A “public utility” is a business that:

- Is a natural monopoly, typically due to large demands for capital and other barriers to entry.2 and
- Is affected by the public interest and of great importance to health, welfare, or the economy.3

“Public” utilities often are not in fact public, in the sense of being owned or operated by the public, but instead are owned by private stockholders. They are referred to as “public” not because of the nature of the ownership of the utility, but because the entity regulating public utilities in a state is usually the public service commission or public utilities commission.5 The rationale for regulation is that, if public utilities are not regulated, the lack of effective competition over prices and terms would allow price-setting at levels above what is fair and reasonable. Regulation is desirable in these industries because it allows the capture of large economies of scale, but it prevents price-setting at levels above what is fair and reasonable.2

Until recently, gas, electric, telephone, and water service were all regarded as natural monopolies. Utilities were granted a monopoly franchise to serve a particular geographic area on the premise that this would result in overall lower prices for consumers than would a situation in which several companies competed for the same set of customers. In exchange, the franchised utilities had the obligation to serve all customers in that service area. State and federal governments (and sometimes local governments) regulated these enterprises to achieve what the free market could not: the provision of reliable service at reasonable prices to anyone who demands it.5

Traditional thinking has been that too few companies would choose to compete in an unregulated utility market, resulting in a lack of effective competition over prices and terms.2 The probable outcome would be that a small number of enterprises (or perhaps one) would dominate the market and set prices at economically unjustified levels—the classic monopoly situation. This would happen for several reasons.

For one, a plant that produces and supplies a public utility service requires a large amount of fixed equipment and investment before it can begin operating.3 Only entities with sufficient financial resources can seriously consider entering a public utility business. Because of the large “start-up” expense involved, enterprises have an incentive to recoup costs by maximizing revenue as quickly as possible. Once one company is established and signs up a large number of customers in a given area, it becomes extremely difficult if not impossible for other companies to enter the field. The first company or the first few companies quickly dominate the market and set prices at will.

Furthermore, public utilities are considered to be natural monopolies; that is, they return substantial economies of scale. At the outset of the development of the electric, gas, and telephone industries, and for decades thereafter, prices declined as the number of customers grew. An unregulated utility would not only be able to recoup its initial investment quickly, but it would also be able to set prices at whatever levels it saw as optimal. Regulation is desirable in these industries because it allows the capture of large economies of scale, but it prevents price-setting at levels above what is fair and reasonable.2

Another characteristic that distinguishes public utilities from their unregulated counterparts is the need for “unused capacity,”41 which in many other industries would be considered unproductive excess capacity. Most utility services—such as communications and electricity—cannot be economically stored. Yet consumers expect and require that these services will be available whenever they wish to use them. Consequently, while other types of companies would simply be able to turn customers away (think of the convenience store that runs out of ice on a hot summer day), public utility facilities must be constructed with excess capacity so as to accommodate peak demands for service. However, periods of peak demand may exist for only a few hours or a few months. At other times, the utility has no use for the capacity it maintains to serve peak demand, but it is required to have that excess capacity available.

Furthermore, to keep prices reasonable, most utilities do not charge customers the full cost of using energy or services at peak times.44 In an unregulated environment, firms do not allow this. They may allow shortages in the short run and, in the longer run, raise prices to balance demand with supply. They also discriminate among customers, segmenting the market by charging less to those that are more responsive to price (such as leisure air travelers, who can choose not to travel if the price is too high) in order to fill excess capacity. Thus, some consumers are required to pay higher rates than others. Because of the importance of public utility services to the public welfare and the economy, and the lack of price discipline from competition, the goal of public policy has been to prevent shortages, to outlaw unreasonable prices, and to prohibit discrimination.42
Public utilities differ from other providers of necessities—food, shelter, and clothing, for instance—in how they relate to the individual consumer, as well.¹ For one thing, most consumer demand for public utility services is relatively inelastic. Because these commodities are indispensable, price increases or decreases have relatively little impact upon consumer demand. This phenomenon, of course, stands in marked contrast to almost all other goods and services, changes in the price of which influence consumer purchase patterns. Even when necessities are involved, consumers will choose cheaper cuts of meat or smaller apartments in response to price increases; such choices are more difficult to make in the purchase of utility services. Although recent rate increases have demonstrated that consumer demand for the services of public utilities is not as inelastic as was once thought, clearly, consumers will reduce spending on other items before they reduce spending on their heating and water service.² Studies have shown that low-income families reduce their food expenditures and cut back on other necessities in order to pay higher energy bills during cold winter months.³

Footnotes


4 A few states regulate the provision of sewer service, some regulate propane to a very limited extent, and some regulate customer service aspects of cable television companies.

5 See Weld v. Gas & Elec. Light Comm’rs, 84 N.E. 101, 102 (Mass. 1908) (“The state, through the regularly constituted authorities, has taken complete control of these corporations so far as is necessary to prevent the abuses of monopoly.”).

6 These bodies have different names in different locations. For example, Iowa has a “utilities board,” and New Mexico has a “public regulation commission.” We refer to a public service commission (PSC) or a public utility commission (PUC) generically throughout this treatise, recognizing that other names may be more accurate. For contact information for each state utility commission, go to www.naruc.org and click on the “About NARUC/State Commissions” tab.


For example, many observers think that the long-distance telephone market, with its four dominant participants, is not competitive, although it is no longer fully treated as a public utility industry. E.g., Harry M. Trebing, Regulatory Assistance Project, Concentration and the Sustainability of Market Power in Public Utility Industries (Mar. 1998).

Under the typical scenario, a public utility would have to obtain a franchise or certificate of public convenience and necessity from the appropriate authorities prior to entering the market. Once operational, the enterprise would have to supply a minimum level and quality of service to its customers (see the discussion of the duties of public utilities below). In addition, the utility would also have to seek permission before ceasing operations and abandoning service.

Some utilities vary price by time of day or season of the year. For example, some gas companies have higher base rates in the winter heating season and flow through the actual cost of procuring gas; some electric companies charge more during the summer months or during peak day-time hours. But, in general, prices are based on the average cost for most residential customers.

As described in §§ 1.1.6 [1], 1.2.1.3 [2], and 1.2.2.3 [3], infra, many legislators and regulators believe that there can be sufficient competition in the generation sector of the electricity market if the monopoly franchise is eliminated, and that the resulting competition could discipline prices with little or no regulation. This model of the electric industry leaves unanswered serious questions about which entities or institutions would make sure that there is an adequate supply of electricity at times of peak demand. This model also opens up the possibility of price discrimination against, for example, residential customers, customers with bad credit histories, and those living in remote areas.

However, a study by the National Consumer Law Center found that income is an indicator of energy use. Low-income households uniformly use less energy than their average-income neighbors. National Consumer Law Center, Energy and the Poor—The Crisis Continues (1995).

During the summer of 2001, California disproved the conventional wisdom that consumers will not significantly reduce their consumption during peak periods (for example, hot summer or cold winter days) even in response to high prices. Faced with skyrocketing prices resulting from the restructuring of its energy markets and from market manipulation by energy traders such as Enron, California funded and launched an emergency conservation program. In the peak month of June 2001, California reduced consumption by 14% compared to June 2000 after adjusting for changes in weather and employment. For the 2001 four-month summer period, consumption was 10% below the same period for 2000. For a further discussion of California’s experience and how it could apply to New York’s power markets, see C. Komanoff, Riverkeeper/Pace Law Sch./NRDC, Securing Power Through Energy Conservation and Efficiency in New York—Profiting from California’s Experience [4], May 2002, available at www.riverkeeper.org.

1.1.5 The Concept of the Public Utility

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