

Franchise Competition in the Electric Utility Industry

Franchise competition is—and should be—an integral part of enhanced competition. It serves the traditional goal of encouraging lower costs through the threat of takeover or purchase. However, the issue of utility recovery for stranded costs stands as a major unresolved question affecting customers' ability to partake of this central aspect of competition.

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One day in the near future, when some enterprising soul writes the textbook on what happened when competition collided with the electric utility industry, one of the early chapters will no doubt assess the "powder keg" topic of franchise competition.

In its simplest context, franchise competition means potential displacement of one utility by another for service to retail consumers. Although one investor-owned utility may compete to displace another at the retail level, fran-

chise competition normally entails replacement of one type of electric utility by another.

The two most notable examples of franchise competition are:

- *Municipalization*—forming a municipal utility; and
- *Privatization*—supplanting a municipal utility with a private entity.

Consumers dissatisfied with local rates or service may change suppliers in the hopes of bringing lower costs and better service. A recent large and highly publicized municipalization effort is that of

Las Cruces, New Mexico, which, on August 30, 1994, voted 2-1 to establish a new municipal utility to displace El Paso Electric Co., its current retail supplier.¹ Las Cruces selected another private utility, Southwestern Public Service Co. (SPS), as its wholesale power supplier and expects SPS to provide local operation and maintenance, under the city's control, for an initial period.

While many other cities are likewise examining formation of municipal utilities, few have been formed.² In fact, more municipal utilities have been bought than formed in recent years.³

Some view franchise competition as a revolutionary new development. Others maintain that it is simply a continuation of a traditional form of competition, albeit one which could have the potential to accelerate based upon the new pro-competitive environment in the electric industry and the enactment of the Energy Policy Act of 1992 (EPAct), which authorizes the Federal Energy Regulatory Commission to order wheeling.⁴ A new FERC Notice of Proposal Rulemaking (NOPR)⁵ may put the brakes on franchise competition through municipalization, however.

What seems to have been lost in the current debate is an appreciation that franchise competition—the threat that a city will form a municipal utility or that an existing municipal utility will be purchased—is traditional in the electric utility industry. Formation of new municipal utilities has been fostered since the beginning of

this century by granting preference to municipalities and rural electric cooperatives in purchasing low cost federally developed hydroelectric power—the so-called “preference clause.”

Concern has been expressed that large awards for stranded generation investment will discourage franchise competition. Consumers who seek lower rates by displacing their current supplier (whether that supplier is an investor-owned utility, municipal

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utility, or rural electric cooperative) could be faced with paying for the high-cost generation they seek to replace. To the extent that consumers are in fact required to pay the costs they seek to avoid, they will have no reason to change suppliers, and franchise competition will not be a competitive threat.

This article seeks to place the issue of the formation of new municipal utilities in the context of franchise competition. It will then review a municipality's ability to condemn, address some valuation

issues applicable to conversion from one form of ownership to another, and, finally, discuss the thorny subject of “stranded investment.”

I. History and Theory of Franchise Competition

A. The Role of the Preference Clause in Fostering Franchise Competition

Competition based upon the different types of electric utilities (e.g., investor-owned, municipally owned, and rural electric cooperatives) has a long history, beginning when cities initially decided between taking service from investor-owned utilities or establishing their own electric utilities. Subsequently, many municipal utilities were sold and a number of municipalities formed municipal systems. At its height in 1923, there were 3,066 municipal utilities as compared with approximately 2,200 today.⁶

Nationally, franchise competition was encouraged through legislation giving a preference to “public bodies” (such as municipal utilities and public power districts)⁷ and to rural electric cooperatives in purchasing power from low-cost federally developed or licensed hydroelectric projects.⁸ Theoretically, customers of investor-owned utilities, which are *not* statutorily entitled to a preference, could decide to form a municipal utility based on a comparison of rates between the two entities.⁹ Franklin D. Roosevelt himself referred to a municipality's ability to form its own utility

as the "birch rod in the cupboard." In a 1932 speech, he stated:

I therefore lay down the following principle: that where a community, a city, or county, or a district, is not satisfied with the service rendered or the rates charged by the private utility, it has the undeniable right as one of its functions of government ... to set up ... its own governmentally owned and operated service [T]he very fact that a community can, by vote of the electorate, create a yardstick of its own, will, in most cases, guarantee good service and low rates to its population. I might call the right of the people to own and operate their own utility a birch rod in the cupboard, to be taken out and used only when the child gets beyond the point where more scolding does any good.¹⁰

FERC has stated that the preference clause provides that "birch rod in the cupboard":

The power purchasing preference is said to provide "yardstick competition" because ... it helps keep down the rates of those served by private utilities. As long as preference power is available to public bodies and non-profit cooperatives, private power interests will be forced to hold down their rates to attract and retain customers. Otherwise, existing public bodies and non-profit cooperatives, or new ones that may be formed, will claim a share of the preference power and compete for the industrial and commercial loads of the private interests, as well as their domestic and rural loads.¹¹

The very basis of the preference clause was to encourage franchise competition in order to keep rates low.

B. Lack of Transmission Access as Impediment to Franchise Competition

While the preference clause encouraged franchise competition, municipalities seeking alternative sources of power supply were often denied transmission access and therefore discouraged from forming a municipal system. To obtain transmission service, municipalities occasionally turned to

EPAct created the potential for enhanced franchise competition, but FERC's stranded investment policy threatens to close that door.

the antitrust laws.¹² Now that FERC has authority to order wholesale wheeling, however, municipalities need not resort to antitrust remedies to obtain transmission access.¹³

II. Current and Potential Impact on Franchise Competition of Energy Policy Act of 1992

One of the most profound developments affecting franchise competition has been the enactment of EPAct. That Act not only establishes a framework for more-competitive generation, but also

requires utilities to transmit power for newly formed municipal electric systems. In most instances, this effectively eliminates utilities' ability to stymie the formation of new systems by refusals to wheel power.

