The history of the FERC's efforts regarding the treatment of transition and stranded costs has been summarized in United Distribution Companies v. FERC.[28] It also has been chronicled by Dryden and Bowe in a monograph commissioned by the Edison Electric Institute.[29] Having required "open access" to the interstate pipeline system, in Order No. 436, the FERC largely ignored embedded costs related to "take-or-pay" contract liabilities and then tried meekly to address them, in Order No. 500.[30] The U.S. Court of Appeals for the District of Columbia Circuit twice remanded the matter to the FERC for enhancement of its efforts to address these "take-or-pay" issues.[31]

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[28] 88 F.3d 1105, 1176-1191 (D.C. Cir. 1996).

[29] Dryden, J. and Bowe, J.F., Jr., FERC Treatment of Stranded Investment in the Natural Gas Pipeline Industry (Edison Electric Institute, 1994).

[30] Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 436, 50 Fed. Reg. 42, 408 (Oct. 18, 1985), [Regs. Preambles 1982-1985] FERC Stats. & Regs. Para. 30,665 at 31,495, modified, Order No. 436-A, 50 Fed. Reg. 52,217 (Dec. 23, 1985), [Regs. Preambles 1982-1985] FERC Stats. & Regs. Para. 30,675, modified further; Order No. 436-B, 51 Fed. Reg. 6398 (Feb. 24, 1986), [Regs. Preambles 1986-1990] FERC Stats. & Regs. Para. 30,668, reh'g denied; Order No. 436-D, 34 FERC Para. 61,405, recon. denied; Order No. 436-E, 34 FERC Para. 61,403, vacated and remanded sub nom.; Associated Gas Distributors v. FERC, 824 F.2d 981 (D.C. Cir. 1987); Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 500, [Regs. Preambles 1986-1990] FERC Stats. & Regs. Para. 30,761 (1987), modified; Order No. 500-B, [Regs. Preambles 1986-1990] FERC Stats. & Regs. Para. 30,772 (1987), modified further; Order No. 500-C, [Regs. Preambles 1986-1990] FERC Stats. & Regs. Para. 30,786 (1987), vacated and remanded sub nom.; Associated Gas Distributors v. FERC, 893 F.2d 349 (D.C. Cir. 1989).

[31] In subsequent proceedings, the FERC adopted, and the appellate court approved, various measures designed to allow pipelines to pass through take-or-pay obligations to their customers. Under the revised FERC policy, a pipeline could agree to absorb between 25% and 50% of its take-or-pay costs in exchange for the right to bill customers an equal share through a fixed demand surcharge, and recover the remaining amount through a volumetric surcharge based on total throughput. United Distribution Companies v. FERC, 88 F.3d 1105, 1177 (D.C. Cir. 1996).

In Order No. 636,[32] the FERC concluded its massive natural gas industry restructuring and explicitly recognized the need to address other embedded transition cost issues proactively. Order No. 636 provided mechanisms for the recovery of four types of transition costs: unrecovered purchased gas cost balances, gas supply realignment costs, stranded costs and new facilities costs. The FERC has also stated that it will not apply the "used and useful" standard to the transition costs recoverable under Order No. 636. Part of this progressive change in the FERC's approach to stranded cost recovery is due to its growing sense that "it is the Commission-mandated sea-change in the regulation of the natural gas industry that is the proximate cause of the stranding of investment in gas supplies and facilities pipelines are now confronting."[33]

In Order No. 636, the FERC mandated unbundling and also authorized customers to reduce their pipeline gas purchases. When customers exercised their rights under Order No. 636 and secured gas supplies from other sources, the pipelines once again incurred substantial "take-or-pay" liabilities. Although the FERC defined these liabilities as "gas supply realignment" ("GSR") costs in Order No. 636, they arose from the same type of contract provisions as the "take-or-pay" costs considered in Order No. 436. In Order

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[32] Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 636, 57 Fed. Reg. 13,267 (Apr. 16, 1992), III FERC Stats. & Regs. (CCH) Para. 30,939 (Apr. 8, 1992), order on reh'g; Order No. 636-A, 57 Fed. Reg. 36,128 (Aug. 12, 1992), III FERC Stats. & Regs. (CCH) Para. 30,950 (Aug. 3, 1992), reh'g denied; Order No. 636-B, 57 Fed. Reg. 57,911 (Dec. 8, 1992), 61 FERC (CCH) Para. 61,272 (1992), aff'd in part and remanded in part; United Distribution Companies v. FERC, 88 F.3d 1105 (D.C. Cir. 1996).

[33] Dryden and Bowe, supra at 33.

No. 636, however, the FERC revised its policies regarding recovery of these transition costs to better address the needs of the pipelines.

