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Traditional Municipalization and Duplication of Facilities Cases: Background, Facts, and Status

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In connection with the University of New Mexico School of Law's Symposium on Electric Industry Bypass Policy, we have been asked to provide background on the facts and status of a number of "traditional" municipalization efforts, including those which have involved duplication of facilities. Additionally, we have been asked to provide the basic facts and status on certain other bypass efforts that do not necessarily involve municipalization of an electric system. This article briefly summarizes the basic steps of municipalizing electric systems, sets forth some threshold legal and factual issues arising from municipalization, and outlines some of the recent efforts to bypass existing investor-owned utilities.

I. BACKGROUND

A. Overview

Municipalization refers generally to the process whereby a unit of local government, most commonly a municipality, acquires ownership and operational control of the electric distribution system serving the environs in (and perhaps around) the municipality's corporate limits. In virtually every case electric service prior to the municipalization effort is provided by a regulated, investor-owned public utility. The impetus for municipalization is the pursuit of lower electric rates and, in some instances, improved reliability of service.

Municipalizations occur most frequently in areas with high electric rates. By creating a municipal electric system, the municipality becomes a wholesale customer that can pursue lower cost bulk power supply from a supplier other than the high-cost supplier that had been serving the city at retail. Transmission service is of course necessary to enable the city to obtain delivery of that lower cost power and energy from the alternate source. As a wholesale electric customer, the city is entitled to such transmission service under the open access transmission tariffs that regulated trans-

mission owners are required to make available under the Federal Energy Regulatory Commission's (FERC) Order No. 888.¹

In Order No. 888, the FERC is requiring all public utilities that own, control, or operate transmission facilities which transmit electricity in interstate commerce to file with the FERC open access transmission tariffs. In addition, the rule provides public utilities with the ability to recover "stranded costs"² associated with providing open access service.³ Prior to Order No. 888, municipal wholesale customers were able to compel the necessary transmission service either through negotiation or pursuant to the antitrust laws.

The initial impetus for investigating the feasibility of municipalization can, and does, come from a variety of sources. Civic leaders may urge the city to consider municipalization with the hope and expectation that lower electric rates will enable the city to better retain existing business and better compete for new business. Citizen groups, sometimes primarily comprised of residential interests and sometimes of commercial interests, can be the moving force. In other cases, one or two large industrial customers, interested in economizing on their own electric rates, will initiate municipalization efforts; unable to obtain "retail wheeling" or direct access,⁴ the industrial customer can achieve much the same effect by becoming a customer of a new municipal system that will in turn acquire lower cost wholesale electric power supply.

B. Brief Summary of the Traditional Municipalization Process

In broad terms, the basic steps of a municipalization effort are relatively straightforward. A city interested in municipalization will ordinarily first conduct a preliminary feasibility study. This engineering report will examine the economic feasibility of a municipalization effort in order to determine whether the potential savings in power costs are likely to exist at all and, if so, to what approximate extent. Such studies will often consider the feasibility based both on acquisition of the existing distribution system and construction of a new duplicative distribution system. Because

1. See Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, FERC Stats. & Reg. [Regs. Preambles] ¶ 31,036 (1996)[hereinafter Promoting].

2. Stranded costs refers to a utility's investment in plants which it may not recover because of the loss of sales as customers obtain the ability to buy power from another supplier.

3. Promoting, *supra* note 1.

4. The term "retail wheeling" (also referred to as "direct access") is used to describe the scenario in which end-users (retail customers) have the freedom to choose their electric supplier.

municipalization efforts are typically expensive, both in monetary and political capital, city leaders need to assess whether the matter is worthy of pursuit.

A preliminary legal review is also ordinarily undertaken, either before, during, or shortly following the preliminary feasibility study. This legal review will typically examine threshold issues including the municipality's authority under state law and effect of the present power supplier's franchise to provide service in the municipality, status and effect of pertinent contracts, if any, authority to obtain transmission service, referenda requirements, the city's authority to takeover the existing distribution system by way of condemnation, and various related financing issues.