Although EPAct created the potential to open the door to enhanced franchise competition by municipalities, FERC has proposed to close that door by maximizing stranded investment recovery. FERC's NOPR could preclude franchise competition from municipalities based upon economics while not addressing incentives for investor-owned utilities to purchase municipally owned utilities. This section will focus first on expanded transmission access through EPAct and second on restricted competition through proposed stranded investment recovery.

A. Transmission Access

Pursuant to EPAct, utilities—including municipally and cooperatively owned systems—may seek an order from FERC requiring transmission service. Although FERC must grant such an order in most instances, there are a few caveats to such opportunities. *First*, a municipality seeking to establish a municipal utility may not be able to "line up" wheeling. Only utilities that "sell electricity,"¹⁴ or generate electric power at wholesale,¹⁵ may seek a wheeling order. This concern may be resolved, however, if the planned power supplier for the new municipal agrees to request the transmission service.

Second, FERC has accepted transmission tariffs which seem to deny transmission service to new municipal utilities serving customers formerly served by the filing utility—at least if the municipal utility is established solely to facilitate or obtain transmission service for ultimate consumers.¹⁶ This language could have a chilling effect upon formation of new municipal systems. In its NOPR, however, FERC has proposed both network and point-to-point service, which would be available to any electric utility eligible to receive service pursuant to EAct. If the NOPR is ultimately adopted, transmission tariffs filed thereunder would allow service to new municipal systems.

Third, EAct has an as-yet-untested provision prohibiting “sham wholesale transactions.”¹⁷ While this provision should not preclude wheeling to newly formed municipal utilities, it may discourage or delay their formation. EAct’s “sham transaction” provision was designed to preclude FERC from ordering “retail wheeling,” i.e., transmission directly to ultimate consumers. It does not, by its terms, preclude establishment of a municipal utility to serve a single industrial customer or industrial park. The authors anticipate, however, a challenge, based on the “sham transaction” language, to any request for transmission service to such a municipality.

If the above-cited caveats can be overcome, EAct may, at minimum, remove the “refusal to wheel” arrow from the quiver of

activities which have previously discouraged formation of municipal utilities. Possibly more importantly, the new competitive era for electric utilities could encourage all utilities to streamline their operations—as many have in recent years—thus removing the impetus for some to seek to change retail suppliers. This possibility is, however, threatened by FERC’s proposed “stranded investment” recovery, discussed in the following section.

A utility should have no more expectation of obtaining renewal of a franchise than of obtaining renewal of a wholesale contract.

B. Stranded Investment Recovery Proposal

In its NOPR, FERC has proposed that stranded investment be recovered on a “revenues lost” approach, i.e., the revenues the utility would have received from a departing customer, less the market value of the power foregone and the transmission revenue to be received from the departing customer.¹⁸ Questions raised by the Commission include: (1) whether projections and assumptions regarding future rate changes may be collected; (2) how

mitigation measures should be reflected in stranded costs; and (3) the time period for recovery of revenues lost (FERC suggested as possibilities one additional contract extension period or the length of a utility’s planning horizon).

FERC’s proposed approach has at least four potential effects. First, it will likely enable a utility to collect at least as much as it would have collected had the customer remained. Second, it will probably make formation of a municipally owned utility at least as costly as remaining a retail customer of a utility. Third, it is likely to discourage any utility streamlining based upon threats of formation of a municipal utility.¹⁹ Fourth, since it provides a forum for recovery of stranded costs for investor-owned utilities, but not for municipal utilities (which are non-jurisdictional), it will do nothing to discourage takeover of existing municipal utilities.²⁰

While the NOPR recognizes that stranded investment should be recovered only if a utility had a “reasonable expectation” of continued service, it links that expectation to state territorial laws and state-imposed obligations to serve.²¹ This contrasts with the linkage to a notice provision in contracts for wholesale customers.²²

In fact, an expiring franchise is analogous to an expiring contract. A utility should have no more expectation of obtaining renewal of a franchise than of obtaining renewal of a wholesale contract. This is particularly true where a

municipality (or a wholesale customer) has been publicly searching for alternative power supply.

To the extent that retail consumers do seek to change their local utility, potential new suppliers will still face obstacles, such as public relations battles for consumers' affections and the economic viability of the takeover.

III. Forming or Buying a Municipal System: Authority, Cost, and Regulatory Treatment

Prior to considering a takeover, a proposed new utility must determine: (1) whether there will be a cost advantage of a takeover; and (2) whether the cost of the takeover will be recoverable in rates. Even without cost savings, a takeover could result in a strategic advantage. For example, an investor-owned utility could expand its retail base, or a municipality could control its electric destiny. This section examines a number of issues relating to changes in utility ownership, including: (1) construction or purchase options; (2) authority to condemn; (3) valuation issues; and (4) ratemaking treatment.

A. Construction or Purchase Options

There are generally three alternatives for formation of municipal utilities: construction of a separate distribution system, condemnation, or voluntary purchase. While construction would be at book value,²³ either condemnation or purchase could be at above book value.

An investor-owned utility supplanting a municipal system, whether by purchase or by construction of a separate system, would normally require a franchise from the municipality to be served. Following any construction, the investor-owned utility would compete with the existing municipal system for customers unless the municipal utility voluntarily ceased operations. Such competition would normally be considered in any economic feasibility analysis.

Ohio municipalities have a constitutional right to 'acquire, construct, own, lease and operate' a public utility.

If an investor-owned utility lacks a valid franchise, the municipality may be able to construct a separate distribution system and oust the utility.²⁴ Otherwise, the municipality may be required to compete, door-to-door, for customers and must take such competition into account in its economic analysis.

While an investor-owned utility cannot take over a municipal system through eminent domain, a municipality may seek to condemn an investor-owned utility's facilities and, where applicable, its

franchise. In such a situation, one threshold issue is whether the municipality has the right to condemn. A second—and almost equally important—issue is the value of the system upon condemnation. Each of these issues is considered below.

