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# DENIAL OF REGULATORY ASSISTANCE IN STRANDED COST RECOVERY IN A DEREGULATED ELECTRICITY INDUSTRY

*by Elizabeth A. Nowicki\**

## I. INTRODUCTION

For many decades, electricity producers and distributors (“former monopolists”) have held the coveted positions of state regulated monopolists. Former monopolists have been the exclusive providers of electricity to residential consumers, and most commercial consumers and have been permitted to run their electricity lines and erect electricity poles in public rights-of-way. In addition, they have been afforded returns on their less-than-optimal investments, and they have been allowed to charge rates that compensate often inefficient management and cover related costs. This is all in exchange for allowing state regulators to set the rates they charge—generally set at profit margins based on very liberal cost projections. Now, due to technological innovations and changes in the industry structure, deregulation is occurring, and competition is emerging in the electricity generation facet of the industry, threatening former monopolists’ omnipotent positions.

Faced with more efficient competitors with newer technology, leaner management, and lower costs, former monopolists realize that a competitive market will not allow them to continue to recover the cost of every inefficient layer of management, every uneconomic

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investment, and every obsolete generator. They, therefore, are currently arguing that these “stranded costs” are costs incurred as part of a regulatory contract<sup>1</sup> with state regulators, and that, even in a deregulated electricity generation market, they should be afforded regulatory assistance in recovering their stranded costs from consumers.

While most academics, practitioners, and regulators agree that consumers will ultimately bear a portion of the stranded cost burden, one can argue that regulatory assistance in stranded cost recovery via consumers—who have sustained the monopolists for almost a century—can be fully denied. After discussing the background and development of the electric industry, the stranded cost recovery problem, and several solutions, the author concludes that denying regulatory assistance to former monopolists in the recovery of their stranded costs can be justified both legally and economically.

## II. BACKGROUND OF THE ELECTRIC INDUSTRY

### *A. Natural Monopoly Status*

The electricity market, which by traditional definition encompasses generation, transmission, and distribution, was assumed for years to be a “natural monopoly.”<sup>2</sup> Economists characterized the market as a natural monopoly based on the fixed costs and economies of scale of providing electricity.<sup>3</sup> The fixed costs encompassed such things as land, environmental pollution control and monitoring, generation plants, poles and lines, transmission facilities, and related technical support facilities.<sup>4</sup> If a second market participant were to enter the market, it could not justify investing in these fixed costs as

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1. This is also referred to as “regulatory compact.”

2. A “natural monopoly” exists if a single firm can supply the market at a lower cost than can two or more firms, because, over a large range of output, the average cost curve height for the relevant product declines with increasing output. See MARK W. FRANKENA & BRUCE M. OWEN, *ELECTRIC UTILITY MERGERS* 5-6 (1994); RICHARD L. GORDON, *REFORMING THE REGULATION OF ELECTRIC UTILITIES* 20 (1982); Daniel F. Spulber, *Deregulating Telecommunications*, 12 *YALE J. ON REG.* 25, 31 (1995).

3. See GORDON, *supra* note 2, at 20-23.

4. See *id.* at 22-23.

such an investment would be redundant.<sup>5</sup> The economies of scale<sup>6</sup> resulted from one market participant: (1) building several units on one site to maximize the centralization of management and environmental monitoring and to fully supply the available distribution and transmission capacity;<sup>7</sup> and (2) building a large enough individual unit to serve the ideal electricity load.<sup>8</sup> Establishing multiple firms in a market which lends itself, according to traditional theories, to economies of scale was economically inefficient and contraindicated. In spite of this theory and ample academic analysis of fixed costs and economies of scale indicating that the market should be treated as a natural monopoly, turn of the century industrialists and others were producing their own electricity. As one might have predicted, these producers eventually experienced shake-out, and this failure bolstered the idea that electricity was, and should be regulated as, a natural monopoly.

### *B. Historical Regulatory Treatment of the Electricity Industry*

Recognizing that the electricity industry was a natural monopoly, both the states, vis-à-vis state Public Service Commissions, and the federal government, vis-à-vis the Federal Energy Regulatory Commission (FERC),<sup>9</sup> traditionally have regulated the industry.<sup>10</sup>

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5. For example, if one utility invested in one set of electricity poles and lines in a given area, the cost of another firm doing such in the same locale, thereby having erected two sets of poles and lines, would be inefficient.

6. Economies of scale exist if unit costs decline with the volume of production over the relevant range of output. See J. Gregory Sidak & Daniel F. Spulber, *Deregulatory Takings and Breach of the Regulatory Contract*, 71 N.Y.U. L. REV. 851, 868 (1996). In the electricity industry, the unit costs traditionally decline with the volume of production because the significant technology costs, such as those of an electricity plant, do not vary with the amount of electricity produced. Thus, the more electricity that is produced, the more units to spread the fixed costs over and the lower the unit cost.

7. The economies of scale in transmission and distribution have been said to be large enough to, in and of themselves, justify treatment of the electric industry as a natural monopoly. See Richard J. Pierce Jr., *Using the Gas Industry as a Guide to Reconstituting the Electricity Industry*, RES. IN L. & ECON., 1991, at 16-17.

8. See GORDON, *supra* note 2, at 21-23.

9. Name changes by the FERC over the past twenty years have been disregarded by the author.

10. See JOSEPH P. TOMAIN & JAMES E. HICKEY, JR., ENERGY LAW AND POLICY 159-61 (1989).

These regulatory agencies have set the rates the utilities charged their customers, monitored the quality of service provided, ensured the provision of "universal service,"<sup>11</sup> and addressed a host of other issues arising in such a crucial industry displaying monopoly characteristics.<sup>12</sup>

While regulation has served the function of keeping in check an industry that could otherwise fall prey to the perils of monopoly power,<sup>13</sup> regulation has not achieved all that consumer watchdogs had hoped. Particularly over recent years, analysts have noted that the regulated rates of electricity charged to customers significantly

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11. Universal service simply means the provision of service to all who so desire, regardless of their proximity to a generation facility. Universal service generally requires rate subsidies, which are only feasible in a regulated environment. In a truly competitive market, a farmer in rural Wyoming likely could not have electric service because the cost of running the electric lines to his farm would exceed any reasonable fee that he could pay. In a regulated environment, where governmental agencies establish and enforce universal service plans, regulatory agencies can set electricity rates to allow for subsidies ("cross subsidization") from the customers who can be serviced cheaply, such as concentrated blocks of customers in urban areas, to the customers who carry a high cost of service provision, such as the farmer in Wyoming. See GORDON, *supra* note 2, at 209.

12. See TOMAIN & HICKEY, *supra* note 10, at 161-62.

13. There are three main concerns when dealing with a monopolist: the charging of "monopoly rents," the reaping of "monopoly profits," and "deadweight loss."

A monopolist reaps monopoly rents when it earns profits in excess of those required to cover costs, including capital costs. These rents create no incentive to cut costs and become more efficient, and these rents become a monopolist's *idée fixe*, inducing the monopolist to do whatever possible, within the budget provided by the rents, to preserve its monopoly position.

A monopolist earns profits when it chooses to sell less of its product than the market demands at a price higher than that which would have been set in a competitive market. This forces some consumers, who would be willing to purchase the product at the lower competitive market price, to forgo purchasing the product at the higher monopolist price.

Loss of economic wealth when willing consumers are denied a purchase at a competitive market price is termed a "deadweight loss" to consumers.

Regulation avoids these monopoly problems by: (1) setting rates that deny monopoly rents by keying rates to costs; and (2) setting rates that deny monopoly profits and prevent deadweight loss by analyzing the demand for the product and striving to realistically meet the demand through rate subsidies. See FRANKENA & OWEN, *supra* note 2, at 3-7.

exceed current market prices<sup>14</sup> of electricity generated by independent power producers.<sup>15</sup> The solution to such a problem seemed to be competition since market forces would drive electricity prices toward marginal costs. Regulators, however, feared that the industry was not ready to be treated as anything other than a regulated natural monopoly and, therefore, was not ready to be opened to competition. They feared that the power of a monopolist would regenerate itself if the electricity industry was free of the thumb of governmental regulation.

