

ENERGY LAW JOURNAL

Volume 22, No. 2

2001

THE EFFICIENT ALLOCATION OF PROCEEDS FROM A UTILITY'S SALE OF ASSETS

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I. INTRODUCTION

Utilities are facing transformative events such as deregulation and restructuring, technological innovation, changes in governance and strategy, and changes in consumer demand. Those events may make it advantageous for a utility to divest assets. In August 2001, for example, American Electric Power filed papers with the Securities and Exchange Commission to divide its assets into two entities—one a deregulated power generation company that will sell power and energy at wholesale, and the other a regulated energy distribution company that will own transmission and local distribution facilities, transport energy, and perform metering functions.¹ For other energy companies, asset dispositions may be necessitated by a crisis, as in the case of Pacific Gas and Electric, which voluntarily filed for Chapter 11 bankruptcy in April 2001.² If a utility proposes the sale of certain assets that have risen or fallen substantially in value since their acquisition, the question will naturally arise how regulators should allocate those gains or losses among ratepayers and shareholders. Therefore, for regulated energy companies, and indeed for utilities in any of the other traditionally regulated network industries, the allocation of the proceeds from a utility's sale of assets is a policy question of both current and significant topicality, given the current climate of deregulation and structural change.

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1. Application or Declaration under the Public Utilities Holding Company Act of 1935, *American Elec. Power Co. Inc.*, File No. 70-9785 (filed S.E.C., Aug. 21, 2001) available at <http://www.acp.com/news/corpsep/64136.pdf>.

2. Form B1, Voluntary Petition for Bankruptcy, *Pacific Gas and Elec. Co.*, Case No. 01-30923 SMF11 (Bankr. N.D. Cal., Apr. 6, 2001).

Most public utilities in the United States operate as privately held companies subject to state and federal regulation. The utility, like any privately held company, obtains the necessary funding from investors through public issues of shares in stock and bond markets. With these funds the utility, like any privately held company, constructs plants, purchases equipment, and contracts with employees to provide the services that the utility has been required by the state regulator to provide. As with all investments, investors provide funds to the utility in the expectation of earning at least a competitive return at a prescribed level of risk on investment. The "process" is one in which the utility makes business decisions in a myriad of purchase contracts with the goal being to maximize the residual revenues to shareholders.

At the same time, however, a utility must answer to its regulator. The regulator's goal is to protect the consumer from monopoly practices on the part of the utility, which is typically the sole supplier of service for that customer. Thus, the regulator limits the utility's managerial discretion over key decisions, including prices, service offerings, and the prudence of plant and equipment investment decisions. In particular, the utility generally has to obtain authorization from its regulator before selling an asset used to produce regulated services.

This article evaluates that regulation of a utility's purchase and sale decision over assets. Part II examines three reasons why, as part of the regulatory oversight of utilities, regulators constrain the discretion of the utility's management when disposing of the proceeds from an asset sale. Part III analyzes the efficient decision rule for allocating proceeds from a utility's asset sale. Part IV analyzes the competing interests of shareholders and customers with respect to a utility's asset sale. Using a survey of actual asset-sale decisions, in cases before regulatory agencies in the United States, Part V attempts to test empirically the hypothesis that regulatory bodies indeed apply the efficient decision rule that Part III articulates to solve this problem of competing interests.

II. REGULATORY OVERSIGHT OF UTILITY COMPANIES

When a utility sells an asset previously used to provide regulated service, the regulatory agency with jurisdiction reviews the terms of the transaction and intervenes in the disposal of the sale proceeds. There are three reasons for such a process. First, it prevents the utility from degrading the quality, or reducing the quantity, of the regulated service so as to harm consumers. Second, it ensures that the utility maximizes the aggregate economic benefits of its operations, and not merely the benefits flowing to some interest group or stakeholder. Third, it specifically seeks to prevent favoritism toward investors to the detriment of ratepayers affected by the transaction.

A. *The Protection of Consumers from Harm from Asset Sales*

The regulator's task is to protect the consumer from adverse results

brought about by any of the utility's transactions.³ The sale of assets could reduce the quantity and/or quality of the service offered by the utility if the asset were sold for less than its value in current, productive activities. In forming the "regulatory contract," inherent in the license and the approved tariff, the regulator and the utility agree that the utility will sell, at the agreed-upon price, gas, electricity, or other regulated service of a specified quality level on demand to all who reside in the utility's service territory. The utility is not allowed to change the quality of service, or restrict the volume of service to less than demanded, by selling an asset used in that service to the advantage of the utility's bottom-line profit.

The regulator is responsible for approving a tariff ensuring that consumers can purchase service at a prescribed quality level at a "just and reasonable" rate. This assurance can be difficult because it is difficult to measure quality; nonetheless, the regulator takes an active role in specifying energy content and in determining the prices that regulated companies may charge. In setting prices or rates, the regulator examines and ultimately approves the "revenue requirement" for recovering the cost of service at predicted levels of consumer demands. In specific cases, where asset sales are at issue, the regulator considers the impact of the utility's sale of an asset on the "just and reasonable" rate level because of the possibility that purchase of a replacement asset at a higher price necessarily would pass on greater expense to customers.

B. The Maximization of Economic Benefits

Optimally, the regulator is responsible for ensuring that its oversight results in a tariff that enhances the economic benefits to consumers from the utility's operations. At the same time, the service provider has to be allowed to generate revenues that recover all long-run costs of operations. That twin goal is achieved when the "target" price level generates revenues sufficient to recover all costs of providing the quality and reliability of service demanded by all consumers in the market. Of course, changing conditions of cost, demand, and technology prevent that goal from being achieved exactly in actual service markets at any point in time. Even so, these goals should be intended to be achieved on an expected-value (actuarially fair) basis for any planning period. Investments in assets should take place up to the level at which revenues from products just exceed at the margin asset costs.

This economic principle has implications for the allocation of the proceeds from an asset sale. Such allocation must take place in ways that would not dampen the utility's incentive to make investments that achieve

3. At this point in the analysis, we do not introduce the possibility of "regulatory capture"—that is, the possibility that regulation serves the private interests of regulated firms by effecting a form of government-sponsored cartelization. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). Later, we will raise the possibility of regulatory opportunism. For the time being, we give the stylized rendition of the regulator as a person or institution whose genuine motivation is the advancement of the public interest.

this optimal growth of the system. If the utility does not have an incentive to dispose of old assets at a rate consistent with optimal growth, the utility will be compelled to raise rates (that is, prices) to cover excessive costs or to operate so that the quality of service declines.

C. *The Prevention of Favoritism*

To ensure that benefits to consumers are enhanced, the regulator's role is to prevent favoritism toward interest groups (such as material suppliers, employee groups, or environmental activists) that might otherwise occur in the sale of the utility's assets. Favoritism shown toward any one group in the sale of the assets will reduce the real price that the group pays for the asset; thus, favoritism induces inefficiency. For example, if the utility were to sell the asset to an affiliated (unregulated) company at less than market value, and then replace that asset, it would raise the utility's cost of service and consequently raise the price ultimately paid by consumers for the regulated service above optimum levels. Regulators, such as the Federal Energy Regulatory Commission in its affiliate rules, have focused on the distortion of demand and/or supply in previous discussions of the diversion of regulated assets, particularly from use of that asset by private "trading" companies affiliated with the utility.⁴ The concern applies as well to the sale of assets, and it is addressed by state laws that govern the disposal of a utility's assets specifically to prevent such diversion.⁵

III. THE EFFICIENT DECISION RULE FOR ALLOCATING PROCEEDS FROM THE UTILITY'S SALE OF ASSETS

In deciding to allow the utility to sell a particular asset, the regulator essentially determines how to allocate the proceeds of the asset sale. Should ratepayers or shareholders receive any net proceeds over and above the net (undepreciated) investment in that asset? Or should the regulator split the proceeds between those two groups? In determining the answers, by setting a decision rule for allocating the proceeds from the asset sale, the regulator considers three factors: (1) regulatory goals; (2) expected results (that is, results under certainty equivalence); and (3) the efficient treatment of risk if these results do not eventuate.

A. *The Regulatory Goals*

The regulator's first goal is to ensure that the utility uses resources efficiently and that consumers pay an amount for the regulated service that

4. Standards of Conduct for Interstate Pipelines With Marketing Affiliates, 18 C.F.R. Pt. 161 (2000).

5. See, e.g., CAL. PUB. UTIL. CODE § 851 (West 2001). The California Public Utilities Commission explains that this statute "requires Commission authorization before a utility may sell, lease, assign, mortgage, or otherwise dispose of or encumber utility property." *Application of Pacific Gas and Electric Company for an Order Under Section 851 of the California Public Utilities Code to Sell Certain Assets and to Lease Office Space and Related Assets to PG&E Corporation*, Decision No. 99-02-061, Application No. 98-09-006, 1999 Cal. PUC LEXIS 56, at *11 (Feb. 18, 1999).

equals the cost of those resources. The goal is to determine the “just and reasonable” level of prices in the tariff price structure that will induce consumers to use, and utilities to produce, the amount of the service available at full long-run marginal costs. Too low a price level will induce consumers to demand too much, contrary to both economic efficiency and social goals of energy conservation, while too high a price will deny consumers enough of the service and induce inefficient consumption of more costly substitutes. Moreover, if the price is too low, the utility cannot generate sufficient levels to recover a competitive return on its invested capital; the result will be disinvestment, which will reduce the amount and the quality of service demanded in the market. Consequently in proposed tariff changes, the company proposes to operate with cost levels for variable inputs, depreciation, interest, and equity returns on undepreciated investment (or rate base). The regulator then uses this information to determine whether the rates that the utility proposes to charge its customers are “just and reasonable.”

In setting rates, the regulator includes some amount for the value that is lost by the use of the asset, in particular, depreciation and property taxes. Customers pay for such costs through their rates. In considering allocations of returns from asset sales, ratepayers at times allege that by their payments they implicitly purchase the asset from the utility’s investors.⁶ This reasoning is incorrect; the ratepayer covers the cost of using up the asset, not the holding cost of what remains. The utility carries such an asset at net book value (the original purchase price minus accumulated depreciation).

B. The Predicted or Expected Optimal Result

One may define the “expected result” of utility regulation as the condition under which the utility generates revenues on all its regulated services such that the total equals the costs of producing those services. In most markets for utility services, there is both an access (or option) component and a usage component. Within this framework of a two-part tariff, the “demand charge” covers the long-run incremental cost of access (that is, the customer’s option to take service); the “commodity charge” covers the long-run incremental cost of delivery.⁷ Any joint cost or common cost is included in the demand charge, because the customer’s option demand for the utility’s service is typically less sensitive to distortion by prices that exceed incremental costs than is the customer’s demand for actual delivery. Regulated prices achieve the intended result when the demand charges equal the cost of extending these services (including asset depre-

6. Annual Price Change Pursuant to the Alternative Rate Plan, *Central Maine Power Co.*, Docket No. 99-155, 2000 Me. PUC LEXIS 469 (2000).

7. “Incremental cost” is a generic concept referring to the addition, per unit of the output in question, to the firm’s total cost when the output of X expands by some preselected increment. For comparison of this cost concept with marginal cost, see generally WILLIAM J. BAUMOL & J. GREGORY SIDAK, *TOWARD COMPETITION IN LOCAL TELEPHONY* 56-58 (MIT Press 1994).

ciation, interest, and a competitive equity return on the undepreciated asset), and commodity charges cover the costs of providing actual service that is used in that time period.

The tariff-setting process should result in this "correct" schedule of prices if the predicted cost and demand conditions are actually realized. The (predicted) demand for service is projected to generate revenue that will suffice to recover the investments that the utility made to provide such service. This "recovery" includes the original outlays, as well as annual debt payments and competitive equity returns. While this revenue flow is not guaranteed, it is equal to the "expectation" of proceeds. Actual results depart from that amount because the economy and the market deviate from expected performance, or because the utility deviates from its expected operating performance, because of unexpected technical outcomes. Given the nature of the tariffing process, the departures from expected levels of costs and demands are absorbed by the utility, to provide certainty of both price and service quality to consumers and to result in incentives to operate as efficiently as possible.⁸

C. *The Treatment of Risk*

To advance efficiency, the regulator should allocate the proceeds from an asset sale so that the party who bears the risk of varying returns to the asset is either properly rewarded with gains or properly subjected to losses from the asset's sale. This party is the owner of the asset, the utility, unless otherwise specified (that is, unless ownership is "contracted out" to a third party). A utility faces two types of risk in owning an asset: (1) that there will be a change in the regulatory conditions and rules that allow returns and recovery of that asset investment, and (2) that there will be a change in conditions in the market or internal operations within the company such that the utility will be unable to provide service for the cost that it anticipated or consumers will be unwilling to take service at the level anticipated. The utility's ratepayers bear the risk that, when a change in the

8. Baumol and Sidak have explained this notion of a return to investment that is an actuarially fair expected value. They describe one "fundamental precept of the competitive market model for regulation" to be "that the regulator never take any step that *precludes* investors in the regulated firm from the *ex ante* expectation that earnings will be sufficient in the long run to return the investors' capital plus a competitive rate of return on that investment." WILLIAM J. BAUMOL & J. GREGORY SIDAK, TRANSMISSION PRICING AND STRANDED COSTS IN THE ELECTRIC POWER INDUSTRY 103 (AEI Press 1995). They elaborate:

Taking both the possibility of loss and that of gain into account, investors in a free competitive market will provide resources to the firm only if the actuarially expectable return is at the competitive level—offering, on the probabilistic average, repayment of the funds provided, plus a competitive rate of return on those funds, plus a suitable payment for the risk entailed in the investment.

Id. at 103-04. Similarly, Baumol and Sidak argue, under utility regulation—often called the "regulatory compact" or "regulatory contract"—regulators were able "to reconcile their ceilings on the earnings of utilities with the requirement of the competitive market model that, in terms of actuarially expected value, prospective investors be offered a competitive rate of return on their investments." BAUMOL & SIDAK, at 104-05.

regulatory conditions and rules occurs, the utility will be unable to provide service at the same quality and same quantity for the same price. The utility's shareholders bear the risks that investments will not be recovered at specified rates and service requirements in the tariff because of departures from actual market ("firm external") or operational ("firm internal") conditions. A change in either the regulatory rules or these market and operational conditions means that either an unexpected loss or an unexpected profit will occur, depending on whether the change decreases or increases the value of the utility's assets.

