

TRACKING STRANDED COSTS

Ajay Gupta*

I. INTRODUCTION

Electric utilities in the United States have been allowed to recover several costs through regulated rates that they almost certainly will be unable to pass on to consumers in a competitive market. Incumbent utilities in states that have introduced or are contemplating introducing competition for retail electric sales are faced with the prospect of being “stranded” with significant amounts of such costs. Aggregate estimates of these so-called “stranded costs” range from tens of billions to several hundred billion dollars.¹ Sources of potential stranded costs include: (1) investments in generation assets whose market values may have declined below book values; (2) long-term agreements to purchase fuel or deliver electricity at prices that may no longer be competitive; (3) “regulatory assets” that represent previously incurred expenditures whose collection has been deferred by regulators; and (4) state-mandated participation in “energy welfare” programs, such as subsidies to renewable energy providers and low income consumers. The states that have embarked on electricity deregulation have had to confront the phenomenon of stranded costs as well as how to allow for their recovery.²

Those who advocate reimbursing utilities for all costs that may be stranded in a competitive market invoke the concept of a “regulatory compact” between the state and the utility and rely on notions of equity and fairness. They also argue that burdening a utility with stranded costs would cause investors to demand a premium from the utility that reflects the risk of a regulator unexpectedly taking future actions that arbitrarily expropriate shareholder wealth. It is claimed that the company would face a higher cost of capital as a result.³ Opponents of stranded cost recovery have highlighted its perverse effects on a utility’s incentives to control costs. They have also focused on ratepayers’ interests who, under regulation, bore the consequences in the form of higher rates resulting from

* Ajay Gupta (M.B.A. Yale University; J.D. Harvard University; A.M. University of Stanford) is a Senior Associate at Analysis Group/Economics in San Francisco, CA. He has previously served as an Associate at Gibson, Dunn & Crutcher, L.L.P.

1. See, e.g., Baxter & Hirst, *Estimating Potential Stranded Commitments for US Investor-Owned Electric Utilities*, ORNL/CON-406, Jan. 1995 (estimating the stranded costs that were made before deregulation was introduced in any state). Baxter and Hirst examined 160 investor-owned utilities in the United States and concluded that 153 of them would face some stranded costs under competition. “Of these, 17 have [stranded costs] that exceed 100% of their equity, and another 120 have [stranded costs] between 10[%] and 100% of [their] equity.” *Id.* at 17. Baxter and Hirst estimated the utilities’ total stranded costs at \$68.8 billion, a figure that represented 38% of their combined equity. *Id.* at 15.

2. The status of retail electric competition is summarized by a number of organizations on an ongoing basis. See, e.g., Department of Energy, *Energy Information Administration* (EIA) (last modified Feb. 19, 2000) <<http://www.eia.doe.gov>>; *National Association of Regulatory Utility Commissioners* (NARUC) (last modified Apr. 13, 2000) <<http://www.naruc.org>>; William A. Spratley & Associates, Inc., *LEAP Letter* (last issued Jan.-Feb. 2000) <<http://www.spratley.com/leap>>.

3. See, e.g., Stephen F. Williams, Response, *Deregulatory Takings and Breach of the Regulatory Contract: A Comment*, 71 N.Y.U. L. REV. 1000 (1996). See also William J. Baumol & J. Gregory Sidak, *Pay Up or Mark Down? A Point-Counterpoint on Stranded Investment; Stranded Cost Recovery: Fair and Reasonable*, 133 No. 10 PUB. UTIL. FORT., May 15, 1995, at 20.

managerial decisions that subsequently proved to be unwise.⁴ The political issues surrounding stranded costs appear to have been largely settled in favor of allowing recovery. Most states that have enacted electricity restructuring legislation have provided for their incumbent utilities to recover a substantial portion of the total stranded costs that these utilities have claimed.⁵

This article does not seek to revisit the theoretical or policy arguments in favor of or against stranded cost recovery. Instead, it examines the practical issues of measuring stranded costs and devising an appropriate recovery mechanism. These issues have generated considerable debate in proceedings before state public utilities commissions (PUCs).⁶ Academic literature, however, has contributed surprisingly little new or innovative insight to this debate.

Most states that have allowed stranded cost recovery have relied on an administrative process to determine the total amount of such costs that each of their incumbent utilities is likely to face after generation is deregulated. A few states have sought to estimate stranded costs associated with generation assets by encouraging or mandating the divestiture of these assets. Most commentators discussing stranded cost estimation have assumed that these two methods, an administrative determination and a sale of generation assets, are the only available choices for measuring stranded costs.⁷ This article presents another method, one

4. See, e.g., Robert J. Michaels, *Pay Up or Mark Down? A Point-Counterpoint on Stranded Investment; Stranded Investment Surcharges: Inequitable and Inefficient*, PUB. UTIL. FORT., May 15, 1995, at 21.

5. See, e.g., Energy Information Administration, *Status of State Electric Industry Restructuring Activity: Stranded Costs as of December 1, 1999* (last visited Mar. 23, 2000) <<http://www.eia.doe.gov/cneaf/electricity/page/restructure.html>> [hereinafter Electric Restructuring Webpage].

6. This debate has centered on estimating the portion of a utility's investments in physical generation assets that is likely to become uneconomic in a competitive market. Such "stranded investment" is generally the largest and most contentious component of total stranded costs for most utilities. Other elements of stranded costs can be readily quantified. The outstanding balance of regulatory assets on a utility's books represent the amount owed by ratepayers and, hence, constitutes stranded costs in its entirety. The utility's commitments to public support programs, in the form of subsidies to renewable energy sources and qualifying consumers, could be similarly ascertained by inspecting accounting records. Estimating any stranded costs relating to long-term fuel or electricity agreements would involve comparing the contract price with the prevailing market price for agreements of comparable duration. There is no such straightforward method, however, for determining stranded investment.

Stranded investment can be characterized as a loss in the value of a utility's generation plant and equipment arising as a result of deregulation. It is measured as the difference between the net book value, under regulation, of a utility's generation assets and the value that these assets would fetch in the market. The regulated net book value for a utility's generation assets can be verified from rate-base records. Assigning market values to these assets is a much more involved exercise. In state PUC proceedings conducted to determine stranded costs, utilities have urged that market values for their generation assets be estimated by projecting future revenues and expenses under competition. Groups representing electricity consumers, on the other hand, have advocated a mandatory divestiture of these assets to determine their true market values. Alternatively, these groups have argued that any administrative determination of these estimated market values must take into consideration reported sales prices for comparable generation assets from recent transactions.

7. See, e.g., Baxter, *Different Approaches to Estimating Transition Costs in the Electric Utility Industry*, ORNL/CON-423, Oct. 1995 (reviewing and assessing the different proposals for estimating stranded costs that had been advanced early in the restructuring process). Baxter categorized these various alternative approaches along three dimensions: (1) administrative or market valuation; (2) top-down or bottom-up; and (3) ex-ante or ex-post. For example, an ex-ante, bottom-up, administrative valuation would involve projecting revenues and expenses of each power plant of a utility in a competitive market. An ex-ante, top-down, market valuation, on the other hand, would consist of divestiture of bundled generation assets. All the market valua-

that is based on the use of tracking stocks and yields a market-based measure of stranded costs without forcing a divestiture of generation assets.

A tracking stock is a customized class of common stock that is deliberately created to represent an ownership interest in a specific business group of a diversified company. A tracking stock results in an economic separation of the tracked business group from the rest of the company's businesses, but does not require an actual segregation of assets or operations. The separate tracking stocks for a vertically integrated utility's generation and non-generation operations will yield a readily ascertainable market-based measure of the value of the utility's generation business. By relying on such a market value of the generation business, the proposed tracking stock method of estimating stranded costs will avoid the subjectivity and arbitrariness inherent in any administrative determination. The tracking stock method will facilitate a market valuation of a utility's generation business in a manner that allows the utility to continue to maintain ownership and control of its generation assets. Thus, unlike a mandatory divestiture, the tracking stock method will not confront the utility with a choice between stranded cost recovery and retaining its electricity generation business.

In addition to proposing a tracking stock based method for estimating stranded costs, this article also advocates a recovery mechanism that pays out stranded costs directly to the utility's shareholders. The discussion on stranded cost recovery mechanisms, in policy forums and in the academic literature, has been much more muted than the exchange over the appropriate methods for estimating stranded costs. Several states have allowed stranded cost recovery by levying a competition transition charge (CTC) on ratepayers. Academics have generally agreed on the virtues of securitizing such a CTC.⁸ Most state PUCs have followed suit and facilitated such a securitization.⁹ Securitization is desirable because it eliminates regulatory uncertainty over future receipts of stranded cost recovery. However, the proceeds from the securitization of a CTC should be paid out directly to the utility's shareholders instead of being made available to its management.¹⁰ Such a direct pay out will reduce any incentives on the part of the utility's management to exaggerate the magnitude of stranded costs.

Using a hypothetical utility in a fictitious state that has just enacted electricity restructuring legislation, this article develops the proposed tracking stock

tion proposals that Baxter reviewed entail selling generation assets, either individually—the “bottom-up” approach—or in groups—the “top-down” method. The distinction between the ex-ante and ex-post options is the time of the asset sale, i.e., before regulation is repealed or after competition is introduced. None of the market valuation approaches that Baxter reviewed looks to the capital markets to seek a value for a utility's generation assets under competition. Since the early days of this debate over stranded cost estimation, no serious proposal has emerged that has advocated a reliance on investor expectations to derive market values for generation assets. This article attempts to fill this gap.

8. See, e.g., Ward L. Smith & James W. Durham, *Securing Lower Costs for the Present and Future*, ELECTRICITY J., Oct. 1997, at 20; Robert J. Michaels, *Securitized Transition Costs; Rethinking Who Wins and Who Loses*, ELECTRICITY J., June 1998, at 58; Walter R. Hall II, *Securitization and Stranded Cost Recovery*, 18 ENERGY L.J. 363 (1997). But see John R. Hodowal, *The Securitization Swindle: Bailout for Utilities, Bad Deal for Consumers*, ELECTRICITY J., Oct. 1997.

9. See, e.g., Electric Restructuring Webpage, *supra* note 5.

10. One published article has advocated paying a stranded cost recovery directly to the utility's shareholders. Robert J. Michaels, *After Stranding Recovery, What?*, PUB. UTIL. FORT., June 1, 1996, at 14.

method of stranded cost estimation, fleshes out its details, explains the considerations that motivate its various provisions, and demonstrates its use in actual practice.¹¹ The article highlights the advantages of the tracking stock method over both an administrative determination of stranded costs and a forced sale of assets. Finally, it discusses the benefits of tracking stocks in general. Reasons are given, unrelated to any motivations for stranded cost estimation and recovery, that make separate tracking stocks for generation and non-generation businesses compelling capital structures for utilities in a deregulated environment.

The remainder of this article is organized as follows. Section II provides an introduction to and a brief background on tracking stocks. Section III presents a summary of the proposed tracking stock method for estimating stranded costs. Section IV develops a detailed description of the tracking stock method using the example of a hypothetical single jurisdiction utility. Section V highlights the advantages of the tracking stock method over both an administrative determination of stranded costs and a forced divestiture of generation assets. Section VI outlines provisions that will make the tracking stock method safe from any attempted manipulation aimed at increasing stranded cost estimates. Chief among these is reserving a stranded cost pay out exclusively for the incumbent utility's shareholders. Section VII examines the possibility of market failures in the pricing of tracking stocks that might distort stranded cost estimates. Though any such theoretical market failures are unlikely to occur in reality, there are certain safeguards that will make the tracking stock method immune from their effects. Section VIII applies the tracking stock method to the case of a typical real-world utility, a holding company with diversified business operations in power, gas, and other energy and non-energy sectors. Section IX discusses the attractions of a capital structure based on tracking stocks for utilities in the context of the ongoing deregulation in the electric industry. This article argues that utilities should seriously consider issuing separate tracking stocks for their generation businesses regardless of any requirements that a state may impose for estimating and paying out stranded costs. Section X presents some concluding remarks.

II. TRACKING STOCKS

Tracking stocks are also called letter, alphabet, or targeted stocks.¹² A tracking stock is a class of common stock that usually represents an ownership

11. The discussion is limited to retail competition for electricity generation. However, the proposed tracking stock based method can be easily adapted for estimating stranded costs associated with wholesale competition as well. Under this method, a utility that has both a retail and a wholesale load would be no different from any other utility with multi-jurisdictional operations. Interstate wholesale electricity transactions fall within the jurisdiction of the Federal Energy Regulatory Commission (FERC). Therefore, in applying the tracking stock method to a utility with wholesale customers, the FERC would be treated as the equivalent of another PUC that has jurisdiction over the utility.

12. At least 21 different companies have issued a total of 50 tracking stocks, six of which have since been retired, divested, or acquired. The existing listings of tracking stocks, as of the end of 1999, had a combined market capitalization in excess of \$400 billion. Most issuers chose to distribute their new class of tracking stock as a stock dividend to their current shareholders. However, almost one-fourth of all tracking stock issues have been initial public offerings (IPOs) that have raised additional capital for the issuers. See *Country Briefing, USA Finance: Tracking-Stocks Experience Revival*, CFO MAGAZINE, Nov. 9, 1999 [hereinafter *Country Briefing*].

interest in a discrete set of assets and operations of a diversified company. Shares of conventional common stock reflect the fortunes and prospects of the entire company. By contrast, shares of a tracking stock are designed to be the economic equivalent of an equity stake in a particular business line, division, or group within the company.¹³ A tracking stock is linked to this "tracked" division or group by means of separate financial reporting¹⁴ and certain provisions in the company's charter documents that specify the rights, preferences, and privileges of holders of the tracking stock.¹⁵ However, such a division of the company's business operations into separately tracked groups is merely an economic or financial segregation. Issuing a tracking stock for a specific group does not require that the assets or operations of that group be placed in a separate subsidiary. Therefore, even after a company issues separate tracking stocks for some or all of its different business groups, it can continue to directly own and operate these various groups. A tracking stock thus allows investors and the market to place a value on a specific division or group within a company without requiring the company to divest itself of ownership or control of the particular business.

Since tracking stocks offer the benefit of a market-based valuation of assets and operations without requiring actual divestiture, they would constitute an ideal basis to assess the value that an incumbent utility's generation business would fetch in a competitive regime. Such a measure of market value of the utility's generation business could then be used to estimate the total amount of costs that are likely to be stranded as a result of deregulation. This, in a nutshell, is the method for estimating stranded costs which is being proposed. This method requires the incumbent utility to issue a separate tracking stock for its generation business. Because this new stock would track only the generation business, the utility's existing stock would then be linked to its remaining non-generation businesses. A capital structure based on separate tracking stocks for a utility's generation and non-generation businesses would allow the market to value the two businesses separately. Such a separate valuation, however, would be achieved without dislocating the utility's existing management structure or disrupting the utility's day-to-day business operations. The utility could continue to own and operate both its generation and non-generation businesses as

13. For an overview of the main features of tracking stock capital structures, see Erica H. Steinberger & Jeffrey J. Hass, *Introduction to Tracking Stocks*, in *ACQUISITIONS, MERGERS, SPIN-OFFS, AND OTHER RESTRUCTURINGS*, 825 PLI/CORP. 523 (1993).

14. All securities, including tracking stocks, that trade on national securities exchanges, such as the New York Stock Exchange (NYSE), or on the NASDAQ, must be registered under section 12 of the Securities Exchange Act of 1934 (Exchange Act). As a result, such securities are subject to the disclosure requirements of the Exchange Act and any rules that the Securities Exchange Commission (SEC) has promulgated under it. See generally LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 387-471 (3d ed. 1999). The SEC requires companies with tracking stock equity structures to distribute two sets of financial statements to their shareholders. The first set should contain details of the financial performance of the business group that is linked to the particular class of tracking stock that the investor holds. The second set of financial statements must contain details on the financial performance of the entire company on a consolidated basis. Companies usually send both sets of financial statements to their shareholders in a single disclosure document. See, e.g., US Steel Group, 1995 Annual Report, Feb. 13, 1996 (detailing the financial performance of both USX Corp. as a whole and its Steel Group during 1995).

15. See generally Jeffrey J. Hass, *Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness*, 94 MICH. L. REV. 2089, 2096-97 (1996).

before.¹⁶

III. SUMMARY OF THE TRACKING STOCK METHOD FOR ESTIMATING STRANDED COSTS

Consider Electrico, a vertically integrated electric utility, incorporated in Harmony State, a state in Middle America.¹⁷ Electrico has a single class of common stock listed on the New York Stock Exchange (NYSE) under the trading symbol "E." All of Electrico's generation assets and electric customers are located in Harmony State.¹⁸ Electrico is regulated by the Harmony Public Utilities Commission (HPUC). The Harmony legislature has just passed an electricity deregulation bill which provides for competition in the electricity generation market to commence on January 1, 2001. The bill acknowledges that deregulation of electricity generation may impose stranded costs on some of Electrico's generation assets. Consequently, the legislature has authorized the HPUC to evaluate the magnitude of any such stranded costs and devise a mechanism for compensating Electrico's shareholders for them. After public hearings on the issue, the HPUC has submitted a restructuring plan to the Harmony legislature.

