Environmentalists' Statement No.3

8-21-97
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R-973954

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Before the

Pennsylvania Public Utility Commission

Pennsylvania Power & Light Company Restructuring Plan

Docket No. R-00973954

Testimony and Exhibits of

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Dated: July 2, 1997

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QUALIFICATIONS

Q. Please state your name and business address.

A. Peter A. Bradford, P.O. Box 497, Peru, Vermont.

Q. Please describe your educational background and prior work experience.

A. I have served as chair of the New York State Public Service Commission (1987-1995) and the Maine Public Utilities Commission (1974-75 and 1982-87). I have been a commissioner on the U.S. Nuclear Regulatory Commission (1977-82) and on the Maine PUC (1971-77 and 1982-87). During my terms on the Maine and New York State Commissions I participated in deciding more than 1,000 utility rate cases, of which several dozen involved substantial nuclear issues. I was President of the National Association of Regulatory Utility Commissioners (1986-87) and was at different times a member of its committees on electricity, gas and communications as well as its Executive Committee and its subcommittee on nuclear issues. I was briefly Maine's Public Advocate (1982). After leaving the New York State Public Service Commission, I had a one year fellowship with the Regulatory Assistance Project (RAP), writing and teaching on energy regulation.

I have written a number of articles on utility regulation and energy policy, as well as one book concerning energy policy. I am a graduate of Yale University (1964) and Yale Law School (1968). A complete resume is attached to this testimony as Exhibit PAB-1.

Q. Please describe the nature of your current consulting activities.

A. I continue to work part-time with RAP, though my testimony in this proceeding is not on RAP's behalf. In addition, I have testified on aspects of strandable cost recovery in Vermont (on behalf of the Department of Public Service) and New Hampshire (on behalf of the Office of Consumer Advocate). I have also advised on this subject in Maryland (on behalf of the Maryland People's Counsel), and I have advised the Vermont Legislature on electricity restructuring. In recent months, I have advised on aspects of restructuring in Nevada and Ohio and on merger-related matters in Kansas and Washington, D.C. The testimony that I gave in Vermont was subsequently adapted for publication in Public Utilities Quarterly.

I served on a 1996-97 panel advising the European Bank for Reconstruction and Development as to whether the completion of nuclear power plants at Rivne and Khmelnitsky in Ukraine represent the least cost way to replace the remaining Chernobyl units, which are to be closed in 2000. I am also advising the government of Armenia on its newly enacted energy law and on regulatory policy generally. In the past two years, I have taught courses on regulation and restructuring in Russia, Indonesia and India.

Q. Have you testified previously in Pennsylvania?

A. Yes. I have testified in the PECO securitization case (Docket No. R-00973877) and have filed testimony in the PECO restructuring proceeding (Docket No. R-00973953).

TESTIMONY

1. Summary of Testimony

Q. What is the purpose and scope of your testimony?

A. I have been retained by the parties in this case collectively known as "The Environmentalists" to assess aspects of the legal and ratesetting obligations involved in the matter of strandable investment. My testimony demonstrates that there has never been a societal compact that compels a regulatory commission to assure the full recovery of every dollar of investment not found to have been spent imprudently. Rather, the opportunity for recovery can be expressly conditioned on full utility cooperation in achieving the best result for customers and the environment in the years ahead.

Q. Please explain why you believe that there has never been a societal compact that compels the PUC to assure full recovery of stranded investment.

A. Although utilities across the country have been alleging that commissioners are bound by an ancient and clear compact, understood by regulators, investors, customers and utilities since the beginnings of utility regulation, I have found no discussion of such a compact before the early 1980s. Even then, one finds not affirmation of an ongoing agreement but warnings and laments that the compact is broken, scarcely a sound basis for naive investor reliance. Before then, one finds only general arrangements that varied from state to state and from time to time, arrangements that might give rise to investor hopes but not to the rights now claimed by utilities.

To the best of my knowledge, no court has endorsed anything like the claims being advanced in Pennsylvania. Nor are Commissions inclining in that direction. A New York Supreme Court decision rejecting similar arguments[1] has been reaffirmed in an opinion dismissing a petition for clarification[2]. This decision is being appealed.

The Texas Public Utilities Commission has recently rejected similar contentions from the Central Power and Light Company[3] as has the New Hampshire Commission rejected them from Public Service Company of New Hampshire[4] and the Vermont Public Service Board from Central Vermont Public Service[5]. The Pennsylvania Commission has reserved the issue for further consideration in this proceeding[6].

Q. Does the absence of a societal compact then compel the PUC to disallow recovery of any stranded costs?

A. No. The absence of such a compact does not compel such a result. Many states have made

[1]"These arguments (existence of a regulatory compact that would be breached by failure to guarantee full recovery) are contradicted by the public service law and have repeatedly been rejected by the courts (citations omitted)", Energy Association of New York State et. al v. New York PSC 653 NYS 2d 502, 174 PUR 4th 406 (Sup. Ct. 1996).

[2] Supreme Court, Albany County, April 18, 1997. Slip opinion, Index no. 5830-96.

[3]Application of Central Power and Light Company for Authority to Change Rates, Texas PUT, Docket No. 14965, March 31, 1997.

[4]"Restructuring New Hampshire's Electric Industry: Final Plan", DR 96-150, Legal Analysis, February 28, 1997.

[5]"The Power to Choose", Vermont Public Service Board, Docket No. 5854, December 31, 1996, pp 56-66.

[6]Docket No. R-00973877, May 22, 1997, p.26.

bargains whose explicitness rebukes those who claim specific entitlements based on gauzy and implicit historic arrangements. New York's Shoreham settlement, the allowances pursuant to which Central Maine Power Company sold its interest in Seabrook, and state-ordered power purchase contracts or DSM programs might be such arrangements. Actual prudence findings count heavily in states that have traditionally allowed full recovery of prudent investments.[7]

Furthermore, a substantial amount of strandable investment has already been recovered, whether the 1994 California announcement or the federal Energy Policy Act of 1992 or the competitive developments throughout the utility industry after the late 1970s are used as starting points for the dissolution of expectations based on pure monopoly. Because neither these sums nor the amounts being collected daily under present rates will be refunded, a complete disallowance seems out of the question.

Q. How, then, do you propose that the PUC should evaluate utility claims for recovery of stranded costs?

A. Since the most sensible compact proponents do not insist on full recovery of all strandable investment,[8] this issue seems amenable to a resolution in which the opportunity for substantial

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[7]Note, however, that such a bargain cannot be inferred from exhortatory statements or letters from public officials. Utilities that have for years frustrated firm regulatory, legislative and/or gubernatorial exhortations with which they disagreed (concerning, for example, DSM programs or marginal cost pricing) can hardly claim that they rushed headlong into dubious power plants or purchases just because they were told that public officials so desired.

[8]See for example, the December, 1994 paper by William J. Baumol, Paul L. Joskow, and Alfred E. Kahn, entitled "The Challenge for Federal and State Regulators: Transition from Regulation to Efficient Competition in Electric Power," which the Edison Electric Institute submitted to FERC in the rulemaking proceeding that led to Order 888, stating at p.24, "A failure now of policy makers to ensure the companies at least some reasonable level of recovery of their regulatorily approved costs in any transition to competition would leave investors, in effect, with

recovery is expressly conditioned on full utility cooperation in achieving the best result for customers and the environment in the years ahead.

Q. Please explain the basis for this conclusion.

A. My conclusion is based on several propositions:

- There never was such a regulatory compact.
- Electric utility investors have long been well aware that serious losses, even bankruptcy, were possible in the electric utility industry and that no compact protected them from technological or regulatory change.
- Electric utility investors have for many years been compensated at levels sufficient to cover the risk of some loss of their strandable investment.
- Not all strandable commitments were prudently incurred.