The regulator then must ask and answer the question: "Who should be responsible for absorbing the unexpected loss or who should receive the unexpected gains that occur?" In the case of a change in the regulatory conditions, ratepayers are at risk of a change in the rates that they pay or in the service that they can obtain from the utility. A change that abolishes the "rules of the game" that set rates and service puts the ratepayers at risk. A change in operational or market conditions puts the utility's investment in the assets at risk. Shareholders bear this risk as the residual claimants to the utility's profit.⁹

The leading takings case involving regulated utilities, *Duquesne Light Co. v. Barasch*,¹⁰ gives limited guidance on the consequences of deregulation and wholesale abrogation of the existing regulatory regime in the name of establishing a competitive marketplace. In *Duquesne*, the Duquesne Light Company began making investments in new nuclear power plants.¹¹ Those investments were reasonable (prudent) in light of the then-current costs of different production technologies and expected future demand at the time they were made. Changes in the relative costs and risks of nuclear power (for example, the Three Mile Island nuclear mishap) resulted in a further (prudent) decision to abandon the nuclear power plants. Duquesne had spent roughly \$35 million in planning and preparation by that time.¹² Du-

9. Residual returns refer to the returns from an asset after all prior claimants have been paid; thus, equityholders in a corporation obtain the returns after debtholders and other creditors have been paid. The parties entitled to the firm's residual returns are called residual claimants. Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 328 (1983). Obviously, an unexpected change in market conditions or regulatory rules may harm or benefit bondholders as well. Such change will unexpectedly increase or decrease the risk that the utility will default on its debt. That change in default risk will be evident in an increased or reduced bond rating for the utility. Moreover, the interests of the utility's bondholders will be adverse to those of its shareholders when an extraordinarily bad outcome, such as the California electricity crisis of late 2000, threatens to drive the utility into bankruptcy. The interaction between shareholders, bondholders, and ratepayers in the face of extraordinary financial outcomes for the utility is a topic deserving of further analysis. But it exceeds the scope of this article, the focus of which is the regulator's allocation among shareholders and ratepayers of the various kinds of extraordinary gains or losses that the utility experiences.

10. *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989). For further analysis of *Duquesne*, see also J. GREGORY SIDAK & DANIEL F. SPULBER, *DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT: THE COMPETITIVE TRANSFORMATION OF NETWORK INDUSTRIES IN THE UNITED STATES* 241-46 (Cambridge Univ. Press 1997); BAUMOL & SIDAK, *supra* note 8, at 111. *Contra*, Richard Goldsmith, *Utility Rates and "Takings"*, 10 ENERGY L.J. 241 (1989).

11. Several other utilities were involved in *Duquesne*. For simplicity, we refer only to *Duquesne*.

12. *Duquesne*, 488 U.S. at 302.

quesne sought to add those sunk-costs to its rate base and to recover them through amortization and the allowed rate of return. Unfortunately for Duquesne, however, after the expenditure but before the inclusion of the nuclear costs in the rate base, Pennsylvania enacted legislation that foreclosed the Pennsylvania Public Utility Commission from granting Duquesne recovery of those costs through higher utility rates.¹³

The Supreme Court examined whether the state legislation caused a taking of the property of Duquesne's shareholders without just compensation and concluded that it did not. Writing for the Court, Chief Justice Rehnquist noted that Duquesne had "a state statutory duty to serve the public" and that its "assets [were] employed in the public interest," but that the company was "owned and operated by private investors."¹⁴ The majority opinion emphasized, among other facts, the small percentage that the disallowance represented of Duquesne's total rate base,¹⁵ and the fact that the denial of cost recovery caused by the behavior of the Pennsylvania legislature did not threaten Duquesne's financial survival.¹⁶ However, the Court expressly reserved the possibility that more significant regulatory changes could constitute compensable takings.¹⁷

When, unlike *Duquesne*, regulatory change is significant, as in the case of electric restructuring, it is argued that the regulator should not allocate the proceeds of a utility's asset sale to ratepayers, especially when the proceeds imply significant losses.¹⁸ The argument is that the utility's allowed return to capital has already compensated the firm for the risk that the regulator will breach the regulatory contract.¹⁹

This reasoning is not persuasive on economic grounds, however, because it would imply for the utility in a period of widespread deregulation a prohibitively high cost of capital due to inefficient risk bearing. The risk premium, in effect, would consist of a prepayment of the discounted pre-

13. *Id.* at 303-04.

14. 488 U.S. at 307.

15. *Id.* at 312.

16. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 312 (1989).

17. *Id.* at 315

("[A] State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions. But the instant case does not present this question.").

Justice Scalia, joined by Justices O'Connor and White, concurred but warned, more forcefully than did Chief Justice Rehnquist's opinion for the majority, that the holding in *Duquesne* would not answer the question of whether just compensation would be due in future takings cases where the nature and magnitude of the utility's prudent investment differed substantially from Duquesne's. *Id.* at 317 (Scalia, J., concurring).

18. On electricity restructuring, refer to Transmission Access Policy Study Group v. FERC, 225 F.3d 667 (D.C. Cir. 2000), *cert. granted sub nom.* New York v. FERC, 121 S. Ct. 1185 (2001). For other examples of significant regulatory change, see the extensive discussion of uncompensatory access pricing in SIDAK & SPULBER, *supra* note 10, at 246-55, 307-92.

19. SIDAK & SPULBER, *supra* note 10, at 430 (rebutting argument that the utility's cost of capital compensates the firm for breach of the regulatory contract).

sent value of the damage remedy available to the utility for breach of the regulatory contract. As such, it is inefficient for the regulator to create uncertainty for the utility's investors; regulators are in a better position than investors to predict and influence regulatory change, and thus regulatory agencies (acting on behalf of the ratepayers whom they exist to protect) are the more efficient bearers of this form of risk. There are few, if any, benefits from shifting that risk to investors, and the costs can be high.²⁰ To avoid inefficient risk bearing in the context of a utility's asset sale, the regulator should allocate proceeds properly to the ratepayer.

When there is substantial technological change, an issue requiring consideration is whether, in the depreciation schedule for the utility's asset, the designated useful life is "reasonable." Suppose, as has occurred in the telecommunications industry, that the depreciation schedule is so protracted that the utility cannot recover its costs before technological change renders the partially depreciated asset obsolete and thus worthless. As a first approximation, the amount of undepreciated asset, or the (regulatory) net book value of the asset, consequently becomes unrecoverable. If the proximate cause is not technological change per se, but rather the regulator's constraint on the utility's legitimate recovery of its capital costs over a depreciation schedule that would accurately reflect the useful life of the asset, given reasonable expectations of technological obsolescence in the industry, then the remaining undepreciated value of the asset can be termed as "stranded."

For example, suppose that the asset is computer software. Such an asset has a relatively short lifespan in the unregulated world. But suppose that the regulator nonetheless assigns a significantly long lifespan for calculating depreciation to the utility's operation system software for purposes of cost-of-service regulation. The regulator has stranded the utility's asset by mandating an unrealistic lifespan. Meanwhile, ratepayers have benefited from such a depreciation policy. They have paid artificially lower rates that have retarded the utility's legitimate capital recovery at an economically prudent pace. Ratepayers should therefore bear the risk that the true economic lifespan of the utility's asset turns out to be significantly shorter than the regulator's mandated lifespan.

It has long been the rule in the United States that, if a change adverse

20. *Id.* at 437. We associate Professor Baumol with having expounded—orally through testimony, if not in any published academic paper—this principle of risk-bearing in the context of the choice between "foresight" and "hindsight" models of regulating cost recovery. In both regulated and unregulated markets, some entities are more efficient risk bearers than others. Typically, a life insurance company is a more efficient bearer of the risk of premature death than the head of a middle or lower income family. That is why people purchase life insurance despite its price. The buyer of a life insurance policy reduces the real cost that he bears by transferring the risk to the more efficient risk bearer. Thus, the rational basis for choosing between a foresight test and a hindsight test of cost recovery, for example, is the evidence on whether the firm or its customers are the more efficient risk bearers. If a hindsight test is selected, so that the firm is required to bear the risk, then the firm must be compensated for carrying out this task through a suitable addition to the allowed rate of return. Nevertheless, the payment of this risk premium may benefit all parties *if* the regulated firm and its investors are the more efficient bearers of the risks. SIDAK AND SPULBER, *supra* note 10.

to revenue generation occurs in market conditions, then, notwithstanding the tariff, the investor shall incur the loss from unexpected reductions in revenues. As construed in the Supreme Court's 1945 decision in *Market Street Railway Co. v. Railroad Commission of California*,²¹ the regulatory contract puts at risk investments that changes in market conditions render unrecoverable.²² The Market Street Railway was a privately owned railway operating a streetcar and bus line in and around San Francisco. Its customer base and revenues had fallen over several years due to competition from various new forms of transportation. The company petitioned the regulator for a rate increase, which was granted. Nonetheless, the revenues of the Market Street Railway continued to decline, as did its service quality. The regulator held an inquiry and thereupon ordered an experimental decrease in the rates from seven cents to six cents. The Market Street Railway sued the regulator on the theory that its order to decrease rates was confiscatory (and thus violated the Due Process Clause of the Fifth Amendment of the U.S. Constitution) because it forced the company to operate at a loss—even though the regulator derived the lower rates from the amount at which the Market Street Railway had offered its assets for sale. The California Supreme Court rejected the Market Street Railway's due process challenge to the regulator's rate reduction, as did the U.S. Supreme Court. Consequently, the Market Street Railway's investors bore the company's losses.

Three factors in *Market Street Railway* supported the conclusion that investors, rather than ratepayers, properly bore the loss. First, the Market Street Railway's realized costs exceeded revenues because of changing demands for transportation, due in good part to technological changes, not because of decisions by the regulator or changes in the practice of regulation (such as a transition from rate-of-return to price-cap regulation). Second, the obsolescence of the streetcar infrastructure drastically undermined the Market Street Railway's ability to argue that a higher rate of return was essential to attract future capital investment. The streetcar industry was dying, and further capital investment would have been inefficient. Third, the regulator made a good-faith effort to improve the Market Street Railway's competitive position to the extent feasible in the face of competition from other transportation providers.

Market Street Railway established that the regulator's guarantee to the utility of the opportunity to recover its costs under expected market conditions does not extend to losses arising from all possible realized market conditions. Rather, that guarantee extended only to costs stranded by regulatory change that abrogated the utility's franchise grant.²³

21. *Market St. Ry. Co. v. R.R. Comm'n*, 324 U.S. 548 (1945).

22. For a more extensive discussion of the economics of *Market Street Railway*, see also SIDAK & SPULBER, *supra* note 10, at 256-62, 461-63.

23. There is a reciprocal to the rule of *Market Street Railway*. The regulator must symmetrically treat the realization of variation of costs and revenues from expected levels, regardless of whether that variation is positive or negative. Both good and bad outcomes caused by market-wide changes are borne by, or accrue to the benefit of, the equity investor. To confine unexpected losses to the utility

D. The Symmetric Treatment of Positive and Negative Returns on Asset Sales

The symmetric treatment of excess costs and profits that a utility realizes is appropriate when extraordinary profit or loss outcomes result from variations in market conditions and internal firm conditions. However, ratepayers sometimes dispute, whether the regulator should permit investors to keep the profit generated when the utility sells an asset at more than undepreciated book value that the firm previously used to provide regulated services but which now has a higher-valued use elsewhere.

The response to the question of who gets to receive the excess over the undepreciated book value of an asset is that "it depends." The regulator's proper treatment of profits from asset sales under deregulation differs from the treatment that the regulator should give to windfalls that arise from asset sales in the utility's normal course of business under the regulatory status quo. Ending regulation may make some of the utility's assets more valuable, as was the case for some rail assets after deregulation in the early 1980s.²⁴ Such windfalls from deregulation, sometimes termed "stranded benefits," "stranded margins," or "givings," offset stranded costs. But windfalls in the normal course of business belong to the shareholder.

It would be improper for the regulator to use increased margins on *unregulated* services to offset stranded costs on *regulated* services. The reason is that unregulated activities were never subject to any guarantee by the regulator that the utility would have a reasonable opportunity to earn the recovery of, and a competitive return on, its invested capital used to supply the unregulated services.²⁵ If the increased margins result from changes in market demand or technology, and if those benefits go to shareholders, then any complaint by ratepayer or regulator about a lack of symmetry would be baseless. Symmetry *already* exists, because *Market Street Railway* does not give the utility any constitutional right to compen-

while allocating unexpected positive net revenues to other stakeholders would condemn the utility to disinvestment, because with random variation the utility would never achieve its (positive) expected returns. Such a rule would ensure that the utility would receive less than the expected returns necessary for it to recover costs for any sustained period of time. Stated differently, asymmetrical returns that by regulatory fiat may only be equal to, or less than, the competitive equity level of return would ensure negative average returns for the utility. The incentive would be to reduce investment to levels below that necessary to provide optimal service given that the average rate of return would be less than the cost of capital. For these reasons, it would be inefficient, and contrary to the long-run interests of consumers, for the regulator to treat a utility's extraordinary profits differently from its extraordinary losses. See generally KENNETH E. TRAIN, *OPTIMAL REGULATION: THE ECONOMIC THEORY OF NATURAL MONOPOLY* 96 (MIT Press 1991); William J. Baumol & J. Gregory Sidak, *Stranded Costs*, 18 HARV. J.L. & PUB. POL'Y 835 (1995).

24. SIDAK & SPULBER, *supra* note 10, at 466-71.

25. Justice Holmes wrote for the Supreme Court in *Brooks-Scanlon Co. v. Railroad Comm'n of La.*, 251 U.S. 396 (1920), that it is impermissible to judge whether rate regulation is confiscatory for purposes of the Takings Clause by including the returns to unregulated operations of the company in question. "The plaintiff may be making money from its sawmill and lumber business but it no more can be compelled to spend that than it can be compelled to spend any other money to maintain a railroad for the benefit of others who do not care to pay for it." *Id.* at 399. See also *Norfolk & W. Ry. v. Conley*, 236 U.S. 605, 609 (1915) (Hughes, J.).

sation for losses arising from such nonregulatory changes.

