

# COMPETITION BETWEEN PUBLIC AND PRIVATE DISTRIBUTORS IN A RESTRUCTURED POWER INDUSTRY

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## I. INTRODUCTION

Hardly a day goes by anymore when the general press does not offer some story about the new world of electric competition. In many states where retail electric “choice” plans are about to be implemented, one can hear ads on radio and television touting the advantages of various electric suppliers. For years, the only significant competitive battles being waged in the electric utility industry were between public and private electric systems. Those of us old enough to remember may even recall the defense typically offered by private utilities against charges of anticompetitive conduct in so-called “price squeeze”<sup>1</sup> cases during the late 1970s and early 1980s. The supplying utilities would often argue they could not be acting anticompetitively because, with the possible, limited exception of competition for the patronage of aluminum processors, there was no such thing as retail competition in the electric business!<sup>2</sup>

That competition in the retail sale of electric power is now accepted

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1. Price squeeze cases generally involved claims by municipal utilities or rural electric cooperatives that their wholesale suppliers – who also operated adjacent distribution systems – were charging their wholesale customers more for power supply than they “charged” themselves, thereby giving the wholesale suppliers an unfair competitive advantage in the sale of power at retail. *See, e.g., Federal Power Comm’n v. Conway Corp.*, 426 U.S. 271, 274 (1976).

2. *See, e.g.,* testimony cited in *Union Electric Co.*, 8 F.E.R.C. ¶ 63,026, at 65,256 (1979). Dr. Fox-Penner suggests that the criticism may be too harsh since one could consistently advocate robust wholesale markets without believing that electric competition exists at the retail level. Comments on draft of Article, May 16, 1998. Dr. Fox-Penner’s recent book, in fact, notes the views of several economists that franchise competition for new or relocating customers is usually dominated by other factors than the price of electricity. PETER FOX-PENNER, *ELECTRIC UTILITY RESTRUCTURING: A GUIDE TO THE COMPETITIVE ERA* 113 n.50 (1997). For its part, the Federal Energy Regulatory Commission (FERC) had some time ago identified rivalry between utilities for industrial customers and competition for customers located along the borders of utility service areas—“fringe area competition”—as two forms of retail competition in addition to franchise competition. *See, e.g., Connecticut Light & Power Co.*, 8 F.E.R.C. ¶ 61,187, at 61,654-56 nn.25-27 (1979).

by many private utilities not only as inevitable, but as a desirable goal, however, does not render the debates about the benefits of public/private electric competition matters of only historic interest. It is true that discussions about competition for the supply of *power* – what some economists call “competition *in* the market”— no longer are logically confined to choices between public and private utility providers. Delivery or distribution services,<sup>3</sup> however, remain natural monopolies subject to regulation—and to limited, but statutorily protected “competition *for* the market,” i.e., for the right to serve a market.

This article examines the importance of this competition, particularly between publicly and privately owned distribution systems.<sup>4</sup> Part II dispels the myth that a regulatory compact exists to protect regulated monopolies from the risks of competition. Part III looks at the historical role of franchise competition between public and privately-owned utilities. Part IV discusses the relative efficiency of public and private distributors and the relevance to the value of franchise competition. Part V discusses the experience of policy makers in the U.S. and abroad with efforts to promote “competition for the market.” Part VI describes the added importance of franchise competition in a restructured electric industry. Part VII analyzes the anti-competitive shortcomings of the FERC’s open access policies. Finally, Part VIII proposes some modest steps that Congress can take to protect institutional competition.

## II. THE MYTH OF THE REGULATORY COMPACT

Notwithstanding frequent, if unsupported, references by regulated utilities to the alleged “regulatory compact” between regulators and regulated utility monopolies to protect them from the risks of competition<sup>5</sup> and the FERC’s unfortunate, uncritical acceptance of these arguments,<sup>6</sup>

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3. By delivery or distribution *services*, the author refers to delivery or distribution unbundled from the sale of the *commodity* – in this case the sale of electric power.

4. While franchise competition exists – at least on a theoretical level – wholly among private utilities, it is not the focus of this article. One private utility, for example, could take over the operations of a distribution system from the incumbent private utility when its franchise term is up. While this type of competition is no doubt valuable (in an Aug. 20, 1998, conversation with the author, World Bank economist Phil Gray points out that this private-to-private franchise competition is the norm in Argentina), in the author’s experience, it rarely occurs in the United States. The local governments who grant franchises historically have been the most likely competitors for the distribution functions of private utilities. As discussed *infra*, local governments often possess the power of eminent domain. They also have the ability to finance acquisition of utility property through bond issuance. Private utilities potentially competing to replace existing franchises do not have these advantages. Those factors aside, the stranded cost hurdle to franchise competition, discussed later in this article, would impede private-to-private franchise competition in the same way as it limits franchise competition from municipal utilities.

5. See, e.g., *Southern California Edison Co.*, 70 F.E.R.C. ¶ 61,215, at 61,673 (1995).

6. In describing the alleged need for a stranded cost recovery mechanism, FERC’s Notice of Proposed Rulemaking that led to its 1996 order mandating that electric utilities provide open access transmission service (Order No. 888) reasoned as follows:

Moving to competitive generation markets will fundamentally change long-standing regulatory relationships. Utilities have invested billions of dollars in order to meet their

obligations. Those investments have been made under a "regulatory compact" whereby utilities—and their shareholders—expect to recover prudently incurred costs. With the advent of competition, even prudent investments may become stranded. Reliance on past contractual and regulatory practices must be recognized and past investments must be protected to assure an orderly, fair transition to competition.

Notice of Proposed Rulemaking, *Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, F.E.R.C. STATS. & REGS. ¶ 32,514, at 33,049 (1995). FERC adopted its proposed stranded cost rule and the underlying rationale in Order No. 888, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, F.E.R.C. STATS. & REGS. ¶ 31,036, at 31,637, 31,785-89 (1996), 61 Fed. Reg. 21,540, *order on reh'g*; Order No. 888-A, F.E.R.C. STATS. & REGS. ¶ 31,048 (1997), 62 Fed. Reg. 12,274 (1997), *order on reh'g*; Order No. 888-B, 81 F.E.R.C. ¶ 61,248 (1997), *order on reh'g*; Order No. 888-C, 82 F.E.R.C. ¶ 61,046 (1998), *appeals pending*; *Transmission Access Policy Study Group v. FERC*, D.C. Cir. No. 97-1715.

The concept of a "regulatory compact" to protect utilities against the risks of competition that FERC actions might promote, however, runs exactly counter to the intent of federal law. The "history of Part II of the Federal Power Act" the Supreme Court wrote twenty-five years ago, "indicates an overriding policy of maintaining competition to the maximum extent possible consistent with the public interest." *Otter Tail Power Co. v. United States*, 410 U.S. 366, 374 (1973) [hereinafter *Otter Tail*]. Thirty-five years ago, the FERC's predecessor, the Federal Power Commission, eschewed the notion of a regulatory compact when it authorized construction of a pipeline to compete with the incumbent, a decision endorsed by the United States Court of Appeals for the District of Columbia Circuit:

Investors in the natural gas industry, although granted an opportunity for a 'fair return,' are by no means guaranteed freedom from risk or competition. Such assurance would, in a case such as this, deprive competitors of the right to compete, inhibit efficient allocation of resources and deny ultimate consumers the lowest prices to which they are entitled.

