Extension of the Social Control of Utilities

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Selecting the Recipe

There now is general agreement that the regulation of business is a normal function of government, providing the institutional and legal limits as well as many of the instruments through which business can be carried on. And since the behavior of business inescapably affects the general welfare, it is right and proper that the visible hand of regulation be substituted for the invisible hand of Adam Smith. But, as with most policy, the extent and character of that regulation is what is at issue. This paper (1) suggests the extension of the public utility concept to the national defense industry of airframe manufacture, and (2) argues for bold institutional inventiveness in the elaboration of the yardstick principle of regulation and social control of existing utilities through regionalizing state regulatory commissions.

Old Wine, Old Bottles

Independent commission regulation is of course only one form of many in the matter of public control—administrative regulation by boards, departments, agencies of myriad types and topics characterizes the business scene. It is widely felt that the regulatory process has largely become an ubiquitous element in national life and that most signs point to its continuance and extension.¹ And while government activity (generally labeled "participation" by supporters and "interference" by detractors) often ad-

vances and seldom retreats, we move in this direction with heavy ambivalence. Traditionally slow to embrace "big government," we yet look to governmental solutions for the many new problems that stem from the additional complexities of economic activity, greater sectional interdependence, technological changes, and international uncertainty. For purposes of later exposition it is perhaps helpful at the outset to recall the pertinent history and status of the public utility concept—that particular dimension of government activity that is of chief concern here.

The now well-trodden path from Chicago's *Munn vs. Illinois* in 1877 to New York's *New State Ice Case* of 1932 is lined with the inclusion of utility industries uniquely designated as "affected with the public interest." Those sixty years of sustained litigation and judicial argumentation did little to clarify the concept as to just what it was but did much to support the fact that it was assuredly a legal creation, not to say legal fiction. Then the Nebbia Case in 1934 marked the passing of the public utility concept—it is persuasively argued—by finding that whether or not the milk business was a public utility it is affected with the public interest and the legislature could fix prices in the industry without contravening the Fourteenth Amendment. For our purposes, however, the Nebbia Case can conversely be looked on, not as killing the concept but rather allowing for its expansion, for now it was left to the legislatures to decide which industries should be so blessed.

Whatever its imprecision in legal terms, the public utility concept has been given in the literature of the period ample definition in social science terms. Characteristically the buyer is disavantaged in facing the seller in that the service (perhaps product?) is essential, bought continuously by many small consumers with urgent needs that are not postponable, and has no acceptable alternatives. Further, internal cost structures of the firm—fixed and variable cost relationships, economies of scale—and resource duplication are generally to be considered in appraising a candidate for utility regulation. The summary point is that the economist, while admitting a lack of neatness in the distinction between utility and non-utility categories, finds "a social evaluation of private industries that is based more on the managerial behavior and the social significance of the industries than on the technical characteristics of utility markets and services." But it is to these two aspects—social significance, and technical firm and market characteristics—that the case for extending the public utility concept to the airframe manufacturers is tied.

*New Wine, Old Tasters*

A slight disclaimer is perhaps in order at the outset. This appraisal of the airframe companies in terms of the traditional tests for public utilities is designed to be illustrative of the kind of analysis necessary to make such a determination and is not intended to be definitive on such a large and complex matter. The fact remains, however, that the public utility concept has occasionally been referenced or obtusely hinted at in connection with the aircraft industry and surely

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2 Ibid.
3 *Munn v. Illinois*, 94 U. S. 113 and *New State Ice Co. v. Liebmann*, 285 U. S. 262, respectively.
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is worthy of examination as an alternative means of controlling profits and insuring supplies. The fact that historically only the service industries have come under the utility umbrella seems to present no special problem to the standard. For one thing, since the Nebbia Case, serious doubt has been cast on the legal exclusion of product industries; for another, whether a product or a service is at issue is surely not a key determinant in the essentiality aspect of the standard; and finally, it could be argued broadly that what the airframe manufacturers produce after all is a service—that of national security. Moreover, few would contend that the service is not of unusual public significance and apparent, long-lasting duration. In fact, on the former point, on one occasion in 1962 in a court case involving the Boeing Company (supra, footnote 5,) government lawyers cited Munn vs. Illinois in labeling the contractor's business as "affected with a public interest." (It is, of course, very doubtful that the government was prepared to accept all the institutional changes that its line of argument there implied but the point of this section is that perhaps it should.)