> Instead of refusing to establish a mechanism for pipelines to recover their take-or-pay costs, as it originally had in Order No. 436, FERC authorized pipelines to bill their customers separately for 100% of their GSR costs. This policy was, in fact, a substantial change from even Order No. 500, which permitted pipelines to surcharge their transportation customers for take-or-pay costs only if they agreed to absorb between 25 and 50% of those costs. The Commission set forth the mechanisms available to pipelines under Order No. 636 as follows:
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> > . . . The Commission will permit pipelines full cost recovery of prudently incurred gas supply realignment costs deemed to be eligible under this rule. To recover these costs, a pipeline will be permitted to use either a negotiated exit fee, or a reservation fee surcharge recoverable from Part 284 firm transportation customers.
> >
> > Under this rule, a firm entitlement holder has options as to how to react to gas supply realignment costs: it may remain a sales customer of the pipeline; otherwise, it may take an assignment of the pipeline's existing contracts or pay an exit fee/reservation fee surcharge for costs approved by the Commission.
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> Order No. 636, ¶ 30,939, at 30,458. On rehearing, FERC modified this ruling somewhat, and required pipelines to bill 10% of their GSR costs to interruptible transportation customers.[34]

Under Order No. 636, pipelines were also permitted to recover three other types of significant transition costs: (1) unrecovered gas costs or credits remaining in the purchased gas adjustment ("PGA") account when a pipeline terminated its PGA mechanism; (2) costs of pipeline assets (e.g., storage facilities) currently used to provide bundled sales

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[34] United Distribution Companies v. FERC, 88 F.3d 1105, 1177 (D.C. Cir. 1996).

service which are not directly assignable to customers of the unbundled services ("stranded costs"); and (3) costs for equipment required to physically implement Order No. 636 ("new facility costs"). On review, the D.C. Circuit largely upheld the FERC's current treatment of the recovery of stranded and transition costs.[35]

There is an important similarity between the initial treatment of long term purchasing agreements in the gas industry and the use of TELRIC in arbitrations: the LECs' long term investments in providing interconnection and network elements are priced under TELRIC as if users are entering a long term purchasing contract with the LEC. There is no such contract, because users are free to drop the LEC's services at will, with no "exit fee." Thus, the TELRIC methodology essentially prices network elements, other services, and facilities as long term investments, without any long term commitment to pay for them. This approach seems destined to create enormous stranded costs in the future.

3. State Regulatory Policies Addressing Stranded Cost Recovery in the Natural Gas Industry

State regulators also have crafted several means to prevent and mitigate potential stranded costs resulting from restructuring of the natural gas industry. For example, after the FERC's "open access" pipeline requirements were implemented in the mid-1980s, many state commissions began offering gas local distribution companies ("LDCs") rate flexibility as necessary to retain industrial customers that were presented with

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[35] Id. at 1191. However, the court remanded for further explanation of the FERC's decisions to allow pipelines to pass through all their GSR costs to customers, and to allocate 10% of GSR costs to interruptible transportation customers, and the FERC is presently considering the remanded issues. See id.

an option of switching fuels or tying directly into a gas pipeline to bypass the LDC. This helped mitigate potential stranded costs by assuring that industrial customers at least continued to stay on the LDC's system while covering the marginal cost of service and some contribution to fixed system costs.

In addition, state regulators have routinely passed through to customers "take-or-pay" contract costs and FERC-mandated "transition" costs through automatic adjustment clauses known as Purchased Gas Adjustment Clauses ("PGAs"). The PGA mechanism ensures that all customer classes, including large industrial customers that choose to use competitive suppliers of natural gas, would pay their fair share of the take-or-pay contract costs and transition costs.[36]

4. Summary of Regulatory Policies Addressing Stranded Cost Recovery in the Natural Gas Industry

In summary, state and federal regulators have recognized the need to allow regulated natural gas pipelines the opportunity to recover actual costs associated with the transition from regulation to market competition in the natural gas industry. These transition costs have included massive "take-or-pay" contract liabilities, similar "gas supply realignment" costs, stranded costs associated with facilities used to transport and store natural gas, new facility costs required to physically implement the industry restructuring, and certain unrecovered gas costs that remained on the books following the elimination of the pipelines' purchased gas adjustment mechanisms. Although the FERC initially ignored these

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[36] This practice recently has been affirmed in Missouri. See State ex rel. Midwest Gas Users' Association v. Public Service Commission of Missouri, Case No. CV195-1318cc (Cole County Cir.Ct., 1996).

transition costs, the federal courts, upon appeal, required the FERC to more proactively address their recovery.

Upon remand, the FERC developed policies designed to allow natural gas pipelines to be reimbursed for a substantial portion of the transition costs. State regulators also have been responsive to the need to pass through to customers these transition costs through the widespread use of automatic adjustment clauses and similar recovery mechanisms. Moreover, state regulators and the FERC have also used the experiences with the recovery of stranded costs in the natural gas industry as models for the recovery of stranded costs in the electric industry as the electric industry transitions to a more competitive market structure.