B. Ability to Purchase or Condemn

Authority to purchase or condemn an existing system may be broadened or limited by state law. Additionally, authority to condemn rural electric cooperatives could be limited by Federal preemption.²⁵

1. *Authority to Condemn Investor-Owned Utilities.* Property in public use may normally be condemned if a municipality will operate such property:

If ... the purpose of such acquisition is to transfer the ownership and operation of such property from a public service corporation (which, although a quasi-public entity, is nevertheless a private corporation organized for profit) to a municipality or other purely public corporation, it has been held that the greater public use and increased public benefit which result from governmental operation justify such acquisition.²⁶

In many states, municipalities may condemn utility property pursuant to non-specific eminent domain authority.²⁷ Other states have specific authority. For example, Ohio municipalities have a constitutional right to "acquire, construct, own, lease and operate" a public utility and to acquire such utility by condemnation or

otherwise.²⁸ In California, a political subdivision may choose to condemn utility facilities either through the Public Utilities Commission²⁹ or through the California Code of Civil Procedure.³⁰

2. Authority to Condemn Rural Electric Cooperatives.

A municipality may seek to take over a rural electric cooperative—either totally or partially—through annexation. There are two opposing theories as to whether such takeovers would be pre-empted by the Rural Electrification Act (REAct).³¹

Rural electric cooperatives often have loans financed by the Rural Electrification Administration (REA). Two circuits of the U.S. Court of Appeals have held that allowing municipal condemnation of REA-financed rural electric cooperatives would frustrate the purpose of the REAct.³² Those courts reasoned that municipal annexation of a cooperative's most economically viable territory would frustrate the REAct's objective of providing reliable and low-cost power to rural areas.

In a contrary decision, the Minnesota Court of Appeals found that a municipality could condemn cooperative property of a rural electric cooperative so long as such taking would not seriously undermine important federal interests.³³ The state court specifically disagreed with the Ninth Circuit's reasoning in *Public Util. No. 1 of Pend Oreille County*³⁴ and with the district court's decision in *Morgan City*,³⁵ finding more persuasive the reasoning in *Arkansas Elec. Coop. Corp. v. Arkansas*

Pub. Serv. Comm'n,³⁶ in which the U.S. Supreme Court concluded that the REAct does not preclude state rate regulation of an REA-financed utility unless a state sets a rate so low as to compromise such federal interests as the cooperative's ability to repay its loans.

C. Cost of Facilities

Valuation issues in condemnation³⁷ include: (1) the cost of physical facilities; (2) the potential for severance or consequential dam-

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ages; and (3) the possibility of recovery for going concern value. One of the key—and potentially most expensive—issues relating to “consequential” damages is that of “stranded investment,” discussed below.

1. OCLD—Book Value. Original cost less depreciation (OCLD or “book value”) valuation is based upon a ratemaking analysis: Since a utility cannot earn a return based on more than OCLD, no greater amount should be recovered in condemnation. This method has been followed by

courts,³⁸ included in franchises (such as that of the City of New Orleans), and identified in statutes.³⁹

2. RCLD/RCNLD. Utility property has also been evaluated by the reproduction cost less depreciation (RCLD) and reproduction cost new less depreciation (RCNLD) methods.⁴⁰ While RCNLD assumes duplication of the exact system being valued, RCLD assumes replacement with a potentially better, or more efficient, system. Normally, RCNLD is determined by increasing the original cost of facilities using historical information regarding cost increases in utility facilities.⁴¹ Reproduction costs include both the actual cost of erecting the physical plant and related elements such as overhead expenses, executive and management costs, and legal and engineering fees.

3. Consequential and Severance Damages. Municipalities may be required to pay consequential or severance damages in addition to the cost of the physical assets. Consequential damages in the context of eminent domain proceedings may be understood as those “caused by intervening and supervening acts of others than the taking authority,”⁴² and the difference in market value of the remaining property just before and just after the time of the taking.⁴³

Severance damages may be granted for a partial taking resulting in actual damage to the residue. Such damages may be considered to be compensation for the diminution in value of the resi-

due and measured by the cost to cure such diminution.⁴⁴

In *Town of Massena*,⁴⁵ New York Commissioners of Appraisal rejected attempts by Niagara Mohawk to obtain consequential and severance damages for disconnecting its facilities from those to be owned by the town and reconnecting those facilities to a new substation. The commissioners suggested that the expense of severing and reconnecting (estimated at almost \$2 million) could be avoided through cooperation between the utility and the town.⁴⁶ Other appraisers, however, have allowed severance damages for disconnecting facilities and constructing new facilities.⁴⁷

4. Going Concern Value. Consideration of the "going concern" value of a utility may be used instead of, or in addition to, property valuation based on OCLD, RCLD or RCNLD.⁴⁸ Where a utility has a continuing right to serve a community, some courts have valued a system based solely on capitalization of future earnings.⁴⁹ Such valuation encompasses the value of both the property condemned and the anticipated future profits of the utility currently serving the community; thus, the values of tangible and intangible assets are not separately identified and then aggregated.

Although some courts reject compensation based on capitalization of future earnings,⁵⁰ they may nevertheless allow some value in recognition of the fact that a utility is a going concern. Such compensation has been claimed to re-

fect the advantages inherent in acquiring an operating business as compared to starting a new business with only land, buildings, and equipment in place.⁵¹

The value associated with lost earnings frequently depends on the nature of a utility's right to serve and the profitability of that service. Where a utility's franchise is nonexclusive, indeterminate (i.e., revocable at will), or expired, earning power is considered limited or nonexistent.⁵² A utility's non-exclusive certificate of con-



venience and necessity is considered to be a mere privilege, not compensable in an eminent domain proceeding.⁵³ Similarly, a utility will not be able to recover for lost future earnings where past operations have been unprofitable.⁵⁴

5. Financing Municipal Utilities. Until 1987, a municipality could finance the construction or purchase of a privately owned distribution system with tax-exempt bonds. Then, the Internal Revenue Code was amended in 1987 to establish a volume cap limita-

tion on each state's use of tax-exempt bonds for private financing—defined to include the purchase of facilities of investor-owned utilities.⁵⁵

As a result of this amendment, a municipality may not use tax-exempt bonds to finance the purchase of investor-owned utility facilities, unless that municipality is able to obtain an allocation from its state volume cap. If, however, a municipality constructs a separate distribution facility, it may do so with tax-exempt financing.