The elements of the HPUC's plan that deal with stranded cost estimation and recovery can be summarized as follows. The HPUC would refrain from an administrative determination of the value of Electrico's generation assets in a deregulated market. Instead of seeking to predict the values that a competitive market would or should assign to these assets, the HPUC would allow the market to proceed with its valuation exercise. Specifically, the HPUC would require Electrico to issue separate "tracking" or "letter" stocks that would be economically linked to its generation and non-generation businesses, respectively. Relying on share price data for these generation and non-generation tracking stocks, the HPUC would compute the market value of Electrico's generation assets and use this value to derive stranded cost estimates. The HPUC would authorize recovery of stranded costs by means of a CTC that would be levied on Electrico's ratepayers. Stranded cost reimbursements are intended to compensate Elec-

16. In addition to owning and operating all its assets as before, the utility would continue to be governed by a single board of directors and executive management team. See *infra* Part IX discussing the benefits of combining deregulated generation with regulated transmission and distribution operations and of a unified management for a vertically-integrated utility competing for generation in the deregulated market. Even though a tracking stock capital structure does not formally require any corporate governance changes, separate shareholder bases for the utility's generation and non-generation businesses may lead to ambiguities regarding the board's fiduciary duties of care and loyalty owed to each of the two business groups. In order to minimize the potential for conflict, the utility might put into place institutional arrangements that safeguard the interests of each set of shareholders. Several companies that have adopted tracking stock equity structures have sought to address shareholder fairness issues by setting up separate board committees to oversee the relationship between their different business groups. See Haas, *supra* note 15, at 2091-92. See also *Country Briefing*, *supra* note 12.

17. The State of Harmony lies entirely in the author's imagination. It is to the "right" of Minnesota, to the "left" of Utah, and in proximity to Dorothy's Kansas. See (quite literally) *THE WIZARD OF OZ* (Metro-Goldwyn-Mayer 1939).

18. Electrico has only retail customers and makes no sales in the wholesale electricity market. Since its entire generation is produced and consumed within the State of Harmony, the FERC does not have jurisdiction over Electrico's operations.

trico's shareholders for losses sustained from repeal of the "regulatory compact." Therefore, the HPUC would require that the entire stranded cost recovery be effected as a cash pay out to Electrico's shareholders. To accomplish this, the HPUC would ask the legislature to set up a trust or other special purpose entity (SPE) that would securitize the CTC and make a one-time cash payment directly to Electrico's shareholders.

IV. DESCRIPTION OF THE TRACKING STOCK METHOD FOR ESTIMATING STRANDED COSTS

A. Separate Tracking Stocks for Generation and Non-Generation Businesses.

Under the HPUC's restructuring plan, Electrico would create a separate class of its common stock, called Class "G" common stock, that would be the economic equivalent of an equity stake in Electrico's electricity generation business only. This so-called tracking or letter stock would be linked to the earnings of Electrico's generation assets. Electrico would issue to its existing shareholders, as a stock dividend, one share of its Class G common stock for each share of its existing common stock they hold.¹⁹ Electrico would list its Class G shares on the NYSE under the trading symbol "G." Electrico's existing common stock would continue to trade under the symbol "E."

Creating a separate class of common stock that tracks only the generation business will, by definition, affect the economic and legal rights of Electrico's existing class of common stock which will now track only the non-generation businesses. Since Class G common stock would track Electrico's generation business, each of Electrico's existing shares would be transformed from an equity stake in all of Electrico's business operations into the economic equivalent of an equity stake in only its non-generation businesses. Therefore, in creating Class G common stock, Electrico would not only define the rights, preferences, and privileges of Class G shareholders, but would also redefine the analogous terms of its existing common stock. In effect, Electrico would be splitting or dividing its existing common stock into two separate classes of tracking stocks, a

19. For a summary of the important federal securities law considerations that arise in connection with issuing tracking stocks, see Peter Wirth & William Reardon, *Tracking Stock for High Tech Companies: Part II*, INSIGHTS, Mar. 1995, at 9. For an overview of the federal statutory and administrative framework of securities regulation, see LOSS & SELIGMAN, *supra* note 14. In order to implement a tracking stock capital structure, Electrico will require shareholder approval to amend its charter to authorize its new Class G Common Stock, set forth its terms, and redesignate the terms of its existing Class E shares. Electrico would obtain such shareholder approval by circulating among its shareholders a proxy or information statement that complies with the proxy rules of Regulation 14A, promulgated under section 14(a) of the Exchange Act. Electrico will also amend the Exchange Act registration of its Class E Common Stock to reflect its redesignated terms. In addition, to allow its distributed Class G shares to be listed and traded on the NYSE, Electrico must register these shares under section 12 of the Act. Such a registration is effected by filing a straightforward statement with the SEC and does not involve any staff review. Electrico will also face the question of registering the distribution of Class G shares under the Securities Act of 1933. A tracking stock recapitalization entails a shareholders' vote on a proposal for exchanging one security for two different securities, each with its own respective set of rights, preferences, and privileges. Therefore, a tracking stock dividend, unlike an ordinary stock dividend, may constitute a "sale" under section 2(3) of the Securities Act and, consequently, require a Securities Act registration. In practice, issues seem to register tracking stock dividends under the Securities Act since they must prepare the required disclosure document to satisfy the proxy rules under the Exchange Act.

Class G stock that tracks Electrico's generation business alone and its "transformed" or redesignated existing common stock that would be economically linked to Electrico's remaining non-generation businesses. As indicated above, Electrico's existing common shares will continue to trade, as before, on the NYSE, under their old symbol "E." Even so, in order to distinguish Electrico's "pre-split" or "unified" common shares from those that would be linked only to the generation businesses, the former are referred to as "Class E" shares and the latter as "Class N" shares. Using this terminology, Electrico's capital restructuring can be restated as a split or division of each of its existing Class E common shares into one Class G share, which would track the generation business, and one Class N share, which would be linked to the non-generation operations.

B. Economic Division of Common Stock

In order to issue link Class G and Class N shares, Electrico would undertake a recapitalization. It would amend its charter to specify the respective voting and liquidation rights and dividend policy for each of these two classes of common stock. In addition, Electrico would reorganize its business, at a financial reporting level, into two separate groups or segments, one relating to electricity generation (the Generation Group) and the other relating to the non-generation businesses (the Non-Generation Group). Electrico would prepare separate sets of financial statements for the Generation and Non-Generation Groups. However, Electrico would not be required to separate its actual operations between the two groups. In fact, the ability to "financially" partition a diversified company into different groups, while keeping "real" business operations integrated, is one of the main attractions of tracking stocks. Electrico would effect this financial or economic division by adopting managerial and accounting policies that would enable it to prepare and report complete financial results for each group as though it were a stand-alone enterprise. This would require Electrico to assign its various assets and liabilities to each of the respective groups and to establish policies for allocating the costs of any shared resources between the two groups.

For an integrated utility, separating its generation and non-generation fixed assets should be relatively straightforward. Assigning current assets, such as receivables, and current liabilities, such as payables, to the Generation and Non-Generation Groups should not pose significant problems. However, apportioning the total amount of debt between the two groups might not be an entirely objective process. A simple rule of thumb to accomplish this apportionment in a non-discretionary manner would seek to identify the specific debt instruments issued to finance each of the fixed assets. Each fixed asset, along with its respective debt financing, would then be assigned, as a paired asset and liability bundle, to one of the two groups. Debt for working capital purposes, such as lines of credit, would be apportioned based on the working capital requirements of the two groups.

As a result of the "financial reporting" separation between the two groups, the Generation Group's balance sheet would contain all assets that support Electrico's generation business and its associated liabilities.²⁰ The Non-Generation

20. These assets and liabilities might appear on the Generation Group's balance sheet, and on Electrico's

Group's balance sheet, on the other hand, would contain all of the assets and liabilities relating to the transmission and distribution operations which will continue to be regulated. Since the Generation Group would conduct all of Electrico's operations that would be exposed to competition, it would include all possible sources of stranded costs.

C. Estimating the Market Capitalization of the Generation Business

A period of three months after Electrico splits its common stock into Class G and Class N shares, the HPUC would compute the market value of the Generation Group's assets by adding together the market values for the group's equity and debt. In order to estimate the market value for the Generation Group's equity, the HPUC would look at the preceding month's average of the daily high stock price of Class G shares.²¹ The market capitalization of the Generation Group, derived by multiplying the Class G shares' average daily high stock price by the total number of Class G shares outstanding, would provide an estimate of the stock market's value of the Generation Group's equity.²² However, the adequacy of this measure of the market value of the Generation Group's equity would depend upon the depth and liquidity of the trading market that develops

consolidated balance sheet, at amounts that are different from their respective balances on the books under regulation. Deregulation of its generation business will cause Electrico to make adjustments to the book values of its generation related assets and liabilities. This is required by Issue No. 97-4, released by the Emerging Issues Task Force (EITF) of the Federal Accounting Standards Board (FASB), which addresses some of the regulatory accounting issues raised by the restructuring of the electric utility industry (EITF 97-4). Electrico might write down the amounts of certain assets whose values would decline under competition. Such "impaired assets" would include all regulatory assets that Electrico would be unable to collect from consumers under a competitive pricing regime. Within the parameters of generally accepted accounting principles (GAAP), Electrico would revise the book values of its other assets and liabilities affected by Harmony's deregulation plan.

21. The Generation Group's market capitalization will reveal the equity market's evaluation of the amount by which the Group's assets exceed its liabilities. These assets and liabilities would appear on the Generation Group's balance sheets at amounts which would have been adjusted after the repeal of regulation. However, any such adjustments would have been limited to those required by EITF 97-4 and permitted by GAAP and applicable financial accounting standards. Such principles and standards are arbitrary and rigid and, therefore, unlikely to yield book values representing economic reality. Investors, on the other hand, would not be constrained by these rules of financial accounting in assigning values to the Generation Group's assets and liabilities. Instead, they will seek to ascertain the actual earning potential of the Group's assets and the true cost of discharging its obligations. Further, investors will not limit their scrutiny to the assets and liabilities that appear on the balance sheet alone but will consider all items, whether revealed in notes to the financial statements, in other disclosure documents, or gleaned from "market" sources, that might contribute to the Generation Group's income or cause the Group to incur a loss. In doing so, investors will truly "mark to market" each and every possible source of potential stranded costs. Physical generation assets as well as long-term fuel and supply contracts will be assessed at their current replacement values. Investors will discount Electrico's commitments to public support programs to the extent the utility cannot derive any monetary benefit from them. Similarly, the market will write-off all of Electrico's regulatory assets because Electrico will be unable to collect them from customers under a competitive pricing regime. In this one respect at least, the accountants' practice will coincide with the capital market's judgment.

22. Concurrent with, or subsequent to, issuing Class G shares as a stock dividend to its existing shareholders, Electrico might have issued additional shares of Class G common stock. Electrico might have sold Class G shares to investors to raise additional capital for its generation business. Electrico could also have issued new Class G shares as consideration to a target's shareholders in an acquisition. Finally, Electrico might have issued Class G shares to its employees upon exercise of options.

for Class G shares. Since Class G common stock would be a new issue, an active market for it might not develop immediately. Further, Class G shares would represent a new and different kind of security than the securities that investors in utility stocks are accustomed to. Since it would track only Electrico's generation business, and because the prospects of that business would be uncertain due to impending deregulation, traditional buyers of utility stocks might choose to wait before investing in Electrico's Class G stock. Therefore, initially at least, there might be little trading in Class G shares. As a result, focusing exclusively on the market capitalization of Class G common stock might introduce a negative bias in the estimates of market value for the Generation Group's equity.

To overcome any downward bias resulting from lack of a sufficiently liquid market in Class G shares, the HPUC would look at an alternative measure of the Generation Group's equity, one that relies on the Class N common stock's market capitalization. Specifically, the HPUC would estimate the decrease in market value of the integrated utility's equity as a result of economically separating its generation business from its non-generation operations. The trading price of Electrico's "pre-split" Class E common stock would provide an estimate of the market capitalization and, hence, the market value of Electrico's equity before the economic division between the Generation and Non-Generation Groups. From this estimate of Electrico's "pre-split" equity, the HPUC would subtract the market value of the Non-Generation Group's equity as revealed by the market capitalization of Class N common stock.²³ To smooth out short-term fluctuations, the HPUC would compute the market capitalization of Electrico's Class E common stock using the daily high price of Class E shares for the one-month period before the split into Class G and Class N shares. The Non-Generation Group's market capitalization would be derived from the average daily low prices for the one-month period immediately preceding the computation.

The difference between the market capitalizations of Electrico's Class E and Class N common stock would capture the effects on Electrico's equity of the economic division between the Generation and Non-Generation Groups. This would yield an alternative measure of the market value of the generation business' equity. This measure would depend, not on the existence of a liquid market for Class G shares, but instead on active trading in Class N shares. This condition would be automatically satisfied in all instances where an active market previously existed for Electrico's "pre-split" Class E common stock. The previously traded Class E shares will, after the issuance of Class G shares, track only

23. After instituting its tracking stock structure and distributing Class G shares as a stock dividend, but before stranded cost estimation, Electrico might have issued additional shares of Class N common stock. Electrico might have sold Class N shares to investors to raise additional capital for its non-generation businesses. Electrico could also have issued new Class N shares as consideration to a target's shareholders in an acquisition. Finally, Electrico might also have issued Class N shares to its employees upon exercise of options. Any such additional Class N shares that Electrico might have issued, and all net proceeds that Electrico has received from them, should be ignored in computing the market capitalization of the Non-Generation Group. Therefore, the total number of Class N shares that are outstanding should be reduced by the number of additional Class N shares that Electrico has issued. Further, the value of the total assets of the Non-Generation Group should be reduced by the net proceeds that Electrico has received from such shares. The imputed net proceeds for Class N shares that Electrico has issued for consideration other than cash, such as those to a target's shareholders or to employees, should be the market value of the shares on the respective dates of issuance.

the non-generation businesses. These Class N shares will continue to be traded in the same market and with the same institutional support structures as before.

The HPUC would thus have two alternative measures of the market value of the Generation Group's equity, one based on the market capitalization of Class G common stock and the other based on the market capitalization of Class N common stock. The HPUC would choose the higher of these two measures as the value that the market imputes to the Generation Group's equity.

D. Computing Stranded Costs

Electrico's stranded costs would include all costs that the utility would be unable to recover in a competitive market for electricity generation. To quantify these stranded costs, the HPUC would compare the value that the market assigns to Electrico's generation business with the "accounting," or book value, of this business under regulation. For a market value of Electrico's generation business, the HPUC will rely on investors' collective estimates of the Generation Group's total asset value. To obtain the book value of Electrico's generation business, the HPUC will add up the outstanding balances of all of Electrico's generation-related assets as they appeared in the utility's rate base before generation was deregulated.

A simple way to derive the Generation Group's total asset value would be to aggregate the value of all claims on the income streams associated with the Generation Group's various assets. Class G shareholders and holders of the Generation Group's debt will be the only claimants on the future earnings of these assets.²⁴ The sum of the market values of the Class G shareholders' and debtholders' respective claims will, therefore, constitute the Generation Group's total asset value. The Generation Group's market capitalization will represent the value of Class G shareholders' claims on the income from the Group's assets. The HPUC would estimate the market capitalization of the Generation Group in the manner detailed above. The market value of the Generation Group's debt, on the other hand, would represent the amount that Class G shareholders would have to pay to gain sole and complete control over the income from all of the Group's assets. In other words, it would be the amount required to discharge all the Group's obligations in full, including any applicable prepayment penalties. Thus, the HPUC would add the cost of retiring the Generation Group's debt to the Group's market capitalization deriving an estimate for the market value of the Group's assets.

The HPUC will arrive at an aggregate book value, under regulation, for Electrico's generation-related assets by inspecting historical accounting records. The HPUC will not be able to rely on the Generation Group's balance sheet for this exercise. The respective amounts at which these assets would be carried on the Generation Group's balance sheet would be different from their net book

24. The respective claims of Class G shareholders and holders of the Generation Group's debt on the income from the Group's assets will be "economic," rather than legally enforceable claims, consistent with the "financial reporting" segregation of Electrico's assets into the Generation and Non-Generation Groups. A tracking stock capital structure does not create separate legal entities. Therefore, based on their liquidation rights, Class G and Class N shareholders will share in the assets of both the Generation and the Non-Generation Group, after satisfying all creditors and any preference shareholders.

values under regulation. Deregulation of its generation business will prompt Electrico to make adjustments required by generally accepted accounting principles (GAAP), and within the parameters of applicable financial standards, to the book values of its generation-related assets. Electrico might write down the amounts of certain assets whose values would decline under competition. Electrico would, in all likelihood, write-off all of its regulatory assets since it would be unable to collect any of these outstanding amounts from consumers under a competitive pricing regime. All of Electrico's previously rate-based generation-related assets would be assigned to the Generation Group. However, because of adjustments to its book value, a given generation-related asset that has been "included" in the Generation Group might only appear on the Group's balance sheet at a fraction of its rate base book value or may not be shown at all.

