thus, the Commission could not possibly question the reasonableness of PGT recovering costs imposed upon it by the Canadian government. This would be true even if those costs were unreasonable—a question the Commission expressly declined to consider. The Commission's actions in promptly approving all the increases PGT has requested since its tariff was modified strongly support this conclusion.4

In another case involving the passthrough of Canadian gas costs, the Montana Supreme Court sustained a 1972 Montana Public Service Commission approval of a rate order containing a purchased gas adjustment clause which authorized the company to increase or decrease its charges, subject to commission review on a periodic basis. The commission held a hearing limited to the issue of the cost of Canadian gas in 1973 and allowed the passthrough. In 1974, however, the Montana Consumer Counsel sought to have the hearing expanded to cover all items of the cost of service. The Montana Supreme Court, reversing a district court ruling requiring the expanded hearing, said:

Consumer Counsel contends that the Commission is without power and jurisdiction to issue the 1974 rate order on the basis of a so-called "mini hearing" . . . The substance of his argument . . . is that the Commission is without power to approve a utility rate increase without conducting a full scale hearing and examination of all factors that affect a fair rate of return for the Company.

. . . .

Here the Company did not apply for an increased rate of return. . . Instead, the Company's application simply sought to maintain this rate of return . . . by "passing through" to its customers the tremendous increases in the costs of purchased gas and royalty expense. Under such circumstances, the rate of return and annual net earnings were not germane to the Company's application, and a full scale hearing into factors affecting the rate of return and general rate structure of the Company was beyond the scope of the inquiry before the Commission.

. . . .

In our view the underlying justification for the use of "automatic adjustment clauses" and procedures lies in the realities of the market place. As the cost of purchased gas and royalty expense of the utility rise or fall, a corresponding increase or decrease in the

4 Id. at 397-98 (Bazelon, C.J., dissenting).
prices charged its customers must occur. Otherwise the utility will either be driven out of business or it will reap windfall profits. Today, in a period of rapid increases in costs of these items to the utility, the former consideration is paramount; at another time, the situation may be reversed and the latter may be the principal concern. Automatic adjustment clauses and procedures are simply a means whereby rapid fluctuations in these costs to the utility can be reflected in equally rapid and corresponding changes in prices charged the utility's customers.45

Matters other than the recovery of costs are properly considered by commissions and courts, even in adjustment clause situations. For example, the Federal Power Commission, while considering a proposed rate increase for resale customers, determined that it lacked authority to take into account the fact that state regulation of the resale customer prevented it from recovering its added wholesale costs. This exposed the customer to a "price squeeze" in having to pay more at wholesale than he could charge his own retail customers. This holding was reversed by the Court of Appeals for the District of Columbia and the United States Supreme Court affirmed.46 While adjustment clauses were not involved in that case, the situation could arise under their application.47

After a regulatory commission has agreed that it is in the public interest to adjust rates to track certain classes of costs more rapidly than would be possible by full rate case procedures, is it logical for the commission to limit the recovery of costs to a specified percentage increment? The Michigan Public Service Commission limited a fuel adjustment clause to no more than 90% of the experienced cost increase;48 an equivalent provision is contained in the proposed "Electric Utility Rate Reform and Regulatory Improvement Act."49 Such provisions postulate a duty on the part of the investors to bear a percentage of the burden of attrition.

It has been suggested that adjustment clauses are a part of a natural progression in the move from rate hearings, to ratemak-

47 See note 21 supra.
ing through rulemaking procedures, to regulation by formula.\textsuperscript{50} When the rate of return was deemed a stable item in the ratemaking formula, inflationary and deflationary pressures were sought to be accommodated in the rate base valuation process.\textsuperscript{51} "Trending" of rate base valuations was never automatic, and generally was not judicially validated, but the objectives sought to be accomplished were the same as those sought in adjustment clauses.