### III. DEVELOPMENTS IN THE ELECTRICITY INDUSTRY

#### A. *Evolution of Competitive Trends in the Electricity Industry*

The notion that the electricity industry was anything other than a pure natural monopoly slowly became apparent when competition appeared spontaneously in bypassing for electricity generation.<sup>16</sup> When wholesale electricity became increasingly expensive in New York state in the late 1980s, many large factories either began purchasing power from smaller, independent power generators or began producing their own power.<sup>17</sup> Similarly, municipalities began generating their own electricity to sell to their residents.<sup>18</sup> Thus, it became clear that there was room for some sort of competition in the electricity market. By definition, a natural monopoly exists when a

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14. Market price in an efficient market is the price at which the marginal cost, as a general measure of the value of the resources expended in production, equals the value that a consumer places on a product. See GORDON, *supra* note 2, at 24-25.

For purposes of this paper, when referring to a market as a competitive market, it will be assumed to be fully competitive, and, as such, market prices will be assumed to be efficient as above defined.

15. See, e.g., Richard D. Kinder, *The Monolith is Cracking: Electric Restructuring and Its Implications for Gas*, PUB. UTIL. FORT., Sept. 15, 1995, at 22.

16. "Bypassing" occurs when a utility customer decides not to purchase all of the regulated monopoly product that it needs from the traditional regulated monopoly, but rather finds an outside seller or provides the service themselves. See James L. Plummer, *Bypass Concepts and Transmission Access*, in COMPETITION IN ELECTRICITY: NEW MARKETS AND NEW STRUCTURES 43 (James L. Plummer & Susan Troppmann eds., 1990).

17. See, e.g., Michael Farrell, *Glens Falls Looking to Leave NiMo's Grid*, CAP. DIST. BUS. REV., June 19, 1995, at 1.

18. See *id.* at 28.

single firm can supply the market at a lower cost than can two or more firms. If firms other than the natural monopolist were partially supplying the electricity generation component of the market at a lower cost than the natural monopolist, the theory that a true natural monopoly existed in the electricity industry was wrong.<sup>19</sup> Further, technological advances in the electricity industry indicated that the economies of scale were not so great that the industry must be a natural monopoly.<sup>20</sup> Regulators, academics, and economists began to query, then, whether the electricity generation market was ready to be deregulated and opened to competition.

### B. *Current Status of the Industry*

Though federal and state regulators began to acknowledge that there was some competition in the electricity generation facet of the electricity industry, their legislative partners were not willing to concede that the industry was ready for deregulation until the 1990s. It was then that legislation was introduced at both the state and federal levels, which contemplated deregulation of electricity generation, while retaining regulation of transmission and distribution to compel reasonable access.<sup>21</sup>

Currently such deregulation legislation is progressing, and there is agreement now that there can be full and robust competition in electricity generation. However, neither the states nor the federal regulators can yet fathom competition in the transmission and distribution of electricity, because it is simply still more efficient to run one set of lines and poles.<sup>22</sup> Further, it is important that regulators monitor the transmission and distribution networks in the nation to

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19. See FRANKENA & OWEN, *supra* note 2, at 5-6. Private monopolists have recently supplied about 75% of the nation's electric power. See *Consumers' Lower Electric Bills Hinge on Congress*, USA TODAY, Mar. 7, 1997, at 10A.

20. See Sidak & Spulber, *supra* note 6, at 873-74.

21. See Electric Consumers' Power to Choose Act of 1997, H.R. 655, 105th Cong. (1997); Consumers Electric Power Act of 1997, H.R. 1230, 105th Cong. (1997); Electric Consumers Protection Act of 1997, S. 237, 105th Cong. (1997); New York State Electricity Industry Restructuring Act, S. 1460, 220th Leg., Reg. Sess. (N.Y. 1997).

22. The lack of competition in most facets of electricity transmission and distribution confirms that those aspects of the industry are still natural monopolies. See Plummer, *supra* note 16, at 43.

ensure that one firm does not control the transmission and distribution in an anticompetitive manner or in a manner which will thwart reliable electricity provision to everyone who seeks it.<sup>23</sup> Thus, while competition is beginning to march forward in the electricity parade, initially only generators will be marching.<sup>24</sup>

### C. Goals in the Electricity Market

It is generally stated in absolute terms that deregulation and competition in the electricity market will result in lower electricity costs.<sup>25</sup> Moreover, it is hoped that broader additional benefits will be reaped by deregulating the electricity generation market and opening the market to competition.<sup>26</sup>

The New York state<sup>27</sup> legislature, for example, specifies that its intent in moving toward deregulation is, in part, "to avoid economic waste and duplication while providing the lowest possible prices for electricity for consumers, consistent with a determination of what is fair, just and reasonable for electric utilities."<sup>28</sup>

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23. See H.R. 655; H.R. 1230; S. 237; N.Y. S. 1460.

24. While the argument can be made that transmission and distribution are, in fact, ready to be deregulated, for purposes of this paper, the author will assume that only generation is at a stage where it can be deregulated. See N.Y. S. 1460, §2.

25. See *Consumers' Lower Electric Bills Hinge on Congress*, *supra* note 19, at 10A (estimating potential savings on the average customer's bill of 10% to 26% per year after deregulation); Peter Coy, *The New Marketplace in Utilities May Bedevil Small Business*, BUS. WK., Mar. 3, 1997, available in 1997 WL 8268765 (in a fully competitive market, "electricity rates for small business could fall as much as 20% in states with low-cost power now, and up to 60% in states with high-cost power"); Kinder, *supra* note 15, at 22.

The highest rate in the nation for 1992-1993 was that of Long Island Lighting Co., a New York electric company, at 16.2 cents/kwh. See *25 Most Expensive Electrics*, PUB. UTIL. FORT., Jan. 15, 1994, at 54.

The lowest rate in the nation for 1992-1993 was 4.3 cents/kwh charged by both Washington Water Power Co. and Pacific Power & Light Co. See *25 Least Expensive Electrics*, PUB. UTIL. FORT., Feb. 1, 1994, at 54.

26. See Charles G. Stalon, *Oversight Hearing on Cogeneration and the Public Utility Regulatory Policies Act of 1978 (PURPA)*, in COMPETITION IN ELECTRICITY: NEW MARKETS AND NEW STRUCTURES, *supra* note 16, at 319, 337.

27. Throughout this paper, New York will be the point-of-reference state, as it is one of the more progressive states in the move toward deregulation of traditionally regulated utilities.

28. N.Y. S. 1460, §2.



The House of Representatives of the 105th Congress hopes that “[t]he development of vibrant competition in the retail market for electric energy will: (A) reduce the costs of electric energy to even the smallest consumers of electricity; (B) create jobs as American businesses are able to lower costs and better compete in world markets and against foreign competition here at home; and (C) result in a more efficient utility industry.”<sup>29</sup>

The United States Senate notes that “[i]t is in the public interest that consumers receive reliable and inexpensive electric service and competition among electric suppliers can produce these benefits.”<sup>30</sup>

Given the agreement that a competitive electricity market will rectify some of the existing economic problems in the current market, a competitive market, at least in electricity generation, is unavoidable.

#### IV. STRANDED COST RECOVERY “PROBLEM” IN A DEREGULATED INDUSTRY

##### *A. Factual Scenario*

Former monopolists are currently faced with new electricity generation competitors who are using modern, more efficient technology, who have leaner management structures, who have cheaper environmental compliance systems, and who have not made poor investments. At the same time, former monopolists are burdened with outdated technology, disadvantageous contracts,<sup>31</sup> and inefficient

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29. Electric Consumers’ Power to Choose Act of 1997, H.R. 655, 105th Cong., §2(a)(5) (1997).