Assuming the city determines municipalization is feasible, the city will then begin implementing the efforts. Depending on state law, a referendum may be one of the first required steps in order to establish the city's authority to proceed. This will often precipitate a substantial public relations battle between the city and the existing retail service provider wherein the city promotes the benefits of lower rates and the utility attempts to discredit the city's assumptions. The city must arrange power supply and transmission service. In most cases, the city will have to secure transmission service from the retail supplier/transmission owner because the city is likely to be interconnected with only that supplier. In some cases, the geographic layout is such that the city may have the option of constructing a new interconnection with a different transmission provider.⁵ The city also must either take-over the distribution system (by negotiated purchase or through litigated condemnation proceedings), or construct a new system.

As a result of FERC Order No. 888, the city may also face claims by the utility for stranded cost recovery, a topic in and of itself. It is too early to tell with certainty whether, on balance, efforts to municipalize will be helped or hindered by Order No. 888; open access should make the acquisition of transmission service easier, but the stranded cost recovery portions of Order No. 888 may well burden the effort with greater litigation and, most obviously, may well alter the economic feasibility of a given municipalization effort.

In the end, four key pieces must come together: (1) acquisition of the distribution system, or construction of a new system; (2) alternative wholesale power supply arrangements; (3) transmission arrangements; and

5. If there is another utility in the area, the city may be able to construct new transmission facilities that physically connect the city's distribution system to that company's transmission system.

(4) financing. Because the utility that had been providing retail service to the city is typically not a proponent of the municipalization effort, litigation on any number of issues in any number of fora is common. Legal issues raised in litigation will vary from case to case, but could include claims under: (1) local procedural requirements; (2) condemnation laws; (3) public bidding laws; (4) state regulatory laws; (5) state constitutional provisions relative to utility and municipal matters; (6) financing-related laws; and (7) FERC and other federal laws and policies relative to transmission service and rates.

In 1922, government-owned electricity served 13 percent of the population.⁶ Municipal ownership of electric systems peaked in 1923.⁷ From that point, municipal ownership declined as local governments sold their distribution systems to private companies.⁸ Some commentators believe that municipalization efforts will boom again in the immediate future.⁹ Because of Order No. 888's open-access provisions, municipal systems will have greater opportunity to choose the utility from which they will buy their power. This may enable municipals to reduce their costs, thereby reducing their rates to consumers.¹⁰ Neighboring towns, seeing the benefits of lower rates, may also pursue municipalization. However, as explained, stranded cost recovery and protracted litigation will, at least to some degree, frustrate municipalization efforts by limiting the potential cost savings to the community.

C. Key Bypass Policy Issues Presented by Municipalization Efforts

Some of the more important issues presented by traditional municipalization efforts include:

1. Can municipalization be considered a consequence of FERC's open transmission access policies (i.e., Order No. 888) in view of the fact that many municipalizations were successfully undertaken prior to adoption of this policy (e.g., Massena, NY; Clyde, Ohio; Kanab, Utah)?

6. Robert L. Bradley, Jr., *The Origins of Political Electricity: Market Failure or Political Opportunism?*, 17 ENERGY L.J. 59, 67 (1996), (citing RALPH DEWEY, *THE MUNICIPAL PLANT: IS IT COMING OR GOING?*, GOVERNMENT OWNERSHIP OF POWER AND LIGHT UTILITIES) 59 (Claiborne Duval ed., 1934).

7. *Id.*, (citing, DAVID SCHAPP, *MUNICIPAL OWNERSHIP IN THE ELECTRIC UTILITY INDUSTRY*, 9, 26 (1986)).

8. *Id.*

9. See, e.g., Richard J. Pierce, Jr., *The State of the Transition to Competitive Markets in Natural Gas and Electricity*, 15 ENERGY L.J., 323, 345 (1994).

10. See *id.* at 345-6.

2. Does national policy favor competition on the wholesale level on an unlimited basis and, if not, what are the appropriate limits under which competition and customer choice should give way to other policy considerations?
3. Need we be concerned about "sham" forms of municipalizations and, if so, how are bona fide forms of municipalizations to be distinguished from "sham" efforts?
4. Is duplication of facilities an acceptable price to pay, when necessary, to enable municipalization bypass efforts to continue?
5. What will be the effect of FERC's policy on stranded cost recovery on future municipalization efforts?
6. What will be the effect of retail wheeling/direct access laws on future municipalization efforts?
7. What is the distinction between a "paper" or "partial" municipalization and power marketers that own no generating or transmission facilities?

