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[II. Richard La Capra, Principal, La Capra Associates](#)

[III. Dr. Phillip O'Connor, Principal, Coopers & Lybrand](#)

I. Kodwo Ghartey-Tagoe
Mays & Valentine, L.L.P.

{1} Good morning, my name is Kodwo Ghartey-Tagoe and I am with the law firm of Mays & Valentine of Richmond, Virginia. Our first session this morning relates to stranded costs and their potential impact on retail competition in the electric industry. While I was preparing for this session, I reviewed some notes from a professor friend of mind who teaches economic regulation at the College of William & Mary. In his course, he covers electric restructuring and stranded costs. I found certain definitions that I think will settle the whole debate here. For example, he defines stranded costs as costs that are stranded when you play golf with Judge Morrison. He also defines stranded benefits as the benefits you get when you play golf with Judge Middleton. Stranded people are most people who walk around the General Assembly opposing Judge Mohring in the last session of the General Assembly, and who now have rate cases pending in his court. I think you agree the debate has been settled.

{2} Our speakers have come a long way and we will not allow them to leave without saying something. On our panel today we have Richard La Capra, Founder and Principal of La Capra Associates. He has been involved in major restructuring activity in all six New England states, other parts of the country, and overseas. His biography is contained in your materials. Our second speaker is Philip O'Connor. Dr. O'Connor is with Coopers & Lybrand Consulting and is a former chair of the Illinois Commerce Commission. He is a nationally recognized expert on the development and implementation of competitive strategies in regulated industries. His biography is also included in your package. We have an additional handout from Dr. O'Connor, located at the front of the room. Now, I'll ask Richard to give us no more than a ten minute overview of his position on stranded costs and how that will impact retail competition. Then, we will have Dr. O'Connor speak and open up for questions.

II. Richard La Capra

Principal, La Capra Associates

{3} Good morning. Just having coffee on the way in I was told there are no such things as stranded costs. That gave me some time to kill this morning. It is a very compelling thesis.

{4} But to the extent that some of us believe that there are stranded costs, let me offer a few definitions and a few points that may serve to further the discussion this morning. Stranded costs, I would define simply as those costs which are represented now in the energy industry (particularly electric utilities) which would not be recoverable under an open competition among different entities for electric markets. These costs arrive for several reasons. There is not any particular one, and it will vary in magnitude from company to company among things like overly costly investments, companies who have been subject to rapid technological changes, companies entering into long term contracts which don't reflect current market conditions, regulatory assets which have been built up because of various public service requirements, public policy obligations that step forth from legislative or regulatory mandates, and unfunded liabilities. Each one of these costs represent an area which can not be easily collected from a competitive marketplace. In measuring these costs, in all cases I would contend the burden of proof is with the utility. There are certain arguments that tended to support a recovery of these costs under that burden. These generally have been an obligation to serve, (and costs which arose because of that) a regulatory compact, prevailing law, or regulation requirements, and various accounting requirements.

{5} Now given these arguments, they have stranded cost positions which have varying validity in my opinion. We need to look at the validity of these costs against certain measures. Costs must be determined individually. This is an issue by which the burden of proof is created, and a utility must demonstrate which costs should be recoverable through non by-passable charges and protected against competitive pressures.

{6} The other side of this burden is that utilities did have significant discretion in the investments they made. They can be evaluated within their given markets. All of us probably face the situation within what would otherwise be considered a common market utility with costs varying greatly, some by as much as 50 to 60 percent.

{7} The same opportunities for fuel supply investments were available to all utilities in the region. I think these require some explanation in this discussion. Utilities did have significant regulatory and legislative burdens and how much of a percentage of this resulted in stranded costs must be determined on a case by case basis. Stranded costs in their ultimate measurement is a net value. That is, utilities have some assets above market and some below, the final result is the netting of these two. Dealing only with above market costs will create a windfall. Administrative measurements of stranded costs tend to be inadequate. These are often necessary simply because better market models are not available. I would contend that administrative costs almost always overstate stranded costs by not valuing various kinds of assets which the market would value but the regulatory rate phase does not account for. Determination of stranded costs must be subject to very strict mitigation goals. Once we have a number, we must look at that number, particularly the administrative calculation in terms of what is the minimum practical value that the going forward collection should be.

