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Cancelled Utility and Traditional Ratemaking Theories: Are Either Used and Useful

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CANCELLED UTILITY PLANT AND TRADITIONAL RATEMAKING THEORIES: ARE EITHER USED AND USEFUL?

Within recent years, investor-owned utilities have cancelled uncompleted generation plants with increasing frequency. The size of some cancellation losses are in the billions of dollars. Regulatory agencies have attempted to apply traditional ratemaking theories to allocate the losses between ratepayers and shareholders. This Comment analyzes regulatory decisions on cancelled utility plants and provides recommendations for improving the application of traditional ratemaking theories.

INTRODUCTION

Ratepayers, utilities, and regulatory agencies have become increasingly sensitive to the dilemma posed by cancellation of uncompleted electric generating projects. Plant cancellation losses are recoverable from only two groups: local ratepayers and utility shareholders. Regulatory agencies have had the unenviable task of allocating the loss between these groups, both of which are limited in their size and their ability to bear the significant burden of the loss.[1] These agencies have faced the challenge by employing varied and unpredictable ratemaking theories.

The largest plant cancellations are only now occurring.[2] Consumer

1. *See, e.g.*, Wald, *Adding Power but no Plants*, N.Y. Times, July 6, 1984, § D, at 2, col. 1 (characterizing rate increases presented by potential plant cancellations as "hyper-rate shock").

2. *See, e.g.*, Hiltzik & Rosenblatt, *Who Will Pay the Cost of Nuclear Bankruptcies*?, L.A. Times, May 13, 1984, § V, at 1, col. 1 (The authors discuss potential cancellations. Among other periled projects, the authors comment on the multi-billion dollar Seabrook project which poses the possibility of the first major utility bankruptcy. The utility, Public Service of New Hampshire, has a 35% share in the project, which is estimated to equal 160% of the Company's net worth). In addition to the increase in the size of individual cancelled plant losses, their frequency is also rising. For example, the author's research found that in 1980 and 1981 there were about 8-10 cancelled plant orders annually. In contrast, there were at least 22 cancelled plant orders in each of 1982 and 1983.

Power Company's recent cancellation of its Midland project is a prime example of the immensity of the problem.[3] Regulators are torn between persuasive ratepayer[4] and utility[5] arguments that support a shift of any loss from one side to the other. Ratepayers consider themselves innocent bystanders being forced to bear the consequences of a utility's blunder.[6] Utilities argue that they are only attempting to fulfill their responsibility to serve their customers' future energy needs and that the loss should be recoverable from the ratepayers.[7] Between those opposing policy considerations stand the legal and regulatory theories underlying the ratemaking process. The critical question is how regulators can apply these theories in extraordinary circumstances and still maintain the integrity of the process.

This Comment will review and analyze regulatory proceedings dealing with a utility's prudently[8] incurred expenditures on a plant that was cancelled prior to entering commercial operation, that is, a plant that was never "used and useful."[9] Unlike the bulk of existing literature on the subject, which deals primarily with pre-1982 decisions,[10] the Comment covers only the most recent regulatory decisions on cancelled plant losses.

The Comment will provide some background on the investor-owned electric utility industry and its regulatory aspects, followed by a summary of the ratemaking process. Additionally, an energy perspective of the 1960's and 1970's will provide a glimpse of the oper-

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3. *See* Wall St. J., Aug. 2, 1984, at 2, col. 2 (utility requesting seven billion dollars in rate relief for cancelled plant).

4. The terms "ratepayer," "customer," and "consumer" will be used interchangeably to mean those parties paying rates for the electricity provided by the utility.

5. The term "utility" refers to those utilities that are investor-owned corporations. Therefore, losses or gains sustained by the corporation actually accrue to its shareholders or investors.

6. *See, e.g.*, Note, *Public Utilities: The Black Fox Nuclear Project Cancellation Dilemma: Of Judicial Review and Reform of Oklahoma's Administrative Process*, 36 OKLA. L. REV. 190, 208-10 (1983). More forcefully stated, ratepayers believe that "[m]anagement, not the consumers, should be responsible for the consequences of its follies." *Id.* at 227.

7. *See, e.g., id.* at 208-09.

8. "Prudent" or "reasonable" expenses is a utility regulatory term of art. Significantly, only "prudent" expenses may be passed on to the ratepayers, while imprudent expenses are absorbed by the company shareholders. 1 A. PRIEST, PRINCIPLES OF PUBLIC UTILITY REGULATION 47-51 (1969).

9. "Used and useful" is another utility regulatory term of art. Whether items of utility property are "used and useful" in rendering service to the public is the primary test in deciding whether the utility may earn a rate of return on the property. *Id.* at 174-77.

10. *See, e.g.*, Sommers, *Recovery of Electric Utility Losses from Abandoned Construction Projects*, 8 WM. MITCHELL L. REV. 363 (1982); Wilson, *Ratemaking Treatment of Abandoned Generating Plant Losses*, 8 WM. MITCHELL. L. REV. 343 (1982); Note, Consumer's Counsel v. Public Utilities Commission: *Who Shall Bear the Cost of Abandonment*, 11 CAP. U.L. REV. 91 (1981).

ating forces that contributed to the rash of cancelled plants. The Comment will conclude by analyzing regulatory agency decisions and integrating them into recommendations, with contrasting good and bad examples of agency ratemaking.

UTILITY INDUSTRY BACKGROUND

The utility industry is diverse in the nature and scope of its operations,[11] the size of the entities that operate within it, and its ownership features.[12] The Comment addresses only the investor-owned electric utility companies (hereinafter "public utility" or "utility"). Public utility operations are highly capital intensive.[13] Because the cost of utility operations is so high, efficiency is better served by concentrating a single utility's services within a governmentally assigned service territory.[14] In this way, one utility's large fixed costs[15] are spread over a specified customer base, resulting in a lower average expense per unit of output than if two companies were to compete in the same geographic service territory. For this reason, public utilities are frequently referred to as "natural" monopolies created by market forces.[16] Nevertheless, some observers criticize unquestioning acceptance of the naturalness of a utility's capital requirements.[17]

The structure of the electric public utility industry is a significant factor in considering the cancelled plant issue. There are approximately 2700 utility systems that are not privately owned.[18] Never-

11. *See, e.g.*, Appendix, *Characteristics of the Public Utility Regulatory Agencies in the United States*, 28 BAYLOR L. REV. 1157 (1976) (illustrating the types of utility industries regulated by the various commissions).

12. For example, a utility may be an investor-owned company, a municipal agency, a cooperative, a federal agency, a state or county authority, or a separate utility district.

13. *See, e.g.*, L.S. HYMAN, AMERICA'S ELECTRIC UTILITIES: PAST, PRESENT, AND FUTURE 199 (1983) (a utility generally requires three or four dollars of plant to produce only one dollar of revenue).

14. Generally, state laws or regulations specify geographical service boundaries. Often, such laws bar the granting of multiple franchises where the area is already being served. Service authority is normally obtained by award of a certificate of convenience and necessity from the appropriate state agency. *See* THE U.S. DEPT. OF ENERGY, THE NEED FOR POWER AND THE CHOICE OF TECHNOLOGIES at ii (1981).

15. These fixed costs are generally associated with the construction and maintenance of large central power stations and the electrical distribution system. *See, e.g.*, Urban, *Allocating the Costs of Failed or Abandoned Projects of Regulated Public Utilities*, PUB. UTIL. FORT., May 24, 1984, at 34.

16. *See, e.g.*, Jackson v. Metropolitan Edison Co., 419 U.S. 345 (1974) (the Court decided that a public utility's conduct vis-a-vis a customer was not "state action" because the market created a utility's monopoly status, not the state).

17. L.S. HYMAN, *supra* note 13, at 200.

18. J. TOMAIN, ENERGY LAW IN A NUTSHELL 215 (1981). *See also supra* note 12

theless, the investor-owned utilities play the dominant role in electric power generation in the United States, accounting for approximately seventy-seven percent of the total generating capacity.[19] Therefore, U.S. investor-owned utilities play a critical role in this country's economy. The authority and obligations of the utility within its service territory, and the potential for monopolistic pricing, are sufficient threats to warrant governmental regulation of investor-owned utilities.[20]

Regulation

Public utility regulation theoretically achieves for society both the benefits of competition and the relative efficiency of a monopoly. The regulatory agency is responsible for assuring reliable service for the customer, fairly apportioning service costs among the customer groups, and setting utility revenues that provide a reasonable opportunity for a fair return on investment.[21] Regulatory agencies are also incorporating other social responsibilities into the regulatory process.[22] Additionally, controversial issues have stimulated public participation in regulatory proceedings.[23] Whether the regulators have misconstrued their function is subject to debate.[24]

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for a listing of non-private utility ownership forms.

19. J. TOMAIN, *supra* note 18, at 215. Additionally, the role of investor-owned utilities (IOU's) has shown steady growth in relation to non-investor utilities. In 1965, IOU's accounted for about 69% of available electricity. In 1981, IOU's accounted for 75%. *See* L.S. HYMAN, *supra* note 13, Table 14-2, at 102. Significantly, the 35 largest investor-owned utilities account for over 60% of the total IOU generating capacity, and the top 100 account for about 95% of the IOU capacity. *See* Joskow, *Mixing Regulatory and Antitrust Policies in the Electric Power Industry: The Price Squeeze and Retail Market Competition*, MIT Energy Laboratory Working Paper, MIT-EL 83-023WP, Oct. 1983, at 5.

20. *See* Urban, *supra* note 15, at 34.

21. *See* L.S. HYMAN, *supra* note 13, at 133.

22. "The final set of regulatory goals — minimum service reliability, honesty and fair dealing, informed choice and full disclosure of relevant information, and health, safety, and environmental protection — are more recent in origin and do not require full scale intervention in the business." E. GELLHORN & R. PIERCE, REGULATED INDUSTRIES IN A NUTSHELL 12 (1982).

23. For example, members of the San Diego community recently created the Utility Consumer Action Network (UCAN). UCAN intends to represent ratepayer interests on important issues before the California Public Utility Commission, while working cooperatively with the local utility to solve common problems (as reported by the statements of the UCAN Interim Board of Directors in its September, 1983 mailer enclosed in the San Diego Gas & Electric customer billings).

24. There is a fashionable notion that the Commission can, in the public interest, simply deny requests for rate increases. The proper Commission role is perceived to be to battle against inflation, an economic condition which neither the companies nor the Commission can control, not merely to temper the potential abuses of unbridled monopoly power. In this "competing interests" view of rate regulation, the lower the rates and rate increases allowed by the Commission, the more "just and reasonable" they are thought to be. But this perception is simply wrong. As elementary as it will seem to most readers, it must be ob-

Public utility regulation is separated into two basic jurisdictional areas: federal and state. Primary regulation is accomplished through state-created agencies,[25] because most of the investor-owned utility business is performed at the "retail" level.[26] Typically, state commissions are granted authority through legislative or constitutional provisions.[27] However, despite the similarities in their creation and basic ratemaking powers, the state commissions vary considerably in the extent of their jurisdiction.[28]

Regulation of electric utilities by the federal government is relatively recent vis-a-vis state regulation, but it is expanding steadily.[29] Initially, federal regulation was accomplished through the Federal Power Commission,[30] but this task has since been assumed by the Federal Energy Regulation Commission (FERC).[31] The FERC exercises "wholesale" jurisdiction over sales of electricity intended for subsequent resale to end users.[32] This jurisdiction over interstate commerce involves two basic types of transactions: (1) coordination sales, where one utility sells electricity to another based on temporary differences in cost or supply between them,[33] and (2) require-

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served that the provision of "safe and adequate service" carries a market-determined price tag, and the level of "just and reasonable rates" is the level which exactly pays that price.
New York P.S.C. No. C27679 (ALJ Harrison, 1982).

