

Transcending the “Regulatory Compact”
Parsing the Legal Facts and Fictions of Stranded Assets and Cost Recovery

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May 5th, 2020

Introduction.....	2
I. A Survey of Contemporary Restructuring.....	3
A. Causes & Catalysts	4
B. Reform Efforts	7
C. Identifying Challenges	9
II. The Myth of the “Regulatory Compact”: Legal Shield, or Political Weapon?	10
A. The Legal Framework.....	11
B. Applying “Just & Reasonable”	13
III. Conclusion	16

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Introduction

In 2019, a *Washington Post* headline described how a “[c]oalition of unlikely allies calls on state to break up utilities, deregulate energy.”¹ This headline referred to Virginia, but it aptly describes recent events in a slew of states where energy system overhauls are being considered.² These overhauls aim to open retail electricity markets to provide greater consumer choice.³ Phillip O’Conner heralded this movement in a 2017 report in which he harkened back to an earlier era of competitive restructuring in the 1990s.⁴ He described a “pending second wave of competitive electricity restructuring.”⁵ This paper will explore that second wave: who is leading it, what they want to accomplish, and the obstacles they face.

The first “wave” referenced in O’Conner’s report crested two decades earlier.⁶ Traditionally, electricity markets in the United States were served by monopoly utilities.⁷ These companies received monopoly franchises from regulators, allowing them to generate, transmit, and distribute power without competition in return for guaranteeing universal service and allowing regulators to control the rates they charged.⁸ However, over time, the modern interconnected grid opened the door to the notion of competitive generation regimes, under which independent power producers generate power and sell it on the open market.⁹ Meanwhile, in the 1970s and 1980s, regulated monopolies became the subject of “intense criticism.”¹⁰ Critics pointed to the inefficiency of monopolies and regulators’ susceptibility to capture by the industry.¹¹ Spurred by federal policies that opened the door to wholesale energy market competition, some states restructured their systems to allow retail competition as well.¹² This movement largely halted

¹ Gregory S. Schneider, *Coalition of unlikely allies calls on state to breakup utilities, deregulate energy*, Wash. Post (May 7, 2019 3:05 PM), <https://www.washingtonpost.com/local/virginia-politics/coalition-of-unlikely-allies-calls-on-state-to-break-up-utilities-deregulate-energy/2019/05/07/72916a2e-70e9-11e9-8be0-ca575670e91cstory.html>.

² *E.g.*, Fla. Initiative 1810 (2018); Nv. Question 3 (2016, 2018); IN THE MATTER OF POSSIBLE MODIFICATIONS TO ARIZONA CORPORATION COMMISSION’S RETAIL ELECTRIC COMPETITION RULE 1S, AZ. CORP. COMM’N UTILITIES DIVISION, Docket No. RE-00000A-18-0405 (Jul. 2, 2019); SB 998, Gen. Assemb. Reg. Sess. (S.C. 2019).

³ *E.g.*, VIRGINIA ENERGY REFORM COALITION, ABOUT, <https://www.virginiaenergyreform.org/about/> (last visited Apr. 6, 2020).

⁴ PHILLIP R. O’CONNOR, RESTRUCTURING RECHARGED: THE SUPERIOR PERFORMANCE OF COMPETITIVE ELECTRICITY MARKETS 2008-2016 31 (RETAIL ENERGY SUPPLY ASSOCIATION 2017)

⁵ *Id.*

⁶ O’CONNOR, *supra* note 4, at 9-10.

⁷ See Ann E. Carlson & William Boyd, *Accidents of Federalism*, 63 U.C.L.A. L. REV. 810, 827 (2016).

⁸ *Id.* at 827, 835.

⁹ William Boyd, *The Public Utility & the Low-Carbon Future*, 61 U.C.L.A. L. REV. 1614, 1630-31 (2014)

¹⁰ *Id.* at 830.

¹¹ *Id.*

¹² *Id.* at 833.

after competitive markets were blamed for the California energy crisis of 2000-2001.¹³ Increased retail demand, a sudden spike in wholesale energy prices, and capped retail rates combined to bankrupt California's largest utility, and other states got cold feet about exposing their own utilities to the potential volatility of competitive markets.¹⁴

But today, states that drew back from restructuring in earlier decades are experiencing renewed interest in retail competition.¹⁵ And with demand for climate solutions also on the rise, climate advocates and competition champions have at times made common cause, but at other times competed for space.¹⁶

This paper will examine the nascent restructuring efforts of the last several years, with an eye toward identifying causes and challenges. Part I will explore the motivations driving renewed interest in restructuring, and survey efforts thus far. I conclude that support from environmental reformers is a critical component of modern restructuring, but that many environmentalists are hesitant to join the competition movement. One of the major causes for this hesitance is concern about ratepayers being required to bear the cost of power plants and other assets that are left unprofitable, or "stranded," by restructuring.¹⁷ Part II explores the legal framework for assigning stranded costs. I find that, in debates about restructuring, the legal obligation to allow recovery of stranded costs from ratepayers is overstated, and state governments have significant discretion to allow or deny recovery.

I. A Survey of Contemporary Restructuring

Competitive restructuring largely lay dormant in the two decades after the California energy crisis.¹⁸ However, in the past few years, restructuring has reemerged as a frequent topic of conversation in academia and the popular press.¹⁹ From the Eastern seaboard to the desert

¹³ *Id.*

¹⁴ *Id.* See also, Severin Borenstein, *The Trouble With Electricity Markets: Understanding California's Restructuring Disaster*, 16 J. ECON. PERSP. 198-200 (2002).