*Lynchburg Gas Co. v. FPC*, 336 F.2d 942, 949-50 (D.C. Cir. 1964); *see also* *Panhandle E. Pipe Line Co. v. FPC*, 169 F.2d 881, 884 (D.C. Cir.) *cert. denied*, 335 U.S. 854 (1948). FERC's solicitude for the "stranded cost" burden competition might place on incumbent electric distribution companies also contrasts sharply with its near contemporaneous pronouncements in the natural-gas industry. *See, e.g., Transcontinental Gas Pipe Line Corp.*, 75 F.E.R.C. ¶ 61,072, at 61,227 (1996). "[T]he benefits that accrue to the public as a result of competition in the natural gas industry outweigh any adverse impact that competition may have on particular parties in a particular case." *Great Lakes Gas Transmission L.P.*, 68 FERC ¶ 61,376, at 62,501 (1994). "The Commission, under its bypass policy, will not shield LDCs from the effects of competitive market forces. . . . [T]he Natural Gas Act does not guarantee that current service relationships will remain unchanged." The FERC, it should be noted, has also afforded natural gas pipelines an opportunity to recover portions of the gas supply costs they incurred on behalf of local gas distribution companies (LDCs) where the bundled wholesale gas supply contracts between the pipelines and the customers were prematurely terminated and the customers were given the right to "unbundle" those contracts and purchase only transportation from the pipelines. In Order No. 436, the FERC allowed wholesale customers to "convert" their wholesale contracts to transportation service over a five year period. The Court upheld the general scope of the rule but directed the agency to consider the take or pay impact of its order on the pipelines whose contracts were abrogated. *See Associated Gas Distributors v. FERC*, 824 F.2d 981, 1013 (D.C. Cir. 1987), *cert. denied*, 485 U.S. 1006 (1988). In subsequent orders the FERC directed that the pipelines absorb a portion of the costs of the gas supply contracts they no longer needed. *See American Gas Ass'n v. FERC*, 888 F.2d 136, 144 (D.C. Cir. 1990). Later, in Order No. 636, FERC took the step of immediately terminating the pipelines' remaining wholesale contracts with their customers and directing full conversion to unbundled service offerings. In that context, it concluded that the pipelines should be permitted full recovery of any gas supply realignment (GSR) costs the pipelines prudently incurred but would not be able to recover as a direct result of its rule. *See* Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, F.E.R.C. STATS. & REGS. Preambles ¶ 30,939, at 30,457-462, 57 Fed. Reg. 13,267, *order on reh'g*; Order No. 636-A, F.E.R.C. STATS. & REGS. Preambles ¶ 30,950, 57 Fed. Reg. 36,128, *order denying reh'g and clarifying*; Order No. 636-B, 61 F.E.R.C. ¶ 61,272

Congress has consistently favored the protection of competition from the market power of regulated monopolists.<sup>7</sup> That is why, even in highly regulated industries, there is a presumption that competition should still play a vital role and regulated monopolies should be fully subject to the nation's antitrust laws.<sup>8</sup> Express statutory antitrust exemptions, therefore, "are to be very narrowly construed."<sup>9</sup> It is also the very reason why legislators often make utility franchises non-exclusive.<sup>10</sup>

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(1992), *order denying reh'g*; 62 F.E.R.C. ¶ 61,007 (1993), *aff'd. in part and remanded in part*; *United Distribution Companies v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996), *cert denied*, 117 S.Ct. 1723 (1997); *order on remand*, Order No. 636-C, 78 F.E.R.C. ¶ 61,186 (1997), *reh'g denied*, Order No. 636-D, 83 F.E.R.C. ¶ 61,120 (1998). The District of Columbia Circuit subsequently concluded that the FERC had failed to explain why consumers should be forced to bear the full cost of the transition to a competitive market. See *United Gas Distribution Cos. v. FERC*, 88 F.3d 1105, 1188 (D.C. Cir. 1996). The FERC's stranded cost rule for electric utilities differs from these cases in that it permits utilities to claim stranded costs from former customers even after their contracts have expired. See Order No. 888 at 31,831. In fact, wholesale customers purchasing power under existing contracts cannot obtain open access transmission service *until* their contracts have expired and municipalities forming new electric distribution systems can face stranded cost exposure even where they do not propose to start operations until their franchise agreements with the incumbent utilities have expired. See, *City of Las Cruces v. El Paso Electric Co.*, 83 F.E.R.C. ¶ 63,017 (1998)(Initial Decision)(franchise agreement expired in 1993).

7. *Georgia v. Pennsylvania R. Co.*, 324 U.S. 439 (1945); *McLean Trucking Co. v. U.S.*, 321 U.S. 67, 86 (1944); *Panhandle E. Pipe Line Co. v. FPC*, 169 F.2d 881, 884 (D.C. Cir. 1948), *cert. denied*, 335 U.S. 854 (1948); *Silver v. New York Stock Exch.*, 373 U.S. 341 (1963).

8. See *Silver*, 373 U.S. 341 (1963). See also *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 351 (1963) (stating that only where there is a "plain repugnancy between the antitrust and regulatory provisions" will repeal be implied). Electric utilities have long known that the fact of regulation does not exempt them from the antitrust laws. See, e.g., *Otter Tail*, 410 U.S. 366. And, while states may adopt restrictions on trade if: (1) their policies are "clearly articulated and affirmatively expressed as state policy," (emphasis added) *Lafayette v. Louisiana Power & Light Co.*, 435 U.S. 389, 410 (1978); and if (2) they "supervise actively any private anticompetitive conduct," *Southern Motor Carriers Rate Conf. v. United States*, 105 S.Ct. 1721, 1726-27 (1985), mere approval of a utility's anticompetitive conduct by a regulatory agency will not shield it from antitrust liability. See *Cantor v. Detroit Edison Co.*, 428 U.S. 579 (1976) (holding that state-approved tariff under which utility provided electric customers with "free" lightbulbs did not foreclose private antitrust claim that the practice constituted an unlawful tying arrangement).

9. *Northern Natural Gas Co. v. FPC*, 399 F.2d 953, 960 (D.C. Cir. 1968) (citing *California v. FPC*, 369 U.S. 482, 485-86 (1962)). The principle that competition and regulation are complementary forces is an undercurrent of national antitrust policy. Even limited competition permits the regulator to "universalize these benefits" through the regulatory process. *Id.* at 965.