25. Both federal and state authorities may exercise jurisdiction simultaneously over the utility. Although the volume of wholesale transactions subject to federal jurisdiction have been increasing, an IOU's financial performance "depends primarily on state regulation since the bulk of a typical IOU's operating costs, capital facilities and revenues are associated with serving its retail customers." Joskow, *supra* note 19, at 11. State regulatory agency titles include: public utility commission, public service commission, state corporation commission, and department of public utilities. *See, e.g.*, Appendix, *supra* note 11, at 1157 (providing a list of commission titles). Hereinafter, these agencies will be referred to as "commissions."

26. Retail transactions refer to the sale of electricity to the direct consumer, e.g., a household or a business.

27. *See* Appendix, *supra* note 11, at 1157.

28. *See* W.T. GORMLEY, THE POLITICS OF PUBLIC UTILITY REGULATION 10-11 (1983). Fundamentally, however, "public utility commissions have substantial control over rates, supply, and demand." *Id.* at 11.

29. *See* J. TOMAIN, *supra* note 18, at 216-20 (providing a summary of federal regulatory development).

30. Federal Water Power Act, ch. 285, 41 Stat. 1063 (1920).

31. 42 U.S.C. § 7171 (1980). The Federal Power Commission was dissolved at the inception of the FERC. *See* Opinion No. 1, 1 FED. ENERGY REG. COMM. (CCH) ¶ 61,001 (1977).

32. Regulations Preamble, FED. ENERGY REG. COMM. (CCH) ¶ 30,455, at 30,496 (June 1, 1983).

33. *Id.* These sales account for approximately two-thirds of electricity bought or sold under the FERC's jurisdiction.

ments sales by which electric utilities regularly purchase part or all of their electricity from other utilities for distribution to their customers.[34] Despite its limited jurisdiction, the FERC does provide persuasive authority for state commissions and, in some circumstances, even dictates a course of action for a state commission.[35]

Limitations on governmental regulation of public utilities exist but they are quite flexible. A state may delegate power to its commission within the confines of its police power.[36] Generally, state violations of these limits are alleged as governmental takings of private property for a public use without just compensation.[37] The FERC is limited to those powers granted by federal legislation[38] and constitutionally permissible. Within their limitations, the state and federal regulatory commissions employ various methods to accomplish their goals. However, the most common and influential method is "cost-of-service" ratemaking by which the level of utility revenues is regulated.[39]

Ratemaking

A familiarity with basic ratemaking concepts is required in order to understand the regulatory treatment of cancelled plants. Essentially, the ratemaking process employs subjective standards to arrive at quantitative results.[40] The conceptual theories underpinning the process are dynamic and subject to broad interpretation. Theoretically, the ratemaking process should replicate for a utility the market forces that act on unregulated private businesses. Regulatory goals are effectively communicated to a utility by manipulating its level of authorized revenues, while still balancing the interests and rights of the ratepayers and investors.[41] The level of revenues, or

34. *Id.* Although only a relatively small amount of IOU revenues are achieved through requirements sales, any changes in wholesale rates greatly affect municipal and cooperative utilities that lack adequate, or any, generating capacity. This direct relationship may explain the reason that municipalities do not want another utility's construction costs included in wholesale rates before the plant is operational.

35. For example, if the FERC allows wholesale cost recovery in rates between utilities under a requirements contract, the state commission may not disallow the recovery of those costs by the buying utility. Under the supremacy clause of the Constitution, federal authority overrides the state's denial. *See* Northern States Power Co. v. Hagen, 314 N.W.2d 32 (N.D. 1981).

36. In discussing the limits of state police power, the U.S. Supreme Court has stated, "[w]e deal . . . with what traditionally has been known as the police power. An attempt to define its reach or trace its outer limits is fruitless, for each case must turn on its own facts." Berman v. Parker, 348 U.S. 26, 32 (1954).

37. *See* E. GELLHORN & R. PIERCE, *supra* note 22, at 103-09.

38. *See generally* 42 U.S.C. §§ 7171-77 (1982).

39. *See* E. GELLHORN & R. PIERCE, *supra* note 22, at 12-13.

40. *See, e.g.*, A. PRIEST, PRINCIPLES OF PUBLIC UTILITY REGULATION (1969); J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES (1961) (both are classic texts on rate regulation). *See also* J. TOMAIN, *supra* note 18; E. GELLHORN & R. PIERCE, *supra* note 22 (both are less technical, and easily understood references).

41. *See* J. TOMAIN, *supra* note 18, at 106.

rates, is determined by the commission in a public proceeding, generally called a "rate case."[42] It involves an analysis of three basic elements: rate base, rate of return, and allowable expenses.[43]

The first step in setting rates is determining the "rate base," which represents the utility's investment in, or fair value of, assets employed in providing service.[44] Because it generally earns a return only on that property included in the rate base, the utility has a strong incentive to maximize the size of its rate base, although there are reasonable limits. The four major issues arising in the determination of the rate base[45] are the selection of (1) the method of valuation, (2) which assets are used and useful,[46] (3) the treatment of property intended for future use,[47] and (4) the type of depreciation for the rate base assets.[48] Although commissions have used a variety

42. The "rate case" is not always the only process by which a utility can request rate adjustment. In California, for example, there are interim proceedings to bring major facilities into the rate base (Major Additions Adjustment Clause), and adjust for price changes in natural gas (Consolidated Adjustment Mechanism) and fuels used in electric generation facilities (Energy Cost Adjustment Clause). *See, e.g.*, San Diego Gas & Elec., California PUC Decision No. 83-09-007 (Sept. 7, 1983) (the PUC's first formal adoption of a Major Additions Adjustment proceeding).

43. *See* 1 A. PRIEST, *supra* note 8, at 45.

44. 1 A. PRIEST, *supra* note 8, at 139.

45. *See generally* E. GELLHORN & R. PIERCE, *supra* note 22, at 110-30.

46. The commonly accepted "used and useful" test is applied to an asset to determine whether it is properly included in the rate base. Additionally, the "prudence" of a utility's investment in an asset is studied. Typically, imprudently incurred costs are not recoverable in rates. *See* E. GELLHORN & R. PIERCE, *supra* note 22, at 115-21. *See also* 1 A. PRIEST, *supra* note 8, at 174-77. Commissions apply the "used and useful" standard either as a matter of policy, or because of statutory requirements. The supporting rationale is that a ratepayer should not pay for a facility that is not providing a benefit. This test offers a substantial obstacle to a utility attempting to obtain a return on its investment in a cancelled generating plant, because such a facility was never "used and useful" to the ratepayer. This circumstance and variations in the application of the test by commissions is addressed later in this Comment.

47. Utilities engaging in construction of facilities for future use accrue costs in Construction Work in Progress (CWIP) accounts. The used and useful test usually precludes these costs from being placed in the rate base until the facility is commercially operational. Many jurisdictions accommodate the present value of money problems associated with CWIP held for long periods by providing an Allowance for Funds Used During Construction (AFUDC). Essentially, AFUDC is a setoff to the utility's cost of money held in its CWIP account. *See* 1 A. PRIEST, *supra* note 8, at 177-80. High construction costs, cash flow problems, the fluctuating cost of money (interest rates), and "rate shock" as large assets enter the rate base at the time of commercial operation are influencing commission attitudes about the effectiveness of the CWIP/AFUDC methodology. *See* E. GELLHORN & R. PIERCE, *supra* note 22, at 121-26. An excellent discussion of the entire controversy surrounding CWIP inclusion in the rate base has been provided by the FERC. *See* Regulations Preamble, FED. ENERGY REG. COMM. (CCH) ¶ 30,455 (June 1, 1983).

48. A utility's rate base is depreciated to account for the "consumption" of its

of approaches to value the rate base, the U.S. Supreme Court has rejected any specific mechanical approach and inquires whether the "end result" is fair.[49]

The second step in setting the level of rates is determining the authorized rate of return.[50] The primary considerations in setting a rate of return are fairness to both investors and consumers and recognition of the utility's need to attract capital. The utility is not guaranteed a return; it is "given an opportunity . . . to earn a return."[51] Methods of determining the authorized rate of return vary among the jurisdictions. Although some commissions follow statutorily mandated approaches, others concentrate on setting revenue levels that permit the utility to provide adequate, efficient service at reasonable rates. Irrespective of the method selected, the commissions' decisions "must be measured as much by the success with which they protect those [public] interests as by the effectiveness with which they 'maintain credit and . . . attract capital.' "[52]

The last step in setting the level of rates is determining operating expenses. Expenses include wages, salaries, supplies, maintenance, and research and development costs. However, not all expenses are "allowable" for the purposes of determining rates.[53] The commissions usually evaluate whether the expenses were "prudent."[54] Thereafter, the commission may set the allowable revenues by ad-

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assets over time. The depreciation amount is withdrawn from the rate base so that a return is no longer earned on the "exhausted" portion of the asset and is added as a current year expense to be recovered in rates. When fully depreciated and expensed, the asset no longer provides a return for the utility. *See* E. GELLHORN & R. PIERCE, *supra* note 22, at 126-30.

49. Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 951 (1944). *See* E. GELLHORN & R. PIERCE, *supra* note 22, at 103-9 (discussing *Hope* and other Supreme Court decisions in the ratemaking area).

50. The rate of return is "[t]he percentage by which a utility's rate base is multiplied to determine the wages of capital." 1 A. PRIEST, *supra* note 8, at 191. Therefore, a change in the rate of return on a given rate base will result in greater or lesser "authorized" net income for the utility. *See generally* E. GELLHORN & R. PIERCE, *supra* note 22, at 130-41.

51. 1 A. PRIEST, *supra* note 8, at 191.

52. Permian Basin Area Rate Cases, 390 U.S. 747, 791 (1968). As stated by A. J. Priest, "[w]orkers who are not adequately compensated will take a walk; so will investors." 1 A. PRIEST, *supra* note 8, at 191.

53. Commissions may disallow expenses where (1) the outlays were imprudent, (2) management discretion was abused, (3) the action taken was against the public interest, (4) there was economic waste, or (5) the expenditures exceeded the reasonable charge. 1 A. PRIEST, *supra* note 8, at 51.

54. A series of analytical steps should be taken to review the prudence or reasonableness of a management decision: (1) the good faith of the managers is presumed (West Ohio Gas Co. v. Ohio Pub. Util. Comm'n, 294 U.S. 63, 72 (1935)); (2) the decisions must be reviewed based on facts known at the time and not on hindsight (Wisconsin Tel. Co. v. Pub. Serv. Comm'n, 232 Wis. 274, 287 N.W. 122, 167 (1939), *cert. denied*, 309 U.S. 657 (1940)); and (3) the commission should not substitute its judgment for that of the management (294 U.S. at 72).

ding the net income[55] to the allowable expenses.[56] Those allowable revenues are then translated into rates charged to customers.

The second phase of the basic ratemaking process is rate design, which involves scheduling rates for different customer groups.[57] Although rate design is important to individual customer groups, more regulatory and public attention is concentrated on the setting of a rate level.

In summary, the ratemaking process serves a variety of public and utility interests. Although these interests have been served effectively for many years, numerous factors[58] are causing observers to question many of the methodologies employed.[59] Increasingly, plant cancellations are one of the forces in this trend.