¹⁵ See Fla. Initiative 1810 (2018); Nv. Question 3 (2016, 2018); AZ. CORP. COMM'N UTILITIES DIVISION, *supra* note 2; HB 20-1064, Gen. Assemb. Reg. Sess. (Co. 2020).

¹⁶ Schneider, *supra* note 1; Sarah Vogelsong, *Ten things to know about the Clean Energy Economy Act*, Virginia Mercury (Feb. 20, 2020).

¹⁷ See, e.g., Schneider, *supra* note 1; Herman Trabish, *Securitization fever: Renewables advocates seize Wall Street's innovative way to end coal*, UTILITY DIVE (May 28, 2019), <https://www.utilitydive.com/news/securitization-fever-renewables-advocates-seize-wall-streets-innovative-w/555089>.

¹⁸ Severin Borenstein & James Bushnell, *The US Electricity Industry After 20 Years of Restructuring*, 7 AN. REV. ECON. 437, 438 (2015).

¹⁹ O'CONNOR, *supra* note 3, at 31; see also, e.g., Herman K. Trabish, *Nevada's Question 3 pits retail against uncertainty in battle of billionaires*, UTILITY DIVE (Nov. 1, 2018); Kristi E. Swartz, *Proponents of competition zero in*

Southwest, policy makers have confronted new calls for competitive retail markets.²⁰ But the conversation has changed since the 1990s. Most importantly, the growth of consumer-owned, distributed energy resources and discontent with utilities' reliance on fossil fuels figure ever more prominently in today's competition movements.²¹

A. *Causes & Catalysts*

The belief that ratepayers are paying too much for power remains a root driver of restructuring proposals.²² Interest in restructuring often grows when people are dissatisfied with utility rates, because a competitive market can drive competitive pricing.²³ In the run-up to the “first wave” of restructuring, competition advocates pointed out that regulated rate structures incentivize companies to over-invest and “gold plate” their infrastructure to increase the returns they can collect from ratepayers.²⁴ These concerns persist to this day, and modern ratepayer advocates point to utility rates that increase even as the cost of renewable generation plummets.²⁵

Rate concerns go hand-in-hand with criticism of the utility planning process. Dominion Energy customers accuse the utilities of overbuilding gas infrastructure,²⁶ while Duke customers in South Carolina are still paying off the costs of disastrous nuclear construction.²⁷ Competition advocates point out that incumbent utilities wield immense political power in state government,

on Fla. ballot measure, E&E NEWS (Jan. 9, 2019), <https://www.eenews.net/energywire/stories/1060111315/>; Schneider, *supra* note 1.

²⁰ See, e.g., Trabish, *supra* note 19; Swartz, *supra* note 19; Sydney Lake, *Bipartisan bill seeks to demonopolize state electric energy market*, VIRGINIA BUSINESS (Jan. 2, 2020), <https://www.virginiabusiness.com/article/bipartisan-bill-would-demonopolize-electric-energy-market/>; Courtney Holmes, *Arizona regulators consider potential rules for electric retail competition*, ABC15 (Feb. 26, 2020 7:46 PM).

²¹ See, e.g., John Farrell, *The Economics of Distributed Generation*, INSTITUTE FOR LOCAL SELF-RELIANCE (June 20, 2011), <https://ilsr.org/electricitys-unnatural-monopoly/>.

²² See, e.g., Boyd, *supra* note 12, at 1655-56; Darren Sweeney, et al, *Overpowered: in Virginia, Dominion faces challenge to its reign*, S&P Market Global Intelligence (Dec. 4, 2019), <https://www.spglobal.com/market-intelligence/en/news-insights/latest-news-headlines/54171542>; Lake, *supra* note 20.

²³ See Boyd, *supra* note 12, at 1659; Lake, *supra* note 20.

²⁴ Boyd, *supra* note 12, at 1655-56.

²⁵ See, e.g., Steve Soychak, *Tell the Public Utilities Commission what you think of Xcel's rate hike plan*, THE DAILY SENTINEL (Nov. 3, 2019); Brian Murray, *Reforming the Carolinas' Power Markets: Producing a Panacea or a Pandora's Box?*, FORBES (Oct. 11, 2019 1:29 PM), <https://www.forbes.com/sites/brianmurray1/2019/10/11/reforming-the-carolinas-power-markets-producing-a-panacea-or-a-pandoras-box/#d2fb7efc5ea2>; Sweeney, et al, *supra* note 22.

²⁶ Sweeney, et al, *supra* note 22.

²⁷ Murray, *supra* note 25.

raising the specter of regulatory capture and corruption.²⁸ Capture and corruption in turn enable overcharging.²⁹

Meanwhile, distributed energy technology has created a new constituency for competition.³⁰ Renewable resources are available at smaller scale than fossil fuels,³¹ and improvements in control technology allow distributed energy resources (DER) to be seamlessly integrated into the grid.³² DER can create new competitors by enabling smaller projects,³³ and “democratiz[e] the electricity system” by allowing consumers generate power.³⁴ Distributed generation also reduces reliance on transmission, improving efficiency and resilience³⁵ By reducing reliance on large utilities, DER poses a significant threat to the traditional utility business model.³⁶ Many modern reformers believe competition will aid in the integration of DER,³⁷ and want to limit ownership its’ by incumbents.³⁸ Traditional utilities earn a rate of return based on load served, and so are disincentivized from allowing competing resources onto the grid.³⁹ Advocates hope that retail competition will reduce structural barriers for DER.⁴⁰

²⁸ See, e.g., Swartz, *supra* note 19; Sarah Vogelsong, *Lawmakers’ split stance on energy competition reveals shifts in utility’s power*, Virginia Mercury (Feb. 13, 2020), <https://www.virginiamercury.com/2020/02/13/lawmakers-split-stance-on-energy-competition-reveals-shifts-in-utility-power/>.