Every current and future effort at municipalization will face some or all of these issues. As the regulatory environment evolves, new issues will inevitably arise.

II. ILLUSTRATIVE "TRADITIONAL" MUNICIPALIZATIONS

The following traditional municipalizations involve(d) efforts to condemn the existing utility or duplicate facilities. Under the condemnation approach, the city takes over the existing utility's facilities, and the existing utility ceases to operate in the relevant market. Duplication, however, is the process whereby the city constructs additional facilities which operate alongside those of the existing utility.

A. Massena, New York

Massena is a landmark case of municipalization in upstate New York and is serving to motivate other towns in the region to municipalize. The process in Massena, however, predated the EPAct, Order No. 888, and current New York Condemnation Law. Massena's effort to municipalize began in 1968 with an initial feasibility study which considered the costs involved in condemning Niagara Mohawk's facilities.¹¹ The initial study and subsequent studies indicated that the net book value of Niagara

11. Wallace L. Duncan, *Massena, New York: The "Granddaddy" of Municipalizations*, 6 1995 (paper presented at Infocast, Inc. conference, Sept. 21-22, 1995) [on file with author and NAT. RES.J.].

Mohawk's facilities was approximately \$1.8 million.¹² The study approximated the start-up costs to be under \$4.5 million.¹³ In the end, the process took 13 years¹⁴ and cost Massena \$1.5 million in legal fees alone.¹⁵ This was a battle of public relations. The voters initially approved the effort in May, 1974.¹⁶ Following the vote, litigation ensued, which ultimately lasted over six years.¹⁷

Some of the issues involved included: (1) whether Massena's change in plan to take delivery from Niagara Mohawk's substations rather than directly from the Power Authority of the State of New York (now the New York Power Authority) invalidated the referendum; (2) valuation of Niagara Mohawk's facilities; (3) whether Niagara Mohawk was required to provide the town with transmission service; and (4) whether Niagara Mohawk's refusal to provide transmission service violated antitrust laws.¹⁸ The parties ultimately settled the litigation, with Niagara Mohawk agreeing to wheel in Mohawk's two substations, service center, and distribution facilities in surrounding towns for \$7.7 million.¹⁹ The town claims that the rates have dropped by approximately 29 percent since municipalizing.²⁰ The Massena effort was concluded long before the industry entered the modern restructuring era. Thus, Massena needed to obtain wheeling rights from Niagara Mohawk, but was not confronted by the current rules regarding stranded cost recovery nor by any prospect of New York's proposing legislation establishing retail wheeling.

B. Glens Falls, New York

The municipalization effort in Glens Falls²¹ was driven by proponents' estimate that town municipalization could save the citizens approximately 40-50 percent in rates over their current rates from Niagara Mohawk based on a feasibility study commissioned by the local Industrial Development Agency.²² Niagara Mohawk challenged this estimate, in part, based on its claim that municipalization would leave the company with

12. *Id.*

13. Duncan, *supra* note 11, at 7.

14. *Id.* at 2.

15. *Id.*

16. *Id.* at 7-8.

17. *See id.* at 10-19.

18. *Id.*

19. *Id.* at 19.

20. *Id.* at 3.

21. Grammer Kissel Robbins Skancke & Edwards is legal counsel to Glens Falls.

22. *Glens Falls, N.Y. intrigued by the public power option*, PUBLIC POWER WEEKLY, June 25, 1995, at 2.

over \$50 million in stranded costs.²³ Niagara Mohawk argued that the citizens would experience an increase in rates through municipalization.²⁴ Glens Falls had planned to issue industrial revenue bonds or Electric System revenue bonds to raise capital for the project.²⁵ Glens Falls contemplated a traditional municipalization effort, including takeover of the existing distribution system. Niagara Mohawk placed considerable emphasis on stranded cost claims. Glens Falls held a referendum in November, 1996.²⁶ The referendum did not pass, thereby defeating the effort to create a municipal system.