ENERGY PERSPECTIVE

It is difficult to appreciate the cancelled plant dilemma without a glimpse of the recent past of the electric utility industry. Through 1970, U.S. consumption of electricity grew at a rapid rate.[60] In 1970, consumption estimates indicated a four-fold demand increase by 1990.[61] Recognizing their obligation to serve the customer,[62] utili-

55. The authorized net income is determined by multiplying the "rate base" by the authorized "rate of return."

56. For example, assume a utility has a rate base of $1,000,000, a 10% rate of return, and expenses of $1,000,000. The authorized net income would be 10% (rate of return) of $1,000,000 (rate base), or $100,000. The rate level would then be set to gain revenues to recoup $1,100,000 (expenses plus net income). Although it may realize its authorized revenues, the utility will miss its net income target if actual expenses exceed those projected in the rate case. The result of higher-than-expected expenses is an actual rate of return lower than the utility's authorized rate of return.

57. *See, e.g.*, J. TOMAIN, *supra* note 18, at 115-21 (generally discussing rate design).

58. One industry consultant considers the three most important factors to be (1) inflation, (2) the fact that unit production cost of electricity is not decreasing with technological advances as in previous years, and (3) a national energy situation that has created instability in the economy and has had a disproportionate impact on utilities. *See* Swartwout, *Some Plain Talk About Reform of Ratemaking*, PUB. UTIL. FORT., Feb. 16, 1984, at 17.

59. *See, e.g., id.* at 15-19. *See also* Stauffer & Navarro, *A Critique of Conventional Utility Rate-Making Methodologies*, PUB. UTIL. FORT., Feb. 26, 1981, at 25 (a general critique of the ratemaking process).

60. Between 1920 and 1970 electricity consumption doubled about every ten years. In comparison to a total energy consumption increase of about three and one-half times during the same period, electricity consumption in the U.S. increased about twenty-nine times. *See* REPORT OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, ELECTRICITY AND THE ENVIRONMENT 18 (1972) [hereinafter cited as ELECTRICITY AND THE ENVIRONMENT].

61. *Id.*

62. Representative of the utility mood was the following statement by an industry

ties began constructing large electric generating facilities because of their economic advantages.[63] Additionally, the nuclear industry began more fully developing its commercial applications in the 1960's, and the perceived advantages of nuclear power caused some observers to predict that it would comprise forty-four percent of the nation's generating capacity by 1985.[64] The electric industry entered the 1970's with aggressive construction programs[65] to meet reasonably predictable electricity needs.[66]

The new decade brought much turmoil for a traditionally stable industry. The first major shock was the 1973 OPEC oil embargo.[67] The result was a quadrupling of the price of oil for a utility industry increasingly dependent on this energy resource. Besides stimulating a worldwide recession in 1974-75, the economics of higher fuel and electricity costs for utilities and customers resulted in fundamental changes in energy consumption and policy. Demand for electricity started dropping.[68] Other factors caused increased utility costs, espe-

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lawyer:

> Today, all of the electric energy requirements of the nation are being served. While these requirements are expected to grow by leaps and bounds, the non-federal segments of the industry which have the utility responsibility to meet new requirements are in a position and are laying plans to do so.

Address by T.J. Debevoise on the "Legal Aspects of the National Power Survey" before the A.B.A. Section of Public Utility Law (Aug. 10, 1965). Events disputed Mr. Debevoise's assertion that all of the nation's electricity requirements were being served. Three months later in November, 1965, the Northeast Blackout put a dark cloud over the electric utility industry. One observer characterizes 1965 as the watershed year for the industry, after which it sank into a sea of problems. *See* L.S. HYMAN, *supra* note 13, at 100-15.

63. Utility generating plants are designed to meet a variety of electrical demands, including base-load and peak-load requirements. For some of the economic considerations, see L.S. HYMAN, *supra* note 13, at 35-36. Illustrative of the growth of plant size is the fact that large plants in the early 1950's were 200 megawatts, while early 1970's plants were 1000 megawatts and often sites contained multiple units. Plant size was expected to triple by 1990, while accounting for an increasingly large share of the generating capacity. ELECTRICITY AND THE ENVIRONMENT, *supra* note 60, at 24.

64. *See* 2 A. PRIEST, *supra* note 8, at 772. In fact, nuclear power only accounted for roughly 10% of the nation's generating capacity by 1981 and will not meet the more optimistic 1985 projections. *See* L.S. HYMAN, *supra* note 13, Table 31-1, at 275. *See also* Olsen, *The Washington Public Power Supply System: The Story So Far*, PUB. UTIL. FORT., June 10, 1982, at 15-19 (an informative summary of the inception, development, and demise of one 1960's nuclear project).

65. At the time, construction cycles for plants were relatively short, about five to seven years. *See, e.g.*, Luce, *Where is the Electric Utility Industry Headed in the 1980's?*, PUB. UTIL. FORT., June 23, 1983, at 15.

66. Projecting future demand was a relatively easy process at the time. Steady growth curves essentially allowed planners to extrapolate based on past consumption. *See* L.S. HYMAN, *supra* note 13, at 36-39.

67. *See generally* ENERGY POLICY 13-16 (Congressional Quarterly ed. 1981) (a summary of the events surrounding the embargo).

68. Until the 1973-74 price increases, annual electricity growth averaged about seven percent. By the end of the decade, this rate had dropped to three percent or less. *Id.* at 14.

cially construction delays[69] and the general rate of inflation. The nuclear power industry was then dealt a strong setback with the Three Mile Island nuclear plant accident. Public and regulatory concerns[70] caused nuclear power plant construction costs to increase dramatically, and political support for the nuclear option faded quickly.[71] Operating rules for electric utilities had changed significantly and the future was uncertain.[72]

The events of the 1970's left the industry in a vulnerable position as it entered the 1980's. Consumers had experienced significant rate hikes.[73] As a result, electric sales continued to decline,[74] with a corresponding drop in utility revenues and a deterioration of utility financial positions.[75] Simultaneously, plant construction costs continued to escalate.[76] In this environment of lower-than-expected demand, lower net incomes, rising construction expenditures, and increased financial uncertainty and risk, many utilities selected the only "prudent" alternative: cancel the construction of their new elec-

69. Early delays were generally attributable to labor problems and equipment failures. However, regulatory delays caused by environmental and other concerns were expected to rise. *See* ELECTRICITY AND THE ENVIRONMENT, *supra* note 60, at 22-23.

70. These concerns included radioactive disposal, plant safety features, licensing procedures, public safety, and allocation of nuclear accident and plant decommissioning costs. ENERGY POLICY, *supra* note 67, at 80.

71. Compare President Nixon's enthusiasm for nuclear power with President Carter's. "Nuclear power . . . is an essential part of our program of achieving energy self-sufficiency . . . . I have directed that steps be taken to reduce the licensing and construction cycle to 5-6 years, without compromising safety and environmental standards." Address of President Nixon on Jan. 23, 1974, *reprinted in* ENERGY POLICY, *supra* note 67, at 245-46. In contrast, President Carter stated that the Three Mile Island Accident "demonstrated dramatically that we have other energy problems" besides oil prices. Address of President Carter on April 5, 1979, *reprinted in id.* at 256-58 (The balance of President Carter's speech referred to nuclear power only in the context of improved safety measures.).

72. Reflecting on the events of the 1970's, one former utility chairman of the board wrote that "[a]nyone asked to prophesy where the electric utility industry is headed in the 1980's must approach the subject with humility." *See* Luce, *supra* note 65, at 15 (the article also provides a useful comparison of basic utility assumptions for the 1970's and what actually happened).

73. A recent study by the National Association of Regulatory Utility Commissioners (NARUC) reported that the average residential customer's bill increased 156% between 1972 and 1982. The highest increase was in Hawaii where rates increased 340%. San Diego Union, June 21, 1984, at B-3, col. 5. Other areas still face significant increases as a new plant comes into the rate base. N.Y. Times, Feb. 26, 1984, § 1, part 1, at 1, col. 3.

74. *See* L.S. HYMAN, *supra* note 13, Table 3-1, at 23.

75. *See generally id.* at 104-15.

76. *See, e.g., What Others Think*, PUB. UTIL. FORT., May 27, 1982, at 47 (a discussion of the causes of plant cancellations).

tric generating facilities.[77]

CANCELLED PLANT ORDERS

Associated Costs

Cancelled plant losses include those costs accrued on the project, including expenditures for land, labor, materials, taxes, licensing fees, environmental studies, financing, and other charges. These costs are normally capitalized in Construction Work in Progress (CWIP)[78] and Allowance for Funds Used During Construction (AFUDC) accounts.[79] The ratemaking treatment of accrued CWIP and AFUDC charges is generally limited to one of two basic methods.[80]

The first method reflects the capitalized AFUDC as non-cash income on the utility's books. Ratepayers do not pay rates on the AFUDC carrying charge until the plant goes into operation. At that time all CWIP and AFUDC is recovered through rates by adding them to the rate base, and depreciating the amounts accordingly.[81] The second method for recovering the cost of money accrued in the CWIP account is to include CWIP in the rate base. Contrary to the AFUDC approach, the utility presently recovers cash income from the ratepayers through the rate of return components of its rates.[82] Theoretically, each method should result in identical cost recovery for the utility. The main difference is timing — when the customer will actually begin to pay rates reflecting these construction-related

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77. *See, e.g.*, Zitser, *The Nuclear Plant Problem Needs a Federal Solution*, PUB. UTIL. FORT., Mar. 29, 1984, at 22-26 (summary of the current cancelled plant scenario).

78. CWIP is the total amount of the capital expenditures which have accrued to facilities and equipment not yet in service for the ratepayers. CWIP may include an element called Allowance for Funds Used During Construction (AFUDC) which accounts for the capitalization of financing costs of the facility. *See supra* note 47 for treatment of financing costs where CWIP is not included in the rate base.

79. Essentially, AFUDC is a charge made to capital projects to reflect the cost of money (capital) invested in the project. The actual "interest cost" is dependent on the authorized AFUDC percentage rate and the CWIP amount.

80. *See* Regulations Preamble, FED. ENERGY REG. COMM. (CCH) ¶ 30,455, at 30,491.

81. An argument for this approach is that rates should not cover "non-used and useful" facilities. For example, the current ratepayer may move before the plant is operational, or it may be cancelled. Conversely, an argument against the AFUDC approach is that AFUDC amounts to a bookkeeping entry that does not pay any bills in the interim period before the plant is operational. Therefore, a utility may have to seek external financing to solve any cash flow problems. *See, e.g.*, The Energy Daily, Aug. 23, 1984, at 3, col. 2 (95% of the second quarter earnings of Long Island Lighting were represented by non-cash AFUDC).

82. *See* Regulations Preamble, FED. ENERGY REG. COMM. (CCH) ¶ 30,455, at 30,491. This avoids the need to add AFUDC to the CWIP account for recovery when the plant enters service.

charges.[83] Nevertheless, CWIP policy generates strong feelings on both sides of the issue,[84] and has a significant effect on a commission's approach toward cost recovery for a cancelled plant.[85]

Regulatory commissions initially engaged the cancelled plant cost recovery issue armed with the traditional "prudent expense," and "used and useful" theories.[86] As the problem developed, new theoretical approaches were formulated. For example, an "equitable sharing" theory allocating the prudent loss between ratepayers and the utility gained favor.[87] However, despite newly developed approaches to allocating the loss, some questions remain basic to resolving the plant cancellation problem. They include:

1. Were the decisions to commence, and subsequently to cancel, the facility prudent;[88]
2. May the prudently incurred expenses be recovered;[89]
3. If recoverable, over what period of time will the expenses be amortized;[90] and

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83. *See, e.g.*, L.S. HYMAN, *supra* note 13, at 141-43.

84. For a discussion of CWIP policy, see, e.g., Hobelman, Knapp & Walsh, *Construction Work in Progress for Electric Utilities: A Compendium of Comments Presented to the Federal Energy Regulatory Commission in Docket No. RM81-38, reprinted in* ELECTRIC POWER 65 (PLI ed. 1982).