²⁹ See Boyd, *supra* note 12, at 1655-56; Schneider, *supra* note 1.

³⁰ See, e.g., Sharon Jacobs, *The Energy Prosumer*, 43 *ECOLOGY L.Q.* 519, 560-63 (2016).

³¹ Farrell, *supra* note 21; Morgan Krueger, *Distributed Energy Generation is Upsetting the Energy Monopoly*, PACIFIC DATA INTEGRATORS, <https://www.pacificdataintegrators.com/insights/Distributed-Energy-Generation-is-Upsetting-the-Energy-Monopoly> (last visited Mar. 6, 2020).

³² Scott Weiser, *Microgrid summit in Denver brings together unlikely allies*, Complete Colorado (Nov. 21, 2019), <https://pagetwo.completecolorado.com/2019/11/21/microgrid-summit-in-denver-brings-together-unlikely-allies/>.

³³ E.g., Maria Gallucci, *Clean Power Startups Aim to Break Monopoly of US Utility Giants*, INSIDE CLIMATE NEWS (Dec. 12, 2012), <https://insideclimatenews.org/news/20121212/renewable-power-startups-georgia-solar-panterra-energy-gen110-distributed-generation-rooftop-solar-hurricane-sandy>; see also Krueger, *supra* note 31; Kevin Ridder, *The Problem with Monopoly Utilities*, APPALACHIAN VOICE (Oct. 17, 2018).

³⁴ Jacobs, *supra* note 30, at 557-59; JOHN FARRELL, *DEMOCRATIZING THE ELECTRICITY SYSTEM* vii, 14-15, THE NEW RULES PROJECT (June 2011).

³⁵ Jacobs, *supra* note 30, at 558; Farrell, *supra* note 21; Sanaullah Ahmad & Sana Sadar, *Impact of Distributed Generation on Reliability of the Local Distribution System*, 8 *Int. J. of Adv. Comp. Science & Applications* No. 6 375 (2017); *Wildfires Spark Interest in Scalable Microgrids*, APR Energy (Jan. 7, 2020), <https://www.aprenergy.com/outages-expected-california-wildfires-spark-interest-local-power/>.

³⁶ See Boyd, *supra* note 12, at 1677; Gallucci, *supra* note 33; Chris Nelder, *Can the Utility Industry Survive the Energy Transition?* GREEN TECH MEDIA (April 9, 2013), <https://www.greentechmedia.com/articles/read/can-the-utility-industry-survive-the-energy-transition>.

³⁷ E.g., VIRGINIA ENERGY REFORM COALITION, *supra* note 3.

³⁸ *Rewired: Why Utility-Owned Rooftop Solar is So Controversial*; GREENTECH MEDIA, <https://www.greentechmedia.com/multimedia/view/Rewired-Why-Utility-Owned-Rooftop-Solar-Is-So-Controversial> (last visited Mar. 7, 2020).

³⁹ See generally Ari Peskoe, *Unjust, Unreasonable, & Unduly Discriminatory: Electric Utility Rates & the Campaign Against Rooftop Solar*, 11 *TEX. J. OIL, GAS, & ENERGY L.* 211 (June 2016); Christian Roselund, *The Energy Freedom Act has passed the South Carolina senate*, PV MAGAZINE (May 8, 2019).

⁴⁰ See, e.g., Farrell, *supra* note 21 (distribution system as a “common carrier”);

Climate change plays an increasingly prominent role in most energy debates, restructuring included. While renewable energy played a role in the restructuring movements of the 1990s,⁴¹ as calls for aggressive climate action grow, more observers point to traditional incumbent utilities as part of the problem, rather than the solution.⁴² Monopoly utilities have been some of the slowest to transition from coal to gas and renewables, lagging noticeably behind national averages.⁴³ The regulatory structure often serves to insulate monopoly utilities from swift changes in consumer demands, including demand for more renewables.⁴⁴ Electric utilities also have a long history of suppressing climate data and funding scientific controversy about the impact of fossil fuels.⁴⁵ Many contemporary calls for restructuring are born out of anger at incumbents and hopes that a competitive market will be more responsive to consumer demands for clean energy.⁴⁶

In short, the conversation has changed since the 1990s, when competition advocates were focused primarily on lower rates and the efficiency of market competition.⁴⁷ Contemporary movements are built on overlapping goals that often produce strange political bedfellows.⁴⁸ Environmental advocates and libertarians make common cause against monopoly utilities, utilities that they believe use ill-gotten political clout to privatize profits and socialize risks at the expense of ratepayers and the planet.⁴⁹ And while the climate movement and competition movement are not perfectly aligned, many advocates believe they can work hand-in-hand.⁵⁰

⁴¹ Carlson & Boyd, *supra* note 7, at 830; Boyd, *supra* note 9, at 1660.

⁴² See generally David Anderson, Matt Kaspar, & David Pomerantz, *Utilities Knew: Documenting Electric Utilities' Early Knowledge and Ongoing Deception on Climate Change From 1968-2017*, Energy & Pol'y Inst. (Jul. 2017);

⁴³ U.S. ENERGY INFORMATION ADMINISTRATION, ENERGY EXPLAINED, ELECTRICITY IN THE UNITED STATES, <https://www.eia.gov/energyexplained/electricity/electricity-in-the-us.php> (last visited Mar. 6, 2020) (national average); Ken Silverstein, *It's Taken Time, But Electric Utilities Are Warming Up to Climate Change*, Forbes (Aug. 1, 2017 8:31 AM), <https://www.forbes.com/sites/kensilverstein/2017/08/01/its-taken-time-but-electric-utilities-are-warming-up-to-climate-change/#48e1a4af73eb> (the one hundred largest utilities); see also Ridder, *supra* note 33.

