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ALFRED E. KAHN\*

## Competition and Stranded Costs Re-Revisited

We've had two first rate presentations this morning,<sup>1</sup> lucid expositions of diametrically opposed views on the questions raised by municipalization and bypass—in particular, on the legitimacy of permitting electric utility companies to recover costs that these developments threaten to leave stranded.

In commenting on them, I'm going to make a heroic effort to avoid mentioning stranded costs until it becomes absolutely inescapable, because that issue, however huge the number of dollars at stake, is really only an incident in the evolution of this industry. How we get over that hurdle, however, could have an important effect on the viability of the new competitive order that most of us evidently either advocate or are prepared to accept.

If competition means anything, it means bypass; it means cream skimming. These are simply different ways in which buyers seek to patronize sellers who offer service at lower prices and sellers seek out customers whom they can serve at prices lower than they are now paying. I'm an enthusiast for competition, on grounds of experience not just in the economy generally or with the airlines or trucking, in both of whose deregulations I played a role, but—as I propose to explain—on the basis of experience in the electric industry itself. In this I am in clear agreement with Professor Maloney.

### THE CONVERGING HISTORICAL FORCES UNIQUE TO ELECTRIC POWER

While what's happening in the electric industry is clearly part of a worldwide phenomenon, with worldwide explanations, the motivating forces have been in very large measure peculiar to this industry (although with important similarities to what has been happening in telecommunications and in the interstate transmission of natural gas), the product

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1. See Michael T. Maloney, et al., *Customer Choice, Utilities' Loss: Stranded Cost Recovery in the Deregulation of America's Electric Power Industry*, 37 NAT. RESOURCES J. (1997); and see Michael J. Doane & Paul W. MacAvoy, *Transmission Access Pricing and "Non-bypassable" Competitive Transition Charges*, 37 NAT. RESOURCES J. (1997).

of a particular and quite possibly ephemeral conjuncture of historical developments.

The easiest way to document that proposition is to remind you that there was (as far as I know) no significant pressure for deregulation of the electric utility industry or opening it to competition in the '50s or the '60s. The simple explanation is that the average retail price in the United States declined 43 percent in real terms, under the influence of apparently ever-expanding economies of scale and technological progress, not just in the industry itself but in the production of the fossil fuels that constitute its major input. It is worth remembering, moreover, that despite the two explosions of fossil fuel prices in the middle and late '70s—which occurred, serendipitously, just as I became, respectively, Chairman of the New York Public Service Commission and Inflation Czar—the price of oil and gas today is lower than it was 40 and 50 years ago, in real terms.

Nor were there any substantial inroads of competition or pressures for deregulation in the '70s and '80s, when the price of electricity increased much more than the Consumer Price Index. The reason, it seems clear, is that deregulated, competitive prices would have been even higher: regulation held prices below marginal cost—both short-run and the long-run cost of efficient new plants.

What has changed since then? Manifestly, the relationship between price and marginal cost, both short- and long-run: what other answer would you expect from an academic economist?

The reasons for that dramatic change are familiar: First, the entry into service of long-lead-time base-load plants, constructed over a period of double-digit inflation of interest rates and construction costs and in anticipation of a continued expansion of demand at six to seven percent annual rates. These developments and the abrupt deceleration of demand left utilities, particularly on the East and West coasts, with average generating costs in the range of perhaps six to ten cents a kWh and, because of their excess capacity, short-run marginal costs of one to two cents. Second, the collapse of fossil fuel prices in the middle 1980s, in combination with, third, the development of combined cycle gas turbine technology, which have made it possible to build 100-megawatt or smaller new plants with average costs below four cents a kWh.

Fourth, the nuclear fiasco. And, fifth, PURPA (the Public Utility Regulatory Policy Act), with its legacy of multi-billion dollar contractual obligations of the electric companies to buy more independently generated power than it turns out they need, at avoided costs estimated by regulators on the basis (among other considerations) of an expectation that the price of oil would by now be approaching \$100 a barrel. All these developments have combined to produce regulated rates in some regions of the country

far above both short- and long-run marginal costs. And that in turn has created irresistible temptations for sellers—including utility companies, *outside* their own franchise territories—to offer eager buyers an escape from those inflated rates.