The central argument is that the ratepayer is intended to receive service at a fixed price dependent on expected costs and demands. The equity investor is intended to receive the net revenues after all costs are paid, equal to the present value of original investment at the time of that investment. Any variation in costs or revenues, including any variation from asset sales, would not affect rates but would affect the residual amount of net revenues. The dispersal of some portions of that residual, by after-the-fact reallocation to stakeholders, undermines that investment process.

The preceding points highlight the danger that regulators or courts will compress two pertinent economic distinctions into one when identifying the appropriate risk bearer. The first distinction is whether the service in question is regulated or unregulated. The second distinction is whether the source of the risk is regulatory change or market (nonregulatory) change. Table 1 helps to clarify the limited circumstances in which ratepayers are the appropriate risk bearer.

TABLE 1: EFFICIENT ALLOCATION OF EXTRAORDINARY GAINS AND LOSSES IN REGULATED AND UNREGULATED MARKETS

	Market Change	Regulatory Change
UNREGULATED SERVICE	Shareholder is assigned the risk of extraordinary gains and losses	Not applicable
Regulated Service	Shareholder is assigned the risk of extraordinary gains and losses	Ratepayer is assigned the risk of extraordinary gains and losses

Of the four cells in this matrix, only one—a regulated service experiencing extraordinary gains or losses because of regulatory change—results in the ratepayer bearing the loss or gain. In the other possible circumstances, except where irrelevant, economic efficiency dictates that the shareholder should bear the risk of loss or gain.

There is a tendency for regulators, perhaps in the erroneous belief that they are benefiting ratepayers, to treat extraordinary losses and gains differently from smaller losses and gains. Consider two examples of an extraordinary loss or gain. In the first example, if a utility makes a decision that later proves to have been improvident (for example, to build a power plant that ultimately is never put in service because its costs are far more than expected), then, as *Duquesne* illustrates,²⁶ there is a tendency to force the utility's ratepayers to bear part of the cost of the "mistake" rather than to allocate the entire cost to the shareholders. In the second example, suppose alternatively that the utility makes a decision that results in much greater profits than expected. For example, the utility negotiates long-term contracts for the supply of fuel just before the spot price of fuel unexpect-

26. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 302-04 (1989).

edly increases. The unexpected low cost, with increased prices on sales, leads to higher than expected profits, which regulators seek to reduce. The outcomes in both examples are incorrect because they shift gains and losses away from those most efficiently bearing the risk. In such a case, there is a temptation for the regulator to allocate the gains to ratepayers, because allowing the utility to retain large extra profits would result in its earning more than the expected (allowed) return. But truncating both large gains and losses, when the probability of losses is greater, reduces the costs of capital to levels below comparable market levels, given the implicit subsidy provided by ratepayers. When the probability of gains is greater, it results in reduced investment. Such asymmetry between large and small changes can skew the utility's decisions in a way that ultimately frustrates the regulator's goals and reduces consumer welfare.²⁷

IV. THE POSITIONS OF SHAREHOLDERS AND CUSTOMERS

A utility's customers are not its owners, for they are not residual claimants. In the course of obtaining service from a regulated company, customers have a contract with the company, for a fixed price and defined service. They purchase goods or services at a price that covers the firm's cost of using its assets; customers thereby pay for the use of the land and equipment that the firm employs. The payment does not incorporate acquiring ownership or control of the utility's assets.

There are other ownership forms in which customers are simultaneously investors: mutuals, cooperatives, and public enterprises. But an investor-owned utility is not analogous to a mutual, a cooperative, or a public enterprise. Rate payers do not "own" positive or negative deviations in a utility's profit margins. Thus, ratepayers are not entitled to appropriate the capital appreciation on assets that management chooses to divest.

A. Customers

To obtain the services of the utility, customers pay a tariffed rate, which the regulator approves. This rate, one in a tariff rate schedule, provides the utility the expected revenues for an appropriate (competitive) return on its investment and covers the costs of operation, including depreciation and property taxes. The tariffed rate that the customer pays, however, does not usually include an amount to cover the purchase of new (replacement) productive assets at current market prices for those assets. Nor does it contain funds for a reserve account in case of a recession, or storm damage, or war. Because the utility's customers never participate in the pricing of the utility's assets, they do not share in the risk of gain or loss from these assets.

Customers do bear the risk of a price change resulting from any (authorized) change in the cost of service. This change is determined only periodically in a tariff review by the regulator. Although customers benefit

27. TRAIN, *supra* note 23, at 96-97.

from paying the utility no more than its expected costs, customers can benefit in such a proceeding from falling costs, which imply lower prices; customers can suffer from costs rising to new, expected levels if the regulator allows prices to increase. When the regulator certifies automatic changes in the tariff, the utility can pass on price variations in raw materials or fuel directly to the consumer. Because the consumer bears that risk, the utility must pass on any gains from lower costs. For example, the Natural Gas Policy Act of 1978²⁸ required pipelines to pass on to retail distributors the weighted average cost of gas (WACOG) in the combined price of merchant gas and transport services.²⁹ But if the tariff specifically caps retail prices, inclusive of fuel, then the utility bears the risk of variations in fuel prices. If the fuel price falls below the level expected under the cap, the utility is free to buy the lower-priced fuel in spot markets and keep the difference. Alternatively, if fuel prices are greater than expected, the utility must purchase fuel at the higher price or use its own fuel reserves (with a higher opportunity cost) and absorb the losses. Electric utilities in California experienced such losses in 2000-2001. The risk in this variant of the regulatory contract is borne by the shareholder, who therefore keeps the gains and losses on unexpected variations in fuel prices.

If the regulator were to "take" all windfall cost reductions to apply them to lowering rates, the utility would have no incentive to increase its efficiency. For example, utilities that restructured, retiring old equipment to be more efficient, could be subject to a governmental taking of the profits from doing so. Firms would not make the decision to remove the equipment and adopt the new technology, as they would not be made any better off by doing so. The principal benefit of relying on internal decision-making within the utility would fail to materialize. In its place would arise the apparent need for a new layer of regulatory intervention to manage the utility's operational decisions.

The regulator's attempt to appropriate a utility's excess net revenues for ratepayers causes a form of highly sophisticated opportunism to emerge, based on no more than political short-term gains for the regulator (or the elected official who appointed the regulator) at the expense of long-term reduced quality of service. In addition, as discussed above, such regulatory opportunism increases the utility's cost of capital, as investors are less willing to accept the risk. Thus, they have to be paid a larger premium to invest their funds. Moreover, the prospect of such regulatory opportunism poses a serious diagnostic problem: Is the higher margin that is observed to exist for particular services the result of a lapse in regulation, which the regulatory agency may freely reclaim for distribution to ratepayers, or is it the result of the utility's superior management?³⁰ The answer, if

28. Pub. L. No. 95-261, 92 Stat. 3397 (1978) (codified as amended at 15 U.S.C. §§ 3301-3432 (2000)).

29. PAUL W. MACAVOY, *THE NATURAL GAS MARKET: SIXTY YEARS OF REGULATION AND DEREGULATION* 61 (Yale Univ. Press 2000).

30. Evidence from telecommunications deregulation is informative here. Following the enactment of the unbundling requirements of the Telecommunications Act of 1996, the state public utilities

incorrect, can deter strategies to reduce costs.

B. Shareholders

The shareholders invest in a company with the expectation that it will use their capital to increase share value. Shareholders realize, however, that value may actually fall due to an incorrect forecast or business decision on the firm's part.

It is efficient for a regulated firm to replace an asset when it can thereby reduce its cost of service—when the variable cost of the old asset's production is greater than the fixed plus variable cost of the new asset. The result is that the sum of average fixed costs of the two assets plus average variable cost of production with the new asset is less than the established price.³¹ The utility realizes any (authorized) part of the difference between the old price and the new cost, plus the disposal value of the old asset; the consumer realizes any (authorized) price reduction from the cost reduction in a future tariff proceeding calling for a reduced rate.

V. CASES ALLOCATING GAINS FROM A UTILITY'S SALE OF AN ASSET

Numerous cases in the United States courts and agencies have allocated proceeds from asset sales. The allocations of gains (or losses) from the sale of a utility's asset have not universally followed principles espoused in the preceding sections of this paper. However, regulators in almost all cases have used the economically correct argument to disburse

commissions that required incumbent local exchange carriers (ILECs) to charge the lowest (and hence least compensatory) prices for unbundled network elements (UNEs) were states that had replaced rate-of-return regulation with price-cap regulation. The lower relative prices for UNEs in price-cap states were financed by regulatory expropriation of some or all of the productivity gains that price caps were designed to elicit from the ILECs. *See generally*, DALE E. LEHMAN & DENNIS WEISMAN, *THE TELECOMMUNICATIONS ACT OF 1996: THE "COSTS" OF MANAGED COMPETITION* (Kluwer Acad. Press 2000).

31. This relationship is as follows. In regulatory equilibrium, the utility's revenues R equal its total costs, which in turn equal the sum of fixed cost under the old technology FC_1 plus variable cost under the old technology VC_1 :

$$(1) FC_1 + VC_1 = R.$$

Assuming that the utility must charge a single rate (that is, that price p is uniform across all ratepayers), revenues are the product of price p and quantity q . Thus, equation (1) is equivalent to

$$(2) FC_1 + VC_1 = pq.$$

The utility will replace its old technology with a new technology having fixed costs FC_2 and variable cost VC_2 if the sum of those costs is less than the variable cost under the old technology:

$$(3) FC_2 + VC_2 < VC_1.$$

Substituting equation (3) into equation (2) yields:

$$(4) FC_1 + FC_2 + VC_2 < pq.$$

Dividing equation (4) by quantity yields an expression in terms of price, average fixed cost under the old and new technologies (AFC_1 and AFC_2), and average variable cost under the new technology AVC_2 :

$$(5) AFC_1 + AFC_2 + AVC_2 < p.$$

Thus, the sum of the average fixed costs of the two assets plus the average variable cost of production with the new asset is less than the utility's uniform price.

gains and losses on assets that have resulted from changes in market conditions. They have consistently relied on the premise that return should follow risk, with the proceeds from sales of assets in which the shareholders have taken the risk going to shareholders. But in a select few cases, the agencies and courts have argued that ratepayers have been at risk, because they have been responsible for depreciation payments, so that the proceeds should be allocated to them. In these cases, ratepayers incorrectly are said to have "paid" for the purchase of the asset and the proceeds should for that reason be allocated to them. But the risk that these payments would be realized falls on the investor as residual claimant to profit returns. In these instances the regulatory commissions and courts have followed the economically correct theory but have applied it mistakenly to disburse the proceeds of sale to the wrong party. Finally, a few cases are marked by correct application of the theory to disburse gains to the ratepayer. In these cases, specific payments are made for products or services, with these payments varying by their cost; the gains are correctly given to the ratepayer.

The cases presented below are broken into three separate groups, based on the premise that disbursement should follow from risk taking. In the first set of cases, shareholders made the investment and took the risk, and the regulator returned or should have returned the proceeds of the asset sale to them. In the second set of cases, there was a change in the regulatory regime for which the ratepayer was at risk; consequently, the regulator correctly allocated the proceeds to the ratepayers. In the third set of cases, the risk of a change in market conditions was borne by the ratepayers; thus, the ratepayer was entitled to the returns from the asset sale.

The cases cited in the following tables reflect those cases in the United States from 1975 to 2001, plus the landmark cases in the area from prior years in which an asset was sold and the allocation of the proceeds was determined.³² This sample of cases does not include all of the cases in which "stranded benefits," "stranded costs," "stranded investment," and "transition costs" are mentioned; but it does include those cases that deal specifically with the sales of utility assets.

A. Assets Sold Due to Changes in Market or Operational Conditions

When a utility asset is sold due to a change in market or operational conditions, investors are entitled to any gains received because they are subject to any losses. Table 2 contains all those cases in the sample for which disbursements were made and to whom the proceeds from the sale were allocated.³³ As Table 2 indicates, the courts and regulators allocated the proceeds in such cases to shareholders in fifteen cases, split the proceeds in seven cases, and allocated them to ratepayers in five cases.

32. These are cases published in *Public Utilities Reports*, in which assets were sold and funds disbursed to investors or ratepayers. Court cases that were cited in *Public Utility Reports* but not found there were collected from LEXIS. In addition, cases cited in the *Transalta Utilities* case were included.

33. A description of each case is included in the Appendix.

TABLE 2: CASES IN WHICH ASSETS WERE SOLD DUE TO MARKET OR OPERATIONAL CHANGE

Case	State	Year	Proceeds Allocated to Ratepayers or Shareholders?
New York Telephone	NY	1926	Shareholders
City of Lexington	KY	1970	Shareholders
Boise Water Corporation	ID	1978	Shareholders
Casco Bay Lines	ME	1978	Split so as to provide incentive to company to sell unneeded assets
City of Nashua	NH	1981	Shareholders
Philadelphia Suburban Water	PA	1981	Shareholders
Washington Public Interest Organization	DC	1982	Shareholders
Tampa Electric Company	FL	1982	Ratepayers
Boston Gas	MA	1982	Ratepayers
Associated Natural Gas	MO	1983	Shareholders
Maine Water Company	ME	1984	Shareholders
Sierra Pacific Power Company	NV	1985	Ratepayers
Arizona Power	AZ	1988	Split ¹
Distribution Systems Annexed by Municipality	CA	1989	Shareholders ²
Southern California Gas Company	CA	1990	Shareholders ²
Cobbosseecontee Telephone Company	ME	1991	Shareholders
Suburban Water Systems	CA	1994	Shareholders
Potomac Electric Power Company (Case No. 939)	DC	1995	Shareholders
U S WEST Communications	UT	1995	Split
Boston Gas	MA	1996	Ratepayers
Connecticut Water Company (No. 99-05-31)	CT	1999	Shareholders ³
Connecticut Water Company (No. 99-01-28)	CT	1999	Split ⁴
BHC Company	CT	1999	Split ⁴
Puget Sound Energy (Colstrip)	WA	1999	Ratepayers
Birmingham Utilities, Inc. (No. 99-11-04)	CT	2000	Split ⁴
U S WEST Communications	ID	2000	Split ⁵
Birmingham Utilities, Inc. (No. 00-05-16)	CT	2000	Shareholders

¹ Split undertaken at company's initiative.

² Proceeds accrued to shareholders after ratepayers were kept whole.