⁴⁴ Ridder, *supra* note 33.

⁴⁵ See generally Anderson, Kaspar & Pomerantz, *supra* note 42.

⁴⁶ See, e.g., Martin Stevenson, *Opening the Electricity Market to Competition a Win for Renewables, Ratepayers*, RENEWABLE ENERGY WORLD (Mar. 8, 2018, <https://www.renewableenergyworld.com/2018/03/08/opening-the-electricity-market-to-competition-a-win-for-renewables-and-ratepayer/#gref>). William Driscoll, *North Carolina group calls for end to monopoly utility, 100% renewable energy*, PV MAGAZINE (Feb. 28, 2019).

⁴⁷ See, e.g., Carlson & Boyd, *supra* note 7, at 830-31.

⁴⁸ M.J. McAteer & Richard Foster, *Back to the Future?* VIRGINIA BUSINESS (July 29, 2019); Schneider, *supra* note 1; Weiser, *supra* note 32.

⁴⁹ E.g., McAteer & Foster, *supra* note 48; Weiser, *supra* note 32; *VERC to New General Assembly Winners: Time for Energy Reform*, Virginia Energy Reform Coalition (Nov. 6, 2019), <https://www.virginiaenergyreform.org/2019/11/07/verc-to-new-general-assembly-winners-time-for-energy-reform/>.

⁵⁰ See, e.g., Stevenson, *supra* note 46; Driscoll, *supra* note 46; VIRGINIA ENERGY REFORM COALITION, *supra* note 3.

B. Reform Efforts

In the last few years, competitive restructuring ballot initiatives have been proposed in Florida and Nevada.⁵¹ In 2018, the Arizona Corporation Commission, acting on its own initiative, opened a docket to explore retail competition.⁵² Legislation in the Carolinas proposes more modest steps toward competition like competition study committees⁵³ and participation in a regional transmission organization.⁵⁴ However, some North Carolina advocates and legislators in particular would like to see full retail competition implemented.⁵⁵ These different state efforts each have a unique story, but this section will look in greater detail at Virginia, where legislators considered a particularly diverse array of energy reforms.

Virginia started down the road to restructuring in 1999, but shifted back toward traditional regulation in the 2000s.⁵⁶ However, as of 2019, some retail choice existed for customers who wanted to buy from 100% renewable providers and did not have access to a 100% renewable option through their incumbent.⁵⁷ Commercial or industrial customers with demand greater than five megawatts also had access to competitive providers.⁵⁸

However, the 2020 Virginia Energy Reform Act (VERA) called for full competitive restructuring in the vein of the first wave of the 1990s.⁵⁹ The coalition behind the VERA contains diverse partners: environmental nonprofits, a conservative conservation group, a libertarian thinktank, and the Virginia Poverty Law Center, among others.⁶⁰ They point to Texas as an example of successful retail competition,⁶¹ and their bill closely resembles the Texas plan.⁶² It requires unbundling generation and marketing from transmission and distribution⁶³ and filing

⁵¹ Initiative 18-10, DIV. OF ELECTIONS (Fla. 2018); Question 3 - Energy Choice Initiative, SECRETARY OF STATE DIV. OF ELECTIONS (Nev. 2016).

⁵² AZ. CORP. COMM'N UTILITIES DIVISION, *supra* note 2, *Revised Staff Report* 1.

⁵³ SB 998, Gen. Assemb. Reg. Sess. (S.C. 2019).

⁵⁴ HB 958, Gen. Assemb. Reg. Sess. (N.C. 2019).

⁵⁵ Driscoll, *supra* note 46; David Boraks, *NC and SC Lawmakers Call for Studies of Electricity Market Reforms*, WFAE 90.7 (Jan. 17, 2020), <https://www.wfae.org/post/nc-and-sc-lawmakers-call-studies-electricity-market-reforms#stream/0>.

⁵⁶ *Electricity Regulation in Virginia: A Timeline*, DIRECT ENERGY (Oct. 4, 2018), <https://business.directenergy.com/blog/2018/october/electricity-regulation-in-virginia>.

⁵⁷ VA. CODE ANN. § 56-577 (2019).

⁵⁸ *Id.*

⁵⁹ H.B. 1677 Gen. Assemb., Reg. Sess., (Va. 2020) (hereinafter *VERA*), Ch. 29 § 56-615

⁶⁰ VIRGINIA ENERGY REFORM COALITION, *supra* note 3; *see also* Schneider, *supra* note 1.

⁶¹ Schneider, *supra* note 1.

⁶² For a thorough account of Texas's model, see LYNNE KIESLING, *RETAIL RESTRUCTURING & MARKET DESIGN IN TEXAS ELECTRICITY RESTRUCTURING: THE TEXAS STORY* (2009).

⁶³ VERA § 56-615.

open-access rate tariffs for transmission and distribution.⁶⁴ It provides a slate of consumer safeguards.⁶⁵ The Virginia Corporation Commission is also tasked with assessing market power and market abuses,⁶⁶ and with establishing an independent distribution system operator.⁶⁷ The VERA also addresses environmental concerns. For instance, the bill includes the right to self-generate and to have access to renewable energy providers.⁶⁸

Ultimately, however, Virginia opted HB 887,⁶⁹ which took much smaller steps like removing the prohibition on purchasing from an independent provider if a customer's incumbent offers a 100% renewable option.⁷⁰ Similarly, the General Assembly rejected the Green New Deal Act, which would have mandated an end to fossil fuels by 2036.⁷¹ Instead, they passed the Virginia Clean Economy Act.⁷² This sweeping legislation provided for a transition to one hundred percent renewables, but on a longer timeline than the Green New Deal Act.⁷³ It also provided more financial assurances to incumbent utilities, and received criticism for failing to address the structure of Virginia's electricity system.⁷⁴ Environmental advocates accepted compromises to get the Clean Economy Act to the Governor's desk, and without their full support, restructuring faltered.⁷⁵

Thus far, retail competition has been stymied in other states as well. Public debate restructuring has been on hold in Florida after the state supreme court struck the ballot measure due to misleading language in the proposed summary.⁷⁶ In Arizona that debate is just beginning, but already incumbents have voiced opposition.⁷⁷ environmental groups have held back,

⁶⁴ *Id.* at § 56-628.