B. The Electric Industry

As discussed above, a number of federal court cases stand for the proposition that when costs incurred by a regulated utility are stranded by regulatory or legislative action, the regulatory agency must provide the utility with reasonable methods and opportunities to recover such costs from customers on whose behalf they were incurred.[37]

The FERC, which has federal jurisdiction over the electric utility industry as well as the natural gas industry, clearly learned from its experience with the transition of natural gas pipelines to a more competitive market, and determined that the same mistakes should not be repeated in the case of electric industry restructuring. As a result, the FERC

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[37] Associated Gas Distribs. v. FERC, 893 F.2d 349 (D.C. Cir. 1984), cert. denied, 111 S.Ct. 277 (1990). See also KN Energy Inc. v. FERC, 968 F.2d 1295, 1301-02 (D.C. Cir. 1992); American Gas Ass'n. v. FERC, 912 F.2d 1496 (D.C. Cir. 1990); United Distribution Companies v. FERC, 88 F.3d 1105 (D.C. Cir. 1996).

has devoted considerable attention to the issue of stranded cost recovery in the current transition to a competitive wholesale electric generation market in the United States. In addition, the state commissions are treating stranded cost recovery as an essential element of transition to retail electricity competition. As has been observed by industry commentators:

> From both the state and federal perspective, the key to the efficient competition necessary to produce abundant supplies of electricity at the lowest costs to society is the comparable treatment of similarly situated consumers. Consumers who benefit from transactions structured to avoid system costs are not situated comparably to customers required to bear such costs. . . . Thus, if a state permits consumers to have the option of direct access to electricity suppliers of their choice, it should condition the availability of such access on the consumer's payment of its fair share of system costs.[38]

This is consistent with a general policy requirement that costs be recovered from those users that incur them.

1. Transition To Competition In The Electric Industry

Historically, state and local regulation of electricity pre-dated federal involvement. Investor-owned electric utilities generally were regulated by city councils from whom they had received operating franchises and, eventually, by state utility regulatory commissions. However, a jurisdictional void became apparent in 1927 when the U.S. Supreme Court held that Rhode Island could not regulate the rate of a sale at wholesale by a Rhode Island utility (Attleboro Steam and Electric Company) to a Massachusetts

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[38] Steinmeier, W. and Stuntz, L., Stranded Costs: A Study on the Treatment of, and Jurisdiction Over, Electric Utility Costs During Transition to a More Competitive Industry (Edison Electric Institute 1994) ("Electric Utility Stranded Costs Study") at 11-12.

distributor.[39] To close what became referred to as the "Attleboro Gap," Congress passed the Federal Power Act ("FPA")[40] in 1935, giving the Federal Power Commission (later the FERC) authority over transmission in interstate commerce and wholesale power transactions. At the same time, Congress reserved to the states complete jurisdiction over costs associated with generation and distribution of electricity to retail customers. Thus, it has been observed, "[t]he FPA links the jurisdiction of the states and the FERC in a common purpose: 'to encourage the orderly development of plentiful supplies of electricity and gas at reasonable prices.' Congress contemplated nothing less than a system of cooperative federalism."[41]

Within that system, both federal and state regulatory regimes provided for limited entry into the electricity business and imposed on certificated service providers an "obligation to serve" all customers. In 1978, in response to OPEC oil embargoes and the ensuing energy crises in the United States, Congress passed the Public Utility Regulatory Policies Act of 1978 ("PURPA"),[42] which encouraged the development of cogeneration and small-power production facilities fueled by renewable resources in a national effort to squeeze out and utilize every available energy source and achieve "Energy Independence." Although PURPA required utilities to purchase the output of PURPA cogenerators and small-

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[39] Public Utilities Commission v. Attleboro Steam and Electric Company, 273 U.S. 83 (1927).

[40] 16 U.S.C. § 824 et seq.

[41] Electric Utility Stranded Costs Study, supra, at 10-11 (quoting NAACP v. FPC, 425 U.S. 662, 669-70 (1976).

[42] Pub. L. No. 95-617, 92 Stat. 3117 (codified generally as 16 U.S.C. § 2601 et seq.).

power producers ("Qualifying Facilities," or "QFs") at each utility's avoided cost, it did not introduce direct competition for customers into the electricity industry.

The federal Energy Policy Act of 1992 ("EPAct"),[43] however, did introduce direct competition into the wholesale generation segment of the electric industry. EPAct required that third-party suppliers of electricity be given "open access" to electric transmission facilities under FERC jurisdiction (those of investor-owned electric utilities). Subsequent orders of the FERC are implementing EPAct, culminating in Order No. 888, issued April 24, 1996.[44] These orders are creating the framework for a workably competitive wholesale generating market based on "comparability" of terms and conditions for electricity transmission. All investor-owned utilities ("IOUs") have been required to file open access tariffs with the FERC, permitting third-party suppliers to use their transmission facilities on the same terms and conditions as the IOU itself. These tariffs unbundle wholesale electricity rates into specific generation, transmission, and ancillary services elements, similar to the rate unbundling in natural gas and telecommunications.[45]

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[43] Pub. L. No. 102-486, 106 Stat. 2776 (1992) (codified as 15 U.S.C. § 79z-5a, 16 U.S.C. §§ 796, 824).

[44] Promoting Wholesale Competition Through Open-Access Non-Discriminatory Transmission Services by Public Utilities: Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, Final Rule, FERC Stats. and Regs. Para. 31,036 et seq. (1996).

