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The *Duquesne* Opinion: A Practitioner's Comment

Alan P. Buchmann†

Drs. Kolbe and Tye¹ demonstrate that modern utility regulatory systems expose investors to significant risks with no compensating upside opportunities. While this is not a particularly new insight, the situation is obviously exacerbated when regulators, either by decisional or legislative changes, switch in midstream from one mode of regulation to another or impose new, previously unanticipated restrictions on rate recovery. In this respect, *Duquesne*² serves as a satisfactory takeoff point, although not one necessary for the underlying problem discussed by Kolbe and Tye. Whether or not *Duquesne* changed the law in any material respect, or, more precisely, authorized Pennsylvania to change the law, is not quite the issue. The inherent regulatory bias plainly exists and whether it is a result of "new rules" or has been there for a long time does not seem critical.

There is, as often with cases of this kind, more to *Duquesne* than immediately meets the eye. In 1980 the five electric utilities known collectively as "CAPCO"³ cancelled four nuclear units, all then in the planning stage.⁴ Each of the five companies then sought recovery of their respective investments in the cancelled units.⁵ Both the Ohio and Pennsylvania Commissions authorized recovery through expense amortizations over a period of years.⁶ Appeals followed in both states. In 1980, on direct appeal from the Ohio Commission, the Supreme Court of Ohio held that such recovery was impermissible under Ohio law.⁷ Successive attempts to obtain review in the United States Supreme

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1. Kolbe & Tye, *The Duquesne Opinion: How Much "Hope" is There for Investors in Regulated Firms?*, 8 YALE J. ON REG. 113 (1991).

2. *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

3. The Central Area Power Coordination Group (CAPCO) comprised five companies: Cleveland Electric Illuminating Company and Toledo Edison Company are now both subsidiaries of Centerior Energy Corporation, and, with Ohio Edison Company, they render retail service only in Ohio. Duquesne Light Company and Pennsylvania Power Company render retail service only in Pennsylvania.

4. Erie 1 and 2 and Davis-Besse 2 and 3. Construction continued on three other units, Beaver Valley 2 and Perry 1 and 2. There were, therefore, other CAPCO plants subject to the risk of abandonment. See Kolbe & Tye, *supra* note 1, at 145 n.97. Beaver Valley 2 and Perry 1 were completed in 1987; work on Perry 2 is currently suspended.

5. Ohio Edison also sought recovery on its investment. The Ohio Public Utilities Commission denied this recovery in *Ohio Edison Co.*, No. 80-141-EL-AIR, at 8 (Ohio P.U.C., 1981).

6. See *Id.*; *Cleveland Elec. Illuminating Co.*, 38 PUR 4th 494 (Ohio P.U.C., 1980); *Toledo Edison Co.*, 42 PUR 4th 561 (Ohio P.U.C., 1982).

7. *Consumers' Counsel v. P.U.C.*, 67 Ohio St. 2d 153, 423 N.E. 2d 820 (1981).

Court were unsuccessful.⁸ The Pennsylvania members of CAPCO obtained similar results. They too were authorized recovery by the Pennsylvania Commission, whose ruling was affirmed by the Commonwealth Court⁹ However, this decision was in turn reversed by the Supreme Court of Pennsylvania,¹⁰ which was then affirmed by the *Duquesne* decision.

While the Pennsylvania appeals involved a specific statute,¹¹ enacted after commencement of construction on the subsequently cancelled units and later modified over this issue,¹² it is not at all clear that the Pennsylvania court might not have reached the same result anyway. It may, however, have been the Pennsylvania legislative history which led the United States Supreme Court into its tendentious discussion of various systems of regulation and their relative "risks". The Ohio litigation history also may have influenced the arguments presented in *Duquesne*.

In any event, the idea that *Duquesne* "changed" the law and vitiated a general regulatory "contract" is not supportable.¹³ For example, Ohio has had a "used and useful" statute since 1911.¹⁴ That statute was invoked on numerous occasions to disallow rate base treatment of plainly prudent investments.¹⁵ Whether these disallowances represented breaches of a regulatory "contract" or not, it is important to note that comparatively minuscule amounts of money were involved. The existence of a contract became important only when large sums of money were at issue.¹⁶ Even if regulatory risk was asymmetrical, there was a long period when that asymmetry did not matter very much.

When electric rates increased rapidly and threatened to increase further, a political response developed. This, too, came as no surprise. The regulatory process has always been political. Regulators sought means to keep down rate increases and found such means in the readily exploitable "used and useful"

8. *Cleveland Elec. Illuminating Co. v. Consumers' Counsel*, cert. denied, 455 U.S. 914 (1982); and from subsequent rate cases, *Cleveland Elec. Illuminating Co. v. Pub. Util. Comm.*, cert. denied, 464 U.S. 802 (1985); cert. denied, 459 U.S. 1094-95 (1983).