⁶⁵ These safeguards include clear and transparent billing and information about competitive choice, and protection from disconnection, discrimination, and deceptive practices. *Id.* at § 56-616.

⁶⁶ *Id.* at §§ 56-625, 56-626.

⁶⁷ *Id.* at § 56-624.

⁶⁸ VERA Cha. 29 § 56-616(9)(B)(3).

⁶⁹ HB 887, Gen. Assemb. Reg. Sess. (Va. 2020).

⁷⁰ *Id.* § 56-577(5).

⁷¹ Hb 77, Gen. Assemb. Reg. Sess. (Va. 2020).

⁷² David Iaconangelou & Carlos Anchodo, 'Remarkable leap'; Va. Backs 100% carbon-free electricity, E&E NEWS (Mar. 9 2020)

⁷³ Vogelsong, *supra* note 16.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ Kristi E. Swartz, *Supreme Court kills electricity ballot initiative*, E&E NEWS (Jan. 20, 2020), <https://www.eenews.net/energywire/stories/1062037865/search?keyword=restructuring>.

⁷⁷ Edward Klump, *Fights, fears surround push to overhaul Ariz. Electricity*, E&E NEWS (Aug. 8, 2019), <https://www.eenews.net/stories/1060871667>.

pointing to unanswered questions about how the final proposal could affect renewable goals.⁷⁸ As of this writing, the study bills introduced in the Carolinas remain in committee.⁷⁹ But in Nevada, where two successive votes are required to amend the constitution, retail competition passed in 2016, only to lose in 2018.⁸⁰ Major environmental groups opposed the measure in 2018 out of concern that market uncertainty would “put [incumbent] NV Energy’s planned renewables investment at risk” and “upend the growth of rooftop solar.”⁸¹

C. Identifying Challenges

Clearly, voices from the environmental movement are an indispensable component of modern restructuring efforts. But not all environmentalists favor competition, and division among renewable energy proponents has thus far blocked Virginia’s and Nevada’s restructuring movements. Skeptical environmentalists in different states often return to two general concerns about restructuring.

First, some posit that the green transition may require the kind of central planning and financing provided by the regulated monopoly structure. Some experts believe that traditional ratemaking can serve as an important vehicle for climate action.⁸² William Boyd argues that the transition to clean energy will require coordination, systemic organization, and cost recovery certainty that “markets alone seem unable to provide.”⁸³ While recognizing the vulnerabilities of the traditional model, he describes planning and investment, coordination and systems operation, and innovation as “central” to that model.⁸⁴ This line of reasoning was particularly influential in defeating the Nevada ballot measure in 2018, where environmentalists wanted to preserve NV Energy’s promises to invest in renewables.⁸⁵

Second, some advocates shy away from reforms that do too much to threaten the bottom line of incumbent utilities, out of fear that ratepayers will have to shoulder the costs.⁸⁶ The

⁷⁸ *Id.*

⁷⁹ S.C. LEGISLATURE, BILL SEARCH, S. 998, 123rd Reg. Sess., <https://www.scstatehouse.gov/billsearch.php?billnumbers=998&session=123&summary=B> (last visited Apr. 17, 2020).

⁸⁰ Lauren Debter, *Billionaire Sheldon Adelson Is Loser in \$96 Million Fight Over Who Powers Las Vegas*, FORBES (Nov. 7, 2018 7:37 AM) <https://www.forbes.com/sites/laurengensler/2018/11/07/warren-buffett-sheldon-adelson-nevada-energy-deregulation/#29df03f6476d>.

⁸¹ Trabish, *supra* note 19.

⁸² Boyd & Carlson, *supra* note 7, at 841-42; Boyd, *supra* note 9, at 1682-1710.

⁸³ Boyd, *supra* note 9, at 1683.

⁸⁴ *Id.* at 1635, 1683, 1708.

⁸⁵ *Id.* at 1635, 1683, 1708; Trabish, *supra* note 97.

⁸⁶ See Schneider, *supra* note 1; Vogelsong, *supra* note 16; Vogelsong, *supra* note 28.

stranded cost concern has been the subject of great debate for decades, and was especially visible in the Virginia 2020 legislative session, where many green advocates felt compromising with incumbents would be the cheapest option for ratepayers.⁸⁷

The first question is one of policy: which system will better serve the needs of transition? This conversation is beyond the scope of this paper, and many arguments have been well elucidated on both sides.⁸⁸ However, the second question, about the due utilities are owed by the public for reforms that result in lost profits, is often cast in legal terms. The second portion of this paper will focus on states' legal obligations associated with stranded assets, and assess their validity as a barrier to restructuring.

II. The “Regulatory Compact”: Legal Shield, or Political Weapon?

As we saw in the last section, legislators who advocate compromise with utilities often point to the fact that the cost of moving quickly or on many fronts must be borne by ratepayers, and that such actions should therefore be avoided.⁸⁹ But this assumption is unfounded. In fact, courts avoid formulaic requirements for cost recovery and give policymakers broad discretion to decide when allowing costs to be recovered from ratepayers will best serve the public interest, and when those costs should be borne by utility investors.