Entirely apart from the dominating question of whether the utility companies are entitled to recover the difference between their sunk costs and competitive rates, these developments raise a serious economic question: How can one know whether the resulting competition is on the basis of the true relative efficiency of the several contestants? The sunk costs that inflate the rates of the incumbent companies have nothing to do with whether social efficiency is improved by their losing customers to competitors unencumbered by that legacy. We have the identical uncertainty in telecommunications: competitors are flocking into markets whose rates have, because of regulatory policies, far exceeded the marginal costs of the incumbent utility companies themselves. The main sources of those inflated markups have been the entitlement of the companies to recover heavy inherited book costs inadequately depreciated heretofore and, even more, regulatorily-imposed underpricing of basic residential telephone service, which has necessitated corresponding overpricing of toll and of service to businesses in concentrated metropolitan areas.

In both these industries, inefficient entry could readily be forestalled if the incumbent companies were to price the cross-subsidizing services down to their own marginal costs, as regulators are increasingly permitting them to do. The problem of course is that by so doing they would be surrendering recovery of billions of dollars of costs that they believe they are entitled—and under obligation to their stockholders to try—to collect.

So, we find ourselves drawn irresistibly back to the multi-billion dollar issue about the legitimacy of that asserted entitlement. Before retreading that well-worn path, it seems to me useful to extend this historical recital one minute into the future. If indeed the pressure for competition in the electric industry is primarily the adventitious consequence of a combination of historical circumstances that have set regulated prices far above both short- and long-run marginal cost, what will happen when and if that relationship is reversed, as experience gives us every reason to believe it will be? A look at what happened earlier in this election year when the price of gasoline jumped from something like \$1.22 to \$1.42 a gallon offers little basis for an expectation of regulatory or deregulatory consistency. Almost immediately, we witnessed a discouraging—indeed disgraceful—spectacle of Presidential candidates falling all over one another to do something about it—to eliminate the pitiful 4.3 cents a gallon Federal tax on gasoline or to draw down the

Strategic Petroleum Reserve. (Observe how scrupulously non-partisan I am being in heaping scorn on both.)

Yet that increase in the gasoline price was clearly the consequence of competitive forces—a severe winter, necessitating above-normal refinery yields of heating oils and correspondingly below-normal building up of gasoline inventories; the beginning of the heavy driving season; the raising of the national 55 mile an hour speed limit and the increasing vogue of recreational semi-trucks: male ego-reinforcement guzzles gas.

That recent incident does not offer much basis for confidence that when the causes of the present vogue of competition in electric power are reversed, our society will long retain its new infatuation with competition. This consideration is directly pertinent to the issue of the entitlement of the utility companies to recovery of their strandable costs—the multi-billion dollar question to which you have been waiting impatiently for me to turn.

### STRANDED COST RECOVERY: A BAKER'S DOZEN PROPOSITIONS

Considering the scores of billions of dollars at stake, it should not be surprising that public discourse on the issue of whether electric utility companies are entitled to recover the costs likely to be stranded by competition consists largely in statements of diametrically opposing positions, such as we have just heard ably expounded by my two predecessors on this platform. I will take advantage of the issue having been so thoroughly explored, by delivering my proposed resolution (which will of course be unexceptionable) in the form of 13 propositions—a good prime number.

1. Opponents of stranded cost recovery—prominently among them Peter Bradford, until recently Chairman of the New York Public Service Commission<sup>2</sup>—assert that the frequent reference by utility companies to a regulatory “compact” or “bargain,” entitling them to a reasonable opportunity to recover their threatened costs, traces back only to the time, 10 to 15 years ago, when they were suddenly given reason to fear it was not going to be honored. While I leave a definitive assessment of this claim to the legal archeologists, I have the impression it is essentially right.<sup>3</sup>

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2. Presentation of Peter A. Bradford before the Vermont Public Service Board on behalf of the Department of Public Service (July 15, 1996) at 3 <<http://www.cit.state.vt.us/psd/vttesty2.htm>>.