The ratemaking process long tended to be less rather than more formulary. \textit{FPC v. Hope Natural Gas Company}\textsuperscript{52} represented very nearly the outer limits of departure from formulas. The ability of the regulatory commissions to frame their decisions to avoid judicial interference with their policymaking prerogatives has been severely challenged by shortage allocation and environmental issues. Hearings, particularly full-scale hearings, have become tools capable of being manipulated by the competing forces with commissions being caught in the middle. The poignant discussion by the New Mexico Commission of the "tyranny of the rate case" is illustrative:

The essential situation \ldots is that traditional, adversary, formal service rate proceedings, which are occurring with ever increasing frequency and urgency, are simply proving both inadequate to the task and too time and energy consuming. In short, this commission and its staff are subject to the tyranny of continuous rate cases, and our other regulatory responsibilities are neglected in the consequence. \ldots As mentioned earlier, service costs have become a moving target which scarcely holds still long enough to be quantified, with the result that even the most painstaking determination of an energy utility's test-year costs, annualized and adjusted to current levels, and service rates fixed at levels to cover such costs, often prove woefully inadequate by the time the rates become effective. All too often during the past several years, newly authorized service rates have failed to cover the energy utility's rapidly increasing total costs of service, with the result that, while its operation, maintenance, tax, depreciation and amortization costs may be covered, its capital costs are not, even though the service rates were carefully designed to do so. When the earnings stability and reliabil-

\textsuperscript{50} Schiffel, \textit{supra} note 33.

\textsuperscript{51} Before the virtually universal acceptance of original cost valuation, utility commissions struggled with the application of trending and indexation techniques. \textit{Cf.} West \textit{v. Chesapeake & Potomac Tel. Co.}, 295 U.S. 662 (1935).

\textsuperscript{52} 320 U.S. 591 (1944).
ity of an energy utility are reduced, the market responds by increasing its costs of capital and the customer inevitably suffers.\textsuperscript{35}

Legislative consideration of such problems, undoubtedly influenced by the volume and intensity of consumer complaints about rate increases, seems to be devoted much more to the hearing process and its length than to the substantive issue of attribution and how to meet it. The right of a utility to file for an increase deemed necessary for its continuance of adequate service to the public is an essential substantive due process aspect of utility regulatory methodology.\textsuperscript{34} Thus, legislative proposals to forbid "pancaked" rate filings, the filing of a second, third, or fourth rate case while earlier ones are still not finally determined,\textsuperscript{55} is likely to present important issues for courts to resolve.\textsuperscript{56}

III. Economic Considerations

The conventional wisdom that regulation results in lower rates has been academically\textsuperscript{57} and politically\textsuperscript{58} challenged. So has the conventional wisdom that low rates are preferable to high rates in all circumstances. The comments of William W. Lindsay, now Associate Chief of Economics at the Federal Power Commission, are apt on the latter point:

What has perhaps not been so widely recognized is the fact that regulatory lag also interferes with the ability of rates to perform


\textsuperscript{34} Particularly is this true where, as is usually the situation, the regulatory commission can suspend a rate filing for no more than a specified number of months. Although rates thereafter collected are subject to refund, the company has the cash flow necessary to keep it in operation, if its contentions turn out to be wholly or partially correct.

\textsuperscript{55} H.R. 12461, 94th Cong., 2d Sess. § 304 (1976).

\textsuperscript{56} Such provisions could revive the Ben Avon Doctrine, Ohio Valley Water Co. v. Ben Avon Bureau, 253 U.S. 287 (1920), that a claim of confiscation requires a fair opportunity for submitting that issue to a judicial tribunal for independent determination of both law and facts.


\textsuperscript{58} Council of Economic Advisers, 1975 \textit{Economic Report to the President}. Chapter 5 addresses "Government Regulation," and contains these comments:

This discussion of governmental regulation suggests that existing laws and institutions are imposing significant costs on the economy. . . . Precise estimates of the total costs of regulation are not available, but existing evidence suggests that this may range up to 1 percent of gross national product. . . .

