Perspective on Strandable Investment in the Electric Power Industry

Presentation of Peter A. Bradford
Before the City Council of New Orleans
October 9, 1997

The following is testimony presented by Peter Bradford at a meeting exploring electric restructuring topics, specifically stranded cost recovery, held by the New Orleans City Council. The City Council had opened an investigation into electric competition in mid-1996, and since has held two public hearings. The City Council through home rule authority regulates retail electric rates. The Louisiana Public Service Commission also has opened a restructuring docket. Entergy-New Orleans is a major player in both proceedings, and on September 17 it filed with the Council its proposal for the transition to a competitive market, asking for a six-year transition period, and 100% stranded cost recovery, which includes its interest in the Grand Gulf nuclear plant.

Strandable investment consists of money invested in power plants that are too expensive to recover their full costs at today's market prices. In most industries, such investments must be written down until competitive prices cover the remaining costs. However, electric power customers must rely on monopoly transmission and distribution systems for access to inexpensive power plants, so surcharges for the use of those wires can be used to recover the costs that a competitive market would "strand." The issue facing states and cities around the country is whether and to what extent to permit such surcharges.

Those who support recovery of uncompetitive investment say that such recovery, presumably reduced by the extent to which low cost plants can recover more than their cost, is a matter of constitutional right or basic fairness, to be recognized before bargaining starts or balances are struck.

However, you are not bound to allow full recovery of strandable investment within your jurisdiction. New Orleans has the power to set its own agenda with regard to restructuring and to develop a strandable investment policy that furthers that agenda. You may find compelling policy reasons to permit some level of recovery, but you need not accede to the utility gambit of claiming full recovery as an absolute right while deferring discussion of other public interest items until your greatest leverage is gone.
This morning I will explain why the utility claims of an absolute right to full recovery are overstated. I will show

- that the Constitution does not require full recovery,
- that the asserted regulatory compact does not exist,
- that neither state commissions nor courts are accepting the sweeping utility claims of entitlement.

I will show also

- that regulatory practice and theory have allowed the disallowance or loss of prudent investment in the past,
- that the risk for which investors command substantial returns includes some risk of such loss,
- that not all investment presently in rates can be considered prudent.

Finally, I will discuss approaches being taken in a number of other states as well as options that are available to you.

The Regulatory Compact Does Not Exist

This disclosure evokes the same expressions of horror and derision as met the youth who pointed out that the emperor wasn’t wearing any clothes, and for the same reason: it exposes much that is embarrassing to courtiers and to monarchs.

After all, the phrases "regulatory compact" and "regulatory bargain" have robed the decisions of the Federal Energy Regulatory Commission (FERC) and the last two reports of the President’s Council of Economic Advisors. They are used with casual familiarity by distinguished professors and economists and by some regulatory commissions. Who am I to tell you that the fabric isn’t there?

Well, it isn’t.

It just isn’t. And there hasn’t been a search for a nonexistent compact to match this one since Harrison Ford set out to find the long lost Ark of the Covenant in Raiders of the Lost Ark.

I began regulating utilities in Maine in 1971. I did so in Maine, Washington D.C. and New York for twenty-five years. I do not recall encountering the terms "regulatory bargain" or "regulatory compact" until 19851. Even then, the term was always used by those alleging that the compact had been broken. Yet they now claim that investors put billions of dollars into the electric industry in reliance on a compact of which they had never heard until its breaching was being decried weekly by prominent financial spokesmen and utility executives.

This is not a point that needs to rest on my memory or on my opinion. None of the standard texts on utility regulation written before the mid-1980s mentions the regulatory compact. I have testified on this point in cases involving stranded investment claims in excess of ten billion dollars. None of the utility witnesses has offered any factual proof to the contrary.

Furthermore, two central tenets of the alleged compact - that utilities have a right to full recovery of prudent investment and that they have accepted exclusive franchises in return for their obligation to serve - cannot be reconciled with regulatory practices that are common in many states. Here are three examples:

First, many states as well as FERC have disallowed investment that was not "used and useful", even if it was prudent when made. State and federal reviewing courts have sustained this policy.

Second, courts have held for many years that regulation is not required to compensate investors for prudent investment undermined by competition and technological advance. This point is particularly important in the context of restructuring. Utilities argue that change in government policy is solely responsible for stranding and that government must therefore assure compensation2. However, changes in electric generating technology are at least equally responsible for stranding. Retail customer choice in the absence of combined cycle gas generation would pose a far smaller challenge to existing values, and technological change is a risk which investors have borne in large part. When strandedness is understood to result from technological change and from competitive forces as well as from changes in government policy, the claims that a governmental "taking" is occurring are substantially undermined.