To obtain an accurate measure of the regulated value of Electrico's generation business, the HPUC would have to consider the net book values of all generation-related assets in Electrico's rate base immediately prior to deregulation. The HPUC could identify all of Electrico's previously regulated generation-related assets through a simple process of elimination. Beginning with Electrico's rate base before deregulation of generation, the HPUC would remove those assets that would continue to be included in the rate base for the transmission and distribution operations. The remaining assets would be Electrico's generation-related assets since they had ceased to be subject to the regulatory process once generation became competitive. To obtain the book value of Electrico's generation business under regulation, the HPUC would sum up these assets' respective net book values, as shown in the rate base.

After the HPUC has reconstructed an aggregate book value for Electrico's generation-related assets from rate base records, it would deduct from this book value the market value for the Generation Group's assets to get an estimate of Electrico's total stranded costs.

E. Summary of Stranded Cost Calculation

To summarize, the HPUC would estimate Electrico's total stranded costs as follows: $\text{Total Stranded Costs} = \text{MV}(\text{GG A})^{25} - \text{NBV}(\text{Gen A})^{26}$.

V. ADVANTAGES OF THE TRACKING STOCK METHOD OVER ALTERNATIVE APPROACHES

As indicated earlier, almost all approaches for stranded cost estimation developed by public policy experts envisage assigning values to utilities' generation assets based on either an administrative determination or a forced sale.²⁷

25. $\text{MV}(\text{GG A})$ means market value of the Generation Group's total assets. $\text{MV}(\text{GG A}) = \text{Max} [\text{Avg. daily high} (\text{Class G}) * \text{Number} (\text{Class G}); \{\text{Avg. daily high} (\text{Class E}) * \text{Number} (\text{Class E}) - \text{Avg. daily low} (\text{Class N}) * \text{Number} (\text{Class N})\} + \text{MV}(\text{GG D})]$. $\text{MV}(\text{GG D})$ means market value of the Generation Group's total debt. $\text{Number}(\text{Class G})$ means the total number of Class G shares outstanding; $\text{Number}(\text{Class E})$ means the total number of Class E shares outstanding when Class G shares were first issued to existing shareholders; and $\text{Number}(\text{Class N})$ means the total number of Class N shares outstanding.

26. $\text{NBV}(\text{Gen A})$ means net book value of previously rate-based generation-related assets. $\text{NBV}(\text{Gen A}) = \text{Sigma} (i = 1, N) (\text{NBV Ai})$.

27. See *supra* note 7 and the accompanying text. In proceedings that the Arizona Corporation Commis-

PUCs in most states that have allowed stranded cost recovery have used some form of an administrative determination of the value of a utility's generation assets. A minority of states that have deregulated electricity generation have required incumbent utilities to divest their generation assets in order to collect any stranded costs.²⁸ Other states, while refraining from mandated divestiture, have actively encouraged it. The academic community has also largely concluded, implicitly if not explicitly, that generation asset values can only be determined either administratively or by auction. Academia has so far failed to present a credible third alternative.²⁹

A. *Mandatory Divestiture of Generation Assets*

The price at which a utility sells a generation asset would, by definition, represent a "market valuation" of the asset. However, this actual sale price would not necessarily constitute the asset's definitive market price or true economic value. Such a value would be given by the asset's worth in its best available use. For an asset that is extremely valuable to its current owner, any sale

sion conducted to determine a plan for electric restructuring in the state (Docket No. U-0000-94-165), the Arizona Attorney General's Office, endorsing a proposal initially advanced by the Goldwater Institute, advocated calculating stranded costs "using a true market mechanism, and the most economically sensitive measure of the actual loss. For investor owned utilities, the value should be the book value of the company before deregulation, and the value of their stock holdings after." Testimony of Enrique A. Lopezilira, January 21, 1998, at 8. The Arizona Attorney General's search for a "true market mechanism" is a departure from the position adopted by most consumer advocate groups who have argued for mandatory divestiture of assets or examining comparable transactions. See *supra* note 6. But this simple-minded suggestion to compare book value under regulation to the utility's total market capitalization after deregulation hardly constitutes a practicable plan for measuring stranded costs. Any estimate of stranded costs based on such a comparison ignores the fact that a utility's market capitalization would reflect the value of not only its generation business but also its transmission and distribution operations. It does not provide for measuring the market capitalization of the generation business solely in a manner that isolates the effects on stock prices of factors others than deregulation. It also does not take into account the holding company structure of utilities. In the case of Arizona, one of the incumbent utilities, Arizona Public Service Co. (APS), is a wholly-owned subsidiary of Pinnacle West Capital Corp., an NYSE-listed company that has interests in regulated and deregulated businesses in several states. The APS itself is not publicly traded. The proposed method of using tracking stocks to estimate stranded costs is designed to address these practical difficulties of capturing the impact of deregulation on the market value of a utility's generation business.

28. Connecticut has required incumbent utilities to sell their non-nuclear generation assets by January 2000 and divest interests in nuclear generation assets by January 2004. Maine's legislature has mandated divestiture of all generation assets by March 2000. Legislation in Massachusetts, HB 5117, enacted to restructure the electric power industry, "encourages divestiture of generation assets." Rhode Island and Nevada require utilities that will continue to distribute electricity to customers after deregulation to transfer ownership of their generation assets to separate affiliates. New Jersey's restructuring law authorizes the Board of Public Utilities to "order divestiture to alleviate market power."

29. One published article has suggested looking at investor expectations to estimate stranded costs. Steven Isser & Robert Michaels, *Stranded Investment: Utility Estimates or Investor Expectations?*, PUB. UTIL. FORT., June 1, 1997, at 26. However, the authors' "Financial Expectations" method ignores a utility's non-generation businesses, fails to isolate the impact of deregulation from other factors affecting a utility's stock price, and does not allow for a holding company structure. Therefore, the proposed method suffers from all the same drawbacks as the Arizona Attorney General's suggestion to compare book values under regulation with market capitalization after deregulation. See *supra* note 27. In addition, this method relies on forecasts of earnings that a utility is likely to generate in the future, and is subject to much of the criticism that is leveled against a revenue-based approach for estimating market values for generation assets. See *infra* Part V for a discussion of these arguments.

could only be at a price that is lower than its true economic value. An incumbent utility such as Electrico may often be the most efficient employer of its own generation assets. Electrico would have made considerable investments in acquiring and refining asset-specific operating and maintenance skills. Electrico's employees would have developed a thorough understanding of the functional characteristics of these assets. Electrico may enjoy joint economies of operating these assets with its other generation and non-generation assets. Consequently, Electrico would be able to derive maximal benefits from these assets at minimal costs. Mandatory divestiture of any such generation asset would transfer its control to someone who would value it less and would result in sub-optimal use of the asset. Therefore, the asset's sale price will not reflect the value that a competitive market would assign to it.

The proposed tracking stock method for stranded cost estimation would not require Electrico to sell any of its generation assets. This method relies on the efficiency of the capital markets to ensure that all of Electrico's assets, including its generation assets, are employed in their best use. Electrico's management, seeking to maximize shareholder value, will act such that the utility retains only those assets that are worth more to it than to a third party. Management may not always be motivated by a desire to further the shareholders' best interests. However, the market for corporate control will ensure the availability of potential acquirers or "corporate raiders" whose presence and actions will cause Electrico's generation assets to move to their optimal use. Consequently, the market capitalization of Electrico's Generation Group would reflect the market's consensus of the true economic value of Electrico's generation assets and operations.

As discussed above, a divestiture may cause an inefficient transfer by moving control of generation assets to an operator who is able to extract less from them than the incumbent owner. Further, the price in any divestiture will be a static measure of the assets' value that will be extremely sensitive to the exact terms of the transaction. The timing of the sale will determine the potential buyers who may be able to participate or arrange financing. The design of the auction mechanism will influence the participants' bidding behavior.³⁰ Terms governing credit screening of the bidders and payment schedules will affect the identity of the successful bidder. Consequently, the winning bid would vary significantly as one or more of these factors are changed. However, a sale is a one-time event. The price at which an asset is sold cannot be adjusted to control for the actual conditions of sale and to reflect an ideal transaction structure. As a result, a mandatory divestiture of generation assets will rarely, if ever, result in a price that represents the market's consensus of an asset's value.³¹

30. Over the years, economists have developed several structures for conducting auctions, each with their own truth-revealing properties. See generally Robert Wilson, *Strategic Analysis of Auctions*, in 1 HANDBOOK OF GAME THEORY WITH ECONOMIC APPLICATIONS 227 (Robert J. Aumann & Sergiu Hart eds. 1992). See also Lisa J. Cameron, Peter Cramton, & Robert Wilson, *Using Auctions to Divest Generation Assets*, *ELECTRICITY J.*, Dec. 1997, at 22-31 (explaining a survey and critical assessment of various auction designs that have been used in generation asset divestitures).

31. The sale price of any asset also depends significantly upon the exertions of the seller. In most situations, sellers seek to get the highest price possible for the asset in order to maximize their profits. However, in a mandatory divestiture of generation assets, the utility's management would have little incentive to increase the sale price. Any difference between the sale proceeds and book value of the assets would constitute stranded

In contrast to a forced divestiture that provides an unchanging sale price, the proposed tracking stock method is a dynamic valuation process. The respective market capitalizations of Electrico's Generation and Non-Generation Groups will reflect the capital markets' assessment of the worth of the two businesses. The markets will continuously update their assessment. As investors acquire additional and better information relating to the two groups' current performance and future prospects, they will revise their evaluations, and Class G and Class N share prices will move accordingly. The HPUC will compute the market capitalization figures for the Generation and Non-Generation Groups based on share price data from a thirty-day period rather than any single trading day. The longer time horizon will serve to smooth out the effects of short-lived events on the prices of Class G and Class N shares. Consequently, the tracking stock method will provide a measure that better captures the long-term value of Electrico's generation business than a sale of its generation assets could.

As with yielding prices that are peculiar to the time of the transaction, an asset divestiture is also incapable of valuing a utility's generation business. A mandatory divestiture of Electrico's generation assets will result in a sale price for each of the assets. Adding up these individual sale prices will provide a value for all of Electrico's generation assets. But such a piecemeal valuation will not capture the enterprise value of Electrico's functioning generation business. By comparison, the tracking stock method would allow the HPUC to compute the market capitalization of Electrico's Generation Group, which, when added to the market value of the Group's debt, would represent the market's valuation of the Generation Group as a stand-alone viable business. This would be a more comprehensive measure of the Generation Group's value than would a simple aggregation of the sale price of each of its assets. The sum of the Generation Group's equity and debt would account for not only the value of all tangible and intangible assets that appear on the Group's balance sheet, but also those that do not. Examples include management's organizational ability, workers' skills, Electrico's reputation among its customers, cost, and operational synergies from combining generation, transmission, and distribution.

Finally, a forced sale of generation assets would impose significant costs on the selling utility.³² A mandatory divestiture of Electrico's generation assets would fundamentally change the nature of its business by forcing it to exit electricity generation. Any economies that Electrico could reap by combining its transmission and distribution operations with generation would be lost. A re-

costs and be received as a stranded cost recovery. To the extent that the utility sells any of its generation assets for a price that is lower than it could have received, the difference will be made up, at the ratepayers' expense, in a higher stranded cost recovery. In order to minimize this "moral hazard" problem, some jurisdictions that have required mandatory divestiture have also limited stranded cost recovery to less than 100% of the difference between the generation assets' book value and sale price. The percentage that the state agrees to pay can be analogized to the proportion of total damages that an insurer agrees to reimburse under a casualty policy. This provides the insured with an incentive to exercise caution and limit damages. Similarly, the less than complete stranded cost recovery aligns management's incentives with the state's incentives in maximizing the sale price for the divested assets.

32. In addition to the costs that the seller would face, the potential buyers will bear significant out-of-pocket expenses as well. Each bidder would engage its own team of accountants, lawyers, and bankers to conduct due diligence, prepare its bid, structure and document the transaction, and arrange financing.

quirement to sell generation assets will also disrupt Electrico's day-to-day operations. Preparing for a sale would distract management from the task of running the company. In addition to handing over control of the generation assets, Electrico would have to lay off or transfer employees working in its generation business. The effects of these changes to Electrico's business and disruptions of its operations, brought about by an asset sale, would be reflected in a decline in Electrico's stock price and a corresponding increase in its cost of capital. In contrast, the proposed tracking stock structure would avoid such transaction costs. Electrico's Class G shares will yield a market value for the Generation Group without forcing Electrico to leave the generation business. And since issuing Class G and Class N shares will not require Electrico to separate its operations and assets between the Generation and Non-Generation Groups, any disruption of Electrico's day-to-day operations will be minimal.

B. Administrative Determination of Plant Values

1. The Revenue-Based Method of Estimating "Market" Value

Administrative determinations of "market" value for generation assets have largely used a so-called "revenue-based" method. This method imputes a value to a given generation asset by projecting its revenues under competition, subtracting forecast expenses from such projected revenues, and discounting the resulting net cash flows to the present. The results of such an exercise are extremely sensitive to the underlying assumptions that are necessarily made at each stage. Projecting revenues under competition requires predicting future market clearing prices and generation levels. These predictions, in turn, depend upon assumptions of future demand for electricity and the amount and nature of additional competing generation capacity. Forecasts of future expenses depend upon predicted trends in fuel prices, general levels of inflation, and the likely path of environmental regulation. Finally, selecting a discount rate entails an assumption about the future cost of capital for generation assets. In any given proceeding before a state PUC, there is usually little consensus on these assumptions. As a consequence, in most administrative proceedings, estimates of the value under competition of an incumbent utility's generation assets range from amounts that are significantly below net book value to levels that are two-to-three-times larger than net book value.³³

33. In proceedings before the Public Service Commission of West Virginia, Case No. 98-0452-E-GI, company witness John R. Howells claimed, on behalf of Monongahela Power Company and The Potomac Edison Company, stranded costs related to generation facilities, of \$64.219 million and \$17.106 million, respectively, in 2001 dollars. Direct Testimony of John R. Howells, July 6, 1999, at Exhibit JRH-1. In contrast, Randall J. Falkenberg, testifying on behalf of the West Virginia Users Group (WVEUG), claimed that the two utilities would face negative stranded costs, i.e., enjoy stranded benefits under deregulation, of \$170.675 million and \$139.260 million, in 1999 dollars. Direct Testimony and Exhibits of Randall J. Falkenberg, July 1999, at Exhibit No. RJF-4a and Exhibit No. RJF-5a. Company witness Howells relied on competitive market price forecasts made by Howard W. Pifer III, Chairman of Hagler Bailly, Inc. and PHB Hagler Bailly, Inc. Pifer used a proprietary production cost model called GE MAPS to develop price forecasts for the entire Eastern Interconnection. Direct Testimony of Howard W. Pifer III, July 6, 1999, at 21. WVEUG witness Falkenberg of J. Kennedy & Associates, Inc., projected ECAR market prices using a probabilistic market price simulation model called CUMULUS. Direct Testimony and Exhibits of Randall J. Falkenberg, at 19.

The tracking stock method outlined above would provide an objectively verifiable measure for the portion of Electrico's generation assets' value that might be stranded as a result of deregulation. The method would not require any of the arbitrary assumptions that a revenue-based administrative determination of stranded costs necessarily rely upon. Individual investors would certainly base their respective valuations of Class G and Class N shares upon their own forecasts of the factors listed above. However, the market prices for these shares would aggregate and synthesize these individual forecasts. Therefore, the estimates of market value for the Generation Group's assets and stranded costs will not vary significantly as a result of minor variations in the predicted levels of any one of the inputs required for a revenue-based method for determining value.

2. Comparable Transactions Analysis

Though most administrative determinations of generation asset values have used some form of a revenue-based approach, intervenors in several proceedings have argued, usually unsuccessfully, for a "comparable transactions" analysis. A comparable transactions analysis seeks to place a value on a generation asset based on sales prices for similar assets in recently reported transactions. The rapid pace of electricity deregulation has caused significant turnover in the ownership of almost all kinds of generation assets.³⁴ This has resulted in a large volume of asset sale transactions. Prices paid in these transactions constitute the database for a comparable transactions analysis. Proponents of such an approach analyze this sales price data to ascertain prevailing market prices for different types of assets.

Unlike a revenue-based method that substitutes its analysis for the marketplace, a comparable transactions approach looks at actual market prices for generation assets. But even a comparable transactions analysis involves predicting the market's likely assessment of the worth of the generation asset. Instead of relying on projections of revenues and expenses, a comparable transactions analysis bases its predictions on recently reported sales prices for generation capacity. However, generation capacity is not a homogeneous good. Generation assets are distinguished by several different characteristics, such as fuel type, vintage, geographic location, etc. The ability of a comparable transactions analysis to account for these differences depends, to some extent, on the degree of sophistication of the methodology employed. But each generation asset is unique, and no method, however sophisticated, can account for all possible variations among different generation assets. Also, the available data for a comparable transactions analysis is neither complete nor reliable. Fossil fuel assets are disproportionately represented in recent sales. Most sales transactions are, as such, subject to a self-selection bias. Finally, several recent transactions have involved "bundled" generation capacity consisting of power plants of different types.