\textit{Id.} at 159.
another of their principal functions—that of demand control. Recent
proposals to revise traditional electric rate structures, whether or not
one happens to believe they are misguided, have served to empha-
size the proposition that the amount of electricity taken is affected
by the price charged. Since the amount of resources allocated to the
production and distribution of electricity depends on the demand for
the service and the latter depends on the level and structure of rates,
resources will be misallocated to the extent that rates fail to reflect
costs. In this sense, among others, prices which do not reflect costs
are not in the public interest. 39

Much of the legal framework within which the economy of
the United States operates is predicated on the assumption of
reasonable price stability in the general price level, 40 and reminds
us that "indexation" might well be a cure as well as a palliative
for inflation, citing Friedman's argument that by reducing the
windfall gains to government and other groups (in this case, pre-
sumably, ratepayers) and by more promptly transmitting disin-
flationary tendencies throughout the economy, these clauses may
serve a basic economic objective beyond that of either the rate-
payers or the investors. 41

40 Kendrick, supra note 24, at 299. This may be an appropriate place to note that the
assumption of price stability was central to the thinking of Justices Brandeis and Holmes
in their concurrence in Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv.
Comm'n, 262 U.S. 276 (1923) and thus contributed mightily to the adoption of the original
cost methodology for valuation of rate base. Justice Brandeis said, dissenting from the
opinion but concurring in the judgment:

Engineers testifying in recent rate cases have assumed that there will
be a new plateau of prices. . . . The course of prices for the last 112 years
indicates, on the contrary, that there may be a practically continuous decline
for nearly a generation; that the present price level may fall to that of 1914
within a decade; and that, later, it may fall much lower.
Id. at 303 n.16.

Query: Would we now be utilizing fair value rather than original cost methodology
to keep pace with inflationary pressures if Justice Brandeis had more clearly forseen the
future? Future query: Are we approaching the more prescient suggestion of Professor A.
J. G. Priest who said:
The Brandeis technique for determining a public utility's rate base can
remain simple even under conditions of inflation if an appropriate factor is
developed for expressing high-value dollars in terms of dollars which have
lost much of their purchasing power. Tailor-made price indices accurately
and honestly predicated on a utility's experience have provided such a solu-
tion in a number of instances. The use of general price indices in such
circumstances has been condemned, but specific indices which are generally
applicable to the property examined plainly are less subject to criticism.
41 Kendrick, supra note 24, at 300.
Any study of adjustment clauses must begin with the question of their role in combatting or contributing to inflation. It was the supposed contribution to inflation which most preoccupied the Moss Subcommittee. One of its “findings” was that “automatic fuel adjustment clauses have accounted for nearly two-thirds of the $8 billion increase in the price of electricity in 1974.” This is a misleading statement. The differential, if any, between the actually experienced increased costs of furnishing electric service, and the rates charged to recover these costs, is a valid inquiry, but using an adjustment clause does not itself establish the existence of a differential.

The New Mexico Public Service Commission’s experiment has intriguing economic, legal, and administrative consequences. The commission’s adjustment clause is tied to return on the equity of the common stockholders. The commission did not agree that this amounted to a guaranty of investor profit or that it contributed to inflationary pressures. With an elliptical, but discernible reference to the Stiglerian hypothesis that regulation does not really affect prices very much, the commission said:

The cost or rate of return a public utility must pay or be able to pay in order to obtain common equity funds from the private capital markets is set for the company by the market, not by this commission or the company.

The commission was orthodox in its conclusion that the cost of common equity capital is simply another cost of furnishing service not generically different from any of its other costs.

Any adjustment clause case must begin by determining the base rates against which the adjustments should apply. The New Mexico Commission tempered the effect of its adjustment clause by differentially scaling downward the base levels below the rates being collected under bond, so that the company was allowed to raise the rates for its large use customers proportionately less

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45 Id.
46 Id.
47 The schedule is as follows:
than its smaller use and residential customers, presumably because the former could be expected to bear the heaviest burden of the future effects of the adjustment clause, applied by a specified per kilowatt hour amount. The right to stay any requested adjustment, pending a hearing and resolution of contested issues was reserved; and reports of the company were required to be available for public inspection.\textsuperscript{87}

One provision of the New Mexico Commission's order is conceptually inconsistent. An existing monthly fuel cost adjustment procedure was continued in effect.\textsuperscript{88} Perhaps this was to maintain separate visibility in a customer's bill for this particular item of cost. In theory, the cost of service indexing keyed to return on common equity obviates all other adjustment clauses.