3. Even though Chairman Bradford has been so foolhardy as to assert (on p. 3) that the concept of neither a “compact” nor a “bargain” appears anywhere in the 559 pages of my book, ALFRED E. KAHN, *THE ECONOMICS OF REGULATION* (MIT Press 1988) (1970-71), it seems a trifle

2. At the same time, if there had been no previous understanding about such an entitlement of companies regulated on an original cost or prudent investment basis, then what was the point of all those rate cases over which I presided—and Peter Bradford after me—at the New York Public Service Commission? Cases in the course of which contending parties spent all their energies arguing about the dimensions of the costs legitimately recoverable in rates—the costs of hunting lodges? charitable contributions? or—Lord save us!—of capital? Surely somebody must have thought ascertaining those costs was relevant to something. To what? So far as I can see, it could have been only to setting rates that would give the companies a reasonable opportunity to recover their costs, past, present and future. If, for whatever reason of politics, law or aesthetics, one objects to characterizing the implicit basis of those convoluted determinations as a compact or bargain, then, by good fortune, we have an historical precedent for an alternative appellation—let us call it, for convenience, a banana.

3. The historical commitment of regulators to permit the recovery of prudently incurred costs was never absolute. So far as I recall, it was always subject to possible disallowances if the assets were not “used and useful”—a clearly substantive modification, since the prudence of costs incurred can logically be judged only as of the time when they were incurred, whereas disallowances under the used and useful doctrine are necessarily on the basis of how the expenditures have *turned out*. Similarly, the *Market Street Railway* doctrine<sup>4</sup> exempted regulatory authorities from responsibility for attempting to permit cost recoveries that changing technology or other exogenous market developments had rendered unachievable—such as occurred when roads and motor vehicles rendered street railways obsolete.

4. But what if the entry of competition, which has arguably rendered some facilities unused and useless, was not an exogenous development but the consequence of a change in

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unfair for me to observe that it took me some five minutes to find I had italicized Justice Holmes' characterization of the task of setting a fair rate of return as “not a matter of economic theory, but a fair interpretation of a bargain.” *Id.* at 43, in the Chapter: “The Traditional Issues in the Pricing of Public Utility Services.”

4. *Market St. Ry. v. Railroad Comm'n of State of California*, 324 U.S. 548 (1945).

*regulatory policy*—specifically the abandonment or regulatory modification of franchised monopoly? I can't see how invoking the *Market Street Railway* rule or the used and useful doctrine could in those circumstances be interpreted in any way except as a violation of the regulatory . . . banana.

5. In operating under an understanding that I had some sort of obligation to provide utility companies an opportunity to recover their actual prudently-incurred costs, I was by no means motivated exclusively by either legal or ethical considerations. A central consideration was the purely economic recognition that if service was to continue, of acceptable quality, companies had to have a fair shot at recovering their true economic costs. Of course I recognized, as the first of our two Michaels points out (in this *Journal*<sup>5</sup>), that the strictly economic case for recovery applies only to current and future costs. To appreciate fully how that economic compulsion got translated into defining legitimate revenue requirements in terms of all costs prudently incurred, past and present, it helps to recall the tortured controversies of the first decades of this century over use of a reproduction-cost versus a prudent-investment rate base. The essential economic case for the former standard was that it came closer than the latter to true economic cost and produced a course of prices over time more nearly resembling the results of competition. I will not attempt to describe the constipation of the regulatory and judicial process created by attempts to apply the reproduction cost standard—I allude to them in my book, drawing heavily on the wonderfully caustic descriptions by Ben W. Lewis<sup>6</sup>; but, apart from considerations of administrative practicability, the economic consideration that carried the day was the general recognition that if investors were guaranteed a reasonable opportunity to recover their actually incurred or book costs, that would equally well fulfill the essential economic function of their being able to attract capital in the future—the consideration that ultimately triumphed in *Hope Natural Gas*.<sup>7</sup>

6. That decision, however, as later interpreted in *Duquesne*<sup>8</sup>, clearly leaves commissions a wide range of discretion to disallow

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5. Maloney et al. *supra* note 1.