These factors mean that a comparable transactions approach is unlikely to predict, with any level of accuracy, the value that a generation asset would fetch

34. See, e.g., Richard Stavros, *Generation Asset Divestiture: Steal of the Century?*, PUB. UTIL. FORT., Sept. 1, 1999, at 42.

in the market. By contrast, the tracking stock method does not seek to predict how the market would behave. Instead, it simply allows the market to proceed with pricing the asset.

VI. CHECKS AGAINST "STRATEGIC BEHAVIOR"

Though being largely immune from the uncertainty of subjective assumptions and forecasts, the tracking stock method might, on initial consideration, appear to be susceptible to manipulation. Electrico and its shareholders, who would gain from increasing the size of the stranded cost recovery, might engage in strategic or "gaming" behavior designed to lower market value estimates for the Generation Group's assets. However, as discussed below, certain safeguards and appropriate policing by the HPUC will prevent any such strategic behavior from succeeding.

The fact that the amount of stranded costs would depend upon the respective trading prices of Class G and Class N shares might allow one to question the integrity of the respective market for these shares. Specifically, it could be argued that trading prices for these shares would not provide accurate measures of the market capitalizations of the Generation and Non-Generation Groups since investors' trading behavior would be influenced by a desire to maximize stranded cost recovery. However, as detailed below, if the stranded cost recovery mechanism is structured appropriately, any "strategizing" in trading Class G and Class N shares would be counterproductive.

A. The Recovery Mechanism: Stranded Cost Recovery Coupons

To reduce incentives for gaming the market for Class G and Class N shares, the right to receive stranded cost recovery would be separated from these securities. Any actual payment compensating Electrico for stranded costs would be made directly to its shareholders by means of a stranded cost recovery coupon (SCRC). Electrico would issue one such SCRC for each of its "pre-split" Class E shares. Electrico's shareholders of record as of the date the company effects the economic division of its equity into Class G and Class N shares would receive the SCRCs. After the HPUC makes a final determination of the total amount of Electrico's stranded costs, each SCRC would become redeemable in cash in the amount of total stranded costs divided by the total number of SCRCs. This redemption value would represent the amount of loss suffered by each "pre-split" Class E share as a result of the diminution in value of Electrico's generation assets due to deregulation. The State of Harmony would finance the cash payment for redeeming the SCRCs by levying a CTC on Electrico's ratepayers. A trust or other SPE authorized by the legislature would then issue CTC-backed bonds and use their proceeds to make the cash payment to redeem the SCRCs. Since the cash flows from the stranded cost recovery would never be received by Electrico, the SPE's cash payment will not constitute a dividend on the part of the company. Therefore, it will not implicate any dividend or payment covenants in any of Electrico's bond or debt indenture. If any applicable state laws prevent the Harmony legislature from authorizing a cash payment directly to holders of SCRCs, then the SPE would pay the stranded costs to the company. However, the HPUC would require Electrico's charter to provide holders of

SCRCs with prior rights to cash dividends, aggregating the total amount of the stranded cost recovery and imputed interest, before allowing any dividends or any liquidation or other payments to Electrico's shareholders. Reserving the stranded cost recovery exclusively for holders of SCRCs would weaken investors' motivations to attempt to increase stranded cost estimates while trading Class G and Class N shares.

SCRCs will act to insulate Class G and Class N share prices from the effects of investor speculation regarding the final amount of any stranded cost recovery.³⁵ In all likelihood, an active trading market for SCRCs will develop.³⁶ The trading price for the SCRCs will reflect the market participants' expectations of the size of the total stranded cost recovery that the HPUC might authorize. Several Electrico shareholders who would receive SCRCs might prefer to sell them, and their rights to a stranded cost recovery, rather than await the HPUC's final determination. Such trades would be prompted by variations in estimates of the final stranded cost recovery amount and differences in risk-bearing costs among investors. Further, large institutional investors, exempt from income taxes, would be eager buyers of SCRCs. Such investors will not be subject to taxes on any stranded cost pay out received directly from the SPE or as a cash dividend from Electrico. These investors will place a higher value on a SCRC than would an Electrico shareholder who is required to pay taxes on a stranded cost pay out. Disproportionate tax effects will create incentives for "tax reducing" transactions in SCRCs. As a result of such trades in the SCRCs, several Class G and Class N shareholders will no longer hold any SCRCs and, therefore,

35. Securities similar to the SCRCs that represent interests in a future regulatory or judicial recovery have been used by publicly traded companies to prevent speculation regarding the final recovery amount from influencing trading in shares of their common stock. For example, California Federal Bank, now a subsidiary of Golden State Bancorp, Inc., has issued Contingent Litigation Recovery Interests (NASDAQ: CALGZ) and Secondary Contingent Litigation Recovery Participation Interests (NASDAQ: CALGL), representing interests in a potential recovery by California Federal in its supervisory goodwill litigation against the U.S. government. Independently, on May 7, 1998, Golden State Bancorp issued Litigation Tracking Warrants (NASDAQ: GSBZN) to its shareholders, which allow warrant holders to receive Golden State common stock equal to 85% of any final damage award paid, net of expenses and taxes, in a separate supervisory goodwill claim against the U.S. government brought by Golden State's subsidiary, Glendale Federal Bank.

36. Electrico would register the SCRCs under the Exchange Act so that they may be traded on a national securities exchange such as the NYSE, or on NASDAQ. Electrico would issue the SCRCs as a stock dividend, and stock dividends do not ordinarily constitute a "sale" under section 2(3). Therefore, no Securities Act registration would be required. However, the SCRCs would be issued following a shareholder vote on the tracking stock recapitalization plan. Therefore, the SEC could conclude that the shareholders' decision to implement a tracking stock structure and exchange Class E shares for Class N shares, Class G shares, and SCRCs constitutes an investment decision. If so, Electrico's issuance of the SCRCs would be a "sale" under section 2(3) of the Securities Act.

The SCRCs could be publicly traded even in the absence of an effective Securities Act registration statement. In this respect, from a federal securities law perspective, the SCRCs would be similar to additional shares of stock that a company issues upon a stock-split. The SCRCs could also be analogized to shareholder rights issued under a company's shareholder rights or "poison pill" plan. Such rights to acquire additional shares of the company's capital stock at a deep discount are automatically triggered when a raider acquires a pre-specified percentage of the company's total outstanding capital stock. The SEC allows companies to issue such rights without a Securities Act registration. The SEC takes the position that issuing these rights to shareholders does not constitute a "sale" under section 2(3) of the Securities Act. These rights may be, and in the event of a take-over battle between two or more bidders often are, separated from the underlying shares and traded as independent securities.

will not be entitled to a stranded cost pay out.

Only the holders of SCRCs will stand to gain from increasing the size of stranded cost estimates. To such investors, artificially depressing the market price for Class G shares might appear to be a way of increasing the amount of stranded cost recovery. However, in the tracking stock method outlined above, the amount of stranded costs is influenced by the market price of not only Class G shares, but also Class N shares. Therefore, keeping Class G shares below their "true" market price is unlikely to affect the total amount of stranded costs unless, simultaneously, prices for Class N shares are somehow maintained above their "true" value as well.

B. Strategic Trading in SCRCs

Strategic behavior intended to increase stranded cost recovery by depressing market prices for Class G shares and inflating prices for Class N shares, in order to succeed, will have to overcome the "collective action problem"³⁷ in the respective trading market for each of three different securities: SCRCs, Class G shares, and Class N shares.³⁸ First, consider the market for SCRCs. Electrico's shareholders of record, who will initially receive SCRCs, will also hold Class G and Class N shares. These SCRC holders will be aware that lower trading prices for Class G shares and higher Class N share prices will increase stranded cost estimates and, thus, the redemption value of their SCRCs. Collectively, these Electrico shareholders could increase their gains if they held their SCRCs until redemption and colluded to keep Class G share prices low and Class N share prices high. But, as discussed above, several of these shareholders may have opportunities to engage in value-enhancing transactions by selling their SCRCs. If the joint effort between Electrico's shareholders to increase stranded cost estimates is modeled as a "prisoner's dilemma" game,³⁹ several individual share-

37. A "collective action" problem arises where individuals cannot be excluded from participating in the joint benefits of a group's efforts. Since each individual is better off by "free-riding" on the actions of others, groups often fail in mobilizing enough support. Smaller groups are generally more successful in overcoming this hurdle. MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 43-52 (1971).

38. In addition to the challenge of overcoming the collective action problem in the market for three different securities, investors who seek to maintain artificially high prices for Class N shares and artificially low prices for Class G shares will also have to evade the reach of federal securities laws. The SCRCs, Class N shares, and Class G shares will all trade on the NYSE and be registered under section 12 of the Exchange Act. Section 9 of the Exchange Act prohibits manipulative conduct that has the effect of creating a false demand or artificial price for any security traded on a national securities exchange such as the NYSE. The SEC could seek enforcement action against any investor or group of investors who, in violations of section 9, attempts to inflate trading prices for Class N shares and lower market prices for Class G shares. Section 9(e) of the Exchange Act provides for a private right of action to persons who buy or sell securities whose prices have been affected by such manipulative conduct. Thus, an investor who sells his Class G shares at a price that has been artificially kept low or an investor who buys Class N shares in a market where shareholders have colluded to maintain high prices could sue for damages against the participants in such a conspiracy to rig prices. Apart from the specific private right of action provided by section 9(e), any such aggrieved seller of Class G shares or buyer of Class N shares could also bring a claim under Rule 10b-5 of the Exchange Act, which contains broad anti-fraud language.

39. The "prisoner's dilemma" is a standard "game" (attributed to the mathematician A.W. Tucker) used by decision theorists to characterize situations in which self-interest leads "players" to take mutually disadvan-

holders' dominant strategy in this game will be to "defect" and sell their SCRCs. Any shareholder who follows this strategy will no longer be entitled to stranded cost recovery. Such a shareholder will only hold Class G and Class N shares. Therefore, considerations of increasing stranded cost estimates will not influence such a shareholder's trading decisions with respect to Class G and Class N shares.

C. Gaming the Market for Class G Shares

Next, consider the market for Class G shares. Holders of Electrico's "pre-split" Class E shares will initially receive Class G shares as a stock dividend. Concurrently, their "pre-split" Class E shares will "convert" to Class N shares. These shareholders will realize that lower trading prices for Class G shares, if accompanied by higher Class N share prices, will increase stranded cost estimates. But only those shareholders who do not sell their SCRCs will have an incentive to increase stranded cost estimates. Of these, only those who continue to hold both Class G and Class N shares will consider themselves in a position to influence the prices of both securities and, consequently, stranded cost estimates. These shareholders may try to keep trading prices for Class G shares low by holding on to their allotted shares and not bidding up prices. This will lead to a thin market for Class G shares. However, any actual or potential investor in Class G shares will have an incentive to acquire Class G shares for a price that he considers below its "true" value. As a group, those Electrico shareholders who also hold SCRCs would benefit by keeping trading of Class G shares to a minimum, thus depressing their prices. Nevertheless, several of these shareholders will face powerful individual incentives to trade. The effort to keep Class G share prices low, when modeled as a "prisoner's dilemma" game, is predicted to fail. Equilibrium prices for Class G shares in this game would, in fact, reflect the market's collective view of a Class G share's economic worth. For most shareholders in the game, the dominant strategy would be to either buy or sell Class G shares to maximize individual pay-offs. Facing the prospects of significant "defections," these shareholders will be unlikely to build and maintain a large enough coalition to keep prices for Class G shares below the market's perception of their true value.

D. Inflating the Price of Class N Shares

Finally, consider the market for Class N shares. Here too, motives of short-term individual gains will, in all likelihood, triumph over considerations of longer-term group benefits. Such individual incentives will probably prevent a successful cartel that would maintain prices for Class N shares above their perceived true values. To begin, only those Electrico shareholders who also hold SCRCs will be motivated to keep prices for Class N shares artificially high.

tageous decisions. WILLIAM J. BAUMOL, *ECONOMIC THEORY AND OPERATIONS ANALYSIS* 452 (4th ed. 1977); R. DUNCAN LUCE & HOWARD RAIFFA, *GAMES AND DECISIONS* 94-95 (Dover Publications 1989) (1957). Self-interest is the usual explanation for the game's sub-optimal results. For an alternative interpretation, see AMARTYA KUMAR SEN, *ON ETHICS AND ECONOMICS* 82 n.22 (1987). The prisoner's dilemma's description of behavior in the situations it models is widely believed to be accurate.

Further, this motive will be absent for a shareholder who has sold his Class G shares. Such a shareholder would be unable to affect Class G share prices and, thus, powerless to influence stranded cost estimates. A shareholder who has sold his SCRC will be willing to accept an offer for his Class N shares at a price that he considers above a Class N share's true or intrinsic value. A shareholder who holds his SCRCs, but has sold his Class G shares, may also succumb to such an offer. Realizing that higher Class N share prices, in the absence of lower Class G share prices, will not affect stranded cost estimates, such a shareholder might conclude that by selling his Class N shares, he is not contributing to lowering the redemption value of his SCRCs. Also, if the market believes that a Class N share's true value is below its current trading price, risk arbitrageurs will have an incentive to sell short Class N shares. In other words, market forces motivated by private profit will act to keep prices for Class N shares from rising above the level warranted by their perceived economic worth. As indicated above, these forces may also work to prevent prices for Class G shares from falling significantly below their perceived true value. The effect of such disciplinary forces is likely to be even stronger in the case of Class N share prices. Class N shares, as "successors in form" of Electrico's "pre-split" Class E shares, will continue to trade within the same institutional framework as Class E shares did. As a result, the market for Class N shares is likely to be deep and liquid with numerous analysts issuing reports and recommendations. Thus, any deviations in Class N share prices from the value that the market attaches to them would probably be severely punished and, therefore, short lived.

E. Manipulating the Economic Division between the Generation and Non-Generation Group

Reserving a stranded cost pay out exclusively for Electrico's shareholders of record would weaken management's incentives to try to increase stranded cost estimates. However, as indicated earlier, state laws may force the SPE to make the stranded cost pay out to the company. In addition, members of management who are also shareholders in the company would be allotted SCRCs. Consequently, management might try to influence stranded cost estimates in implementing the tracking stock structure. Electrico's management could attempt to manipulate the economic division of the company's total equity into the Generation and Non-Generation Groups to increase estimates of total stranded costs. Such manipulation could include assigning assets and debt to the Generation Group with the sole intent of lowering the market value of its equity. However, the structure of the tracking stock method for estimating stranded costs and the HPUC's continued oversight of the regulated portion of Electrico's business will prevent such efforts from being successful.

1. Apportioning Assets between Generation and Non-Generation Groups

Electrico's management might seek to apportion total assets between the Generation and Non-Generation Groups in a manner that increases stranded cost estimates. The HPUC will compute Electrico's stranded costs by deducting the market value of the Generation Group's assets from the aggregate book value of all of the utility's generation-related assets. The separation of Electrico's assets

between the Generation and Non-Generation Groups will not affect the generation-related assets' aggregate book value, which the HPUC will derive from historical rate base figures. Consequently, the only way management could increase stranded cost estimates would be by apportioning the utility's assets between the two Groups such that it lowers the market value for the Generation Group's assets. For fixed assets, management could do this by not assigning to the Generation Group a profitable asset that is part of the utility's generation operations and properly belongs in the Generation Group. Such an exclusion will reduce earnings estimates for the Generation Group among investors and analysts which, in turn, will lead to lower market values for the Group's equity and assets.

A simple rule will eliminate any such strategic separation of assets. Any previously rate-based asset that the HPUC concludes will not be allowed in the rate base for the regulated transmission and distribution businesses must be included in the Generation Group.⁴⁰ This will ensure that management assigns all fixed assets that are related to the utility's generation operations to the Generation Group.

Management would have little opportunity to influence stranded cost estimates by exercising discretion in dividing current assets between the Generation and Non-Generation Groups. Both inventory and receivables relating to the utility's generation business would be readily identifiable.⁴¹ Apportioning the company's total cash balance between the two groups would also be non-controversial. Management might minimize the amount of cash allocated to the Generation Group in an effort to increase stranded cost estimates. However, a stand-alone deregulated generation company would seek to optimize its working capital requirements by eliminating surplus cash balances. Therefore, low cash on hand would not be an anomaly for the Generation Group and would not distort estimates of market value for its equity and assets.

2. Assigning Debt to the Generation and Non-Generation Groups

The tracking stock method, by considering the market values for equity of both the Generating and Non-Generating Groups, will prevent management from increasing stranded cost recovery by arbitrarily apportioning debt financing instruments between the two. To the extent that management assigns additional

40. "Including" an asset in the Generation Group would simply mean that all income from that asset be assigned to the Generation Group's results of financial performance. Management would not, however, be required to carry all such assets on the Group's balance sheet. Once Harmony begins implementing its deregulation plan, Electrico will adjust the outstanding balances of its generation-related assets and liabilities in accordance with the requirements of EITF 97-4 and within the parameters of GAAP and applicable financial standards. Several assets might be written-down in value or written-off in their entirety. As a result, an asset that has been "included" in the Generation Group might only appear on the Group's balance sheet at a fraction of its rate-based book value or may not be shown at all. Nevertheless, once an asset has been assigned to the Generation Group, if it does, in fact, produce any income in the future, the Group will include such income in its financial results.