Third, some states do not offer exclusive franchises. In a jurisdiction in which the franchise is not exclusive, a utility cannot credibly argue that investors have had a bargain that protected them from a governmental decision to allow competition.

In short, there is no basis for the claim of a nationwide regulatory compact, clearly understood by regulators and investors alike, stretching back over the decades. Instead, regulatory practices have varied widely among the 50 states and have given rise to different investor hopes and expectations in every jurisdiction.

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1 Bruce Louiselle, now testifying to the compact on Entergy’s behalf, was a frequent witness before the Maine PUC during the 1970s. I do not believe that he or his firm ever mentioned the regulatory compact. No doubt he will provide proof if my memory is incomplete on this point.

2 Note, however, that they tend not to follow this logic when it comes to exit fees, which would be a significant and costly change in the expectations of customers with regard to historic regulatory arrangements.

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template ever fit them all.

This is one reason why compact proponents have fared poorly in recent proceedings. As far as I know, no court has endorsed anything like the claims being made in Louisiana. Certainly no state or federal court ever mandated full recovery of prudent investment as part of the transition to competition in the telephone or gas industries. A New York Supreme Court decision rejected arguments based on the regulatory compact last year, as did the regulatory commissions in Vermont, New Hampshire and Texas.

The absence of a compact does not mean that utilities have no claim to recover stranded investment. Such claims must be assessed in the context of the law and the practices in each jurisdiction. There may be specific bargains that should be honored. There may be investments ordered by the state. However, the utility claims can be balanced against others that are before you in the context of restructuring.

The Government Didn't Make Them Do It

One of the more daring efforts to toss dust in regulators' eyes in the compact discussions is the claim that utilities built nuclear power plants because the government wanted them to do so. When, as with the Public Utility Regulatory Policies Act of 1978, the government adopts policies to which utilities object, years of litigation and evasion follow. No doubt the City Council can recall times that it has expressed a desire for an action that the power company did not perform. There is no such history of reticence with regard to federal endorsement of nuclear power.

I have yet to see an order from any government agency requiring a utility to develop nuclear power, to build a specific plant or to keep building a plant that it wanted to cancel1. The National Energy Plan of 1977 described nuclear power as the "option of last resort". The decisions of Presidents Ford and Carter to oppose nuclear fuel reprocessing and the breeder reactor were met with massive opposition from the nuclear industry.

National or state energy plans endorsing nuclear power as one way to diversify energy supply are a far cry from a mandate to build a specific plant at a specific site at a multibillion dollar cost. Many utilities did not go nuclear. Many others canceled plants when costs outran demand.

Of course, where actions were taken in response to specific government mandates, the case for recovery of prudently incurred costs is strong. Prudent decommissioning costs should also be recoverable (although these costs presently travel with the nuclear kilowatt hours, not with the wires).

However, it is important to be precise as to what was actually mandated and what was within utility control. A governmental approval of a utility application is not an order to perform that action, and a governmental approval based on a cost estimate of $1 billion is not a blank check for a $4 billion power plant.

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1 When the Department of Energy did, in 1989, seek a court order requiring a reluctant Long Island Lighting Company to operate the Shoreham nuclear plant, a U.S. Court of Appeals rejected the unprecedented petition, stating that DOE was seeking to convert a license to operate Shoreham into a sentence to do so.

Peter A. Bradford is currently a consultant advising and teaching on utility regulation, restructuring and energy policy in the U.S. and abroad. In 1985 and 1990 he taught and advised on utility restructuring issues in Indonesia, India, Russia and Armenia. He chaired the New York State Public Service Commission from 1987 until January, 1995, and the Maine Public Utilities Commission from 1982 until 1987. He was Maine's Public Advocate in 1982 and served as President of the National Association of Regulatory Utility Commissioners during 1987. He served on the U.S. Nuclear Regulatory Commission from 1977 until 1982. During his term, the NRC undertook major upgrading of its regulatory and enforcement processes in the wake of the Three Mile Island accident.

Prior to becoming a member of the NRC, he had served on the Maine Public Utilities Commission (1971-1977) and was Chairman in 1974-1975.

Mr. Bradford served as an adviser to Maine Governor Kenneth Curtis from 1968 to 1971, with responsibilities for oil, power and environmental matters. He assisted in preparing landmark Maine Laws relating to oil pollution and industrial site selection and was Staff Director of the Governor's Task Force on Energy, Heavy Industry and the Coast of Maine.


He is a 1964 graduate of Yale University and received his law degree from the Yale Law School in 1968. Upon graduation from law school, he worked for Ralph Nader during the summer of 1968 on a study of the failure of the Federal Trade Commission to enforce federal consumer protection laws.