2. Discussion of absence of societal/regulatory compact

a. Lack of any such compact

part - a very large part - of the value of their property expropriated by the change in the rules of the game." (emphasis added) Dr. Kahn restated this point in the December, 1994, Electricity Journal, "I have systematically refrained from making recommendations about the extent of the entitlement of utility companies to recover their sunk costs... It has been my consistent explicit policy to leave such determinations to regulators on the basis of considerations of equity, the likely effect of disallowances on the future cost of capital and assessments in the particular circumstances of the extent to which investors might properly be held to have had foreknowledge of the possibility of the change in the rules to their disadvantage or to have been compensated for such risks." at p.80.

Q. Please elaborate as to why you do not believe there ever has been a regulatory compact.

A. Some compact proponents trace the concept back into the last century, before regulation and into municipal franchises[9] . However, their assertion of a smooth evolution from the contractual aspects of early franchises into state regulation is incorrect. State regulation was not an extension of the contractual aspect of franchise regulation but a repudiation of it. As Charles Phillips, Jr's treatise makes clear,

> "the franchise as actually used proved a defective instrument for detailed regulation....Changes in the prescribed rates or in the service standards were made with great difficulty. This difficulty was due to a Supreme Court decision that held that a franchise had the status of a contract, which a state could not impair (citing Trustees of Dartmouth College v. Woodward, 4 Wheaton 518, 643 [1819]); thus both parties had to approve a change....It was often impossible, consequently, for franchise or charter provisions to be changed 'however ill considered or antiquated with respect to current need for regulation they might be (citation omitted)'...Direct legislative control was inflexible as well as slow. Local franchise control had the same defects. Each of these methods was incapable of adapting to the development of an industrialized and highly complex society - a development requiring expertise, flexible regulation and continuity of policy."[10]

In short, the contract characteristics of municipal franchises were among the main reasons that state regulation supplanted them. It makes little sense then to argue that regulation embodied the very contractual attributes that it was intended to correct.

Furthermore, the cases cited show only that these franchises were often contracts, not that the franchisee is entitled to any particular rate treatment not spelled

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[9]J. Gregory Sidak and Daniel Spulber, Deregulatory Takings and the Regulatory Contract, 71 N.Y.U. L. Rev. 4, (Oct. 1996) p. 851, at 905.

[10]Phillips, The Regulation of Public Utilities, pp. 130-132.

out in the franchise. To infer such an entitlement at this late date is to ignore "the rule universally applied .... that the grant will be strictly construed in favor of the sovereign and against the grantee.[11]"

This rule was emphatically applied by the U.S. Supreme Court in Charles River Bridge v. Warren Bridge.[12] In that case, the proprietors of the Charles River Bridge sued because Massachusetts permitted construction of the Warren Bridge, which allowed free passage close to their toll bridge. Despite the contention that the new bridge rendered their franchise of no value , the Charles River Bridge owners' claim was rejected, as was the notion of implying bargains broader than the specific terms of the franchise:

> "And what would be the fruits of this doctrine of implied contracts on the part of the states...if it should now be sanctioned by this court? To what results would it lead us? If it is to be found in the charter to this bridge, the same process of reasoning must discover it in the various acts which have been passed within the last forty years, for turnpike companies...Let it once be understood that such charters carry with them these implied contracts, and give this unknown and undefined property;...and...we shall be... obliged to stand still, until the claims of the old turnpike corporations shall be satisfied; and they shall consent to permit the states to avail themselves of the lights of modern science, and to partake of the benefit of those improvements which are now adding to the wealth and prosperity, and the convenience and comfort, of every other part of the civilized world...This Court are not prepared to sanction principles which must lead to such results."[13]

Utility history is replete with state decisions to permit competition that

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[11] Waukeag Ferry v. Arey, 128 Me. 109, at 115 (1929).
[12] 36 U.S. 420, 9 L. Ed. 773 (1837)
[13] Ibid, at 542-543.

impaired the value of previously granted franchises[14]. If a regulatory compact actually required compensation for assets stranded by decisions to permit competition in areas of regulated monopoly franchises, dozens of court cases establishing and construing that compact would have been inevitable long before now. There are no such cases.

Q. Are the terms regulatory compact or regulatory bargain found in the literature that discusses economic regulation?

A. I have not been able to find any references to the phrases regulatory compact and regulatory bargain in any book or article written before 1985.[15] Further, while I

[14]For example, the early electric franchises quickly took the entire lighting business from their predecessor manufactured gas franchisees. Telephone franchises undermined the value of the telegraph. Trains undermined canals and were in turn diminished by trucks. Street railways lost business to taxi franchises. As one history describes this process, "Competition of electric lighting with gas lighting has driven the gas industry into other lines of service.....These forms of competition....when no new business of a different nature can be secured, result finally in receivership and bankruptcy", J. M. Bryant and R.R. Herrmann, Elements of Utility Rate Determination, (New York, McGraw-Hill, 1940), p. 235, quoted in Kenneth Rose, "An Economic and Legal Perspective on Electric Utility Transition Costs" NRRI, Columbus, Ohio, 1996), p. 62-63.

[15]The earliest reference to such a compact of which I am aware comes from the memories of two individuals who recall that Eugene Meyer, then a cost of capital witness with Kidder, Peabody, asserted such a compact in testimony in the early 1980s. According to these recollections, Mr. Meyer was emphatic in stating that the compact had already been broken. His testimony in a 1984 Puget Power and Light case may have contributed to the strong but - as far as I know - unique endorsement of the compact's existence that appears in Washington Utilities and Transportation Commission v . Puget Sound Power and Light Co. 62 PUR 4th 557, 581-583 (1984).
A June 17, 1996 letter to the Wall Street Journal by William Baumol and J. Gregory Sidak does contend that Professor Gregory Priest has "produced ample evidence in published work that such a contract can be traced to the earliest days of public utility regulation". However, the Priest article says nothing of the sort and has nothing to do with the debate over a regulatory compact. Its intent is to establish that the emergence of regulatory commissions ninety years ago was evolutionary from aspects of municipal franchise contracting, not a sharp

cannot claim to recall all of the testimony and argument presented in rate cases during my first term (1971-77) on the Maine Public Utilities Commission, I am reasonably confident that neither phrase was used to support rate increases in those turbulent years, when utilities were using every argument that came to mind.

Neither Bonbright nor Phillips nor Kahn discuss such a compact or bargain in the editions of their leading treatises on utility regulation published in the 1970s. Dr. Kahn's first use of the phrase apparently came in an August, 1985 op-ed piece in the Wall Street Journal[16]. Because this is an early, clear and typical articulation of the bargain, it is worth examining closely. Dr. Kahn warns that

> "(commissions that) define prudency on the basis of hindsight, and only for failures... play a regulatory game of heads-the-consumer-wins, tails-the-investor-loses thereby violating the essential basis of public utility regulation...an implicit bargain between consumers and investors that, in exchange for a monopoly franchise, the company accepts the strict legal obligation to serve all customers on reasonable terms. This means that shareholders accept a return on investment equivalent only to something like the market cost of capital...along with the duty conscientiously to anticipate the future needs of the public and to make whatever investments may be necessary

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departure. It does say that "early regulation is difficult to distinguish from long term contracting dominated by predictable problems of unilateral or mutual adjustment over time in response to changing conditions and that franchise contracts were seldom exclusive...city governments often threatened competition...". Priest, "The Origins of Utility Regulation and the 'Theories of Regulation' Debate", XXXVI, Journal of Law and Economics 289 (1993), at 294 and 312.

[16]Dr. Kahn acknowledges his belief that the assertion that the terms regulatory compact or bargain "trace back only to the time, ten or fifteen years ago, when (utilities) were suddenly given reason to fear it was not going to be honored...is essentially right", Kahn, "Competition and Stranded Costs Revisited" University of New Mexico School of Law Symposium, August 2, 1996, pp.6-7. He also mentions that his book The Economics of Regulation does (Vol. 1, p. 43) quote Justice Holmes describing a particular adjustment as "not a matter of economic theory but of fair interpretation of a bargain". However, the bargain in question is not a societal compact but the bargain struck in a particular franchise, Cedar Rapids Gas Light Co. v. Cedar Rapids, 223 U.S. 655, 669 (1912).

in order to meet them efficiently.

