

# ELECTRIC UTILITY RESTRUCTURING AND THE LOW-INCOME CONSUMER

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## What's a "Stranded Cost"?

The electric utility industry is one of the most capital intensive industries in the world. Throughout the years, electric utilities have spent literally tens of billions of dollars to build power plants to provide consumers power. Today's debate over "stranded costs" involves the question of who pays for those costs that are rendered uneconomic by a competitive market.

### Current Cost Recovery

Under many state laws, the local electric utility is entitled to recover its expenditures on power plants unless the company has been shown to have been "imprudent" in making the expenditures. In other states, the local utility has to show that the power plant is both in operation and providing benefits to consumers in order to include the costs in rates.

In all states, the level of utility profit is tied to the level of capital investment the local electric company has made. Since the amount of profit increases as the amount of invested capital increases, utilities have an incentive to maximize their capital investment, so long as they can show that it was "prudent" and providing benefits to consumers.

Given this regulatory framework, not all utility expenditures have been wise investments. Some utilities invested heavily in nuclear power, at a cost of billions of dollars per generating plant. Other utilities built too many power plants (or built plants that were too big). These utilities ended up with plants that produced electricity far beyond the amounts that consumers actually consumed, a result known as "excess capacity." Under existing regulatory structures, most of these utilities were still charging the costs of these bad investments to consumers.

### The Impact of Competition

Under a restructured electric industry, this would all change. If consumers were given the option of buying power from a less expensive electric company, the companies that did not have nuclear power plants (or that did not have substantial "excess capacity") would be able to offer consumers prices much cheaper than could the companies with the excess costs.

In order to compete, the local utility would need to lower its prices to the same level as the cheaper companies. These lower prices, however, would not allow the utility to recover its entire investment in plant. Some of the costs of the power plants would be "stranded."

What stranded costs are, therefore, are those existing power plant expenses which a utility would pass on to consumers under regulated rates so long as the utility was a monopoly, but which it could not recover in a competitive electric industry. Thus, if a utility built a \$4 billion nuclear power plant, but could only collect \$3 billion if it had to lower prices to compete under a restructured electric industry, it would have a "stranded cost" of \$1 billion.

### Who Pays for "Stranded Costs"?

One of the major issues facing public policymakers is to what extent utilities should be allowed to recover their stranded costs despite the move to a competitive electric industry. If stranded cost recovery is allowed, customer bills will include a "surcharge" to pay for the utility's uneconomic investments. The surcharge will be the difference between the actual cost of the power plants and what the utility could charge

for those plants under competitive conditions.

### **The Argument Against Stranded Costs**

People who argue against allowing the recovery of stranded costs say that it makes no sense to make the electric industry subject to competition and then to force consumers to pay the high prices that could not be supported in a competitive industry. Such a policy is simply a multi-billion dollar bailout of the utility industry, forcing consumers to bear the brunt of bad business decisions made by utility managers. No other competitive industry has the ability to force consumers to pay for bad investments.

In addition, these people urge, allowing the recovery of stranded costs defeats the entire purpose of restructuring the electric industry. The purpose of restructuring is to allow consumers to choose lower priced electric suppliers. If consumers have to pay for the past bad investments of utilities, consumers have no chance to obtain those lower prices.

Finally, stranded cost opponents say that just as the food store, or the auto dealer, or the shoe store must bear the consequences of making bad business decisions, so, too, should the electric utility industry. That is the nature of our economic system.

### **The Argument for Stranded Cost Recovery**

In contrast, electric industry proponents argue that consumers should pay for all power plants that were built to provide electricity. Any power plant that was built, these analysts say, was approved by regulators at some point in time before construction. Part of that approval process was a requirement that the utility prove the "need" for the plant.

In addition, these proponents say, the power plants at issue were built, at least in part, because the utilities had an "obligation to serve."

Utilities have a legally enforceable obligation to provide sufficient power upon demand. When a customer flips a light switch on, there must be enough electricity to run all of the lights.

It would be unfair, these proponents conclude, to require utilities to shoulder this obligation to serve without imposing an "obligation to pay" at the same time. Under this argument, consumers should have an obligation to pay for all expenses that the utility incurred in responding to the responsibilities imposed upon it by law for the consumers' benefit.

### **Summary**

Electric utilities facing competition will not be able to charge prices sufficiently high to allow the recovery of all costs for existing power plants. In light of this reality, the debate over stranded costs poses the following question: is this inability to recover costs simply a natural result of the functioning of a competitive market toward businesses that made bad investments, or, is it instead an unfair imposition on an industry that was operating under a legal obligation to serve?

The answer to that question has multi-billion dollar implications both to consumers and to utility investors.

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