6. ALFRED E. KAHN, *THE ECONOMICS OF REGULATION* 37-39 (1988).

7. *Id.* at 35-41, 190-216.

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

costs, whether explicitly on grounds of imprudence or on the basis of the used and useful doctrine: we need only remind ourselves of the multi-billion dollar disallowances of the costs of nuclear plants during the '80s. But the *Duquesne* decision also contains a warning against regulators "arbitrarily" changing the rules of the game "back and forth."<sup>9</sup> And so do the purely economic, capital-attraction considerations that are the essence of *Hope*<sup>10</sup> and constitute the ultimate economic justification of prudent investment regulation.

7. With respect to this strictly economic function, the antagonists typically overstate their cases—which creates a wonderful opportunity for a reasonable person like me to take a firm stance in the middle. The writings of J. Gregory Sidak and Professor William J. Baumol, seeming to insist on the necessity of total recovery of costs in the absence of explicit findings of imprudence, clearly imply that the consuming public will lose more in higher costs of capital henceforward than they gain directly from illegitimate disallowances.<sup>11</sup> Not only can no one make such an assertion with confidence, in my opinion; it is surely subject to substantial discount, in recognition of investors' notoriously short memories. Somewhere in the middle, we have Professor Maloney's statement that any increase in the cost of capital, which such disallowances might well occasion, would be a good thing. The proper response, I think, is that to the extent the cost of capital goes up in recognition of the usual risks of the new competitive regime, it reflects a true economic cost and is properly reflected in price. To the extent, however, that it goes up because of regulatory inconsistency and the associated fear that rules changed one way may, under altered circumstances, be changed back, it is neither efficient nor desirable. The rationalizations by the opponents of stranded cost recovery, at the other extreme, can hardly increase the confidence of investors that what they are urging is anything other than simple regulatory opportunism. Professor Robert Michaels offers the modest suggestion that any utility that claims a nuclear stranding

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9. *Id.* at 315.

10. *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

11. See e.g., William J. Baumol & J. Gregory Sidak, *Stranded Cost Recovery: Fair and Reasonable*, PUB. UTIL. FORT., May 1995, at 22; William J. Baumol & J. Gregory Sidak, *Recovering Stranded Costs Benefits Consumers*, 19 REGULATION 12-15 (1996) [hereinafter Baumol & Sidak, *Recovering Stranded Costs*].



be required to show that regulators gave it no choice but to build or complete the plant despite the utility's preference for an alternative<sup>12</sup>—a guilty-if-not-100 percent-innocent rule that not only ignores the active governmental encouragement of the nuclear alternative but also, incidentally, obfuscates the entitlement of utility companies to recovery of the multi-billion dollar obligations to purchase independently generated power that were undeniably forced on them by governments. And former Chairman Bradford seems to regard as relevant the zero rating he gives to the chances that regulators have actually disallowed every dollar imprudently spent by the utility companies under their supervision<sup>13</sup>—which suggests two alternative, equally fair calculations: first, what percentage of the huge disallowances of nuclear plants in the 1980s were based even avowedly on findings of imprudence? And, second, what percentage of these were genuinely justified on bases other than hindsight? Moreover, neither his comment nor Professor Michaels' test makes any allowance for the likelihood that the economically irresponsible completion of nuclear plants was forced on the companies by the system of regulation itself, which threatened them with disallowance of the costs of uncompleted plants as not used and useful.

8. These considerations about the consequences of disappointing the reasonable expectations of investors take on additional emphasis if the flip of regulators from cost-plus to competition gives rise to a reasonable possibility of a similarly opportunistic future flop in the opposite direction. That is the significance of my previous observations about the quite possibly transitory nature of the price to marginal cost relationship that has in recent years sparked the enthusiasm for deregulation. The greater the perceived likelihood that a reversal of that relationship could lead to a mirror-image reversal of the present deregulation process, the greater will be the inefficient inflation of the cost of capital—a cost that consumers will inescapably bear.