9. *Cohen v. Pennsylvania P.U.C.*, 90 Pa. Commw. 98, 494 A.2d 58 (1985).

10. *Barasch v. Pennsylvania P.U.C.*, 516 Pa. 142, 532 A.2d 325 (1987).

11. 66 PA. CONS. STAT. ANN. § 1315 (Purdon Supp. 1990).

12. *Id.* at § 520.

13. It would not be the first time that "economists have been giving bad advice." Kolbe & Tye, *supra* note 1, at 136. Note that the characterization of the Pennsylvania statute as "retroactive" assumes the existence of the regulatory "contract." See Kolbe & Tye, *supra* note 1, at 153. It was certainly not "retroactive" in the sense normally used by lawyers.

14. 1911 Ohio Laws 549, 557.

15. The obvious example, frequently experienced in Ohio, was the exclusion of a portion of the real estate underlying a substation, on the ground that all of the acreage was not required (and hence not "used and useful"), when anyone could see that it was cheaper to buy the entire parcel than to appropriate a portion and pay damages for the residue (see, e.g., *Cleveland Elec. Illuminating Co.*, 46 PUR 4th 63, 70-71 (Ohio P.U.C., 1982).

16. Kolbe & Tye, *supra* note 1, at 127 n.47. See Pierce, *Public Utility Regulatory Takings: Should the Judiciary Attempt to Police the Political Institutions?*, 77 Geo. L.J. 2031, 2046, 2049 (1989).

concept, particularly in its "excess capacity" aspect and in "prudence" reviews, described in a publication of the National Regulatory Research Institute as "a handy regulatory tool."¹⁷ Indeed, it *has* proven a handy tool, for, while billions of dollars of investment have been disallowed rate base treatment because of "imprudence" findings, such findings are virtually unassailable on appeal, because there is always some sort of evidence to support them.¹⁸

It is highly unlikely that the Pennsylvania legislature, in enacting Section 1315, thought it was breaching a regulatory "contract" or even knew that such a "contract" was thought by some to exist. It was concerned primarily with ensuring that electric generating plants did not get admitted to *rate base* until they were in service. The eventual construction of the statute resulting in the disallowance of the amortization of cancellation costs as an *expense* item was probably unintended.¹⁹ The real significance of *Duquesne* lies, not in its holding that a "used and useful" mode of rate regulation is constitutional, a result clearly following from *Federal Power Commission v. Hope Natural Gas Co.*,²⁰ but in its recognition that there *is* a constitutional dimension to state utility rate regulation.

This aspect of *Duquesne* is of considerable importance and has not received the attention it deserves. Decades had passed since the United States Supreme Court had reviewed state rate regulation, permitting the Supreme Court of Ohio to agree that "the constitution no longer provides any special protection for the utility investor."²¹ Others had come to the same conclusion.²² It is

17. THE NATIONAL REGULATORY RESEARCH INSTITUTE, *THE PRUDENT INVESTMENT TEST IN THE 1980's*, at 186 (1985).

18. Professor Pierce opines that different prudence findings in different prudence cases "could reflect differences in patterns of conduct rather than differences in the political biases of the decisionmakers," making test comparisons "difficult." Pierce, *supra* note 16, at 2066. There is at least one instructive comparison involving the same generating unit, Perry 1, one of the completed CAPCO projects. The Pennsylvania Commission found no imprudence at all in its construction. Pennsylvania Pub. Util. Comm'n v. Duquesne Light Co., No. R-860378, at 12 (Pa. P.U.C., Mar. 5, 1987); the Ohio Commission disallowed \$627,812,000, plus interest. In the Investigation into the Perry Nuclear Power Station, No. 85-521-EL-COI (Ohio P.U.C. Jan. 12, 1988). The experts offered for the companies and the respective commissions' staffs were the same. This may not quite be what Kolbe and Tye call a "moral hazard," but there are "amoral gunfighters" out there. See Kolbe & Tye, *supra* note 1, at 146-46. Certainly, the Perry experience may lead investors to perceive that some decisions are based on "subjective and political factors." *Id.* at 153.

19. As was the construction of the statute to prohibit inclusion in rate base of land held for future use, Barasch v. Pennsylvania P.U.C., 516 Pa. 142, 532 A.2d 325 (1987), the inclusion of which, where actual use within a reasonable time period was anticipated, had been long-standing Pennsylvania practice. See Pennsylvania Pub. Util. Comm. v. Pennsylvania Power, No. R-811510, at 3-5 (Pa. P.U.C., Jan. 22, 1986). Certainly the Ohio General Assembly was not thinking of a regulatory "contract" in 1911, but its seventy-year old "used and useful" standard was held by the Ohio Supreme Court, similarly, to bar inclusion, as an *expense*, of cancellation costs.