30. Electric Consumers Protection Act of 1997, S. 237, 105th Cong., § 2(b), (1997).

31. In the 1970’s and 1980’s, when the energy crisis made uncertain the stability of traditional oil, gas, and electricity energy sources, many state Public Service Commissions encouraged the formation of independent power producers (“IPPs”), to establish stand-alone power plants. These plants solely generated power for sale to former monopolists, to ensure that electricity would be available to meet any upswing in demand due to problems with other energy sources. The Public Service Commissions required that, to continue to be afforded protected monopoly treatment, former monopolists (e.g., Niagara Mohawk, in New York state) must contract with the IPPs to purchase some of their electricity to make it feasible for the IPPs to continue in business even in times of non-energy crisis. Some would argue that the Public Service Commissions contracted with the former monopolists such that if former monop-

management. Former monopolists have realized that their costs are significantly higher than that of their new competitors, but they have chosen not to write off outdated investments and force their shareholders to assume realization of the risks inherent in a deregulating industry. They have also decided to forgo a frantic search for ways to cut costs and slim down management. Instead, former monopolists have begun clamoring for state and federal regulatory agencies to force electricity consumers to bear the brunt of these costs. Former monopolists refer to these costs as "stranded costs" and argue that these costs were incurred as part of a regulatory contract with the regulators. They ignore the fact that they voluntarily incurred the costs in order to receive favored regulated treatment, and they therefore maintain that they have a compelling case for imposing the recovery of such costs on electricity consumers.

### B. *Stranded Costs Defined*

Stranded costs merit specific definition. They have been defined by the New York State Public Service Commission as "the difference between the net embedded cost of utility plant and the plant's market value," but they "can also encompass factors such as transaction costs associated with reducing a company's work force, carrying charges on excess capacity or revenue losses due to customer migration to competitive alternatives."<sup>32</sup> Stranded costs have been defined

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lists purchased power from the IPPs through long-term contracts, the Public Service Commissions would allow former monopolists to recover the cost of such IPP electricity for as long as former monopolists were under contract with the IPPs. See Sidak & Spulber, *supra* note 6, at 879-81. In Part VIII.A. of this paper, it is shown that no such "contracts" were entered into. Rather, former monopolists chose to do what the Public Service Commissions so required, to avoid losing the benefits that the Public Service Commissions were affording them.

Unfortunately, former monopolists contracted with the IPPs to purchase electricity at prices that were high due to the energy crisis and the inflation at that time. Thus, in the early 1990's, it became clear that the contract prices former monopolists were paying the IPPs for electricity were well above the prices at which former monopolists could self-generate the electricity. These contracts, then, are uneconomic, and they fall within the definitions of stranded costs, provided in Part IV.B., *infra*.

32. Public Service Commission's Memorandum of Law, *In re Energy Ass'n v. Public Serv. Comm'n*, 653 N.Y.S. 2d 502 (N.Y. Sup. Ct. 1996) (Index No. 5830/96).

by the New York judiciary as “[r]evenue shortfalls occasioned for diverse reasons.”<sup>33</sup> Practitioners have defined stranded costs as “the immediate differential between a utility’s fully allocated rate and the market price.”<sup>34</sup> The author primarily views stranded costs as costs associated with independent power producer contracts, archaic and inefficient production facilities,<sup>35</sup> and imprudent facilities investments.<sup>36</sup> These costs create a difference between a utility’s fully allocated rate and the market price because the market price, stabilizing at marginal cost, does not reflect the costs of outdated facilities, imprudent investments and inefficient technologies.<sup>37</sup> To the extent that such costs create a difference between the net embedded cost of a utility’s plant and the plant’s market value, account for the immediate differential between a utility’s fully allocated rate and the market price, and create revenue shortfalls, the author’s categorization of stranded costs coexists with the other abovementioned definitions of stranded costs.<sup>38</sup>

Regardless of the nuances in such definitions of stranded costs, the problems created by stranded costs are the same: they are costs incurred by the utilities for which pure market pricing or pricing in accordance with marginal costs will not allow recovery.<sup>39</sup> Phrased differently, in a fully competitive market where the price of electricity will eventually fall to marginal cost, stranded costs, which by definition are not included in marginal cost, cannot be recovered through the market pricing of electricity.<sup>40</sup>

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33. *Id.* at 928 n.3.

34. See Stephen L. Teichler, *Generation, Deregulation, and Market Power: Will Antitrust Laws Fill the Void?*, PUB. UTIL. FORT., Oct. 15, 1996, at 34.

35. See Coy, *supra* note 25.

36. See *Consumers’ Lower Electric Bills Hinge on Congress*, *supra* note 19, at 10A.

37. See Alfred E. Kahn, *Can Regulation and Competition Coexist? Solutions to the Stranded Cost Problem and Other Conundra*, ELECTRICITY J., Oct. 1994, at 26.

38. See *id.*

39. See *id.*

40. See *id.*

In short, stranded costs are costs outside of efficient marginal costs, and everyone agrees they are bad<sup>41</sup>—they are not an economically positive phenomena.<sup>42</sup> Academic definitions aside, they might best be defined as the “‘Tonya Harding’ of our industry.”<sup>43</sup>

## V. POSSIBLE SOLUTIONS TO STRANDED COST PROBLEM IN A DEREGULATED INDUSTRY

Market prices in a competitive electricity generation market will not allow for recovery of stranded costs. Therefore, former monopolists who have stranded costs to recover cannot automatically do so.<sup>44</sup> This is troubling to them. What, then, are the possible ways to deal with the “stranded cost problem?” There are a plethora of proposals on the table from various legislators, consumer advocacy groups, utility organizations, economic think tanks, academics, regulators, and others.<sup>45</sup> Full, partial, or total denial of recovery of stranded costs through regulatory assistance are the most noteworthy of the proposals.

### A. Full Recovery of Stranded Costs Through Regulatory Assistance

Full recovery of stranded costs could be achieved with the help of state regulators. The regulators could impose surcharges, or “access fees,” on the independent generators who desire access to former monopolists’ transmission and distribution systems.<sup>46</sup> Such fees

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41. See, e.g., Alexander Cockburn, *Utilities’ \$500-Billion Power Play*, L.A. TIMES, Mar. 6, 1997, at B9 (“The word ‘stranded’ is used in the sense of ‘beached,’ as in a beached whale. . .”).

42. See, e.g., *FERC Commissioners, Sharp, Downplay Ramifications of Court’s Energy Ruling*, ENERGY REP., July 18, 1994, available in 1994 WL 2490462 (“[S]tranded investments are ‘uneconomic assets’ that occur in all businesses.”).

43. *NARUC Eyes Stranded Investment Jurisdictional Issues*, ENERGY REP., Mar. 7, 1994, available in 1994 WL 2490964 (quoting Dave Penn, American Public Power Association’s policy analysis director).

44. See generally *Stranded Costs Seen at \$200-Billion, with Utilities Bearing Most of Burden*, ELECTRIC UTIL. WK., Nov. 28, 1994, at 8 (estimating stranded costs at about \$200 billion).

45. See Lester Baxter et al., *Mitigating Transition Costs: The Utility’s Role*, PUB. UTIL. FORT., Jan. 15, 1997, at 30 (discussing proposals for addressing stranded costs).