9. The high prices that ratepayers are paying today for the industry's past mistakes have been, in large measure, the product of the previous system of rate base/rate of return regulation: it

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12. Robert J. Michaels, *Stranded Investments, Stranded Intellectuals*, 19 REGULATION at 49 (1996).

13. Bradford, *supra* note 2, at 11.

encouraged the companies to build big, capital-intensive plants—even to the point of their feeling compelled, under the threat of the used and useful doctrine, to complete nuclear plants that might better have been abandoned. Given the irrationality of that system, PURPA made sense: the companies had no incentive to seek out and buy cheaper power, even at prices lower than their own avoidable costs, because those cost savings would have merely flowed through to their customers and the reduction in their own production would have jeopardized the return on their investments. For this reason, it took governmental compulsion to make the companies purchase independently generated power whenever it made economic sense for them to do so, and to set the prices of those purchases. This led in turn to multi-billion dollar errors. So, as characteristically happens, a regulatory system with severe imperfections elicited a superficially plausible remedy<sup>14</sup> that has turned out worse than the disease it was intended to cure. In these circumstances it would be unconscionable to force the shareholders of the utility companies to absorb the costs of those regulatory errors, even, as I have already pointed out, under the Michaels guilty-if-not-100 percent-innocent doctrine.

10. The problem posed by the prospect of stranded costs is essentially political in both the broadest and the narrowest senses of the term. As for the former sense: even though we cannot find an objective measure of the costs of regulators playing a game of heads-we-win, tails-you-lose—giving investors original cost or market value, franchised monopoly or competition, whichever produces the lower price—there is an inescapable political question of the extent to which governments can with impunity change the rules in this way, consistently with a healthy market economy. As for the narrower sense, politics is the process that determines who gets what—what burdens and what benefits. Ultimately, these issues can best be resolved only by pragmatic compromises likely to strike disinterested arbiters (of which there are precious few) as fair.<sup>15</sup>

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14. See my description of "the tendency of regulation to spread," II KAHN, *supra* note 3, at 28-32 *passim*; and Alfred E. Kahn, *The Changing Environment of International Air Commerce*, 3 AIR LAW (Netherlands Journal) (1978).

15. See also Alfred E. Kahn, *Who Should Pay for Power-Plant Duds?*, WALL ST. J., Aug. 15, 1985, Op Ed Section.

11. The historical principles of utility regulation clearly give regulators a substantial margin of discretion to determine what results would be equitable and, in the present circumstances, in fairly distributing the burden of what have turned out to have been huge mistakes. In exercising this discretion, they will necessarily take into account two economic arguments that have been made in opposition to recovery.

One is that the cost of capital, which regulators have generally attempted to give companies a fair opportunity to recover, includes compensation for risks of this kind. The logical fallacy of that assertion, however frequently it has been repeated, is easily demonstrated: The cost of capital does unquestionably include a compensation for symmetrical risk—the risk (indeed the certainty) that achieved returns will at times be higher, at other times lower than the target level. But it cannot by its very nature compensate for biased or asymmetrical risk of the kind at issue here. If regulatory authorities systematically allow companies only the cost of capital on investments that have proved successful—or at times when such an allowance produces prices lower than unregulated ones—and disallow such a return on investments that have turned out unsuccessfully—or at times when competition would produce lower results—it is arithmetically impossible for investors on average to recover the cost of capital. So asymmetrical regulation that attempts to set returns only at the cost of capital is incapable of yielding investors the return that they must see a reasonable probability of earning *on average* if they are to make their capital available.<sup>16</sup>

12. More arresting is the possibility that regulatory commissions have typically allowed electric utility companies returns in *excess* of the cost of capital, whether as a matter of policy or by accident. For example, Irwin Stelzer contends that investors have had plenty of notice, at least since the early 1980s, that—to put it pejoratively—they couldn't trust regulators not to change the rules; or, to put it less so, that even prudently incurred costs