85. For a summary of regulatory treatment of a cancelled plant and how jurisdictional treatment of CWIP bears on the issue, see *A Survey of Regulatory Treatment of Plant Cancellation Costs*, PUB. UTIL. FORT., Mar. 31, 1983, at 52.

86. *Cf.* Avery, *The Costs of Nuclear Accidents and Abandonments in Rate Making*, PUB. UTIL. FORT., Nov. 8, 1979, at 18-19 (discussion of the analogous problem of cost recovery for a plant that was "used and useful" before abandonment).

87. *See, e.g., Re* Virginia Elec. & Power Co., 29 Pub. Util. Rep. 4th (PUR) 65, 81 (Va. Mar. 19, 1979) (noting that the plant was never used and useful, the Commission considered that "equity" demanded VEPCO share the risk of loss with the ratepayers).

88. *See supra* notes 53-54 and accompanying text.

89. Generally, this issue arises where the jurisdiction statutorily precludes the commission from allowing recovery in rates of a loss from a plant never used and useful. *See, e.g.*, Comment, *A New Approach to Allocating Financial Responsibility for Cancelled Nuclear Units* — Consumer's Counsel v. Public Utility Commission of Ohio, 13 U. TOL. L. REV. 1469 (1982) (discussion of statutory preclusion).

90. Amortization involves the gradual extinguishment of a loss or debt. Assume the circumstances of a $10,000,000 loss on a prudent investment. If the commission were to allow the entire loss to be written off for ratemaking purposes in one year, i.e., expensed, the allowable utility revenues would increase by $10,000,000 with a corresponding effect on consumer rates. If the commission wants to soften the rate increase, it can amortize the loss over a number of years. Assuming a ten-year amortization period, the utility would expense $1,000,000 each year for ten years. The longer the amortization period, the longer it takes the utility to recover its loss through rates. Depending on the treatment awarded on the "unamortized" balance, the utility may lose some portion of the investment because of the time value of money. Additionally, carrying the loss on the books while awaiting recovery may force the utility to seek external financing to maintain

4. May the utility earn a return, or be awarded a carrying charge, on the unamortized balance of the expense?[91]

Other ancillary issues may also arise, such as the proposed treatment of tax deductions and AFUDC components.[92] In responding to these basic questions, commissions have awarded three general ratemaking treatments of cancelled plant losses. They are "full recovery," "partial recovery," and "no recovery."

Full Recovery

In "full recovery," the commission establishes the prudent costs associated with the project.[93] Subsequently, an amortization period is selected over which the prudent costs are recovered. Actual cash recovery is accomplished by expensing the current year's amortized amount, which has a corresponding effect of increasing rates.[94] The unamortized balance of the loss, or some portion of that unrecovered amount, is included in the rate base or is awarded a "carrying charge." Therefore, although not immediately recovering all prudent costs, the utility is earning a return on the amount not yet recovered. Rate base treatment increases rates by enlarging the rate base and, therefore, the allowable net income. The recoverable balance is gradually reduced by the annually amortized amount until the loss is completely recovered. "Full recovery" is generally more favorable to

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its financial integrity.

91. Utilities want to maintain the value of their money over time and also earn a return on their investment. After a plant is cancelled, it can no longer accrue AFUDC. However, the utility may be able to keep CWIP in the rate base if it was originally allowed. Where the costs have not been put into the rate base, the cessation of AFUDC accruals and the amortization of the loss will cause the money to lose value over time at some rate, e.g., the rate of inflation. To ameliorate this gradual lessening in value, a utility will often request one of two authorizations. First, the utility may request authorization to put the unamortized balance in the rate base. Each year the rate base is decreased by the annual amortization amount, which is expensed. Generally, the major objection to this alternative is that the plant was never used and useful. Second, if no rate base treatment is awarded, the utility may request a fixed "carrying charge" to accrue on the unamortized balance. Arguably, this approach is analogous to rate base treatment. Opponents often characterize this alternative as providing AFUDC on Construction Work *Not* in Progress. Therefore, award of either rate base inclusion for the unamortized balance or of a carrying charge favors the utility's maximum cost recovery. Conversely, exclusion of any return on the unamortized balance results in relatively lower rates for the ratepayers. Nevertheless, some observers argue that failure to award rate base treatment actually raises rates over the long run because of the utility's increased costs of capital.

92. *See, e.g.*, Small, *FERC Electric Rate Primer*, 5 ENERGY L.J. 107 (1984) (an analysis of the approach of the FERC to cancelled plants).

93. Prudent costs may be determined in many ways. Generally, a commission analyzes all expenditures and determines the reasonableness of each expense. A commission may also determine a prudence "cut-off" date, beyond which all expenditures are imprudent and, therefore, unrecoverable. *See, e.g., Re* Boston Edison Co., 46 Pub. Util. Rep. 4th (PUR) 431, 471 (Mass. Apr. 30, 1982) (finding that the uncertainty at an earlier date was high enough to warrant cancellation at that time).

94. *See supra* note 90 for an example.

the utility, and should increase customer rates to the greatest extent. However, this approach is used sparingly and can be applied without enhancing utility recovery.[95]

Those jurisdictions that have awarded full recovery justify their decisions on a variety of theories. For the proposes of clearly explaining the basis for its decision, the New York Public Service Commission's (NYPSC) *Re Rochester Gas & Electric Corp.*[96] opinion provides a good example. After establishing the prudent costs[97] of the Sterling project[98] the NYPSC discussed whether the utilities should be awarded a carrying charge of some percentage on the unamortized balance of the loss. Intervenors, opposing the utilities' request, argued primarily that the loss should be shared between ratepayers and shareholders in a manner "reflecting the benefits that each group would have realized from a completed facility."[99] However, the argument failed to persuade the NYPSC to depart from its earlier established policy of awarding full recovery.[100] Furthermore, the NYPSC's criticism that the intervenor's evidence made only a poor attempt at carrying the burden of proof[101] gave additional support

95. *See, e.g., Re* Potomac Elec. Power Co., 29 Pub. Util. Rep. 4th (PUR) 517 (D.C. P.S.C. June 14, 1979). PEPCO decided to build a nuclear facility in 1970, and terminated the project in June 1977. The cancellation resulted in a jurisdictional loss of about $66,000,000. However, a sale of nuclear fuel rights resulted in a net gain, which actually caused a temporary reduction of the rate base by being included therein. The PSC staff opposed the decision to grant rate base treatment because of its precedential value, should there be a net loss in the future. The Commission responded that such a "result does not necessarily follow." *Id.* at 579. *Cf.* Wisconsin Elec. Power Co., Wis. P.S.C. Case No. 05-CE-3 (Feb. 14, 1980) ("full recovery" offered as an incentive to cancel the project immediately).

96. 45 Pub. Util. Rep. 4th (PUR) 386 (N.Y. Jan. 13, 1982).

97. A significant element in establishing the utilities' prudence was the effect of the statutory "obligation to serve" on management decisions. *See* 45 Pub. Util. Rep. 4th (PUR) at 391.

98. The Sterling nuclear power project was a joint effort by four utilities. In 1978, the N.Y. Siting Board issued a certification to build the plant. In 1980, the Siting Board revoked the certification on the grounds that a need had not been established. The utility participants did not appeal the Siting Board decision, but instead sought full recovery from the NYPSC for net expenses of about $100,000,000. *Re* Rochester Gas & Elec. Corp., 41 Pub. Util. Rep. 4th (PUR) 438, 442 (N.Y. Jan. 6, 1981).

99. *Id.*

100. NYPSC precedent "established a practice of allowing full recovery of all sunk costs, including carrying charges [analogous to rate base treatment], irrespective of the relative benefits that may have flowed from the abandoned or uncompleted project." *Id.* Compare the dissenting commissioner's view of NYPSC precedent: "As far as I'm concerned, the issue faced here is of first impression for the commission in that we have never dealt with an abandonment loss of this magnitude arising from a plant never in service. I would therefore place less weight on precedent than does the majority. . . ." *Id.* at 411 (Mead, Commissioner, dissenting).

101. Responding to an argument that rigorous analysis of the "potential benefits"

for its full recovery decision. Subsequently, the NYPSC awarded a carrying charge on the unamortized balance of the loss, which is analogous to rate base treatment.[102]

The NYPSC then analyzed the effect of various amortization periods on the shareholders and ratepayers of each respective utility.[103] The NYPSC rejected the staff proposal of a thirty-year amortization,[104] considering that ratemaking and accounting principles did not theoretically support the staff's proposal, that shorter amortization periods were not unreasonably adverse to customer rates, and that each utility's financial status warranted periods shorter than that proposed. Subsequently, each utility's circumstances were analyzed individually, and each awarded an amortization period. Although a dissenting commissioner faulted the majority's selection of certain amortization periods,[105] the evidence supporting his allegation was not substantial enough to find that the majority acted unreasonably.[106]

Another full recovery decision provides a useful contrast to the *Rochester* proceeding. In *Re Boston Edison Company* (BECO),[107] the Massachusetts Department of Public Utilities (DPU) confronted BECO's $278,000,000 loss on the cancelled Pilgrim II plant. BECO requested cost recovery over ten years with a carrying charge on the unamortized balance.[108] In discussing risk and loss allocations, the DPU stated that the Pilgrim II project "represents nothing less than

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sharing concept was needed, the NYPSC found that the intervenor "did not attempt to provide it," and that the intervenor's "proposed equal sharing was based on a rough estimate of the benefits as it saw them." *Id.*

102. A carrying charge is a percentage return that is provided to the utility on some assets or costs. Technically, this is not rate base treatment because the expenditures are not included therein and subject to the utilities' authorized rate of return. Practically, a carrying charge is analogous to rate base treatment because some return is earned through rates. The major difference, then, is the established carrying charge percentage. In *Rochester*, the staff argued for a carrying charge at the "risk free" rate, e.g., U.S. Treasury Bonds, or other government securities. The NYPSC rejected this approach and provided a carrying charge at the utility's "cost of capital" which is more analogous to a market rate. *Id.* at 411.

103. *See generally id.* at 403-10. In selecting the amortization period, three considerations were analyzed: (1) general ratemaking principles, (2) the impact on customer bills, and (3) the utility's financial integrity.

104. The staff proposal was based on the useful life of an operational facility, i.e., 30 years.

105. "The determination of amorization periods should take into greater account the impact such periods will have on the ratepayers . . . ." *Id.*

106. Under the dissenter's proposal, the monthly costs per customer for the cancelled plant would have dropped about 30 to 60 cents. *Id.* In comparison to the effect on the utility's financial situation, this customer impact seems minimal. Whether the NYPSC follows its precedent in future cases may be severely tested if either of the billion dollar Shoreham or Nine Mile Point nuclear projects is cancelled.

107. 46 Pub. Util. Rep. 4th (PUR) 431 (Mass. Apr. 30, 1982), *as modified* 53 Pub. Util. Rep. 4th (PUR) 349 (Mass. May 31, 1983), *aff'd sub. nom.* Attorney Gen. v. Dep't of Pub. Util., 390 Mass. 208, 455 N.E.2d 414 (1983).