On the latter point—the length of the Cold War—while one might make the case that giving any quasi-government permanence to a substantial part of the armaments industry would play into the hands of those who characterize the United States as a "warfare state" and would be hurtful to any arms control and disarmament climate, the case might equally be made that even an arms control agreement would not necessarily lessen significantly the national demands on the industry in terms of exotic inspection vehicles and apparatus.

Before attempting any appraisal of the airframe industry it is necessary to set out some of its distinguishing features. The industry is effectively comprised of nine companies: Boeing, Convair, Douglas, Lockheed, Martin, McDonnell, North American, Northrop, and Republic. They receive annually about thirty per cent of the military procurement dollar for the research, design, development and production of aircraft, missile assemblies, and electronic systems, attesting to the well known heavy concentration in the defense industry. Military sales as a per cent of total sales are extremely high (almost 100% in some cases) and those that have significant commercial sales can, with some cost-assignability problems, sort these activities out. Government furnished equipment (GFE) in the form of plant and equipment is very substantial and from this it has followed that, while profits as a per cent of sales are relatively modest, they are highly favorable when figured—as they properly should be—on return on the investment. Considerable economies of scale are present—especially in the expensive matter of research and development where cumulative engineering

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6 Writing in 1961 about the defense burden Schlesinger opines, "The aircraft industry may properly be viewed in many respects as a public utility— which the government must be prepared to subsidize and bail out in the case of difficulties." (Emphasis supplied.) J. R. Schlesinger, "Will the Defense Burden Be Lighter?" Challenge, June 1961, p. 32. See also the Boeing Tax Court Case where government lawyers compared Boeing with public utilities and "other concerns whose profits are fixed by regulatory agencies and courts." Boeing Company, Petitioner v. Renegotiation Board, Respondent, Docket No. 935-R, filed January 10, 1962.

skills and preparation, presentation, and representation are critical. As with production economies of scale, this may serve as an effective barrier to entry. And though ease of entry is not characteristic of the industry, involuntary exit is extremely low. Thus while it is a widely held belief that the airframe industry is very risky because of internal uncertainties of the unpredictability of Research and Development outcomes and external vagaries of doctrinal shifts, ready capital flows into the industry, earnings are strong and government-procurement policies are decidedly favorable to the weapons firms bringing this view of riskiness into real question.\(^8\) Finally, the buyer-seller relationship between the government and the industry and within the industry as to price, product, and performance is essentially non-market in character.

How well, then, might the industry "fit" as a public utility? Clearly any suggested answer must involve consideration of what the new institutional outlines of the industry would look like and what might be accomplished by the shift. The boundaries of the industry would have to be delineated in the legislation and a regulatory commission and staff set up—perhaps somewhat along the lines of the Atomic Energy Commission. The airframe companies could either be required to purchase the existing government-furnished plant and equipment and include this in their rate base to be earned upon—or required to continue with their existing facilities, earning a lower rate of return on them with some small provision made for the management of the GFE facilities. The determination of allowable operating costs, of the rate base "used and useful" in doing business, and of the rate of return which would allow earnings that would attract new capital, would become the familiar task of the regulatory commission. And all this consistent with satisfactory standards of product performance.

The results to be hoped for are those approximating the venerable tests of workable competition: prices that show a reasonable relation to costs; earnings which show a reasonable relation to risk; efficiency in resource allocation through, for example, avoiding the competitive excesses of hoarding technical personnel, squandering scarce creative skills, and duplicating research and design efforts; and innovational advances by removing the pressures toward preoccupation with tangible and immediate production consequences in the firm’s development efforts. For labor it could mean stable employment at a long-run maximum average wage; for management more stable earnings prospects; and for the public a minimum long-run price and high quality product.

Such treatment of the airframe manufacturers would place them midway between the arsenal concept with its direct government ownership and their present private but privileged position. Making them public utilities might secure the best of both worlds for the country at large—for whose benefit, ultimately, national security expenditures are made. Surely any arrangements where disputes over the amount of excess profits realized by an airframe company in a single year can range from zero to $20 million does not inspire great confidence in the precision of present statutory controls.\(^9\) Current revisions of procurement policies

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\(^8\) Procurement policies here referred to include cost-reimbursement type contracts, spreading of contracts, cancellation penalty provisions and the advent of weapon system manager and single source procurement arrangements.

\(^9\) Boeing Case, \textit{op. cit.}
and practices may relieve some of the
grosser problems noted but this pro-
posal suggests a whole new institutional
arrangement.