As consumers purchase power from independent retailers, the amount of power that they buy from incumbents decreases, leaving some of those incumbents with more power plants than they need to meet demand.⁹⁰ These “stranded assets” are facilities and investments that are no longer profitable but which have also not yet fully depreciated—meaning that the utility expects to still recoup additional earnings from them.⁹¹ If utilities are allowed to transfer the cost of these stranded assets to ratepayers, these policies may come at a considerable cost to the average energy user.⁹²

Some utility representatives, academics, and government officials argue that utilities are entitled by law to recover stranded costs as a result of the “regulatory compact” that exists

⁸⁷ See Part III, *infra*; Schneider, *supra* note 1; Vogelsong, *supra* note 28.

⁸⁸ See, e.g., Boyd, *supra* note 9, at 1635, 1638, 1708; but see, e.g., Stevenson, *supra* note 46; Farrell, *supra* note 21.

⁸⁹ E.g., Schneider, *supra* note 1; Trabish, *supra* note 17.

⁹⁰ Peskoe, *supra* note 39, at 287; J. Gregory Sidak & Daniel Spulber, *Deregulatory Takings & the Breach of the Regulatory Contract*, 71 N.Y.U. L. REV. 851, 867 (Oct. 1996).

⁹¹ Sidak & Spulber, *supra* note 90.

⁹² Elizabeth Nowicki, *Denial of Regulatory Assistance in Stranded Cost Recovery in a Deregulated Electricity Industry*, 32 Loy. L. Rev. 431, 439 (Jan. 1999).

between regulators and utility companies.⁹³ However, modern jurisprudence and scholarship have found this “regulatory compact” ephemeral, and indicate that states are on sound legal and policy footing in denying most, if not all, costs that are stranded by environmental and competitive reforms.⁹⁴ Critics of regulated monopolies argue vociferously that ratepayers should not have to bear these costs, particularly when they result from bad investments, inefficient management, and regulatory capture.⁹⁵

A. *The Legal Framework*

In 1997 J. Gregory Sidak and Daniel Spulber published *Deregulatory Takings & Breach of the Regulatory Contract*, the seminal case for legally enforceable contractual relationships between regulators and utilities.⁹⁶ They point to the early history of public utility law as the foundation for a “a bargain” between states and utilities in which utilities accepted regulation in return for special benefits.⁹⁷ This bargain was solidified in the explicitly contractual monopoly franchises formed by municipalities with utilities in the 19th century.⁹⁸ Sidak and Spulber argue that when regulation by state public utility commissions superseded municipal franchises in the early 20th century, utilities voluntarily agreed to the change in authority but retained their rights under contract law.⁹⁹

This argument flies in the face of jurisprudence and history.¹⁰⁰ For while 19th century courts recognized enforceable claims in municipal utility contracts,¹⁰¹ no such enforceable contracts have ever been formed in the course of state utility regulation.¹⁰² While courts and regulators have recognized a “compact of sorts” in the regulated monopoly structure,¹⁰³ legal scholars have pointed out that this is at most a metaphor, and one that has only appeared recently in the

⁹³ See, e.g., Sidak & Spulber, *supra* note 90, at 867, 884; Ari Peskoe, *Utility Regulation should not be Characterized as a ‘Regulatory Compact’*, Comment to the Quadrennial Energy Review Taskforce 2, DEPT. OF ENERGY.

⁹⁴ E.g., Peskoe, *supra* note 93, at 8-9; see generally Nowicki, *supra* note 92.

⁹⁵ See generally, e.g., *id.*; John Farrell, *Power Plant Securitization: Coming to a State Capital Near You*, INSTITUTE FOR LOCAL SELF-RELIANCE, <https://ilsr.org/power-plant-securitization-coming-to-a-state-capitol-near-you/>.

⁹⁶ J. GREGORY SIDAK & DANIEL SPULBER, *DEREGULATORY TAKINGS & BREACH OF THE REGULATORY CONTRACT* 101 (1997).

⁹⁷ *Id.* at 897.

⁹⁸ *Id.* at 897-905.

⁹⁹ *Id.* at 906.

¹⁰⁰ Herbert Hovenkamp, *The Takings Clause & Improvident Regulatory Bargains*, 108 YALE L. J. 801, 808 (1999); Jim Rossi, *The Irony of Deregulatory Takings*, 77 TEX. L. REV. 297, 308-09 (Nov. 1998).

¹⁰¹ E.g., *City of Walla Walla v. Walla Walla Water Co.*, 171 U.S. 1, 23 (1898).

¹⁰² Hovenkamp, *supra* note 101, at 807-08; Rossi, *supra* note 101; Peskoe, *supra* note 93, at 7-8.

¹⁰³ *Jersey Central Power & Light Co. v. Federal Energy Regulatory Comm’n*, 810 F.2d 1168, 1189 (D.C. Cir. 1987).

regulatory lexicon.¹⁰⁴ In light of this observation, a strict contractual reading of the “regulatory compact” is foreclosed under the unmistakability doctrine.¹⁰⁵ This doctrine states that a government only surrenders its legislative powers in “unmistakable terms.”¹⁰⁶ “General language of statutes and regulations ‘is not intended to create private contractual or vested rights,’ it merely reflects a discretionary policy choice.”¹⁰⁷

Sidak and Spulber’s novel contractual argument is followed by a more familiar argument rooted in the Takings Clause of the Constitution, which utilities have raised for centuries.¹⁰⁸ The Fifth Amendment protects against the taking of property “for public use without due compensation.”¹⁰⁹ However, here too, Sidak and Spulber depart from jurisprudence and history.¹¹⁰ They root their analysis in case law which, while applicable to some fields of regulation, diverges from the law of public utilities.¹¹¹ When considering states’ potential liability, legislators need not concern themselves with all Takings Clause jurisprudence, only with the lineage of rulings that govern public utilities.¹¹²