> This means that if the company makes a particularly successful investment ..., the lion's share of the benefit goes to the consumer....The other side of the bargain is, and has to be, that investors are permitted to earn that same minimum return on the dollars that they put into investments that turn out sour."[17]

Q. Does this quote from Dr. Kahn support the existence of a binding regulatory compact?

A. No. Dr. Kahn is not, in fact, articulating a contract. He is articulating a way that regulation ought to work. A utility's legal right to recover stranded costs turns on whether utility investors had so absolute an assurance that regulation would work *in* Dr. Kahn's recommended fashion that any risk to the contrary cannot be assigned to them. Alternatively, have they been compensated for bearing such a risk?

Q. Please explain why you believe the investment community must have understood that the bargain described by Dr. Kahn never characterized universal regulatory practices?

A. Regulatory practices have varied widely among the 50 states. No one arrangement ever fit them all. Several deviations from Dr. Kahn's statement of the bargain were so pervasive that the

[17]Similar formulations appear constantly after 1985, invariably in the context of assertions that the bargain has been broken. See, for example, Charles Phillips, The Regulation of Public Utilities (Arlington, Va.: Public Utilities Reports, 1993, 3rd ed.), p. 21, quoting Irwin M. Stelzer "The Utilities of the 1990s", The Wall Street Journal, 7 January, 1987, p.20. The lament for the lost bargain was often accompanied by prophecies of blackouts and brownouts in the early 1990s if the bargain were not restored. See, for example, Vincent Butler, "A Social Compact to be Restored", Public Utilities Fortnightly, 26 December, 1985, p 17-21; Peter Navarro, The Dimming of America, (Cambridge, Ma.: Ballinger, 1985) 5-7; Richard J. Pierce, Jr., "Using the Gas Industry as a Guide to Reconstituting the Electric Industry", Research in Law and Economics 13, (1991) 14-15.

investment community must have been aware of them. The first was the doctrine in many states that customers are not required to pay for property that is not used and useful . The second is the proposition that regulators cannot be expected to compensate investors for values undermined by competition. In addition, investors from the late 1970s forward were subject to a blizzard of articles, speeches and other warnings from the financial community and from utility executives that regulators were not allowing rate increases adequate to support traditional returns, and that bankruptcy for some utilities was a real possibility, especially in light of the fact that the recently discovered compact was badly broken. Finally, franchise terms themselves differ from state to state. New Hampshire franchises, for example, are not exclusive and state agencies are under a constitutional duty not to further monopoly power[18]. The Texas Constitution (Article I, Section 26) provides that "Perpetuities and monopolies are contrary to the genius of a free people and shall never be allowed".

Q. Please discuss how regulatory authorities and the courts have interpreted the used and useful standard.

A. In many states and at FERC, the used and useful doctrine has provided for the disallowance from rates of prudent investment. In 1981 the D.C. Circuit Court of Appeals restated its affirmation of this result as follows:

"NEP says that capital prudently invested in a generating facility is taken for public use and therefore must be included in the rate base....The general rule recognized by this court is that expenditure for an item may be included in a public utility's rate base only when the item is 'used and useful' in providing service: that is, current rate payers should bear only legitimate costs of

[18]Appeal of Public Service Company of New Hampshire 141 N.H.1 (1996), construing Part II, Article 83 of the New Hampshire Constitution.

providing service to them."[19]

The D.C. Circuit reaffirmed this view in an en banc opinion by Justice Bork:

Absent that sort of deep financial hardship described in Hope, there is no taking and hence no obligation to compensate, just because a prudent investment has failed and produced no return.[20]

The U.S. Supreme Court reached the same result in Duquesne Light and Power v. Barasch.[21] It is clear also that investors had no guarantee that the used and useful rule is restricted to a one-time application at the time the plant is ready for service. Such a result risks violating elementary statutory construction principles by concluding that the word " useful" is a mere redundancy of used . As a Pennsylvania court held in upholding an excess capacity adjustment in which the Commission denied Philadelphia Electric Company a return on several existing power plants that had previously been included in rate base, "To the degree there is excess capacity there are generating properties that are not used and useful in rendering service to ratepayers."[22]

[19]NEPCO Municipal Rate Commission v. FERC 668 F.2d 1327, 1333 (1981).

[20]Jersey Central Power & Light Co. v. FERC, 810 F. 2d 1168, 1181 n.3 (1987). Judge Starr concurring wrote "The prudence rule looks to the time of investment whereas the 'used and useful' rule looks toward a later time. The two principles are designed to assure that the ratepayers whose property might otherwise be 'taken' by regulatory authorities, will not necessarily be saddled with the results of management's defalcations or mistakes, or as a matter of simple justice, be required to pay for that which provides ratepayers with no discernible benefit...The 'used and useful' rule operates as a restraining principle, reminding utility managers of economic forces working against an investment which is prudent at the time it is made." at 1190.

[21]488 U.S. 299 (1989). The Court noted that "... a rigid requirement for the prudent investment standard would foreclose a return to some form of the fair value rule just as its practical problems may be diminishing....The emergent market for wholesale electric energy could provide a readily objective basis for determining the value of utility assets." at 316.

[22]Philadelphia Electric Company v. Pennsylvania PUC, 61 Pa. Commw. 325, 328; 433 A.2d 620, 622-3 (1980). The Pennsylvania Supreme Court reached the same result in applying the used

Indeed, Pennsylvania is a clear example of a state in which investors have had explicit notice that neither recovery of prudent investment nor protection from substantial losses were part of any bargain on which they could rely. A string of court cases could not have been clearer:

> "It does not follow that a unit prudently constrcuted must always be included in rate base." Philadelphia Electric Company v. Pennsylvania Public Utilities Commission, 433 A2d. 620, 623 (Pa. Cmwlth, 1981), citing cases from 1952 forward.

> "We find no authority in Hope or other decisions, indicating that broad public interests are to yield to the interests of investors whenever the financial integrity of a utility company is imperiled ... It may simply be said that the utility has encountered one of the risks that imperil any business enterprise, namely the risk of financial failure. The express language of the Hope decision weighs against regarding utilities as a protected class of business enterprise which are to be relieved of such normal business risks ... If the Hope decision were to be interpreted as providing constitutional guarantees for the achievement of investor interests the "used and useful" principle would have to yield, at least in the situation where the financial integrity of a utility is imperiled, but we do not perceive from Hope that investor interests are to be accorded such a guaranteed status." Pennsylvania Electric Company v. Pennsylvania Public Utility Commission, 502 A2d 130, 134-136 (Pa., 1965), noting also that the U.S. Supreme Court had implicitly approved an identical result in declining to review Jersey Central Power & Light Co. v. Board of Public Utilities, 466 U.S. 947, 104 S.Ct. 2146, 80 L.Ed.2d 533 (1984) for want of a substantial federal question.

> "In the instant case, the Commission has interpreted the word 'useful' as requiring that: the plant and its accociated capacity contribute no more than necessary to system reliability in the accepted, technical sense ... because we determine that the Commission's interpretation of the phrase 'used and useful' is a reasonable one, we will not overturn it ... the Commission determined that such a balancing of competing interests was fair, in that the risk of excess capacity is properly laid more heavily on PP&L's shareholders who voluntarily assumed that risk ..." Pennsylvania Power & Light v. Pennsylvania Public Utilities Commission, 516 A2d. 430-432 (Pa. Cmwlth., 1986).

Professor Joseph Kalt, a witness for PP&L in this proceeding, himself warned in 1987 that

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and useful rule to both Three Mile Island units, even though both had been in rate base and even though only one was destroyed in the 1979 accident, Pennsylvania Electric Company v. Pa. PUC, 59 Pa. 324, 334, 502 A. 2d 130, 135 (1985), appeal dismissed, 476 U.S. 1137 (1986). The Texas PUC has recently reached the same result, holding that "Utility investment that exceeds market cost is inherently economically and technologically unuseful, or at a minimum less useful in rendering service", Application of Central Power and Light Company, Docket No. 14695, March 31, 1997, p. 2.

adoption of the used and useful approach by a state indicated that the regulatory bargain was no longer in effect in that jurisdiction and created the possibility that prudent investment would not be recovered. His paper thus asserts that the ratemaking approach long employed by Pennsylvania was "at the heart of the breakdown in the regulatory bargain" and created a "requirement that future investments meet a market test"[23].

b. Lack of investor expectation for full compensation of competition losses

Q. You indicated that investors could never have expected regulators to compensate them for losses due to competition. Please explain.