6. Ratemaking Concerns in Franchise Competition.

Ultimately, either shareholders or ratepayers pay the cost of a transition from a municipal system to a private system or vice versa. Because many municipalities are regulated by city councils, rather than by state regulatory agencies, they may have substantial leeway to include the purchase costs in rates. In contrast, investor-owned electric utilities are subject to state regulation and may have more difficulty including in rates any premium above original cost less depreciation, unless a countervailing ratepayer benefit is demonstrated to the jurisdictional regulatory agency.⁵⁶

IV. Stranded Investment: Its Implications for Franchise Competition

Where municipalities seek to condemn facilities owned by investor-owned utilities, the utilities have sought compensation for "stranded investment"—investment a utility claims to have made to serve a customer and

which cannot be recovered at market rates.

There are two recent decisions and two proposed rules addressing the "stranded investment" issue—two at the federal level and two at the state level.

First, the U.S. Court of Appeals for the District of Columbia Circuit analyzed stranded investment in the context of an "open access" transmission tariff filed in connection with a request for market-based generation rates. In *Cajun Electric*,⁵⁷ the court stated that (1) charging former requirements customers for stranded investment in transmission rates appears to be anticompetitive;⁵⁸ (2) FERC erroneously decided, without a hearing, that a utility's market power could be mitigated by an open-access transmission tariff which includes authority to charge for stranded generation investment;⁵⁹ and (3) FERC must consider the legitimacy of

stranded investment charges at the same time as it examines whether a utility has market power.⁶⁰ In addition, the court questioned whether there can be any such thing as "stranded" investment at all, since power can always be sold if the price is sufficiently low.

The *Cajun* court's consideration of stranded investment was in the context of an open-access transmission tariff combined with a request for market-based rates, and FERC's failure to hold an evidentiary hearing. Some have argued, therefore, that the court's statements concerning stranded investment may be limited to that specific context. Others argue to the contrary that the court's decisions have far-reaching implications.

Second, as discussed above, the FERC has issued a NOPR which proposes broad recovery of stranded investment based upon revenues which would otherwise

be lost, with no shareholder contribution. In its NOPR, the FERC has interpreted *Cajun* as limited to an order to hold an evidentiary hearing, and has claimed that its treatment of stranded investment in the NOPR is justified based upon the transition to a competitive electric power industry.⁶¹

Third, the New York Public Service Commission (PSCNY) allowed stranded investment recovery where a Qualifying Facility (QF) proposed to provide electric service to Alcan Rolled Products Company (Alcan), one of Niagara Mohawk's five largest customers.⁶² Niagara Mohawk argued that it should be compensated for the *full* expected earnings stream from Alcan—based on Niagara Mohawk's 6.68 cent tariff rate (approximately \$14.2 million annually). Alcan and the QF, on the other hand, argued that no fee should be imposed. Resolving the dispute, the PSCNY ordered the



With new open-access opportunities, munis will call for all manner of proposals.

QF to pay an exit fee based on the difference between the competitive rate (defined as the rate to be charged to Alcan by the QF) and Niagara Mohawk's long-term avoided cost.⁶³

Fourth, on February 28, 1995, the Maine Public Utilities Commission announced a rule on stranded investment to be applicable to newly formed municipal electric utilities and competing electric utilities within a single service area. It would calculate stranded costs as one-half of the difference between a utility's embedded and marginal costs, available for the earlier of (1) ten years or (2) the point at which a utility's embedded costs meet its marginal costs.

Thus, the two state commissions considering the matter have proposed a sharing of stranded investment between shareholders and the departing ratepayer or succeeding supplier; the Federal Court of Appeals has given guidance indicating a preference to put any stranded investment burden on the shareholders; and FERC has proposed to require the departing customer to bear 100 percent of the burden

A. Analytical Framework for Stranded Investment Analysis

As commonly used, the term "stranded investment" refers conceptually to that portion of a utility's generation and transmission facilities which were prudently planned for a customer but not paid for by that customer. Applying this definition, there are a number of potential ways in

which an investment in facilities may be stranded:

- A utility has planned for load growth which does not occur because of its high rates or because of an economic downturn;
- A utility has planned for load growth which does not occur because its load forecasting mechanism was severely flawed;
- A utility has planned for load growth which does not occur because of successful demand-side management programs;



- A retail customer has planned for an expansion which it decides not to make;
- A retail customer relocates to another service territory and departs before using the utility facilities;
- A retail customer decides to take power from another utility which may serve that customer based on either "fringe area" or direct competition with the current retail supplier;⁶⁴
- A retail customer decides to install self-generation;
- Retail customers decide to form a municipally-owned electric utility by purchasing the util-

ity's electric distribution system or by constructing a separate distribution system;

- A retail customer obtains "retail wheeling" in order to purchase power directly from another utility; and
- A wholesale customer does not renew its contract for power supply and, instead, obtains transmission service from its former power supplier.

In each of these examples, except the last three (and, in some states, the last five), the utility normally cannot recover for stranded investment unless it has a contractual right to do so.

B. Questions Regarding Stranded Investment

1. *Should a Utility Recover for Stranded Investment?* Supporters of stranded investment recovery often cite the regulatory compact: Utilities are granted guaranteed service territory in exchange for their obligation to provide sufficient power for the current and future use of native load customers. This obligation implies the need to construct new generation and transmission for consumer needs in the future and anticipates that customers will pay for these facilities through rates. In contrast, opponents of stranded investment recovery argue that any alleged stranding of utility investment is due to the utility's inability or unwillingness to compete.⁶⁵

In past consideration of stranded investment recovery, FERC has concluded that: (1) stranded investment is a common occurrence in the industry, not

normally requiring recovery; (2) a utility facing loss of power supply customers due to its initiating transmission service may, during a limited "transition period," be able to recover for stranded investment on a case-by-case basis; and (3) such recovery would be an exception to the normal rule that utilities handle stranded investment through contractual notice and termination provisions.⁶⁶ FERC has also stated that stranded investment recovery should be limited to situations where the transmitting utility had a reasonable expectation that the customer would continue to purchase power.⁶⁷

Now, however, there are two diametrically opposing views on stranded investment recovery through the FERC—particularly where it relates to formation of new municipal electric utilities. As discussed above, the FERC has made a preliminary finding in its NOPR that a utility may recover in transmission rates its *total* anticipated retail revenue stream from a newly formed municipal utility which switches from being a retail to a transmission customer.