³ Proceeds re-invested in the company.

⁴ Proceeds split in accordance with Connecticut's Accounting Rules for Water Utilities.

⁵. Proceeds split as part of a settlement agreement.

In those cases where the proceeds were not all allocated to the shareholders, there were four basic reasons given for departure from this rule. First, the company determined that it was in its interest to share the proceeds with ratepayers. For example, in *Arizona Power*, the company suggested that the proceeds be split between ratepayers and shareholders in acknowledgement of the ratepayers' having made payments that subsidized the service from the asset for a number of years before its sale. In *U S West*, the company agreed to split the proceeds with the ratepayers as a business decision presumably related to resolving litigation.

But, in a second category, a handful of decisions have allocated part or all of the proceeds to ratepayers on the basis of a flawed theory of ownership. The regulator reasoned that, because the utility had used the assets in question to provide service to the ratepayer, the ratepayer thus acquired an ownership interest in the asset, and the ratepayer consequently should have been allocated some or all of the gains on the utility's sale of the asset. This argument is incorrect. The ratepayer owns none of the utilities' assets. If the argument were correct, it would imply that the ratepayer was liable for guaranteeing the returns on that asset to shareholders. Examples are the *Casco Bay Lines* case of 1978, *Boston Gas* cases of 1982 and 1996, and the *Tampa Electric Company* case of 1982.

In *Casco Bay*, the utility commission assigned almost all of the proceeds to the ratepayers on the grounds that the payment of rates had included all of the depreciation, and thus, over time, the ratepayers had acquired the vessels that the firm had used to provide service.³⁴ In the *Boston Gas* cases, the Massachusetts Department of Public Utilities determined, incorrectly according to our analysis, that because the land in question was a regulated asset, any proceeds from sale should accrue to the ratepayers.³⁵ In *Tampa Electric*, the Florida Public Utility Commission took the position that the charges that the ratepayers paid to depreciate the former headquarters building implied that the ratepayers owned the building and all net proceeds from its sale.³⁶ In *U S West Communications*, the carrier in selling a telephone exchange to another local operating company changed regulatory venue, a risk to the ratepayer. Specifically, ratepayers would have been put at risk if the land and other equipment being used to subsidize current services had not sold, and they should receive the benefits.³⁷ In *Puget Sound Energy*, the company was selling some of its generation assets. The sale was intended to produce short-term cost savings, which the company was planning to retain, and long-term cost increases, which the company was planning to pass on to the ratepayers. The regulator re-

34. *Casco Bay Lines v. Public Util. Comm'n*, 390 A.2d 483 (Me. 1978).

35. *Boston Gas Co.*, D.P.U. 1100, 49 P.U.R.4th 1 (Mass. Dep't Pub. Utils. 1982); *Boston Gas Co.*, D.P.U. 96-50, at § 6 (Phase I), (Mass. Dep't Pub. Utils. 1996).

36. *Tampa Electric Co.*, 49 P.U.R.4th 547 (Fla. Pub. Serv. Comm'n 1982).

37. *U S West Communications, Inc.*, 163 P.U.R.4th 413, Case No. 94-049-08, at §§ 1-7 (Utah Pub. Serv. Comm'n 1995).

sponded by invoking a “no harm” rule for the ratepayers (requiring that they be made no worse off by the sale of assets) and allocated all of the gains from the sale to the ratepayers.³⁸

Another central justification for the proceeds being allocated to ratepayers was that such an allocation was required by statute. In Connecticut, for example, the legislature enacted the rule that “the economic benefits of the sale of any land that has been in a water company’s rate base be equitably allocated between shareholders and ratepayers.”³⁹ The Connecticut Department of Public Utility Control interpreted that provision to require that the net after-tax proceeds of any sale of land by a water company be shared. As a result of the statute, the allocation of the proceeds was no longer an exercise in economic efficiency; rather, it became an exercise in statutory implementation infused with political notions of a fair income distribution.

The final justification for allocating proceeds to ratepayers is as a means of repaying the ratepayers for prior overcharges associated with the asset. In *Sierra Pacific*, the land had previously been incorrectly classified as an expense in the rate base, rather than as land held for future use. Thus, the ratepayers had been paying for use of the asset through their rates when it was out of use. As a result, as a means of repaying the ratepayers for the monies they had paid, the regulator allocated the proceeds to the ratepayers.⁴⁰

B. Regulated Assets Sold Due to Changes in Market or Operational Conditions in Which the Ratepayers Had Been Put at Risk

Table 3 lists cases in which the ratepayer has been determined directly to have been at risk for the loss when there was a change in the market or operational conditions. In these cases, whether the ratepayers purchased the asset or risk was shifted to them by other means, the ratepayer was at risk for the proceeds from its use. Thus, for economic efficiency, all variations in proceeds from sale of the asset should have been allocated to the ratepayers. But from these case reports it is difficult to determine whether the shift in risk was actual or was merely contrived to justify the decision. If ownership was established for the ratepayer merely because depreciation was paid then the definition of a shift in ownership was incorrect. For example, in *City and Borough of Juneau*, in his dissenting opinion, one commissioner states: “the problem here is that it is nowhere established on this record that the ratepayers ever paid an annual charge more than the annual depreciation or amortization expense. In fact, it is nowhere established that the utility ever included a depreciation or amortization expense

38. 3rd Suppl. Order, *Puget Sound Energy, Inc.*, Docket No. UE-990267, at § I(c) (Wash. Utils. & Transp. Comm’n 1999).

39. CONN. GEN. STAT. § 16-43(e)(2001).

40. *Sierra Pacific Power Co.*, 73 P.U.R.4th 306, Docket No. 85-532, at § B.1 (Nev. Pub. Serv. Comm’n 1985).

attributable to the certificate;"⁴¹

In *New York Water Services*, the system of cost accounts applicable to water utilities allowed "land sold at a loss to be debited to the depreciation reserve and thus increase the rate base."⁴² In *Democratic Central Committee*, the company purchased another transit company at about \$10 million less than its book value. After the purchase, to convert to an "all-bus" system, the company filed to remove unneeded tracks and other equipment. To pay for this, the regulators established a fund for "extraordinary retirement losses" associated with the company's conversion. This fund for changing the business was paid in by the ratepayers.⁴³ In *El Paso Natural Gas*, the abandonment of a pipeline imposed on the ratepayers increased expenses and reduced gas deliveries.⁴⁴ The abandonment also caused other pipelines on the system to experience increased expenses for which the ratepayers were responsible. In *Washington Gas Light*, the ratepayers were at risk for losses on propane held in storage for use during peak periods, so that they were deemed to be entitled to cost savings that occurred when propane backup was eliminated.⁴⁵ In *Potomac Electric Power Company*, as a result of reductions in nuclear power generation, ratepayers were made responsible for potential losses associated with nuclear fuel contracts.⁴⁶ In *Central Maine Power*, the regulator stated that it would shift responsibility for any losses from sales of the Maine Yankee property to the ratepayers unless it found that the company had been imprudent; in addition, it was argued that the land in question had been acquired by the company through eminent domain, so that shareholders had not invested in the land.⁴⁷

Many aspects of a complete argument are lacking in these cases. In all of them, "ownership" by the ratepayers is implied incorrectly. The key to ownership is alienability—the right to sell the asset; lacking that right, the ratepayer has no call on the proceeds, but the cases do not so specify that it is present. Others, such as *Potomac Electric Power*, virtually guarantee returns to shareholders so that both gains and losses should accrue to the ratepayers.

41. Order No. 7[iv], *City and Borough of Juneau*, Docket No. U-84-23 (Alaska P.U.C. 1986) (Agi, dissenting).

42. *New York Water Serv. Corp. v. Public Serv. Comm'n*, 12 A.D.2d 122, 208 N.Y.S.2d 857, 864 (N.Y. App. Div. 1960).

43. *Democratic Cent. Comm. v. Washington Metro. Area Transit Comm'n*, 485 F.2d 786 (D.C. Cir. 1973).

44. *El Paso Natural Gas Co.*, 1 F.E.R.C. ¶ 61,108, (1977).

45. *Washington Gas Light Co. v. District of Columbia Pub. Serv. Comm'n*, 450 A.2d 1187 (D.C. 1982).

46. Order No. 8529, *Potomac Elec. Power Co.*, 76 P.U.R.4th 275, 7 D.C. P.S.C. 350, Formal Case No. 685, at § 1 (D.C. Pub. Serv. Comm'n 1986).

47. *Central Maine Power Co.*, Docket No. 99-155, at § I (Me. P.U.C. 1999).

TABLE 3: CASES IN WHICH ASSETS WERE SOLD AFTER OWNERSHIP WAS ALLEGEDLY SHIFTED TO RATEPAYERS

Case	State	Year	Proceeds Allocated to Ratepayers or Shareholders?
New York Water Services Corporation	NY	1960	Ratepayers
Democratic Central Committee	DC	1973	Ratepayers
El Paso Natural Gas	FERC (TX)	1977	Ratepayers
Washington Gas Light	DC	1982	Ratepayers
City and Borough of Juneau	AK	1986	Ratepayers
Potomac Electric Power Company (Formal Case No. 685)	DC	1986	Ratepayers
Central Maine Power Company	ME	1999	Ratepayers

C. Regulated Assets Sold Due to a Change in Regulations

When systems of regulation change, the ratepayer is at risk for utility losses when the opportunity is eliminated for capital recovery under the old tariff and rate schedule.⁴⁸ Any change in the regulations that causes costs to be stranded renders ratepayers liable, over time, to pay. The ratepayer is thus entitled to any net returns, over remaining book value, that accrue as a result of the sale of stranded assets. Table 4 lists cases in which ratepayers were at risk because of regulatory change and, thus, the efficient result was to allocate the proceeds for asset sales to them.

There were two changes in regulation that occurred in these cases, the first being the reduction in use of nuclear power as it fell out of favor with consumers and regulators. The required abandonment of a number of plants imposed costs that could not be recovered, which became the responsibility of the ratepayers.⁴⁹

The second reason for change in regulation was a decision to deregulate the network utilities. As a result, a number of companies realized

48. Order No. 888, Final Rule, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, 61 Fed. Reg. 21,540, 21,630 (1996) (construing Pub. L. No. 102-486, 106 Stat. 2776 (1992) (codified at 15 U.S.C. § 79z-5a, 16 U.S.C. §§ 796, 824)), *aff'd*, *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *cert. granted sub nom.*, *New York v. FERC*, 121 S. Ct. 1185 (2001).

49. *NEPCO Mun. Rate Comm. v. FERC*, 668 F.2d 1327 (D.C. Cir. 1981); *Carolina Power & Light Co.*, 55 P.U.R.4th 582, Docket No. E-2, Sub 461 (N.C. Util. Comm'n. 1983); *Arizona Pub. Serv. Co.*, 91 P.U.R.4th 337, Docket No's. U-1345-86-062, U-1345-85-367, Decision No. 55931 (Ariz. Corp. Comm'n 1988); *Pacific Gas & Elec. Co.*, A.96-08-001; A.96-08-006; A.96-08-007; Decision 97-11-074, at § 8 (Cal. P.U.C. 1997); *Western Mass. Elec. Co.*, D.T.E. 97-120-1 (Mass. Dep't Pub. Utils. 1988); *Connecticut Light & Power Co.*, 191 P.U.R.4th 373, Docket No. 98-01-02, at § 8 (Conn. Dep't Pub. Utils. Control 1999); *Connecticut Light & Power Co.*, 195 P.U.R.4th 74, Docket No. 99-02-05, at § 1 (Conn. Dep't Pub. Util. Control 1999); *The United Illuminating Co.*, Docket No. 99-03-04, at § I (Conn. Dep't Pub. Util. Control 1999).

changes in the competitiveness of markets that left them with reduced prices, market shares, and consequently restricted cash flow with which to generate allowed returns to investors—classic stranded costs.⁵⁰

TABLE 4: CASES IN WHICH THE REGULATED ASSET WAS SOLD DUE TO A CHANGE IN REGULATION

Case	State	Year	Proceeds Allocated to Ratepayers or Shareholders?
NEPCO Municipal Rate Commission	DC	1981	Ratepayers
Carolina Power & Light	NC	1983	Ratepayers
New York Telephone	NY	1983	Ratepayers
Arizona Public Service Commission (Palo Verde 2)	AZ	1988	Ratepayers
Williston Basin	DC	1997	Ratepayers
Pacific Gas and Electric Company Dkt. No. 96-06-009	CA	1997	Ratepayers
Pacific Gas and Electric Company Dkt. No. 96-08-001	CA	1997	Ratepayers
Eastern Edison Company	MA	1997	Ratepayers
Montana Power Company	MT	1997	Ratepayers
Western Massachusetts Electric Company	MA	1998	Ratepayers – once proceeds realized (2003)
Connecticut Light and Power Dkt. No. 98-01-02	CT	1999	Ratepayers
Connecticut Light and Power Dkt. No. 99-02-05	CT	1999	Ratepayers
United Illuminating Company	CT	1999	Ratepayers
Electric Service Market Competition and Regulatory Practices	DC	1999	Ratepayers
Boston Edison Company	MA	1999	Ratepayers
PacifiCorp	OR	2000	Split so as to provide incentive to company to sell unneeded assets

An example in which regulators allocated less than the total proceeds to ratepayers was *PacifiCorp*.⁵¹ In Oregon, PacifiCorp was selling its steam generation facilities and the associated coal mine in response to a change

50. Board of Pub. Util. Comm'rs v. New York Tel. Co., 271 U.S. 23 (1926); Williston Basin Interstate Pipeline Co. v. FERC, 115 F.3d 1042 (D.C. Cir. 1997); *Pacific Gas & Elec. Co.*, A.96-06-009; Decision 97-04-024 (Cal. P.U.C. 1997); *Eastern Edison Co.*, D.P.U./D.T.E. 96-24 (Mass Dep't Pub. Utils. 1997); Order No. 5898d, *Montana Power Co.*, Docket No. D96.2.22, (Mont. Pub. Serv. Comm'n 1997); Order No. 11576, *Electric Serv. Mkt. Competition and Regulatory Practices*, Formal Case No. 945, (D.C. Pub. Serv. Comm'n 1999); *Boston Edison Co.*, D.T.E. 98-119 (Mass. Dep't Telecomm. & Energy 1999); Order No. 00-112, *PacifiCorp*, UP 168, (Or. P.U.C. 2000).

