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**LARRY BRUNEEL\***

## **Bypass as an Option for Health: Medicine v. Business<sup>1</sup>**

Bypass can connote either a positive or negative action depending on whether you are in an economics class, in a small town, in a doctor's office, or in the business world. In a small town, you mention bypass and you might get the reaction that everything was going well until they built that bypass up the road a bit. Then the town dried up and one by one everyone moved away leaving Andy Griffith to run what's left. Does this have a corollary to electric utilities? Will today's utility CEO be tomorrow's Don Knotts? We all like getting to our destination faster, but is there a price for this newfound efficiency?

You could look at the term bypass in the context of open heart surgery where the surgeon is trying to save the patient by bypassing the blockage to healthy circulation. Years of eggs, sausage, and butter can lead to open heart bypass surgery. This could be the view of the electric customer looking for paths around the blocking utility. They want to bypass the old and dying tissue and replace it with fresh and healthy tissue. Today's electric customers are looking for the surgeon that can perform this radical new procedure without killing the patient. Will it be Dan Schaefer, M.D. or Dr. Markey Kildare? Ben "Casey" Johnson is retiring at the end of the season. Some patients are not waiting for the doctor and are trying to perform the operation on themselves.

Bypass takes on a different connotation when you enter the business world. People tend to think of economic bypass as avoiding the middleman. Bypass could be defined as trying to avoid a cost that one would otherwise be obligated to pay. This seems to be the situation that many utilities are facing as they watch customers trying to avoid paying high electric bills.

In what context should we look at the term bypass? Does it have a positive or negative connotations? Obviously, the answer is both. Where you stand on the retail bypass question is likely, where you sit. Your view on bypass depends on whether you are a utility executive facing an increasingly agitated group of investors or whether you are a retail customer facing high electric bills. From these respective positions, there is a right answer and a wrong answer, which happen to be different. This is exactly why we have regulators, legislators and well founded democratic

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1. Adaptation of remarks given at the University of New Mexico School of Law, Symposium on Electric Industry Bypass Policy.

processes for resolving tough social questions. Decision makers need to be able to step out of the fray and look at broader social interests.

What I think we are all concerned about are the details of customer choice. Hopefully, we are past the point of discussing whether customers will get choice or not, because the availability of customer choice is inevitable. It may not be tomorrow or the next day, but it is already happening and will continue to happen. The big question is who is going to pay for the investments made to serve customers before they were given a choice of power suppliers. Try as we might, discussion of stranded costs cannot be avoided when we address customer choice issues.

Commitments and investments made in the old electric industry environment may not be the same ones that would be made in a more open and competitive environment. The old way of conducting business was characterized by captive customers and regulated returns. The new way of doing business may not have captive anything and returns may fluctuate with regard to risks taken. The problem is that some of those old investments are still not paid off. Given that the government is involved in changing the electric business environment, the question must be asked, "should government provide some assurances of recovery of those past investments?"

In last year's *Economic Report of the President*, President Clinton's Council of Economic Advisors pointed out the differences of risk in regulated versus unregulated markets. Specifically, the Council demonstrated how protection from the risk of competition is traded for limited returns on good investments. However, when the rules of competition change, "a strong case therefore can be made for allowing utilities to recover stranded costs where these costs arise from after-the-fact mistakes or changes in regulatory philosophy toward competition, as long as the investments were initially authorized by regulators."

The Federal Energy Regulatory Commission [HEREINAFTER Commission] noted this advice from the President's economic council. The Commission also noted that legislators from both sides of the aisle were offering similar opinions. Chairman Schaefer, Senator Johnson and Chairman Murkowski have all talked about the need to honor past commitments as the electric industry goes through this transition. In the end, the Commission took a principled stand on the issue of stranded cost recovery. The Commission's position was not an easy one, and there has certainly been much criticism of its final decision. However, there has been virtually no criticism of the Commission's process. After two Notices of Proposed Rulemaking and almost two years of comments, discussion and reflection, it is unlikely that anyone would complain that they did not have a chance to express their views. The real question is how many times did they express them?

The Commission has issued a clear statement and proposal for recovery of wholesale stranded costs. Specifically, the Commission's position is that it will provide for recovery of legitimate, verifiable, and prudent wholesale stranded costs. In the purely retail stranded cost issue, the Commission has asserted a leadership role in advising the states to attend to this issue. The Commission did this, not to pre-empt the states, but to highlight the fact that because retail stranded costs are potentially so large as to threaten the financial health of some companies, the recovery of retail stranded costs is national in scope. Certainly, nobody wishes to bankrupt specific companies and to the extent the Commission can provide leadership on the stranded cost recovery issue, it may be able to prevent unnecessary financial harm.

The Commission's rules adopt the "revenues lost" approach for identifying stranded costs. Essentially, this approach requires calculating the amount of revenue a utility would have received from a particular customer had that customer not left before expected. The Commission adopted the approach over more complicated approaches that would have required analysis of specific investments made and costs incurred to serve specific customers. This more complicated approach would engender even more litigation than is already likely.