{8} We can continue. We have performance standards on government reviews. Whatever I think, mitigation is an essential part of the equation. In mitigation there is one item that always comes up - securitization. I would like to touch on it again to enhance further discussions. Securitization is a valuable vehicle. I would contend that securitization must be dealt with using extreme care. By way of definition, securitization means taking a certain amount of costs, in this case small stranded costs, and repackaging them as assets through a separate

corporation. The asset is then refinanced at a low rate because the payment is guaranteed, either through some legislative act or something carrying the force of law.

{9} Lastly, I will jump to the answer to today's question regarding whether stranded costs repeat competition, and I will put forth the premise that stranded costs and competition are entirely different things only marginally related. Stranded costs are not a result of competition. A full recovery of stranded costs would not impede or delay competition. Nor are stranded costs a prerequisite to competition. Stranded costs are a settlement issue. Competition is an issue that deals with the viability of markets, the control of market power, and the proper creation of affiliate rules. The settlement of stranded costs is an entirely different issue and I would like to put forth the premise for this discussion that the two are separate and should be dealt with separately.

III. Dr. Phillip O'Connor *Principal, Coopers & Lybrand*

{10} First of all, thank you very much. I am flattered to be invited and I am grateful to Richard not only for being my counterpoint here but for setting this up quite well.

{11} I take a somewhat different position at the outset. My emphasis, in contrast to Richard's, is really on stranded cost recovery being sort of assumed as part of the transition. Richard is more in the camp that says that the industry should be compensated somewhat by exception; i.e., the explicit demonstration of a particular cost. I fall in a different school and make an assumption that there is a bundle of transition or stranded costs and for the most part we should have a bias toward compensating for those costs. I shall explain why that is. First of all, when I was a regulator back in the mid-1980s, my colleagues in the regulatory arena (people in the industry and some of the legislators) wanted to throw a net over me because I had suggested that we ought to generate competition. That was about 1984. So, it has been a long struggle and we can now just begin to taste it.

{12} The question posed by this particular session is whether stranded cost questions have a relationship to getting the competition, or stranded cost questions either somehow impede it or that addressing the question can somehow smooth the path. So one of the questions, of course, is "transition to what?" Where is it that we are going from and to? I would suggest that we are trying to make a transition a world from which our old paradigm had certain basic assumptions to one where those assumptions are significantly altered. I belabor these, but I think back to the time when I was a regulator and I would go to work every day and distort prices all day long. God forbid that anybody should know, through the price, what it really cost to produce a kilowatt of electricity! So you make your own list. The point, however, is that we are making a very significant sort of a switch here. From a public policy standpoint though, what is the key difference between the regulatory and de-regulatory years? I would suggest that in the regulatory era what we were involved in was trying to use the force of government to get at efficiencies, or to elicit efficiencies that arise out of the introduction and deployment of a new technology. If you go back to all of the regulated network industries, one of the roles of government was to provide a set of conditions which enhance the ability of those introducing that technology to deploy it as widely as possible.

{13} What we do in the de-regulatory era, with government and public policy, shows that we are after the same goal. Our goal is efficiencies and there a lot of things about technology that contribute to progress, and we are still trying to do things like help a network industry attract capital, etc. But we have a somewhat different objective. We assume that efficiencies are going to arise out of innovations that are high value additions to the basic technology. So again we go back to all the network industries that has been pretty much been our practice. Once we have a fairly mature deployment of the basic technology, we back away and attract

capital (for instance, by letting entrepreneurs into what would otherwise have been restricted markets). But one of the interesting problems (and it is both a policy problem and pragmatic problem) is transition costs. (I include in these costs primarily the stranded costs that Richard was talking about but also the cost of making the change.) Those exist because, over time, practice departs from regulatory principles in the network industries. Take a couple of quick examples.