51. Order No. 00-112, *PacifiCorp*, UP 168, (Or. P.U.C. 2000).

in environmental regulations. Given the ownership structure of these facilities, PacifiCorp anticipated not being able to make the investment needed in newly required environmental upgrade equipment. Thus, it wished to sell the property, rather than have it shut down. The Oregon Public Utilities Commission determined that nearly all of the proceeds of the sale (95%) should go to the ratepayers. The exception was a small amount (5%) allocated to shareholders to give PacifiCorp the incentive to sell redundant assets in the future. The regulator's decision benefited the ratepayers in two ways: they received the proceeds from the sale and were not subjected to the costs of the plant shutdown. At the same time, investors were compensated for making the transaction.

VI. CONCLUSION

Asset sales by utilities are a natural consequence of the fundamental changes occurring in the energy industry—from the vertical divestiture of gas and electric utilities ordered or encouraged by state and federal regulators, to the bankruptcies and restructurings precipitated by the California electricity crisis of 2000-2001. How the gains or losses from utility assets sales are allocated between investors and ratepayers will therefore continue to be an important question of law and economic policy for years to come.

In this article, we have presented an economic framework for analyzing the efficient allocation of proceeds from a utility's sale of assets. Over time, a utility's actual net revenues vary from expected net revenues, and that variation may be positive or negative. Economic efficiency requires that the regulator allocate these variations to the investor. Given symmetric treatment of profit and loss outcomes, the investor is compensated for the risks that he bears under the regulatory contract. The shareholder should receive any gain as a result of a change in *market* conditions, including changes in technology that reduce the demand for the utility's service or render its capital stock obsolete. In contrast, the ratepayer should receive any gain that the utility experiences as a result of a change in *regulatory* conditions. Only on the utility's sale of an asset that has been used to provide regulated services and that has appreciated in value, are the utility's shareholders the correct recipients of the proceeds from the asset's sale. This rule, which follows from efficiency theory, is evident in the reported decisions by courts and regulatory commissions in the United States. In short, the jurisprudence on the allocation of windfall proceeds from a utility's sale of assets advances economic efficiency.

APPENDIX: CASES IN CHRONOLOGICAL ORDER

Board of Public Utility Commissioners v. New York Telephone Co., 271 U.S. 23 (1926). The company had used a rate of depreciation greater than required for its proper protection and thereby created an excess fund, which was termed "over-accruals." The Court determined that this fund could not later be used to lower rates. The Court stated that as it had

found earlier "[t]he just compensation safeguarded to the utility by the Fourteenth Amendment is a reasonable return on the value of the property used at the time that it is being used for the public service and rates not sufficient to yield that return are confiscatory."⁵² The Court further found that

"[t]he revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses, including the expense of depreciation is the company's compensation for the use of its property. If there is no return, or if the amount is less than a reasonable return, the company must bear the loss. Past losses cannot be used to enhance the value of the property or to support a claim that rates for the future are confiscatory."⁵³

In the opinion it was stated,

"[c]ustomers pay for service, not for the property used to render it. Their payments are not contributions to depreciation or other operating expenses or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in the property used for the convenience or in the funds of the company."⁵⁴

The Court held that the company was not required to transfer "over-accruals" to earnings in subsequent years.⁵⁵

New York Water Service Corp. v. Public Service Commission, 12 A.D.2d 122, 208 N.Y.S.2d 857 (N.Y. App. Div. 1960). The company sold the land in question six years before the rate proceeding in which the issue appeared. The proceeds of the sale, following the accepted accounting principles of the state, were to be credited to a depreciation reserve account. Any losses that occurred were to be recovered through this same account from the ratepayers, albeit over time.⁵⁶ With the formation of the account, and by including both the profits and the losses in this account, the investors were not at risk for losing their investment as the ratepayers paid for the market value of the asset, albeit over time through the depreciation. This case is different from most with regard to the sale of land assets in that the asset was "paid for" by the ratepayers. As a result, the risk was transferred to the ratepayers through the accounting procedures.

City of Lexington v. Lexington Water Co., 458 S.W.2d 778 (Ky. Ct. App. 1970). The case involved the sale of watershed land no longer needed by a water utility because it had obtained a different source of water. The city alleged that the company had obtained the source of water through "condemnation or threat thereof." The company denied this claim.⁵⁷ The company acquired the property between 1897 and 1908 and used it until it became inadequate. The asset was then retired from service and sold, with

52. *Board of Pub. Util. Comm'n*, 271 U.S. at 31 (citing *Willcox v. Consolidated Gas Co.*, 212 U.S. 19, 41; *Bluefield Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692.)

53. *Board of Pub. Util. Comm'n*, 271 U.S. at 31

54. *Id.* at 32.

55. *Board of Pub. Util. Comm'n*, 271 U.S. at 32.

56. *New York Water Serv. Corp.*, 208 N.Y.S.2d at 865.

57. *City of Lexington*, 458 S.W.2d at 778.

water being obtained through pipelines extending from the Kentucky River. The circuit court in reversing the Kentucky Public Service Commission's decision opined: "Having contributed nothing to its acquisition and having acquired no interest therein, the ratepayers assumed no risk in its disposition whether it be profit or loss."⁵⁸ The court held that the utility was entitled to retain the gain on sale of land no longer used in serving customers.⁵⁹ This sale resulted from a change in the market and operational conditions of the company, thus the investors were at risk.

Democratic Central Commission. v. Washington Metropolitan Area Transit Commission, 485 F.2d 786 (D.C. Cir. 1973). This decision is the most cited among cases of this type. In the case the court allocated the proceeds from an asset sale to the ratepayers. Although this distinction is sometimes missed, the case is distinct from those finding that the investors are entitled to the gains from the sale of the assets, in that, the ratepayers had "borne the costs" involved. Briefly the facts of the case are that the costs of the conversion of the transit system to an all-bus operation were borne by the ratepayers, including the cost of retirement of equipment and facilities and the cost of removal of streetcar tracks. The ratepayers had also paid for the acquisition of capital assets (the new busses). Although some of the retired assets were no longer useful to the company, they could be sold for entirely different and more valuable uses at a substantial gain and the company did so.⁶⁰ The court found that, as ratepayers had borne the unique and substantial burden of the retirement of equipment and of track removal, they were entitled to share in the gains from the sale of property which this conversion program had made possible. Since the ratepayers made the investment in assets there was a transfer of risk from the shareholders to the ratepayers, they were entitled to the gains.

Federal Energy Regulatory Commission, Re El Paso Natural Gas Co., 1 F.E.R.C. ¶ 61,108, 23 P.U.R.4th 66, Opinion No. 4, Docket No. CP75-362 (1977). El Paso Natural Gas Company wished to abandon one of its natural gas pipelines in the Southwestern United States and convert the pipeline to a crude oil pipeline. Due to the nature of its business, it had to receive approval from the federal regulatory agency. In its opinion the Federal Energy Regulatory Commission (FERC) determined that part of the gain resulting from the abandonment of a natural gas pipeline was to be allocated to ratepayers, reducing the rate base, and accordingly reducing cost of service as to return, taxes, and depreciation.⁶¹ In making this decision, the FERC acknowledged that the ratepayers would be put at greater risk as a result of the abandonment. The FERC believed that there would continue to be sufficient capacity on the remaining parts of the system to meet the natural gas needs of the consumers, however, the remaining system would experience higher compressor fuel usage and there was a

58. *Id.* at 779.

59. *City of Lexington*, 458 S.W.2d at 779.

60. *Democratic Cent. Comm'n*, 485 F.2d at 833.

61. 1 F.E.R.C. ¶ 61,108.

small risk that the pipeline would be needed in the future. The the FERC believed that the probability of having to replace the pipeline was very small, thus minimal weight was put on this in their decision. The higher compressor fuel usage was an issue, however, and because of this additional risk the ratepayers were compensated with some of the proceeds from the sale through the rate base reduction.⁶² In this instance, there was a change in the market conditions that led El Paso Natural Gas to want to convert the pipeline, but this simultaneously led to a change in the regulatory contract. The risk to the shareholders as a result of the change was minimal, while the risk to the ratepayers of higher prices was substantial. As a result, the abandonment of the pipeline resulted in a shift in the risk from the shareholders to the ratepayers.

Boise Water Corp. v. Idaho Public Utilities Commission, 578 P.2d 1089 (Idaho 1978). The court reversed the Idaho Commission's decision and allocated the gains on transfer of utility watershed land to the shareholders. The land had been in utility service about ninety years, and had appreciated to a value about eighty times its original cost. In making its determination, the court relied on the fact that the capital had been supplied entirely by the utility investors, there had been no depreciation paid in rates, and the utility had earned a return only on its original cost. Therefore, the court opined, the utility customers should not be treated as equitable owners of the property. In dicta, the court acknowledged that in different circumstances a different result should apply, stating that on a transfer of depreciable property the gain on sale should be "treated as if it were the sale of the ratepayer's property."⁶³ Since the investors contributed the funds for this purchase and had not been compensated for it, their investment was at risk.

Casco Bay Lines v. Public Utilities Commission, 390 A.2d 483 (Me. 1978). In 1974, Casco realized a net gain of \$28,396.47 upon the sale of three vessels as depreciable property. The Supreme Judicial Court held that the ratepayers were entitled to the proceeds minus 10% given to the shareholders as incentive.⁶⁴ The court approvingly noted that the Maine Public Utilities Commission treated the gains as follows: "If there is a gain from the sale of depreciable property, it indicates that depreciation has been miscalculated and that the ratepayers have been overcharged."⁶⁵

NEPCO Municipal Rate Commission v. FERC, 668 F.2d 1327 (D.C. Cir. 1981). The Court of Appeals for the Circuit of the District of Columbia here affirmed the FERC's rate determinations concerning four nuclear power companies (the Yankees). The New England Power Company objected, claiming "that FERC, having allowed recovery for cancelled project expenditures, must include expenditures for cancelled projects in the rate

62. *Id.* at 61,267-271.

63. *Boise Water Corp.*, 578 P.2d. at 1092.

64. *Casco Bay Lines*, 390 A.2d at 489.

65. *Id.*

base.”⁶⁶ In its opinion, the court noted that the NEP Yankee investment could be excluded from rate base because it was already reflected as common equity in the capital structures of the plants: “The rates charged NEP by the Yankee companies is reflected in NEP’s cost of service as purchased power expense and thus passed through to NEP’s customers.”⁶⁷ Thus, the FERC was found to have articulated a rational basis for its determination. The court also defended the inclusion of Yankee investment in the total capital structure of the New England Electric System. Noting that an approval of a past settlement agreement called for a 10% return for a Yankee company, “FERC determined that NEP must be afforded the opportunity to earn a 13.28 [percent] return on its investment in its own operating rate base facilities, if it were to have the opportunity to earn [a competitive return] on a composite basis.”⁶⁸ Over the objection of customers, the court held that the approach taken by the FERC did not improperly guarantee returns to shareholders, but was “a recognition that the risk and appropriate returns are different” for NEP-operating and NEP-Yankees.⁶⁹

Appeal of the City of Nashua, 435 A.2d 1126 (N.H. 1981). New Hampshire Public Utilities Commission Accounting rules require that land be included in the rate base at cost and that, upon its retirement from service, it be withdrawn from the rate base and transferred to the non-operating assets account at cost. The city of Nashua appealed an order by the New Hampshire Public Service Commission, which, following its accounting rules, found that the proceeds from Pennichuck Water Works’ sale of 1,490 acres of land belonged to the shareholders. The land in question was owned for fifty years but was no longer needed to provide utility service. The New Hampshire Supreme Court upheld the New Hampshire Commission’s decision leaving the proceeds with the shareholders. In doing so, the court opined: “under the commission’s accounting rules and as a ‘matter of general equity,’ the profits realized from the sale of fixed capital belong to the stockholders rather than the ratepayers because any loss realized from the sale of such assets could not be charged to future consumers.”⁷⁰ The court further opined that:

[i]t would be manifestly unfair and unjust to reduce the utility’s rate base by the current market value of the land withdrawn from the rate base when it has been included only at its historical costs. Inclusion at the lower figure has resulted in a benefit to consumers, because using the current market value of the land could have required an increase in rates

66. *NEPCO Mun. Rate Comm’n*, 668 F.2d at 1333.

67. *Id.* at 1342 n.4.

68. *NEPCO Mun. Rate Comm’n*, 668 F.2d at 1343.

69. *Id.* at 1343-44. The court also held that the approach taken by the FERC did not improperly guarantee returns to shareholders did not violate the “filed rate doctrine” articulated by the United States Supreme Court. *See also* *Montana-Dakota Utils. Co. v. Northwestern Pub.*, 341 U.S. 246, 251 (1951).

70. *Appeal of the City of Nashua*, 435 A.2d at 1128.

in order to yield a 'reasonable return' on its investment.⁷¹

As seen in the court's opinion, the shareholders were at risk for any loss that could have occurred, and thus they were rightly due the benefits that did occur.

Philadelphia Suburban Water Co. v. Pennsylvania Public Utilities Commission, 427 A.2d 1244 (Pa. Commw. Ct. 1981). The court reversed the Pennsylvania Public Utility Commission's decision that reduced the rates of Philadelphia Suburban by the current market value of the company's land sales. The land was in service for over fifty years and had appreciated more than tenfold. The company sold the land, but the Pennsylvania Commission determined the proceeds should be used to lower rates. The court found the commission's action constituted confiscation without due process and just compensation.⁷² The court relied on the concept that the ratepayers had not paid for any of the investment through depreciation, that the ratepayers had paid rates based only on the original cost of the land for fifty years, and that utility customers pay only for the use of land, but do not gain equitable or legal rights therein.⁷³ Since they had made the investment, the shareholders were at risk for any loss and thus entitled to any gain as well.