New Wine, New Tasters

In the field of utility regulation, new
ideas are infrequent in generation and
interminably slow in implementation.
The twin obstacles of institutional iner-
tia and active disinterest are formidable
indeed. A persistent criticism is properly
levied that commissions act only in nega-
tive (or passive) fashion—regulating
only profits and preoccupied with
property rights, accounting procedures and
reporting forms; thus abdicate entirely
from any creative role of directing and
shaping the character of the industries
regulated. This need not be so for the
opportunities for institutional inven-
tiveness and innovational regulation are
many and the need for a utility industry
coaxed, cajoled—even coerced—toward
social objectives that are essential to a
modern mature economy is great. Bold
experimentation is thus called for in
schemes of both direct and indirect
controls. One of these is the further elabora-
tion of the yardstick method of regula-
tion.

The doctrine of yardstick regulation
was formulated to achieve some sort of
measuring device for the making of pub-
lic policy regarding efficiency, quality of
service, and reasonable prices in the
affected industries. Also the existence of
a public enterprise, e.g., a municipal
electric plant or a TVA, in an area along-
side private plants in the same service
industry has had the residual effect of
depressing rates to consumers of the pri-
ivate service—another type of regulation
by force of example. 10

It is here proposed that we consider
nationalizing (with appropriate com-
ensation, of course) one East-West and
one North-South railroad and one trans-
continental and one feeder airline for
purposes of finally getting at the actual
experience data essential to optimum
regulatory policy and, if the operating
experience so indicated, keeping rail and
air transport rates "in line" at reason-
ably low levels. 11 From this experiment
would hopefully flow significant data on
operating costs under varying conditions,
the shape of the illusive long-run average
cost curve, and the applicability of the
economies-of-scale argument to the in-
dustries. On the demand side a shaft of
light could be shed on the relative
elasticities of the services, their substitu-
tabilities, the effects of experimental
pricing or earnings, and even a possible
resolution of the long-standing argu-
ments in the literature on marginal cost
pricing in the transport industry. It
would provide "living laboratories" for
the introduction of innovational devices
and policies and organizational arrange-
ments previously untested or inade-
quately tried, including matters of facil-
ities design (e.g., freight and passenger
terminals) and managerial controls. Fi-
nally, to the extent that the operation of
these enterprises provided reliable data
for commissions to use in regulation and
at the same time had the implicit effect
of depressing transport rates and en-
hancing service, the idea is consistent
with the thought expressed in Professor

10 Depressed rates is here equated with increased
    corporate welfare as well as increased consumer wel-
    fare for the total receipts; and savings of the private
    plants have generally risen as a result of the elastic-
    ities involved.
11 Choosing one East-West and one North-South
    railroad is, of course, designed to get at operating
    experiences—climate, terrain, traffic flows, etc. For
    the same reason one transcontinental and one feeder
    airline are suggested for experimentation.
James Bonbright’s famous phrase, “the minimum squawk theory of regulation.”

A second suggested institutional innovation is the abandoning of the traditional form of state regulatory commissions. The inauspicious history of the state-commission concept with its more recent distortions and deterioration of effectiveness—some would say decline and fall—is often cited and well documented in the scholarly literature on the subject. The problem is in part the conservatism of the courts, more the inadequacy of the legislation, and most of all the quality of the commissioners and their staffs.

The axiom that every state must have its own commission and policies for the regulation of electric and telephone companies—which are generally organized on an interstate basis—deserves re-examination and may well turn out to be an encumbering fiction. Surely the New England states have more in common from a regulatory standpoint than they have in differences: likewise the Rocky Mountain, the Pacific and the Southwestern states. Regional public utility commissions, then, could be organized so as to reflect reasonable operational commonality much as motor rate bureaus and the Federal Reserve Banks have been districted. This arrangement would permit the regional standardization of regulatory policies and the equalization of their effects between states within the region; would provide larger appropriations for the hiring of a larger and more competent staff; would allow large-scale economies of control not available to state commissions; would insulate commissions from harmful local pressures; and would enhance the commissions’ position by making them more the equal of the industries they are designed to regulate.

It is all too true that sound, socially effective, rational regulation is not realizable through quick leaps but rather is evolved in faltering stops and starts. Yet after thirty years of relative dormancy it may be timely to try a few new steps.

12 In the former case the New England Motor Rate Bureau, the Middle Atlantic, the East-Central, and the Southern Motor Rate Bureau are examples.