C. Franklin and St. Lawrence Counties

Many towns in these upstate New York counties are exploring municipalization. Eight towns in this area in upstate New York have recently passed referenda approving municipalization, five by large margins.²⁷ The towns are motivated to lower electric rates to their consumers compared to Niagara Mohawk's rates. The residential rate is currently 12 cents/kwh.²⁸ Massena, in contrast, pays a rate of approximately four cents.²⁹ The effort is backed by an independent power producer located in Houston, the "Wing Group".³⁰ John Wing, the CEO of the Wing Group, is a native of Norfolk, one of the towns which passed a referendum.³¹ The Wing Group has offered to front the costs of municipalization, including feasibility studies, engineering, and legal expenses.

Assuming the towns municipalize, they will repay the outlay through bonds representing the out-of-pocket costs plus interest at the prime rate or, in the alternative, the towns will provide the Wing Group with 33 percent of the savings from reductions in rates.³² Additionally, the Wing Group will, over 15 years, receive a fee per kwh sold, not greater than 50 percent of the savings in any quarter.³³ An additional 11 towns have

23. *Id.*

24. PUBLIC POWER WEEKLY, *supra* note 22, at 2.

25. *Id.*

26. *Glens Falls looking to leave Nimo's grid*, CAPITAL DISTRICT BUSINESS REVIEW, June 19-25, 1995, at 1.

27. Coopers & Lybrand, *Electric Municipalization Review 26* (1996) [hereinafter "Coopers"].

28. *Louisville joins public power movement in New York*, PUBLIC POWER WEEKLY, March 11, 1996, at 3.

29. *Id.*

30. Coopers, *supra* note 27, at 25.

31. *Id.*

32. *Id.* at 26.

33. *Id.*

signed letters of intent to work with the Wing Group.³⁴ Niagara Mohawk has argued that the towns will not save through municipalization because, inter alia, they will face high stranded costs, which were not likewise recoverable in the case of Massena.³⁵ As is the case with respect to Glens Falls, the municipalities in Franklin and St. Lawrence Counties will need to confront Niagara Mohawk's claims for stranded cost recovery, as well as the possibility of retail wheeling at some future date.³⁶

A further issue in New York is Niagara Mohawk's proposal entitled "PowerChoice," which it filed with the New York Public Service Commission in October, 1995.³⁷ The plan represents an attempt by Niagara Mohawk to restructure in a manner which will enable the company to reduce its rates. A distinction between the Glens Falls effort and the Wing Group's approach arises from the Wing Group's proposal to its clients to municipalize on something of a turnkey basis, with its payback drawn from the savings to be achieved. In contrast, Glens Falls is currently pursuing a more traditional approach in that it is assuming the up-front costs and risks and thus will retain the full benefit of savings for the city and its residents.

III. DUPLICATION OF FACILITIES

A. Aberdeen, New Jersey

Aberdeen sought to duplicate Jersey Central Power & Light's ("Jersey Central") distribution system, but the town defeated the referendum by a margin of 6 to 1.³⁸ Aberdeen sought duplication rather than traditional municipalization based on New Jersey's Condemnation Law, which imposes a fair market value valuation methodology.³⁹ The township also preferred to avoid lengthy litigation.⁴⁰ Aberdeen sought to reduce rates by at least 12 percent.⁴¹ Jersey Central's rates are approximately 15 cents/kwh in the Summer and 12 cents in the Winter.⁴² The impetus for duplication came from Anchor Glass, the major industrial customer located

34. *Id.*

35. Coopers, *supra* note 27, at 26.

36. The staff of the New York Public Service Commission has recommended that retail wheeling go into effect in New York by 1998. The New York State Senate has also considered legislation by Senator Johnston, which proposed a start date in 2010. Coopers, *supra* note 23, at 28.

37. *Id.* at 27.

38. *Id.* at 21.