The relationship between adjustment clauses and another regulatory mechanism put forward to combat the effects of inflation, inclusion of construction work in progress in rate base, was also discussed by the New Mexico Commission. Construction work in progress is financed with either debt or equity, so the formula should not provide for the inclusion of an offsetting allowance for funds during construction as a revenue item. The company was allowed to capitalize the allowance for funds used during construction and add it to the plant account only with respect to non-revenue-producing investment such as environ-

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<tr>
<td>Irrigation</td>
<td>15.3</td>
<td>15.3</td>
</tr>
<tr>
<td>Water and Sewage</td>
<td>6.7</td>
<td>6.7</td>
</tr>
<tr>
<td><strong>Average Increase</strong></td>
<td><strong>11.5%</strong></td>
<td><strong>9.7%</strong></td>
</tr>
</tbody>
</table>

\textsuperscript{Id. at 121.}
\textsuperscript{\textsuperscript{\textsuperscript{1 Id. at 123.}}}
\textsuperscript{\textsuperscript{\textsuperscript{2 Id. at 122.}}}

\textsuperscript{87}
mental equipment, and transmission, distribution, and miscellaneous additions.  

On the other hand, the allowance for funds during construction which was related to investment in generating capability was required to be included as a revenue item, and capitalized, thus deferring recovery in rates of the cost of capital associated with such investment until after the plant goes on line. The FPC has changed its rules with a similar distinction being made.

The equivalent of the legal question of confiscation is presented in economic policy terms in the matter of dilution of stock value, and in the matter of comparing the costs and benefits of maintaining coverage ratios (earnings as a multiple of debt service costs) and, ultimately, in the matter of measuring the costs of utility bankruptcy. The latter question was emphasized in testimony before the Moss Subcommittee, when a utility witness said that in view of the increase in the delivered price of coal by 131% over a one year period, the company would have been unable to pay its bills when due, and would most likely have been bankrupted, if it had not had an adjustment clause.

The New Mexico Commission discussed the costs of attempting to finance expansion for a company whose common stock value is below book value:

[If a utility continually attempts to sell common stock at prices below inevitably declining book values to raise that portion of its new capital requirements dictated by the need to keep its debt capital ratio in reasonable balance, sophisticated investors and ultimately the entire market may soon be unwilling to buy at any price.]

The commission also reacted favorably to testimony which quantified the cost of losing a bond rating level:

Quite logically, these [rating] institutions perceive increases in debt ratios and declines in coverage ratios as indicative of an increase in risk to the investor and downrate the securities of the public utility accordingly, with the result that the cost of new debt and preferred stock capital to it is increased by the capital market

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49 Id. at 124.
51 Moss Comm. Hearings 716.
proportionately . . . [T]he current difference between the cost of AA and A rated utility bonds and preferred stocks is 0.89 per cent. Estimating that approximately 85 per cent of the capital necessary to finance PNM’s five-year construction budget—i.e., $625,760,000, must be generated externally or from the private capital markets, that 65 per cent of this amount must be raised by the sale of bonds and preferred stock, and that the new plant in which it will be invested will have a 30-year life, . . . retention of PNM’s AA rating would result in 30-year savings in the amount of approximately $110 million.13

IV. Administrative Problems

To obtain administrative approval, the advantages of adjustment clauses must be found to outweigh the disadvantages. The regulatory agency must be persuaded that adjustment clauses are adequately resistant to abuses which frustrate regulatory objectives. This presents various administrative problems.

The process of balancing competing interests in having or not having a full rate case involved accepting tradeoffs. The expectation approaching certainty that costs will increase, not decrease, during the period following a rate determination, has dominated ratemaking for a number of years. Rate models which incorporate anticipated future changes, such as in financing, revenues, rate base, taxes, depreciation, and operating expenses, are routine. Rates are fixed upon a cost-of-service which may be based upon a “forward test year.”14 The policy argument as to inclusion of construction work in progress in the rate base is summarized in a recent FPC order as follows:

The allowance of CWIP in the rate base involves a judgment that it is equitable for present ratepayers to provide funds that would otherwise be provided by future ratepayers. At the present time, there is only one area where the Commission has agreed for all companies that this outcome would be equitable. This is in the area of facilities which are required because of the current generation’s commitment to the control of pollution, or its consumption of existing stocks of natural resources. Thus, we will allow the inclusion of CWIP in rate base where the construction is of facilities to be used for pollution control, or for the conversion to the burning of other fossil fuels of plants which now burn oil or gas. In these cases, it is the profligacy of the present generation which requires the new facilities, and we