10. Most state constitutions contain prohibitions of various sorts against the granting of exclusive franchises to individuals or private corporations. See cases cited at 54A AM. JUR. 2D *Monopolies, Restraints of Trade, And Unfair Trade Practices* § 829 (1996). While states often restrict competition among private utilities within designated franchise areas, they do not usually preclude the localities in which the utilities operate from forming their own competing systems. See FEDERAL POWER COMMISSION, NATIONAL POWER SURVEY, Part I, at 19 (1964). (In some states there may be additional hurdles. Maryland, for example, requires municipalities—other than Baltimore—to obtain a certificate of authority from the Maryland Public Service Commission before they can supply gas or electricity to their residents. MD. CODE ANN. art. 78 §53(a)(1997)). On the contrary, the presumption is that, in the absence of an agreement as to exclusivity, the mere grant of a franchise by a municipality to a public utility does not give the public utility a right to be free from competition by the municipality or a third party. *Tennessee Elec. Power Co. v. Tennessee Valley Auth.*, 306 U.S. 118 (1939); *Puget Sound Power & Light Co. v. Seattle*, 291 U.S. 619, 626 (1934) (utility assumed risks of competition

Utility executives and investors have understood the risks of competition as well. Richard Abdoo, CEO of Wisconsin Electric Power Company, testifying before the House Energy and Power Subcommittee in July 1994, stated that "[O]ur company has written off its uneconomic assets, so allowing others to recover stranded costs would penalize us."<sup>11</sup> "A year later he was blunter still, 'Stranded cost is a utility term. In economics its [sic] called uneconomic assets. And in Economics 101 those sunk costs get written off. There's no rocket science involved.'"<sup>12</sup> And, as former Court of Appeals Judge Kenneth Starr wrote in a 1987 case, it has long been settled that "the Fifth Amendment does not provide utility investors with a haven from the operation of market forces."<sup>13</sup>

In short, there is no regulatory compact guaranteeing utilities a return allowance or protection against franchise competition (i.e., the competition between public and private entities for the right to serve) in return for accepting rate regulation.<sup>14</sup> Rather, utilities are regulated because they

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"when it entered the field"). This is true even though, by entering into competition with the public utility, the municipality might thereby undermine the value of the utility's franchise. See 36 AM. JUR. 2d *Franchises* § 35 (1968). In his book, Dr. Fox-Penner notes that until the 1920s "the awarding of franchises, often for short periods or non-exclusively to promote competition, was the primary means of controlling the industry." Peter Fox-Penner, *Electric Utility Restructuring: A Guide to the Competitive Era*, in PUB. UTIL. REP. 95 (1997) (emphasis added). The foregoing is not to say that the franchise is irrelevant. On the contrary, where a franchise agreement has a stated term and related notice of termination provisions; the agreement, like a wholesale contract, establishes mutual rights and obligations. If a franchise agreement is terminated early, or a wholesale contract is terminated before its term has expired, the supplying utility would logically be entitled to some form of compensation. Equitable considerations of a similar, quasi-contractual nature may also come into play in the retail wheeling context. While there are typically no existing contracts between the distribution utility (public or private) and its retail customers, there is a statutory or common law utility obligation to serve. In other words, as long as the utility has a franchise to operate, it cannot refuse service to any retail customers in its operating territory. In these circumstances the regulator may conclude that a shift to retail wheeling amounts to premature termination of the quasi-contractual arrangement between the utility and its customers and fashion some form of relief.

11. David W. Penn, *ELECTRICITY J.*, Dec. 1994, at 2.

12. Peter A. Bradford, former Chairman of the Maine Public Utilities Commission and the New York Public Service Commission, Presentation before the Vermont Public Service Board (July 15, 1996) <<http://www.state.vt.us/psd/Vttesty2.htm>> (quoting *ENERGY DAILY*, Dec. 4, 1995, at 4) [hereinafter Bradford Testimony].

13. *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1191 (D.C. Cir. 1987) (Starr, J. concurring). This is an old lesson. "The loss of, or the failure to obtain, patronage due to competition," the Supreme Court wrote in 1933, "does not justify the imposition of charges that are exorbitant and unjust to the public. The clause of the Constitution here invoked does not protect public utilities against such business hazards." *Public Serv. Comm'n of Montana, v. Great N. Utils. Co.*, 289 U.S. 130, 135 (1933). In other words, while utilities are assured a reasonable *opportunity* to earn their allowed return, they have no right to charge "exorbitant" rates to achieve allowed returns, since such rates would be beyond the "zone of reasonableness." *Jersey Cent.*, 810 F.2d at 1177. Judge Starr did describe a "compact of sorts" involving a "monopoly on service in a particular geographical area" and "a regime of intensive regulation," *Id.* at 1189, but pointed out that while confiscatory rates would constitute a regulatory taking, "[i]n like manner, a regulatory order requiring ratepayers to pay monopolistic prices would fail to achieve the constitutionally required balance of interests." *Id.* at 1191 n.4. See also, *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1988).

14. Bradford Testimony, *supra* note 12, at 2. But cf. J. Gregory Sidak & Daniel F. Spulber, *Deregulatory Takings and Breach of the Regulatory Contract*, 71 N.Y.U. L. Rev. 851 (1996). The central

possess market power and because competition, while still valuable, was believed to provide insufficient protection to the public against abuse of that market power.<sup>15</sup> When regulators take actions within their lawful authority to promote competition they are not contravening any regulatory compact; they are acting in furtherance of their historic obligations to treat regulation and competition as complementary forces.

In this context, the institutional competition between public and private distribution systems remains an important form of consumer protection—one that is threatened by elements of the FERC's stranded cost policies under Order No. 888<sup>16</sup> that erect enormous barriers to the formation of new municipal electric utilities. By focusing on the avoidance of what it perceives would be large-scale "stranded" generating costs attending municipalization,<sup>17</sup> the FERC has ignored the benefits of franchise competition in keeping retail distribution costs to the customer in check.<sup>18</sup> This is a message Congress should bear in mind as it considers

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theme advanced by the authors is that when government acts to promote open access to regulated network industries (like gas pipelines, electric transmission systems and telecommunications facilities) it diminishes private property values in violation of the Constitution's Takings Clause. While the authors acknowledge the breadth historically accorded to government to regulate without "taking," *id.* at 939, they argue that the Constitution's protection of property holders against government interference "with distinct investment-backed expectations," *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978), warrants stranded cost protection for utilities now forced by regulation to open their systems to competition. 71 N.Y.U. L. Rev. 851, at 945-46. The argument, however, presupposes that "[p]rivate property protection is the basis for utility regulation." *Id.* at 953. As discussed above and at note 15, however, regulation is a response to the dangers of unfettered market power and is not intended to immunize those regulated from the vicissitudes of competition. Moreover, as discussed in Section VII, note 48, *infra*, electric utilities plainly cannot claim a reasonable expectation of protection from wholesale competition.

15. See, e.g., *Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137, 143 (1960) ("primary practical problem that led to the passage of the [Natural Gas] Act was the great economic power of the pipeline companies . . ."); *Tenneco Oil Co.*, 26 F.E.R.C. ¶ 61,030, at 61,069 (1984), *remanded on other grounds* ("The fact that interstate pipelines can dictate the terms of their contracts entered into with their customers forms at least one of the premises for regulation."); *Maryland People's Counsel v. FERC*, 761 F.2d 768 (D.C. Cir. 1985); Harvey L. Reiter, *Is the Pipeline's Certificate Obligation an Impediment to Competition in the Natural Gas Industry?*, 5 J. ENERGY L. & POL'Y 217, 221 n.22 (1984) ("The legislative decision to regulate is itself an implicit determination that competition in the regulated industry supplements but does not completely substitute for regulation . . ."); *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1508 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 1034 (1984) ("It is of course elementary that market failure and the control of monopoly power are central rationales for the imposition of rate regulation." (citing S. BREYER, REGULATION AND ITS REFORM 15-16 (1982))).