A. Investors have for many years been aware that no compact or other claim assures them of protection in the case of assets whose value is undermined by competition. As long ago as 1932, the Supreme Court warned that "the Constitution does not assure to public utilities the right under all circumstances to have a return upon the value of the property so used. The loss of, or the failure to obtain patronage, due to competition, does not justify the imposition of charges that are exorbitant and unjust to the public. The clause of the Constitution here invoked does not protect public utilities against such business hazards."[24].

Twelve years later, the Supreme Court sustained a decision of the California Commission to use as a rate base not the prudent investment in the Market Street Railway but instead the price that the utility had asked of the city for its properties. In an opinion devoid of any discussion of

[23]Joseph Kalt, Henry Lee and Herman Leonard, "Re-establishing the Regulatory Bargain in the Electric Utility Industry", March, 1987, p. 2.

[24]Public Service Commission of Montana et al. v. Great Northern Utilities Co. 289 U.S. 130, 135 (1932).

stranded investment, exit fees or compacts, the Court wrote as follows about state-franchised utility assets whose value had diminished as a result of state-encouraged competition from state-built highways and streets, and state-certified taxis and trucks:

> The Due Process Clause has never been held by this Court to require a commission to fix rates on....an investment after it has vanished, even if once prudently made, or to maintain the credit of a concern whose securities already are impaired. The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces[25].

Q. Is there evidence in recent years that the financial community was aware that regulation would not guarantee investment value?

A. Yes, there is considerable evidence to that effect. For example, burdened by power plant construction costs, Consolidated Edison Company of New York omitted its dividend payment in April, 1974. Leonard Hyman, former head of the utility research group at Merrill, Lynch, describes investor reaction as follows:

> "Con Edison's dividend omission hit the industry with the impact of a wrecking ball. It smashed the keystone of faith for investment in utilities: that the dividend is safe and will be paid. Wall Street firms, at the behest of panic stricken clients, prepared lists that showed which utilities were in bad shape....Investors had to accept the possibility of financial risk in utility securities."[26]

A decade later Cincinnati Gas and Electric announced in October, 1983, that it could not afford to complete the Zimmer nuclear plant. Within twelve months, six utilities cut or omitted dividends, almost $6 billion of construction effort was consigned to oblivion, and the stock prices

[25]Market Street Railway Co. v. Railroad Commission of California et al, 324 U.S. 548, 567 (1944).

[26]Hyman, America's Electric Utilities, Past, Present and Future 3rd Ed. (Arlington, Va.: Public Utility Reports, 1988) p.109.

of the affected utilities fell 60-80% from their 1983 highs. According to Hyman, "the message was clear. Utilities with serious problems caused by construction failures and extreme cost overruns would not be made whole by regulatory agencies. Investors could not depend on regulators for guaranteed returns or for bailouts."[27]

Q. Similarly, was there ever any evidence that a regulatory compact would protect investors from the effects of changing technologies that could render much or all of their investments obsolete and thus valueless?

A. No. In fact, James Bonbright, probably the most-studied utility economist of the 1950s and 60s, warned investors and utility executives of precisely what would happen if market prices fell below historic costs. Bonbright foresaw this turn of events with remarkable clarity and warned,

> "The second objection is that the original cost principle will be publicly rejected whenever, for reasons of price deflation or of technological progress, its maintenance calls for the establishment of rates of charge for service higher than current replacement cost...This objection runs to the effect that original-cost rate making is a deviation from competitive price determination popular with the consuming public only as long as the deviation is in their favor. But let reproduction-cost appraisals fall in the future....and the very persons who now so loudly proclaim the fairness and efficiency of the actual cost tests will shift their position and demand that public utility rates be set free from the bondage of inflated historical costs. Those rare stalwarts who demand consistency even of themselves will be hopelessly outnumbered by newer experts, by more recently appointed commissioners, and by other persons not bound by embarrassing prior commitments....full recovery of the cost of old plant and equipment may be precluded by revolutionary developments in the technique of production, for example, in the field

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[27]Hyman, ibid, at 110-111. Furthermore, a municipal corporation, the Washington Public Power Supply System, defaulted on some $2.5 billion worth of revenue bonds showing that even investments backed up by actual contracts were not fully protected. Phillips, supra, pp. 681-2.

of atomic energy.[28]

Those who argue that past investors could not foresee today's risks must somehow explain away the fact that Bonbright warned of today's condition with great clarity. Yet, he did not describe that condition as a violation of a compact. Indeed, he mentions no compact to be violated. Instead, he prescribes as remedies "rapid cost recoupment in the form of liberal allowances for depreciation. As to any danger that may still remain, it can be and should be allowed for in the concession to public utility companies of 'fair rates of return' well in excess of interest on secure loans."[29]

The utility claim seems to be that they have an entitlement despite this history because the particular traumas of retail competition could not have been foreseen. As a factual matter, this claim is wrong[30].

Investment community awareness of potential competition has been growing for many

[28]Principles of Public Utility Rates (New York: Columbia University Press, 1961) at 188-89.

[29]Ibid at 189.

[30]Here, for example, is the testimony of Joseph Brennan of Associated Utility Services on behalf of Philadelphia Electric Company in a 1981 rate case in which the company's allowed return on equity was determined to be 17.75%: "There is a federal trend to foster competition in the utility business. The telephone and other industries engaged in communications....are some examples, and now there is talk of deregulation of electric generation. Deregulation...may increase risk", filed testimony, p.7. Larry Ruff of Putnam, Hayes and Bartlett told a 1989 electric utility Chief Executives' Forum, that "the U.S. and Great Britain, are being driven by the same technological, economic and political forces towards a similar long run future: a competitive industry in which electricity is a commodity, much like any other".

years. Competition was widely discussed in the utility business from the early 1980s onward[31]. In Pennsylvania, the Philadelphia Inquirer ran an extensive feature entitled "Have the Utilities Outgrown Monopoly?" in its June 20, 1982 Business Section. . This article mentioned a task force chaired by Lieutenant Governor Scranton to study reforms, including deregulation. It mentioned also that the Edison Electric Institute had just completed "a detailed study of various deregulation schemes designed to foster more competition and efficiency in the industry".

The possibility of substantial losses and the nonexistence (or, as many in the industry allege, the "dishonoring" or "failure") of the regulatory compact, were part of the conventional wisdom of the electric utility industry as long as 15 years ago[32]. Visions of utility investors putting their money into Pennsylvania utilities in reliance on the regulatory compact just cannot be reconciled with reality. Indeed, the President of the Pennsylvania Electric Association in 1985 warned prospective investors in Pennsylvania utilities:

[31]"Let's End the Monopoly", speech by William Berry, President, Virginia Electric Power Company, Edison Electric Institute Fall Financial Conference, October 6, 1981, stated, "Let's open electricity generation to competition - with free entry, no franchises and no obligation to serve.". Berry expanded this theme in "The Case for Competition in the Electric Power Industry", Public Utilities Fortnightly, September 16, 1982, p. 13. The Fortnightly asserted in the descriptive lead-in that "the current debate over electric power deregulation is moved beyond its initial exchange of generalities".

[32]Vincent Butler, president of the Pennsylvania Electric Association warned in his December, 1985 Public Utilities Fortnightly article that the compact had been "bent out of shape in the past decade, but it now appears to be disintegrating". He added that regulators "impose on utility investors a new dimension of risk (nonrecovery of prudent investment if it is excess capacity) not previously experienced", Butler, supra, n.18, pp.19, 20. Professor Joseph Kalt warned that adoption of the used and useful test alone "clearly stated that simply being prudent was not sufficient. If capacity was unneeded or its costs above the price of power from alternative sources, it would not be included in rate base. Investments would be judged against their value in the competitive market as they came on line." Paper, supra, note 23, p.1.