Alternatively, *Cajun Electric* raises the question whether stranded investment should ever be recovered. A utility would claim stranded investment only where a customer changes from a generation and transmission customer to a transmission-only customer. Thus, in each instance, a utility would be seeking to tie stranded investment charges to transmission-only service—a re-

quirement which the D.C. Circuit termed a traditional anticompetitive tying arrangement.⁶⁸

2. What Should Be the Measure of Stranded Investment? FERC has concluded that mitigation of damages is appropriate in a stranded investment situation.⁶⁹ Both FERC and courts in condemnation have linked a utility's planning horizon to reduction or termination of service.⁷⁰ A good-faith offer by a municipality to purchase power at wholesale from a



utility is generally admissible in condemnation proceedings to show that the utility will not suffer a property loss or that the loss will not be as great as alleged.⁷¹

However, the NOPR suggested that "mitigation" be limited to the present value of the market price of power.⁷²

As noted above, the NOPR would allow full recovery of a utility's anticipated retail revenue stream (less mitigation and transmission revenues), while *Cajun Electric* suggests that no stranded investment recovery would be appropriate. One middle ground, adopted by the PSCNY in *Sithe*,⁷³

is recovery of the amount the customer would have paid at a competitive rate less the utility's avoided costs. This approach compensates the utility, but only at a mitigated competitive rate. Another middle ground, proposed by the Maine Public Utilities Commission, and discussed above, would have shareholders and departing ratepayers share in paying the difference between marginal and embedded cost of generation.

3. Who Should Pay for Stranded Investment? Once the measure of stranded investment is determined, the remaining question is who should pay—the consumer who will benefit from lower rates, the utility that captured the consumer, the remaining customers of the former utility, the shareholders of the former utility, or, potentially, taxpayers? Clearly, one or more of these entities or groups will be required to pay unless the utility is able to obtain a full recovery from new customers.

Both the PSCNY and the Maine solutions recognize the responsibility of ratepayers for facilities planned for their use and some responsibility of shareholders for the non-competitive rates which encouraged a former customer to depart. The *Cajun Electric* decision does not address ratepayer responsibility.

There are at least three compromise treatments for payment for stranded investment: (1) the New York solution; (2) the Maine solution; or (3) a solution similar to that used in the FERC's treatment of canceled plant: a 50-50 split of

the "stranded investment" cost between shareholders and the departing customer (or the utility serving the departing customer), with no return on investment.⁷³

V. Conclusion

Competition is becoming increasingly important in the electric industry, and utilities should be encouraged to compete so that customers may enjoy the benefits of the resulting efficiencies and economies. This is particularly true since enactment of EPAAct—which should have put utilities on notice that they cannot bank their expectations on continuation of the status quo.

The FERC NOPR, while promoting transmission access as a means of encouraging competition, threatens to isolate and undermine one important and historic form of competition: franchise competition from newly formed municipal electric utilities. In so doing, FERC has not focused upon the traditional role of states and municipalities in franchising electric utilities, or the similarities between an expiring wholesale contract for power supply and an expiring retail contract. In reconsideration of the NOPR, FERC has the opportunity to promote all types of competition—including franchise competition—through a moderate approach to the stranded investment issues.

Franchise competition is—and should be—an integral part of the current era of enhanced competition. It serves the traditional goal of encouraging lower costs

through the threat of takeover or purchase.

A properly limited stranded investment recovery will enable franchise competition to thrive. Utilities will be forced to streamline operations to retain customers and will be required to plan for customer *loss* in addition to customer *expansion*. Traditional benefits of competition—in lower costs and better service—will likely result. To the extent that utilities are guaranteed customers



or their equivalent in revenue flow, these competitive benefits will likely be lost. ■

Endnotes:

1. A municipal utility in Las Cruces, a city of less than 70,000 residents, would be the largest new municipal utility formed in 50 years.
2. During 1980-89, 31 new local, publicly owned electric utilities commenced operations. Sixteen had been formerly served by investor-owned utilities; the remainder had been served by non-utility businesses, federal agencies, or other local, publicly owned electric utilities. No new local,

publicly owned electric utility has been established since 1989.

3. During 1980-93, 56 local, publicly owned electric utilities were sold. Thirty-nine were sold to investor-owned utilities and 17 were sold to rural electric cooperatives. Eight were sold during 1990 through 1993.

4. 16 U.S.C. 824j, 824k (Supp. V 1993).

5 Promoting Wholesale Competition Through Open Access; Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, 70 FERC 61, 357 (1995) (hereinafter "NOPR").

6. See AMERICAN PUBLIC POWER ASS'N, PUBLIC POWER IN AMERICA: A HISTORY 7.

7. A "public body" must be an actual, operating electric utility with control over distribution lines. See Allegheny Electric Coop. v. FERC, 922 F.2d 73 (2d Cir. 1990), cert. denied, 112 S. Ct. 55 (1991).

8. See, e.g., Bonneville Project Act of 1937, 16 U.S.C. 832c, 832d (1985); Fort Peck Project of 1938, 16 U.S.C. 833c (1985); Reclamation Project Act of 1939, 43 U.S.C. 485h(c)(1986); Water Conservation and Utilization Act of 1940, 16 U.S.C. 590z-7 (1985); Flood Control Act of 1944, 16 U.S.C. 825s (1985); Eklutna Project of 1950, 64 Stat. 382; 67 Stat. 574; Small Reclamation Projects Act of 1956, 43 U.S.C. 422e (1985); Flood Control Act of 1958, 72 Stat. 311; Niagara Power Project Act of 1957, 16 U.S.C. 836 (1985); Bradley Lake Project, Flood Control Act of 1962, 76 Stat. 1193.