Florida Public Service Commission, Re Tampa Elec. Co., 49 P.U.R.4th 547 (Fla. Pub. Serv. Comm'n 1982). In this case the Commission took the position that the charges that the ratepayers paid in rate base to depreciate the former headquarters building formerly devoted to public service implied that the ratepayers owned the building and all net proceeds from its sale.⁷⁴

Washington Gas Light Co. v. District of Columbia Public Service Commission, 450 A.2d 1187 (D.C. 1982). The Court of Appeals held that the net gain from the sale of propane, which had been stockpiled, should be allocated to ratepayers. In reviewing the District of Columbia Public Service Commission's decision in the case, the court stated that there was not enough information to determine if the case involved depreciable or non-depreciable assets and that "[t]he more important inquiry in determining who should receive the gains from the propane sales is the question of who has borne the risks and burdens associated with its maintenance."⁷⁵ In the case the court also noted that the commission relied on the fact that the ratepayers would be asked to cover the loss if such an event occurred and that the ratepayers paid the propane storage costs over the years.⁷⁶ In addition, the propane was used to cover peak demand periods on the system. The court, thus determined that since the ratepayers had paid the cost

71. *Id.* at 1128-29.

72. *Philadelphia Suburban Water Co.*, 427 A.2d. at 1246.

73. *Id.* at 1246-7.

74. *Tampa Elec. Co.*, 49 P.U.R.4th at 571.

75. *Washington Gas Light Co.*, 450 A.2d at 155.

76. *Id.*

of storage and transportation of the propane and it was held to be used in times of shortages to cover the needs of the ratepayers, they incurred the risk after sale and thus, the proceeds should be allocated to the ratepayers. In this case there was a change in the market conditions that no longer made the storage necessary, but the risk had been shifted to the ratepayers as they were paying for the gas, the storage, and the transportation, and they would be subject to paying for any losses that occurred.

Massachusetts Department of Public Utilities, Re Boston Gas Co., 49 P.U.R.4th 1, D.P.U. 1100 (Mass. Dep't Pub. Utils. 1982). The Massachusetts Department of Public Utilities allocated the proceeds from the sale of land to the ratepayers on the grounds that it was "an above-the-line item."⁷⁷ And, thus, the net proceeds from the sale should receive above-the-line treatment that is credited to the ratepayers. In this case, the company argued that some of the price of the land had not been included in the rate base, and thus at a minimum the proceeds should be split accordingly. The Massachusetts Commission, however, stated the record provided them with no basis for determining what portion, if any, of the premium originally paid for the property and not included in the rate base could properly be considered as representing a part of the value of these parcels.⁷⁸ Thus, they did not split the proceeds in any way. In this case the Massachusetts Department of Public Utilities misallocated the proceeds.

Washington Public Interest Organization. v. District of Columbia Public Service Commission, 446 A.2d 28 (D.C. 1982). The District of Columbia Public Service Commission determined that "[t]he allocation of gains on the land sales to shareholders alone is the appropriate ratemaking treatment for maintaining the financial integrity of the WGL [Washington Gas Light] and PEPSCO [Potomac Electric Power Company] and establishing rates which are just, reasonable and nondiscriminatory."⁷⁹ The court upheld the action of the commission allowing the gain on the sale of land by the two utility companies to be retained by the respective utilities and not to be used to reduce rates. The court relied on the commission's findings that depriving the utilities of the gain on sale, both in terms of effect on expected earnings and on investor assessment of the regulatory climate, would increase the cost of capital to the utilities to the ultimate detriment of their customers.⁸⁰

Missouri Public Service Commission, Re Associated Natural Gas Co., 26 Mo P.S.C. (N.S.) 237, 55 P.U.R.4th 702 (Mo. Pub. Serv. Comm'n 1983). Associated Natural Gas applied for permission to sell to a municipality a gas distribution system. In its application it stated that it planned to use the proceeds to retire bonds, that is to pay back some of its investors, and invest in new plant. Both of these actions are valid uses for the proceeds

77. *Boston Gas Co.*, 49 P.U.R.4th 1.

78. *Id.* at 26.

79. *Washington Pub. Interest Org.*, 446 A.2d at 29-30 (quoting *Washington Pub. Interest Org. v. Pub. Serv. Comm.*, 393 A.2d 71, 92 (D.C. 1978)).

80. *Id.* at 30-31.

from such a sale. This action was supported by the Missouri Public Service Commission's order which held that, where the utility proposed to apply the proceeds of the sale to a municipality of a gas distribution system to the retirement of bonds and to investment in new plant, resulting in a reduction in interest expense and increased debt coverage, the gain need not be allocated to ratepayers.⁸¹ Although staff had argued the gains should accrue to ratepayers, the commission concluded that the proposed disposition of the sale proceeds would result in a sharing of benefits to both the ratepayers and the shareholders, and that ratepayers would benefit from the reduction in interest expense and the increase in interest coverage.⁸² The Commission thus allocated the gains to the shareholders.

North Carolina Utilities Commission, Re Carolina Power & Light Co., 55 P.U.R.4th 582, Docket No. E-2, Sub 461 (N.C. Utils. Comm'n 1983). In this case the gain from the sale of interests in generating units was used to benefit ratepayers through a reduction in rate base amortized over a particular period. This, however, resulted not from a specific North Carolina Commission decision, but from the company, Carolina Power & Light Company, agreeing (or at least not contesting) that the gains from the sale of these particular assets should flow to the ratepayers as compensation for the expenses they were incurring as a result of the termination of the company's nuclear plant construction.⁸³ As with many nuclear plants, the plants had been taken out of service, leaving stranded costs for which the ratepayers were responsible. Since the ratepayers were at risk for the losses, any benefits that did accrue were used to offset these losses.

New York Public Service Commission, Re New York Telephone Co., 54 P.U.R.4th 220, Case 28264, Opinion No. 83-11 (N.Y. Pub. Serv. Comm'n 1983). The New York Public Service Commission (PSC) determined that the gain from the sale of customer premises equipment should flow through to ratepayers by treating the gain as an above-the-line item as a credit to depreciation expense. At the time, the New York Telephone Company was being divested, along with the remaining Bell Operating Companies, from its parent company AT&T. The case first went to an administrative law judge panel that found that any gains from such sales should be allocated to the ratepayers. The New York PSC agreed with the judges that the staff's basic approach, which would provide current benefits to the general body of ratepayers, was superior to the company's proposal to credit depreciation reserves. Moreover, the New York PSC found it conformed to generally accepted accounting principles, and resulted in a lower rate year revenue requirement.⁸⁴ Given the change in the regulatory regime that was causing the change in the ownership of the assets, the economically efficient result was to allocate the benefits to the ratepayers.

81. *Associated Natural Gas Co.*, 55 P.U.R.4th 702.

82. *Id.*

83. *Carolina Power & Light*, 55 P.U.R.4th 582 (Evidence and Conclusions for Finding of Fact No. 7).

84. *New York Tel. Co.*, 54 P.U.R.4th 220.

Maine Water Co. v. Maine Public. Utilities Commission, 482 A.2d 443 (Me. 1984). The court reversed the commission and ruled that gains from sale of two geographical utility divisions to a municipal district should be retained by the shareholders and not used to reduce rates to customers in the remaining districts. The property transferred included both depreciable and non-depreciable assets. The investors had generally purchased the assets and put them into use for the benefit of the ratepayers. Thus, although the Maine Commission mistakenly allocated the proceeds to the ratepayers, the court reversed this decision, and allocated the proceeds to the shareholders. In selling the asset, the market conditions changed and the company determined that the most efficient means of operating the two plants was through their sale, thus the investors were at risk for any losses that might occur.

Nevada Public Service Commission, Re Sierra Pacific Power Co., 73 P.U.R.4th 306, Docket No. 85-532, (Nev. Pub. Serv. Comm'n 1985). In this Nevada Public Service Commission case, the proceeds from an asset sale by Sierra Pacific Power Company were allocated to the ratepayers. The land in question had been previously incorrectly classified for ratemaking purposes. Thus, ratepayers had been paying a return on this property that should not have been included in the rate base. This factored into the decision by the Nevada Commission to allocate the proceeds of the sale to the ratepayers. The Nevada Commission states that "[i]n such a circumstance, allocation of the gain above the line seems warranted both by equity and by accounting procedures."⁸⁵ As a result of the incorrect classification, it could be argued that the ratepayers had, in fact, been paying for the purchase of the land and not just the use of it, as there was no use of it at the time. Thus, there was a shift in the risk to the ratepayers as a result of the land previously being incorrectly classified.

Alaska Public Utilities Commission, Re City and Borough of Juneau, 76 P.U.R.4th 99, Docket No. U-85-23, Order No. 7 (Alaska P.U.C. 1986). Claiming that it had a property right in the form of a certificate of public convenience and necessity, S & S Development argued that it should be able to keep \$25,000 gained pursuant to an agreement to amend its certificate with the City and Borough of Juneau. While disagreeing with the holding of the D.C. Circuit in *Democratic Central Committee*, S & S furthermore suggested that the findings of that case were irrelevant to the instant case because ratepayers had not paid in accordance with any depreciation or amortization schedule. Nonetheless, the Commission found that since ratepayers had borne the risk of loss of the capital investment, as well as the economic burden of acquisition costs, they were therefore "entitled to benefit from the payment made by CBJ to S & S." To support its findings the Commission noted that "[t]o the extent that possible profits on sale of the utility may be the owner's objective, the public is likely to be the loser."⁸⁶ In a forceful dissent, however, Commissioner Agi criticized the

85. *Sierra Pac. Power Co.*, 73 P.U.R.4th 306

86. *City and Burough of Juneau*, 76 P.U.R.4th at 108.

Commission for finding no value inherent in the property rights of the certificate, well-established by the Uniform System of Accounts.⁸⁷ "There can be no contention in this proceeding that certificate expenses, which are in fact start-up or pre-operation expenses, had ever been paid for by ratepayers."⁸⁸ Believing that the S & S had been wrongly punished for the "regulatory stigma to a utility's having unserved pockets in its service area at any point in time," the dissenting commissioner suggested that "[w]hat has happened here [before the proceeding] is only that a utility's owners have recognized and profited from an unregulated transaction."⁸⁹

District of Columbia Public Service Commission, Re Potomac Electric Power Co., 76 P.U.R.4th 275, 7 D.C. P.S.C. 350, Formal Case No. 685, Order No. 8529 (D.C. Pub. Serv. Comm'n 1986). On remand from the District of Columbia Court of Appeals, the Commission examined the equities involved in its treatment of the net gain from an electric utility's sale of a nuclear fuel rights contract and reaffirmed its decision to: (1) amortize the gain from the sale over a ten-year period (thus benefiting ratepayers by increasing revenues and correspondingly lowering the revenue requirement for rate-making purposes); and (2) deduct the unamortized credit from the sale from rate base. The Commission found that ratepayers bore the risk of loss associated with the nuclear fuel rights contracts and that its treatment of that loss was therefore consistent with the long-standing rate-making principle that capital gains rightly belong to those who have borne the risk of loss.⁹⁰ The change in the regulatory contract regarding nuclear plants resulted in the ratepayers paying for the nuclear plants and the associated assets, thus, the ratepayers were at risk for any losses associated with the contract and should also receive any benefits.

Arizona Corp. Commission, Re Arizona Public Service Co., 91 P.U.R.4th 337, Docket Nos. U-1345-86-062, U-1345-85-367, Decision No. 55931 (Ariz. Corp. Comm'n 1988). The gain on the sale and leaseback of depreciable asset (Palo Verde Unit 2) was amortized against annual lease payments over life of the lease, and the unamortized balance removed from rate base. The rate base of an electric utility was reduced to reflect the unamortized balance of gain resulting from the sale and leaseback of a portion of the utility's ownership interest in a nuclear generating facility. Without such a consideration, customers would not receive all of the financial benefits of the sale and leaseback transactions, and would pay for a return on a portion of the investment in the generating facility that had been refinanced at a zero cost of capital.⁹¹ The Arizona PSC determined that a sale/leaseback was not the same as an outright sale of the assets and thus treated the allocation of the proceeds differently.⁹² They argue that a

87. *Id.* at 116.

88. *City and Burough of Juneau* 76 P.U.R.4th at 117.

89. *Id.* at 118.

90. *Potomac Elec. Power Co.*, 76 P.U.R.4th 275.

91. *Arizona Pub. Serv. Co.*, 91 P.U.R.4th 337.

92. *Id.*

sale/leaseback simply rearranges the method and timing of compensating investors for a return of and return on investment. It does not entirely avoid the need for that compensation, as in the case of an outright sale. If the gains on the sale/leasebacks were not used to reduce rate base, customers would not reap all of the financial benefits of those transactions and would pay for a return on a portion of the investment in Unit 2, which has been refinanced at a zero cost of capital. The leaseback changed the regulatory contract with the ratepayers and put them at risk for a change in prices. On a separate issue within the same Arizona Power case, the allocation of the proceeds from sale of a street lighting system to the city of Phoenix was also at issue. The Commission divided the gain on sale 50/50 between the ratepayers and the shareholders. The company proposed this allocation because throughout the history of the system the ratepayers had subsidized its operation.⁹³ Although the proceeds were misallocated in this case it was done at the company's suggestion.

California Public Utilities Commission, Re: Rate-making Treatment of Capital Gains, 104 P.U.R.4th 157, Docket No. 89-07-016, R.88-11-041 (Cal. P.U.C. 1989). The company desired to sell a water system to a municipality after determining that the municipality could operate the system more efficiently. The California Public Utilities Commission (CPUC) determined that "when a public utility distribution system is sold in whole or in part to a municipality, which then assumes the obligation to serve the customers formerly served by the utility within the area served by the transferred system, any gains or losses from the sale should be allocated to the shareholders of the public utility"⁹⁴ In this case, the CPUC made the exception to its general rule that proceeds from such sales should accrue to the shareholders in order to ensure that ratepayers, who were receiving the same basic service via the same facilities with only a change in providers, were not harmed. In this case, the shareholders had originally paid for the asset and the ratepayers had not contributed to the purchase of the asset. However, as a political and equity consideration, the CPUC determined that the consumers should not be harmed by the transaction, thus, in order to retain the regulatory contract as it was the ratepayers were allocated some of the proceeds.

California Public Utilities Commission, Re S. California Gas Co., 118 P.U.R.4th 81, Decision 90-11-031, Application 78-07-041 (Cal. P.U.C. 1990). In 1987, the Southern California Gas Company requested permission to sell its headquarters building as it needed additional space and the value of the property was substantially more to others. With that request, the California Public Utilities Commission had to make a determination as to how to allocate the assets from the sale, as the market value of the building was significantly greater than the book value upon which the ratepayers had been paying expenses. The commission allocated the pro-

93. *Arizona Pub. Serv. Co.*, 91 P.U.R.4th at 362.