41. Assigning receivables to the Generation Group would not require that they be shown on the Group's balance sheet at their rate-based book values. Pursuant to the guidelines set forth in EITF 97-4, Electrico will write-off all receivables from its books that it is unlikely to collect from customers under a competitive pricing regime.

debt that is not related to generation assets to the Generation Group, it will only increase the HPUC's estimate of the market value of the generation assets and thus lower stranded cost estimates. If, on the other hand, management assigns excessive debt to the Non-Generation Group, this will act to depress the market price for Class N shares which, in turn, will increase the HPUC's estimate of market value for the Generation Group's equity and also lower stranded costs.

VII. MARKET FAILURES IN PRICING CLASS G AND CLASS N SHARES

Two possible situations can be conceived of where it may be argued that the tracking stock method outlined above might distort measurement of stranded costs: (1) investor confusion; and (2) a "fraud" on the HPUC. It is unlikely that either of these situations will affect the measurement of stranded costs in practice. However, certain additional precautions described below will render the tracking stock method immune from any theoretical objections that might be made.

A. *Confusion among Investors*

Investor confusion about the tracking stock structure might arguably lead to an inaccurate measurement of stranded costs. It could be asserted that Electrico's existing shareholders may not understand the structure and purpose of the two classes of common stock to be created and their respective effects on stranded cost recovery and, as a result, on the value of their investments. The shareholders will be unsure exactly what claims Class G and Class N shares will confer and will thus be unable to assess the value of each of these two classes. Rather than acquiring and holding securities about whose respective worth they are unsure, the shareholders would prefer selling their "pre-split" Class E shares. This would cause the market price for Class E shares to decline in the period before Electrico's tracking stock capital structure becomes effective. However, as the market understands the method for computing stranded costs, so-called "smart money" would move in and start acquiring Class N shares, thus bidding up their prices. Lower market prices for Class E shares and higher prices for Class N shares will tend to narrow the difference between the two. The trading price for Class G shares, on the other hand, would remain depressed since an active market will fail to develop for them. Because both the prices for Class G shares and the difference between the prices for Class E shares and Class N shares will be low, the estimates for market value for the Generation Group's equity, and hence its assets, will be below their perceived true value. Such an outcome will increase the amount of stranded costs that Electrico will be able to recover.

Though such an argument may well be advanced, it is unlikely to withstand scrutiny. This argument assumes that smart money will only be sporadically smart in its investment decisions. Specifically, sophisticated investors who acquire Class N shares because they represent good value will fail to spot the investment potential in Class G shares whose prices will continue to remain depressed. In actual practice, investors willing to bid up prices for Class N shares would also be likely to risk their capital to acquire Class G shares that they believe are trading below their perceived true value. This will cause prices for

Class G shares to rise until they reflect the market's belief of the true value of the Generation Group's equity. Therefore, concerns that the amount of stranded cost recovery will be exaggerated by initial confusion on the part of Electrico's existing shareholders followed by an invasion by sophisticated investors appear unwarranted. Even so, any risks of investor confusion could be minimized by communicating to Electrico's shareholders, in a clear and concise manner, the nature and mechanics of the tracking stock structure, the respective economic and legal rights of each class of common stock, and the methodology for estimating stranded costs that the HPUC will adopt. The proxy statement that will accompany the solicitation for shareholder votes to approve the tracking stock structure should accomplish this. This will be especially true if this proxy statement follows the Securities Exchange Commission's (SEC) guidelines on "Plain English" disclosure.⁴²

B. Conspiracy to Defraud the HPUC: Unwinding the Tracking Stock Structure

The second situation that might theoretically distort stranded cost estimates that are based on tracking stock trading prices is one where Electrico's management, with tacit collaboration of the capital markets, is able to perpetrate a fraud on the HPUC. This would entail management assigning debt that was used to finance generation assets, and that properly belongs in the Generation Group's balance sheet, to the Non-Generation Group. This would decrease the total debt for the Generation Group. Assuming trading prices for Class N shares do not decline, this would also lower market value estimates for the Generation Group's assets, thus increasing estimates of stranded costs. However, including a debt instrument related to a generating asset in the Non-Generation Group would necessarily result in excessive debt on the Non-Generation Group's balance sheet. By itself, this fact should depress the market price for Class N shares. Lower prices for Class N shares would lower stranded cost estimates by decreasing market value estimates for the Generation Group's equity and assets. However, according to the fraud on the HPUC argument, management would somehow signal to Electrico's existing shareholders and the capital markets that the tracking stock capital structure is only a transient phenomenon. Management would convey to investors the message that the company has separated its equity into Class G and Class N shares solely to address regulatory concerns and allow for a swift and sizable stranded cost recovery. This would lead Electrico's shareholders to conclude that after stranded costs have been recovered, the "artificial" division of equity between Class G and Class N shares will be unwound and the

42. See, e.g., Brian M. McNamara & Robert A. Barron, *Quarterly Survey of SEC Rulemaking and Major Appellate Decisions*, 26 SEC. REG. L.J. 234, 239-40 (1998) (the SEC adopted the so-called "Plain English Rules" to give issuers guidance on how to make disclosure documents clear, concise, and understandable); Lillian B. Hardwick, *The SEC's Plain English Rule*, 61 TEX. B.J. 1176 (1998). The SEC's "Plain English Rules" currently apply only to Securities Act registration statements. Electrico's proxy statement would be a mandated disclosure under the Exchange Act. The SEC has not yet required such statements to be drafted in plain English. However, several companies have voluntarily complied with the SEC's "Plain English" disclosure guidelines in preparing their Exchange Act reporting statements and have distributed to their shareholders more "reader friendly" annual reports and proxy statements. See, e.g., Charles Schwab Corp., Proxy Statement, Mar. 31, 1999.

company will revert to a single class of common stock. As a consequence, these shareholders will hold their SCRCs instead of selling them to investors who may assign higher values to them, for tax or other reasons. Seeking to maximize stranded costs, these shareholders will opt to cooperate with management by preventing prices for Class G shares from rising and those of Class N shares from declining.

Management may, in fact, undo the economic division of Electrico's common stock into Class G and Class N shares by redeeming or exchanging shares of one class of common stock with those of the other, or by consolidating both classes of common stock.⁴³ However, a plan to unwind the tracking stock equity structure will distort stranded cost estimates only if all actual and potential investors are convinced of its existence before hand. In other words, not only will management have to be prepared to unwind the tracking stock structure as soon as practical after stranded cost recovery, it will also have to send a credible signal to investors regarding its intentions. At the same time, management will have to maintain an official posture before the HPUC that commits it to the tracking stock structure for the indefinite future. Since management's stated position will be at odds with its plan to reunite the two classes of common stock, management will be unable to openly and directly communicate its real intentions to investors. Instead, it will have to rely on the market's ability to decipher subtle hints and suggestions. It is difficult to believe that any such suggestions will convince market participants of management's intention in the face of a diametrically opposed public position.

Even if management somehow convinces investors of its actual intention to undo the tracking stock structure, its task will not be done. To complete the fraud on the HPUC, management will also have to maintain a large enough coalition of Electrico shareholders who will hold their SCRCs and also risk their capital to keep Class G share prices low and Class N share prices high. As discussed above, several individual shareholders will be able to increase their total expected gains from stranded cost recovery by selling their SCRCs instead of waiting to redeem them. Shareholders who opt to do so will not benefit from an increased stranded cost recovery. Therefore, these shareholders will have no incentive to continue to participate in the fraud on the HPUC. A shareholder who

43. Such an exchange or consolidation would leave only one class of common stock outstanding. For example, CMS Energy recently unwound its tracking stock equity structure. In July 1995, CMS Energy became one of the first utilities to issue a tracking stock when it had conducted a public offering of its Class G shares that represented a 25% stake in its natural gas operations, the CMS Gas Group. In October 1999, CMS Energy retired each issued and outstanding Class G share by exchanging it for 0.7041 shares of common stock in its electricity business, the CMS Group. "While Class G stock helped CMS gain market recognition for our gas utility business when it was first issued, our gas business has since grown significantly. . . to the point where having a separate tracking stock for our gas utility is no longer useful," said Chairman and Chief Executive Officer William McCormick, in a September 9 press release. *CMS Class G Stock 'No Longer Useful'; To Be Exchanged for Common Shares*, ELEC. UTIL. WK., Sept. 20, 1999, at 17.

Ralston Purina Co. is another company that has unwound its tracking stock equity structure. The company had adopted a tracking stock equity structure in June 1993. However, in May 1995, the company exchanged outstanding shares of Ralston-Continental Baking Group Common Stock for shares of Ralston-Ralston Purina Group Common Stock. The exchange was conducted in anticipation of the July 1995 sale of the Ralston-Continental Baking Group to Interstate Bakeries Corp. See Carl Quintanilla, *Interstate Bakeries Set to Buy Ralston's Continental in \$560 Million Agreement*, WALL ST. J., Jan. 9, 1995, at B6.

retains his SCRCs will, nonetheless, have an incentive to “defect” from the coalition and acquire Class G shares and sell or sell short Class N shares at their respective artificially-maintained prices. Assuming enough investors act on such motives, Class G share prices will move up and Class N share prices will move down, thus defeating management’s objectives.

A conspiracy between management and investors to depress Class G share prices and inflate Class N share prices is unlikely to succeed in practice. Even so, several institutional arrangements can make the possibility of such an eventuality even more remote. Some of these safeguards can be invoked by appealing to existing legal structures, while others can be effected by contractual provisions.

1. Protection against Unilateral Unwinding of Tracking Stock Structure

Existing federal securities laws will restrict management’s ability to design and work towards an outcome that is the complete opposite of its publicly adopted position. In doing so, disclosure laws would be violated and would constitute a “deceptive practice connection with the sale and purchase” of both Class G and Class N shares. This would expose management to liability under the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act).⁴⁴ Knowledge of management’s potential liability will undermine the credibility of any signals to the market regarding the transient nature of Electrico’s tracking stock equity structure.

Most state corporation laws allow a company’s charter to require a separate vote of each class of shares on any matter that may have a disproportionate effect on such classes.⁴⁵ Under such a provision, an action that merges Class G and Class N shares, either by an exchange or consolidation, would require approval of both Class G and Class N shareholders voting as separate classes. The HPUC could mandate that a provision for separate votes be included in Electrico’s

44. For an overview of the civil and criminal liability provisions of the Securities and Exchange Acts, see LOSS & SELIGMAN, *supra* note 14, at 744-903, 972-1159. See also Paul Vizcarrondo, Jr. & Andrew C. Houston, *Liability Under Sections 11, 12, 15 and 17 of the Securities Act of 1933 and Sections 10, 18 and 20 of the Securities Exchange Act of 1934*, in UNDERSTANDING THE SECURITIES LAWS, 1138 PLI/CORP. 583 (1999). Management would be liable for any false or misleading statement of material fact contained in, or omitted from, the proxy statement seeking approval of the proposed tracking stock structure or any other disclosure that may be required under the various provisions or rules of the Exchange Act. Sections 18(a) and 32 of the Exchange Act impose civil and criminal penalties, respectively, for willfully and knowingly making false or misleading statements with respect to any material fact in a required disclosure under the Exchange Act or its rules. Management would also face liability under various provisions of the federal securities laws, including section 17(a)(3) of the Securities Act and Rule 10b-5 promulgated under section 10(b) of the Exchange Act, designed to protect investors from fraudulent acts.

45. State corporate law generally provides that the separate vote of a class or series may be required before specific corporate actions may be taken. See, e.g., DEL. CODE ANN. Tit. 8, § 102(b) (West 1999).

In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters . . .

(4) Provisions requiring for any corporate action, the vote of a larger portion of the stock or of any class or series thereof, or of any other securities having voting power, or a larger number of the directors, than is required by this chapter.

Id. As a general rule, however, the voting rights of the shares of stock of a particular class or a particular series within a class cannot be varied. *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977).

charter. To the extent that Electrico's existing shareholders continue to hold their originally allotted Class G shares and all their Class N shares, the two classes would represent identical economic interests and, therefore, vote in the same manner. However, even if a significant number of existing shareholders sell their Class G or Class N shares, or acquire additional shares of either class, the shareholdings of the two classes will diverge. In such a case, a separate vote of Class N shares to undo the tracking stock structure would provide an additional restriction on management's ability to defraud the HPUC. Merging the two classes of shares into one would mean that all shareholders would have the same rights, preferences, and privileges. This would mean transferring value from Class N shares, whose prices were maintained at artificially high levels, to Class G shares, which traded at artificially low prices. Class N shares might not be willing to allow such a transfer, especially after stranded costs have been recovered and paid out. In game theoretic terms, Class N shareholders' dominant strategy would be to "defect" after stranded cost recovery. Foreseeing this, Class G shareholders would have little incentive to "cooperate" with Class N shareholders and management in the first place.

2. Requirement to Disgorge Stranded Cost Recovery upon Unwinding Tracking Stock Structure

In order to further remove any incentive for management to plan for an ultimate unwinding of the tracking stock structure, one could devise a contractual arrangement between the HPUC and Electrico. The HPUC could require Electrico to "disgorge," or to return a percentage of the stranded cost recovery, if the company undoes the tracking stock structure within four years from the date of the pay out of stranded costs. The percentage of stranded costs to be returned would be determined by the actual timing of the unwinding transaction based upon a sliding scale. For example, if Electrico unwinds the tracking stock structure within one year of stranded cost recovery, the HPUC could require disgorgement of 100% of stranded costs along with imputed interest. An unwinding transaction after one year, but before the end of two years from the date of stranded cost recovery, would entail a return of 75% of stranded cost with imputed interest. The disgorgement or return of stranded costs would be made to the SPE that issues CTC-backed bonds and pays the stranded costs to Class G shareholders or to Electrico.

The requirement to return stranded costs upon an unwinding of the tracking stock capital structure could be fulfilled in a transaction that does not involve any cash payments and, therefore, does not disrupt Electrico's day-to-day operations. Specifically, the HPUC could require Electrico to issue warrants to the SPE that become exercisable into Class N shares at a nominal amount, as low as a penny a share, in the event that Electrico reverts to a capital structure with a single class of common stock within four years of stranded cost recovery. The actual number of warrants would be determined by dividing the total dollar amount of stranded costs to be returned by the difference between the market price of Class N shares at the time that Electrico reunites its Class G and Class N shares and the exercise price of the warrants. Such a contractual arrangement between the HPUC and Electrico would create a powerful incentive for Class N shareholders

to withhold consent from any proposed unwinding transaction. Further, by creating a "market overhang" of a substantial issuance of additional Class N shares, on significantly dilutive terms, upon exercising the warrants issued to the SPE, the disgorgement mechanism itself will prevent market prices for Class N shares from rising to artificially high levels.

a. Allowing Management to Pursue Strategic Combinations

The disgorgement requirement described above will almost certainly prevent management from unilaterally unwinding Electrico's tracking stock capital structure. Such a requirement should, however, be carefully enforced. Any transaction that transfers control of Electrico's common stock to a third party and involves exchanging Electrico's common stock for cash or for another company's capital stock could have the effect of unwinding Electrico's tracking stock equity structure. The requirement to return stranded costs, if applied to such transactions, will dissuade management from pursuing opportunities to enhance shareholder value through strategic combinations, acquisitions, mergers, or dispositions. Electrico's shareholders would thus be deprived of the premium for control that acquirers normally pay in most change in control transactions. Therefore, the requirement to return stranded costs upon reverting to a single class of common stock should not apply where a third party acquires control of Electrico in an arms length transaction.

The HPUC's review of any such acquisition of Electrico's common stock should be restricted to the following.⁴⁶ First, the HPUC should ensure that the acquisition is indeed a bona fide arms length transaction and not a sham that merely unwinds Electrico's tracking stock structure.⁴⁷ Second, the HPUC should examine the prices paid for Class G and Class N shares in any acquisition to determine whether its estimates of stranded costs might have been excessive. The HPUC should ascertain whether the acquisition values Class G shares in excess of, and Class N below, their respective valuations for estimating stranded costs. If an arms length acquisition assigns a significantly higher value to Class G shares and an appreciably lower value to Class N shares than their respective valuations for stranded cost estimation, then the HPUC should review the total amount of Electrico's stranded cost recovery. The HPUC should consider whether this pay out was justified in light of the market's subsequent valuation of Class G and Class N shares as revealed by the terms of the acquisition. If, based on certain objective criteria, the HPUC concludes that the acquisition prices of Class G and Class N shares demonstrate that Electrico's stranded cost

46. The discussion below of such a PUC-review relates only to one conducted to ascertain any excess stranded cost recovery that may have been allowed. The PUC would also look at each such transaction as part of its anti-trust review of mergers and acquisitions between utilities where it would consider any possible anti-competitive effects of the transaction.