13 Id. at 130-31 (footnote omitted).
consider that the equitable argument favoring this allocation of costs is sufficient to tip the balance in favor of the allowance of CWIP on these facilities.\textsuperscript{75}

In theory, at least, the nature of ratemaking precludes a company's realized rate of return from matching that used for ratemaking purposes except as a transient coincidence. The pressures of inflation have resulted in commissions candidly allowing rates of return higher than otherwise might have been allowed in order that the time period between rate cases can be extended.

It may be less than fair, therefore, to make too much of the comparison of the workings of adjustment clauses against the alternative of full rate cases. A well-designed adjustment clause can permit a ratemaking agency to allow a lesser revenue level than would be the case if it did not have the adjustment clause.\textsuperscript{76} Adjustment clauses may well be more certain and more favorable to consumers than alternative regulatory devices. Nevertheless, the administrative problems associated with adjustment clauses are frequently presented as if the alternative of a full hearing procedure was a model of certainty.

In any adjustment clause situation, as in ratemaking without such clauses, the traditional objective is to maintain sufficient incentives for management to reduce costs by making a wise choice among alternative generation modes, by hard bargaining with suppliers of labor, materials, and fuel, by shrewd selection among financing alternatives, and by alert planning and supervision.

The psychology of utility management is not the subject of this paper. However, there is a massive difference between the incentive of a professional's pride in doing a good job and the incentive of staving off bankruptcy for an extra month or so. The regulatory agency must furnish incentives to the management of the regulated utility. Do adjustment clauses reduce incentive? Requiring a full rate hearing for every increase is administratively burdensome, and the disarray among the states' attitudes about adjustment clauses reflects to a degree differences in their views about the tradeoff between incentive and administrative conveni-

\textsuperscript{75} FPC Docket No. RM75-13 (Nov. 8, 1976), 41 Fed. Reg. 51392 (1976).
ence, more than it does a difference in view about the recovery of proved costs.

The Moss Committee hearings emphasized administrative problems, including one it called “over-collection.” In an adjustment clause context, this is basically not different from the circumstance that realized revenues sometimes exceed projected revenues. This is not called over-collection. Experience usually varies from projection and it can occur in an adjustment clause context.

The California Public Utilities Commission split on treatment of such a variation in a situation where the mix of hydro and fossil fuel generation changed. By a 3-2 rate decision, the commission required PG&E and Southern California Edison to “refund” $203 million because of the “over-collections.” The dissenting commissioners said that “while we can concur in the revision of the fuel-cost-adjustment clause from a forecast basis to a recorded basis, we dissent when the majority decides to exceed the law to order refunds.” The company announced that the decision would be appealed.\(^7\)

The skewing of rate design is a more substantive matter, but critics of this effect generally fail to realize that it works in favor of the low load factor residential users at the expense of the high load factor industrial and commercial customers. The characterization of this differential as a “windfall profit” seems to be highly inappropriate.\(^8\)

Another administrative problem is one discussed in connection with Philadelphia Electric Company. The company’s tariff excludes nuclear fuels from the workings of its fuel adjustment clause. Investment per kilowatt in nuclear generation so far exceeds conventional fossil generation, that inclusion of nuclear fuel without recognition of this fact would heavily penalize the nuclear utility until it can include the new investment in its rate base.\(^9\) Fuel clauses are administratively difficult to handle where several companies are part of an integrated system. Derivation of a base cost for a particular company’s fuel, procured from long

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\(^7\) Wall Street Journal, Apr. 28, 1976, at 15, col. 2.

\(^8\) Moss Comm. Hearings 361.

\(^9\) Id. at 354.
term contracts, from captive mines, and from spot purchases, is
difficult. The supervision or audit of fuel purchasing practices
is relatively easy on a post hoc basis, and critics of the workings
of fuel clauses can easily insist that the company should have
operated its system differently. Therefore, requiring purchase
contracts to be submitted for review is becoming more common.81

Accommodating efficiency factors into adjustment clauses
was extensively discussed by the West Virginia Public Service
Commission,82 in considering a situation where one regulated
company used a variable efficiency factor, and another used a
fixed efficiency factor. In the former, heat rating and line loss
factors are determined each month, whereas in the latter, a fixed
line loss and constant heating rating are determined.