46. See Peter Passell, *A Makeover for Electric Utilities: Power Industry, Facing Competition, Struggles With Change*, N.Y. TIMES, Feb. 3, 1995, at D6.

could serve, in part, to pay for the recovery of former monopolists' stranded costs.<sup>47</sup> Regulators could also allow former monopolists to charge "customer exit fees" if customers chose to have their electricity supplied to them by other independent generators rather than by the local former monopolists.<sup>48</sup>

*B. Partial Recovery of Stranded Costs Through Regulatory Assistance and Partial Denial of Assisted Stranded Cost Recovery*

A partial recovery of stranded costs could be achieved by recovering some stranded costs attributable to electricity generation through a combination of transmission access fees and exit fees while still forcing the former monopolists to deal with some stranded costs themselves.<sup>49</sup> This would be the result if the consumer advocates and the utilities compromised on each of their positions.<sup>50</sup> In the end, neither side will have gotten its dream solution but will have instead struck a "grand bargain."<sup>51</sup>

*C. Cold Turkey: Total Denial of Regulatory Assistance*

Former monopolists could be left entirely on their own to deal with stranded costs—they could be forced to go "cold turkey." They could: (1) write off their archaic investments, ancient facilities, and poor investments;<sup>52</sup> (2) be purchased by a company that needs the ability to write off assets to decrease profits and book values; (3) defer writing off the stranded costs until they need a tax deduction; or

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47. *See id.*

48. *See Coy, supra note 25.*

49. *See Maine Stranded Investment Rule Seen as Gypping Utilities, Slamming Munis*, N.E. POWER REP., Mar. 17, 1995, available in 1995 WL 2366423 (discussing Maine's 50% state assisted recovery rule with regard to stranded costs).

50. *See Ray Pospisil, The California Aftershock*, ELECTRICAL WORLD, Sept. 1994, at 29 (quoting John Anderson, executive director of the Electricity Consumers Resource Council: "You have to compromise on stranded costs").

51. Passell, *supra note 46*, at D1 (quoting Peter Bradford, the recently retired chairman of the New York Public Service Commission).

52. *See FERC Commissioners, Sharp, Downplay Ramifications of Court's Energy Ruling, supra note 42.*

(4) buy out their disadvantageous IPP contracts or negotiate for better terms.<sup>53</sup> In reality, they could choose from several options to unilaterally deal with stranded costs, requiring them to assume full responsibility for their costs.

## VI. WHICH STRANDED COST SOLUTION LOOKS BETTER TO WHOM

### A. Former Monopolists

Clearly former monopolists would like to fully recover stranded costs by charging access fees, imputing costs to state regulated transmission rates, and charging customer exit fees.<sup>54</sup> Such recovery will ensure that they will not have to take a loss on stranded costs, which will in turn allow them to protect their investors while still attracting new investors and capital.

### B. Electricity Consumers

From an electricity consumer's perspective, former monopolists' recovery of no stranded costs is ideal. This theoretically ensures that consumers will not have to further support an industry which they have funded for years. Consumers will be able to reap the benefits of deregulation and competition quickly, and they will not have to be tied to a rate structure that does not reflect the market conditions.<sup>55</sup> That some traditionally powerful utilities will potentially go bankrupt by not being allowed to recover stranded costs is not a fatal impediment to the benefits that the consumers will reap from the non-recovery of stranded costs. The dynamics of the electricity generation market are such that new market entrants can efficiently and reliably supply cheaper power in place of that supplied by former

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53. See *American Gas Ass'n v. FERC*, 912 F.2d 1496, 1505 (D.C. Cir. 1990); *NIMO Offers to Buy Out 44 Contracts with Independent Power Producers*, N.E. POWER REP., Aug. 16, 1996, at 1; see also Erik Kriss, *Environmental Groups Fight State Aid for NiMo*, POST STANDARD, Dec. 13, 1996, at C5 (discussing proposed legislation which will provide state guarantees to aid Niagara Mohawk Power Corporation improve its credit rating in order to borrow money to buy out the IPP contracts).

54. See Cockburn, *supra* note 41, at B9 ("The utilities' dream is to unload the \$500 billion in debts on these plants and other mature facilities onto rate-payers and taxpayers instead of onto their shareholders.").

55. See *id.*

monopolists' generators.<sup>56</sup> Also, the Public Service Commissions will continue to operate—ensuring that some mechanism for maintaining reliable service will exist.<sup>57</sup>

### C. Business Owners

From the perspective of business owners who compete with out-of-state businesses, it is essential that utilities do not recover stranded costs from the customer.<sup>58</sup> When stranded costs are recovered through rates charged to the customer, the business owner who is an electricity customer in such a jurisdiction will be at a huge cost disadvantage compared to the business owner who is an electricity customer in a jurisdiction where stranded costs are not recovered through rates charged to the customer.<sup>59</sup> For the business owner in a jurisdiction where stranded costs are recovered through customer rates, his costs are per se higher than those of a comparable business owner in another jurisdiction, and he will ultimately have no option other than to leave the jurisdiction if he wants to retain the ability to price his wares at competitive levels.<sup>60</sup>

### D. Employees

From an employee's perspective, denial of stranded cost recovery is critical lest the employer migrate to a state where stranded utility costs are not recovered through rates to the consumer. Further, an employer will likely try to cut costs to survive by laying off staff before moving to a non-stranded cost recovery jurisdiction.<sup>61</sup>

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56. See Electricity Consumers Resource Council ("ELCON"), *Policy Changes Affecting Non-Utility Generators*, in COMPETITION IN ELECTRICITY: NEW MARKETS AND NEW STRUCTURES, *supra* note 16, at 61, 66.

57. See Kahn, *supra* note 37, at 23.

58. See Affidavit of Warren E. Myers at 4, *In re Energy Ass'n v. Pub. Serv. Comm'n*, 653 N.Y.S. 2d 502 (N.Y. Sup. Ct. 1996) (Index No. 5830/960).

59. See New York State Electricity Industry Restructuring Act, S. 1460, 220th Sess., § 2 (N.Y. 1997).

60. See *id.*

61. The irony is that laying off staff will never usefully lower the employer's costs to the extent that the employer is able to price competitively against another producer in a jurisdiction where stranded utility costs are not recovered through the customers. To the extent that stranded costs are recovered through electricity prices to one producer, and to the extent that two producers use the same optimally efficient amount of electricity in the production of their wares, the costs for the producer who purchases electricity in a

Thus, both in the short and long terms, it is important to an employee, qua employee, that stranded costs are not recovered via customer rates.

## VII. FORCING FORMER MONOPOLIST TO GO COLD TURKEY IS AN ECONOMICALLY JUSTIFIABLE OPTION

It is economically justifiable to force former monopolists to address their stranded costs themselves, without any sort of regulatory intervention. While this choice is defensible because it mimics the truly competitive market by rewarding efficiency, inducing cost reductions, and encouraging careful planning, it is also better in many respects than other options.

### A. Other Options Have Competitive and Economic Weaknesses

From a basic economic standpoint, forcing recovery of costs through transmission and distribution rates higher than those at which the market would otherwise stabilize is inefficient. If part of the goal of deregulation is to allow natural competition to lower prices to reflect efficient marginal costs, then forcing consumers to pay stranded costs—costs above competitive marginal costs—is completely contrary to the goal of the deregulation movement.

Further, allowing recovery of stranded costs attributable to electricity generation through access fees charged for transmission and distribution is undesirable because it skews costs.<sup>62</sup> To allow recovery of costs attributable to one market via rates in another market is just economically bizarre.

Similarly, allowing stranded cost recovery through exit fees will “thwart the very efficiency gains that will prevent stranded investment tomorrow.”<sup>63</sup> To the extent that non-recovery penalizes

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stranded cost recovery jurisdiction will never be able to equal or be lower than the costs of the other producer in a non-recovery jurisdiction. Therefore, the producer who purchases and uses electricity in a jurisdiction where stranded costs are recovered through rates to the consumer will never, regardless of how much of the staff is laid off to lower costs, be able to price goods at the prices of the latter producer.