He is married and has three children.
Investors Have Been Compensated for the Risk of Substantial Loss

Aside from the legal claims being made, it is often argued that investors are being treated unfairly because they could not foresee the possibility of competition until the early 1990s. This claim is factually dubious and in any case is beside the point.

It is factually dubious because the possibility of competition has been widely discussed within the electric industry at least since the early 1980s. Obviously the probabilities have increased in recent years, but we are not talking about a bolt from the blue, of which investors had no warning.

Also, investors have long been on notice that regulators could not protect them from the possibility of substantial loss. In April, 1974, burdened by power plant construction costs, Consolidated Edison Company of New York omitted its dividend payment. Leonard Hyman, former head of the utility research group at Merrill Lynch, describes investor reaction as follows:

"Con Edison's dividend omission hit the industry with the impact of a wrecking ball. It smashed the keystone of faith for investment in utilities: that the dividend is safe and will be paid. Wall Street firms, at the behest of panic-stricken clients, prepared lists that showed which utilities were in bad shape....Investors had to accept the possibility of financial risk in utility securities."

A decade later Cincinnati Gas and Electric announced in October, 1983, that it could not afford to complete the Zimmer nuclear plant. According to Hyman, within twelve months, six utilities cut or omitted dividends, almost $6 billion of construction effort was consigned to oblivion, and the stock prices of the affected utilities fell 60-80% from their 1983 highs....the message was clear. Utilities with serious problems caused by construction failures and extreme cost overruns would not be made whole by regulatory agencies. Investors could not depend on regulators for guaranteed returns or for bailouts."

In short, electric utility investors have known for many years of the possibility of substantial losses, especially in utilities building nuclear plants with large cost overruns. Many of today's investors bought their stock at prices far below book value and far below today's prices. Many others chose to hold their stock through those difficult times. Claims that all investors confront profound inequity if any prudent cost goes unrecovered mock the concept of risk, which is by its nature not entirely foreseeable.

The risk that generation costs would fall and that customers would find ways (including demanding governmental changes to the market structure) to take advantage are not risks from which utility investors have ever been entitled to complete protection. Electric utility investors have known for many years of the possibility of substantial losses, including bankruptcy. That these risks may have been greater than they perceived or have come from a different direction does not compel the imposition by regulators of an unconditioned stranded investment tax to assure full recovery.

Furthermore, electric utility investors have not fared badly relative to investors generally over the last quarter century. Indeed, studies performed by the staff of the National Association of Regulatory Utility Commissioners show that as of 1992 electric utility investors had done slightly better than investors generally over the two previous decades. Even utility cost of capital witnesses make the same point.

Economist Robert Michaels reinforces this conclusion with the observation that between 1977 and 1991 electric utilities beat the market on both return and risk, while their managements were putting in place about $200 billion of unneeded capacity whose economic value would turn out to be zero."

If electric utilities have really kept pace with industrial companies, whose investors accept the risk of bankruptcy and adverse governmental action, then surely utility investors too have been compensated for the risk that some of their investment will be lost, by stranding or by some other means. This conclusion is reinforced by the fact that most utility stocks have traded significantly above book value for all or most of this era. This condition can only occur if they are earning in excess of their bare market cost of capital, that is, in excess of the constraint to which they have ostensibly agreed as part of their obligation under the alleged compact.

Not All Investment Currently in Rates Has Been Found to be Prudent

Another premise of the argument for a guaranteed right of full recovery is also flawed. This is the assertion that all investment currently reflected in rates is assuredly prudent.

The City Council doesn't need me to remind them of the resistance this region encountered when it tried to

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4 See the testimony of Charles Benore before the Kansas Corporation Commission in the Western Resources/Kansas City Power & Light merger, "Because historical returns for electric companies for the last five, ten, and twenty years ending in 1993 were comparable to the market, or the S&P 500, it is evident that investors have succeeded in being rewarded for risk beyond that implied by the unadjusted betas". (pp. 50).

5 "Stranded Investments, Stranded Intellectuals", Regulation, Volume 19, No. 1, June, 1996.
undertake reviews of the prudence of the cost of Grand Gulf. And, of course, FERC declined ever to do a prudence review on the dubious ground that it had not been asked to do so.

Grand Gulf aside, mismatches in resources between regulatory agencies and the dollar volumes that they deal with assure that much utility investment is never scrutinized for prudence. In many jurisdictions, active utility involvement in the commissioner selection process, the setting of regulatory budgets, the defining of regulatory jurisdiction and the influencing of regulatory outlook is impossible to reconcile with the concept of a statesmanlike regulatory compact.

