When President Johnson nominated me to serve on the Federal Power Commission, I moved from a job where I made many speeches to one where I make very few. But the few are more work than the many. Regulators, as all of you know as well as I, are denied the luxury of expressing idle opinions. Our speeches are read by regulator-watchers as weather vanes of our views on cases, as evidence of having made up our minds prematurely on certain questions, or as indicators of our political, social, or economic philosophy.

The New York Times last April carried a full-page ad, paid for by officials of companies subject to regulation by a particular commission, bringing one regulator's colorful speech in full to the attention of the readership of the "World's Greatest Newspaper." I have had my own speeches cited in Briefs and oral argument, and the Court of Appeals had to clear a speech of one of my predecessors of the charge that it indicated prejudgment and bias.

In such a situation, the temptation today is to stick to the blandness of pledges of cooperation and protestations of mutual respect for each other's prerogatives.

I resist the temptation--I am going to express some thoughts about rate of return.

Learning is a process of relating new experiences in patterns or relationships with prior experiences. Having served for six years in an executive department which served many "constituencies"--commercial and noncommercial users of the public lands, commercial and noncommercial fishermen, Indians and territorials, reclamation interests, conservation and pure water groups, etc., etc.--I have developed the hypothesis that there are "constituencies" of regulation. Note carefully that I do not confuse "constituencies" with "publics" or "the public interest". The concept of the public interest as an overriding objective is implicit at all times.

My definition of a "constituency" is a group which has common interests and viewpoints. Generally speaking, constituencies simplify issues, as indeed they must. It is the task of others--regulators, for example--to grapple with ambiguities, and to resolve questions between right and right. "Constituencies" can be single-minded.

Broadly speaking, I identify three "constituencies" of regulation--consumers, management, and investors. Obviously there are others, but I think every regulatory agency deals at least with these three.
within my definition I must find that it too simplifies issues. Here I am on shaky ground, but I would say that at this moment in history this "constituency" of regulation would simplify regulation by measuring it in terms of the realism with which it approaches the question of rate of return. The investment constituency, it sometimes seems, would almost define "realism" of regulation as a function of its approach to the ideal of no regulation—the regulatory equivalent of the idea that that government is best which governs least.

A separate measuring rod applied by the investment community is predictability or reliability of the regulatory process. This applies not only to the rules and regulations, but to decisions and personnel. The remarkable success record of the FPC before the Supreme Court has not gone unnoticed by the financial world.

Returning to the rate of return question, the magnitude of this item as a share of the revenue dollar is sometimes not fully appreciated, even by those whose every day business is regulation. David Kosh, in his paper on rate of return to the American Bar Association in 1965, says that sixteen cents of each dollar of telephone revenue goes to return, about the same amount as goes to maintenance. For the typical electric utility, return is seventeen cents of the revenue dollar; for a randomly selected gas pipeline, twenty cents. On an assumed rate base of $100,000,000, a tenth of a percent change in allowed rate of return will change earnings $100,000. A one percent change in rate of return changes revenue requirements $2,000,000 a year, about two dollars of revenue being required to produce one dollar of return at current tax levels.

A generalization not gleaned from my dinner companions at the financial forum is the hypothesis that treatment of rate of return by regulatory commissions scatters over a surprisingly broad spectrum or scale. This hypothesis would place at one end of the spectrum a hands-off approach, which would open the question of rate of return only infrequently. Commissions at this end of the scale would maintain only casual supervision, and would rely on complaints to surface the need for re-examination of rate of return.

At the other end, regulatory eagle eyes poise to pounce upon regulated companies. Commissions with this leaning tend to prefer a formulary approach, which, as a matter of "policy" limits overall return regardless of capital structure, special risks, changing technology, or other variables which torture the theorist in this area.

The investment or financial community tends, I think, to look upon this variability with amused tolerance, confident that the price of money to finance a particular enterprise will appropriately value—apply premium or discount—whatever
process is present or absent depending on whether assumptions are explicit and supportable, whether the upper or lower limits of reasonableness are favored.

There are legal questions in all of this. But with Mr. Kosh, who feels [or hopes] that law follows economics, it seems that the courts will not fault a commission if the end result is to attract the capital to meet the utilities' needs. Of course, this must be established in such a manner as to convince a reviewing court, and more and more reviewing courts are concerned with charges that the return is too high, rather than, as in earlier eras, that it is too low.

The "end result" test leads, of course, into the same jungle that the FPC recently successfully traversed in one of its consolidated tax return cases: the jungle of treating the regulated company as if it had done something which in fact it did not do, for the purpose of fixing the rate base. Flow-through of liberalized depreciation and an assumed equity-debt ratio present similar problems.

Judge Harold Leventhal, in his fine article in the Yale Law Journal on "Vitality of the Comparable Earnings Standard for Regulation of Utilities in a Growth Economy" suggests a legal dimension by saying that that standard rests on a concept of fairness to the old capital--on the public's keeping its faith impliedly given.

If my hypothesis of a spectrum of regulatory attitudes about rate of return is valid, the question follows--where is the "right" place on that spectrum? It has been my objective to suggest that regulation should look realistically at rate of return; that it should see it as the many-sided problem it is; and that it should be willing to break out of the shackles of policy or formulary rigidity. In a word, I think that regulation should not begin consideration of each new problem at the end, i.e., the last rate of return allowed.

If that puts me to one side or the other of the middle of the spectrum, I shall have to accept the charge. I'm not particularly bothered so long as no one has decided whether one end of the spectrum is necessarily better than the other.

Regulators have a vital role in the economic well-being of our complex system. We owe it to ourselves to develop and use analytical techniques which will test, reinforce, or destroy old theories. Boldness and inventiveness in this area are not conventional virtues, but being in the kitchen of regulation is a privilege worthy of the pain of the heat.

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