39. Telephone Interview with counsel for Aberdeen (July 11, 1996).

40. *Id.*

41. *Id.*

42. *Id.*

in Aberdeen.⁴³ Jersey Central made Anchor Glass two offers to stunt the process, but Anchor rejected both. The first would save Anchor \$1.7 million, but Anchor did not agree to the risk tied to the plan, which provided for a minimum of 208 hours of interruption.⁴⁴ The second provided for a buy-through of the interruptions and for \$1 million in savings, but Anchor would be bound to Jersey Central and could not seek to municipalize Aberdeen for five years.⁴⁵ Anchor rejected this offer because it did not have the authority to bind the city.⁴⁶ Despite Aberdeen's belief that stranded costs could be minimized because: (1) state law precludes exclusive franchises and (2) Aberdeen intended to secure transmission from an alternate supplier, the township could not persuade its citizens to vote in favor of the referendum.⁴⁷ Anchor subsequently closed its business operations in Aberdeen.⁴⁸

B. Clyde, Ohio

From 1893 to 1965, Clyde owned and operated its own municipal system.⁴⁹ Clyde then sold its system to Toledo Edison, which served Clyde principally until 1989, at which time, in contrast to Aberdeen, Clyde completed a duplication of facilities.⁵⁰ Clyde originally contemplated traditional municipalization, but changed its position in response to Toledo Edison's legal argument that Clyde would owe for "generation rendered useless."⁵¹ Toledo Edison's argument was the precursor to stranded investment. Toledo Edison estimated this figure to be approximately \$40 million.⁵² Clyde did not want to incur such costs in addition to \$3.5 million, its estimate for the value of Toledo Edison's distribution facilities. Furthermore, Clyde wanted to avoid litigation. The citizens voted in favor of duplication in 1987, in part, because Whirlpool, the largest industrial customer in Clyde, endorsed the project. Duplication cost Clyde approximately \$5 million.⁵³ Clyde avoided "stranded costs" because its

43. Coopers, *supra* note 27, at 21.

44. Coopers, *supra* note 27, at 21. Interruption means that the utility discontinues its service for a discrete amount of time.

45. *Id.*

46. *Id.*

47. Telephone Interview with counsel for Clyde (July 11, 1996).

48. Coopers, *supra* note 27, at 23.

49. *Clyde, Ohio begins serving first customer*, PUBLIC POWER WEEKLY, April 24, 1989, at 7.

50. *Id.*

51. Gregg D. Ottinger, "Municipalization in the Electric Power Industry: The Case Study of Clyde Ohio," 15-16 (1996) paper presented to Infocast, Inc. conference, (Feb. 29-Mar. 1, 1996).

52. *Id.* at 15.

53. *Id.* at 15-16.

efforts predate the modern era and, in any event, Clyde now receives transmission from Ohio Power rather than Toledo Edison.⁵⁴ Clyde's rates are reported to be around 25 percent lower than Toledo Edison's rates.⁵⁵ Since municipalization, Toledo Edison has lost 95 percent of its load in Clyde.⁵⁶

IV. CONCLUSION

Order No. 888 will likely send conflicting messages to local governments which are considering municipalization. On the one hand, government-owned electric systems will be able to shop for cheaper power, thereby enabling them to reduce expenses; on the other hand, existing utilities will pursue aggressively claims for stranded costs. Ultimately, the future of municipalization will hinge on the individual circumstances in each case. Towns considering municipalizing their electric systems will have to perform a cost benefit analysis to determine whether the effort, in the end, will provide the community with lower electric rates. If the city's liability for stranded cost payments outweighs the savings that otherwise would be achieved, the city will be more likely to forego municipalizing its electric system.

The apparent advent of retail wheeling or direct access will complicate the analysis. In some cases, adoption of state law mandating direct access will make "traditional" bypass efforts either unnecessary or more difficult. In other cases, savings will still be achievable through municipal operation of the distribution (local delivery) service that remains a key component of total electric service even in an age of direct access. The core message that appears to be universal is that competitive forces will not in the end allow themselves to be stifled.

54. See Coopers, *supra* note 27, at 43.

55. Ottinger, *supra* note 51, at 23.

56. See Coopers *supra* note 27, at 43.