{14} Usually regulatory principles in the early part of these network industries are directed toward a fair price objective. Gradually, this migrates toward a highly ritualistic approach to profit regulation. The focus becomes much more on whether someone has made a buck than whether the price itself is fair. Another problem is that we do a lot of crazy things with the rules of the game. And, therefore, we depart from reality. For instance, accounting, believe it or not, is supposed to be a rough representation of reality. Well, we begin to do things like defer costs, and say that costs are, in a sense, not really being incurred today, but we say that they will be incurred at a later date and recovered at some later date. We were able to get away with that because we enforce monopolies. The other thing, which is even more important, is that when we have public control or regulation of a large network industry, we find it very convenient to place other agendas on top of it. Whether that is in the case of electricity national energy strategies, where we promoted certain technology or whatever, we do a lot of wealth redistribution. The network industry just naturally tracks that, particularly the more ritualistic the regulation becomes. So I would submit, (and I think you have a paper that we prepared for the Edison Electric Institute a while back,) that when we look back at other network industries, we do find that they all had transition stranded costs of various kinds. We find that policy makers found ways to mitigate those transition costs and in a variety of ways -- found ways to partially compensate incumbents-- and did so with less with attention to specific justification of costs than to assumptions of rough justice about how to get the transition made more quickly. The trade off there has been to secure deregulation by reducing incumbent opposition. That has been the pragmatic strategy of policy makers.

{15} As the first regulator advocate of electric deregulation, my position on the role of stranded costs is, first, there is a pragmatic reason for deregulation; and that is to reduce the opposition of incumbents to a basic policy choice of removing competition. If they have these costs, they have not only the incentive, but often the ability, to string this out far longer than the transition really ought to take. The other reason, though, is one that goes to the heart of how we make and change public policies. My position is that to try to go back fifteen to twenty years in some cases, and re-justify and simulate what the decision making was for the costs that existed then is to engage in an exercise that is a fool's errand. What we have to do is make an assumption about the fabric of policies under which investment and other kinds of decisions were made about the deployment of technology and make a rough justice cut here for compensation. Crucial to this is that one of the key policy principles in this country is that when we change public policy we do not look at the former policy to deligitimize it. The principles of many other ways of doing business in the world is that, when new policy makers come along and policies are changed, you actively attempt to change or make illegitimate the policies. Therefore, you try also to avoid the residual consequences of those policies. In this country we have been generally careful about accepting the residual consequences of past policies and accommodating those unpleasant consequences when we go about the process of changing a public policy. This has been fairly consistent, and although sometimes less formal and less conscious, nevertheless consistent in the deregulation of the other network industries.

{16} So let me conclude with a final suggestion. We in the industry have two reasons we are so conscious this time around of these costs and how we might go about dealing with them. First, they are just big. They are bigger than in any other network industry, not only because this is the biggest industry yet to go through this transition, but also because we have really used this network industry for a lot of things that we wanted to get done. The second reason is that this is the first network industry in which the transition policy is being actively shaped by customers. In none of the other network industries were customers really that actively involved in shaping public policies. Generally, it has been an elitist exercise. So what I would suggest, and this is where I depart from Richard's standpoint, is that if we go back and look at the context of public

policies that form the fabric in the framework under which these costs have arisen, what we will find out is that it is extraordinarily difficult and ripe with potential for abuse to try and sort out exactly which costs are the results of which policies. It would be far better to make a rough justice determination that we have a bundle of costs we can reconcile against some measure, if we decide to do so, or we can make one time determinations. It is a public policy choice. But then we must provide some formula for a rough approximation of recovery at some level rather than try to sort out exactly which costs we are going to be compensated for and which ones we will not. It is simply just too big a mess.

{17}The other thing is that the process of doing that will be so long that it will actively move many of the benefits we are trying to get from the transition to competition, and in many cases actually result in full recovery by maintaining prices at regulated levels which are providing for rather dramatic levels of stranded costs of recovery as we go from day to day.

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