[45] See note 27 supra.

2. FERC Treatment of Transition and Stranded Costs in the Electric Industry

The FERC drew upon the lessons learned from the transition to greater competition in the natural gas industry to recognize immediately that EPAct would create the stranding of certain costs incurred by utilities under traditional regulation. Therefore, in June, 1994, FERC issued a Notice of Proposed Rulemaking ("NOPR") entitled "Recovery of Stranded Costs by Public Utilities and Transmitting Utilities."[46] The next year, without issuing a final rule in that docket, the FERC incorporated its proposed stranded cost recovery provisions into a massive and comprehensive open access NOPR[47] (commonly referred to as the "Mega-NOPR") which resulted in FERC Order No. 888.

In the process of implementing the new, Congressionally-mandated system of open access electricity transmission, the FERC recognized that open access would cause the "stranding" of costs (as well as assets) of electric utilities that were incurred under traditional regulation.[48] In Order No. 888, the FERC clearly acknowledged that it was government action, and not simply the operation of coincident, external market forces, which created the condition of unrecoverability of certain embedded and other costs of utilities. The Order states:

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[46] 59 Fed. Reg. 35,274 (July 11, 1994).

[47] Promoting Wholesale Competition Through Open-Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Notice of Proposed Rulemaking and Supplemental Notice of Proposed Rulemaking, FERC Docket Nos. RM95-8-000 and RM-94-7-001, 60 Fed. Reg. 17662 (Apr. 7, 1995), FERC Stats. & Regs. Para. 32,514 (1995); Real-Time Information Networks and Standards of Conduct, Notice of Proposed Rulemaking, FERC Docket No. RM95-9-000, 60 Fed. Reg. 66,182 (Dec. 21, 1995), FERC Stats. & Regs. Para. 32,516 (1995).

[48] See FERC Order No. 888 at 451-455.

> We will not ignore the effects of recent significant statutory and regulatory changes on the past investment decisions of utilities. . . . With the new open access, the risk of losing a customer is radically increased. If a former wholesale requirements customer or a former retail customer uses the new open access to reach a new supplier, we believe that the utility is entitled to recover legitimate, prudent and verifiable costs that it incurred under the prior regulatory regime to serve that customer.[49]

The FERC also directly acknowledged that its decision concerning stranded electricity cost recovery was impacted by its prior experience with the natural gas pipeline industry:

> As we stated in the Supplemental NOPR, the court's reasoning in the gas context applies to the current move to a competitive bulk power industry. Indeed, because the Commission failed to deal with the take-or-pay situation in the gas context, the court invalidated the Commission's first open access rule for gas pipelines. Once again, we are faced with an industry transition in which there is the possibility that certain utilities will be left with large unrecoverable costs or that those costs will be unfairly shifted to other (remaining) customers. That is why we must directly and timely address the costs of the transition by allowing utilities to seek recovery of legitimate, prudent and verifiable stranded costs.[50]

The FERC recognized both the legitimacy of the right of utility investors to recover stranded costs and the policy necessity of providing for such recovery in order to achieve a fully competitive market. In its Order No. 888, the FERC stated: "We are issuing the Stranded Cost Final Rule simultaneously with the Open Access Final Rule because we believe that the recovery of legitimate, prudent and verifiable stranded costs is critical to the successful transition of the electric industry to a competitive, open access

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[49] Id. at 452-453.

[50] Id. at 454.

environment."[51] The Commission confirmed its view that failure to provide for stranded cost recovery could impair the financial ability of a utility to continue to provide reliable service, and could erode a utility's access to capital markets.[52]

The FERC also recognized that "stranded costs" were not synonymous with "stranded assets," that is, specific assets which would no longer be used and useful in a competitive environment. Rather, "wholesale stranded costs" would include "any legitimate, prudent and verifiable cost incurred by a public utility or a transmitting utility to provide service" to a wholesale requirements customer that changes suppliers, or a retail customer or newly created wholesale power sales customer that subsequently becomes an unbundled wholesale transmission services customer of the utility.[53] Recoverable stranded costs are to be based on a "revenues lost" approach, calculated by subtracting the competitive market value of the power the customer would have purchased from the revenues that the customer would have paid had it stayed on the utility's generation system.[54] "The revenues lost approach does not attempt to identify specific uneconomic assets," the FERC explained, "and is not limited to only long-lived assets. Instead, it . . . encompasses all fixed costs of providing service."[55]

Therefore, FERC Order No. 888 carefully provides for the full recovery by electric utilities of stranded costs from wholesale customers who choose to change suppliers:

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[51] Id.

[52] Id. at 514.

[53] Id. at 618, 624.

[54] Id. at 573, 595.

[55] Id. at 617.