Earlier legislation had given a preference to municipalities and states without regard to utility ownership. See Town Sites and Power Development of 1911, 43 U.S.C. 522 (1985); Federal Water Power Act of 1920, 16 U.S.C. 800(a) (1985); Boulder Canyon Project Act of 1928, 43 U.S.C. 617d (1985). Although the Federal Power Act preference is not based on the form of utility ownership, this preference has been denied to a municipality which cannot form a municipally owned electric utility pursuant to state law. See Allegh-

eny Electric Coop., 20 FERC (CCH) 61,049 (1982), *reh'g denied*, 26 FERC (CCH) 61,119 (1984).

9. This comparison is often called "yardstick competition," which Professor Kahn defines as follows:

This is of course the principal kind of rivalry between the government-owned cooperative and privately-owned utility system. It is a competition by example: each company is concerned that the way in which it treats its own customers compares favorably with the corresponding performance of its rivals, in hope of a favorable political decision whenever the question arises of which kind of utility system is to be certificated for future service areas, or to serve the expanding needs or indeed the present requirements of existing ones.

ALFRED E. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 319 (1971).

10. MORGAN, RIESENBERG AND TROUTMAN, TAKING CHARGE: A NEW LOOK AT PUBLIC POWER 9 (Env'tl. Action Foundation, 1976).

11. Municipal Elec. Util. Ass'n of New York State v. Power Authority of the State of New York, 21 FERC (CCH) 61,021 at 61,135 (1982).

12. See Sections 1 and 2 of the Sherman Anti-Trust Act, 15 U.S.C. 1, 2 (1988); see, e.g., United States v. Otter Tail Power Co., 331 F. Supp. 54 (D. Minn. 1971), *aff'd in relevant part*, 410 U.S. 366 (1973); Town of Massena v. Niagara Mohawk Power Corp., 1980-2 Trade Cas. (CCH) 63,526 (N.D.N.Y. 1980).

If the potential transmitting utility owns a nuclear power plant and is subject to license conditions requiring the type of transmission service sought, a municipality may be able to obtain wheeling through license conditions imposed by the Nuclear Regulatory Commission pursuant to Section 105c of the Atomic Energy Act, 42 U.S.C. 2135(c)(1973).

13. The history preceding this authority warrants noting. Congress considered, but rejected, a provision making public utilities common carriers in the 1935 Federal Power Act. See Otter Tail

Power Co. v. United States, 410 U.S. 366, 374 (1973). With enactment of the Public Utilities Regulatory Policies Act of 1978, FERC obtained nominal authority to order wheeling. However, this authority was limited by language requiring retention of existing competitive relationships. See South-eastern Power Admin. v. Kentucky Util. Co., 25 FERC (CCH) 61,204 (1983), *reh'g denied*, 26 FERC (CCH) 61,127 (1984). Other decisions rejected attempts to obtain wheeling through Section 206 of the Federal Power Act. See Florida Power & Light Co. v. FERC, 660 F.2d 668 (5th Cir. 1981), *cert. denied*, 459 U.S. 1156 (1983); New



York State Elec. & Gas Corp. v. FERC, 638 F.2d 388 (2d Cir. 1980), *cert. denied*, 454 U.S. 821 (1981); Richmond Power & Light v. FERC, 574 F.2d 610 (D.C. Cir. 1978).

At least one court left open the possibility that FERC could order wheeling to remedy undue discrimination. See Associated Gas Distrib. v. FERC, 824 F.2d 981 (D.C. Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988).

FERC has authority pursuant to Section 203 of the Federal Power Act to order wheeling. See Northeast Util. Serv. Co., 56 FERC (CCH) 61,269 at 62,013 (1991), *modified*, 58 FERC (CCH) 61,070 (1992); Utah Power & Light Co., 45 FERC (CCH) 61,095 at 61,282, *clarified*, 45 FERC 61,132 (1988). Thus,

municipalities seeking to change retail power suppliers could not obtain wheeling through FERC until 1992—unless their potential transmitting utility was seeking to merge.

14. 16 U.S.C. 796(22), 824j(a) (1985 & Supp. V 1993).

15. 16 U.S.C. 824j(a).

16. See Entergy Services, Inc., 60 FERC (CCH) 61,168 at 61,626-27 (1992).

17. 16 U.S.C. 824k(h)(2). This section provides:

No order issued under this Chapter shall be conditioned upon or require transmission of electric energy

(2) to, or for the benefit of, an entity if such electric energy would be sold by such entity directly to an ultimate consumer, unless:

(A) such entity is a Federal power marketing agency; the Tennessee Valley Authority; a State or any political subdivision of a State (or an agency, authority, or instrumentality of a State or a political subdivision); a corporation or association that has ever received a loan for the purposes of providing electric service from the Administrator of the Rural Electrification Administration under the Rural Electrification Act of 1936 [7 U.S.C. 901 et seq.]; a person having an obligation arising under State or local law (exclusive of an obligation arising solely from a contract entered into by such person) to provide electric service to the public; or any corporation or association which is wholly owned, directly or indirectly, by any one or more of the foregoing ...

18. NOPR at 215-16.

19. Since FERC proposed to leave some leeway to the states to consider stranded investment for retail customers, utilities may still seek to streamline to retain existing retail customers.

20. To the authors' knowledge, stranded investment has not, to date, been an issue in the takeover of a municipal system by an investor-owned utility.

21. NOPR at 237.

22. NOPR at 205.

23. Courts have rejected requests for monetary damages where a municipal-

ity constructs a separate distribution system and the utility previously serving the city lacks a valid franchise or where the previous retail supplier is allowed to remain in business, even where it is subject to "ruinous competition." See, e.g., *Greater Tangipahoa Util. Co. v. City of Hammond*, 255 So. 2d 510 (La. Ct. App. 1971), *cert. denied*, 255 So. 2d 773 (La. 1972); *Jamaica Water Supply Co. v. City of New York*, 236 N.Y.S.2d 816 (1962), *summary judgment granted*, 242 N.Y.S.2d 275 (1963), *aff'd*, 270 N.Y.S.2d 975 (1966); *Alabama Power Co. v. City of Guntersville*, 177 So. 332 (Ala. 1937).