47. For example, Electrico might set up a shell holding company that would acquire all outstanding Class G and Class N shares in exchange for the holding company's stock. This nominal "acquisition" would, in substance, be a unilateral unwinding of Electrico's tracking stock capital structure, designed to circumvent the requirement that Electrico repay a percentage of its stranded cost recovery upon such an unwinding. If this is really the case, then the PUC should withhold approval from such a transaction until Electrico has complied with the requirement for disgorgement of stranded costs described above.

estimates were higher than warranted, then the HPUC should require a return of some portion of Electrico's total stranded cost recovery.⁴⁸

The actual amount of stranded costs that the HPUC requires Electrico to return should, of course, depend upon the amounts by which the consideration for Class G and Class N shares differ from their respective values used in stranded cost estimation. The higher the acquisition price for Class G shares, and the lower the consideration for Class N shares than their respective values for stranded cost estimation, the larger should be the proportion of its stranded cost recovery that Electrico must return. Any such return of stranded costs should also take into account the time that has elapsed since stranded cost recovery, because exogenous factors might have influenced the respective valuations of Class G and Class N shares in the intervening period. Therefore, the total amount of stranded cost recovery that Electrico is required to return should vary directly with the magnitude of differences in the respective valuations of Class G and Class N shares. It should also vary indirectly with the length of time between stranded cost recovery and the change in control transaction.

b. Allowing Genuine Fluctuations in Share Prices

Any rule for the return of a part of stranded costs must allow for genuine fluctuations, due to market-wide or firm-specific factors, in the prices for Class G and Class N shares that occur after Electrico's stranded cost recovery. The HPUC could accommodate such fluctuations by reviewing only those acquisitions where both the value of Class G shares is higher and the value of Class N shares is lower than their respective valuations in estimating stranded costs. This will eliminate those transactions where Class G and Class N share prices have both simultaneously moved in the same direction as a result of changes in market outlook for the electric utility industry or investors' reevaluation of Electrico's management.⁴⁹ The HPUC should also allow some room for Class G share prices to move above, and Class N share prices to move below, their respective valuations in stranded cost estimation.⁵⁰ This "window" of allowable share price

48. This review of Electrico's stranded cost recovery would constitute a "true up" mechanism where the PUC would verify the soundness of its initial estimates of stranded costs after considering any additional information revealed by the terms of a subsequent acquisition. In such an exercise, the PUC would be motivated by concerns different from those underlying the requirement that Electrico disgorge stranded costs upon unilaterally unwinding its tracking stock capital structure. The disgorgement requirement would act to prevent a conspiracy between management and investors to defraud the PUC. See *supra* text accompanying notes 43-45. However, a "true up" revision could also have a salutary effect on any intentions that Electrico's management might harbor to manipulate Class G and Class N share prices to increase stranded cost estimates after having already negotiated an acquisition. Management could try to accomplish this by keeping market prices for Class G shares below their expected acquisition price and by bidding Class N shares above their expected acquisition price. The "true up" procedure discussed above would render any such attempt ineffective because the PUC would reconsider its original stranded cost estimates upon a change in control of Electrico's common stock.

49. As long as the same management is responsible for the generation and non-generation businesses, changed perceptions of managerial competence would have the same qualitative effect on the desirability of holding either class of stock.

50. After deregulation, capital markets will develop different yardsticks to assess the performance and prospects of utilities' generation businesses than those for their non-generation operations. See *infra* Part IX discussing the differences in the valuation bases for competitive generation and regulated transmission and distribution operations. Since electricity generation would be opened up to competition for the first time, analysts

movements should be expanded with time after stranded cost recovery has been effected. A simple rule of thumb would allow a 10% movement in Class G and Class N share prices for every month that has elapsed since Electrico's stranded cost recovery.⁵¹

c. Requirement to Return "Excess" Stranded Costs

The HPUC could adopt the following criteria for determining whether Electrico should be required to return any of its stranded cost recovery following a change in control of its common stock that places higher values on Class G shares and lower values on Class N shares than those used in estimating stranded costs. Upon any such transaction that occurs within ten months of Electrico's stranded cost recovery payment, the HPUC would recompute Electrico's stranded costs using the higher acquisition price for Class G shares and the lower acquisition price for Class N shares, after allowing for a 10% movement in prices for each calendar month since the pay out date.⁵² This would result in a revised figure for Electrico's stranded costs that will be lower than the amount that Electrico's shareholders received as stranded cost recovery. The difference between this revised estimate of stranded costs and the actual amount of stranded costs paid out would be termed "excess" stranded costs. Electrico would be required to return all such "excess" stranded costs, along with imputed interest, if there is a change in control of its common stock within a period of ten months from the date of its stranded cost recovery.⁵³

would quite frequently revise their projections of the profitability of the industry and the specific companies. Transmission and distribution, on the other hand, would continue to be regulated; forecasts relating to Electrico's non-generation business thus might not be as volatile. Therefore, the chances of Class G and Class N share prices moving in opposite directions would increase over time.

51. This rule would automatically limit the PUC's review to only those transactions that Electrico enters into within 10 months of its stranded cost recovery. Such a limited review or "true up" period would be judicious. For an acquisition that takes place more than 10 months after stranded cost recovery, too many independent intervening events would have affected the prices of Class G and Class N shares to render any comparison of their acquisition prices meaningless with their respective valuations for stranded cost estimates. A brief "true up" period will also reduce uncertainty surrounding the finality of a stranded cost award.

52. In effect, the PUC would increase the price of Class G shares by $(100-10x)\%$, and decrease the price of Class N shares by $(100+10x)\%$, of the respective amounts by which their acquisition prices and their prices used in the original stranded cost calculation differ. In this calculation, "x" represents the number of calendar months since the date of the stranded cost recovery.

53. Computing the amount of any "excess" stranded costs revealed by an acquisition or change in control transaction would require placing a specific monetary value on the consideration paid by the acquirer for Electrico's Class G and Class N shares. Valuing any cash component of the consideration will be straightforward. Imputing a value to any of the acquirer's stock included in the consideration should not be difficult as long as the acquirer's stock is publicly traded. In fact, the acquisition agreement itself will often specify the value that the acquirer is assigning to the acquired shares.

It is possible, though highly unlikely, that the consideration for Class G and/or Class N shares consists of, or includes, stock that is not publicly traded at the time of the acquisition. This might happen in the unusual case where the acquirer is a private entity that will issue its own stock to acquire Electrico's Class G and Class N shares and, as a result, will become a publicly held corporation. In all probability, Electrico's shareholders would not approve of such a transaction because they would be unable to objectively value the consideration being offered for their respective holdings of Class G and Class N shares. In the rare event that Electrico's shareholders do grant approval to such a transaction, the stock offered for their Class G and Class N shares would have to be registered with the SEC under the Securities Act. The exchange of the acquirer's

The actual return of any "excess" stranded costs, calculated as described above, in the event of an acquisition, could be affected using the same mechanism as that for disgorgement of stranded costs upon a unilateral unwinding of the tracking stock equity structure. Under this arrangement, Electrico would be required to issue warrants to the SPE that securitizes the CTC and pays out the stranded costs. These warrants would be exercisable into Class N shares at a nominal exercise price, as low as a penny a share. The warrants would become exercisable upon a change in control of Electrico's common stock on terms that result in "excess" stranded costs, as defined by the formula described above. The actual number of Class N shares issuable upon exercise of the warrants would be determined by dividing the amount of such "excess" stranded costs by

newly issued shares for Electrico's publicly held Class G and Class N shares would constitute a "sale" under section 2(3) of the Securities Act and would, therefore, be subject to the registration requirements of section 5 of the Securities Act. The acquirer would also, almost certainly, register its newly issued stock under the Exchange Act and list it on a securities exchange in order to provide liquidity to Electrico's shareholders. An Exchange Act registration and a securities exchange listing can be done in conjunction with a Securities Act registration at little additional cost. An Exchange Act registration is effected by filing a straightforward statement with the SEC and does not involve any staff review. See LOSS & SELIGMAN, *supra* note 14, at 240-47. The acquirer would request that its Securities Act and Exchange Act registrations become effective concurrently. A securities exchange listing would also be a routine exercise assuming that the acquirer meets the exchange's listing criteria.

In the event that the acquirer lists its stock on a securities exchange, the PUC could wait for a period of time after the listing to allow an active market to develop in the acquirer's stock. The PUC could then use an average of the daily closing prices of the stock to value the total consideration for Class G and Class N shares. But this method of valuing the consideration for Class G and Class N shares would focus on its ex-post realization rather than the ex-ante or expected value that would have constituted the basis for the acquisition. In order to estimate the expected value of the consideration, the PUC could use a reliable market forecast of the trading price for the acquirer's stock. If such stock is to be issued in an underwritten deal, then the underwriters would price the stock before it begins trading, and the PUC could use such pricing information to value the consideration for Class G and Class N shares. The PUC could also rely on estimates furnished by Electrico's financial advisor in any fairness opinion that it delivers to Electrico's board of directors. In such a fairness opinion, the financial advisor typically quantifies the value of the consideration that the target company's stockholders will receive and opines as to its adequacy.

Another possible acquisition structure could be one where the acquirer, especially one interested in Electrico's non-generation operations, issues its own publicly traded stock and exchanges it for Electrico's Class N shares but issues a new tracking stock that it exchanges for Class G shares. The recently announced acquisition of Sprint by MCI WorldCom Inc. provides an example of such a transaction.

For the separate Sprint PCS tracking stock, MCI WorldCom would issue a new tracking stock, swapping one new share for one old share. In addition, owners of the tracking stock would get a bonus of 0.1547 shares of MCI WorldCom common stock for each share they own.

Peter S. Goodman, *Questions Greet MCI-Sprint Deal; FCC Chief Raises Price Concerns*, WASHINGTON POST, Oct. 6, 1999, at A1. Also, AT&T, which recently completed its acquisition of TCI that it had announced in June 1998, has retained TCI's Liberty Media Group stock as its own tracking stock. See *infra* note 77.

See *infra* Part IX for a discussion of the benefits of tracking stocks in facilitating such acquisitions where the acquirer is interested in retaining only part of the target's total operations. In such a transaction, the acquirer would, in effect, adopt Electrico's Class G shares as its own tracking stock. The consideration for each Class N share in this acquisition would be the market value of the acquirer's shares for which it is exchanged. The consideration for Class G shares would be their own market price since these shares would continue to be substantially the same securities after the acquisition as before. Upon consummation of the acquisition, the acquirer's new tracking stock that is exchanged for Class G shares would be economically linked to the same generation business that the Class G shares tracked, i.e., Electrico's generation assets and operations that the acquirer would now control. Thus, the acquisition will merely reclassify Class G shares as the acquirer's tracking stock instead of Electrico's tracking stock.

the value imputed to Class N shares in the acquisition. As with the disgorgement of stranded costs upon a unilateral unwinding of the tracking stock capital structure, the warrants issued for return of "excess" stranded costs would create a "market overhang" of Class N shares. The prospect of a substantial, and dilutive, additional issuance of Class N shares would counteract any attempts by management or investors to inflate the market price of Class N shares in order to increase stranded cost estimates.

VIII. THE TRACKING STOCK METHOD IN THE REAL WORLD

A. *Costs of Instituting Tracking Stock Structure*

The discussion thus far has ignored the cost of instituting the tracking cost structure and issuing Class G and Class N shares. Such costs, though small in comparison to the costs of an administrative determination of market value of generation assets, are nonetheless unlikely to be trivial.⁵⁴ These transaction costs would reduce the combined market capitalization of Electrico's equity comprised of its Class G and Class N shares. Since these costs would be incurred in issuing the new tracking stock—the Class G shares—they should be allocated solely to the Generation Group. These transaction costs should also be deducted from the market capitalization figure for Electrico's "pre-split" Class E common stock when this figure is used to provide an alternative measure for the Generation Group's market capitalization.⁵⁵ This will yield consistent measures of the mar-

54. USX Corp., which issued tracking stocks for its US Steel Group and Marathon Oil Group in 1991, see *supra* note 14, paid Lehman Brothers approximately \$4 million for advice on recapitalization and assistance with drafting the proxy statement. See Russ Banham, *Track Stars; Does Breaking out a Separate Stock for a Business Unit Help a Company's Fortunes Soar?*, J. ACCT., July 1, 1999, at 45. Lehman Brothers' fees amounted to less than 0.05% of USX Corp.'s total market capitalization, which exceeded \$8.5 billion at the time it implemented its tracking stock structure. USX Corp. also incurred additional expenses for hiring outside legal counsel and accountants to amend the company's charter and prepare SEC registration statements. USX Corp.'s tracking stock recapitalization was especially complex since it was instituted in response to a takeover threat from corporate raider Carl Icahn. USX Corp.'s steel business had been struggling for some time while its Marathon Oil division had just announced "an oil find in Tunisia that the market thought would be bigger than Saudi Arabia." Icahn did not think that the value of Marathon Oil was properly represented in the marketplace and believed it would be better valued if spun-off. He saw a business that, if focused on separately, would command much higher multiples in earnings. *Id.* As a result, management had to be extra vigilant in allocating debt between the two business groups and in devising rules for inter-company charges. "We wanted each entity to have its own resources to serve its own debt prudently," says Barbara Byrne, Lehman managing director. *Id.*

A utility that issues tracking stocks for its generation and non-generation businesses is likely to find its task a lot easier than USX Corp.'s. The utility's transmission and distribution operations will remain regulated even after generation is opened up to competition. Therefore, the utility would have already initiated the process of apportioning its assets and debt, and formulating rules for allocating joint costs, between its regulated and non-regulated operations. This separation of assets and debts, conducted in anticipation of the impending regulatory restructuring, would also constitute the basis for the economic division between the utility's generation and non-generation businesses that a tracking stock equity structure would require. Also, the large number of tracking stock issues that have been completed since the USX recapitalization have led to an increased understanding of the relevant transactional issues among the bankers, lawyers, accountants, and other professionals involved. Consequently, a tracking stock issue is a less expensive proposition today than it was in 1991.

55. This alternative measure is the difference between the market capitalization figures for the "pre-split" Class E and the "post-split" redesignated Class N shares.

ket value of Electrico's generation assets. As a consequence of such a deduction, the market value estimates of the generation assets will be reduced by the total amount of the transaction costs incurred in implementing the tracking cost structure.⁵⁶ The total amount of stranded costs will correspondingly increase by the amount of these transaction costs.

B. Multi-Jurisdictional Holding Company Utility

Thus far, this article has been examining the application of the tracking stock method for estimating stranded costs to Electrico, a hypothetical stand-alone operating utility with generating assets and ratepayers in a single jurisdiction. Such a model was constructed in order to highlight the basic theory and essential mechanics of the tracking stock method without getting distracted in complicating details. However, several utilities in the United States are structured as holding companies with vertically integrated subsidiaries that have generation, transmission, and distribution assets and operations, as well as customers, in several different jurisdictions. Therefore, it is essential to drop the simplifying assumptions and consider how the tracking stock method would be applied to the typical real world utility. Instead of focusing on Electrico, the following hypothetical involves Holdco, a holding company registered under the Public Utilities Holding Company Act of 1935 (PUHCA). Holdco is a diversified energy holding company, incorporated and headquartered in the State of Harmony, with several wholly owned subsidiaries engaged in electricity generation, transmission, and distribution in various states. Holdco, as the holding company, is the publicly traded entity, and its single class of common stock listed on the NYSE represents an ownership interest in all its subsidiaries and their respective assets and operations.

1. Appropriate Jurisdictional Split

The multi-jurisdictional character of Holdco's operations will pose the question of an appropriate "jurisdictional split."⁵⁷ The tracking stock method for

56. These costs are likely to be an insignificant percentage of the total stranded costs at issue. See also note 54 for a discussion of the costs that USX Corp. incurred for its tracking stock recapitalization in 1991. Furthermore, such costs are likely to be less than the total costs incurred either in an administrative determination where the PUC and each utility employ their own consultants to prepare and review market value estimates or in an asset divestiture where each potential buyer conducts due diligence, prepares its bid, structures and documents the transaction, and arranges financing. The tracking stock method of estimating stranded costs can be even more cost-effective if more than one jurisdiction decides to adopt it. Different jurisdictions can use a given utility's tracking stock structure to estimate the respective market values of the utility's generation operations and, hence, the stranded costs related to each of them. See *infra* Part VIII.B for a discussion of these economies of scale offered by the tracking stock method. If several jurisdictions agree to use the tracking stock method, then a given utility's costs of instituting the tracking stock structure will constitute joint costs that could be shared among these jurisdictions based on each jurisdiction's respective share of the utility's total stranded costs. The fact that a utility's tracking stock structure can be used by more than one jurisdiction implies that there might be positive externalities of using the tracking stock method for estimating stranded costs. A jurisdiction that relies on a utility's existing tracking stock structure after other jurisdictions have paid for its costs will, in effect, be able to get a "free ride." In addition, since the utility will collect the costs of instituting the tracking stock structure in its stranded cost recovery, the utility's shareholders will not have to pay for any benefits, independent of stranded cost recovery, that the tracking stock structure affords the company.