> Show me the investor who will put his money into electric utility securities under existing conditions and I'll show you the embodiment of the principle that a fool and his money are soon parted.[33]

Furthermore, such a claim mocks the notion of risk, which is by its nature not entirely foreseeable. The risk that generation costs would fall and that customers would find ways (including demanding governmental changes to the market structure) to take advantage are not risks from which utility investors have ever been entitled to complete protection. Electric utility investors have known for many years of the possibility of substantial losses, including bankruptcy. That these risks may have been greater than they perceived or have come from a different direction scarcely compels the imposition by regulators of an unconditioned strandable investment tax to assure full recovery.

Q. Have utility investors received returns on their investments well in excess of interest on secure loans?

A. Yes. Michael Foley, NARUC's Director of Financial Analysis, for many years compiled an analysis of utility shareholder returns. Here are some of the key findings from the most recent edition:

1.)The common stockholders of 72% of all major electric and telecommunications utility companies earned a higher internal rate of return than did the average stockholder of the major non-regulated U.S. industrial corporations over the 21 year period 1972-1992....

[33]Butler, p. 20.

2.)A second technique for determining the returns ... documents that 45% of electric and telecommunications utility companies earned a higher rate of return than did the average stockholder of the major non-regulated U.S. industrial corporations over the same 21-year period.

3.) A third method...shows that 73% of electric and telecommunications utility companies earned a higher rate of return than did the stockholders of the major non-regulated U.S. industrial corporations over the same 21-year period.[34]

In an Electricity Journal article reporting an earlier edition of the same study, the authors conclude that individual investors have earned returns from electric utility common stock which exceeded those of non-regulated industrial corporations over the 17 year period 1972-1988.[35]

c. Investors' past compensation for investment risks

Q. Does this evidence support the contention that utility investors have been compensated for the risk of a substantial loss of their investments?

A. Clearly it does. If electric utilities have really outperformed industrial companies, whose

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[34]Michael Foley and Ann Thompson, "Electric and Telephone Utility Stockholder Returns: 1972-1992" (Washington D.C.: NARUC, 1993), p. I. This study, like most NARUC publications, does not purport to represent the views of the Association.

[35]Foley and Thompson, "The Pains and Gains of Electric Utility Stock Ownership", Electricity Journal, June 1989, 28-35, 34. This article quotes John V. Cleary, then CEO of Green Mountain Power stating, "If you had invested $100 in utilities in 1955 and another $100 in a composite of industrials and reinvested all the dividends paid on both portfolios, the total pretax return in nominal dollars on your utility investment at year end 1986 would have been, you guessed it, greater than the return on industrials." at 29. Forbes Magazine is quoted as concluding that "Utility stocks have soundly beaten the market since 1975 - catching much of the street napping." at 29.

investors accept the risk of bankruptcy and adverse governmental action, then surely utility investors too have been compensated for the risk that some of their investment will be lost, by stranding or by some other means. This conclusion is reinforced by the fact that most utility stocks have traded significantly above book value for all or most of this era. This condition can only occur if they are earning in excess of their bare market cost of capital[36], i.e., in excess of the constraint to which they have ostensibly agreed as part of their obligation under the compact.

Q. Is this view shared by some in the electric utility industry?

A. Yes. For example, Wisconsin Electric CEO, Richard Abdoo, told the House Energy and Power subcommittee in July, 1994, "Our company has written off its uneconomic assets, so allowing others to recover stranded costs would penalize us."[37] A year later he was blunter still, "Stranded cost is a utility term. In economics it's called uneconomic assets. And in Economics 101 those sunk costs get written off. There's no rocket science involved."[38]

d. Lack of prudence assumption for all utility investments

Q. Based on your experience as a regulator, is it reasonable to conclude that all investments made by utilities that are currently in rate base were prudently incurred?

A. No. For a variety of reasons, only a small percentage of the total utility rate base is ever actually reviewed for prudence[39]. The discrepancies between the resources available to regulatory

[36]Kahn, The Economics of Regulation, at p.50.
[37]Quoted by David W. Penn in Electricity Journal, December 1994, p.2.
[38]Energy Daily, December 4, 1995, p. 4.
[39]This concern figures prominently in other critiques of the proposition that all investment not specifically found imprudent must be recovered. See, for example, Judge Stephen Williams,

agencies and the revenue streams and construction budgets of utilities is so great that millions of dollars make their way into rates without serious scrutiny. That is one reason why most states put the burden of justifying even the existing rate level on the utility in any rate proceeding.[40] Finally, to believe that current rates at all times reflect prudent expenditures is to believe that the utility economizing of recent years somehow reflects efficiencies that reasonable managements could not have achieved sooner.

In many states, utilities use their considerable political involvement to harass regulatory budgets and appointments in a manner hardly consistent with a statesmanlike compact. Those usually among the first to assert and assist the shortcomings of regulation do not blush to assert its perfection at having measured their past prudence.

Q. Have you read the testimony of Joseph Kalt in this proceeding?

"Deregulatory Takings and Breach of the Regulatory Contract: A Comment", 71 NYU Law Review 1000, stating "First, this may be empirically wrong in many cases--that is to say costs are commonly not evaluated by the regulatory agency at all unless challenged in a rate case. But more generally, if one of the defects of regulation is that we doubt the ability of regulators to identify inefficiency, the fact of their failure to do so proves little... Can one clearly say that there is a compelling principle of political economy requiring compensation for one hundred percent of the losses attributable to inefficiency?", at pp 1001, 1002. See also Professor Oliver Williamson, "Deregulatory Takings and Breach of the Regulatory Contract: Some Precautions", 71 NYU Law Review 1007, stating "...To describe all behavior antiseptically 'as if' there were full and candid disclosure and 'as if' all investments were prudent is unwarranted. I am not persuaded that the 'formality of the regulatory process...' should be described as a reliable mechanism for verifying the mutuality of voluntary exchange and a meeting of the minds. Neither am I persuaded that investments made by a natural monopolist are assuredly "prudently incurred' because '...regulators and intervenors carefully scrutinized the utility's investments before they were made'. Finally...Sidak and Spulber appear to assume that regulated firms are operated in least cost ways. That is unduly sanguine", at p. 1007.

[40]For example, "...at any hearing involving a rate, the burden of proof... that the existing rate...is just and reasonable shall be upon the...utility...", New York Public Service Law, Section 72.

A. Yes, I have.

Q. Do you agree with the significance that he imputes to a regulatory compact having been "recognized at the highest levels of economic and public policy-making"?

A. Not at all. The highest levels of our government for defining the rights and duties that contracts create are the federal and state courts and, for utility purposes, the regulatory commissions. The Council of Economic Advisors has no special expertise in this area and has in any case begun to qualify the 1996 view cited by Professor Kalt[41]. The federal courts as well as the courts of Pennsylvania have consistently held that no contractual or other requirement compels full recovery of prudently incurred costs. Respected economists share neither the Council's conclusion nor Mr. Kalt's[42].

Economists are quick to assert (often with good reason) that utility regulatory policy is more properly their province than that of lawyers. However, Professor Kalt's offhand dismissal (Kalt, p. 11) of "legalistic arguments" about the existence and significance of the regulatory compact

[41]The 1997 Report states, "At the same time, however, regulated firms may engage in wasteful investments if (strandable investment) recovery is guaranteed unconditionally. To avoid creating this incentive, a presumption in favor of cost recovery should apply only for costs incurred to comply with specific regulatory mandates or before competition became a significant prospect.", at 205. The telecommunications section adds (at pp. 204-205) that "such recovery should be limited to investment expenses not already recovered through past earnings", a Delphic pronouncement perhaps intended to recognize that past earnings include some compensation for investment risk.

[42]See, for example, Professor Williamson, supra, note 39, and Irwin Stelzer, Director of Regulatory Policy Studies at the American Enterprise Institute, "Stranded Investment: Who Pays the Bill", remarks to the Southeastern Electric Exchange, March 30, 1994, p. 6ff, and "Restructuring the Electric Industry: The Next Step", remarks at the JFK School of Government, May 24, 1995.

suggests that economists too may sometimes overstep. The existence and terms of this contract have somehow eluded those best qualified to define and enforce it for many years.