24. See 3 CHESTER J. ANTIEAU, MUNICIPAL CORPORATION LAW 29.09, at 34 (rev. ed. 1992); 12 EUGENE MCQUILLIN, THE LAW OF MUNICIPAL CORPORATIONS 34.51 (3d ed. 1986 & Supp. 1993); Annotation, *Right And Duty Of City And Public Utility Upon Expiration By Limitation Of Street Franchise*, 112 A.L.R. 625, 628 (1938). See also *Detroit United Ry. v. City of Detroit*, 229 U.S. 39 (1913); *Detroit United Ry. v. City of Detroit*, 248 U.S. 429, 433 (1919); *Village of Lapwai v. Alligier*, 299 P.2d 475 (Idaho 1956); *Town of Pittsburgh v. Cochrane*, 159 P.2d 534 (Okla. 1945); *City of Lebanon v. Missouri Standard Tel. Co.*, 85 S.W.2d 613 (Mo. 1935).

25. The authors take no position on the issue of competition for territory between municipalities and rural electric cooperatives, which authority is presently unclear, as noted *infra*.

26. NICHOLS, THE LAW OF EMINENT DOMAIN, 2.2[9] (3d ed. 1994) (hereinafter "Nichols").

27. See, e.g., *City of Rochester v. People's Coop. Power Ass'n, Inc.*, 483 N.W.2d 477 (Minn. 1992); *City of Shokopee v. Minnesota Valley Elec. Co-op*, 303 N.W.2d 58 (Minn. 1981); *Duck River Elec. Membership Corp. v. City of Manchester*, 529 S.W.2d 202 (Tenn. 1975); *City of Palm Bay v. General Dev. Util., Inc.*, 201 So. 2d 912, *cert. denied*, 207 So. 2d 452 (Fla. 1967); *In re City of Brooklyn*, 38 N.E. 983 (N.Y. App. 1894), *aff'd*, *In re Long Island Water-Supply Co.*, 17 S. Ct. 718 (1897).

28. Ohio Const. art. XVIII, 4.

29. Cal. Pub. Util. Code 1401 (West 1975).

30. See, e.g., *City of North Sacramento v. Citizens Util. Co. of California*, 32 Cal. Rptr. 308 (1963); *Citizens Util. Co. of California v. Superior Court of Santa Cruz County*, 382 P.2d 356 (Cal. 1963). Civil Procedure Code 1237, cited in *City of North Sacramento*, *supra*, was repealed in 1975 and superseded by 1240.010, which became operative in July 1976.

31. 7 U.S.C. 901 *et seq.*

32. See *City of Morgan City v. South Louisiana Elec. Coop. Ass'n*, 31 F.3d 319 (5th Cir. 1994); *Public Util. No. 1 of Pend Oreille County*, 417 F.2d 200 (9th Cir. 1969).



33. See *City of Rochester v. Peoples Coop. Power Ass'n*, 505 N.W.2d 621 (Minn. 1993).

34. *Public Util. No. 1 of Pend Oreille County*, *supra*, note 32.

35. *City of Morgan City*, *supra*, note 32.

36. 461 U.S. 375 (1983).

37. These issues may affect the price paid for a voluntary takeover—whether by a municipality or an investor-owned utility—and any regulatory approval of that price.

38. See, e.g., *Pleasant Park Util. Co. v. Public Serv. Comm'n of Wisconsin*, 338 N.W.2d 528 (Wis. Ct. App. 1983) (unpublished); *Town of Southbridge v. Southbridge Water Supply Co.*, 355

N.E.2d 920 (Mass. 1976); *Port Authority Trans-Hudson Corp. v. Hudson Rapid Tubes Corp.*, 231 N.E.2d 734, 738-39 (N.Y. 1967), *cert denied*, 390 U.S. 1002 (1968); *Citizens Util. Co. of Calif. v. San Lorenzo Valley County Water Dist.*, 382 P.2d 356 (Cal. 1963); *New Rochelle Water Co. v. State of New York*, 211 N.Y.S.2d 425 (N.Y. Ct. Cl.), *modified*, 220 N.Y.S.2d 809 (1961); see also *Town of Oxford v. Oxford Water Co.*, 463 N.E.2d 330 (Mass. 1984) (valued at original cost without considering depreciation).

39. A Minnesota statute identifies consideration of OCLD in valuation but does not specify consideration of reproduction cost new less depreciation (RCNLD) or reproduction cost less depreciation (RCLD). Minn. Stat. 216B.47 (1993). It also lists "loss of revenue to the utility, expenses resulting from integration of facilities and other appropriate factors." *Id.*

40. See, e.g., *City of Thibodaux v. Louisiana Power & Light Co.*, 225 F. Supp. 657 (E.D. La. 1963), *aff'd in part and rev'd in part*, 373 F.2d 870 (5th Cir.), *cert. denied*, 389 U.S. 975 (1967) (RCNLD); *City of Sheldon v. Iowa Pub. Serv. Co.*, 114 PUR 4th 482 (Iowa PSC 1990) (RCLD); *Attorney General v. Michigan Pub. Serv. Comm'n*, 316 N.W.2d 187 (Mich. 1982) (RCNLD); *Town of Massena v. Niagara Mohawk Corp.*, Index No. 59244 (St. Lawrence County Ct. Aug. 21, 1980) (unreported) (RCLD); *City of Phoenix v. Consolidated Water Co.*, 415 P.2d 866 (Ariz. 1966) (RCNLD).

41. See *Matter of the Application of Gas Co. of New Mexico*, No. 2235 (N.M. Pub. Serv. Comm'n 1988).

42. Nichols, *supra* note 26, at 14.01[2].

43. *D'Youville Recreational Ass'n v. DeKalb County*, 352 S.E.2d 181, 183-84 (Ga. Ct. App. 1986); see also *Niagara Mohawk Power Corp. v. Olin*, 526 N.Y.S.2d 278 (App. Div. 1988).

44. Nichols, *supra* note 26, at 14.02[3] (citing the dissenting opinion of K.K. Hall, Circuit Judge, in *United States v. 2.33 Acres of Land*, 704 F.2d 728, 731 (4th Cir. 1983)). See also *West Virginia*

Pulp & Paper Co. v. United States, 200 F.2d 100, 102 (4th Cir. 1952).