94. CALIFORNIA PUB. UTILS. COMM'N, *Rate-making Treatment of Capital Gains*, 104 P.U.R.4th 157.

ceeds to the shareholders, after ensuring that the ratepayers would not be harmed by the transaction. In its order, the California commission stated that

...because a headquarters building is included in rate base at its original or historical cost, ratepayers are guaranteed the use of an asset at a fixed price. If sold, that asset must be replaced at a cost set in the current market. To keep ratepayers indifferent to the transaction, we need to allocate to them enough of the gain on sale to compensate for the difference between what the old building would have cost had it continued in rate base, and what the new asset will actually cost.⁹⁵

The California commission then went on to state that if there were any proceeds left over after the ratepayers were made whole, and kept indifferent, that portion represents the higher value of the asset when devoted to some non-utility use and that should and would be given to shareholders as a reward and incentive for seeing that the assets are put to their highest and best use in the economy. This maintains the economically efficient allocation, in that the company has the incentive to act in a way that is most beneficial to shareholders, without harming the captive ratepayers.

Maine Public Utilities Commission, Investigation into Cobbosseecontee Telephone Co. and Lincolnville Telephone Co. Sale of Chances in FCC Cellular Lottery, Docket No. 91-006 (Me. P.U.C. 1991). The companies determined that the best use for their rights to bid in the FCC Cellular Lottery was their sale by auction. The companies then retained the proceeds from these sales. The Commission found that the investors were entitled to these proceeds and that ratepayers had no risks or burdens directly associated with the acquisition, holding or sale of the cellular lottery chances. The shareholders supplied all the funds used to apply for and negotiate the sale of the chances. The ratepayers were required to bear no additional risks or costs in connection with the acquisition and/or sale of chances. Moreover, the cellular lottery chances were intangible assets that never appeared, nor would appear, in the utilities' rate base. The ratepayers had in fact been shielded from any and all risks in the transaction, and thus were not allocated any of the proceeds from the sales.⁹⁶

California Public Utilities Comm'n, Re Suburban Water System, 149 P.U.R.4th 15, Decision 94-01-028, Application 90-10-029 (Cal. P.U.C. 1994). The land on which two of Suburban's operations pumps were located had increased in value as a result of the increase in land value in that area. As a result, Suburban determined that the best use of the land was to sell it and use the proceeds for other purposes. As it had two operating pumps on the land, Suburban negotiated the sale such that it retained access to the pumps and they remained in place. Based on an extensive record of cases in other jurisdictions, Suburban developed a proposed model under which gains on depreciable assets (plant) would go generally to ratepayers and gains on non-depreciable assets (land) would go generally

95. *Southern Cal. Gas Co.*, 112 P.U.R.4th 26 (Cal. P.U.C. 1990).

96. *Investigation into Cobbosseecontee Tel. Co. and Lincolnville Tel. Co.*, Docket No. 91-006 (Me. P.U.C. 1991).

to shareholders following the mitigation of any adverse impact to the ratepayers. The California PUC agreed with Suburban's recommendation because ratepayers pay depreciation expenses in rates, and thus return to investors over time the capital spent for plant and equipment, and any gain or loss is recorded against net plant. In addition, ratepayers neither pay depreciation on land, nor do they bear the risk of loss on sale, hence ratepayers do not reimburse the capital contributed by investors for land purchase. The California PUC also argued that the Uniform System of Accounts required this disposition of gains and losses for plant, equipment, and land. As a result, in this case, the California PUC concluded that shareholders had the right to the gain in this sale of land because it was they who bore the risk of capital loss. To the extent in this case the ratepayers had some risk from the operation of two booster pumps on the property, that utility service continued unchanged and was unaffected by the sale, except to the extent that ratepayer burden had been reduced.⁹⁷

District of Columbia Public Service Commission, Re Potomac Electric Power Co., Formal Case No. 939, Order No. 10698 (D.C. Pub. Serv. Comm'n 1995). Potomac Electric Power Company (PEPCO) transferred some property to its parent company, PCI, who then sold the land to a third party. The D.C. Commission concluded that the proceeds from the gains received from land sales should flow to the shareholders. To do otherwise would require them to raise PEPCO's cost of common equity.⁹⁸

Utah Public Service Commission, Re U S West Communications, Inc., 163 P.U.R.4th 413, Case No. 94-049-08 (Utah Pub. Serv. Comm'n 1995). U S WEST desired to sell an exchange to another local telecommunications company. In doing so, U S WEST initially requested that the entire gain from the subject sales be excluded from ratemaking, while the Division and the Committee argued that the gain should be accounted for through a reduction of rate base. In a compromise the Division and U S WEST reached a middle ground on which shareholders in exchange for concessions kept a reduced gain to ratepayers. The Utah Commission noted that "[a]s a general proposition a utility's property belongs to the shareholders."⁹⁹ The Utah Commission also noted that "as a general proposition, it is the utility investors who bear the risk of loss of utility property."¹⁰⁰ However, based on the record the Utah Commission did not believe that the gain resulted solely from the appreciation of investment assets. The Company had been granted an accelerated depreciation of the assets. In addition, the utility was selling more than the physical plant; it was also selling the privilege of providing monopoly telecommunication services (subject to Commission approval), which has value per se and for which the utility

97. *Suburban Water Sys.*, 149 P.U.R.4th 15.

98. *Potomac Elec. Power Co.*, Order No. 10698.

99. *U S West Communications, Inc.*, 163 P.U.R.4th 413 (citing Board of Pub Util. Commissioners v. New York Telephone Co., 271 U.S. 23, 32, 46 S.Ct., 366 363 (1926)).

100. *Id.* (citing Committee of Consumer Servs. v. Public Serv. Comm'n, 595 P.2d 871, 874 (Utah 1979)).

paid nothing. As a result, the Utah Commission found it reasonable to share some of the benefit with the ratepayer.¹⁰¹ And thus, approved the agreement between the staff and U S WEST. A change in market conditions led to U S WEST wanting to sell the exchange, however, resulting in a change in the regulatory contract.

Massachusetts Department of Public Utilities, Re Boston Gas Co., 174 P.U.R.4th 200, D.P.U. 96-50 (Phase I) (Mass. Dep't Pub. Utils. 1996). During the test year, the Company sold a parcel of land in Gloucester with a book value of \$2,206 to an unrelated party for \$5,000. The Massachusetts Department of Public Utilities policy with respect to gains on the sale of utility property is that the return to ratepayers of the entire gain associated with the sale, if those assets were recorded above-the-line and supported by ratepayers.¹⁰² Given this policy, the profits were amortized over a five year period.¹⁰³ The Massachusetts Department of Public Utilities incorrectly allocated the proceeds from the sale of this asset.

California Public Utilities Commission, Re Pacific Gas and Electric, Application 97-08-006, Decision 97-12-033 (Cal. P.U.C. 1997). Because of the Z'berg-Nejedly Forest Practices Act, it is no longer necessary for Pacific Gas & Electric (PG&E) to retain full fee ownership in order to protect unchecked erosion from rapacious logging practices that might endanger PG&E's electric lines on the property and produce excessive siltation creating problems for PG&E's downstream hydroelectric facilities. This Act resulted in a change in the regulatory contract that allowed PG&E to sell its property. By its original proposal as contained in the June 7, 1996 application, PG&E proposed that the gains from sale of this property, like that of other non-depreciable assets, should go to the utility shareholders, the owners of the property. The Division of Ratepayer Advocates challenged this allocation. While adhering to its belief that it is the shareholder, not the ratepayer who bears the risk associated with non-depreciable property, PG&E recognized that to persist in this stance would delay this and other sales, and the utility's ability to remove underutilized assets from rate base. It recognized its need to expedite the sale of underutilized real property, and that under performance based ratemaking, rate base may no longer help determine revenue requirements. Accordingly, on December 10, 1996, PG&E filed an amendment to its Application (A.) 96-06-009 to replace and supersede the ratemaking treatment initially proposed. Under its amendment proposal, the net-of-tax proceeds from the Lake Van Norden property would be booked to a new memorandum account named Real Property Sales (RPS) Memorandum Account and would accrue interest at the three-month commercial paper rate. Following establishment of the CTC balancing account, PG&E would transfer the entire balance including interest to the CTC balancing account and net it

101. *U S West Communications, Inc.*, 163 P.U.R.4th 413

102. *Boston Gas Co.*, D.P.U. 95-118, at 142 (Mass. Dep't Pub. Utils. 1996); *Barnstable Water Co.*, D.P.U. 93-223-B, at 12 (Mass. Dep't Pub. Utils. 1994).

103. *Boston Gas Co.*, 174 P.U.R.4th 200.

against the balance there.

California Public Utilities Commission, Re Pacific Gas and Electric, A.96-08-001; A.96-08-006; A.96-08-007; Decision No. 97-11-074 (Cal. P.U.C. 1997). Following the adoption of Preferred Policy Decision and AB 1890, PG&E wanted to sell some property. PG&E explained that the gain or loss on sale of depreciable assets has traditionally been flowed back to ratepayers through the depreciation reserve, while gains or losses related to non-depreciable property have been allocated to shareholders. PG&E believes, however, that land must now be treated as depreciable property because of the language adopted in the Preferred Policy Decision and AB 1890. Therefore, PG&E proposed that all gains and losses realized through sale, spinoff, or appraisal of generation assets, including land, should flow back to ratepayers by way of the transition cost balancing account. Conceptually, the Commission agreed that the gain or loss resulting from sale of assets, including land, should now flow through the transition cost balancing account, but they saw no reason to adopt Edison's approach of amortizing any gain over the remaining months of the transition period. The gain should simply be credited to the transition cost balancing account and the appropriate subaccount closed out. As a separate matter, they were in the process of authorizing auctions for assets undergoing divestiture.¹⁰⁴

Montana Public Service Commission, Re Montana Power Co., 181 P.U.R.4th 397, Docket No. D96.2.22, Order No. 5898d (Mont. Pub. Serv. Comm'n 1997). In moving from a regulated market into a deregulated market, the Montana Power Company entered into stipulations allowing for the collection of \$35.6 million in stranded gas production assets¹⁰⁵ and \$24.29 million in stranded gas regulatory assets.¹⁰⁶ Although Enron argued that the requests for stranded costs were premature, and that the commission was not yet allowed to approve their recovery because statutorily defined "open access" had not yet occurred,¹⁰⁷ the company was in fact allowed to pass stranded costs onto ratepayers. The commission noted

The Commission shares Enron's concern that the most desirable outcome for customer choice would be for all customers immediately to be given the ability to choose among gas suppliers. However, a pragmatic view suggests that the present form of MPC's vertically integrated natural gas monopoly has existed for public and private good since about 1930, and in this context, the five year transition period to competition is reasonable.¹⁰⁸

Williston Basin Interstate Pipeline Co. v. FERC, 115 F.3d 1042 (D.C. Cir. 1997). In 1993, the Federal Energy Regulatory Commission denied Williston's request for approval to sell its excess gas storage reserves at market price rather than at cost. In denying a petition for review, the District of Columbia Circuit Court acknowledged that it seemed troubling to

104. *Pacific Gas & Elec. Co.*, Decision 97-11-074.

105. *Montana Power Co.*, 181 P.U.R.4th 397, ¶ 29.

106. *Id.* at ¶ 31.

107. *Montana Power Co.*, 181 P.U.R.4th, ¶ 53.

108. *Id.* at ¶ 55.

deny Williston the benefits of using its purchasing skill to obtain lower costing fuel. Nonetheless, the FERC's restructuring of the natural gas industry had "saddled customers with the burden of losses on storage gas rendered surplus,"¹⁰⁹ so symmetry of risk demanded otherwise.¹¹⁰

Massachusetts Department of Public Utilities, Re Eastern Edison Co., D.P.U./D.T.E. 96-24 (Mass. Dep't Pub. Utils. 1997). On May 16, 1997, Eastern Edison Company (the Company) and Montaup Electric Company submitted a settlement regarding Eastern Edison's restructuring proposal. Eastern Edison estimated its stranded costs at \$601 million, which it claimed was significantly lower than would have been estimated by the FERC formula.¹¹¹ After noting that the company was statutorily required to take all reasonable steps to mitigate its transaction costs, "[t]he Department reviewed the details of the Company's estimates of potentially stranded costs and finds that, subject to future market prices affecting [purchase power agreements] costs and nuclear decommissioning costs, the premitigation amount of stranded costs claimed by the Company is accurate."¹¹² The Department ruled that Montaup's shareholders would assume 20 percent of costs and revenues if it were unable to sell its nuclear units despite retaining decommissioning responsibilities; the Company's ratepayers assume the remaining 80 percent.¹¹³

Massachusetts Department of Telecommunications and Energy, Re Western Massachusetts Electric Co., D.T.E. 97-120-1 (Mass. Dep't of Telecomm. and Energy 1998). WMECo proposed to offset nuclear transition costs with a revenue-sharing performance-based rates (PBR) mechanism, no later than 2003.¹¹⁴ The Department specifically noted that under the Electric Industry Restructuring Act, transition costs could include recovery for nuclear entitlements.¹¹⁵ While the company's plan to securitize the transition costs was not completely approved, the Department held that it had discretion to do so after further investigation.¹¹⁶

Massachusetts Department of Telecommunications and Energy, Re Boston Edison Co., 192 P.U.R.4th 418, D.T.E. 98-119 (Mass. Dep't of Telecomm. and Energy 1999). The Department authorized Boston Edison Company to sell its Pilgrim nuclear power station with related assets, and to recover, potentially unrecovered costs through a fixed component in its transition charge. While noting that "[t]he Restructuring Act does not require electric companies that own nuclear generating assets to divest those units," the Department nevertheless found "that the overall benefit to

109. *Williston Basin Interstate Pipeline Co.*, 115 F.3d at 1044.

110. *Id.* "Thus, if customers are to bear the risk that a dramatic industry transformation (such as restructuring under Order No. 636) will force the realization of losses on specific asset classes, it is hard to see a reason why they should not reap benefits from forced realization of gains."

111. *Eastern Edison Elec. Co.*, Mass. D.T.E. 96-24, at 40.

112. *Id.* at 41.

113. *Eastern Edison Elec. Co.*, Mass. D.T.E. 96-24, at 23.