108. 46 Pub. Util. Rep. 4th (PUR) at 434.

the attempt by the Company to address and meet its service obligation to its customers."[109] The factors bearing on the loss allocation were: (1) BECO's prudence, (2) the equity and fairness of any proposed solution, and (3) the financial integrity of the company and its ability to provide future service.[110]

After reviewing the prudence issue, the DPU addressed the "equity and fairness" consideration. Based on precedent, the DPU disallowed "the equity rate of return portion of AFUDC" from the amount to be amortized.[111] The DPU then considered the two primary factors in structuring recovery: the carrying charge and the amortization period. However, unlike the NYPSC in *Rochester*, the DPU provided little justification for its decisions. After only one paragraph discussing risk-sharing between shareholders and consumers, the DPU authorized BECO a fourteen percent carrying charge on the unamortized balance.[112] Additionally, the DPU's subsequent discussion of the amortization period was limited to only two paragraphs. After deciding that the amortization of the loss should not be tied to the projected life of the cancelled plant, the DPU concluded that a thirteen-year amortization was appropriate.[113]

Irrespective of the *Rochester* and *Boston Edison* decisions,[114] com-

109. *Id.* at 456. A similar observation was made by the ALJ in *Rochester* about the utility's statutory obligation to serve. 45 Pub. Util. Rep. 4th (PUR) at 389.

110. *Id.* at 461.

111. *Id.* at 471. Essentially, the DPU considered that this action placed some of the risk on the common stockholder. The debt (e.g., bonds, etc.) and preferred equity portion of AFUDC was allowed to be included in the recoverable amount.

112. The carrying charge was reviewable and adjustable to any reasonable rate. *Id.* at 472. In fact, the rate was dropped to 9.3% a year later. *Re* Boston Edison Co., 53 Pub. Util. Rep. 4th (PUR) 349 (Mass. May 31, 1983). The justification that this return would support an energy resource plan is a weak counter to the "used and useful" standard. However, the DPU had stated earlier in its decision that "the standard [used and useful] does not, however, determine the recovery question." 46 Pub. Util. Rep. 4th (PUR) at 435.

113. Allegedly, BECO's proposed ten-year amortization "would result in a disproportionately large impact on customers." *Id.* at 473. Unfortunately, the DPU did not provide any quantitative data to support its finding, but based its opinion on "evidence in the record." *Id.* In some respects, the DPU's reference to the record is not unusual in that the transcripts could run thousands of pages on the subject of amortization periods. Nevertheless, other commissions have been less vague by expressing their quantitative basis more clearly. *Cf. Re* Rochester Gas & Elec., 45 Pub. Util. Rep. 4th (PUR) 386 (N.Y. Jan. 13, 1982) (excellent quantitative analysis of various treatment alternatives).

114. The *Boston Edison* and *Rochester* cases provide a sharp contrast of how thoroughly commissions express their decisionmaking rationale. The NYPSC majority devoted a significantly greater portion of its opinion to analyzing the carrying charge and amortization period than the DPU. What possible explanations are there? First, the DPU's perspective of how cost recovery affects the utility and the consumer is a significant factor. Unlike others who consider that limited recoveries are "against" the utility

mission application of full recovery remains limited. Although full recovery was offered to a utility in a subsequent case if it cancelled its nuclear project,[115] the trend remains away from awarding rate base treatment or a carrying charge on any portion of a utility's prudent expenditures. The recent decisions of the North Carolina Utilities Commission (NCUC) are representative of the retreat from "full recovery" awards. In 1980, Virginia Electric & Power Co. (VEPCO) decided to cancel its North Anna 4 nuclear project. The NCUC found VEPCO's decisions prudent and, despite case precedent to the contrary,[116] granted VEPCO's request for rate base treatment of the full unamortized balance because a different result would penalize the shareholders for prudent management decisions.[117]

In 1981, the rate base treatment of North Anna 4 costs again came into issue.[118] The NCUC considered the matter, and decided that now only the unamortized costs associated with senior capital[119] warranted rate base treatment. The NCUC's logic in disallowing a return on the common equity component of these costs was that common stockholders control VEPCO's management and should not receive a return on investments by management in a cancelled plant.[120] It was "fair and reasonable," however, to give senior capital

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and "for" the ratepayer, the DPU believed that any loss allocation eventually falls on the ratepayer. 46 Pub. Util. Rep. 4th (PUR) at 459. Second, and more significantly, the DPU had already extensively investigated the Pilgrim II project in the DPU No. 19494 proceeding of 1981. After 18 months of considering the results of the investigation, the DPU found that Pilgrim II was prudent. *See* Boston Edison Co., Mass. DPU No. 19494 (Sept. 1981). Possibly the DPU's earlier investigation of Pilgrim II provided it with the confidence that BECO's efforts warranted full recovery. An appeal of the BECO decision was unsuccessful. *See* Attorney Gen. v. Dep't of Pub. Util., 390 Mass. 208, 455 N.E.2d 414, 425 (1983).

115. The Oklahoma Corporation Commission considered the Black Fox nuclear project to be economically unsound. Finding that management decisions to date were prudent, it stated that any future construction expenditures would be imprudent. Additionally, it offered the utility a ten-year amortization, and a return on the debt and preferred equity portion of the unamortized balance if the utility cancelled within 30 days. Public Service of Oklahoma, Oklahoma Corporation Commission Order No. 206560 (Jan. 15, 1982). The utility subsequently cancelled the project. For a discussion of the history of the project and the Commission review, see generally Note, *supra* note 6, at 192-95.

116. In a prior proceeding, the NCUC allowed VEPCO amortization over ten years for its cancelled Surry plant loss, but rejected rate base treatment. Rate base treatment was denied because the NCUC considered that the Surry cancellation was not "in the best interests of VEPCO customers." *See Re* Virginia Elec. & Power Co., 48 Pub. Util. Rep. 4th (PUR) 327, 346 (N.C. Aug. 26, 1982).

117. Virginia Elec. & Power Co., N.C.U.C. Case No. E-22, Sub 257 (July 15, 1981).

118. 48 Pub. Util. Rep. 4th (PUR) at 346-47.

119. Presumably, the NCUC's characterization of "senior debt" or "senior capital" refers to those plant costs financed through debt or preferred equity capital, and excludes common equity.

120. 48 Pub. Util. Rep. 4th (PUR) at 347.

holders a return because of their limited impact on VEPCO's decisions.[121]

Possibly the NCUC recognized the weakness of its justification for allowing rate base treatment of senior capital only. In a recent proceeding on VEPCO's newly cancelled North Anna 3 plant, the NCUC reaffirmed its original precedent of awarding no rate base treatment, and only provided VEPCO with cost recovery through a ten-year amortization.[122] Furthermore, the NCUC reversed its previous North Anna 4 decision allowing rate base treatment of senior capital costs, and removed any North Anna 4 costs from the rate base, finally resulting in a "partial recovery."[123] The partial recovery alternative remains the most commonly applied. In contrast, no utility has been awarded full recovery since 1982.

Partial Recovery

The second basic treatment alternative is "partial recovery," which is the most frequently awarded treatment for a cancelled plant loss.[124] The questions presented are identical to those present in full recovery cases. However, commissions awarding only "partial recovery" reject any rate base treatment or carrying charge. Furthermore, in partial recovery cases commissions seem more flexible in sharing the loss between ratepayer and shareholder than in either "full" or

121. *Id.*

122. Virginia Elec. & Power Co., N.C.U.C. Case No. E-22, Sub. 273 (Dec. 5, 1983).

123. A similar sequence of events transpired between the NCUC and Carolina Power and Light (CP&L). Shortly after its August, 1982 VEPCO decision allowing rate base treatment on "senior" capital costs, the NCUC found CP&L prudent in its cancellation of the Shearon Harris plants. *Re* Carolina Power & Light Co., 49 Pub. Util. Rep. 4th (PUR) 188 (N.C. Sept. 24, 1982). Interestingly, the NCUC provided rate base recognition only of costs supported by long-term debt, thereby precluding CP&L from earning a return both on the preferred equity and common equity components. *Id.* at 217. This action served to "fairly and equitably share the burden" between CP&L shareholders and the ratepayers. The primary justification was again that management is controlled by the shareholders, both preferred and common. *Id.* at 218.

However, as with VEPCO, the NCUC reexamined its award of rate base treatment on long-term debt in a subsequent CP&L proceeding. *See Re* Carolina Power & Light Co., 55 Pub. Util. Rep. 4th (PUR) 582 (N.C. Sept. 19, 1983). The purpose of the reexamination was to "develop a more *consistent* and equitable approach to [proper rate making treatment]." *Id.* at 600 (emphasis added). In its reexamination, the NCUC discarded the "management control by equity holders" justification and turned solely to fairness and reasonableness. Because neither the shareholders nor the ratepayers should bear the full brunt of the loss, a more equitable allocation required the removal of all unamortized Shearon Harris costs from the rate base which resulted in a "partial recovery."

124. Of the approximately 45 decisions the author surveyed for 1982-84, about 70% awarded partial recovery.

"no" recovery treatments. Therefore, partial recovery decisions tend to reflect more creativity in shaping rate relief.

As in full recovery cases, the commission faces the resolution of two basic issues after prudent costs are identified: (1) should rate base treatment, or a carrying charge, be granted and, (2) what is the length of amortization? Unfortunately, commissions frequently omit thorough or quantitative explanations of their decisions on these two questions.

The most prevalent justifications for denying rate base treatment are that the plant is not "used and useful,"[125] that jurisdictional precedent does not support such treatment,[126] that such treatment is unfair or inequitable to the ratepayers,[127] or that a shorter amortization period award precludes the need for rate base treatment.[128] Additionally, utilities periodically reach settlements or stipulations which do not provide for rate base treatment,[129] or even decide against ever proposing such an award.[130] Despite these limited reasons for denying rate base treatment or a carrying charge, the commissions offer a variety of opinions regarding what costs are recoverable through amortization, and the length of that period.

For example, commissions periodically employ cut-off dates beyond which costs are imprudent and unrecoverable.[131] In one case,

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125. *See Re* Houston Lighting & Power Co., 50 Pub. Util. Rep. 4th (PUR) 157, 202 (Tex. Dec. 6, 1982); *Re* Pacific Power & Light Co., 49 Pub. Util. Rep. 4th (PUR) 82, 90-91 (Or. Aug. 18, 1982); *Re* Atlantic City Elec. Co., 51 Pub. Util. Rep. 4th (PUR) 109, 115 (N.J. Jan. 13, 1983); Detroit Edison Co., Michigan P.S.C. Case No. 4-6949 (Mar. 31, 1983).

126. *See* Jersey Cent. Power & Light Co., 19 FED. ENERGY REG. COMM. (CCH) ¶ 61,208 (May 28, 1982), *aff'd*, 20 FED. ENERGY REG. COMM. (CCH) ¶ 61,083, *aff'd sub nom.* Jersey Cent. Power & Light Co. v. FERC, 730 F.2d 816 (D.C. Cir. 1984); *Re* Atlantic City Elec. Co., 51 Pub. Util. Rep. 4th (PUR) 109, 115 (N.J. Jan. 13, 1983); *Re* Potomac Elec. Power Co., 50 Pub. Util. Rep. 4th (PUR) 500, 533 (D.C. Dec. 29, 1982); Washington Util. & Transp. Comm'n v. Pacific Power & Light, 51 Pub. Util. Rep. 4th (PUR) 158, 165 (Wash. Feb. 1, 1983).

127. *See Re* Central Vt. Pub. Serv. Corp., 49 Pub. Util. Rep. 4th (PUR) 372, 392 (Vt. Sept. 16, 1982); *Re* Duke Power Co., 49 Pub. Util. Rep. 4th (PUR) 483, 496 (N.C. Nov. 1, 1982); *Re* Houston Lighting & Power Co., 50 Pub. Util. Rep. 4th (PUR) 157, 202 (Tex. Dec. 6, 1982); *Re* Potomac Elec. Power Co., 50 Pub. Util. Rep. 4th (PUR) 500, 532-33 (D.C. Dec. 29, 1982); Washington Util. & Transp. Comm'n v. Puget Sound Power & Light Co., 54 Pub. Util. Rep. 4th (PUR) 480, 497 (Wash. July 22, 1983); *Re* Central Ill. Light Co., 57 Pub. Util. Rep. 4th (PUR) 351, 364 (Ill. Dec. 21, 1982); Pacific Gas & Elec. Co., C.P.U.C. Dec. No. 83-12-068, mimeo at 412 (Dec. 22, 1983).