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16. I attribute my first recognition of this point to the lucid exposition by Prof. Robert H. Litzenger in testimony on behalf of Central Maine Power Company before that State's Public Utilities Commission, Docket No. 84-120, 1984-85 (on file with author). See also A. Lawrence Kolbe & William B. Tye, *The Duquesne Opinion: How much 'Hope' is there for Investors in Regulated Firms?*, 8 YALE J. ON REG. 113-157 (1991), and *The Fair Allowed Rate of Return with Regulatory Risk*, 15 RES. L. & ECON. 129 (1992).

might be subject to disallowance on the basis of hindsight.<sup>17</sup> The typically lower market-to-book ratios of electric companies with heavy involvement in nuclear plants during the '80s lends support to this assertion. The fact remains that if that realization took the form of a demand for higher returns on average (that is, a higher cost of capital) and regulators continued to permit that return only selectively, there would still be no way arithmetically in which investors could be compensated at that level on the totality of their prudent investments. Professor Jerome E. Hass and Sally Hunt have, however, suggested to me an alternative interpretation. As investors have become aware of the possibility of regulatory disallowances (as Stelzer points out), the consequent depression in the market prices of electric company securities and increase in dividend-to-price ratios might have led regulators into overestimating the actual cost of capital, when in fact that increase may have reflected only the recognition by investors of a danger that they would not be permitted to earn that return on the totality of their investments. In the latter event, investors collectively (but not necessarily the ones who sold their stocks at the newly depressed price<sup>18</sup>) would indeed have been compensated for that growing asymmetrical risk.<sup>19</sup>

Whatever the explanation, the fact is that for most of the last 40 years—except during the periods of double-digit inflation—the market price of electric utility shares has exceeded book value. This must have reflected a consensus expectation by

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17. Irwin M. Stelzer, Editorial, *Stranded Costs, Strained Rationale*, 19 REGULATION at 2 (1996).

18. Consideration of the effect of an emerging recognition of a change in the rules of the game on individual purchasers and sellers of the companies' securities invites all sorts of sophistry. For example, the assertion of Dr. Jake Hauck, of the Allegheny Institute for Public Policy, that "stockholders of utilities that are likely to have large stranded costs have had plenty of time to sell their shares and can not be treated as innocent victims of a change in regulatory policy" suggests a convenient, all purpose justification for governments changing the rules of the regulatory game any time they see some political advantage in doing so: (1) announce the possibility of such a change; (2) watch some shareholders sell out at prices depressed by the announcement and take their losses; (3) point out that the losers, having taken their lumps, can no longer be helped; and the new investors who came in and bought the stocks at the new prices "can not be treated as innocent victims of [that] change" and deserve whatever they get. (That leaves unanswered possible complaints by the original stockholders who did not sell out, but nobody's perfect.) See Jake Hauck & Alfred E. Kahn, *The Case Against Stranded Cost Recovery*, UTILITIES & PERSPECTIVES (Standard & Poor's, New York, N.Y.), Dec. 2, 1996, at 1-4.

19. In that event, just like the purchasers of junk bonds, they could have earned the promised return sufficiently in excess of the cost of capital on the successful investments to compensate them for zero returns on the unsuccessful ones. See Kolbe & Tye, *The Duquesne Opinion*, *supra* note 16, at 123-27.

investors of returns in excess of the cost of capital—an expectation presumably vindicated on average over that long period of time. I have no definitive statement to offer about the implications of this historical fact. On the one side, I cannot say with conviction that it legitimizes governments, frustrating those expectations opportunistically, by changing the rules under which they were generated; on the other hand, those excess allowances surely have a bearing on the central (political) question of what would constitute a fair settlement.

13. Whatever pragmatic political settlement is reached, we need some creative thinking about institutional mechanisms for permitting recovery of such potentially strandable costs as that settlement envisions. The amount of costs that would otherwise be stranded is unknowable in advance, since it will be the difference between the companies' revenue entitlements and whatever competitive market prices turn out to be: a recollection that many people were saying, just a few years ago, that those prices would soon reflect a \$100 a barrel price of oil should induce a proper humility about our ability to estimate stranded costs today.

