

Summary of Congressional Budget Office 1998 paper on Stranded Costs¹

In 1998, the Congressional Budget Office issued a white paper entitled “*Electric Utilities: Deregulation and Stranded Costs*” in response to questions about states’ moves to restructure electricity markets and provide more competition and choice for electricity consumers. The paper covers much material in its 27 pages. What follows is a brief review of the paper’s key points.

The paper addresses three main questions:

- What are stranded assets and where do they come from?
- How can they be measured?
- What are the pros and cons of making different groups—consumers, taxpayers, utilities, and their stockholders—pay some or all of the stranded costs?

Stranded costs can be defined as “the decline in value of electricity-generating assets due to restructuring of the industry” (the definition assumes that retail prices will be lower after industry restructuring). The paper cites three main sources of stranded costs:

1. Uneconomical plants: Gap between value of assets in competitive market and pre-restructuring value. This basically boils down to a difference between accounting value and market value of the assets after restructuring. The market value can be affected by many things, such as expected revenues, efficiency, economic conditions, etc.
2. Lower prices: Effect of more efficient providers entering market
3. Lower demand: Loss of revenues due to customers leaving incumbent utility

Stranded costs fall into five main categories. While we tend to think of just the first of these in our discussions, the second and third are also quite consequential:

1. Unrecoverable costs of generation-related assets
2. Long-term contracts for power or fuel that would cause the utility to lose money when market prices for power decline
3. “Regulatory assets,” such as deferred income tax liabilities, that regulators would have eventually allowed but that would not generate returns in a competitive market
4. Capitalized investments in social programs
5. Employment transition costs

Measurement of stranded assets can follow either of three methodologies:

- Administrative *ex ante* estimates: the difference between the present value of revenues with and without competition
- Market valuation, such as an auction mechanism, to value sold-off assets
- Ex post measurements: record actual market prices after the fact and compare to pre-restructuring book values

The question as to **who** should pay for stranded costs depends on the following factors:

- Economic efficiency: whether the proposed structure encourages efficient uses of resources (primarily hard assets, capital, labor)
- Fairness
 - Does the restructuring disrupt the regulatory compact?
 - Does non-recovery of stranded costs constitute a legal “taking”?
 - Are costs higher because of state/federal mandates that could not be avoided?
 - Were past returns held down by regulatory agency? This argument was put forward by the Clinton administration, the administration at the time of the CBO paper’s publication.

How should money be collected to pay for stranded assets? Note: In each case presented here, fees are non-bypassable and temporary until all costs are recovered.

- A per-kWh surcharge on customer bills
 - Some leeway exists as to how costs are allocated among service classes.
 - This is the most popular method, as of the 1998 report.
- A fixed-amount surcharge on all existing customers
 - Generally takes the form of fixed monthly charges for a specified period
 - Would not affect ongoing usage like a per-kWh charge might
 - Allocation based on past usage, perhaps?
- A one-time exit fee paid by those who switch away from the incumbent.
 - Tends to protect the incumbent and lessen competitive opportunities
 - Employed by Michigan in their restructuring in the late 1990s

How should payments be distributed to utilities?

- Securitization is a way to provide the incumbent utility with a one-time lump sum and then spread ratepayer payments over time:
 - Basically, a refinancing whereby the utility’s cost of capital is replaced with a lower rate closer to those seen for municipal bonds, due to the mandated (low-risk) and steady stream of cash flows (ratepayer payments). State legislators authorize securitization, which takes the form of a state infrastructure bank that sells bonds and takes over rights to income streams from ratepayers.
 - May allow utility to accept lower lump sum due to benefits of tax deferral
 - Still subject to vagaries of stranded-cost determination

The report closes with this paragraph, copied here in its entirety:

“On this issue (economic efficiency vs. fairness), economic efficiency plays second fiddle to fairness and politics. Economists can recommend ways to estimate stranded costs, ways to pay them, and ways to collect fees for stranded costs that are the least distorting and least costly to the economy. Economists can also estimate the benefits of restructuring and

identify likely winners and losers. But the decision to compensate—to ease the financial burden of restructuring on the owners and creditors of utilities —is ultimately one for regulators and legislators.”

1. Congressional Budget Office. “Electric Utilities: Deregulation and Stranded Costs.” October 1998.

<https://www.cbo.gov/publication/11252>

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