62. See Mary O’Driscoll, *FERC Learned Wrong Lesson From Gas Deregulation—Enron*, ENERGY DAILY, Dec. 12, 1994, at 1, 4 (“[W]holesale transmission service customers should not have to underwrite ‘damages’ attributable to retail generation customers.”).

63. The 1997 Electric Executives’ Forum, *Which Parts of Your Business*



inefficient investments in a competitive market, allowing recovery of inefficient investments will encourage those poor investments in the future.

Finally, regulatory-assisted stranded cost recovery leads to economic inefficiencies—including inefficient consumer choices.<sup>64</sup> For example, assume that the true market price of electricity is six cents per kilowatt, but the retail price is raised to eleven cents per kilowatt when stranded costs are allowed to be recovered. A residential customer who is considering buying a dishwasher will consider the cost of electricity needed to run the dishwasher. While she would purchase the dishwasher if the cost of running it were only six cents per kilowatt, she will not purchase the dishwasher because the cost of running it is eleven cents per kilowatt. Stated differently, she will not purchase the dishwasher even though she would have been willing to purchase both the dishwasher and the electricity needed to run it had the price of electricity been at its marginal cost, what it costs to produce. Though willing to make an economically efficient purchase—purchasing the dishwasher because she can afford to buy it and run it had electricity costs been set at marginal cost—she was forced to instead make an economically inefficient purchasing decision which resulted in a net loss to the economy.

*B. Forcing Former Monopolists to Go Cold Turkey is Economically Reasonable*

Forcing former monopolists to assume total responsibility for their costs is an economically reasonable method for addressing stranded cost recovery. Such denial of regulatory assistance mimics the treatment that a competitive environment would afford. It also reduces rewards for wasteful investments, embodies notions of fairness in risk assumption, and is not, per se, fatal to the continued economic feasibility of former monopolists.

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*Will Likely See the Greatest Push for Development in the Next 3 to 5 Years, and Why?*, PUB. UTIL. FORT., June 1, 1994, at 18 [hereinafter Electric Executives Forum] (quoting Jeffery K. Skilling).

64. See generally *id.* (discussing how various utility company executives plan to be more efficient for their customers).

1. Denial of regulatory assistance mimics the treatment a competitive environment would afford to stranded costs

Forcing former monopolists to address their stranded costs themselves mimics the way a truly competitive environment would deal with the costs of poor investments and outdated technology. Any economist would say that “[i]n a truly competitive environment . . . uneconomic assets are written off.”<sup>65</sup> While there are other ways for former monopolists to deal with stranded costs,<sup>66</sup> a truly competitive environment would not support regulatory assistance in stranded cost recovery. If electricity had not been a regulated monopoly for almost a century, it is not unlikely that former monopolists would even *ask* for regulatory assistance to recover stranded costs now. A competitive environment simply does not handle costs in such a manner.<sup>67</sup>

When faced with the denial of fully assisted recovery of stranded costs, former monopolists will begin searching for socially productive and economically rational ways to remain competitive. They will cut costs both by reducing expenses to the lowest possible level and by releasing unnecessary management.<sup>68</sup> In addition, they will focus carefully on customer service to encourage customers to remain with them while they fight to lower costs,<sup>69</sup> and they will begin competing on valid issues for which the consumers are the ultimate beneficiaries.

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65. *FERC Commissioners, Sharp, Downplay Ramifications of Court's Energy Ruling*, *supra* note 42.

66. *See infra* Part VII.B.4.

67. *See* Eric Niiler, *Pilgrim Powering Up as Competition Looms*, PATRIOT LEDGER (Quincy, Mass.), Apr. 19, 1997, available in 1997 WL 8174169 (quoting power industry consultant Bruce Biewald “‘There’s no longer a way to shield an uneconomic asset . . . . Competition will make some of these decisions more rational.’”).

68. *See* Baxter et al., *supra* note 45, at 32.

69. *See* Electric Executives’ Forum, *supra* note 63, at 44-48; *see also* Hue Ha, *Meter-Reading Companies Seek Ways to Cash in on Fast-Growing Business*, WALL ST. J., Mar. 19, 1997, available in 1997 WL-WSJ 2413510 (describing meter-reading devices as a means for reducing costs and improving customer service).

2. Denial of regulatory assistance reduces rewards for wasteful investments

In a traditional regulatory environment, a natural monopolist would have little reason to plan every small facet of an investment to ensure that the investment is truly the best one, because regulatory agencies historically have been very liberal in allowing returns on even less than excellent investments.<sup>70</sup> Allowing recovery of stranded costs which, in part, encompass poorly made investments would continue to reward wasteful investments in a manner which would not encourage careful planning and forecasting.<sup>71</sup> However, in a competitive market, participants will be rewarded for basing investment decisions on careful planning and forecasts.<sup>72</sup>

3. Denial of regulatory assistance embodies notions of fairness and risk bearing

There are essentially two parties on whom the burden of stranded costs can fall: the electricity consumers or the electricity investors.<sup>73</sup> Apportioning the stranded cost burden to the electricity investors—as will ultimately occur if former monopolists address stranded costs without regulatory intervention—is the “fairest” thing to do, since the electricity investors were the parties who assumed the risk of non-recovery in return for the potential gains on their investment.<sup>74</sup>

Presumably, an investor invests in a company after analyzing the investment and concluding that the potential gains from investing in the company outweigh the potential losses, and after weighing the respective likelihoods that the investment will produce gains or

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70. See Pierce, *supra* note 7, at 12.

71. See *id.* at 12; see also FRANKENA & OWEN, *supra* note 2, at 6 (describing how monopolies do not have an incentive to be as efficient as possible because of the absence of the threat of competition).

72. See FRANKENA & OWEN, *supra* note 2, at 6; Gordon, *supra* note 2, at 25.

73. See Mary B. Bushnell, *Blinded By the Light: Restructuring Public Utilities for the Promise of a Competitive Energy Future*, in COMPETITION IN ELECTRICITY: NEW MARKETS AND NEW STRUCTURES, *supra* note 16, at 585, 589-91.

74. See Peter Coy & Gary McWilliams, *Electricity: The Power Shift Ahead*, BUS. WK., Dec. 2, 1996, available in 1996 WL 10771765 (“A bond is not a risk-free investment.”).

losses. The risk that the investment will be a bad one is entirely on the investor. Even if it is virtually certain that the investment will increase in value, should the investment fail to do so, the investor must bear the loss. Therefore it is intuitive that the electricity investors should ultimately be the backstop for the non-recovery of stranded costs.

Former monopolists would argue that their investors did not assume the risk of non-recovery of stranded costs because it has always been unfathomable that the electricity companies would not be able to fully recoup their investments. This argument for shifting the burden of the stranded cost recovery to the consumers is unpersuasive because (1) the investors had full knowledge of the contingency of non-recovery of stranded costs, and (2) the market price of their investment theoretically accounted for the uncertainty of stranded cost recovery.

Investors have had full knowledge of the contingency of non-recovery of stranded costs—the electric companies have warned them. For example, Long Island Lighting Company, a New York electric utility, told its investors in its 1988 Annual Report to Shareholders that the recovery treatment to be afforded to its Shoreham nuclear plant—which likely would never go into operation<sup>75</sup>—was uncertain, and it might never be afforded any recovery at all.<sup>76</sup> Similarly, Niagara Mohawk Power Corporation indicated that it faces significant challenges<sup>77</sup> with economic uncertainties relating to competition, recovery of investments, uncertain contracts, and other stranded costs, and filing for bankruptcy cannot be ruled out.<sup>78</sup> Further, numerous investment rating services such as Moody's and Standard and Poor's have publicized the uncertainty regarding

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75. One can safely assume that it was a "bad investment" for purposes of characterizing it as a stranded asset and stranded cost. *See supra* Part IV.B.