57. Not all states where Holdco has operations would be restructuring their electricity industry at the

estimating stranded costs will not, by itself, be able to identify these costs by jurisdiction. In all probability, Holdco would issue one class of tracking stock for all its generating assets and operations that it holds and conducts through its various subsidiaries. A class of stock that tracks generation assets and operations in only one jurisdiction would entail an economic division of Holdco's business not just by function but also by state. Such a reorganization, with separate financial reporting, would probably not be feasible, because Holdco's generating operations are unlikely to be segregated by state. Holdco may have operating subsidiaries that principally serve customers in distinct well-defined regions of the country. Such a region may not be limited to the boundaries of a single state. Further, electricity generated from the same power plants might serve customers in more than one state. Thus, in most cases, it would be impractical to issue generation tracking stocks by jurisdiction. Also, issuing a separate class of tracking stock for each jurisdiction would add to transaction costs and confuse investors. Therefore, Holdco will probably issue only one class of stock that tracks its generation business in all the various states in which it operates.⁵⁸

If Holdco issues only one set of tracking stocks at the holding company level, the tracking stock method outlined above will provide an estimate of the total market value of all of Holdco's generation assets and not just those that generate electricity consumed by a particular state. However, in order to recover stranded costs from a given state, Holdco will have to specify that state's share of the utility's total stranded costs. This would require Holdco to allocate the total market value of all of its generation assets to each of its various states of operation. The most appropriate basis for such an allocation would be the proportion of Holdco's total electricity generation that each jurisdiction's ratepayers have historically consumed. Ideally, this proportion should be calculated using generation and consumption figures for each Holdco power plant since the plant first began operating. Such a proportion, based on historical generation and consumption data, would represent the fraction of Holdco's generation assets that has served a specified jurisdiction's ratepayers. Any individual jurisdiction's

same time. Those that are would, in all likelihood, adopt different policies regarding compensation for stranded costs. The states that do decide to allow incumbent utilities to recover stranded costs would probably each prescribe different procedures for estimating these costs. Some might mandate divestiture of generation assets while others might assign administratively determined values to generating assets. Therefore, any method that only provides aggregate stranded cost estimates for Holdco at the holding company level would be inadequate. In order to serve its purpose of allowing stranded cost recovery, a method for stranded cost estimation should be able to provide estimates for Holdco's stranded costs associated with its operations in any given jurisdiction.

58. Alternatively, Holdco might issue a tracking stock for the generation business of only those subsidiaries that operate in states that have undertaken electricity restructuring and have decided to use the tracking stock method to estimate stranded costs. Holdco might choose to do so if the generation assets and operations of such subsidiaries are large enough to justify a separate tracking stock or if it believes that there will be little benefit of a company-wide tracking stock for all of its generation business. Holdco might also adopt such a limited tracking stock capital structure if it eventually plans to place the generation assets and operations of these specific subsidiaries into a separate company and spin off this company. See *infra* Part IX discussing the use of tracking stocks as an intermediate step towards an eventual spin-off of a specific line of business. Whatever Holdco's motivations, adopting a limited tracking stock equity structure would make identifying generation assets within given jurisdictions easier. If Holdco issues a tracking stock for the generation business of its subsidiaries in only one given jurisdiction, there would be no need to undertake a "jurisdictional split" with respect to such a jurisdiction.

share of Holdco's total stranded costs would then be given by the difference between that jurisdiction's allocated market value of all of Holdco's generation assets and the net book values of Holdco's previously rate based generation assets for that jurisdiction.

Though the tracking stocks used to estimate the market value for Holdco's generation assets would be common across jurisdictions, each jurisdiction that decides to use the tracking stock method for stranded cost estimation would have to set up its own recovery mechanism. Therefore, Holdco would issue separate SCRCs to its shareholders for each such jurisdiction that adopts the tracking stock method. A single set of tracking stocks would be a cost-effective method of estimating any given jurisdiction's share of Holdco's total stranded costs. Several jurisdictions could rely on these stocks' trading prices to estimate the stranded costs relating to each of them. Currently, each jurisdiction engages in its own administrative determination of market values of a utility's generation assets. One set of tracking stocks for a utility would eliminate duplication and reduce costs associated with administrative proceedings. Once a utility has issued tracking stocks for its generation and non-generation businesses, any given state's PUC could rely on them to estimate market values for the utility's generation assets and derive stranded cost estimates relating to that state. Such a PUC could use share price data from a recent period to get the market capitalization of the utility's generation and non-generation businesses. These market capitalization figures would enable the PUC to derive market value estimates for all of the utility's generation assets. Using historical generation and consumption records, the PUC could allocate a portion of this total market value to the state. The PUC would then subtract this allocated market value from the aggregate net book value of the utility's generation assets as they appeared in the state's rate base immediately before generation was deregulated. The resulting figure would represent the state's share of the utility's total stranded costs.

The following example will demonstrate how a jurisdictional allocation of stranded costs will work in practice. Assume that in response to the State of Harmony's electricity restructuring plan, Holdco undertakes the economic division of its equity into Class G and Class N shares on January 1, 2001.⁵⁹ On January 1, 2002, the State of Tranquility announces its own electricity restructuring plan which also adopts the use of the tracking stock method to evaluate stranded costs.⁶⁰ Pursuant to the stranded cost recovery provisions of Tranquility's restructuring plan, Holdco would issue Tranquility SCRCs to its Class G

59. In addition to meeting the registration requirements of the Exchange Act and the Securities Act, *see supra* note 19, since Holdco is a registered holding company under the PUHCA, it would require prior SEC approval, pursuant to sections 6 (a) and 7 of the PUHCA, for its tracking stock recapitalization. The SEC demonstrated its favorable disposition towards such transactions when it approved the tracking stock capital structure of Conectiv, a company formed by the merger of Delmarva Power & Light Company and Atlantic Energy, Inc., *see infra* note 19, and registered as a holding company under the PUHCA. *See* SEC Releases Nos. 35-26832, 70-9069, Feb. 25, 1998, at 47.

60. The State of Tranquility, as does the State of Harmony, *see supra* note 17, lie entirely in the author's mind, though the author's mind scarcely lies in either state. The States of Harmony and Tranquility share a common border with each other and with a third state, the State of Utopia. Utopia, unlike its neighbors, relies on renewable sources for all its physical and metaphysical energy needs and, therefore, has little use for utilities and even less for capital markets.

shareholders as a stock dividend.⁶¹ Each Class G share would be entitled to one Tranquility SCRC. The Tranquility PUC (TPUC) would allow a period of three months from the date of announcement of the restructuring plan to let investors assess its impact on Holdco's generation business. After this three month period, the TPUC would monitor Holdco's Class G share prices for thirty days. The TPUC would compute the market capitalization of Holdco's Generation Group by multiplying the thirty-day average of the Class G shares' daily high price by the number of outstanding Class G shares. Adding this figure for the Generation Group's market capitalization to the market value of its debt would yield an estimate of the market value of Holdco's generation assets.⁶² The TPUC would allocate a portion of this market value to Tranquility based on the state's historical consumption of Holdco's total electricity generation. The TPUC would arrive at Tranquility's share of Holdco's total stranded costs by subtracting Tranquility's share of the total market value of Holdco's generation assets from the net book value of Holdco's generation assets, as they last appeared in Tranquility's rate base before the state deregulated generation.⁶³ The TPUC would then set the redemption value for each Tranquility SCRC by dividing Tranquility's

61. The impending deregulation of electricity generation in Tranquility will affect the business prospects of Holdco's Generation Group. Since transmission and distribution will continue to be regulated in Tranquility, the state's electricity restructuring plan will not have an impact on Holdco's Non-Generation Group. Therefore, Tranquility's stranded cost recovery would be reserved exclusively for Holdco's Class G shares which represent an economic interest in the utility's Generation Group alone.

Tranquility's decision to use the tracking stock method for estimating stranded costs was not known when Holdco first distributed its Class G shares pursuant to Harmony's stranded cost recovery plan. Therefore, considerations of influencing Tranquility's stranded cost estimates could not have distorted trading in Class G shares when the Harmony PUC was estimating Harmony's share of Holdco's total stranded costs. After Tranquility announces its decision to use Class G share prices to estimate stranded costs, the market for Tranquility SCRCs would serve to isolate trading in Class G shares from speculation relating to the size of a Tranquility stranded cost recovery. As during the process of Harmony's stranded cost recovery, individual profit incentives and existing federal securities law will act to countervail any attempt to artificially depress Class G share prices in order to increase Tranquility's stranded cost estimates.

62. It would not be appropriate to use the alternative measure of the generation business' market capitalization based on the difference between the prices of Class E and Class N shares. *See supra* Part IV.C. A year would have elapsed since Class E shares last traded. During this year, the operations of the Non-Generation Group could have undergone several changes with many acquisitions and divestitures. Therefore, the difference between Class E and Class N share prices would no longer provide a reliable alternative measure of the Generation Group's market capitalization. The concerns that had required an alternative measure during Harmony's stranded cost recovery process would be less valid a year later when Tranquility estimates stranded costs. Class G shares would have been trading for a year and a market would have developed for them. The economic division between the Generation and Non-Generation Groups would already have been effected; therefore, there would be no risk of management assigning assets or debt instruments to each of the two groups in a manner that inflates stranded cost estimates. However, the Tranquility PUC would have to ensure that management does not begin reassigning assets and debt between the Generation and Non-Generation Groups once the Tranquility restructuring plan is announced.

63. Holdco would have made adjustments, as required by GAAP and permitted by applicable financial standards, to the book values of its generation assets affected by Harmony's restructuring. Once Tranquility deregulates electricity generation, Holdco would adjust the outstanding balances of its other generation assets whose values might be impacted. Thus, the respective net-book values of Holdco's generation assets, as shown on the Generation Group's balance sheet and on Holdco's consolidated balance sheet, will differ from their net book values under regulation. *See supra* Part IV.E. Therefore, the Tranquility PUC will have to use historical rate base records to identify Holdco's generation related records and compute their aggregate book value under regulation. *See id.*

share of Holdco's total stranded costs by the number of Tranquility SCRCs.⁶⁴

2. Diversified Businesses

One final complication that must be considered is the possibility that Holdco may be engaged in non-electricity businesses. Holdco may have interests and subsidiaries in energy businesses other than electricity, such as oil and gas exploration, production, and supply. It may even have non-energy operations.⁶⁵ Such diversified operations would not affect a successful implementation of the tracking stock method to measure stranded costs as long as the company's Class G shares represent an economic interest in only its electricity generation business. Trading prices for these Class G shares would provide a measure of the market capitalization of the company's generation business, either globally or in a given jurisdiction. An alternative measure would be provided by the difference between the prices of the company's "pre-split" Class E shares and its "transformed" or redesignated Class N shares. The Class N shares would represent an economic interest in all businesses, except those represented by Class G shares.⁶⁶

64. A market in a given jurisdiction's SCRCs would develop after the jurisdiction's restructuring and stranded cost recovery plan is announced. This would be a short-lived market and would cease after the SCRCs are redeemed. The Class G and Class N shares would continue to trade. In this respect, the market for SCRCs may be analogized to a market for cum-dividend shares. Such a market exists only for the period between the announcement of a cash dividend and its payment.

65. Several large holding companies with significant energy operations have recently diversified into telecommunications. The Williams Companies, Inc., an energy conglomerate, recently completed a spin-off of its telecommunications subsidiary, Williams Communications. For more information, visit the company's web site at <<http://www.williams.com>>. Conectiv, *see supra* note 59, provides local, long distance, carrier, and data network services to residential and business customers through its subsidiary, Conectiv Communications. For more information, visit the company's web site at <<http://www.conectiv.com>>. Entergy Corporation, a global energy company with power production and distribution operations, also offers telecommunications services in domestic markets. Its subsidiary, Entergy Technology Company, leases capacity on a portion of Entergy's 2,000-mile fiber-optic telecommunications network to long-distance carriers. Another subsidiary, Entergy Technology Holding Company, has invested in an AT&T personal communications services wireless venture managed by TeleCorp. Entergy recently announced plans to divest portions of its telecommunications interests. For more information, visit the company's web site at <<http://www.entergy.com>>.

66. If Class G shares represent all generation business, then Class N shares would represent all non-generation businesses. If Class G shares represent the generation business in one, or a few, jurisdictions, then Class N shares would represent all non-generation businesses and the generation business in all states except those reflected in Class G shares. In either case, the difference between the company's "pre-split" market capitalization and the market capitalization of Class N shares would provide an alternative measure of the market capitalization of Class G shares. The holding company might have already issued a tracking stock for one of its lines of business. The holding company would have done this to take advantage of the benefits of tracking stocks discussed in Part IX. For example, CMS Energy, *see supra* note 43, had issued a separate tracking stock for its natural gas operations in July 1995. In such a case, the previously issued tracking stock would be excluded from both the "pre-split" and "post-split" calculations.

Assume that Holdco has two classes of common stock: Class A for its gas business; and Class E for its electricity business. In this case, Class E would represent the "pre-split" stock that combines both generation and non-generation businesses. Class E would then be further divided into Class G, which would track the electricity generation business, and Class N, which would track the electricity non-generation businesses. The trading prices for Class G shares would yield the market capitalization for the generation business with the difference between the trading prices of Class E and Class N shares yielding an alternative measure of this market capitalization. *But see supra* note 62, discussing when it may not be appropriate to use such an alternative

IX. TRACKING STOCKS BEYOND STRANDED COST RECOVERY

In a forthcoming article, the benefits of tracking stocks for electric utilities in the context of the ongoing deregulation of their generation business are discussed. There are several reasons for electric utilities to adopt capital structures consisting of distinct classes of common stock that independently track their newly deregulated generation businesses and their regulated transmission and distribution operations. These reasons remain valid even if the state PUC that regulates the utility does not use a tracking stock based method for estimating stranded costs. In fact, as discussed below, a generation tracking stock might be especially attractive to some of those utilities that have already been allowed to recover stranded costs.

A. *The Rapidly Evolving Competitive Generation Business*

As a result of electric industry restructuring and the competitive forces that it has unleashed, the utility generation business has begun to exhibit a markedly different complexion from its transmission and distribution operations that continue to be regulated. Acknowledging the burden of meeting the challenges posed by competition, some utilities have decided to exit the generation business by divesting their generation assets.⁶⁷ Those that have chosen to remain have sought to institute separate management structures to compete in the deregulated generation markets. A tracking stock for a utility's generation business could complement such efforts and enhance the utility's competitive position in the rapidly evolving deregulated marketplace.

Generation, under deregulation, would place upon management a qualitatively different set of demands than those arising from the utility's transmission and distribution operations. However, several synergies would flow from retaining all three businesses under common managerial control. Efficiencies in operating and maintaining generation, transmission, and distribution equipment may yield cost savings that a distribution utility could pass on to its customers. An additional cost savings measure is efficient management of their spare parts inventories. Also, a utility's transmission operations may allow it to arbitrage away any transient price inefficiencies in the spot market for delivered electricity. Control of both generation assets and transmission lines could also enable a utility to reduce locational differences in electricity prices without undertaking

measure to estimate the Generation Group's market capitalization.

67. For example, Con Edison and Montana Power Co. have "recently exited the generation business, a move that was applauded by the market." S. R. Rajan, *Turning Capital to Wealth: A Ranking of U.S. Utilities*, PUB. UTIL. FORT., Dec. 1, 1999, at 39. Some utilities have divested their generation assets and exited the generation business as part of their stranded cost recovery agreements with state PUCs. A few states, such as Connecticut and Maine, have required such divestiture and, in effect, forced utilities to choose between stranded cost recovery and continued ownership of a generation business. New Jersey's restructuring law authorizes the Board of Public Utilities to "order divestiture to alleviate market power." Some states have resisted explicitly mandating a sale of generation assets but have actively encouraged utilities to divest voluntarily. For example, Massachusetts legislation HB 5117, enacted to restructure the electric power industry, "encourages divestiture of generation assets." Other states, such as Rhode Island and Nevada, require utilities that will continue to distribute electricity to customers after deregulation to transfer ownership of their generation assets to separate affiliates. See generally Electric Restructuring Webpage, *supra* note 5.

transmission pricing risk. In the absence of a transmission capability, a utility will be at the mercy of another transmission company that might abuse its market power and try to lock out competing generators.

Operating a distribution business in conjunction with generation may have other spillover benefits. In a deregulated market for generation, competitors will seek to provide customers individually tailored contracts that are designed to meet their specific requirements. The markets for electricity futures and other derivatives, while developing at a rapid pace, are far from completely liquid. As a result, ownership of generation assets may provide more comprehensive protection against the risk of unfavorable price movements in the wholesale power market than a utility could arrange by entering into hedging transactions. This may facilitate developing products that more closely match the energy needs of the utility's distribution customers. Such economies of scale between generation, transmission, and distribution would offer strong reasons for a utility to maintain its vertically integrated character.