16. Order No. 888, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, F.E.R.C. STATS. & REGS. ¶ 31,036, at 31,842 n.868 (1996), 61 Fed. Reg. 21,540 (1996), *order on reh'g*; Order No. 888-A, F.E.R.C. STATS. & REGS. ¶ 31,048 (1997), 62 Fed. Reg. 12,274 (1997), *order on reh'g*; Order No. 888-B, 81 F.E.R.C. ¶ 61,248 (1997), *order on reh'g*; Order No. 888-C, 82 F.E.R.C. ¶ 61,046 (1998), *appeals pending*; Transmission Access Policy Study Group v. FERC, D.C. Cir. No. 97-1715.

17. By "municipalization," the author refers to the process by which a political subdivision replaces an incumbent private distributor of electricity. The first use of the term of which the author is aware appears in Leonard W. Weiss, *Antitrust in the Electric Power Industry*, in PROMOTING COMPETITION IN REGULATED MARKETS 135, 158 (Almarin Phillips ed., 1975) [hereinafter Weiss].

18. Several commentators have taken this concern with "stranded" costs a step further, decrying

comprehensive legislation on electric industry restructuring.<sup>19</sup>

### III. THE HISTORICAL ROLE OF FRANCHISE COMPETITION IN PROMOTING EFFICIENCY

More than twenty-five years ago, Alfred Kahn, in his oft-cited treatise, *The Economics of Regulation: Principles and Institutions*, described the phenomenon of municipalization as an example of the "intense rivalry between . . . public and private systems."<sup>20</sup> "[T]here is strong evidence in the public utility arena," he wrote, "that *competition between* the two systems of organization, like competition among private businesses, is

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municipalization as a means to avoid the legitimate stranded cost obligations that would be paid by a utility's distribution customers once retail wheeling (i.e., transmission to end users) were permitted. See Michael J. Doane & Daniel F. Spulber, *Municipalization: Opportunism and Bypass in Electric Power*, 18 ENERGY L.J., 333, 338 (1997) [hereinafter *Bypass*]. To be sure, some forms of marketing devices, loosely referred to as municipalization, do not involve the lease, acquisition or duplication of distribution networks and hence do not create competition in the distribution of electricity. The authors, for example, describe "muni-lite" proposals by political subdivisions under which the municipality would acquire meters through which power would pass before delivery to the end-user. These meters would constitute the only facilities controlled by the municipal utility, which would resell the power, delivered to its meters, to end-users. *Id.* at 338-40. While section 201(a) of the Federal Power Act, 16 U.S.C. § 824(a), grants FERC jurisdiction to regulate transmission in interstate commerce, and while the FERC can compel transmission of power for resale, it cannot compel transmission to retail customers (retail wheeling). Section 212(h)(b)(2) of the Act bars retail wheeling and "sham" wholesale transactions and the FERC has invoked that provision to deny "muni-lite" wheeling arrangements. *City of Palm Springs, Cal.*, 76 F.E.R.C. ¶ 61,127 (1996); 84 F.E.R.C. ¶ 61,025 (1998) (order directing complainants to show cause why complaint had not become moot). The authors, however, lump muni-lite arrangements together with what they describe as "traditional municipalization" proposals, (*Bypass* at 335) condemning them all as attempts to "evade" legal responsibility for stranded costs. *Id.* at 338. What the authors pejoratively refer to as examples of "opportunism and bypass," however, are ordinarily hailed as examples of the market at work – competitors offering cheaper supplies and customers seizing the economic opportunities to reduce their costs. The irony in these arguments is that the landmark Supreme Court case opening the electric industry to competition, *Otter Tail*, 410 U.S. 366, was a "municipalization" case. In that case the Court upheld a claim that the utility's refusal to "wheel" or transmit lower cost power for a newly-formed municipal distribution utility (one of Otter Tail's former franchise territories) violated the Sherman Act. Under the "takings" theory, Otter Tail could have avoided antitrust liability (and the financial consequences) simply by agreeing to wheel, but then charging the municipality for the same costs (including a return on its investment) that it would have recovered had the municipal utility never gone into business.

19. Equally important, but beyond the scope of this article, is the role of state regulatory policy in ensuring that utility rate structures do not impede the development of "distributed generation," demand-side management, and integrated resource planning as alternatives to local distribution system expansions. See Christopher Cook, *Competitive Distribution Services in a Restructured Electric Industry*, POWER VALUE, Jan.-Feb. 1998, at 26. Cook, Assistant Director for Policy and Planning with the Maryland Energy Administration, writes that traditional state regulatory policies, applied to a restructured power industry, send inadequate price signals about the costs of distribution system expansions. Because the costs of system expansions to serve new loads are typically averaged in with the utility's overall costs in setting rates, distribution costs to all customers rise, but the true costs of the expansion to the new user are masked by the averaging process. *Id.* at 28, 32. Pricing the expansion incrementally, he states, gives customers the incentive to investigate other, potentially less costly alternatives, such as fuel cells, on-site generation, and conservation measures. *Id.*

20. 2 ALFRED E. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 105 (1971).

highly conducive to improved performance."<sup>21</sup> He concluded as follows:

The fact is that the competition-by-example or by threat of displacement by public enterprise has greatly improved the performance of this industry. The competition of public with private power has probably been a much more powerful influence than regulation in this respect, and particularly in bringing about dynamic price reduction, sales promotion, and extension of service.

Congress has historically taken a similar view. The availability of preference power to municipal "public bodies," for example, has long been a means to *induce* franchise competition in the hope that it would spur the private utilities to reduce their rates.<sup>23</sup>

Concerns over franchise competition are also what led Florida Power & Light Company (FP&L)—twenty years ago—to seek cancellation of its wholesale tariff, an action which the FERC found to be anti-competitive:

*Acquisition efforts and Franchise competition.* The principal allegation leveled against FP&L's tariff limitations is that by restricting access to wholesale power the Company may thereby increase its dominance as a retail supplier. The record is richly detailed with evidence of retail competition to serve entire communities between FP&L and existing municipal systems.

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In summary, the record documents 20 years' worth of franchise competition between FP&L and the municipal utilities located within its service territory. At various times FP&L has promoted acquisition or willingly received municipal proposals. Most, if not all, of those incidents occurred when the municipal systems were arranging new bulk power supplies from the options of self-generation, wholesale purchase from FP&L, and retail purchase from FP&L after franchise disposition.

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The Company appears well aware of the relationship between its wholesale sales to municipal utilities and its ability to retain existing retail franchises. In March of 1977, a market development presentation was made to FP&L management which stressed, *inter alia*, the need to maintain the integrity of the Company in relation to publicly financed utilities . . . . Between 1976 and 1985, for example, franchises covering retail sales to 41.8% of the FP&L's customers are to expire . . . . In addition, FP&L serves another 93 communities at retail with no franchise agreement. Franchise competition can be a positive force to encourage better service and lower rates; thus, a utility should not be allowed to tilt the balance by artificially making

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21. *Id.* at 104.

22. *Id.* at 105-06. From the context it appears that Professor Kahn's remarks were addressed to the pressures that franchise competition would place on both a utility's distribution and power costs. *See also*, Matthew Cohen, Essay, *Efficiency and Competition in the Electric Power Industry*, 88 YALE L.J. 1511, 1521-24 (1979).