76. *See* LONG ISLAND LIGHTING CO., 1988 ANNUAL REPORT TO SHAREHOLDERS (1988).

77. *See* NIAGARA MOHAWK POWER CORP., FORM 10-K, 1, 6-7 (Dec. 31, 1995) (visited Oct. 12, 1998) <<http://www.sec.gov/Archives/edgar/data/71932/10000071932-96-00000009.txt>> [hereinafter NIAGARA, FORM 10-K] (pagination off of Internet version; actual pagination may differ).

78. *See* NIAGARA MOHAWK POWER CORP., FORM 10-Q, (June 31, 1996) (visited Oct. 12, 1998) <<http://www.sec.gov/Archives/edgar/data/71932/0000071932-96-000015.txt>>; NIAGARA, FORM 10-K, *supra* note 77.

stranded cost recovery and the related electric company's financial instability.<sup>79</sup>

Recently former New York State Public Service Commission Chairman Peter Bradford concluded regulators should not bail out investors:

Electric utility investors have clearly 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 scarcely compels the imposition by regulators of an unconditioned strandable investment tax to assure full recovery.<sup>80</sup>

More telling is Niagara Mohawk Power Corporation's own summation of the investment, uneconomic contract, competition, and technological uncertainties inherent in its shareholders' investments in its company:

While the Company will seek full recovery if its investment through the rate setting process with respect to the issues described herein, a review of political and regulatory actions during the past 15 years with respect to industry issues and the experiences of virtually every other industry that has gone through deregulation, indicate that utility shareholders *may ultimately bear a significant portion of the burden of solving these problems.*<sup>81</sup>

Thus, it is absurd for former monopolists, when clamoring for full stranded cost recovery for their investors, to attempt to refute the presumption that investors were aware of the stranded cost concerns,

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79. See Curtis Moulton, *Concerns Over Investor-Owned Electric Utilities Outlined*, STANDARD & POOR'S CREDITWEEK, Nov. 22, 1993, at 43; Curtis Moulton, *S&P to Review Electric Utility Benchmarks*, STANDARD & POOR'S CREDITWEEK, Oct. 11, 1993, at 3; MOODY'S INVESTOR SERV., NORTHEAST BREAK EVEN ANALYSIS: MAGNITUDE OF STRANDED INVESTMENT IN REGION HIGHLIGHTS CREDIT CONCERNS, 1 (Dec. 1995).

80. See Affidavit of John D. Stewart at 5, *In re Energy Ass'n v. Pub. Serv. Comm'n*, 653 N.Y.S. 2d 502 (N.Y. Sup. Ct. 1996) (Index No. 5830/96) (quoting Statement on Behalf of the Vermont Department of Public Service, July 14, 1996).

81. NIAGARA MOHAWK POWER CORP., FORM 8-K, at 13 (Feb. 15, 1995) (visited Oct. 12, 1998) <<http://www.sec.gov/Archives/edgar/data/71932/0000071932-95-000008.txt>> ("Management's Discussion and Analysis of Financial Condition and Results of Operations") (emphasis added) (pagination off of Internet version; actual pagination may differ).

and it is impossible for former monopolists to persuasively argue that an efficient investment market did not take into account the financial uncertainties surrounding the electricity industry when pricing the related investments.<sup>82</sup> Investors were aware<sup>83</sup> of the nature of their investments, and the market price for the electricity investments presumably reflected the uncertainties inherent in such investments.<sup>84</sup>

4. Denial of regulatory assistance is not, per se, fatal to former monopolists

While former monopolists plead that forcing them to handle their stranded costs alone will lead them into bankruptcy,<sup>85</sup> they fail to mention that there are other ways that they can address the stranded cost recovery issue or at least mitigate the effects of such costs to avoid bankruptcy.

Former monopolists can look for strategic mergers, from which to adopt cutting-edge technologies, to capture economies of scale, to streamline management for more facilities, and to find other cost-cutting competitive opportunities.<sup>86</sup> To raise capital they can issue new bonds or sell assets, which would relieve their books of unrecoverable costs.<sup>87</sup> They can negotiate down or buy out their uneconomic IPP contracts.<sup>88</sup> They can propose plans for restructuring and make bond offerings in conjunction with such plans. Finally, they can utilize the capital markets and the economic options available

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82. See Peter D. Blair, *Alternative Scenarios for Increasing Competition in the Electric Power Industry*, in COMPETITION IN ELECTRICITY: NEW MARKETS AND NEW STRUCTURES, *supra* note 16, at 461, 462-63.

83. Whether or not each and every investor knew is irrelevant. What is relevant is that the information was freely available to investors, such that each investor essentially had "constructive knowledge."

84. See Dave Alrozo, *Moody's Says High-Cost Producers Face the Abyss in New Environment*, NUCLEONICS WK., Nov. 10, 1994, at 3, available in LEXIS, News Library Arcnews File.

85. See Joseph F. Schuler, Jr. & Lori A. Burkhart, *Moody's: NiMO Bankruptcy Possible*, PUB. UTIL. FORT., July 1, 1996, at 13.

86. See *M&A Strategy Gets Executive Attention*, ELECTRICITY DAILY, Mar. 5, 1996, at 3, available in LEXIS, News Library Arcnews File.

87. See *id.*

88. See *NiMO Offers To Buy Out 44 Contracts With Independent Power Producers*, *supra* note 53, at 1; see also Kriss, *supra* note 53, at C5 (discussing proposed legislation which will provide state guarantees to aid Niagara Mohawk in improving its credit rating in order to borrow money to buy out the IPP contracts).

therein to devise a plan which will ensure their own financial success.

VIII. FORCING FORMER MONOPOLISTS TO GO COLD TURKEY IS A  
LEGALLY JUSTIFIABLE METHOD BY WHICH TO ADDRESS  
STRANDED COSTS

It is legal to refuse to force state ratepayers to pay a power generator's stranded costs. No "regulatory compact" exists between former monopolists and the state Public Service Commissions which would create an obligation for state regulators to assist power generators in recovering one hundred percent of their stranded costs. The disallowance of recovery through rates does not violate the recently established "unmistakability doctrine" or *Winstar* doctrine.<sup>89</sup> Further, though disallowance of recovery through the state ratepayers might possibly result in the electricity generator having to write-off their stranded costs as a loss, thus decreasing the value of their shareholders' investment, it is not an unconstitutional taking of property by the state regulators.<sup>90</sup>

A. *The "Regulatory Compact Theory" is a Fiction*

Some would argue that, years ago, former monopolists entered into a "regulatory compact" with the state regulators similar to that in *Winstar*<sup>91</sup> wherein the state regulators agreed to let the monopolists recover all of their investments and costs in return for supplying reliable service to the state electricity customers and complying with the requests of the state regulators.<sup>92</sup> From former monopolists' view, it is an outstanding theory because it raises contract issues which would ultimately lead to the state regulators having to assist former monopolists in recovering all of their stranded costs. Realistically, it is a theory that is objectively untrue and rather unbelievable in the deregulated electricity context.

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89. See *United States v. Winstar Corp.*, 518 U.S. 839, 871-80 (1996) (articulating the extent to which the "unmistakability doctrine" allows the government to change regulatory structures unless it has promised a contracting party, in unmistakable terms, that it would not).

90. See *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314-15 (1989); see also *Sidak & Spulber*, *supra* note 6, at 995 (listing the four conditions that are both necessary and sufficient for a regulatory taking).

91. 518 U.S. 839.

