Regulating Public Utility Performance:
The Law of Market Structure, Pricing and Jurisdiction

Chapter Two

The Traditional Utility Monopoly

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> *[F]ar from affecting the public injuriously, [the government-granted franchise] has become one of the most important agencies of civilization for the promotion of the public convenience and the public safety.*[1]

For most of the twentieth century, the market structure faced by most retail consumers of electricity, gas, telecommunications and water was a monopoly. The incumbent provider was a vertically integrated company, government-selected, providing prescribed services within a defined territory at approved prices. Supporting this market infrastructure was a legal infrastructure, called a franchise: a "special privilege," granted by the state government to the utility, to provide defined services subject to defined obligations.[2]

The franchise relationship comprises rights, obligations, powers and protections, all designed to align the incumbent's self-interest with the public interest. It typically has seven distinct dimensions:

1. *Exclusive retail franchise*: The utility's right to be the sole provider of a government-prescribed service within a state-defined service territory.
2. *Obligation to serve*: The utility's obligation to serve all customers in that service territory, without undue discrimination.
3. *Consent to regulation*: The utility's consent to all reasonable regulation.
4. *Quality of service*: The utility's obligation to meet service quality standards established by the regulator.
5. *Power of eminent domain*: The utility's power to take private property when necessary to satisfy its public service obligation.
6. *Limit on liability*: The utility's protection from lawsuits for ordinary negligence.

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1. New Orleans Gas Co. v. La. Light Co., 115 U.S. 650, 669 (1885).
2. *See id.* at 669 (describing a franchise as "belonging to the government, to be granted, for the accomplishment of public objects, to whomsoever, and upon what terms it pleases"); Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 519, 595 (1839) (describing franchises as "special privileges conferred by government upon individuals, and which do not belong to the citizens of the country generally of common right"). Courts also have distinguished a "franchise" from a "license." In *McPhee & McGinnity Co. v. Union Pac. R.R. Co.*, 158 F. 5, 10 (8th Cir. 1907), the Court explained that while a franchise is

   > [a] right or privilege which is essential to the performance of the general function or purpose of the grantee, and which is and can be granted by the sovereignty alone, such as the right or privilege of a corporation to operate an ordinary or commercial railroad, a street railroad, city waterworks or gasworks, and to collect tolls therefor, . . . [a license is a] right or privilege not essential to the general function or purpose of the grantee, and of such a nature that a private party might grant a like right or privilege upon his property, such as a temporary or revocable permission to occupy or use a portion of some public ground, highway, or street. . . .

7. *Just and reasonable rates*: The utility's right to charge rates set by the regulator, designed to provide a reasonable opportunity to earn a fair return on equity investment.

This Chapter discusses the first six dimensions of the monopoly franchise and their many variations. Chapters 3, 4 and 5 address policymakers' efforts to introduce competition into these historically monopoly markets. Just and reasonable ratemaking will occupy Chapters 6–11.

2.A. Exclusive retail franchise

A retail franchise is exclusive when the state (a) defines a geographic area, (b) prohibits retail competition for a particular set of services within that area, and (c) appoints a company to be the sole seller of those services. While the term "exclusive" sounds absolute, it is a theme with variations. After illustrating exclusivity granted expressly by statute, we discuss seven variations. Each variation injects uncertainty or impermanence. The ultimate in impermanence is the state's power to revoke a franchise and transfer it to a better performer.

2.A.1. Exclusivity express in statute

South Dakota's statute grants an electric utility company the sole right to serve in its assigned territory, permanently:

> Each electric utility has the exclusive right to provide electric service at retail at each and every location where it is serving a customer as of March 21, 1975, and to each and every present and future customer in its assigned service area.[3]

For existing and new customers, the incumbent utility is the only option.

Until when? Legislatures have three options and a variation on them. First, where the statute grants exclusivity with no express term limit (the South Dakota situation), exclusivity lasts until the Legislature changes the statute. Second, the statute could fix the term; Nevada's statute prescribes 50 years.[4] Third, rather than fixing the term, the statute could authorize the Commission to set the term, thus implicitly or explicitly allowing rivals to compete periodically to be the next franchisee. (*See* the discussion of franchise competition at Chapter 2.A.2.f below.) Finally, each of these approaches could authorize the

3. S.D. Codified Laws § 49-34A-42.
4. *See* Nev. Rev. Stat. § 709.210 ("If, upon the hearing of the application, it appears to the satisfaction of the board of county commissioners that the applicant is engaged in the business of furnishing electric light, heat or power within two or more counties of this state and that the granting of the franchise is in the best interests of the residents of the county, the board of county commissioners shall thereupon grant the franchise for a term not exceeding 50 years.").