23. *See* *Power Auth. of the State of New York v. FERC*, 743 F.2d 93, at 98, 104 (2d Cir. 1984)[hereinafter PASNY]. *See also* *Metropolitan Transp. Auth. v. FERC*, 796 F.2d 584, at 592 (2d Cir. 1986), *cert. denied*, 479 U.S. 1085 (1987). The term "preference power" is typically used in reference to the requirement in various federal laws that power produced by federal projects such as the Tennessee Valley Authority, the Bonneville Project, the Central Valley Project, etc., be sold first to rural electric cooperatives, municipal utilities and other public bodies. PASNY, 743 F. 2d at 104.



wholesale service unattractive to potential retail market entrants.<sup>24</sup>

Franchise competition, of course, runs in both directions. Utilities also take over utility operations from municipal utilities where their operations become uncompetitive.<sup>25</sup> It is the threat of displacement that has the salutary effect on the performance of both public and private utilities.

#### IV. ARE PRIVATE UTILITIES INHERENTLY MORE EFFICIENT THAN PUBLIC ONES, AND IF SO, DOES IT MATTER?

An argument often advanced to support privatization of public assets is that private companies are inherently more efficient than their publicly owned counterparts. It is, in fact, an argument underlying many of the efforts by the World Bank and the International Monetary Fund (IMF) to encourage privatization in developing countries.<sup>26</sup> If public versus private distribution of electricity was purely an either/or choice (as it may be in small, lesser-developed countries), conclusively determining the accuracy of the argument would be of considerable importance. In such a case, one would be faced with two evils: public and private monopoly. Neither is palatable, but one would desire to choose the lesser of the two evils.<sup>27</sup>

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24. *Florida Power & Light Co.*, 8 F.E.R.C. ¶ 61,121, at 61,458, 61,460, 61,461 (1979) (citing *United States v. Otter Tail Power Co.*, 331 F. Supp. 54, 61 (D. Minn. 1971)).

25. Between 1955 and 1965, for example, a period of considerable merger activity, private utilities acquired about 150 municipal electric systems. Weiss, *supra* note 17, at 165. Between 1960 and 1969, 23 new municipal utilities were established, while 72 were acquired by privately-owned utilities. Cohen, *supra* note 22, at 1522 n.53. Between 1970 and 1994 an additional 56 municipal utilities were formed. Fox-Penner, *supra* note 2, at 113 n.50. While, on a theoretical level, there is also franchise competition between private utilities or between public agencies, the institutional nature of franchise competition between public and private utilities adds a dimension not otherwise present. And so far as the author is aware, most documented franchise switches—outside of mergers between large private utilities—occur in a private versus public context. In the case of large private mergers, moreover, particularly between adjacent utilities, franchise takeovers also have the effect of diminishing yardstick competition (a related concept discussed *infra*).

26. RAYMOND M. DUCH, *PRIVATIZING THE ECONOMY: TELECOMMUNICATIONS POLICY IN COMPARATIVE PERSPECTIVE 1* (Univ. of Michigan Press 1991) (citing Don Babai, *The World Bank and the IMF: Rolling Back the State or Backing its Role*, in *THE PROMISE OF PRIVATIZATION: A CHALLENGE FOR AMERICAN FOREIGN POLICY* (Raymond Vernon, ed., New York: Council on Foreign Relations, 1988)). Duch writes that while the evidence indicates that public enterprises typically perform less efficiently than private firms (public ownership of electric utilities in the United States being one exception), significant success stories like publicly-owned Televerket in Sweden (a telecommunications company) suggest that "something other than ownership influences the performance levels of public and private enterprises." Duch, pp. 36-37. That something, he concludes, is the degree of political control or influence. Where governments exercise political control over management decisions, performance is adversely affected whether those firms are publicly or privately owned. *Id.* at 38-40; 259-60. This author's experience in working on several World Bank matters is that Bank officials hope privatization will reduce government's heavy involvement in the management decisions of enterprises now under public ownership. Political influence over the utility sector in lesser-developed countries often results in inefficient subsidies supported by artificial rate structures. See, e.g., *REVIEW OF ELECTRICITY TARIFFS IN DEVELOPING COUNTRIES DURING THE 1980'S*, (World Bank Industry and Energy Department Working Paper, Energy Series No. 32, 1990).

27. Milton Friedman has characterized it as a choice between *three* evils: "private monopoly,

Franchise competition, on the other hand, allows public and private ownership structures to be pitted against one another, thereby enhancing the performance of both. Even without empirical study, for example, it would seem obvious that competition between the U.S. Postal Service and private carriers like Federal Express and UPS has improved customer service for the delivery of parcels and overnight packages. Similarly, both public and private colleges and universities have long competed to perform basic research and each has contributed valuable scientific, medical and other discoveries.

Assuming one could precisely measure the relative efficiency of public versus private ownership structures, the absolute level of efficiency would decline if only one form of ownership existed and franchises were completely exclusive.<sup>28</sup> As John Donahue of Harvard's Kennedy School of Government observes:

Organizations (including public ones) that must match the pace set by ambitious rivals are virtually always more efficient than organizations (including private ones) that are secure against challenge. Most of the kick in privatization comes from the greater scope for rivalry when functions are contracted out, not from private provision *per se*.<sup>29</sup>

In any event, there is no consensus that private electric utilities are relatively more efficient than public ones. On the contrary, a number of studies suggest the opposite to be true. "The evidence," Donahue concludes, "broadly contradicts the common presumption that private utilities will operate more efficiently than their public counterparts."<sup>30</sup> In *Privatizing the Economy*, University of Houston Professor Raymond Duch similarly concludes that, "[a]lthough the results have been somewhat ambiguous, overall they suggest publicly owned utilities are somewhat more efficient than privately held firms."<sup>31</sup> A recent study by George Washington University Professor John E. Kwoka, Jr. reached like conclusions. Kwoka found that "investor-owned utilities achieve greater efficiency in generation," but that publicly owned utilities had lower

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public monopoly, or public regulation." MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 28 (1962).

28. If only private ownership existed, but the market supported many direct competitors, the issue of preserving institutional competition would have far less importance.

29. JOHN D. DONAHUE, *THE PRIVATIZATION DECISION* 218 (1989). In support of his conclusion that "private monopolies develop the same kind of organizational slack that plagues public agencies," Donahue cites Walter Primeaux, *An Assessment of X-Efficiency Gained through Competition*, *REVIEW OF ECONOMICS AND STATISTICS* 59 (1977). *Id.* at 233 n.62. Primeaux's study of direct competition between electric utilities, he notes, "found that competition reduced costs by about 11 percent, on average, regardless of whether utilities are public or private." *Id.*

30. *Id.* at 76.