This lineage rejects a strict requirement for cost recovery. In the landmark *Hope* decision of 1945, the Supreme Court rejected the idea that courts could design any specific formula to guide cost recovery.¹¹³ Instead, it held that regulators must balance “investor and consumer interests” to arrive at an end result that is “just and reasonable.”¹¹⁴ However, courts have consistently made clear that they “do not necessarily guarantee utilities net revenues nor do they immunize utilities from the effects of competition.”¹¹⁵ Balancing investor interests does not mean that utility

¹⁰⁴ See generally, e.g., Peskoe, *supra* note 93; Scott Hempling, *What Regulatory Compact?* SCOTT HEMPLING (Mar. 2015), <https://www.scotthemplinglaw.com/essays/what-regulatory-compact>; see also Hovenkamp, *supra* note 101, at 808.

¹⁰⁵ See also Rossi, *supra* note 101, at 309.

¹⁰⁶ *Bowen v. Public Agencies Opposed to Social Security Entrapment*, 477 U.S. 41, 52 (1986).

¹⁰⁷ Rossi, *supra* note 101, at 309.

¹⁰⁸ *Proprietors of the Charles River Bridge v. Proprietors of the Warren Bridge*, 36 U.S. 420 (1837); *Munn v. People*, 69 Ill. 80 (1873); *Federal Power Comm’n v. Hope Natural Gas*, 320 U.S. 591 (1944).

¹⁰⁹ SIDAK & SPULBER, *supra* note 97, Ch. 6.

¹¹⁰ See Jim Chen, *The Second Coming of Smith v. Aimes*, 77 Tex. L. Rev. 1535, 1558-59 (May 1999).

¹¹¹ SIDAK & SPULBER, *supra* note 97, at 224, 227; but see *id.*; see also Rossi, *supra* note 101, at 313-14 (citing *In re Retail Wheeling Tariffs*, 575 N.W.2d 808, 815-16 (Mich. Ct. App. 1998)).

¹¹² Chen, *supra* note 111, at 1558; Rossi, *supra* note 101, at 314-15.

¹¹³ *Id.* at 602-03.

¹¹⁴ *Hope Natural Gas* at 603.

¹¹⁵ *Energy Ass’n v. Public Serv. Comm’n*, 653 N.Y.S.2d 502, 514 (N.Y. Sup. Ct. 1996); see also *FPC v. Natural Gas Pipeline Co.*, 315 US 575, 590 (1942); *Market St. R. Co. v. Railroad Comm’n of California*, 324 U.S. 548, 567 (1945); *Jersey Central Power & Light Co. v. Federal Energy Regulatory Comm’n*, 810 F.2d 1168, 1189 (D.C. Cir. 1987).

investors are indemnified against risk. It only requires that legislators and regulators exercise “reasoned decision-making”¹¹⁶ to avoid results that are “arbitrary or discriminatory.”¹¹⁷

Courts have also found that the case for denying cost recovery is particularly strong when losses are incurred because of technological or economic shifts.¹¹⁸ When assigning costs, courts and regulators may consider whether the costs resulted solely from a shift in regulation, or whether changes in the economy rendered the investments obsolete.¹¹⁹

In short, legislators and regulators have significant discretion when they decide who pays for stranded costs.¹²⁰ While policy changes are still subject to constitutional review,¹²¹ it is the right, and indeed the duty of policymakers to consider what is just and reasonable on the basis of history, economics, and sound policy. Therefore, these policymakers should not shy away from denying recovery of costs if they determine that doing so will equitably serve the public interest.

B. Applying “Just & Reasonable”

Applying this guidance to competitive restructuring today, there are strong arguments for asking investors to bear some or even all of the cost of stranded assets. Proponents of stranded cost recovery argue that it incentivizes efficient investment and maintains the solvency of incumbents.¹²² However, in the case of competitive restructuring, there are numerous factors that weigh in favor of utility investors shouldering the lion’s share of costs.

Courts “consistently [impose] on regulated firms the risk of changing technological and economic circumstances.”¹²³ Jim Rossi and Herbert Hovenkamp point out that many assets stranded in a competitive market result in part from technological and economic changes that render the assets obsolete.¹²⁴ Additionally, the shift to retail competition is facilitated by, and in many ways a response to, changing technology that makes retail competition viable and

¹¹⁶ *Assoc. Gas Distrib. V. FERC*, 824 F.2d 981, 1023 (D.C. Cir. 1987).

¹¹⁷ *Nebia v. New York*, 291 U.S. 502, 539 (1934).

¹¹⁸ *Market St. R. Co.* at 567; *see also* *Jersey Central Power 1192-93* (J. Starr, conc.).

¹¹⁹ *Market St. R. Co.* at 567; *see also* *Jersey Central Power 1192-93* (J. Starr, conc.).

¹²⁰ Nowicki, *supra* note 92, at 454.

¹²¹ *Id.*

¹²² *See, e.g.*, *Jersey Central Power* at 1192; Hovenkamp, *supra* note 101, at 807.

¹²³ *Market St. R. Co.* at 567; *Jersey Central Power 1192-93*.