128. *See Re* Commonwealth Elec., 47 Pub. Util. Rep. 4th (PUR) 229, 233 (Mass. May 28, 1982); *Re* Fitchburg Gas & Elec. Light Co., 52 Pub. Util. Rep. 4th (PUR) 197, 221 (Mass. Mar. 31, 1983).

129. *See* Virginia Elec. & Power Co., W. Va. P.S.C. Case No. 81-413-E-42T (June 10, 1982); *Re* Bangor Hydro-Electric Co., 46 Pub. Util. Rep. 4th (PUR) 503, 556 (Me. Apr. 8, 1982).

130. *See* Northern Ind. Pub. Serv. Co., Ind. P.S.C. Case No. 36689 (Aug. 11, 1982); *Re* Union Elec. Co., 53 Pub. Util. Rep. 4th (PUR) 565, 590 (Ill. May 23, 1983).

131. *See, e.g., Re* Houston Lighting & Power Co., 50 Pub. Util. Rep. 4th (PUR) 157, 200 (Tex. Dec. 6, 1982) (the Texas Commission removed $166,000,000 from the

the Massachusetts Department of Public Utilities (DPU) even "imputed" imprudence from the lead partner in a project to a participating utility.[132]

Another commission method of identifying recoverable costs is by categorizing the different elements of the loss. The most commonly manipulated element is AFUDC. The majority of jurisdictions consider that AFUDC is an integral part of the construction costs (CWIP);[133] if prudently incurred, the entire AFDUC component is a recoverable cost.[134] However, some commissions consistently disagree.

For example, two northeastern state commissions consider AFUDC something less that a legitimate cost, despite its prudent incurrance. The Massachusetts DPU disallowed the amortized recovery of the equity portion of the AFUDC in *Re Commonwealth Electric Co.*[135] This action was in accordance with the DPU's "risk sharing" methodology, despite Commonwealth's demonstrated prudence.[136] As previously noted, most jurisdictions do not agree

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total $360,000,000 loss because the costs accrued after the date on which the project should have been cancelled).

132. *Re* Commonwealth Elec. Co., 47 Pub. Util. Rep. 4th (PUR) 229 (Mass. May 28, 1982) (Commonwealth's grant of authority was so broad that "sound legal and policy grounds" supported the imputed imprudence). *Accord Re* Fitchburg Gas & Elec. Light Co., 52 Pub. Util. Rep. 4th (PUR) 197, 220 (Mass. May 31, 1983) (similar grant led the DPU to "conclude that the shareholders must bear the consequences of that act."). *Cf. Re* Atlantic City Elec. Co., 51 Pub. Util. Rep. 4th (PUR) 109, 115 (N.J. Jan. 13, 1983) (The utility requested a carrying charge on the unamortized balance because "it had no input into the final decision to abandon the project." Noting that the lead participant, Public Service Electric & Gas, had not received a carrying charge, the New Jersey P.S.C. denied Atlantic City's request.).

133. *See Re* Central Ill. Light Co., 57 Pub. Util. Rep. 4th (PUR) 351 (Ill. Dec. 21, 1983); Carolina Power & Light, S.C.P.S.C. Order No. 83-583 (Oct. 28 1983); Duke Power Co., N.C.U.C. Case No. E-7, Sub. 358 (Sept. 30, 1983); *Re* Union Illuminating, 55 Pub. Util. Rep. 4th (PUR) 252 (Conn. Aug. 22, 1983); *Re* Union Elec., 53 Pub. Util Rep. 4th (PUR) 565 (Ill. May 23, 1983); *Re* Detroit Edison, 52 Pub. Util. Rep. 4th (PUR) 318 (Mich. Mar. 31, 1983); *Re* Duquesne Light Co., 51 Pub. Util. Rep. 4th (PUR) 198 (Pa. Jan. 27, 1983); *Re* Houston Lighting & Power Co., 50 Pub. Util. Rep. 4th (PUR) 157 (Tex. Dec. 6, 1982).

134. One commission stated that "[i]t would be an unwarranted penalty to disallow the amortization of accumulated AFUDC . . . . [T]he carrying costs on the project [AFUDC] are as much a legitimate expense of the project as more tangible costs such as parts and materials." *Re* Union Elec. Co., 53 Pub. Util. Rep. 4th (PUR) 565, 592 (Ill. May 23, 1983).

135. 47 Pub. Util. Rep. 4th (PUR) 229 (Mass. May 28, 1982). An identical fate befell Fitchburg Gas & Electric. *See* 52 Pub. Util. Rep. 4th (PUR) at 220-21.

136. The commission considered that recovery of equity AFUDC would remove the inherent risk associated with common stock. 47 Pub. Util. Rep. 4th (PUR) at 237. However, the DPU's denial of equity AFUDC may have been set off by Fitchburg's and Commonwealth's short amortization periods, three years and two years respectively. Al-

with Massachusetts' "sound" ratemaking principles on AFUDC treatment.

The Maine Public Utilities Commission (PUC), is even less favorable toward AFUDC recovery. Following its precedent of disallowing all AFUDC on cancelled projects,[137] the PUC rejected Bangor Hydro-Electric's request for recovery of the long-term debt component of AFUDC because it would result in an inequitable allocation of the loss.[138] The Maine PUC considered that shareholders assessed their risk to include the loss of any expected return on the entire investment, both debt and equity. Unfortunately, the commission provided no quantitative data to illustrate how its treatment of AFUDC made the award more "equitable."

A commission's selection of an amortization period is also frequently left unsupported in an opinion. A commission will not generally link the length of amortization to the projected useful life of the cancelled facility.[139] However, most commissions still omit an objective analysis supporting their selection of a period justified on "equitable" considerations or its "appropriateness."[140]

Occasionally, a commission does offer some good insight. In *Re Central Vermont Public Service Corp.*,[141] the Vermont Public Ser-

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though Boston Edison had a ten-year amortization period, it was also awarded rate base treatment of the unamortized amount.

137. *See* Central Me. Power Co., Me. P.U.C. Docket Nos. 81-121/81]-206 (Mar. 27, 1982); Central Me. Power Co., Me. P.U.C. Docket Nos. 80-25/80]-66 (Oct. 10, 1980). *Accord* Pacific Gas & Elec., C.P.U.C. Decision No. 83-12-068 (Dec. 22, 1983) (the CPUC's denial of PG&E recovery of AFUDC on a variety of cancelled projects provided a "fair and reasonable sharing").

138. *Re* Bangor Hydro-Electric Co., 46 Pub. Util. Rep. 4th (PUR) 503, 557 (Me. Apr. 8, 1982). However, a utility in extreme financial hardship may be allowed to recover some of the AFUDC. *Id.*

139. *See, e.g.*, Pennsylvania Power Co., FED. ENERGY REG. COMM. (CCH) Opinion No. 211, Docket No. ER81-779-005 (Mar. 22, 1984) (the FERC rejected a thirty-year amortization, based on the expected useful life of the plant, because of the balance of interests between ratepayers and investors. A ten-year amortization was found to have a minimal effect on the ratepayer's cost of service versus the utility's disadvantage of an extended recovery period.).

140. *See, e.g.*, *Re* Central Ill. Light Co., 57 Pub. Util. Rep. 4th (PUR) 351, 364 (Ill. Dec. 21, 1983) (an "equitable balancing"); *Re* Union Elec. Co., 53 Pub. Util. Rep. 4th (PUR) 565, 592 (Ill. May 23, 1983) ("the most equitable accommodation"); *Re* Fitchburg Gas & Elec. Light Co., 52 Pub. Util. Rep. 4th (PUR) 197, 221 (Mass. May 31, 1983) (a three-year period was "appropriate"); *Re* Detroit Edison, 52 Pub. Util. Rep. 4th (PUR) 318, 326 (Mich. Mar. 31, 1983) ("more equitable" and "appropriate to follow case precedent"); *Re* Atlantic City Elec. Co., 51 Pub. Util. Rep. 4th (PUR) 109, 115 (N.J. Jan. 13, 1983) (the "most balanced and equitable result"); *Re* Houston Lighting & Power Co., 50 Pub. Util. Rep. 4th (PUR) 157, 200 (Tex. Dec. 6, 1982) ("more fairly assesses the burden"); *Re* Duke Power Co., 49 Pub. Util. Rep. 4th (PUR) 483, 497 (N.C. Nov. 7, 1982) ("as to the appropriate amortization period, the Commission believes and so concludes that the five-year amortization period proposed by the Company is appropriate."). However, a complete evaluation of the possible basis for a commission's decision is difficult without reviewing the entire transcripts of the proceeding.

141. 49 Pub. Util. Rep. 4th (PUR) 372 (Vt. Sept. 16 1982).

vice Board (PSB) analyzed the effects of a three-year and a ten-year amortization. Determining that a three-year period resulted in a eighty percent ratepayer - twenty percent shareholder split, and a ten-year period in a fifty-five percent ratepayer - forty-five percent shareholder split, the PSB concluded "that a ten-year amortization with no rate base treatment is appropriate."[142] In contrast, the Washington Utilities and Transportation Commission has determined that a ten-year amortization, resulting in a seventy percent ratepayer - thirty percent shareholder split, is an "equitable allocation."[143]

Other partial recovery cases illustrate the problems facing commissions as they consider the competing interests and the varied approaches finally selected. One major problem involves treatment of cancelled plants where the utility operates in multiple jurisdictions. A good example of jurisdictional disputes involved the Northern States Power (NSP) Company's Tyrone nuclear project which affected five jurisdictions — Minnesota, Wisconsin, North Dakota, South Dakota, and the FERC.[144] After the Wisconsin Commission refused to grant a certificate of public convenience to NSP, the Tyrone nuclear project was cancelled. NSP's attempt to recoup its losses resulted in four years of regulatory proceedings and litigation in both state and federal courts. The matter also shows how the effect of the regulatory actions of one state on ratepayers of another state can create ill feelings between jurisdictions.[145]

Occasionally, commissions are compelled to develop other creative "partial recovery" treatments because of policy or legal restrictions

142. *Id.* at 392.

143. *See* Washington Util. & Transp. Comm'n v. Puget Sound Power & Light Co., 54 Pub. Util. Rep. 4th (PUR) 480, 484-97 (Wash. July 22, 1983).

144. *See, e.g.*, Massella, *The Tyrone Case: A Study of Plant Cancellation Costs*, PUB. UTIL. FORT., Mar. 4, 1982, at 58 (detailing the early history of the proceedings).

145. As stated early in the fiasco by the Minnesota P.S.C., "[n]othing in this record has persuaded the commission that it is wrong in its long-held belief that the WPSC [Wisconsin PSC] acted in a parochial fashion, in disregard for and in derogation of the integrated [electrical supply] system concept when it denied the need certificate for Tyrone on solely western Wisconsin growth projections." *Re* Northern States Power Co., 42 Pub. Util. Rep. 4th (PUR) 339, 361 (Minn. Apr. 30, 1981).

Other jurisdictional influences can also develop. *See, e.g.*, Washington Util. & Transp. Comm'n v. Pacific Power & Lighting Co., 51 Pub. Util Rep. 4th (PUR) 158, 167 (Wash. Feb. 1, 1983) (The WUTC initially denied recovery because other jurisdictions had previously rejected PP&L's request. Approval in Washington would constitute a "double recovery" for PP&L. Therefore, the WUTC awarded PP&L a 2.5% return on equity premium.).

on utility recovery.[146] In fact, restrictions on utility recovery are becoming more commonplace.