31. Duch, *supra* note 26, at 36. See also, William J. Hausman & John L. Neufeld, *Property Rights versus Public Spirit: Ownership and Efficiency of U.S. Electric Utilities Prior to Rate-of-Return Regulation*, 73 *REV. OF ECON. AND STAT.* 3 (1991); Lon L. Peters, *Attenuated Property Rights and the Electric Power Industry: Are Publicly-Owned and Privately-Owned Utilities Really Any Different?* (July 1991) (paper prepared for Western Conference Advanced Workshop, San Diego); JOHN E. KWOKA, JR., *POWER STRUCTURE: OWNERSHIP, INTEGRATION, AND COMPETITION IN THE U.S. ELECTRICITY INDUSTRY* 140 (1996).

overall costs, attributable to their lower costs “in the distribution function, attesting to the ‘comparative advantage’ of public systems in end-user tasks.”<sup>32</sup>

#### V. THE EXPERIENCES OF POLICY MAKERS WITH FRANCHISE COMPETITION

Congress has not been unique among legislatures in adopting policies designed to promote franchise competition. Public policy makers around the world, at both national and local levels, have wrestled with options, not only to increase the scope of competition in traditionally regulated industries like telecommunications, electricity and natural gas, but to preserve some form of competition in distribution services, i.e., those services with natural monopoly characteristics. In many countries, governments have sought to supplement regulatory oversight of natural monopoly with mechanisms to create competition “for the market.”<sup>33</sup> Franchising procedures under which local, state or federal governments award franchises of finite duration to entities that will run local gas, electric and water distribution systems, have been employed successfully as a means of introducing a form of competition for the right to do business within the geographic area. In addition to the pressure that a fixed term franchise places on the incumbent to perform well and contain costs, having a multiplicity of distribution franchises to compare allows the regulator to employ comparisons of the performances of various franchisees as a form of “yardstick competition.”<sup>34</sup>

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32. Kwoka, *supra* note 31, at 140. It also bears note that, although private distribution systems, on average, are larger than their public counterparts, that size differential does not itself translate into a cost advantage. Discussing the point in 1964, the Federal Power Commission observed that “[t]he physical nature of distribution systems permits many small distributors to operate their systems with a quality of service and at costs which are frequently comparable to those of larger power systems.” FED. POWER COMM’N NAT’L POWER SURV., pt. I, at 28 (1964). “A major reason why relatively small distribution systems are economically feasible,” it observed, “is that the cost of distribution is much more sensitive to the intensity of customer loads than it is to the size of the system.” *Id.* See also, Leonard W. Weiss, *Antitrust in the Electric Power Industry*, in PROMOTING COMPETITION IN REGULATED MARKETS 135, 145-46 (Almarin Phillips ed., 1975). There are, of course, a number of studies that suggest publicly owned utilities are less efficient, as Dr. Fox-Penner has noted in commenting on an earlier draft of this article. I had not intended to suggest otherwise, but rather to emphasize that there was no consensus that privately-owned electric utilities were inherently more efficient.

33. See, e.g., MICHAEL KLEIN & PHILIP GRAY, WORLD BANK, PUBLIC POLICY FOR THE PRIVATE SECTOR, COMPETITION IN NETWORK INDUSTRIES – WHERE AND HOW TO INTRODUCE IT, (Washington, D.C., Jan., 1997); CAROLYN VAN DEN BERG, PUBLIC POLICIES FOR THE PRIVATE SECTOR, WORLD BANK, WATER PRIVATIZATION AND REGULATION IN ENGLAND AND WALES (1997); Harold Demsetz, *Why Regulate Utilities*, 11 J. L. & ECON. 55-65 (1968).

34. Claude Crampes & Antonio Estache, *Regulating Water Concessions: Lessons from the Buenos Aires Concession*, in THE PRIVATE SECTOR IN INFRASTRUCTURE, PUBLIC POLICY FOR THE PRIVATE SECTOR, WORLD BANK, (1997). See also Weiss, *supra* note 17, at 146. Franchises (“concessions” in the World Bank literature) can take a variety of forms. Ownership of the assets can remain in the hands of the operator (the typical U.S. utility model). Alternatively, the local government can retain asset ownership, but turn control of the assets over to the operator, giving the operator responsibility for facility replacements, expansions and improvements. Discussion with

In 1971, looking to employ yardstick and franchise competition, Minneapolis decided to award two franchises for refuse collection for different parts of the city: one to the municipal sanitation division and a second to a private corporation. The results were striking:

The city kept records on the performance of its own department and of the corporation. The analysis of these records . . . for the period 1971-75, showed that both the municipal sanitation division and the private firms improved their efficiency over the period: the number of tons collected per shift increased whereas the number of customers' complaints decreased. There seems to be no doubt that it is the increased competition which caused the productivity of refuse collectors to rise. Indeed, there was no change in the technology of refuse collection between 1971 and 1975; the same trucks were used throughout the period and the frequency of collection, the crew size and the location of disposal sites remained unchanged. Besides, it could be observed that, as the city department increased its productivity to match that of the private firms (it reduced the number of crews working each day and it emulated the private firms by implementing an incentives system according to which workers could leave the job after completing their routes), the corporation reacted by adding extra services at no extra cost and by agreeing to a 4 percent price reduction in 1975.<sup>35</sup>

## VI. FRANCHISE COMPETITION IN A RESTRUCTURED ELECTRIC INDUSTRY

What has been particularly significant and valuable about franchise competition is that it has acted to place competitive pressure on distribution costs, even where the power generation costs of public and private competitors were expected to be comparable, as highlighted by Florida Power & Light Company's refusal to sell wholesale power, discussed earlier. FP&L was worried that, even if municipalities purchased its power, they could undercut its rates by offering lower cost distribution.<sup>36</sup> Franchise competition as a supplement to regulation of

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Bernard Tenenbaum, Deputy Director, Office of Economic Policy, Federal Energy Regulatory Commission (Apr. 23, 1998). Even privately owned utilities have begun experiments with management of some distribution functions by outside contractors. For example, The Brooklyn Union Gas Company, a gas distribution utility, has entered into one year contract with Enron Capital and Trade Corporation to manage its contracts for gas supply and capacity held on interstate pipelines. See Notice Requesting Comments, *Proposal by The Brooklyn Union Gas Company to Enter into An Asset Management Agreement with Enron Capital and Trade Resources Corp.*, Case No. 98-G-0239, New York Public Service Comm'n (Feb. 20, 1998).

35. Michel Kerf, *The Impact of EC Law on Public Service Concessions—a Legal and Economic Analysis*, 18 *WORLD COMPETITION* 4, at 115 (June, 1995). Kerf also recounts examples of effective yardstick competition being employed by Great Britain, France, Hungary and Argentina in the water and telecommunications industries. See *id.* at 114-17.

36. Dr. Fox-Penner has written that "one keystone issue in utility restructuring is whether to abandon the retail franchise concept entirely in favor of a choice of retail suppliers," Fox-Penner *supra* note 2, at 95, and has suggested in comments on a draft of this Article that I have overstated the importance of competition in distribution. I do not mean to suggest that franchise competition is the predominant form of electric industry competition (distribution typically accounts, after all, for less than ten percent of electric costs), but as Dr. Fox-Penner also notes "direct access itself does not guarantee that economic efficiency of power distribution will improve." *Id.* at 263. The author's point is that retail stranded cost policies can diminish the valuable impact that competition can have on the

distribution monopolies takes on perhaps even greater importance today. As Professor Harry Trebing, former Director of Michigan State University's Institute of Public Utilities, has observed, if regulated utilities can shift resources into unregulated activities like power sales, "asymmetric deregulation will provide an incentive to fragment the network by transferring assets to nonregulated activities [and] will be an inducement to dis-invest in the network whenever alternative profits appear to be higher."<sup>37</sup> "Any network disinvestment," he added, "could result in both a denigration of infrastructure and quality of service."<sup>38</sup> As generation becomes unregulated, and distribution, generation, and transmission become functionally unbundled, private utilities will have increasing incentives to shift resources to unregulated power sales and away from investment in the distribution network. Franchise competition can work to offset this tendency.