In the face of this uncertainty, possible recovery mechanisms can range between two polar extremes. One would set the amount to be recovered on top of an *estimated* likely course of prices, in which event the amounts actually recovered would depend on (a) the degree of success or failure of efforts by the companies to mitigate those strandings, by promoting sales and improving their efficiency, and (b) the course that competitive prices actually take. Such a mechanism would maximize the beneficent incentives of the utility companies: promoting sales makes perfectly good economic sense when marginal costs are far below price, brings closer the day when excess capacity is exhausted and, by raising the competitive price, automatically reduces the costs that are left stranded.<sup>20</sup> But the incentive-maximizing mechanism would result in the companies actually recovering much more or much less than their regulatorily-determined legitimate costs. The other extreme would be an arrangement that makes sure they recover the actual amount of sunk costs settled on—neither more nor less. That would require

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20. See Anna P. Della Valle & Miles O. Bidwell, *Restructuring Rates Creates Value and Reduces Stranded Costs*, 8 ELECT. J. 19-25 (1995).

retroactive trueing up—a cost-plus arrangement with the poorest incentive properties.

Most likely would be a compromise of these two methods and goals, giving the companies some incentive to recover as much of their costs as they can by their own efforts, while at the same time precluding grossly excessive or inadequate recovery of the targeted amounts.

### THE CASE FOR COMPETITION

The peculiar set of historical developments in electric power over the last 20 years that has generated the pressure for competition and given rise to the temptation and danger of opportunistic behavior by regulators constitutes the strongest possible case for deregulating the generation end of the business and turning it over to the discipline of competition. That history clearly demonstrates, as Michael Maloney has cogently argued, the superiority of a system in which, while mistakes of just the kind we have witnessed will surely be made, they are less likely to be, because of the elimination of cost-plus regulation, and when they are, the onus will fall entirely on investors. The other essential side of that coin is that when investments prove successful, the benefits will and should accrue entirely to those investors.

In this connection, I cannot resist the temptation to offer a more recent example of this principle, even though it involves self-advertisement. In the August 6, 1996 issue of the *Wall Street Journal*, I published an Op-Ed commentary on a proceeding in which the Federal Communications Commission is at present engaged, which raises the danger of exactly the kind of regulatory behavior I have been warning against here.<sup>21</sup> The question at issue in that case is how to allocate the costs of multi-purpose fiberoptic facilities capable of delivering regulated telephone and unregulated video and other information services. The Telecommunications Reform Act passed earlier this year sets, as its central goal, encouraging the construction of a versatile, modern telecommunications infrastructure capable of exploiting the explosive potentialities of modern technology by entrusting responsibility to unregulated competitive markets. This goal has as its inescapable corollary exactly the arrangement I have just described: investors must bear all the costs and risks and, symmetrically, reap all the

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21. Alfred E. Kahn, *Ask Not the Bells for Tolls*, *WALL ST. J.*, Aug. 6, 1996, at A14; see also Alfred E. Kahn, *How to Treat the Costs of Shared Voice and Video Networks in a Post Deregulatory Age*, *POLICY ANALYSIS* (The CATO Inst., Wash., D.C.), Nov. 27, 1996.

profits of successful investments. That is the way to ensure that all efficient investments—those whose benefits exceed the costs—will in fact be undertaken.

These are the kinds of situations that create irresistible temptations for regulators. The Commission has already signaled its intention to use the cost allocation process to reduce the regulated rates of telephone services. If it ends up allocating more of the costs than the benefits of such investments to the unregulated services—precisely the kind of asymmetrical policies that are at issue as well in electric power—it would of course be politically popular but, by the same degree, would tend inefficiently to discourage the undertaking of these costly projects. The proper solution is to let the companies bear all the costs and retain all the benefits—which translates into the simple instruction to regulators to leave the regulated rates unchanged.

It is time to resolve the multi-billion dollar question of a fair distribution of the costs of past mistakes and move as rapidly as possible to letting such costs be apportioned instead by the market rather than by temptation-prone regulators.