45. *Town of Massena v. Niagara Mohawk Corp.*, Index No. 59244 (St. Lawrence County Ct. Aug. 21, 1980).

46. *Id.*, slip op. at 11-13. See also *Village of Brooklyn v. Wisconsin Power & Light Co.*, 4 PUR (NS) 178 (Wis. P.S.C. 1934).

47. See, e.g., *City of Thibodaux*, 225 F. Supp. at 661; *City of Redwood*, 20 PUR (NS) 269 (Cal. R.R.C. 1937).

48. Although the capitalization of earnings method is a recognized method of valuation, it has been criticized as speculative and inaccurate both by courts and by at least one commentator. See 2 Orgel, VALUATION UNDER THE LAW OF EMINENT DOMAIN (2d ed. 1953) at 218 and cases cited therein. In Ohio, there may be no recovery of damages for lost profits because of their speculative and remote character. In re Appropriation of Easements for Highway Purposes: *Preston v. Stover*, 190 N.E.2d 446 (Ohio 1963); *Toledo Consol. St. Ry. v. Toledo Elec. St. Ry.*, 6 Ohio C.C. 362 (Lucas County Ct. 1892).

49. See *South Bay Irrigation Dist. v. California-American Water Co.*, 133 Cal Rptr. 166 (Cal. Ct. App. 1976), cert. denied, 434 U.S. 801 (1977); *City of Thibodaux*, 225 F. Supp. 657.

50. Some amount of lost earnings may be an element in determining going concern value. See *Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 311 (1923); *City of Phoenix*, 415 P.2d at 871. Where a franchise has expired, however, courts may refuse to grant any value to lost earnings. See *City of Sheldon*, 114 PUR 4th at 489.

51. *Gray Line Bus Co. v. Greater Bridgeport Transit Dist.*, 449 A.2d 1036, 1038 (Conn. 1982) (citing *Omaha v. Omaha Water Co.*, 218 U.S. 180 (1910)); *Nichols*, supra note 26, at 13.3.

52. See *Nichols*, supra note 26, at 15.42[1].

53. See, e.g., *Citizens Util. Co. of Ill. v. Metropolitan Sanitary Dist. of Greater Chicago*, 322 N.E.2d 857 (Ill. App. Ct. 1974); *Greater Wilmington Transp.*

Auth. v. Kline, 285 A.2d 819 (Del. Super. Ct. 1971); *Hendricks County Rural Elec. Membership Corp. v. Public Serv. Co. of Ind.*, 276 N.E.2d 852 (Ind. Ct. App. 1971).

54. See, e.g., *Gray Line Bus Co.*, 449 A.2d at 1040; *Nichols*, supra note 26, at 15.42[1]. The general valuation test is the amount paid by a willing buyer to a willing seller, and, as the Supreme Court has recognized, "[s]ubstantial prices are not paid for the privilege of conducting a business at a loss." *Roberts v. City of New York*, 295 U.S. 264, 282 (1935).

55. 26 U.S.C. 141 (1988).

56. Cf. *Southwestern Public Service Co. and Black Mesa Power Co.*, 46



FERC (CCH) 61,006 (1989); *Minnesota Power & Light Co.*, 43 FERC (CCH) 61,104 at 61,342 (1988).

57. *Cajun Elec. Power Coop., Inc. v. FERC*, 28 F.3d 173 (D.C. Cir. 1994).

58. *Id.* at 177-78.

59. *Id.* at 180.

60. *Id.* at 179.

61. NOPR, supra note 5, at 166-70.

62. *Re Sithe/Independent Power Partners, L.P.*, 155 PUR 4th 149 (Sept. 8, 1994).

63. The PSCNY ultimately adopted as its decision the terms of an agreement between its staff and the QF under which the latter would pay Niagara

Mohawk a present value amount of approximately \$19.6 million, i.e., the net present value of a \$3.9 million annual fee for 7.5 years. See *Petition of Sithe/Independent Power Partners* (PSCNY Nov. 3, 1994) ("Sithe").

64. For example, the City of Cleveland directly competes for customers with Cleveland Electric Illuminating Co.

65. See R. Michaels, *Unused and Useless: The Strange Economics of Stranded Investment*, ELEC. J., Oct. 1994 at 12; and A. Kahn, *Can Regulation and Competition Coexist?*, ELEC. J., Oct. 1994 at 23.

66. See *United Illuminating Co.*, 63 FERC (CCH) 61,212 at 62,583, reh'g denied, 64 FERC (CCH) 61,087 (1993); *Entergy Services, Inc.*, 63 FERC (CCH) 61,025 at 61,153 (1993); *Entergy Services, Inc.*, 60 FERC (CCH) at 61,631; *Entergy Services, Inc.*, 58 FERC (CCH) 61,234 at 61,770 (1992).

67. See *Massachusetts Elec. Co.*, 66 FERC (CCH) 61,036 (1994).

68. 28 F.3d at 177-78.

69. See *Entergy Services, Inc.*, 60 FERC (CCH) at 61,631.

70. See *Kentucky Util. Co.*, 25 FERC (CCH) 61,205 (1983) (utility could absorb only a 25 MW reduction of load based on its planning horizon); *City of Thibodaux*, 225 F. Supp. at 663 (utility mitigation of stranded investment through conversion of unused generation to other income-producing uses); *Southern Cal. Edison Co. v. Railroad Comm'n of California*, 59 P.2d 808 (Cal. 1936) (mitigation by sale of power at wholesale to the municipality for a period of years).

71. *Puget Sound Power & Light Co. v. Public Util. Dist. No. 1*, 123 F.2d 286, 291 (9th Cir. 1941); *Puget Sound Power & Light Co. v. City of Puyallup*, 51 F.2d 688, 696 (9th Cir. 1931); *Village of Brooklyn v. Wisconsin Power & Light Co.*, 4 PUR (NS) 178, 187, 195-96 (Wis. P.S.C. 1934).

72. NOPR, supra note 5, at 222-23.

73. See *New England Power Co.*, 42 FERC (CCH) 61,016, reh'g denied, 43 FERC 61,285 (1988).