92. See *Sidak & Spulber*, *supra* note 6, at 898-99, 907.

In *Winstar*, profitable savings and loans thrifts such as Winstar Corporation agreed to merge failing savings and loans—to free the government and taxpayers from the burden of those savings and loans—if federal regulators allowed Winstar and other acquirors to treat the goodwill of the failing savings and loan in a favorable manner.<sup>93</sup> When the government later tried to statutorily deny the acquirors their favorable goodwill treatment, Winstar sued the government for breach of contract and unconstitutional taking.<sup>94</sup> The lower court found explicit agreements between the acquiring thrifts and their regulators,<sup>95</sup> and the Supreme Court, on review, did not disturb those conclusions.<sup>96</sup> The Supreme Court then held that later executive or legislative action which interfered with the agreements caused a breach of the explicit contracts, for which the regulators were liable.<sup>97</sup>

Thus, the *Winstar* case did not focus on government regulation of a regulated entity; rather it focused on an entity in an otherwise regulated industry being permitted to do something outside the scope of regulation, as part of an agreement with the government. In exchange, Winstar and similar corporations relieved the government of its burden of failing savings and loans. The key factor in *Winstar* that compelled the Court to afford Winstar the promised favorable goodwill treatment was the true contract governing the parties' actions and obligations.<sup>98</sup> Winstar was not doing anything that it was already obligated by regulation to do.

In the electricity industry, there is no similar regulatory compact. Former monopolists chose to provide reliable service and comply with the requests of the state and federal regulators in return for authorization from the states to use public rights-of-way for electricity poles and electric wire.<sup>99</sup> Accepting consumer rates set by the

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93. See *Winstar*, 518 U.S. at 849-51.

94. See *id.* at 858.

95. See *Winstar Corp. v. United States*, 64 F.3d 1531, 1540 (Fed. Cir. 1995).

96. See *Winstar*, 518 U.S. at 864-67 (1996).

97. See *id.* at 868-70.

98. See *id.*

99. See *Sidak & Spulber*, *supra* note 6, at 898. Recently the judiciary in New York State directly rejected the regulatory compact fiction in the electricity industry on the same basis, saying:

Since the turn of the century, electric utilities have been on notice that



states saved the utilities the costs of negotiating and contracting with each individual consumer.<sup>100</sup> There was never a compact or contract as there was in *Winstar*.<sup>101</sup> Rather, there was only the desire by former monopolists to reap the benefits of legal monopolist status by doing that which the regulators demanded.<sup>102</sup>

*B. Denying Regulatory Assistance in Recovering Stranded Costs in a Deregulated Electricity Industry Would Not Result in an "Unconstitutional Taking"*

Denying regulatory assistance to former monopolists in their pursuit of stranded cost recovery would not result in an unconstitutional taking by the government vis-à-vis the regulators. Such denial is well within the established parameters for constitutional ratemaking, and such denial remains within the boundaries established by case law in this area.

1. Parameters for state ratemaking can be met

Ratemaking by an agency is traditionally afforded very broad protection because it inherently involves the exercise of implied legislative discretion.<sup>103</sup> "How such compensation may be ascertained, and what are the necessary elements in such an inquiry, will always be an embarrassing question."<sup>104</sup> The courts cannot become involved

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they are required to serve the public need for electricity, not in return for a particular ratemaking method, but in return for a variety of powers traditionally reserved to the sovereign, including eminent domain and the use of public rights-of-way.

*In re Energy Ass'n v. Public Serv. Comm'n*, 653 N.Y.2d 502, 514 (1996).

100. See Sidak & Spulber, *supra* note 6, at 898-99 (quoting George L. Priest, *The Origins of Utility Regulation and the "Theories of Regulations" Debate*, 36 J.L. & ECON. 289, 303 (1993)).

101. See generally *Winstar*, 518 U.S. at 843 (recognizing contracts between the government and participants in a regulated industry).

102. See New York State Public Service Commission's Memorandum of Law at 30; *In re Energy Ass'n v. Public Serv. Comm'n*, 653 N.Y.S.2d 502 (N.Y. Sup. Ct. 1996) (Index No. 5830/96).

103. See *Los Angeles Gas & Elec. Corp. v. Railroad Comm'n*, 289 U.S. 287, 304 (1933); *In re Abrams v. Public Serv. Comm'n*, 67 N.Y.2d 205, 212 (1986).

104. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 308 (1989) (quoting *Smyth v. Ames*, 169 U.S. 466, 546 (1898)).

“so long as constitutional limitations are not transgressed.”<sup>105</sup> For purposes of the constitutional inquiry, only the impact of the rate matters.<sup>106</sup> It is the end result, not the theory or rate process underlying the resultant rate that cannot be unreasonable lest it be confiscatory and, hence, unconstitutional.<sup>107</sup>

*a. a fair rate of return is provided*

In assessing whether a rate is confiscatory, one can consider the fair rate of return to be afforded the shareholders, given the risks.<sup>108</sup> Since FERC’s 1996 order opening the electricity generation market to competition, generators have been on notice that they might not be able to recover stranded costs with competitive market rates.<sup>109</sup> As a result, former monopolists have been signaling to their shareholders that they might have to grapple with non-recovery of stranded costs.<sup>110</sup> Investors, therefore, were and are aware of the risks in the deregulated electricity industry,<sup>111</sup> and they assumed the risk of non-recovery of stranded costs in their investment.

*b. investor and consumer interests are balanced*

Nonconfiscatory “just and reasonable rates” should reflect a “balancing of the investor and the consumer interests.”<sup>112</sup> To that

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105. *Los Angeles Gas*, 289 U.S. at 304.

106. *See Duquesne*, 488 U.S. at 310.

107. *See id.* at 307-10; *Fed. Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) (“If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end.”).

108. *See Duquesne*, 488 U.S. at 310; *Hope Natural Gas*, 320 U.S. at 603; *In re St. Lawrence Gas Co. v. Public Serv. Comm’n*, 42 N.Y.2d 461 (1977).

109. *See Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting*, 61 Fed. Reg. 21540 (1996) (codified at 18 C.F.R. pts. 35 & 385).

110. *See James Denn, NiMo Seeks Regulatory Relief as Financial Condition Worsens*, TIMES UNION (Albany, N.Y.), Aug. 31, 1995, at C17, available in 1995 WL 14532083; *see also supra* Part VII.B.3.

111. *See Syracuse Bus.*, Apr. 1, 1996, available in 1996 WL 8863928 (Niagara Mohawk Vice President of Marketing and Economic Development discusses new risks and changes which shareholders and investors are going to face after deregulation).

112. *Hope Natural Gas*, 320 U.S. at 603.

point, it is important to look again at the investors' risks.<sup>113</sup> As discussed above, investors in electric utilities have been aware for some time that stranded cost recovery is problematic. They were aware that the trend toward deregulation might impact the financial stability of the utilities. Thus, they could factor these issues into their decision whether to invest in an electric utility, and they could decide whether or not to assume the risks inherent in such an investment.

There is no corresponding argument in favor of imposing upon the consumer the stranded cost risk and resultant burden. Rather, it can be argued that the consumer has helped the electricity generators recover their fixed and marginal costs over the past decades, and the consumer, in that respect, has already benefitted the investors who have reaped dividends and capital gains over the years.<sup>114</sup>

*c. the market's valuation of the electricity is reflected*

In assessing whether a method of ratemaking or cost treatment is confiscatory, one can consider the public's demand that it pay no more than the services rendered to it are reasonably worth.<sup>115</sup> One objective way to make such a determination in the electricity industry is by allowing the market to set the price for electricity.<sup>116</sup> This, however, would result in a denial of regulatory assistance in stranded cost recovery because the market will set the price for electricity at its marginal costs, which do not include stranded costs.<sup>117</sup>

One can consider the economic market forces at work, as a utility cannot demand that the consumer underwrite the costs of the operation of economic forces.<sup>118</sup> Though *Federal Power Commission v. Hope Natural Gas*<sup>119</sup> indicates that it is just and reasonable to allow a financially sound company to maintain its financial integrity,

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113. See *id.*; see generally *St. Lawrence Gas Co.*, 42 N.Y.2d at 465 (emphasizing that a "utility is not guaranteed a profit and generally its investors run the risk of losses in the same way as any other investor in a private business").