114. *Western Mass. Elec. Co.*, Mass. D.T.E. 97-120-1.

115. *Id.* at § (IV)(B)(1)(a)(ii).

116. *Western Mass. Elec. Co.*, Massachusetts D.T.E. 97-120-1.

ratepayers of the divestiture transaction outweighs the cost of possible non-recovery of the \$43.8 million... associated with municipal contracts.”¹¹⁷

Connecticut Department of Public Utility Control, Re BHC Corp., Docket No. 98-11-25 (Conn. Dep’t of Pub. Util. Control 1999). BHC wished to sell some of its property. The Department of Public Utility Control granted approval for the BHC Company to dispose of 33.0 acres of real property located in the town of Monroe, Connecticut. The transaction consisted of the sale of a 3.17 acre building lot for \$120,000 and the donation of 29.83 acres to the Town of Monroe to use as open space. The net proceeds from the sale will be used to fund the Company’s capital budget. The Department grants a five-year amortization period for the sale of the building lot, providing ratepayers with approximately 31% of the gain and shareholders with 69%. The donated land was never in rate base and therefore is not subject to allocation.¹¹⁸ The Department’s policy with respect to the allocation of the economic benefits of land sales depends upon and must be consistent with the provisions of Conn. Gen. Stat. § 16-43(d). This statute requires that the economic benefits of the sale of any land that has been in a water company’s rate base be equitably allocated between shareholders and ratepayers. The statute directs that the allocation must be based on the facts of each application, and it gives the Department the authority to allocate the gains between shareholders and ratepayers.

Connecticut Department of Public Utility Control, Re Connecticut Light and Power Co., 191 P.U.R.4th 373 Docket No. 98-01-02, (Conn. Dep’t of Pub. Util. Control 1999). Department directs the utility to reflect gains on all land sales expected to occur by December 31, 1999, as an offset to stranded costs of nuclear generation assets, reducing rate base by some \$2.8 million. Consistent with legislation, CL&P will reflect the gain on sale of relevant property as an offset to stranded costs of nuclear generation assets. The company is actively marketing its surplus property. However, legislation has not compelled the company to market surplus properties or seek to identify other properties more aggressively that it might be able to sell and increase the gains available to reduce stranded costs.¹¹⁹

Connecticut Department of Public Utility Control, Re Connecticut Light and Power Co., 195 P.U.R.4th 74, Docket No. 99-02-05 (Conn. Dep’t of Pub. Util. Control 1999). This proceeding sought to quantify the potential stranded costs by determining the projected market valuations of The Connecticut Light and Power’s (CL&P) various generation assets and power contracts. The stranded costs primarily represent department-approved costs for historical generation investment and long-term purchased power contracts that are now above market value. The identification of stranded costs eligible for recovery is premised on projections of market prices and market valuations, which required the establishment of

117. *Boston Edison Co.*, 192 P.U.R.4th 418.

118. *BHC Corp.*, Docket No. 98-11-25.

119. *Connecticut Light & Power Co.*, 191 P.U.R.4th 373.

a market price forecast for both energy and capacity. The elimination of non-nuclear stranded costs and the substantial reduction in nuclear stranded costs is associated with the Company's estimate of \$1,319,413,000 for the net proceeds from the sale of its fossil/hydro generation assets and land sales. Nuclear costs were further reduced by \$36 million for nominal savings the Company estimates will be achieved during the interim period from its nuclear benefit/cost sharing mechanism.¹²⁰ In this case, proceeds from the sales of assets were used to offset the stranded costs that had occurred as a result of the change in the regulatory contracts.

Maine Public Utilities Commission, Re Central Maine Power Co., Docket No. 99-155 (Me. P.U.C. 1999). The land to be sold in this case was associated with the nuclear plants, where the ratepayers were responsible for the costs. The Maine Public Utilities Commission had shifted the risk of loss from the shareholders to the ratepayers with regard to nuclear facilities, as the ratepayers were paying for the losses. Central Maine Power ratepayers pay a return on the depreciable and non-depreciable investment in Maine Yankee even though the plant is no longer operational and the value of the land is likely below its original cost. In this case, if the land were sold at a loss, ratepayers would be expected to compensate shareholders for their lost investment (absent a finding of utility imprudence) through an amortization of the loss. Moreover, the land in this case was gained under the company's power of eminent domain or threat thereof, thus, the investors did not pay for the initial investment in the land and, thus, were not at risk.¹²¹ Thus, the shareholders were not at risk in this transaction.

Washington Utilities and Transportation Commission, Re Puget Sound Energy, Inc., Docket No. UE-990267, 3rd Suppl. Order (Wash. Utils. and Transp. Comm'n 1999). The company had recently undergone a merger and was seeking permission to sell some of its generation assets. This particular sale had not been approved as part of the merger and was thus subject to a separate proceeding. In its evaluation, the Washington Commission found that "there do not appear to be net power-cost savings from the Colstrip sale transaction. To allow short-term savings to be allocated to shareholders, and longer-term losses to be allocated to ratepayers would be a material shift of benefits and burdens."¹²² The Washington Commission further stated:

[i]f all of the gain from the sale, alone, were deferred and allocated to ratepayers, but all of the short-term savings from power costs were allocated to shareholders, then there would still be a material transfer of benefits from ratepayers to shareholders. Because the over-all transaction, including gain from the sale and power-cost savings, only breaks even, all gain and power-cost savings must be allocated to ratepayers to

120. *Connecticut Light & Power Co.*, 195 P.U.R.4th 74.

121. *Central Maine Power Co.*, Docket No. 99-155.

122. *Puget Sound Energy, Inc.*, Docket No. UE-990267, 3rd Suppl. Order.

protect them from loss.¹²³

The ratepayers were subject to the risk in this transaction, as they were liable for any losses that could occur.

Connecticut Department of Public Utility Control, The Connecticut Water Co., Docket No. 99-05-31 (Conn. Dep't of Pub. Util. Control 1999). The Company's financial transactions of the prior few years included several land sales. The Company estimated the net after-tax proceeds from these sales at over \$109,000. The proceeds were designated to help fund the Company's capital construction projects.¹²⁴ With this caveat as to how the funds were to be used, the company was allocated all of the proceeds.

Connecticut Department of Public Utility Control, The Connecticut Water Co., Docket No. 99-01-28 (Conn. Dep't of Pub. Util. Control 1999). In this decision, the Department of Public Utility Control granted approval for The Connecticut Water Company to sell 4.8 acres of real property located on Straitsville Road in Prospect, Connecticut. The Connecticut Water Company was awarded an eight and one-half year amortization period, resulting in an approximate sharing of the net after-tax gain on the sale of 50% to ratepayers and 50% to shareholders.¹²⁵ The Company's predecessor, the Naugatuck Water Company, acquired the Property in 1889 in conjunction with watershed land needed for protection of the Straitsville Reservoir. The Property was that portion of the parcel that is not on the above named watershed. The Company sought to dispose of the unused land asset to realize the value thereof and to use the proceeds to reinvest in the construction of capital improvements to its water supply system.¹²⁶ The Department split the proceeds between the ratepayers and the shareholders following their interpretation of the statutory requirements.¹²⁷ The Connecticut accounting rules with regard to the allocation of proceeds from the sales of water utilities' lands resulted in an inefficient allocation of the resources.

Connecticut Department of Public Utility Control, Re The United Illuminating Co., Docket No. 99-03-04 (Conn. Dep't of Pub. Util. Control 1999). This proceeding sought to quantify the potential stranded costs by determining the projected market valuations of The United Illuminating Company's various generation assets and power contracts.¹²⁸ United Illuminating agreed that the after-tax proceeds estimated at \$455,091 as of December 31, 1999, should be used to reduce stranded costs.¹²⁹ Given that the ratepayers are responsible for any stranded costs that occur, the Connecticut Department of Public Utility Control properly assigned the pro-

123. *Id.*

124. *Connecticut Water Co.*, Docket No. 00-05-16.

125. *Connecticut Water Co.*, Docket No. 99-01-28.

126. *Id.*

127. *Connecticut Water Co.*, Docket No. 99-01-28.

128. *Connecticut Water Co.*, Docket No. 99-03-04.

129. *Id.*

ceeds on the sales of such assets to the ratepayers.

District of Columbia Public Service Commission, Re Electric Service Market Competition and Regulatory Practices, 199 P.U.R.4th 461, Formal Case No. 945, Order No. 11576 (D.C. Pub. Serv. Comm'n 1999). The commission ordered the adoption of a settlement such that "if PEPCO does not recover the costs of its generating assets, regulatory assets, and transition costs from the proceeds of the sale, such amounts will be recovered through an [asset recovery charge], which will be applied to delivery rates on a per kilowatt-hour basis over a period of five years."¹³⁰ "The Settlement also makes provision for the sharing of any profits recovered from the asset sale above the net book value of PEPCO's generation assets . . . through a [divestiture sharing rider] applied to the Company's retail rates."¹³¹ Under the "no worse off" doctrine, shareholders are given incentive to sell assets for a profit since the ratepayers will not be any worse off from the divestiture.¹³²

Connecticut Department of Public Utility Control, Re Birmingham Utilities, Inc., Docket No. 99-11-04 (Conn. Dep't of Pub. Util. Control 2000). The Department of Public Utility Control granted approval for Birmingham Utilities, Inc. to sell approximately 42.5 acres of real property in an area located in the northeastern part of Ansonia, Connecticut, and a very small portion located in the northwestern portion of Woodbridge, Connecticut. Birmingham Utilities, Inc. was awarded a three-year amortization period, resulting in a sharing of the net after-tax gain on the sale of approximately 16% to ratepayers and 84% to shareholders. In its Application, the Company stated that the subject property was never in rate base, and thus, requested that the Department confirm that 100 percent of the gain on sale be allocated to the Company's shareholders. The Department concluded, however, that allocating a portion of the economic benefit from this land sale to the Company's ratepayers is appropriate. Significant in this conclusion was its review of the Original Ledger Sheet of Property Classification submitted by the Company, where it was noted that transactions related to the subject property were classified under Account 110. Under the Uniform System of Accounts, Account 110 assets are classified as Utility Plant and as such are a part of rate base. Due to the presence of the Account 110 classification on the ledger sheet for the subject property, and with no evidence to the contrary, the Department found that the subject property was carried in rate base.¹³³ The Connecticut accounting rules with regard to the allocation of proceeds from the sales of water utilities' lands result in an inefficient allocation of the resources.

Connecticut Department of Public Utility Control, Re Birmingham Utilities, Inc., Docket No. 00-05-16 (Conn. Dep't of Pub. Util. Control

130. DISTRICT OF COLUMBIA PUB. SERV. COMM'N, *Electric Serv. Market Competition and Regulatory Practices*, 199 P.U.R.4th 461, ¶ 128.

131. *Id.* at ¶ 131.

132. DISTRICT OF COLUMBIA PUB. SERV. COMM'N, *supra* note 130, at ¶ 159.

133. *Birmingham Utils., Inc.*, Docket No. 99-11-04.

2000). In this decision, the Department approved Birmingham Utilities, Inc.'s request to enter into a Supplemental Indenture amending the terms of a prior mortgage indenture. Pursuant to the new terms contained in the Supplemental Indenture, the bondholder consented to releasing a parcel of land from the lien of the mortgage indenture so that the Company could sell the land. In exchange for the release from the lien, the Company agreed to (1) reduce the aggregate principal amount of all the Company's outstanding long-term debt from 65% to 60%, and (2) extend the prohibition against voluntary redemption of the Series E bond until September 2, 2003. Section 3.15 of the Indenture requires that the aggregate principal amount of all the Company's outstanding long-term debt does not exceed 65% of total capitalization. The Company agreed to replace it with an agreement such that outstanding long-term debt in aggregate principal does not exceed 60% of total capitalization.¹³⁴ In this case the assets were allocated to the company and the shareholders with the understanding that they would be used to reduce the company's debt.

Idaho Public Utilities Commission, Re U S West Communications, Inc., Case No. USW-T-99-25; Case No. CTC-T-99-2; Order No. 28394 (Idaho P.U.C. 2000). In this case U S WEST and the Commission Staff agreed to split the proceeds from the sale via a stipulation. U S WEST maintained "the proposed transfer to [Citizens] represented a complete liquidation of its northern Idaho operations and that, as a result, its shareholders were entitled to all of the gain on the transaction."¹³⁵ The commission staff disagreed, hence the compromise. The order states that "in order 'to avoid the lengthy process and significant expense involved in extended, contested litigation,' the parties compromised by agreeing to a 'settlement amount' of \$12.44 million to be treated as set forth in the U S WEST/Staff stipulation and a stipulation between Staff and Citizens." In reaching the settlement, U S WEST was able to remove the exchange from its rate base more quickly and obtain the funds from the sale. This transaction resulted in a change in the regulatory contract, but simultaneously the investors were also placed at increased risk as there was a change in the market conditions.

Oregon Public Utilities Commission, Re PacifiCorp, UP 168, Order No. 00-112 (Or. P.U.C. 2000). PacifiCorp filed an application with the Public Utility Commission of Oregon for approval to sell its 47.5% interest in the Centralia Steam Generating Plant (Plant) and the rate based portion of the Centralia Coal Mine (Mine). PacifiCorp's decision to sell the Mine and its share of the Plant was based primarily on its concern that new air emissions rules would require substantial capital expenditures at the facilities. PacifiCorp believed it unlikely that the Owners Group would reach the unanimity required regarding the capital investment required to meet the new environmental rules. That failure could lead to a temporary or even permanent plant closure. In addition, PacifiCorp believed electric utility

134. *Birmingham Utils., Inc.*, Docket No. 00-05-16.

135. *U S West Communications, Inc.*, Order No. 28394.

industry deregulation would threaten the recovery of utility plant-in-service investments. For these reasons, PacifiCorp concluded that it would be preferable to sell the asset. As a result of these changes in the regulatory environment, the Oregon Commission concluded that because PacifiCorp's customers bore the risk, they are entitled to the gain from the sale of the plant. However, the Oregon Commission determined that as an incentive to the company, it would allocate a small portion of the gains (5%) to it as an incentive to the utility both to enhance the value of the plant and to use an asset sale process that is most likely to obtain the best price.¹³⁶

136. *PacifiCorp*, Order No. 00-112.