Judge Stephen Williams made the same point in a more scholarly manner in a recent NYU Law Review piece in which he wrote of assertions of regulatory perfection in establishing prudence, "First, this may be empirically wrong in many cases—that is to say costs are commonly not evaluated by the regulatory agency at all unless challenged in a rate case. But more generally, if one of the defects of regulation is that we doubt the ability of regulators to identify inefficiency, the fact of their failure to do so proves little... Can one clearly say that there is a compelling principle of political economy requiring compensation for one hundred percent of the losses attributable to inefficiency?"

Put another way, those who have zealously emphasized and abetted the shortcomings of regulation are poorly positioned now to allege that it has established prudent costs perfectly to the penny.

Approaches Taken in Other States

Having established that the City Council has considerable flexibility in evaluating claims regarding stranded investment within its jurisdiction, it is useful to review experience in other states.

As noted earlier, states are showing scant inclination to accept utility claims of an entitlement to full recovery. New York and New Hampshire have explicitly refused to set rates assuring full recovery where they consider the resulting rate levels to be unacceptable. Others have, without explicitly disputing the issue, put into place rate plans in which full recovery is uncertain. Still others have extracted or imposed conditions on full recovery, implicitly rejecting the claim that full recovery is a matter of right.

Examples of such conditions include:

- the agreement of the New England Electric System to full divestiture of its generating units together with rate decreases and environmental enhancements. Because this divestiture has produced prices well above forecasted levels, it will produce revenues sufficient to offset most stranded costs and provide rate reductions larger than were originally expected; Maine has also required divestiture of generation by 2000;

- California's incentives for divestiture of half of each utility's fossil fuel capacity;
- Maine's requirement that no distribution utility can market electricity to more than 33% of the customers in its service territory;
- Maine's requirement that a high percentage of its energy come from renewable resources;
- Even FERC's broad endorsement of an opportunity for full recovery must be seen in the context of a trade-off for open transmission access, for FERC's past ratemaking practices included disallowance of prudent investment in both the electric and the gas industries.

Possible Criteria and Conditions for Allowing Strandalbe Investment Recovery

Each jurisdiction that is undertaking restructuring is striking its own balances. Utilities with stranded investment exposure start out from positions similar in many respects to those put forward in Louisiana. Regulators, however, are setting their own terms for recovery.

These terms fall into several categories, all of which are available to you as you evaluate the best structure for New Orleans:

The first of these categories is the promotion of effectively competitive markets. This is an extensive topic in its own right, but the essence of the dilemma is to avoid creating unregulated market dominance in the guise of deregulated competition. As policies to this end, states include such measures as divestiture of generating plants, commitments to relieve transmission constraints through construction of necessary facilities, divestiture of retail marketing operations, and requirements to file with FERC Independent System Operator plans with real independence and the necessary powers to construct and operate a system that truly provides open access. Separation and even divestiture of gas from electric distribution properties is also a possibility.

The second category is more the traditional consumer protection function. Specific steps can include rate reductions, long term rate freezes, performance-based ratemaking, service quality and mitigation of stranded investment. In the category of mitigation, some states have adopted "securitization" of stranded investment. Securitization provides no net gain in efficiency to U.S. society as a whole. It shifts costs among present and future customers, and among customers and taxpayers, in ways that give rate reductions to today's customers. However, such rate reductions have some potential to alleviate restructuring impacts, so limited securitization used wisely may be of some use.

The third category has been termed "stranded
benefits. Investors after all aren't the only ones with fairness claims that may be stranded by the shift to competition. Low income customers, employees, the environment and taxes supporting public services may all be affected. Proposals to cushion these impacts often focus on the same type of nonbypassable 'wires charge' proposed by utilities to collect stranded investment. Other innovations have also appeared in the environmental area, such as requirements to enable customers to buy power from sources that they consider environmentally acceptable. This in turn entails requirements for disclosure by marketers of the fuel sources of their supply, a concept of customer information analogous to nutrition labeling in grocery stores.

Many of these measures are argued to be beyond the direct power of regulators. That is why stranded investment needs to be one of the issues "on the table" as restructuring proceeds. The willingness of utilities to agree to measures that the City Council finds desirable may otherwise be very much in doubt.

**Conclusion**

Utilities sometimes argue that until full stranded investment recovery is assured, they must slow the pace of restructuring, thereby deferring the benefits of competition.

Acquiescence to this give-me-mine-and-then-we’ll-discuss-yours approach to negotiation or to major societal change will not produce satisfactory or stable results. Utility resistance to many desirable changes in industry structure has already manifested itself. It will not go away if the companies are guaranteed stranded investment recovery at the outset. Instead, market power problems, to name an obvious example, will delay the benefits of competition through long and litigious years.

Strandable investment recovery will expedite real competition only if it is conditioned in ways that keep the incentives on the side of the public. Strandable investment is the public’s best leverage to an effectively competitive and an environmentally acceptable future. Those in the public sector should not give it away until that future is well secured.