A Regulatory Compact Worthy of the Name

Owners' claims of a right to full compensation of stranded investment are wrong, but a conditional opportunity to recover is sound policy. Matching sensible conditions to future utility conduct is among the greatest challenges facing government energy officials today.

Peter Bradford

To one who regulated electric utilities continuously from 1971 until this year, the debate over recovery of the full cost of past investments that cannot produce electricity at today's competitive prices is suffused with a surreal glow. In support of such recovery we are told that regulators either compelled these investments or found them to be prudent when made. Therefore they should not now permit customers to "strand" them by buying power elsewhere.

Billions of dollars are at stake here, some stemming from nuclear construction costs, some from expensive power purchase contracts, some from deferred taxes and benefits, some from social programs and obligations—including those protecting the environment. Also at stake is the pace at which U.S. consumers get the benefits of competition in the electricity industry. A compelling case can be made for allowing utilities an opportunity to recover these investments under some circumstances, but this case emphatically does not rest on the proposition that regulators, as society's representatives, have blessed as "prudent" every dollar of investment not specifically disallowed, and must therefore assure full recovery of this money as part of a transition to competition.

Several considerations compel this conclusion.

First, regulation has not reviewed every dollar or every billion dollars of utility investment. States typically spend some $100,000 on regulation for each $50-$100 million in utility revenues, or for each $150-$300 million in utility assets. The notion that $100,000 per year regulators sit like Maxwell's Demon busily sorting $100 million per year ($3.17 per second) into prudent and imprudent piles is silly enough, even if one assumes that all regulators are perfect statesmen.

In fact, the community of regulators has a mixed history. Regulation was in many states chosen and in large part designed by enlightened utility managers, including Samuel Insull, to ward off public ownership or rate setting by legislatures and city councils. Indeed, President Cleveland's Attorney General Richard Olney advised a group of utility executives in 1892 that regulation "can be of great use. ... It satisfies the public clamor for a government supervision, ... at the same time that supervision is almost entirely nominal. The part of wisdom is not to destroy the Commission but to utilize it."

This balance between serious but underfunded regulation and "utilized" regulation has swayed back and forth over the last century. In many states utilities have bought themselves a major voice or veto in commissioner selection, and have used that voice to fur-

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ther the appointment of commissioners whom they would not themselves train for lower management. Even today, after years of enhanced public concern over the quality of utility regulation, utility/commissioner coziness produces at least one highly publicized scandal per year somewhere in the country.

1994 produced a bumper crop, in Tennessee, New Jersey, and Oklahoma. In 1993, California and Florida had their day. As a reality check, I listed the states in which I could recall without research a significant commissioner/utility coziness episode in the last 20 years. Twenty-four states came to mind.

This is distasteful stuff, but when utilities today speak of sacred compacts and "over-regulation," society shouldn't forget that their frequent past subversion of regulation was not just an occasional entertaining embarrassment but a pervasive, and a too-often condoned phenomenon, far more common than the understaffed statesmanship of an Alfred Kahn or a David Lillienthal.

Consider also that the Federal Energy Regulatory Commission, with jurisdiction over all wholesale electric sales, did little by way of serious prudence reviews in the 1980s, despite presiding over some of the nation's most costly nuclear cost overruns.

Because substantial disallowances nevertheless took place in several states, the utility community, its investors and other allies raised an immense hue and cry over regulatory irresponsibility. Not a single dollar invested (or left in investment) in an electric utility after 1980 came in justifiable ignorance of the possibility that it might not be recovered. In fact, Public Service of New Hampshire filed for bankruptcy and the Washington Public Power Supply System defaulted on its bonds in the mid-1980s, surprising no one. A similar filing from Long Island Lighting Co. was a widely discussed possibility during the same time frame.

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Many investors bought stock in imperiled utilities at bargain basement prices in the face of possible bankruptcy, and all who didn't sell at those prices chose to hold in the face of the same risk. Does a Lilco shareholder whose shares were worth $3 apiece 10 years ago really have much of a complaint at the possibility of having to take five or six times that amount today instead of the book value of $21?

Finally, NARUC staff analysis reveals that returns to electric utility investors over the last quarter century have equaled or exceeded those to other industrial investors. This makes it hard to argue that electric utility investors have not been adequately compensated for a level of risk comparable to that of other large industries, whose range of risk includes loss and a small possibility of bankruptcy.

In short, the equitable case for unconditioned full recovery of investment, based on a societal arms-length bargain or on inadequate past compensation, depends on a fantasy of omnipresent past regulatory statesmanship and past investor security that is not to be taken seriously. To assess more limited claims, one must look, category by category, at the components that drive utility costs above market prices. I will touch here only on the generating plant investments and purchase contracts, but taxes, operating efficiencies, regulatory assets and societal benefits all require attention by anyone seeking comprehensive solutions.

The Utility Investment Problem

Once the claim of 100 percent entitlement is out of the way, a strong case for substantial recovery (or opportunity to recover) remains, at least in the case of a utility that is not pursuing anti-competitive or anti-environmental courses. For one thing, utility returns on their most successful investments are limited to the same commission-allowed

return that governs those investments that turn out poorly. In addition, there are a number of explicit, state-sanctioned "deals" (almost all nuclear) apart from some implicit "compact": New York's Shoreham settlement, Pacific Gas and Electric's Diablo Canyon arrangement, and the Maine utilities' unrecovered share of their Seabrook investment are some of those that come to mind. In these and other such cases, a utility's equitable claim for recovery is compelling in the face of anything short of infeasibility, which is not completely out of the question in a case as extreme as Lilco's.