Q. Do you agree with Professor Kalt that regulatory reform should "not take away the reasonable prospect for recovery of costs that utilities incurred pursuant to their obligations under the regulatory regime in place at the time of their key cost-creating decisions".

A. I can agree with these phrases as I understand them. However, I would interpret them according to principles that Professor Kalt may not share. For example,

1) I believe that competition from new technologies, not regulatory reform, threatens the recovery of the above market costs. If retail competition and "regulatory reform" had been decreed when marginal costs exceeded average costs, I wonder how much we would have heard about the regulatory compact.

2) As Judge Williams and Professor Williamson point out (note 39 above), it doesn't make sense to restructure the industry because past regulation gives rise to massive inefficiency and simultaneously to use an assumption of past regulatory perfection to define the stranded cost obligations of the customers.

3) As noted above, the "reasonable prospect for recovery" in Pennsylvania has not included all prudent investment. Professor Kalt's 1987 paper seems correct in stating that investors in Pennsylvania and other used and useful states had no assurance that prudent

investment would be recovered .

4) Customers too have reasonable expectations based on the past regulatory regime. Exit fees are not among them.

Q. Shouldn't the Commission be concerned that failure to assure full recovery will, in Professor Kalt's terms, have "one immediate consequence...a higher cost of capital for firms investing in Pennsylvania, particularly transmission and distribution utilities"?

A. No. Alfred Kahn terms this position "overstated", commenting that "The writings.... seeming to insist on the necessity of total recovery of costs in the absence of explicit findings of imprudence, clearly imply that the consuming public will lose more in higher costs of capital henceforward than they gain from illegitimate disallowances. Not only can no one make such a statement with confidence in my opinion; it is surely subject to substantial discount, in recognition of investors' notoriously short memories".[43] Dr. Kahn's point is enhanced if the disallowances are not illegitimate.

This business of trying to scare commissions into believing that possible disallowances will cause their states to fall to the level of "underdeveloped and unstable countries around the world" (Kalt, p. 13), insults of the intelligence of Pennsylvania regulators. Investors will fare best in the states that achieve a sustainable, balanced and expeditious transition, not in the jurisdictions that bog down in litigation because the interests of one group are afforded a high and an early degree of security while the vital concerns of other participants remain unaddressed.

[43]Kahn paper, supra, n.16, p. 10.

Q. Do you agree that arguments about the existence of the regulatory compact are "beside the point given the fact that the Pennsylvania Legislature recognizes stranded costs" (Kalt, p. 15, lines 11-12).

A. This assertion puzzles me. The Legislature has not mandated full recovery of prudent investment, which compact proponents often insist on.

Q. Do you see any relationship between strandable investment and other expectations that are built into the current regulated prices but that would not normally be reflected in prices set by a competitive market?

A. Yes. Utility regulation in many states provides a layer of environmental protection and resource diversity beyond the statutory and environmental regulatory framework. This layer of protection is real. Our air is cleaner for it, and our security is greater. Some states - Massachusetts may be the most pronounced example - have in past made substantial allowance for these "extrnalities" in choosing among potential power supply sources. These protections are vulnerable in a transition to competition because competition forces competitors to look out for their short term interests, defined primarily in relation to market prices. If customers are able to avoid paying for these protections, many will choose to do so, just as surely as they will choose to avoid paying for above market utility plant or IPP contracts.

If some strandable investment is to be redeemed on the basis of public policy principles, such as keeping faith with investors or on the basis of political principles, such as minimizing resistance to competition, then similar considerations justify comparable treatment of the environmental and

other societal benefits.

The public policy principles are, if anything, stronger with regard to these other benefits, for health and security are generally understood to be considerations that government exists to advance. No good reason exists for the downwind members of society - including the elderly, the ill, the asthmatic - to have to have more difficulty breathing so that others can have slightly cheaper electricity. The related political principle is that the environmental community is no more reconciled than are utility investors or independent power producers to the loss of those aspects of traditional regulation that have been to their benefit.

A decision to allow stranded investment recovery is a social policy decision, as surely as is a renewable portfolio requirement or a lifeline program or an economic development rate. It is a tax that raises the market price to achieve a social result considered desirable by regulators or legislators. Viewed as a tax, it can - like any other sales tax - be charged on a per unit basis. All sales taxes push prices away from marginal costs and can be criticized on that basis. However, if a decision has been made to redeem some of these various strandable expectations, then a sales tax in this context is no less appropriate than a sales tax elsewhere. Indeed, it arguably would serve as a proxy for the externalities that are not reflected in electricity prices at all.

3. SUMMARY AND CONCLUSION

Q. Can you summarize your position regarding utility claims that their strandable investment

claims should be recognized before broader societal concerns such as market power and environmental and social impacts are dealt with?

A. Utilities sometimes argue that until full strandable investment recovery is assured, they must slow the pace of restructuring, thereby deferring the benefits of competition. Others too advocate paying them off first and negotiating about everything else afterwards.

This approach to negotiation or to major societal change is unlikely to produce satisfactory or stable results. Utility resistance to many desirable changes in industry structure has already manifested itself. It will not go away if the companies are guaranteed strandable investment recovery. Instead, market power problems, to name an obvious example, will further delay the benefits of competition through long and litigative years. The way to be sure that stranded investment recovery expedites real competition is to condition such recovery as is allowed in ways that keep the incentives on the side of the public. Strandable investment is the public's best leverage to an effectively competitive and an environmentally acceptable future. Regulators, legislators and others in the public sector must not give it away until that future is well secured.

Q. Does that complete your testimony?

A. Yes, it does.

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Exhibit PAB - 1

to Environmentalists' Statement No.3

Resume of Peter A. Bradford

Pennsylvania Power & Light Company

Restructuring Plan

Docket No. R-00973954

PETER A. BRADFORD

P.O. BOX 497

PERU, VERMONT 05152

(802) 824-4296

PROFESSIONAL EXPERIENCE:

March 1996- date ***Energy Advisor***

Also, Affiliated with Regulatory Assistance Project. Member of International expert panel advising European Bank for Reconstruction & Development on least cost alternatives to continued operation of Chernobyl; Advised on utility restructuring in Indonesia, India, Armenia, District of Columbia, Maryland, Ohio, Texas and Vermont; Testified on restructuring in Vermont, New Hampshire and Pennsylvania.

February 1995 - March 1996 ***Fellow*, Regulatory Assistance Project**

Project funded by the U.S. Dept. of Energy, the Environmental Protection Agency and foundations to provide assistance to state and federal regulatory commissions on energy and environmental matters.Advised on utility regulation and restructuring in India, Russia and Armenia.

June 1987- January 1995 ***Chairman*, New York State Public Service Commission**, Albany, New York

CEO of state agency charged with overseeing $29 billion annual revenues of New York utilities. Responsible for developing and implementing consumer and environmental protection policies, transitions from monopoly to competition in energy and telecommunications industries. 700 employees, $65 million budget.

July 1982- June 1987 ***Chairman*, Maine Public Utilities Commission**, Augusta, Maine

CEO of state agency charged with overseeing $2 billion annual revenues of Maine utilities. Responsible for developing and implementing consumer and environmental protection policies,

including competitive bidding for independent power production and energy conservation services as well as adjusting to the break-up of AT&T. 60 employees, $4 million budget.

March 1982-June 1982 ***State of Maine Public Advocate***

First full-time Maine public advocate; intervened on consumers' behalf in telephone and electric cases; oversaw staff of 6; prepared briefs; cross-examined witnesses.

Aug. 1977-March 1982 ***Commissioner*, United States Nuclear Regulatory Commission, Washington, D.C.**

One of five commissioners in the federal agency whose responsibilities included safety of nuclear power plants and other nuclear facilities; preparing licensing criteria for a nuclear waste repository; licensing exports of nuclear fuel and reactors pursuant to Nuclear Nonproliferation Act; assisted in major upgrades of regulatory and enforcement processes in wake of Three Mile Island accident. 3000 employees, $250 million budget.