#### VII. FERC REGULATORY POLICIES THAT IMPEDE FRANCHISE COMPETITION

Although offering consumers the prospect of lower power supply costs through wholesale and retail choice,<sup>39</sup> the FERC's open access policies do not address the need to provide low cost, reliable, retail delivery services. On the contrary, its policies on municipalization and stranded cost recovery have the effect of dampening franchise competition and the attendant incentives to reduce distribution costs.<sup>40</sup>

Under the provisions of Order No. 888, the FERC has declared itself the primary forum for the resolution of claims by private utilities that municipalization will result in stranded generating costs.<sup>41</sup>

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quality and efficiency of power distribution. Serious concerns about the quality and cost of distribution exist quite apart from the cost of power. The Chicago City Council, for example, ordered a report from its Department of Environment on the franchise agreement between the City and Commonwealth Edison, a report prompted by "serious concerns about the reliability of Edison's electric distribution system." Edison Franchise Five-Year Report, Report to the Committee on Energy, Environmental Protection and Public Utilities, Chicago City Council p. i. (July 29, 1996). The report recommended against takeover, noting that Edison was obligated by its franchise agreement to upgrade its facilities. *Id.* at iii. Cost is also a particular concern in rural areas. Distribution costs in portions of Vermont run as high as 12 cents per kwh, dwarfing the cost of power (3-5 cents). Conversation with Raymond Koliander, Chief of the Economic Division and Director of Rates and Tariffs for the Vermont Department of Public Service (Aug. 4, 1998).

37. H. Trebing, Market Concentration and the Sustainability of Market Power in Public Utility Industries 7 (Nov. 11, 1997) (paper presented at the NARUC annual meetings in Boston, Massachusetts) (on file with author).

38. *Id.*

39. Order No. 888 does not, by its terms, extend open access transmission to retail customers, but the FERC's plain intention has been to hasten and encourage that outcome. *See, e.g., New England Power Co.*, 81 F.E.R.C. ¶ 61,281 (1997); *Montaup Elec. Co.*, 80 F.E.R.C. ¶ 61,222 (1997) (orders approving retail open access programs).

40. The current regulatory system may also inhibit other forms of distribution competition such as the development of technical innovations like the fuel cell. Christopher Cook, *Competitive Distribution Services in a Restructured Electric Industry*, POWERVALUE, Jan.-Feb. 1998, at 26.

41. Order No. 888, *supra* note 6, at 31,842 n.868. This and other aspects of Order No. 888 are the

Municipalization, needless to say, is not a new phenomenon. Examples date back well over a century.<sup>42</sup> Moreover, "[t]here has been a steady stream of franchise-related competition and litigation during at least the past 35 years."<sup>43</sup> Claims that municipalization results in stranded costs, by contrast, *are* new. Where private utilities make the contention that they had a "reasonable expectation" to continue serving a community, even beyond the expiration date of a franchise agreement, they have been given a forum by the FERC to litigate their claims.<sup>44</sup>

Historically, when a municipality formed a new electric distribution system and chose an electric supplier other than the utility that historically supplied power to the community, the utility, by definition, would lose load. No "stranded costs" were ever claimed to have resulted from this familiar process, however.<sup>45</sup> The "idled" generation might be absorbed by load growth or sold to new customers. The utility might even elect to leave rates unchanged (either because it was already earning more than its allowed return or because it might need to absorb some costs to remain competitive). While there could be some cost shifting, the FERC itself once recognized that "other ratepayers are not wholly immune from feeling the pinch of competition."<sup>46</sup>

The same phenomenon occurs when large retail customers install self-generation. Yet the FERC has concluded loss of load resulting from "self-help actions," (i.e., relocation to other service territories or installation of self-generation) would not justify recovery of stranded costs because "[t]hese types of retail stranded costs have long been a fact of [market] life for utilities."<sup>47</sup> The FERC's rules, however, force municipalities to defend against stranded cost claims relating to municipalization for the first time,

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subject of various petitions for appellate review now pending in the U.S. Court of Appeals for the District of Columbia Circuit, *Transmission Access Policy Study Group v. FERC*, Docket Nos. 97-1715 et al. The author represents one of the petitioners, the Vermont Department of Public Service.

42. 1964 FED. POWER COMM'N NAT'L POWER SURV. pt I, at 23-5; David Penn, *Public Power's Vital, Procompetitive Role in the U.S. Electricity Industry's Future*, Remarks before the Annual Conference of Michigan State University's Institute of Public Utilities, Williamsburg, Va. (Dec. 11, 1995).

43. Fox-Penner, *supra* note 2, at 95.

44. The process actually puts the onus on the municipality to seek a hearing where the utility makes a stranded cost claim. The FERC's rules then give the municipality the right to seek a binding estimate of stranded costs from the utility and, if no agreement is reached, to seek a hearing before the FERC regarding the utility's claim that it has a "reasonable expectation" that it will continue to provide service. See, e.g., *City of Alma*, 80 F.E.R.C. ¶ 61,265 (1997); *City of Las Cruces, New Mexico v. El Paso Electric Co.*, 80 F.E.R.C. ¶ 61,160 (1997).

45. Indeed, had Otter Tail Power Company been permitted to claim "stranded costs" when Elbow Lake formed its municipal electric system there never would have been an *Otter Tail* Supreme Court case to prod open access. *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973).

46. *Kentucky Utilities Co.*, 23 F.E.R.C. ¶ 61,317, at 61,691 n.79 (1983) (citing *Atlantic Seaboard Corp. v. FPC*, 404 F.2d 1268, 1273 (D.C. Cir. 1968)).

47. Notice of Proposed Rulemaking, *Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, [1994 Proposed Regulations] F.E.R.C. STATS. & REGS., ¶ 32,507, at 32,864 n.18 (1994).

notwithstanding the risk of municipalization—even before open access—has “long been a fact of life for utilities.” By 1979, *nearly twenty years ago*, utilities subject to Nuclear Regulatory Commission license conditions obligating them to wheel power, accounted for more than 80 percent of the industry’s kilowatt-hour sales.<sup>48</sup>

What is the impact of these rules? Their chilling effect is hard to calculate. The cities of Las Cruces and Alma are proceeding with their municipalization plans and are in the midst of litigation at the FERC over the stranded cost claims of El Paso Electric and Consumers Power. For every Las Cruces or Alma, however, there have been numerous communities that have considered and tabled municipalization plans because of the threat of stranded cost claims and the uncertainty they create.<sup>49</sup> The Court of Appeals for the District of Columbia Circuit has characterized the threat of litigating stranded cost proceedings before the FERC as procedures that “hang over any prospective deal like the sword of Damocles.”<sup>50</sup> The prospect of litigating a stranded cost case, the court observed, “generates uncertainty over costs that may completely bar competitive transactions, not to mention the expense of the process itself which could also prove to be prohibitive.”<sup>51</sup>