More importantly, society's best interests are not well served when utilities believe that they can only recover their sunk investment by resisting competition at every turn. Far better that they should believe the reverse—that the best hope for recovery of their sunk investment is an orderly and prompt transition to competition.

Independent Power Producer Contracts

Here too the case for total recovery may be shaky, but the case for substantial recovery is strong. Many utilities have tried to claim that they were forced to sign these contracts by state and federal governments and should therefore be compensated entirely. The truth is more complicated.

First comes the question of what overpriced supply plans utilities would have perpetrated in the absence of PURPA. According to most utility calculations of "overpayments" due to IPP contracts, they would have shaped an optimal system based on perfect foresight. However, their actual record during these years belies any assumption of perfect foresight in a world without PURPA. Utility submissions in avoided-cost cases in the 1980s typically rested on demand and fuel price forecasts in the same range as those used by the regulatory agencies.

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Indeed, utilities trying to justify completing problem nuclear units were driven to use inconsistent assumptions or to adopt figures at least as high as the states'. Those who have trouble recalling the utility compulsion toward additional large units in the early 1980s should be sentenced to reread such utility-underwritten tracts as Peter Navarro's 1985 book, *The Dimming of America*, which called on regulators to stop "suppressing" rates in order that utilities could resume building power plants to avert blackouts in the early 1990s. All such plants, had they been built, would, of course, face stranding. Mr. Navarro's foreword thanks seven electric utilities, the Bechtel Corporation and the Edison Electric Institute for making research grants on his behalf to Harvard, where he was a research fellow at the time.

At best, the utilities were forecasting a future kW and kWh value 10-15 percent below the adopted long-run avoided cost (LRAC). Thus a conservative utility in 1988 might have valued a 1995 kWh at 7 cents when the state set a value of 8 cents. Since the actual value turns out to be closer to 4 cents, the utility's own build or buy decisions would still have caused at least 75 percent of the actual post-1988 problem had there been no PURPA and no LRACs.

Second comes the question of how wisely the utilities used the negotiating flexibility available to them. Did they seek dispatchability? Did they use competitive bidding? Did they value grid support? Cancellation or buyout clauses?

Does the fact that independent power flows through the fuel clauses, with little opportunity for profit, matter here? Certainly, but when New York utilities were invited to devise ratemaking methods under which their earnings could fluctuate in proportion to purchased power performance, none responded.

That electricity bills in some regions can, through competition, be stabilized and lowered over time is not subject to serious doubt. However, the highest-cost regions, which tend to have more surplus capacity and more stranded investment, have strong incentives to be the slowest to become competitive. As FERC's pressure for open access mounts, however, their preference for gradualism may not remain sustainable. Dramatic interregional price differences of the sort that exist today are likely to last less than a decade—maybe much less.

That is why the opportunity to recover stranded investment and the full honoring of IPP contracts should be tied to utility cooperation in both open access and industry restructuring, as well as to government policies regarding DSM, environmental standards, IPP contracts and other societal expectations. The uncertainty that for some time surrounded the issue of full recovery of gas industry take-or-pay contracts—instruments with roots also in exuberant price forecasts—did a lot to compel renegotiation of those contracts so that amounts ultimately charged to customers were less than one-third of the original contracts.

However, uncertainty can also fuel wars based on false hopes, so it cannot be the basis of long-term governmental policy. Much of the intellectual grappling and legal maneuvering that the electric industry is seeing today represents positioning by all sides in an environment where everyone knows that concessions will be necessary but many parties hope that the burdens can be made to fall on other shoulders.

Because any estimate of the amount facing stranding must rely on the type of price and demand forecasts whose fallibility created the problem initially, and because utilities can take steps to reduce the total amount, some flexibility in the recovery mechanism will be important even beyond the conditions discussed above. For one thing, no arrangement that produces windfalls is likely to be politically sustainable. Picture, for example, a utility recovering stranded nuclear costs though a wires charge while rising oil prices enable the nuclear units to produce large profits for the deregulated utility subsidiary even as the CEO—shades of Great Britain!—is awarded a bonus that slurps in the straw.

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Incentives for utilities to reduce the stranded investment amounts could be crafted in the form of one or more true-ups, or in the form of an initial productivity-type adjustment.

Ultimately, solutions that seek rate reductions for all customers, the avoidance of environmental degradation and an opportunity to recover strandable investment will depend on a comprehensive public policy approach, at least in the high cost states. The strandable assets are only one symptom of the inefficiencies of the present system. The reliance of government on utilities as tax collectors and as environmental enforcers also has more to do with convenience than with real efficiency.

Nevertheless, that reliance has been every bit as real as the reliance of investors on the imaginary regulatory compact. Layers of environmental protection and resource planning depend on ratemaking practices that are threatened by competition just as investors are threatened.

It will be very hard for federal or state officials to justify solicitude for stranded investment while ignoring the potential for transitional conditions to protect stranded benefits of other sorts. Can government really be more solicitous of the reliance of stockholders on historic regulatory patterns than it is of the identical reliance of the nation's lakes and lungs?

Compacts that link together a transitional preservation of each of these protections are the ones worth creating. ■