> We reaffirm our decision that direct assignment of stranded costs to the departing wholesale generation customer through either an exit fee [footnote omitted] or a surcharge on transmission is the appropriate method for recovery of such costs. We believe it is appropriate that the departing generation customer, and not the remaining generation or transmission customers (or shareholders), bear its fair share of the legitimate and prudent obligations that the utility undertook on that customer's behalf.[56]

3. State Treatment of Transition and Stranded Costs in the Electric Industry

A number of states have also recognized the necessity of providing for stranded cost recovery as part of opening retail electricity markets to competition. For example, the California Public Utilities Commission ("PUC") Policy Decision of December 20, 1995, provided for retail customer choice in California beginning on a limited basis in 1998, and for all customers by 2003. That Policy Decision clearly acknowledges the right of utility investors to an opportunity to recover costs stranded by the government action of restructuring the retail electric industry, and provides for the implementation of a Competitive Transition Charge ("CTC") to accomplish that end. Said the PUC:

> We conclude that the utilities should be allowed to recover appropriate transition costs. Longstanding regulatory policies, past Commission decisions, and ongoing regulatory effects persuade us of the need, during the transition to full competition, for a process to account for the lingering effects of today's market structure. Thus, we must develop a method to minimize the effects of the high-cost elements in the competitive market structure, while we close the books on past practices. We will identify utility capital investments and contractual obligations, quantify their costs as accurately as possible, and separately identify a charge to recover these costs. Our goal is to get through this transition period as quickly as possible so that full competition can begin with minimal market distortions.

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[56] Id. at 477.

> We also emphasize . . . that maintaining the financial integrity of the utilities is an important goal of this proceeding, and a goal we will pursue in making the transition to a more competitive marketplace. Investors' uncertainty about the recovery of transition costs may harm the utility's ability to raise capital and may result in a higher cost of debt. If we do not provide for adequate transition cost recovery, the move to competition may threaten the utilities' financial stability. If the utilities were required to write off the entire amount of above-market levels of investments, they could face a financial disruption that might lead to lower system reliability and inefficient operation.[57]

The California PUC also observed that the costs utilities were entitled to recover through the CTC are not new or additional costs to customers. It made this important point: "We note for clarity that future potential transition costs (with few exceptions) are already embedded in utility rates today; transition costs would simply be identified in a different way than they are today and this change should neither create a new ratepayer cost nor result in a higher revenue requirement."[58] Legislation adopted by the California Legislature in 1996 provides the statutory authority necessary to implement the CTC.[59]

The Massachusetts Department of Public Utilities ("DPU") issued a major electric restructuring order in 1995, in which it also acknowledged the legitimacy of the stranded cost recovery issue. The DPU stated that "[r]esponsible policy must provide electric utilities a reasonable opportunity to recover net, non-mitigable stranded costs during

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[57] Governing Restructuring California's Electric Services Industry and Reforming Regulation, Policy Decision, Docket Nos. R.94-04-031, I.94-04-032 (Cal. PUC, issued Dec. 20, 1995, mod. Jan. 10, 1996), at 119-120.

[58] Id. at 113.

[59] See California Assembly Bill 1890 (enrolled Aug. 31, 1996).

the transition period."[60] On December 30, 1996, the Massachusetts DPU issued an "Electric Industry Restructuring Plan: Model Rules and Legislative Proposal," in which it affirmed its conclusion that sound public policy and the public interest require that utilities be given a reasonable opportunity to recover stranded costs, and proposed implementation of a non-bypassable stranded cost access charge to accomplish that end.

Electric industry restructuring orders, proposals and legislation in other states, including Maine, Rhode Island, and Vermont,[61] similarly provide for the recovery of embedded costs by incumbent utilities. A number of states, including California, Florida, Ohio, and Pennsylvania, also have addressed the issue of potential stranded electricity costs by authorizing an acceleration of depreciation of nuclear generating assets and other potential stranded costs.[62]

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[60] Investigation by the Department of Public Utilities on its own motion into electricity industry restructuring, D.P.U. 95-30, Order (Aug. 16, 1995) at p. ii.

[61] See, e.g., Re: Electric Utility Industry Restructuring, Maine Public Utilities Commission, Report and Recommended Plan, Docket No. 95-462 (Dec. 1996); Rhode Island Utility Restructuring Act of 1996, RIGL § 39; Re: Investment into the Restructuring of the Electric Utility Industry in Vermont, Vermont Public Service Board Docket No. 5854, (Dec. 1996).

[62] See, e.g., Re: Southern California Edison Company, California Public Utilities Commission Decision 94-05-068, Application 93-02-010, 152 PUR 4th 263 (May 1994); Re: Petition to Establish Amortization Schedule for Nuclear Generating Units to Address Potential for Stranded Investment by Florida Power & Light Company, Florida PSC Docket No. 950359-EI, (Mar. 1996); Re: Application of Ohio Edison Company, Ohio PUC Case No. 95-830-EL-UNC (Oct. 1995); Re: PECO Energy, Pennsylvania PUC Docket No. P950982 (Feb. 1996); Re: Pennsylvania Power Company, Pennsylvania PUC Docket No. P961028 (June 1996); see also Barnaby J. Feder, The Nuclear Power Puzzle - Deregulation Raises Questions Over Construction Debt, N.Y. Times, Jan. 3, 1997, at D1.