20. 320 U.S. 591 (1944).

21. Dayton Power & Light Co. v. Public Util. Comm'n, 4 Ohio St. 3d 91, 99 (1983), quoting Bernstein, *Utility Regulation: The Little Locomotive That Couldn't*, 1970 WASH. U.L.Q. 223, 259-60 (1970).

quite true that in *Duquesne* the Court did not say *where* the constitutional line was to be drawn, but the reaffirmation in 1989 that there *is* a constitutional line, based upon *Bluefield*²³ and *Hope*, can only have a salutary effect on state regulators, perhaps more salutary than if the Court had laid down some specific standard which the regulators could then set out to evade.

This observation does not really get to the core of the Kolbe and Tye argument, which concerns the recognition of the inherent bias in present utility regulation and the attempt to correct that bias through rate recognition of the risks of disallowances.

Whether the issue is addressed as an allowance for funds used during construction or as rate of return, the crux of the matter is the need to establish, for a project, (1) the likelihood of a disallowance and (2) the likely magnitude of the disallowance, that is, the *measurement* question.²⁴ Kolbe and Tye correctly suggest that "in practice, estimation of such a probability will be difficult."²⁵ This is an understatement.²⁶ It is inconceivable that, even in order to obtain a regulatory risk premium, a utility would be willing to contend that a project in which it has invested a billion dollars and in which it proposes to invest a billion more, has an X% chance of noncompletion or, even if completed, a Y% chance of a disallowance due to excess capacity (physical or economic). First, it would be far too easy for regulators to dismiss the whole idea as "speculation." Second, if the utility really does intend to continue with the project and expend all or a large portion of the next billion dollars on it, it has extended an open invitation to its investors to attack its management. If the supposed risk is that of disallowance of a portion of the investment due to a possible finding of "excess capacity," surely regulators will respond that they will not decide now what they will do in some future case.²⁷

Even if we overcome these evidentiary obstacles there are other difficulties. The calculation of Allowance for Funds Used During Construction (AFUDC)

22. See Drobak, *From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation*, 65 B.U.L. REV. 65 (1985), particularly dealing with "slight" economic impacts. Cf., Pond, *The Law Governing the Fixing of Public Utility Rates: A Response to Recent Judicial and Academic Misconceptions*, 44 ADMIN. L. REV. 1 (1989).

23. *Bluefield Water Works & Improvement Co. v. West Virginia Pub. Serv. Comm'n*, 262 U.S. 679 (1923).

24. Kolbe & Tye, *supra* note 1, at 140-41. See also, "[h]ow to measure regulatory risk and account for it in the allowed rate of return," as the authors have stated it in Kolbe & Tye, *The Supreme Court's Duquesne Opinion—Practical Implications for Regulated Industries*, PUB. UTIL. FORT., Aug. 30, 1990, at 19.

25. Kolbe & Tye, *supra* note 1, at 145.

26. Would regulators really announce that they are increasing returns (and rates) to compensate investors, by a risk premium, for the possibility that those same regulators or their successors will change the rules? Kolbe & Tye, *supra* note 1, at 146-47.

27. In the anticipated physical "excess capacity" situation, the utility possibly can avoid the disallowance by simply delaying the unit until it is "needed." This will necessarily increase costs, due primarily to the continued accrual of AFUDC and, presumably, inflation and thus invite a "prudence" disallowance.

is spelled out in some detail by the Federal Energy Regulatory Commission.²⁸ Simply stated, the equity component is based on the allowed return on equity in the utility's last rate case. This would seem to mean that, if there were recognition of this regulatory risk in the allowed return, it would *ipso facto* be reflected in the AFUDC computation. But there seems to be no provision in the formula for an AFUDC premium for project-specific regulatory risk. Conceptually, it is difficult to see how the accounting profession would permit recording of an AFUDC risk premium which has, as its premise, the possibility of non-recovery. Certainly it is highly unlikely that such a risk premium could be used for financial reporting purposes.²⁹

Approached from a rate of return or, more properly, *allowed* rate of return on common equity perspective, there are also a number of problems. After the Ohio Supreme Court concluded that the cancellation costs of the four CAPCO units could not be reflected in expenses, subsequent cases affirmed the Ohio Commission's finding that the cost of equity had increased for the affected companies.³⁰ This is perhaps the best example to cite in support of the argument that, whatever the statute might have said and whatever warning signs had been exhibited over the years, investors really did believe that there was a regulatory "contract" and that they would at least receive a return *of* prudent investment.