No Recovery

The third basic cancelled plant treatment will be called the "no recovery" alternative. Analysis of these recovery denials essentially involves determining why the commission rejected both rate base and cost of service (amortization) recovery. Recovery denials have been justified by jurisdictional disputes,[147] the failure of the utility to carry its burden of proof,[148] and statutory preclusion.[149] However, since 1981, commissions have been increasingly compelled by legislation to deny any direct rate recovery where the asset is not used and useful.[150] For example, Dayton Power & Light Co. sought recovery for its canceled Killen project through amortization. The Ohio Commission reaffirmed that Ohio law precluded any direct recovery, and the Supreme Court of Ohio upheld the Commission's decision.[151]

In addition to legislative enactment, ballot measures are being used to implement laws denying direct rate recovery on non-used and useful assets.[152] In *Re Union Electric Co.*,[153] the Missouri Commission considered the effect of an anti-CWIP proposition on a utility's request for "partial recovery" of cancellation costs. The Commission found no case law to provide guidance on the scope of the proposi-

146. *See, e.g., Re* Commonwealth Elec., 47 Pub. Util. Rep. 4th (PUR) 229 (Mass. May 28, 1982) (a "purchase power adjustment clause" employed); Public Serv. Elec. & Gas Co., N.J.B.P.U. Case No. 8012-914 (Apr. 1, 1982) ("Energy Adjustment Clause" employed); *Re* Pacific Power & Light Co., 49 Pub. Util. Rep. 4th (PUR) 82, 91 (Or. Aug. 18, 1982) (extraordinary gains offset against plant cancellation losses).

147. *See Re* Arizona Pub. Serv. Co., 38 Pub. Util. Rep. 4th (PUR) 547, 556 (Ariz. May 29, 1980). However, the Arizona Commission buttressed its denial with other justifications including (1) utility failure to carry the burden, (2) a nonrecurring loss that would skew rate case results, (3) that planning of construction was a management function under the shareholder's control, and (4) that another state's adverse regulatory conditions were not avoided through contractual safeguards. *Id.*

148. *See* Southern Cal. Edison Co., Opinion No. 62, 8 FED. ENERGY REG. COMM. (CCH) ¶ 61,198 (Aug. 22 1979). "We also agree [with the ALJ] that the evidence presented by Edison merely consisted of vague generalizations about the problems inherent in all building projects." *Id.* at 61,680.

149. *See, e.g., Re* Cleveland Elec. Illuminating Co., 38 Pub. Util. Rep. 4th (PUR) 494 (Ohio July 10, 1980) (Ohio law prevents any recovery through rates for plant not "used and useful").

150. A survey of commission orders yields approximately five "no recovery" decisions between 1979 and 1981. Of these five decisions, only two involved statutory preclusion, both from the same jurisdiction (Ohio). In contrast, ten "no recovery" decisions were found in the 1982-83 time period. Significantly, six of these denials were based on statutory preclusion, all from different jurisdictions.

151. Dayton Power & Light Co. v. Pub. Util. Comm'n of Ohio, 4 Ohio St. 2d 91, 447 N.E.2d 733 (1983).

152. Generically, these laws are called "anti-CWIP" statutes because of their dictate that only "used and useful" property be recovered in rates. By definition, CWIP expenditures do not meet the requirement.

153. 57 Pub. Util. Rep. 4th (PUR) 169 (Mo. Oct. 21, 1983).

tion. Expecting a court appeal to resolve the issue, the Commission denied cost of service recovery as a matter of law, thereby preserving the "status quo."[154] However, the Commission left the door open for future recovery by not reaching any questions of fact.

Maine has legislated a unique approach to the cost recovery issue. As discussed by the state commission, Maine's law restricts the commission from issuing "any order concerning the recovery from ratepayers of all or any portion of the cost of that [cancelled] facility until after the date last announced for the completion of the plant by the lead participant."[155] However, an exception is available when denial of some or all recovery will injure the utility's ability to "perform its public service or attract necessary capital on just and reasonable terms."[156] In any event, Maine utilities still have an opportunity to recover prudent cancellation costs under the law upon reaching the "announced" completion date of the project.

In contrast, statutes or policies of other jurisdictions are less favorable toward a utility's second trip to the commission requesting a recovery. In *Re Portland General Electric Co.* (PGE),[157] the Oregon Commissioner considered a $132,000,000 loss on the cancelled Pebble Springs nuclear project. Presumably because of Oregon's anti-CWIP statute, the Commissioner made clear the ratepayers' freedom from liability by stating that "[t]he PGE ratepayers will not be expected to pay one cent of the cost of writing off those plants."[158] In case PGE had any ideas about a subsequent recovery, the Commissioner added, "[i]n the future PGE will not seek any further rate increases, or any compensation for the Pebble project in any proceeding before this agency."[159] This policy is obviously harsh where a utility has prudently incurred these costs. However, consistent application of clear policies at least provides investors with some ability to prospectively assess their risk.

Unfortunately, some commissions only increase risk and uncertainty by twisting words, misapplying principles, or misinterpreting statutes. Whether these actions are conscious or unconscious, the investor's perception of increased risk will adversely influence a util-

154. *Id.* at 172.
155. *Re* Central Me. Power Co., 57 Pub. Util. Rep. 4th (PUR) 488, 507 (Me. Dec. 15, 1983). This decision also provides a good example of the commission's actual application of the law.
156. *Id.*
157. 49 Pub. Util. Rep. 4th (PUR) 274 (Or. Sept. 23, 1982).
158. *Id.* at 274.
159. *Id.* at 277.

ity's capital costs. A representative case is *Re Pacific Power & Light* (PP&L),[160] in which the Montana Commission considered PP&L's losses on the cancelled Pebble Springs and Washington Public Power Supply Systems (WPPSS) nuclear projects. PP&L requested rate recovery over five years with a return on its investment.[161] In opposition, the Commission staff recommended the denial of some costs and a longer amortization period. However, the Commission exercised its independence and characterized the issue in the broader context of "who should pay." Liberally interpreting the statutory language[162] to limit any rate recovery to used and useful property only, the Commission denied PP&L's request.

An analysis of the opinion reveals questionable characterizations of recovery theories by both the utility and the Commission. For example, the decision suggests that PP&L attempted to clear the statutory used and useful hurdle by distinguishing rate base treatment from a carrying charge on the unamortized balance. Practically, there is only a technical difference and the Commission properly characterized PP&L's distinction as "one of semantics only."[163] However, the balance of the opinion stands as a model for tortured ratemaking by a commission. Essentially, the Commission's decision creates much uncertainty because of its questionable analysis.[164]

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160. 53 Pub. Util. Rep. 4th (PUR) 24 (Mont. Apr. 18, 1983).

161. PP&L proposed an 11.2% carrying charge on the unamortized balance.

162. Montana law provided that "[t]he commission may, in its discretion, investigate and ascertain the value of the property of every public utility actually used and useful." 53 Pub. Util. Rep. 4th (PUR) at 27.

163. *Id.* at 28.

164. First, when it characterized the broader issue as "who should pay," the Commission implied a context in which an asset was not used and useful "due to misjudgment by the Company's management." *Id.* at 27. This implication leads one to believe that the Commission's real basis for ruling against PP&L was the utility's imprudence, despite the Commission's statement that the prudency issue was never reached.

Second, the Commission's interpretation that the statute applied the used and useful standard to evaluate any recovery appears erroneous. The statutory language provided in the opinion more accurately refers to rate base valuation, as asserted by PP&L and as inferred from the staff's recovery proposal. *See supra* note 162. If other statutory language more clearly denies all recovery, irrespective of prudence, then the Commission should have presented it in the opinion.

Third, the Commission asserted that the statute put the investor on notice of the "used and useful" requirement. Arguably, the Commission's interpretation and application of a statute is what gives notice to an investor. Previously, the Montana Commission allowed recovery but changed its mind in this case because of its "thorough and intensive examination of the used and useful principle and the rationale behind it." 53 Pub. Util. Rep. 4th (PUR) at 30.

Fourth, the Commission's analysis of PP&L's claim that the Commission's actions constituted an unconstitutional taking of property was also weak. Ignoring PP&L's obligation to serve, the Commission said a taking had not occurred because PP&L retained "full control and use of the projects unrestrained by either the commission or the ratepayers." *Id.* at 31. Certainly, PP&L had control, but it had no rate relief.

Then, as if to absolve any of its indiscretions, the Commission held as its final finding of fact that the application of the used and useful standard would be appropriate as a

Unfortunately for PP&L, it had a similar experience before the Wyoming Commission[165] on the issue of cost recovery for the Pebble Springs and WPPSS nuclear projects. Denied any recovery, based on an interpretation of Wyoming statutes, PP&L appealed to the Wyoming Supreme Court which subsequently affirmed the Commission's order.[166] The strained characterizations in the opinion demonstrate that courts, as well as commissions, can misapply ratemaking principles.[167] The denial of cost recovery for a utility on a weak rationale has serious implications.

In summary, requests for cancelled plant recovery have resulted in a variety of ratemaking treatments. The majority of jurisdictions will

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matter of policy, even if not statutorily required. *Cf.* Pacific Power & Light, C.P.U.C. Decision No. 82-07-048 (Dec. 2, 1983) (the C.P.U.C. considered that that the denial of an amortized cost recovery was inappropriate where based on the used and useful standard). Essentially, the Commission's questionable analysis leads to a questionable result.

165. Pacific Power & Light, Wyo. P.S.C. Docket No. 9454, Sub 17 (Oct. 8, 1982). This P.S.C. ruling was made in an open session, so a written order has not yet been prepared.

166. Pacific Power & Light Co. v. Public Serv. Comm'n of Wyo., 677 P.2d 799 (Wyo.), *cert. denied*, 105 S. Ct. 120 (1984).

167. *See generally id.* at 799. The Wyoming Commission interpreted a statute remarkably similar to Montana's authorizing it to "investigate, consider and determine such matters as the cost or value, or both, of the property and business of any public utility, used and useful for the convenience of the public." *Id.* at 804. After reasonably supporting the Commission's interpretation that the statute precluded rate base treatment, the court discussed reasons for denying amortization of the loss, i.e., cost of service recovery. Using a confusing analysis, the court determined that the expenditures "were not 'operating expenses' as that term is generally considered." *Id.* at 806. This determination is contrary to the majority of jurisdictions as evidenced by the allowance of "partial recovery" in most areas.

As if it recognized the weakness of its preceding arguments, the court attempted to bolster its position through a discussion of the balancing of risk between shareholder and ratepayer. The court proposed that if the ratepayers were to assume any of the risk of a utility investment, then the commission should approve the project. Although the suggestion seems reasonable, Wyoming has no statute or rule requiring prior approval. The inconsistency of the court's new requirement was evident in its response to PP&L's arguments that the Commission had allowed the costs of other "unapproved" abandoned projects to be recovered through rates. The court stated, "*[u]sually* the activity which subsequently failed was approved as an activity prior to its inception by the PSC." *Id.* at 808 (emphasis added).

As noted in the discussion of the Montana Proceeding, this type of free-wheeling ratemaking increases the riskiness of utility investments and is detrimental to the ratepayers in the long run because of increased utility costs of capital. *Cf.* Wisconsin Pub. Ser. Corp. v. Public Serv. Comm'n of Wis., 109 Wis. 2d 256, 325 N.W.2d 867 (1982), where the Supreme Court of Wisconsin reversed a P.S.C. order which retroactively amortized $7,500,000 of expenditures on a cancelled plant. The technical effect of the retroactive amortization was to prevent these costs from being considered in the ratemaking test year. Because of ratemaking procedures, the practical effect was to preclude the recovery of these prudent costs from the ratepayers. The court found the Commission's decision of retroactive amortization to be arbitrary and capricious. *Id.*

allow cost recovery over approximately ten years, although the length of the amortization period tends to increase with the size of the loss. Full recovery, with its return on investment component, is practically extinct. In fact, an increasing number of state commissions are denying all direct cost recovery as a matter of law or policy. Nevertheless, the cancelled plant dilemma will persist into the immediate future,[168] and the strains on the regulatory agencies, legislatures, and courts must improve their application and explanation of ratemaking treatments.