V. THE POLICY REASONS FOR RECOVERING ACTUAL LEC COSTS

The recovery of actual costs is necessary for competition to be full, fair, and economically efficient. Failure to allow LECs to recover actual costs incurred in fulfillment of their obligation to serve will prevent competition from being fair and efficient.

A similar concern for the electric industry was addressed by the economists William Baumol, Paul Joskow, and Alfred Kahn in a 1995 monograph, which found that "[c]onsiderations of equity and efficiency alike demand that policy makers face up to the need to give utility companies the opportunity to recover ... potentially stranded costs in any transition to competition."[63]

These distinguished economists went on to say that "[i]f all competitive transactions do not share those costs proportionately, competition . . . will take place on an uneven playing field, and the utility company will be unable to compete even if it is the more efficient provider."[64] Although the authors all "subscribe [to competition] as a general principle,"[65] they advance the view that without stranded cost recovery, "the piecemeal transition that is currently underway will be unnecessarily costly: there will otherwise be no assurance that the most efficient supplier will prevail."[66] Thus, the efficacious mitigation

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[63] William Baumol, Paul Jaskow and Alfred Kahn, The Challenge for Federal and State Regulators: Transition from Regulation to Efficient Competition in Electric Power (Edison Electric Institute, 1995) at 137.

[64] Id. at 51.

[65] Id. at 21.

[66] Id. at 4.

and recovery of potential stranded costs will advance the movement toward an efficient and competitive telecommunications marketplace.[67]

Outside of a true competitive market, if LECs are unable to recover in their rates prudently-incurred costs previously approved for recovery from customers because of policies imposed by the states and the FCC to artificially "jump-start" competition, their cost of capital is likely to increase, reducing their access to available capital in the markets. A LEC's ability to attract adequate capital on reasonable terms has important implications for system replacement, maintenance, and expansion and, therefore, for service quality and reliability.

This concern for investor interests was confirmed by President Clinton's Council of Economic Advisers in the 1996 Economic Report of the President:

> In unregulated markets the possibility of stranded costs typically does not raise an issue for public policy -- it is simply one of the risks of doing business. However, there is an important difference between regulated and unregulated markets. Unregulated firms bear the risk of stranded costs but are entitled to high profits if things go unexpectedly well. In contrast, utilities have been limited to regulated rates, intended to yield no more than a fair return on their investments. If competition were unexpectedly allowed, utilities would be exposed to low returns without having had the chance to reap the full expected returns in good times, thus denying them the return promised to induce the initial investment. A strong case therefore can be made for allowing utilities to recover stranded costs where those costs arise from after-the-fact mistakes or changes in regulatory

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[67] In addition to assuring full, fair, and economically efficient competition, recovery of incumbent LECs' actual costs above forward-looking long-run incremental costs is also necessary out of fairness to LEC shareowners. A large percentage of LEC common stock is owned by individual shareowners, both directly and through pension and mutual funds, who have invested their hard-earned dollars under a long-standing set of rules and expectations affecting investments in local exchange companies, which should not be changed in mid-course to their detriment.

> philosophy toward competition, as long as the investments were initially authorized by regulators.[68]

The concern of the White House in its 1996 report was not just for current investors in the electric industry, but also for maintaining government credibility in order to encourage long-term investment in the U.S. economy generally:

> [R]ecovery should be allowed for legitimate stranded costs. The equity reason for doing so is clear, but there is also a strong efficiency reason for honoring regulators' promises. Credible government is key to a successful market economy, because it is so important for encouraging long-term investments. Although policy reforms inevitably impose losses on some holders of existing assets, good policy tries to mitigate such losses for investments made based on earlier rules. . . .[69]

These powerful reasons apply to the telecommunications industry in its current context, and should be heeded by the FCC in implementing the Telecommunications Act. To do so would be entirely consistent with prior history in telecommunications regulation, as well.

State regulators and the FCC provided for stranded cost recovery during the transition to competitive interexchange markets in the telecommunications industry during the 1980s. When the FCC began to authorize interstate toll competition[70] and the Modified Final Judgment[71] required "equal access" for long-distance competitors, as of September 1,

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[68] The Economic Report of the President (Feb. 1996) at 187.

[69] Id.

[70] See Specialized Common Carriers Services, First Report and Order, FCC Docket No. 18920, 29 FCC 2d 870 (June 1971); Bell Telephone Company of Pennsylvania v. FCC, 503 F.2d 250 (3rd Cir. 1974); MCI Telecommunications Corp. v. FCC, 561 F.2d 365 (D.C. Cir. 1977); MCI v. FCC, 580 F.2d 590 (D.C. Cir. 1978); FCC Docket No. 78-72, Third Report and Order (Feb. 1983).

[71] See United States v. Western Electric Co., 552 F. Supp. 131 (D.D.C. 1982), aff'd., 103 S. Ct. 1240 (1983).

