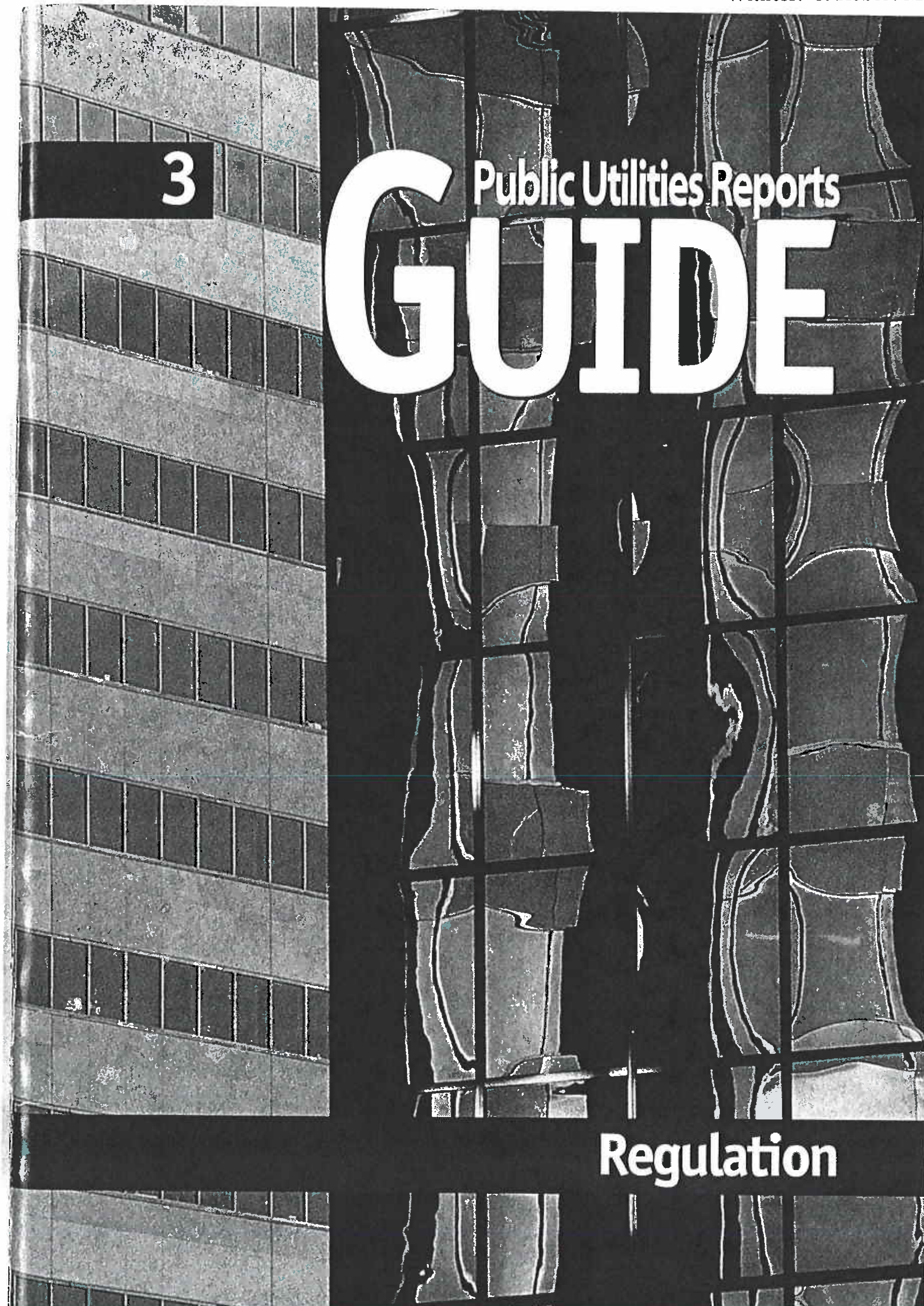
Rocky Mountain Power
Exhibit UIEC-_____ (JRM-1)
Docket No. 10-035-124
Witness: J. Robert Malko



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proportion of fixed cost, a utility is under pressure to increase its volume of business in order to reduce its average cost per unit of output.