Mitigation plays an important role in the stranded cost recovery process. The Commission is not proposing to write a blank check for utilities. Before the utility can recover any stranded cost, it must show that it had a "reasonable expectation" of continuing to serve the customer beyond the terms of the contract. The Commission fully expects the power that is abandoned by the customer gaining access to have some value in the marketplace. Therefore, this value will have to be subtracted from the amount the customer would have paid to the utility in determining the amount the utility can recover.

Any amount of stranded cost recovery will probably, at least initially, have an impact on market transactions in a way that limits opportunities for low price suppliers. Accordingly, we must balance market opportunities against the need for fairness in treating past commitments. When the Commission sought to induce open access on gas pipelines without addressing stranded cost issues, the Court remanded the issue to us to present an approach for recovery. And the recent DC decision appears to affirm the basic decision to allow for stranded cost recovery.

While there may be some short-term impacts of allowing for stranded cost recovery, there may also be ways to minimize the interference in the marketplace. There have been proposals for spreading out costs over time so as to impose the same amount of stranded cost on consumers, but on a smaller per unit basis. More efficient use of stranded assets also minimizes stranded costs. Even with the best mitigation measures, customers will still look for supply option that avoids any method of

stranded cost imposition. Self-generation options and even moving to new service territories may allow customers to escape stranded cost responsibilities. Customers will probably look for loopholes to bypass high bills. Such drastic responses to stranded cost recovery are not desirable and the Commission must not inadvertently encourage such responses. Instead, the Commission should strive to design a fair and reasonable non-bypassable recovery mechanism, in the best interests of the public.

The Commission's goal is not to harm companies financially by encouraging competition. The Commission wants financially sound companies to continue to operate and serve customers. It is not in the public interest to force resolution of these issues in bankruptcy courts.

Clearly, there is one major force in today's environment that has spurred interest in bypass. That force is that the marginal price of power is coming down and prospects for access to that economical power are more tangible now than they have ever been. Open access in wholesale markets is a reality and will force prices even lower. In addition, retail competition, which is coming to some jurisdictions, will give customers direct access to lower priced power. Both of these scenarios, however, will take time to produce benefits. Due to the good policy reasons for allowing recovery of transition costs as we move from a fully regulated to a less regulated industry, many are looking for shortcuts to get the benefits of lower prices now rather than later.

The guiding philosophy behind the Commission's stranded cost policy is to fill all gaps in the recovery of stranded costs. For pure wholesale costs, the Commission has developed an approach to recovery. For pure retail costs, states will take the lead. For retail turned wholesale costs, the Commission is the primary forum with the recognition of the state role. Decision makers are trying to make the transition as fair as possible by developing new rules relevant to today's and hopefully tomorrow's marketplace.

People will probably try to find shortcuts around the transition process. However, for reasons of equity and fairness, this transition and the availability of its benefits to all customers should be made in an orderly manner. The Commission should prevent gaps in the approach to ensure that the transition is fair to all consumers. As long as customers look for loopholes in stranded cost recovery, this issue will stay alive.

While states study the possibilities of retail competition, some customers are seeking alternative ways to gain access to lower cost power supplies. Retail competition requires transmission access which means Commission involvement. Transmission access can come from the Commission if it does not violate the Federal Power Act, particularly sections 212(g) and (h), it can come from a state order (which requires Commission action on rates, terms and conditions), or it can come from new statutory authority. Sections 212(g) and (h) place limits on the Commission's authority.

Sections 212(g) and (h) prohibit the Commission from issuing any order under the Federal Power Act that is inconsistent with state retail marketing area decisions. The sections also prohibit Commission decisions which will result in the provision of transmission service to ultimate consumers through sham transactions. These sections were intended to prevent the Commission from ordering retail wheeling and to preserve any authority that States may have in that regard.

Sections 212(g) and (h) fit well into the Commission's no loophole approach. For example, if a state orders retail access for entities it deems eligible, the State should consider without interference from the Commission, stranded costs caused by such access. Likewise, if an entity is eligible for Commission ordered transmission service, then the Commission should consider costs stranded as a result of the access provided. An entity should not, however, be able to slip through the cracks and get access without some regulatory body giving due consideration to the need for stranded cost recovery caused by the newly provided access.

I believe the Commission in putting in place a no loopholes policy. Several state actions accord well with the approach. The MIT decision in Massachusetts, the California restructuring proceeding, the recent Pennsylvania transition proposal, and others show a commitment to fair recovery of costs which become stranded when customers are given choices. The Commission's Palm Springs decisions regarding natural gas bypass are consistent with this policy approach as well. After all, if the Commission is going to take the heat for making the decision to allow for stranded cost recovery, then it should also implement the policy.

In sum, bypass should not be a free lunch. Customers may find legitimate and illegitimate ways to bypass existing arrangements on supply. However, the Commission should strive to make sure it is not a means for avoiding cost responsibilities. Customers may find self-service ways to get choice, but the Commission should diligently apply whatever stranded cost decisions it ultimately makes.