1986, substantial "stranded investment" became an increased risk for traditional toll providers and local exchange telephone companies. At the same time, however, the FCC moved to ensure that the actual costs of access were recovered more efficiently from those who cause the costs to be incurred.[72]

State regulators have also actively sought to prevent or mitigate potential stranded costs during the introduction of competition into intrastate telecommunications markets. Concern about potential stranded costs and the impact of regulatory changes on LEC shareholders were major elements of state commission decisions in telecommunications about emerging competition. Thus, some state commissions provided for full cost recovery in decisions about the regulatory treatment of inside wiring and embedded customer premises equipment. State commissions also analyzed the impact of competition on cost recovery in determining the terms and conditions of provision of intraLATA toll service, shared tenant services, authorization of fiber-link networks, and other forms of competition to the traditional, monopoly local exchange.[73] For example, the Missouri Public Service Commission spent a great deal of time during the 1980s hearing and evaluating evidence

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[72] The FCC thus authorized a shift of non-traffic sensitive (NTS or "local loop") costs from toll rates to a federal flat-rate, monthly End User Common Line Charge ("EUCL" or subscriber line charge) to be paid by each telephone subscriber as part of his or her monthly bill. This shifting of NTS costs from a usage charge to a fixed charge was to be phased in over several years, beginning January 1, 1984, and was designed to create economically efficient toll competition and prevent uneconomic bypass. The prospect of merely reducing "toll loadings" because they were too high, without providing an alternative recovery mechanism, was not deemed to be a reasonable or legal alternative worth consider.

[73] See, e.g., Re: Southwestern Bell Telephone Company, 26 Mo. P.S.C. (N.S.) 344 (1983); Re: Southwestern Bell Telephone Company 26 Mo. P.S.C. (N.S.) 442 (1983); Re: Southwestern Bell Telephone Company, 27 Mo. P.S.C. (N.S.) 156 (1985); Re: Southwestern Bell Telephone Company, 27 Mo. P.S.C. (N.S.) 338 (1985); Re: Shared Tenant Services, 28 Mo. P.S.C. (N.S.) 95 (1985); Re: Investigation into Telecommunications Issues, 28 Mo. P.S.C. (N.S.) 535 (1986).

concerning the potential stranding of costs that would result from various proposals and developments in the telecommunications industry, and trying to responsibly reduce that potential.

In summary, state regulators and the FCC have recognized that recovery of incumbent LECs' actual costs is needed for economic efficiency and to provide for full and fair competition in emerging competitive telecommunications markets, while promoting fairness to LEC shareholders and improving LECs' access to the capital markets that will be necessary to maintain and improve the quality of service.

VI. THE FCC MUST END THE "SHELL GAME" AND WORK WITH THE STATES TO SOLVE THE COST RECOVERY PROBLEM

The FCC's initial procedural approach to the cost recovery issue resembled nothing so much as a shell game in which the FCC holds out the prospect of actual cost recovery without committing to it. Although the Interconnection Order acknowledges that "some incumbent LECs may have incurred certain actual costs reasonably before the passage of the 1996 Act, based on different regulatory regimes,"[74] it specifies no means by which incumbent LECs can recover those costs under the TELRIC pricing requirements. The Interconnection Order instead refers to other pending proceedings:

> To the extent that any such residual [of embedded costs] consists of costs of meeting universal service obligations, the recovery of such costs can and should be considered in our ongoing universal service proceeding. To the extent a significant residual exists within the interstate jurisdiction that does not fall within the ambit of section 254 [the universal service section of

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[74] Interconnection Order at para. 707.

> the 1996 Act], we intend ... to address that issue in our upcoming proceeding on access reform.[75]

As noted above, the Access Reform Notice does in fact raise the issue of cost recovery in the context of reforming the system of access charges paid by interexchange carriers and end users to LECs.[76] The problem here is that the FCC has already prescribed TELRIC for unbundled elements. If not corrected to ensure recovery of actual costs, uneconomic arbitrage will occur as users choose between those unbundled elements and access services. That notice still provides no assurance that any such costs -- particularly those associated with interconnection and unbundled network facilities -- will be recovered. Indeed, the notice mentions only the interstate potential shortfall and is completely silent on the state side of the problem -- even though the FCC attempted to mandate TELRIC for pricing state elements and interconnection.

By the terms of the Interconnection Order, TELRIC pricing does not apply to the rates charged for all services provided by incumbent LECs. If the states were to adopt TELRIC pricing as envisioned by the FCC, they would be faced with permitting incumbent LECs to recover costs through price increases imposed on LEC retail services and those least subject to competition, in order to avoid confiscatory rates. Many such services and users are located in rural areas.[77] For constitutional purposes, utilities are protected from the net

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[75] Id. (footnotes omitted).

[76] See Access Reform Notice at paras. 247-270.

[77] Of course, many prospective entrants will have no intention or incentive to serve rural areas. It is unsound policy to encourage entry in urban or suburban areas while providing incentives for disproportionate cost recovery from rural retail customers.

effect of rate orders on their property.[78] As a result, state regulators will have a duty to prevent confiscation of incumbent LECs' property because of the effects of TELRIC pricing.