Nearly thirty-five years ago, the Federal Power Commission wrote in its National Power Survey as follows:

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48. Harvey L. Reiter, *Competition and Access to the Bottleneck: The Scope of Contract Carrier Regulation Under the Federal Power and Natural Gas Acts*, 18 LAND AND WATER L. REV. 1, 78 (1983) (citing *The Nuclear Regulatory Commission's Antitrust Review Process: An Analysis of the Impacts* 8 (Transcomm, Inc. Prepared for the Department of Energy, DOE Contract No. DE-AC01-79PE-70025 (June 1981)); II NATIONAL POWER GRID STUDY, Ch. 14 at 375 (Technical Study Reports, DOE-ERA-0056-2 (Sept. 1, 1979)). The FERC erroneously links the availability of open access transmission under the Energy Policy Act and Order No. 888 with the possibility of municipalization. Notice of Proposed Rulemaking, RM94-7, F.E.R.C. STATS. & REGS. ¶ 32,507, at 32,866 (1994). “Open access,” at least open access sufficient to enhance the potential for municipalization, however, was a realistic option decades before Order No. 888 and the Energy Policy Act of 1992. Utilities have been aware, long before the Energy Policy Act was enacted into law, that the wholesale customer might elect not to continue service upon expiration of its power supply contract. Utilities have been aware for 25 years that a refusal to wheel power placed them at risk of antitrust liability. *Otter Tail*, 410 U.S. 366. Indeed, virtually every electric utility that operates a nuclear power plant in the United States is under some form of wheeling obligation incorporated as a condition of the license received. See, e.g., *Consumers Power Co.*, 6 NRC 892 (1977); *Toledo Edison Co.*, 10 NRC 265 (1979); *Alabama Power Co. v. NRC*, 692 F.2d 1362 (11th Cir. 1982), *cert. denied*, 104 S.Ct. 72 (1983); *Florida Power & Light Co.*, 26 F.E.R.C. ¶ 63,019 (1984); *Pacific Gas & Electric Co.*, 11 F.E.R.C. ¶ 61,246 (1980), *aff'd w/o opinion*, 672 F.2d 262 (D.C. Cir. 1982). The FERC, moreover, has directed that utilities obligated to wheel under nuclear license conditions are obligated to incorporate such wheeling obligations into their transmission rate schedules. These wheeling conditions include requirements to wheel for newly formed municipal electric systems. See, e.g., *Pacific Gas and Electric Co.*, 11 F.E.R.C. ¶ 61,246 (1980); *Florida Power & Light Co.*, 26 F.E.R.C. ¶ 63,019 (1984); *Cleveland Electric Illuminating Co.*, 11 F.E.R.C. ¶ 61,114 (1980).

49. The APPA reports that in the very recent past there have been 150 communities that have asked for information about municipalization. To date, only a handful has proceeded with the formal process of condemnation, etc. (Discussions with APPA officials (Jan. 1998)). The fall-off in municipal utility formation is quite noticeable. In the three decades before what might be called the open-access era (1960-1989), 92 new municipal utilities were formed: 38 between 1960 and 1970, 21 between 1970 and 1980 and 33 between 1980-1989. Only two were formed between 1990 and 1994. Fox-Penner, *supra* note 2, at 113 n.50.

50. *Cajun Elec. Coop. v. FERC*, 28 F.3d 173, 179 (D.C.Cir. 1994).

51. *Id.*

The industry's pluralistic institutional structure, while perhaps inhibiting coordinated operations, has proven a powerful competitive stimulus to management improvement and cost reduction. . . . Together, they provide this country with a system of power supply which at the retail level is generally responsive to local needs and local control.<sup>52</sup>

FPC Commissioner Ross, writing prophetically in a 1968 merger case, warned his fellow Commissioners not to ignore the competitive benefits of a viable public sector in electric distribution:

Thus, as a regulator, I find it most disturbing that the majority does not question more fully the wisdom of permitting a situation which, collectively and in time, could mean the disappearance of public power. Such a result could have significant implications for the customers of both public and private systems.

Let me elaborate. First, a pluralistic electric system, in my opinion, has the potential to lead to lower rates and better service for the consumers of all the systems simply because it provides tangible differences against which the consumers are able to assess their particular utility. For example, the manager of a publicly-owned utility may be more highly motivated to provide certain services to customers since these customers are generally the owners of the system as well. To the extent that he satisfies well his consumers-owners, the public system manager will set a standard against which the private system manager will be measured, despite the latter's primary responsibility to more distant and diffuse shareholders. In other words, the effect of the competing philosophies behind public and private utility systems may well be to assert more fully into the private utility's operations the customer orientation of the public system, thus counter-balancing the influence of the stockholders, who are mainly concerned with profits. It should go without saying that managers of public systems would also do well to adopt some of the efficiency criteria that private managers are more likely to employ. The point is: there won't even be such opportunities without the existence of two, competing sectors in the industry.<sup>53</sup>

### VIII. CONCLUSION

What can Congress do? As it considers comprehensive legislation governing the electric industry, it can take some modest, sensible steps to protect institutional competition. If comprehensive restructuring legislation preserves local autonomy, states and municipalities will be best able to decide what types of local service options they want to provide for their citizens. Public preference legislation historically has been used as "seed money" to stimulate institutional competition between public and privately-owned distributors of electricity. Congress may elect to end such preferences as outdated. If it does so, however, it should consider—as a quid pro quo—barring those utilities located in proximity to former sources of federal preference power from asserting any stranded cost claims at the state or federal level against communities within their franchise territories who elect to municipalize. Finally, Congress can ensure that federal regulatory agencies have no power to bar local

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52. 1964 FED. POWER COMM'N, NAT'L POWER SURV. Pt. I, at 4.

53. *Public Serv. Co. of Indiana*, 39 F.P.C. 498, 500 (1968).



governments, directly or indirectly, from competing with private entities in the performance of public utility services, if that is the wish of the citizens affected. The states, not the FERC, should decide what, if any, compensation is due to utilities for "stranded generation" when their franchises are terminated.

Municipalization has never been an easy process.<sup>54</sup> There are referenda, feasibility studies, the high cost of condemnation, etc. to consider. The FERC's stranded cost policies, however, threaten to foreclose entirely even this most difficult form of competitive entry. In an era when distribution of electric power will be divorced from power generation, institutional competition between public and private distribution systems will take on greater importance than ever before. Congress, as well as public policy makers at the state level, should be vigilant about protecting it.

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54. Even proponents of stranded cost recovery, like Professor Paul Joskow have recognized the formidable barriers that exist to establishment of competing distribution utilities. "While in many states electric franchises are technically non-exclusive," he wrote in 1989, "economic and regulatory barriers to the creation of directly competing distribution systems give most incumbents a de facto exclusive franchise." P.L. Joskow, *The Effects of Economic Regulation*, in HANDBOOK OF INDUSTRIAL ORGANIZATION N.7 (Willig & Schmalensee eds. 1989) (quoted in Fox-Penner, *supra* note 2, at 113 n.46).