¹²⁴ Hovenkamp, *supra* note 101, at 828-29; Rossi, *supra* note 101, at 311; Sidak & Spulber, *supra* note 90, at 884.

effective.¹²⁵ Stranded assets in a newly competitive system do not result only from regulatory shifts but also from the underlying economic and technical changes.¹²⁶

Decision-makers should also balance ratepayer and investor risk-sharing in light of each group's ability to assess and mitigate risk.¹²⁷ The competitive restructuring movement has been underway for more than fifty years.¹²⁸ Given the extensive evidence that utility managers and shareholders have been on notice about the potential for stranded assets, it is "absurd" to claim that was not factored into their risk assessment.¹²⁹

Policymakers should also consider stranded costs in the context of regulatory capture. A long history of scholarship documents the risk of regulated industries exerting undue influence over the decisions of the regulators.¹³⁰ And while utilities often wield political clout as a result of campaign expenditures,¹³¹ the story is not that simple. Regulatory capture also results from the "overwhelming" advantages of regulated entities in information and expertise.¹³²

Regulatory capture has two main implications for determining "just and reasonable" compensation. First, utilities initiate most investment themselves, and guaranteed cost recovery encourages overinvestment, not only assets but also in capturing regulators.¹³³ While Sidak and Spulber argue that allowing recovery of cost encourages efficient investment in the future,¹³⁴ denying recovery may also drive companies to efficiency and innovation in order to remain competitive.¹³⁵ Second, when trying to assign costs to investors and ratepayers, policymakers should consider evidence of regulatory capture in the past.¹³⁶ During Virginia's 2020 legislative session, one advocate declared that "there are no stranded costs if you're talking about Dominion, because Dominion is overearning."¹³⁷ Elizabeth Nowicki argues that the consumer

¹²⁵ Hovenkamp, *supra* note 101, at 830.

¹²⁶ Hovenkamp, *supra* note 101, at 828; *see also* Rossi, *supra* note 101, at 311.

¹²⁷ Chen, *supra* note 111, at 1559.

¹²⁸ Nowicki, *supra* note 92, at 455 (1999).

¹²⁹ *Id.*

¹³⁰ Hovenkamp, *supra* note 101, at 825.

¹³¹ Sweeney, et al, *supra* note 22.

¹³² Chen, *supra* note 111, at 1559; Oliver Williamson, Response: Deregulatory Takings and Breach of the Regulatory Contract: Some Precautions, 17 N.Y.U. L. Rev. 1007, 1012 (1996).

¹³³ Hovenkamp, *supra* note 101, at 826; Nowicki, *supra* note 92, at 432, 434, 446; Williamson, *supra* note 133, at 1013.

¹³⁴ *Supra* note 90, at 990.

¹³⁵ Nowicki, *supra* note 92, at 447.

¹³⁶ Nowicki, *supra* note 92, 456; Rossi, *supra* note 101, at 315.

¹³⁷ Vogelsong, *supra* note 28.

“has already benefitted the investors who have reaped dividends and capital gains over the years.”¹³⁸ In short, cost assignment calculations that completely ignore the effects of capture are unlikely to achieve a just outcome. Oliver Williamson sums up these two observations by exhorting decision-makers to, when allocating the burden of stranded costs, “describe feasible modes of organization as they are - whence appeal to benign or otherwise ideal forms of organization is disallowed.”¹³⁹

Finally, public utility law scholars question the pragmatism of trying to assess ex ante stranded costs resulting from restructuring.¹⁴⁰ Hovenkamp points out that in past restructuring periods, “presumably ‘stranded’ facilities have ended up fetching a significantly higher price than initially predicted.”¹⁴¹ Nowicki offers a litany of financial tools that former monopolists can use to lessen the burdens of allegedly stranded costs.¹⁴²

This paper has presented some of the best arguments for denying cost recovery to demonstrate that it is a reasonable and legally viable option. This is not to say that investors should always be required to shoulder all stranded costs. Legislators and regulators should take a hard look at the past, present and future. They should consider the history and economics of electricity regulation in their state. They should consider the roles they expect incumbents to play in a competitive market, roles which might include grid operator or provider of last resort for underserved areas,¹⁴³ and ensure that incumbents are able to provide those services. However, they should not feel that their hands are tied by legal precedent.

Given the scant mentions of the “regulatory compact” in case law and the deference courts give to policymakers, the “regulatory compact” is more useful to utilities as a political sword to warn off competition measures than as a legal shield to guarantee cost recovery if those measures pass.¹⁴⁴ We have seen in this section that it offers no protection in court. However, we saw in the previous section that it can serve as a deterrent to reform. This is not to say that the only just and reasonable decision is full denial of stranded cost recovery. But policymakers must recognize that just assignment of costs is their decision to make.

¹³⁸ Nowicki, *supra* note 92, at 456.

¹³⁹ Williamson, *supra* note 133, at 1020.

¹⁴⁰ Hovenkamp, *supra* note 101, at 831; Rossi, *supra* note 101, at 313.

¹⁴¹ *Supra* note 101, at 831.

¹⁴² *Supra* note 43, at 451-52.

¹⁴³ *See, e.g.*, KIESLING, *supra* note 62, at 154-64.

¹⁴⁴ Rossi, *supra* note 101, at 299.

III. Conclusion

This analysis should relieve legislators trying to balance a rapid transition and just economic reform. They have the power to determine the future of energy policy, unconstrained by fears of the “regulatory compact.” This is not to say they will not face tough decisions. William Boyd’s argument that public utility regulation will play a critical role in the energy transition remains unanswered.¹⁴⁵ The best choices for one state may not be the best choices for another.

The struggle to seriously grapple with climate change and the legacy of fossil fuels is just beginning. By comparison, the “second wave” of competitive restructuring may pass largely unnoticed and unrealized. However, given that the common aims, joint advocates, and collective frustration that these two movements share, it is reasonable to believe that they will move forward together. To the extent that the baggage of the “regulatory compact” presents an obstacle, that obstacle exists in the minds of American lawmakers, not the pages of American jurisprudence.

¹⁴⁵ Boyd, *supra* note 8.