Dec. 1971-Aug. 1977***Commissioner*, Maine Public Utilities Commission**, ***Chairman*** (Aug. 1974-July 1975), ***Augusta, Maine***.

Sept.1968- Dec. 1971 ***Federal-State Coordinator*, State of Maine**

Responsible for many oil, power, environmental and housing matters. Assisted in preparation of landmark Maine laws relating to oil pollution and industrial site selection. Staff Director, Governor's Task Force on Energy, Heavy Industry and the Coast of Maine.

May 1968-Sept. 1968***Research Assistant to Ralph Nader*, Washington, D.C.** *Assisted in study of Federal Trade Commission's failure to enforce federal consumer protection laws.*

Aug. 1964-June 1965 **Athens College, Greece**, ***Teaching Fellowship***

PUBLICATIONS:

1975 Fragile Structures: A Story of Oil Refineries, National Security and the Coast of Maine, Harper's Magazine Press.

1971- Present Numerous articles on utility regulation and nuclear power have been published in The New York Times, The Washington Post, The Los Angeles Times , The Boston Globe, Newsday, and The Electricity Journal.

PROFESSIONAL AFFILIATIONS:

Nov. 1986-Nov. 1987 ***President*, National Association of Regulatory Utility Commissioners**

1977-1995 **NARUC**, Member, Executive Committee; Member, Electricity Committee, Member, Gas Committee; **National Regulatory Research Institute**, Board of Directors

Present **Nuclear Control Institute**, Board of Directors

EDUCATION:

1964 ***B.A.*** History, **Yale University**, New Haven, CT

1968 ***L.L.B.*, *Yale* University School of Law**, New Haven, CT

AWARDS:

Teaching Fellowship, 1964-1965 (see above)

Honorary Degree, Unity College, 1981.

Environmental Award, Natural Resources Council of Maine, 1979.

PERSONAL:

Married (Susan Symmers Bradford)

Three Children (Arthur, Laura, Emily)

PUBLICATIONS of Peter A. Bradford

Books

Fragile Structures: A Story of Oil Refineries, National Security and the Coast of Maine, 1975, Harpers Magazine Press.

Law Review

"Maine's Oil Spill Legislation", Texas International Law Journal, Vol.7, No.1, Summer 1971, pp.29-43.

Articles

Book Review: "*The British Electricity Experiment - Privatization: the Record, the Issues, the Lessons*", Amicus Journal, June, 1997.

"*Gorillas in the Mist: Electric Utility Mergers in Light of State Restructuring Goals*", The National Regulatory Research Institute Quarterly Bulletin, Spring, 1997.

"*Til Death Do Us Part or the Emperor's New Suit: Does a Regulatory Compact Compel Strandable Investment Recovery?*", PUR Utility Quarterly, October, 1996.

"*Electric Bargain's Cost Is Dirty Air*", Newsday, L.A. Times Features Syndicate, 4/18/96.

"A Regulatory Compact Worthy of the Name", The Electricity Journal, November, 1995, pp.12-15.

"Paved with Good Intentions: Reflections on FERC's Decisions Reversing State Power Procurement Processes", The Electricity Journal , August/September, 1995, pp.62-68.

'That Memorial Needs Some Soldiers and Other Governmental Approaches to Increased Electric Utility Competition', The Electric Industry in Transition, Public Utility Reports & NYSERDA, 1994, pp.7-13.

"Market-Based Speech", The Electricity Journal, September, 1994, p.85.

"In Search of an Energy Strategy", Public Utilities Fortnightly, 1/15/92.

Environmentalists' Statement No. 3-SR

Before the

Pennsylvania Public Utility Commission

Pennsylvania Power & Light Company Restructuring Plan

Docket No. R-00973954

Surrebuttal Testimony of

Peter A. Bradford

P.O. Box 497
Peru, VT 05152

Dated: August 15, 1997

Q. What is your overall reaction to the testimony of Dr. Alfred Kahn.

A. I am very glad to have Dr. Kahn participate in this proceeding for several reasons:

First, PP&L's decision to enlist him at this stage seems to acknowledge the unpersuasiveness of the earlier and more extreme Pennsylvania utility positions, including Dr. Kalt's original testimony asserting the existence of a regulatory compact compelling full recovery of all investment not found to have been imprudent[1].

Second, as his testimony states, we do not differ in our fundamental conclusion regarding the power of the Pennsylvania Commission to condition recovery of strandable investment on the achievement of other necessary goals.

Third, Dr. Kahn's testimony offers an opportunity to clarify genuine differences of view in ways that may prove useful to the Pennsylvania Commission.

Q. You do have points of concern then with Dr. Kahn's testimony?

A. Yes. For example, Dr. Kahn says that he agrees with me (Kahn testimony, p.3) regarding the absence of a binding regulatory compact that compels recovery of all prudent expenditure. He then says that my method of presenting this conclusion invites excessive disallowances and opportunistic behavior. However, several of Dr. Kahn's major presentations on this topic have been more vulnerable than mine to misuse in the direction of mandating full recovery not "expressly conditioned on full utility cooperation in achieving the best result for customers and the environment in the years ahead".

My testimony (pp. 4-6) contains a explicit safeguard against such misuse.

Dr. Kahn's principal past papers on strandable investment have contained no such explicit admonitions against interpretations in favor of an absolute right to full recovery. Indeed, the Edison Electric Institute put the 1994 paper authored by Drs. Kahn, Baumol and Joskow (whose cautionary note is buried midsentence on page 24) into the FERC Open Access NOPR in support of full and mandatory recovery[2].

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[1]See also the testimony offered by Messrs. Sidak and Brennan on behalf of PECO Energy.

[2]William J. Baumol, Paul L. Joskow, and Alfred E. Kahn, "The Challenge for Federal and State Regulators: Transition from Regulation to Efficient Competition in Electric Power," stating at p.24, "A failure now of policy makers to ensure the companies at least some reasonable level of recovery of their regulatorily approved costs in any transition to competition would leave investors, in effect, with part - a very large part - of the value of their property expropriated by the change in the rules of the game." (emphasis added) When Dr. Kahn wrote a

That paper contained no caution along the lines of "Does the presence of a societal compact compel regulators to require full recovery....? No. The presence of such a compact compels no such result". If it had, the risk of expensive misunderstanding would have been diminished.

Q. Since you and Dr. Kahn apparently agree that the Commission has wide latitude to condition recovery of strandable investment on the achievement of its view of the public interest within the statutory framework, are the remaining areas of disagreement of any consequence?

A. They do allow me to return Dr. Kahn's favor by protecting him from those who, conceivably emboldened also by his recent branding of many state regulators as "kleptocrats[3]", would misuse his testimony to argue for mandatory recovery of all investment not specifically found to have been imprudent. To that end, several further points are necessary.

First, Messrs. Kahn, Kalt and Moul seem to assert that strandable investment in Pennsylvania is occurring entirely because Pennsylvania is deciding to open its retail markets to competition. Therefore, they assert, government is "changing the rules".

In fact, strandable investment has several interdependent causes. It is not brought on only or even primarily by Pennsylvania's decision to permit retail competition[4]. It is at least as much a product of advances in less costly generating technology, compounded in some circumstances by surplus capacity at current prices. It is for this reason and not to encourage "regulatory opportunism"[5] (surely supine allowance of 100% recovery without full protection of other

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separate piece for the October 1994 Electricity Journal, one reader's misunderstanding of his position led to an extended clarification in the December 1994 issue, "I have systematically refrained from making recommendations about the extent of the entitlement of utility companies to recover their sunk costs...It has been my consistent explicit policy to leave such determinations to regulators on the basis of considerations of equity, the likely effect of disallowances on the future cost of capital and assessments in the particular circumstances of the extent to which investors might properly be held to have had foreknowledge of the possibility of the change in the rules to their disadvantage or to have been compensated for such risks." at p.80.

[3]Speech at Electricity Journal conference, Florida, June, 1997.

[4]For reasons discussed in my original testimony, even strandable investment brought on by government decisions has generally not given rise to successful claims for a right of compensation.