B. Tracking Stocks: More Valuable Currency

While common managerial control over a utility's deregulated generation and regulated transmission and distribution businesses may continue to offer operational efficiencies, a common shareholder base may actually be a disadvantage. A utility's existing shareholders would have originally found the stock attractive because of the utility's steady earnings during both economic expansions and recessions combined with predictable dividend payments. These same shareholders, however, would probably not provide the proper investor base for a generation business that would be exposed to the vicissitudes of the market and show negative accounting earnings for the next several years. Separate tracking stocks for the deregulated and regulated businesses would offer an ideal way of separating the share holdings of the two sets of businesses while maintaining common managerial control over both of them.⁶⁸

68. Companies in other industries, especially telecommunications, have used tracking stock capital structures to get better valuations for their higher-growth businesses. For example, US West issued a tracking stock for its Media Group in September 1995 in a bid to develop a separate investor base for the company's new-economy businesses such as its phone directory, direct marketing, cable TV, cellular, entertainment, and international divisions. See Stephen Keating, *US West Banks on New Class of its Stock*, DENVER POST, Oct. 15, 1995, at G1.

A utility that implements a tracking stock capital structure can use its dividend policy to ensure that the two different classes of tracking stock eventually come to rest in the hands of investors whose investment objectives correspond with the earnings and growth attributes of the respective business groups. US West followed such a strategy when it established and announced separate dividend policies for its Communications and Media Stocks. US West Communications Stock's dividend policy was comparable to the company's existing dividend policy for its conventional common stock. Thus, US West anticipated that it would pay quarterly dividends on its Communications Stock of \$0.535 per share, the same amount that it had paid on its conventional common stock. By contrast, US West noted that it anticipated paying no quarterly dividend on its Media Stock once its proposed tracking stock equity structure was implemented. US West's anticipated dividend policies thus supported its attempt to market its Communications Stock as an "income-oriented" stock and its Media Stock as a "growth-oriented" stock. See US West Inc., Proxy Statement & Prospectus, at 40, 45 (Sept. 5, 1995).

1. As a Step towards a Spin-Off

Even for a utility that has decided on an ultimate spin-off of its deregulated generation subsidiary, a tracking stock linked to the subsidiary could constitute a profitable prelude. Such a tracking stock issue would season the capital markets and may lead to a better price for the generation subsidiary's eventual stock offering.⁶⁹ In addition, where tax-related reasons render a spin-off uneconomical, a tracking stock capital structure would offer an attractive alternative.⁷⁰ Impending restructuring in one or more jurisdictions where a utility operates could also stand in the way of an immediate spin-off of the utility's deregulated generation business. In these circumstances, the utility could use a tracking stock to capture the value of its generation operations until state PUCs complete their restructuring proceedings and allow a spin-off to be conducted.⁷¹

2. As Consideration for Generation Asset Transfer

A tracking stock capital structure may enable a utility to finance additional generation capacity at more attractive terms. For a utility that is reluctant to increase its debt load, an offering of a tracking stock linked to its generation business may constitute a less expensive source of financing to acquire generation assets. By creating a generation tracking stock and issuing its shares to the divesting utility, the acquirer could finance the transaction in a tax-free manner without diluting its existing shareholders or increasing its leverage.⁷² Such

69. The history of tracking stocks offers support for such a strategy of prefacing a spin-off with a tracking stock issue to get a better valuation. Companies often cite greater analyst coverage as one of the major benefits of a tracking stock equity structure. For example, the total market capitalization of The Pittston Company more than doubled in less than six months after it issued a tracking stock for its coal business, Pittston Minerals Group, in July 1993. See Stephen Neish, *Creating Value with Targeted Stock*, CORPORATE FIN., June 1995, at 27-35. And tracking stocks have often paved the way to an ultimate spin-off. US West, which had issued tracking stocks for its Communications and Media Groups in September 1995, see *supra* note 68, announced a spin-off of the Media Group as a separate publicly-traded company under the name MediaOne in 1997. The spin-off was completed in 1998. See Rebecca Cantwell, *Split is Likely to be a Hit: US West Breakup Turning State's Largest Employer into Two Pricey Companies*, DENVER ROCKY MTN. NEWS, May 31, 1998, at 1G.

70. For a spin-off to be structured as a tax-free transaction, the parent and the subsidiary companies must have been part of the same enterprise for at least five years. Also, the IRS may deny tax-free treatment for a spin-off where it believes that the transaction is merely a device to distribute earnings and profits to shareholders. See, e.g., Banham, *supra* note 54. See also Wirth & Reardon, *supra* note 19, and Neish, *supra* note 69.

71. An example of a utility confronting such a situation is Kansas City Power & Light Co. The company recently decided not to proceed with a long-planned merger with Western Resources Inc. and is reportedly considering strategic alternatives that include splitting itself into separately traded companies. However, the company

doesn't yet have legal authority to spin off its generation business, for example, because Kansas and Missouri don't have deregulation laws in place that would permit it. It is unclear when such laws may be passed.

Rebecca Smith, *Kansas City Power Scraps Merger Plan*, WALL ST. J., Jan. 4, 2000, at A3, A14. A generation tracking stock may offer Kansas City Power & Light another means of realizing the value of what its management describes as its "high-potential unregulated" business. *Id.*

72. A favorable federal income tax treatment of a tracking stock depends upon an Internal Revenue Service (IRS) conclusion that the tracking stock is part of the common stock of a single corporate entity instead of property other than the company's common stock. The IRS announced in 1987 that it will cease issuing advance rulings on the proper tax classification of tracking stock transactions. As a result, these transactions pro-

tracking stocks may also allow utilities to retain substantial ownership interests in assets that regulatory agencies have required them to divest, in connection with stranded cost recovery or merger approval proceedings.

3. As Merger Consideration

Tracking stocks linked to generation assets may also enable more efficient transaction structures for asset transfers. The divesting utility could place its generation assets in a separate subsidiary that it would spin-off to its existing shareholders as a tax-free stock dividend.⁷³ The acquiring utility could purchase this subsidiary's outstanding capital stock using, as currency, its existing class of generation stock, or a newly created class of tracking stock.⁷⁴ The spin-off of the generation subsidiary and its subsequent acquisition would both be tax-free transactions for divesting and acquiring utilities and their respective shareholders.⁷⁵ The acquisition, structured as a stock swap, could also qualify for the favorable pooling of interest accounting method. Such an accounting treatment would eliminate the creation of goodwill that the purchaser would otherwise be required to record for an asset acquisition above book value.⁷⁶ This goodwill balance, which appears on the purchaser's balance sheet as an intangible asset, is amortized over several years and, thus, reduces future reported earnings.

Tracking stock capital structures may make vertically integrated utilities more suitable merger candidates to a wider array of acquirers. The tracking stock capital structures may also facilitate mergers between utilities exposed to different degrees of regulatory risk. The target utility's tracking stock structure would allow an acquirer interested in only one of the two businesses, generation or transmission and distribution, to proceed with an acquisition without requiring

ceed based on opinions of tax counsel that a tracking stock capital structure will not create additional tax liability.

73. See *supra* note 70 and accompanying text, discussing the tax treatment of spin-offs, and *supra* note 72, discussing the tax treatment of tracking stock issuances.

74. Tracking stocks were first conceived of as a means to finance acquisitions. General Motors (GM), which issued the first two tracking stocks, used them to acquire, respectively, Electronic Data Systems in 1984, and Hughes Aircraft in October 1985. See General Motors Corp., Proxy Statement/Prospectus (Sept. 21, 1984) (used in connection with GM's acquisition of Electronic Data Systems Corp.) and General Motors Corp., Solicitation Statement (Nov. 13, 1985) (used in connection with GM's acquisition of Hughes Aircraft Co.).

75. The tax-free treatment of such a transaction depends upon an IRS conclusion that the tracking stock the acquirer issues as consideration for the target company's shares is part of the acquirer's common stock. If the IRS makes such a determination, then: (1) the merger will be treated, for federal income tax purposes, as a reorganization within the meaning of IRC section 368(a); (2) the target's shareholders will not recognize any gain or loss when they exchange their shares for the acquirer's tracking stock; (3) their respective tax bases in the acquirer's tracking stock will be the same as that in the target's shares that they surrender; and (4) their respective holding periods for the acquirer's tracking stock will include their holding periods of the target's shares that they surrender, provided that they held these shares as capital assets on the date of the merger. In addition, neither the acquirer (including any acquisition subsidiary that it uses) nor its shareholders will recognize any gain or loss or any corporate income tax liability as a result of the merger.

76. FASB recently issued a proposed rule that will eliminate the pooling of interest method of acquisition accounting for all-stock mergers by January 1, 2001. The proposed rule would require all merger partners to use the "purchase" method of accounting and will result in the creation of goodwill where the purchase price exceeds book value. See P. Scipio, *Potential Increase For M&A Activity*, *MAR/Hedge*, Dec. 1999, at 16.

a prior or concurrent sale of the other. This would afford a distinct advantage in a situation where the market is not immediately receptive to such a divestiture. Tracking stocks would allow a selective acquirer to wait for a better price to sell the portion of the target's business that it does not wish to retain.⁷⁷

4. As Incentive-Based Compensation

Options on a generation tracking stock can provide managers of the utility's generation business with accurately targeted incentives to improve performance. In the absence of a stock that reflects the actual market value of the generation business, utilities have been constrained to experiment with "phantom stocks" in order to attract and retain employees in their deregulated subsidiaries.⁷⁸ For a company whose shares are not publicly traded, the value of its phantom stock is periodically determined by the company's board of directors or its compensation committee. A generation tracking stock would substitute the market's assessment for a board committee's deliberations. Compensation based on the market price of a tracking stock would properly align managers' incentives with investors' interests.

X. CONCLUSION

This article has shown that administrative determinations and asset divestitures are not the only available methods for estimating stranded costs. A tracking stock linked to a utility's generation business yields a market value for the utility's generation assets and avoids the subjective assumptions and arbitrariness that an administrative determination of value necessarily entails. Additionally, a tracking stock equity structure does not force the utility to exit the generation business or disrupt its day-to-day operations.

77. The recently announced acquisition of Sprint by MCI WorldCom Inc. provides an example of such a transaction. Sprint adopted a tracking stock capital structure in November 1998 and has two classes of common stock outstanding. Sprint's Class A Common Stock tracks the company's FON Group, which consists of Sprint's long distance and local telecommunications divisions, and Sprint's PCS Common Stock is linked to the PCS Group, which includes Sprint's wireless mobile telephone services. Under the terms of the acquisition, holders of Sprint's Class A Common Stock

will receive between 0.94 and 1.2228 shares of MCI WorldCom stock for each [Class A Common Stock] share they own. For the separate Sprint PCS tracking stock, MCI WorldCom would issue a new tracking stock, swapping one new share for one old share. In addition, owners of the tracking stock would get a bonus of 0.1547 shares of MCI WorldCom common stock for each share they own.

Goodman, *supra* note 53. Separate stocks linked to the FON Group and the PCS Group make it easier for MCI WorldCom to retain or divest either group after completing the acquisition. Also, AT&T, which recently completed its acquisition of TCI that it had announced in June 1998, has retained TCI's Liberty Media Group stock as its own tracking stock. See Adam Lashinsky, *Will the Boom in Tracking Stocks Derail Investors?*, FORTUNE, Jan. 10, 2000, at 210.

78. Edison International, Inc. had, until recently, a phantom stock plan for senior managers of its unregulated power plant subsidiary, Edison Mission Energy, Inc., and its unregulated finance subsidiary, Edison Capital. Other utilities that have tested or considered implementing variations of such plans include NRG Energy, Southern Company, and Constellation Energy Group. The Edison plan has drawn sharp criticism for the 50-fold increase in the board determined value of Edison Mission's phantom stock between 1994 and 1997 resulting in payments of more than \$150 million to top management. During the same time period, the return on Edison International's publicly traded stock trailed the performance of the S&P 500. See Rebecca Smith, *Some See Dark Side in 'Phantom' Stock*, WALL ST. J., Nov. 15, 1999, at C1.

Beyond the immediate regulatory hurdle of estimating and recovering stranded costs, deregulation of electricity generation poses long-term competitive challenges to today's vertically integrated utility. A unified capital structure with a single shareholder base may hamper a utility's ability to respond to these challenges. A tracking stock equity structure, in contrast, may afford a utility the required flexibility to adapt to the rapidly changing generation business without compromising the investor appeal of its transmission and distribution operations. Separate tracking stocks for its generation and non-generation businesses will allow a utility to benefit from the different valuation metrics for each business while retaining the synergies of vertical integration and the benefits of a single corporate structure. Tracking stocks are currently enjoying a surge in popularity as diversified companies of all types use them to unlock the values of their Internet, telecommunications, and other high-growth operations. Utilities should closely examine the virtues of including their deregulated generation businesses in this category.

APPENDIX A

The Tracking Stock Method at Work

Consider the following example of using tracking stocks to estimate stranded costs.

Electrico has generation assets with a net book value of \$550 million and non-generation assets with a net book value of \$450 million. Its total debt, "marked to market" on its books, is \$500 million. Of this \$500 million in total debt, \$300 million was incurred to finance generation assets, and the remaining \$200 million was issued to acquire non-generation assets. Electrico has a single class of common stock with a total of 10 million issued and outstanding shares and no preferred stock. Electrico's balance sheet as of December 31, 2000, the day before the HPUC begins implementing its stranded cost estimation plan, is as follows (\$ in millions):

Assets		Liabilities	
Generation Assets	550	Debt	500
Non-Generation Assets	450	Shareholder's Equity	500
	1,000		1,000

Under the HPUC regulation, the fair market value of each of Electrico's various assets would be the same as its respective net book value. Thus, the fair market value for Electrico's shareholders' equity would be the same as its book value and would equal \$500 million, or \$50 for each of its 10 million common shares outstanding.

Once the HPUC regulation is repealed, however, the picture will change. Assuming that Electrico's generation assets would be valued at \$350 million in a deregulated market, Electrico's "true" stranded costs are \$550 million - \$350 million = \$200 million. Since Electrico's non-generation businesses would continue to be regulated, the total net book value for its non-generation assets would continue to represent their fair market value. If the State of Harmony refused any stranded cost recovery, Electrico's shareholders would be poorer by the \$200 million in stranded costs. To see this, consider Electrico's balance sheet under deregulation, where its assets are shown at their respective market values, as of December 31, 2000:

Assets		Liabilities	
Generation Assets	350	Debt	500
Non-Generation Assets	450	Shareholder's Equity	300
	800		800

The fair market value for each of Electrico's 10 million common shares under deregulation would be \$30. The trading prices for Electrico's common shares reflect the effects of impending deregulation and during the one month period from January 1, 2001, to January 31, 2001, the average daily high price is \$29.25.

If the State of Harmony commits to making Electrico shareholders whole for the entire amount of stranded costs they face as a result of deregulation, then the fair market value of the stranded cost recovery coupon (SCRC) would be \$20. If the capital markets believe this commitment by the State of Harmony, the SCRC will trade at prices close to its fair market value of \$20.

On December 31, 2000, Electrico announces that effective January 1, 2001, it will split or divide its single class of common stock into two separate classes of tracking

stocks: Class G, which tracks the soon-to-be-deregulated generation business; and Class N, which is economically linked to the non-generation businesses which will continue to be regulated.

The balance sheets for Electrico's Generation and Non-Generation Groups, as of January 1, 2001, would be as follows:

Generation Group			
Assets		Liabilities	
Generation Assets	350	Debt	300
		Class G Shareholder's Equity	50
	350		350
Non-Generation Group			
Assets		Liabilities	
Non-Generation Assets	450	Debt	200
		Class N Shareholder's Equity	250
	450		450

The fair market value for each of Electrico's 10 million Class G shares would be \$5, while the value of each of the 10 million Class N shares would be \$25.

On April 1, 2001, the HPUC computes stranded costs by examining the trading prices for Class G shares and Class N shares during the one-month period from March 1, 2001, to March 31, 2001. Even assuming that capital markets are fairly efficient and shares trade at prices close to their fair market values, since Class G shares are a new issue, an active and liquid market for them will not develop immediately. As a result, during the month of March 2001, the average daily high price for Class G shares is \$4.75. During the same period, the average daily low price for Class N shares is \$24.25.

Based on this share price data, the HPUC estimates the market value of the Generation Group's equity is as follows:

$$\text{Max } (29.25 - 24.25, 4.75) * 10 \text{ million} = \$50 \text{ million}$$

To this figure of \$50 million, the HPUC adds \$300 million, which represents the market value of the Generation Group's debt, to arrive at an estimate of the total market value of the Generation Group's assets: \$350 million. Total stranded costs are then given by the excess of the total net book value, under regulation, of Electrico's generation related assets over the estimated total market value of the Generation Group's assets, or:

$$\$550 \text{ million} - \$350 \text{ million} = \$200 \text{ million}$$

The HPUC's final determination of the amount of Electrico's stranded costs will eliminate any remaining uncertainty regarding the fair market value of the SCRC. After the determination of the amount of stranded costs, and until the cash pay out of this amount, the SCRC will trade within a very narrow range around its fair market value of \$20.