Two points should be noted. First, this relief acted prospectively only and really recognized the abrupt decline in stock price resulting from the "shock" of the disallowance, thus acknowledging an increase in the cost of capital but providing no relief for the pre-existing investor. Second, further application of this precedent implicitly requires a finding that the market *still* does not recognize the risk of disallowance, which requires a high degree of naivete on the part of the investors or their advisors.

This raises another issue. *If* the market is efficient and *if* the investors assimilate all available facts, assumptions made by many analysts, it is difficult to understand why a regulatory risk premium, over and above a market-indicated cost of equity, exists at all. Given the history of the last decade of ratemaking, replete with disallowances for one cause or several, why has the market not taken this risk into account already?³¹ If it has not, what (or who)

28. Electric Plant Instructions, 18 C.F.R. § 101 (1990).

29. Conceivably, the local regulatory commission could allow an AFUDC premium for regulatory purposes and, eventually, include that premium in rate base for ratemaking purposes. If, however, there can be no reported increment to earnings under accounting rules, this is not a real solution to the problem.

30. Consumers' Counsel v. Public Util. Comm'n of Ohio, 4 Ohio St. 3d 111, 447 N.E. 2d 749 (1983).

31. Kolbe & Tye, *supra* note 1, at 152, respond briefly to this question but may overlook what other commentators will say and how regulators likely will decide. Kolbe and Tye believe that the Supreme Court rejected such views, but I do not find that in *Duquesne*. On the contrary, the Court said "presumably the [Pennsylvania] PUC adjusts the risk premium element of the rate of return on equity accordingly . . . to accommodate the varying risk of varying regulatory methodologies." *Duquesne*, 488 U.S. at 312. On an even more fundamental level, who told the investor that regulatory rules could not change? Only those who

has lulled the investor into what must be regarded as a false sense of security?

Kolbe and Tye also note the technical problem raised by statutes such as the Pennsylvania legislation involved in *Duquesne*,³² which provided that investments that did not reach used and useful status should not be reflected in rates directly or indirectly.³³ During the *Duquesne* argument before the Supreme Court the question arose as to whether, if the abandonment costs could not be allowed as an expense for ratemaking purposes, the Pennsylvania Commission, now aware of that legal proposition, could readjust the return on equity to take it into account. In response to a question from one of the Justices, counsel for the appellee declined to disclaim any intention of raising on remand the issue of indirect inclusion in rates.³⁴

A solution to the whole problem might lie in the argument that the asymmetrical nature of "used and useful" regulation itself poses an issue of constitutional proportions. This would require the Supreme Court to take a long step beyond *Duquesne*³⁵ and would probably require a demonstration that the asymmetry not only has not been compensated for in the allowed rate of return, but also that it cannot be.³⁶ A more promising avenue may be to develop Justice Scalia's suggestion in his *Duquesne* concurring opinion that "all prudently incurred investment may have to be counted," even if not included in rate base, in assessing the constitutionality of the particular consequences produced by ratemakers' formulas.³⁷ This seems to mean that, even though an investment has been disallowed for ratemaking purpose, it still *was* an investment and, to pick up on Kolbe and Tye's quite correct observation, the bondholders expect to be paid.³⁸ This should allow a more accurate appraisal of the effect of a ratemaking disallowance on the *equity* owners and permit a demonstration that the "impact of the rate order"³⁹ is constitutionally unreasonable.

believed in the regulatory "contract." This is a circular argument, one hard to accept after *Hope*, 320 U.S. at 591.

32. Kolbe & Tye, *supra* note 1, at 141 n.88.

33. Property not used and useful "shall not be made a part of the rate base nor otherwise included in the rates charged." 66 PA. CONS. STAT. ANN. § 1315 (Purdon 1990).

34. Based on the recollection of the author, present at the argument.

35. Although it is of considerable interest that the Chief Justice said it was fair value regulation which "mimics the operation of the competitive market." *Duquesne*, 488 U.S. at 308.

36. A practical problem is how to find the right situation for development of the argument—a test case—and a client willing to pursue it. After *Public Serv. Co. v. New Hampshire*, 130 N.H. 265, 539 A.2d 263 (1988), *app. dism.* 488 U.S. 1035 (1989), it is hard to model such a case. Given the Supreme Court's treatment of the disallowance in *Duquesne* as "slight," plainly a large amount of dollars must be involved and, the larger the amount of dollars, the greater the reluctance of management to pursue a constitutional argument through to the end if any quicker, even if less satisfactory, solution is available.

37. *Duquesne*, 488 U.S. at 317 (Scalia, J., concurring). Note, however, that this invites regulators to couch disallowances in "imprudence" terms.

38. Kolbe & Tye, *supra* note 1, at 153.

39. *Hope*, 320 U.S. 591, 602 (1944).