[5]Dr. Kahn implication of regulatory "opportunism" on my part (especially pp.16-17, lines 19-3) is not easy to reconcile with his endorsement of the principles upheld by the New York PSC in the 1989 Shoreham settlement in the face of the public sentiment which he describes (pp.11-12). Nor is it consistent with my support of his efforts to get NARUC to endorse marginal cost pricing

legitimate interests is also "regulatory opportunism", perhaps even "kleptocratic") that I pointed out that restructuring at a time when marginal costs were equal to embedded costs would not have given rise to claims of confiscation or opportunism.

Even without the recent Pennsylvania law, wholesale competition coupled with low cost generation, surplus capacity and Pennsylvania's historic position regarding generation not found to be used and useful could produce substantial disallowances of high cost generating plant from rates. Indeed, even with the new law, the statutory provision (Section 2803) defining recoverable investment as that "which traditionally would be recoverable under a regulated environment....." is not as clear in endorsing full recovery of prudent investment as Dr. Kahn asserts , given the Pennsylvania "used and useful" decisions evoked by the word "traditionally".

Of course, investment stranded by competition and by surplus capacity has never been entitled to constitutional protection, so the claims of Pennsylvania utilities must depend ultimately on Pennsylvania's satisfaction with the eventual overall restructuring bargain.

Q. Is this position consistent with the Shoreham result alluded to by Dr. Kahn?

A. Yes. Dr. Kahn's discussion of Shoreham (Kahn testimony, pp.11-13) is instructive in two respects.

First, it illustrates the differences in traditional regulatory practices between New York and Pennsylvania. Pennsylvania commission and court decisions have emphasized the used and useful standard far more stringently than have comparable decisions in New York. I doubt that the 1989 Shoreham settlement would have been sustained in Pennsylvania.

Second, the Shoreham settlement embodies exactly the principle that Dr. Kahn and I agree on. It conditioned the opportunity for full recovery of almost all of the prudent investment in Shoreham on Lilco's agreeing to convey the plant to the Long Island Power Authority, a result that the state did not necessarily have the power to order directly. If Lilco had adopted the view that it had an absolute right to recover its prudent investment and had continued its insistence on running Shoreham as well, the settlement would not have been reached. It was no accident that the ALJ's more sweeping endorsement of a right to recover prudent investment in all circumstances was not approved by the Commission[6].

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in 1975-76.

[6]Similar principles produced similar results during my term on the Maine Commission in 1986-87, when the Maine utilities sold their shares of Seabrook in return for assurances of an opportunity to recover the prudent investment in that plant. In that case also, the utility recovery of nearly all of the prudent cost depended on their cooperation in larger ends that the Commission did not have a clear power to achieve through direct order.

Q. Do you agree with Dr. Kahn's imputation of "significance" (Kahn testimony, footnote 5) to your not having cited commission decisions adopting Professor Bonbright's suggested remedies?

A. Dr. Kahn, with equal significance, makes no claim that Commissions have not done so. Certainly a number of Commissions have adjusted depreciation schedules and returns on equity to reflect shortened service lives or changes in risk. Apparently neither of us has reviewed the Pennsylvania practice in this regard.

Q. Do you advocate retroactive ratemaking (Kahn testimony, p. 19, line 4) when you point out that utilities have historically earned returns comparable to unregulated industrial companies?

A. No. My point was that utility investors have historically been compensated at rates comparable to those available in firms that faced the full range of market risks, including very large possible losses when the imbedded costs of the utility exceeded the costs of their competitors.

Q. What response do you have to the rebuttal testimony of Dr. Kalt?

A. Dr. Kalt's testimony improves the points made in his original testimony but does not introduce new considerations. His general discussion of "the rules of the game" (at pp.49-58) is not specific to Pennsylvania, where - as my original testimony makes clear - investors have never had reason to believe that all investment not disallowed as imprudent would be recovered.

As my original testimony establishes (pp. 18-20), investors had a degree of notice, growing throughout the 1980s, that electric competition was a possibility. They had absolute notice that six and seven figure losses in electric utility investments without imprudence findings were possible, especially in utilities with large nuclear construction programs. They knew that Pennsylvania, in particular, had a strong policy requiring that investment be used and useful even after entering rate base. They had the published view of the chief spokesman for Pennsylvania utilities:

> "Show me the investor who will put his money into electric utility securities under existing (Pennsylvania) conditions and I'll show you the embodiment of the principle that a fool and his money are soon parted[7]".

In short, the Queensberry ideals laid out by the PP&L witnesses and the "the rules of the game" that have shaped the legitimate expectations of Pennsylvania investors seem quite different.

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[7]Vincent Butler, "A Social Compact to be Restored", Public Utilities Fortnightly, 26 December, 1985, p 17-21, at 20.

Q. But could investors have foreseen that the Pennsylvania Legislature would pass a law in late 1996 mandating retail competition?

A. In his novel Gravity's Rainbow, Thomas Pynchon wrote something along the lines of "If they can keep you asking the wrong questions, then they don't have to worry much about the answers."

The foreseeability of retail competition in the electric power industry has grown steadily throughout the 1980s, and - as my original testimony notes - it was seriously discussed by Pennsylvania state government 15 years ago. However, investors are not entitled to specific notice of the nature and timing of each and every risk. Indeed, uncertainty is by definition a component of risk. Furthermore, as noted above, strandable investment is not exclusively the product of government policy and could occur in Pennsylvania even if the 1996 law had not been enacted.

Q. Mr. Moul suggests that investors have not been compensated for the risks of stranded investment and seeks to discredit "the William Foley study". Does his testimony require modification of yours?

A. No. Mr. Moul dismisses the Foley study (presumably the study by Michael Foley and Ann Thompson referred to in my testimony) for several reasons that are unconvincing. His points regarding the foreseeability of retail competition and investor risk in Pennsylvania are rebutted above. In addition:

1) His specific concerns about the 1972 - 1992 period as being atypical do not take into account the fact that the Foley study was performed at least twice during the 1980s and reached similar conclusions. While I do not have the earlier versions, I believe that they covered earlier time periods, negating Mr. Moul's concerns about events in 1972 (Moul testimony, p. 32). These concerns are baseless in any case because the multiple holding period technique used by Foley and Thompson would smooth out abnormalities arising from events in a particular year. Finally, several of the 1972 factors cited as abnormal by Mr. Moul work against utility investors, thereby reducing their gains relative to industrial investors and reinforcing the Foley/Thompson conclusions.

2) The update of the Foley Thompson results performed by Mr. Moul still shows utility returns, and PP&L in particular, to be in the same range as the S&P industrials, despite virtually unprecedented S&P performance in recent years. Such growth, of course, tends to depress the relative performance of utility stocks which are generally less volatile. Mr. Moul's testimony does not make clear whether he duplicated the multiple holding period technique used by Foley and Thompson to diminish the impact of such unique events. If he did not, then the impact of the recent events is magnified further.

Q. Does this conclude your surrebuttal testimony?

A. I would like to conclude by reiterating that my testimony does not compel or endorse full disallowance of prudently incurred investment. It seeks to assist in providing a framework within which legitimate expectations can be balanced to achieve a comprehensive restructuring. It also rebuts claims that entitlements to recover all investment not disallowed as imprudent must be honored before negotiation or decision regarding other aspects of restructuring can proceed.

PETER A. BRADFORD

Affidavit

My name is Peter Amory Bradford.

I submitted direct and surrebuttal testimony in Pennsylvania Power & Light Company- Docket #R00973954- before the Pennsylvania Public Utilities Commission.

I swear that this testimony is true and correct to the best of my knowledge and belief. If called to testify under oath, my testimony would be the same as appears in those pages.

Peter Amory Bradford — 8/20/97

signed: Peter Amory Bradford — Date

At Town of Peru, County of Bennington, State of Vermont, this 19th day of August, 1997. The parties named personally appeared here and acknowledged this instrument by him sealed and subscribed to be his free act and deed.

Before me K A Williams

Notary public

March 5, 1998

Commission expires

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