114. See David DeKok, *Legislators Face Debate on Electric Competition*, PATRIOT-NEWS (Harrisburg, Pa.), Nov. 24, 1996, at D1.

115. See *Duquesne*, 488 U.S. at 308.

116. See *id.* at 316 n.10.

117. See Kahn, *supra* note 37, at 23-37; *supra* text accompanying note 41.

118. See generally *Market St. Ry. v. Railroad Comm'n*, 324 U.S. 548, 567 (1945) (stating that the Due Process Clause of the Constitution does not insure values or require restoration of values that have been diminished by the operation of economic forces).

119. 320 U.S. 591 (1943).

there is no obligation to do so in contravention of market forces.<sup>120</sup> *Market Street Railway v. Railroad Commission*<sup>121</sup> specifically distinguished *Hope Natural Gas* as inapplicable to “a company whose financial integrity already is hopelessly undermined, . . . and where investors recognize as lost a part of what they have put in.”<sup>122</sup>

Moreover, footnote 10 in *Duquesne* sanctioned the use of market prices as an objective basis for determining utility asset values and, hence, rates, thus sanctioning the concept that contravention of market forces to give a utility positive returns is not necessary.<sup>123</sup> Disregarding utilities’ other financial problems, which are independent of the denial of stranded cost recovery, if the electricity generators were competitors in a truly competitive market, they would be in questionable financial shape because they could not charge prices that would allow them to recover the costs of their IPP contracts and uneconomic investments. In a truly competitive market, some competitors would charge rates at their fixed and marginal costs or at their marginal costs alone.<sup>124</sup> Therefore, if some generators tried to charge higher prices to recover stranded costs, they would lose business and go bankrupt. Their viable options would instead include taking losses on the contracts, issuing debt to raise the capital to buy out the contracts, decreasing dividends to cover write-offs each year for uneconomic assets, and selling old assets. Market forces allow no way for an electricity generator to recover all stranded costs through charges to the customer, and there is therefore no legal requirement that a Public Service Commission contravene these market forces and allow the electricity generators to charge rates which will allow evasion of the financial responsibility for their costs.

2. Case law restrictions on rate-making are not violated by denying stranded cost recovery in a deregulated electricity industry

An electric utility would argue that *Associated Gas Distribution v. FERC*,<sup>125</sup> absolutely prohibits a government agency from refusing to make provisions in a rate order to ease the financial burden on

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120. *See id.* at 605.

121. 324 U.S. 548 (1945).

122. *Id.* at 566.

123. *See Duquesne*, 488 U.S. at 316 n.10.

124. *See Kahn*, *supra* note 37, at 25-26.

125. 824 F.2d 981 (D.C. Cir. 1987).

utilities of "uneconomical" contracts, similar to those the electricity generators are currently under with the IPPs. However, *Associated Gas* cannot legitimately be read to so hold. All the court in *Associated Gas* required of an agency setting rates in light of uneconomic contracts in a deregulating industry was "reasoned decisionmaking."<sup>126</sup>

In *Associated Gas*, the gas companies in a deregulating gas industry wanted regulatory assistance in dealing with uneconomic "take-or-pay" contracts.<sup>127</sup> These contracts are similar to the IPP contracts under which former monopolists are currently bound. While the D.C. Circuit took specific issue with many of FERC's reasons for not providing relief from the take-or-pay gas contracts, they made clear that they were not mandating that FERC reach any particular conclusions on remand.<sup>128</sup> Further, in *American Gas Association v. FERC*,<sup>129</sup> the D.C. Circuit later affirmed FERC's adjusted manner of dealing with the contracts<sup>130</sup> indicating that there is some leeway to refuse to free utilities from economic quandaries.<sup>131</sup> Moreover, the Supreme Court in *Mobil Oil Exploration & Producing Southeast v. United Distribution Companies*,<sup>132</sup> when holding that FERC's decision to address the take-or-pay problem in a specific proceeding was within its discretion, indicated that "an agency's reasoned determination" in the "complex area" of take-or-pay contracts should not be second-guessed by the judiciary.<sup>133</sup> Thus, all that is required to satisfy judicial review is "reasoned determination" or "reasoned decisionmaking."<sup>134</sup>

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126. *Id.* at 1023.

127. "Take-or-pay" contracts are requirements contracts which stipulate that gas not purchased or "taken" must still, to some extent, be paid for. Thus, if cheaper gas is available from alternative sources, the buyer can purchase gas from the alternative source, but must still pay for gas that was contracted for, but not purchased, under the "take-or-pay" contracts. *See id.* at 995-96.

128. *See id.* at 1030.

129. 912 F.2d 1496 (D.C. Cir. 1990).

130. Although the court allowed contract buy-outs, it refused to intervene and modify the contracts, thus only partially relieving the gas producers of their burden. *See id.* at 1505-09.

131. *See id.* at 1505-07.

132. 498 U.S. 211 (1991).

133. *See id.* at 231.

134. *Id.* at 230-31; *see Associated Gas*, 824 F.2d at 1023.

In keeping with *Associated Gas's* requirement of reasoned decisionmaking, state Public Service Commissions can refuse to force consumers to assist in the recovery of stranded costs tied to the IPP requirements. This refusal is well-reasoned in light of the IPP contracts.

There is no indication that the utility generators cannot deal with the IPP contracts and related costs. Buyouts of the contracts are certainly an option.<sup>135</sup> Merging with the IPPs to solve the contract problems or merging with another large, solvent utility to bolster financial stability is feasible.<sup>136</sup> Renegotiation of the contract terms, on the basis that the contracts will otherwise bankrupt those bound by them, is possible as well. Sale of segments of the bound utility to either alleviate part of the IPP problems or to raise capital is feasible.

It becomes painfully clear, then, that the denial of regulatory assistance in stranded cost recovery is acceptable rate-making.<sup>137</sup> For the aforementioned reasons, the decision to place the risk, and thus the burden, of stranded cost recovery on investors is reasoned decisionmaking, within the parameters of state regulation and otherwise beyond the review of the judiciary.

#### IX. CONCLUSION

Putting the stranded cost responsibility on those who incurred the costs, former monopolists, can and must be done. It is both legal and economically justifiable. To do otherwise would force an economically inefficient course of action that the law does not require.

In a competitive market, cost recovery is addressed by those who generate the costs. To impose costs on anyone other than those incurring the costs is to create a fiction that is unduly beneficial for those incurring the costs and economically unjustifiable to those

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135. See *American Gas*, 912 F.2d at 1508-09; Kriss, *supra* note 53 (discussing proposed legislation which will provide state guarantees to aid Niagara Mohawk to improve its credit rating in order to borrow money to buy out the IPP contracts); *NIMO Offers To Buy Out 44 Contracts With Independent Power Producers*, *supra* note 53, at 1.

136. See James T. Mulder, *Upstate Utilities May Get an Urge to Merge When Two Downstate Companies Join Forces, Analysts See a Trend*, *POST-STANDARD*, Jan. 3, 1997, at C6; Agis Salpukas, *U.S. Agency Moves to Ease Utility Mergers*, *N.Y. TIMES*, Dec. 19, 1996, at D1.

137. Non-ratemaking, as it were.

bearing the costs. Thus, it is worth considering that there never was a regulatory compact; former monopolists had a nice ride for decades; their investors had a similarly nice ride in that they were shielded from the risks inherent in their investment; but Adam Smith's invisible hand of the free market cannot be continually pushed away.<sup>138</sup> It is time to let the invisible hand bring the benefits of competition to a truly deregulated electricity generation market.

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138. See generally ADAM SMITH, THE WEALTH OF NATIONS (R.H. Campbell et. al. eds., 1976) (1776).