This characterization of the cost structure of utilities is subject to considerable debate. It is commonly pointed out that the electric utility industry is an example of recent trends in utility economics. Some analysts argue that economies of scale are no longer achieved by increasing plant size and prices will rise—or at least not fall—with increased output. The issue is an important one and we will consider it again in our discussion of the manner in which a utility sets a charge for the service it provides.

Why Regulation?

What is the purpose of regulation? In the words of Myron B. Katz, former chairman of the Oregon Public Utility Commission, "The principal objective of utility regulation is to protect consumers from the lack of competition. It cannot be repeated often enough." The Supreme Court's decision in the *Hope Natural Gas* case confirms that one of the historical objectives of utility regulation has indeed been to set fair and reasonable rates for service in the absence of competition. As more and more states begin to authorize competition in the utility marketplace, however, debate is being heard on what purpose regulation will serve in the future. It's important to note that when deregulation or restructuring of the electric and gas utilities is discussed it refers only to the generation side of the business—most industry players agree that regulation of the distribution side of the business will remain in force.

The combination of private ownership and public control of utilities, however, means that some conflicts are inevitable. While regulation is essentially a legislative and legal concept, it is also an economic one. Utilities are economically motivated, as are other private enterprises, but they render public service and, thus, historically have been subjected to detailed government regulation, supervised by the judicial system. Not surprisingly, the regulation of public utilities has not developed in a smooth or always logical manner. Indeed, some would say that regulation has experienced a slow and fitful growth. There always has been controversy surrounding the amount of regulation necessary to protect the interests of consumers—while keeping in mind the financial health of the utility. And every change in policy has met some opposition, with compromise frequently being the ultimate outcome.

Over time, industry observers have argued the merits of other regulatory objectives. In 1940, economist Horace Gray charged that regulation failed to limit the power of the very monopolies that it had created. Public utility status had become "the haven of refuge for all aspiring monopolists who found it too difficult, too costly, or too precarious to

- cannot select a fuel to be used or a source of water supply for a utility company to use in its operations; but environmental laws must be observed.

In the absence of any regulation to the contrary, management is responsible to the owners of the company for the success or competence of its policies in the administration of the company's affairs. In addition, in a competitive marketplace, the question arises: Which companies are regulated? As noted earlier, in states where customer choice already is occurring, commissions may not have the authority to regulate new entrants' rates, for example, but they often have the authority to require nonutility energy service providers to register or license those companies.

Management Decides, Commissions Oversee

The crux of the difference between regulatory responsibility and managerial duty is the matter of initiative. Utility management is expected to initiate action on the economic activities which it directs. It is expected to take the necessary steps to provide the service, to raise the capital, and to file the rates.

This statement does not mean that the regulatory commission has no influence over such action. It may review and (if necessary) revise, but not direct or supervise, the original action. It also means that inaction, inappropriate action, or refusal to act automatically passes the initiative along to the commission, which then has authority to take corrective action under the law. Furthermore, past policies and decisions of the commission also affect and govern present and future action by utility managements.

If a commission upon its own motion and investigation decides that an existing rate schedule is unreasonable, it may issue a "show cause" order to the utility. This places an obligation upon the utility to appear before the commission and show why a revision in the rate schedule should not be made. Commission regulatory functions do not precede managerial determination. Usually, they follow it unless management defaults.

It is often difficult to draw a neat line between the province of regulators and managers. In the late 1980s there were an increasing number of "prudence audits" of utility operations by regulators. In such an audit, regulators examine various actions taken by utility managers, most notably investment in large generating units or fuel procurement practices, and determine what portion of those investments or actions have been prudently incurred. If the regulatory commission determines that management should have acted differently given the circumstances, certain penalties might be imposed. Alternatively, some commissions