OBSERVATIONS AND RECOMMENDATIONS

Ratemaking is significant because all levels of economic growth are heavily dependent on stable, adequate electric energy supplies. Despite the current excess of electric generation capacity, some industry observers predict huge increases in electrical power demand within ten years.[169] Presently, only large base-load generation facilities will be able to meet this demand. Although playing a key role in ensuring that utilities remain focused on the needs of their customers, commissions must also provide utilities with the opportunity to earn adequate revenues or to access the capital markets to support future construction programs. Presently, many cancelled plant decisions create uncertainty and, therefore, perform a disservice to the policy of balancing investor and ratepayer interests. For example, jurisdictions that unequivocally require a plant to be used and useful before any rate relief is awarded are holding shareholders strictly liable. In the present risky business environment, many utilities may defer the construction of new capacity until it is too late to avoid power shortages. Therefore, although the commissions are not the only solution to the problem, they are a large part of it. What can they do?

Based on a review of recent cancelled plant orders, it appears that regulatory commissions can improve the quality of their decisions by

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168. *See* Zitser, *The Nuclear Plant Problem Needs a Federal Solution*, PUB. UTIL. FORT., Mar. 29, 1984, at 22. Additionally, other utilities besides Consumer Power Co. are in financial trouble with potential plant cancellations. *See supra* note 3. *See also* L.A. Times, May 13, 1984, part V, at 8, col. 1 (Long Island Lighting Co. is in serious financial trouble); The Energy Daily, Apr. 17, 1984, at 1, col. 3 (Public Service of New Hampshire faces bankruptcy); *Electric Rate Increase Requested*, PUB. UTIL. FORT., June 21, 1984, at 57, 60 (Public Service of Indiana requires rate relief because of financial problems with Marble Hill project).

169. One industry consultant stated,

> "Demand for electricity will grow at a 4 to 5 percent annual rate for the rest of this decade . . . . The implications for the power supply sector are significant, with new plant and equipment commitments of 450-700 gigawatts [hundreds of billions of watts], or $1.5 - $2 trillion, required over the next ten years."

The Energy Daily, Apr. 12, 1984, at 2, col. 2. *But see* The Energy Daily, Sept. 17, 1984, at 3, col. 1 (disputing predictions of electric power shortages in the 1990's).

clearly analyzing and properly applying rate-making principles. This effort will improve the ratepayers' and investors' understanding of the rationale underlying a commission's decision. Ratepayers will not be misled by rhetoric, and investors can more accurately assess the investment risk presented. Optimally, a utility's cost of capital will then reflect the actual risk factor, so that commissions may take more effective ratemaking actions in the future. The following observations and recommendations are offered:

1. The existing standards of review are still viable, if applied in a straightforward fashion.

a. Prudent costs should be recoverable. The prudency of an action is reasonably determinable, and procedures exist for review of a commission's finding on this issue. Simultaneously, "prudency" allows flexible decision-making without compromising the integrity of the standard.[170] In contrast, many commissions currently pare away at prudent costs using "equitable" considerations.[171] Such actions weaken the integrity of the "prudence" standard.[172] The resulting uncertainty may raise capital costs, which the ratepayer ultimately pays.

b. The used and useful standard should be applied consistently. Some commissions consider that the capital itself invested in an unfinished plant is "used and useful." Others consider that only when the plant enters commercial operation is it "used and useful." Whichever approach is selected, it should be applied consistently. Otherwise, uncertainty increases.

2. The used and useful standard should be restricted to rate base determinations.

a. Holding all prudent utility expenses to the used and useful standard creates an unreasonably high risk. An investor should be reasonably liable, not absolutely liable. The long-term balance of interests is not properly served by the application of this standard, despite its political attractiveness in the short term.

b. However, if a jurisdiction decides to statutorily apply the used and useful standard to all utility expenditures, then it should

170. Nevertheless, the standard must be carefully applied. *See Prudence: The Concept that Could Cost Utilities Billions*, The Energy Daily, June 7, 1984, at 1, col. 1.

171. *See, e.g., Re* Bangor Hydro-Electric Co., 46 Pub. Util. Rep. 4th (PUR) 503 (Me. Apr. 8, 1982) (prudently incurred "equity AFUDC" disallowed based on equitable considerations).

172. The standard is weakened because an investor can no longer depend on the commission allowing recovery of "prudent" costs. Therefore, whether a cost is prudently incurred becomes inconsequential.

also provide an exception for emergency rate relief.[173] An exception provides the commission with some discretion, albeit more restricted. Appropriate exceptions could be based on the utility's financial integrity and ability to access the capital markets. Allowing a commission to grant cost of service rate relief on these exceptions is preferable to the following ratemaking alternatives. First, the commission can deny any rate relief under the statute, despite the utility's prudency. The utility could go bankrupt. Second, the commission can increase the utility's rate of return. This alternative is poor because of the public perception it creates. When a rate-payer hears of a utility rate of return of twenty-five percent, it sounds like "profit." In fact, there may be little or no income present because the return premium is covering disallowed expenses. The third alternative is equally unattractive. The commission can find an asset is used and useful, when it actually is not. Again, inconsistency and uncertainty enter the picture as the commission tries to unreasonably manipulate ratemaking principles.

3. Commissions and courts should be consistent in applying procedural requirements. To deny a utility any recovery because it failed to receive a commission's construction authorization, where none is required, is arbitrary and capricious.[174] Policies and procedure should be clarified early in the process when compliance is achievable, not after the fact. This approach enhances the balancing of the interests involved with plant construction.

4. Utilities should make an extra effort to communicate their plans to their respective commissions, irrespective of the requirement to do so. This communication presents the issues, and may reveal possible disagreements early in the process.[175] Additionally, commission review of utility actions may improve the chances of a utility's conduct being considered "prudent."[176]

5. Commission and court decisions should be models of clarity and thorough analysis.

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173. *Cf. Re* Central Me. Power Co., 57 Pub. Util. Rep. 4th (PUR) 488 (Me. Dec. 15, 1983) (exception provided where a utility shows it cannot adequately access capital markets without rate relief).

174. *See, e.g., Re* Pacific Power & Light Co. v. Public Serv. Comm'n of Wyo., 677 P.2d at 799 (Wyo. 1984) (the court considered that the utility should have received commission approval for the project despite the absence of a procedural requirement to do so).

175. *Cf. Re* Central Me. Power Co., 57 Pub. Util. Rep. 4th (PUR) 488, 492 (Me. Dec. 15, 1983) (commission considered that the utility's construction program was based on "inaccurately high demand figures, inaccurately low cost figures, and inaccurately optimistic completion dates").

176. *Cf. Re* Boston Edison Co., 46 Pub. Util. Rep. 4th (PUR) 431 (Mass. Apr. 30, 1982) (extensive previous investigation of utility's construction project supported a finding of "prudent" conduct). *See supra* note 114.

a. As discussed previously, ratemaking principles should be consistently applied.

b. Poorly explained decisions provide an opportunity for questionable analysis and increased uncertainty. For example, "equitable sharing" is a broad concept. It should be quantitatively explained,[177] not just thrown into the financial markets for interpretation. The investors and ratemakers should see why a commission considers that an "X" percent rate increase is equitable, or why a ten-year amortization is a fair balance, or why a seventy percent to thirty percent shareholder-ratepayer sharing is appropriate.[178] This type of express quantitative analysis presented in the commission decision, not just buried in the hearing transcripts,[179] provides real notice to the public.

c. Strained characterizations undermine ratemaking principles and exacerbate decision-making problems in future proceedings. Denying the equity element of AFUDC because "shareholders have control of management,"[180] or because that element of the cost of construction capital is not really a cost of service[181] is a weak justification. Rather than manipulating prudently incurred AFUDC to balance the loss between investor and ratepayer, the commission could amortize the loss over a longer period. Similarly, the commission should not strain to characterize an expenditure as "not being an operating expense," when the definition provided suggests that it really is a proper expense.[182]

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177. *See, e.g., Re* Rochester Gas & Elec. Co., 45 Pub. Util. Rep. 4th (PUR) 386 (N.Y. Jan. 13, 1982) (opinion provides an excellent quantitative comparison of the effects of different amortization periods, and why the NYPSC considered its selection "equitable").

178. *Cf.* DeWitt Truck Brokers v. Flemming Fruit, 540 F.2d 681, 685 (4th Cir. 1976), where the court discussing the basis for piercing the corporate veil, stated, "[o]ne court has suggested that courts should abjure 'the mere incantation of the term "instrumentality" ' in this context and, since the issue is one of fact, should take pains to spell out the specific factual basis for its conclusion."

179. *Cf. Re* Boston Edison Co., 46 Pub. Util. Rep. 4th (PUR) 431, 434 (Mass. Apr. 30, 1982) (selection of amortization period based on "evidence in the record").

180. *See, e.g., Re* Virginia Elec. & Power Co., 48 Pub. Util. Rep. 4th (PUR) 327, 346-47 (N.C. Aug. 26, 1982) (return on common equity component of AFUDC denied because stockholders control management).

181. *Cf. Re* Commonwealth Elec., 47 Pub. Util. Rep. 4th (PUR) 229, 237 (Mass. May 28, 1982) (equity AFUDC is a risk premium for common shareholders, and not a reflection of the cost of construction monies).

182. *See, e.g.*, Pacific Power & Light Co. v. Public Serv. Comm'n of Wyo., 677 P.2d 799 (Wyo. 1984) (court considered PP&L's expenditures on new plant were not an "expense contributing to the . . . greater efficiency of the utility").

CONCLUSION

The cancelled plant dilemma has strained the ratemaking principles employed by various jurisdictions. However, a review of applicable decisions indicates that these principles are still useful, and can remain so if properly applied. The problem of balancing the interests of ratepayers and investors is not one prone to simplistic generalizations, especially in a complex operating environment and where the impact is so significant. The issue has been characterized as "who should pay?"[183] The practical problem is better illustrated by the question "who wants to pay," and the answer, "no one!" Yet, someone must pay, and it is generally the commissions' decision.

The jurisdictions have extensive authority to accomplish this task. The U.S. Supreme Court has implied that these powers remain strong and the scope of available courses of action broad.[184] It appears that so long as the final result is reasonable, the regulators will not have exceeded their limits.[185] Nevertheless, the commissions still have a strong responsibility to the ratepayers and investors. Similarly, both the legislature in delimiting the commission's powers and the judiciary in reviewing the commission's exercise of those powers have a responsibility to ensure fair ratemaking treatment.

The regulatory commissions and ratemaking principles remain only one part of the broader solution to the cancelled plant problem and this country's energy future. But they are one very important part!

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183. *See* Pacific Power & Light, 53 Pub. Util. Rep. 4th (PUR) 24, 26 (Mont. Apr. 18, 1983).

184. *See, e.g.*, Cleveland Elec. Illuminating Co. v. Consumer's Counsel, 455 U.S. 914 (1982). The Court dismissed CEI's appeal for lack of a "properly presented federal question" in a memorandum opinion. The implication was that the state could enact laws denying rates on non-used and useful property without violating the Constitution.

185. *See* Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944) (it is the "end result" that determines the reasonableness of the decision, not the process by which the decision is reached).