The list of theoretical arguments against an adjustment
clause is long. It is to be expected that to the extent adjustment
clauses withstand the current legislative attack, the design of the
clauses themselves will be influenced by the same considerations
which are urged in connection with such current social objectives
as inhibiting demand, aiding conservation, and advancing envi-
ronmental quality.83

Regulatory lag is always under attack, but the “lag factor”
is an affirmative tool of those opposed to rate increases. Compet-
ing forces might find an area of compromise by agreeing upon a
fixed delay period, or a fixed discount factor. The need to pass
costs along to the customers and the countervailing need to keep
utility management on its toes to save costs might be served in
this fashion. Some lag factor clauses are adopted on the legalistic
ground that a delay in the workings of a clause is necessary for
procedural fairness, to give those affected by the increase an op-
portunity to file complaints and trigger review procedures.

CONCLUSION

The process of ratemaking is legislative, but by tradition and
by statute it has always been required to be conducted in the full-

80 Id. at 730.
81 Id. at 731.
Comm'n 1975).
83 See Avery, Social and Economic Factors in Rate Design, ABA PUB. UTIL. LAW
SECTION ANNUAL REPORT 48 (1975).
hearing format of adjudication. Roger Crampton has contributed considerable insight in his discussion of the rapid expansion of the use of formal evidentiary hearings in administrative decision-making in some fields, while simultaneously such use is under attack in other areas. His paper in the Virginia Law Review relates primarily to the judicialization of the process of nuclear power siting, but what he says about how we should think about procedures is apt on the adjustment clause versus full rate hearing issues. Instead of using talismanic phrases like “fairness” and “due process,” we might follow his suggestions and compare procedural alternatives in terms of whether they further the accurate selection and determination of relevant facts and issues, further the efficient disposition of business, and meet a standard of “acceptability” to the public.

On the test of accuracy, it seems that a well-designed adjustment clause is superior to the full hearing, for the reasons articulated by the New Mexico Commission. The possibility of the traditional full hearing being more accurate than the rates reflecting the workings of a fully litigated rule on adjustments is about equivalent to the comparison of a stopped clock being more accurate than a clock running fast or slow.

As to efficiency, the same can be said. The regulatory process has bogged down to the point of scandal, and the recommendations of the Moss Committee and others as to how to handle the growing crisis are ludicrous. The prescription of more money and more personnel for the regulatory process, or for the use of rules forbidding the “pancaking” of rate cases as if the tide of cost increases could be held back by regulatory or legislative fiat is simply unrealistic.

However, the matter of acceptability may be the shoal upon which not just adjustment clauses, but utility regulation as we have known it, will founder. It is undeniable that the current of sentiment against energy producing and energy delivering companies in this country is running strong. It is unfortunate indeed that the public is being misled into believing that somehow a cost passed through to consumers through the workings of an adjust-

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*Crampton, A Comment on Trial-Type Hearings in Nuclear Power Plant Siting, 58 Va. L. Rev. 585 (1972).*
ment clause is not a real cost. The financial integrity of all utilities is presently shaky, and public confidence is at a very low ebb. In many ways, the utilities are victims of their own past successes, because their achievement of economies of scale and their technological advances for a long time cancelled out the upward pressures of inflation. It is no longer possible to look forward to productivity gains cancelling out the increased costs related to inflation.

The issues are not legal ones. The applicability of an adjustment clause is almost always determinable upon policy grounds dependent upon legislative rather than adjudicative facts. Therefore, due process in a constitutional sense does not demand the kind of adversary hearing which the critics of these clauses seem to assume.

Neither are the issues economic. What should be said here is that the discipline of economics is a fertile field for further empiric research to assist the regulatory process, particularly in the design phase where so many of the administrative problems have been identified.

Adjustment clauses do not deserve the criticisms which have been leveled against them, but decrying the criticisms will have no effect. A positive case must be made, showing that they offer a way to maintain the values and traditions of a regulatory system which has served the public for more than a hundred years.