In order to avoid confiscation, the FCC and state regulators will have to authorize recovery of the costs at issue from services not subject to TELRIC. Almost certainly such services will be those that currently are least subject to competition. The consumers of such services generally will be individuals and small businesses that, paradoxically, state regulators and the FCC seek to protect under universal service principles. Of course, if TELRIC continued to apply to unbundled network elements and interconnection, recovering such costs from services not currently subject to competition would not be sustainable as competition develops.

The FCC's "shell game" thus places ultimate responsibility on the states to face up to the cost recovery issue. If this issue is not addressed, the states risk becoming the FCC's jurisdictional "fall guys." The net effect of adopting the FCC's TELRIC pricing methodology will be to leave state regulators on the horns of a dilemma. They face either imposing confiscatory rates or the necessity of recovering costs by burdening those consumers -- principally rural residential users and small businesses -- who are least likely to be offered services by competitive providers using inexpensive unbundled network elements or interconnection arrangements.

There is no need for the states to face this choice in addressing recovery of incumbent LECs' actual costs. Alternative cost recovery mechanisms based on those used in the gas and electric industries are available.

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[78] See Duquesne Light, 488 U.S. 299, 314.

VII. IN ADDRESSING COST RECOVERY, STATE REGULATORS AND THE FCC SHOULD CONSIDER APPROACHES EMPLOYED BY REGULATORS IN THE NATURAL GAS AND ELECTRIC INDUSTRIES

The parallels among the telecommunications, natural gas and electric industries argue compellingly for state regulators, as well as the FCC, to allow for recovery of actual costs by LECs in a manner that views costs more expansively than through the narrow TELRIC definition. These include the origin of those costs under the regulatory "obligation to serve," the reality of the network facilities represented by those costs, the fact that cost recovery is being affected directly by government action, and the need to assure economically efficient competition. Consistency should also be compelled by constitutional principle, the FERC's experience with the courts, and the logic of expecting different agencies of the government to operate consistently.

A. Origin and Recoverability of the Costs at Issue

The incumbent LECs' costs at issue, which are ignored by TELRIC pricing, are neither abstract nor ephemeral. They are real and concrete. They paid for actual, functioning telecommunications network facilities, including switching and transmission facilities, operations support systems, and billing and maintenance systems, that are used by or for LECs' customers. These costs were incurred pursuant to the LECs' legally-imposed "obligation to serve" all customers, as were the potential and actual stranded costs of gas pipelines and electric utilities. The facilities at issue were not deployed through a series of unfettered market decisions by unregulated enterprises free simply to evaluate the relative costs and benefits of incurring the costs. These costs were incurred in fulfillment of

governmentally-imposed obligations to provide service to customers, including potential competitors.

In addition, the LECs' costs at issue previously have been adjudicated before regulators (or the opportunity for such adjudication has existed) and in many cases their recovery has been approved or permitted by regulators, as were the stranded or strandable costs of gas pipelines and electric utilities. As in the case of electric and gas transition costs, providing for recovery of these costs will not increase LEC revenue requirements since these costs already are reflected in existing LEC rates. The "prudence" or "reasonableness" of the LECs' costs is not at issue. Indeed, from a practical viewpoint, those costs incurred under price cap regulation should be considered prudent and reasonable by definition, given the financial incentives for efficiency imposed by price cap regulation.

What has changed is that under TELRIC pricing, there is no reasonable likelihood that the costs will be recoverable by the LEC from customers (which may include competitive suppliers) over a reasonable period of time, as would have been the case under traditional regulation. Therefore, the ability of incumbent LECs to recover the costs at issue has been directly affected and impaired by government action to restructure the industry, as occurred with natural gas pipelines and is the case with electric utilities.

As observed previously, the FERC has clearly acknowledged that it was government action, and not simply the operation of coincident, external market forces, which created the condition of unrecoverability of certain costs of natural gas pipelines and electric utilities. As stated in Order No. 888:

> We will not ignore the effects of recent significant statutory and regulatory changes on the past investment decisions of utilities.[79] . . .
>
> We learned from our experience with natural gas that as both a legal and a policy matter, we cannot ignore these costs.[80]

Likewise, the FCC has consistently acknowledged that a specific government action, the 1996 Act, has opened the local exchange to direct competition and is driving the need to develop new interconnection, universal service and access charge policies.[81] It is both logical and imperative that telecommunications regulators should learn from the FERC's experience and provide for the recovery of actual LEC costs in setting its pricing policies in the new competitive era.

B. Competitive Policy

The FCC and the states should also learn from the experience of the FERC that transition cost recovery is an essential element of achieving a workably competitive market. For economically efficient competition to take place, LECs must be allowed to recover costs which were incurred under traditional regulation pursuant to the "obligation to serve," costs which new entrants do not bear. This fact closely correlates with the situation of the electric industry as, first, wholesale competition and, second, retail competition have been introduced in markets in which the electric utilities previously were protected from direct competition for reasons of law and public policy. It also correlates with the situation

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[79] FERC Order No. 888 at 452.

[80] Id. at 453.

[81] See, e.g., Access Reform Notices at paras. 1-5.