Washington and Lee Law Review

Volume 43 | Issue 4 Article 13

Fall 9-1-1986

Citizens Action Coalition Of Indiana, Inc. V. Northern Indiana Public Service Company. Should Utility Consumers Pay Now Or Pay Later?

CITIZENS ACTION COALITION OF INDIANA, INC. V. NORTHERN INDIANA PUBLIC SERVICE COMPANY: SHOULD UTILITY CONSUMERS PAY NOW OR PAY LATER?

During the late 1960's and early 1970's electric utility companies faced projections of increased demand for electricity and rising fuel costs.[1] Experts predicted an energy gap resulting in power shortages unless utilities increased their capacity to generate electricity.[2] In response to the prediction of an energy gap and spurred by rising oil prices and the pollution problems of coal-fired generators, many utilities initiated construction of nuclear power plants to satisfy utilities' obligations to meet the power needs of the utilities' customers. The federal government's promotion of the conservation of energy and the development of alternative energy sources, however, diminished the impact of the predicted energy gap.[3] In addition, the rising price of energy and a deepening economic recession motivated consumers to reduce their demand for electricity.[4] Environmental problems and safety concerns, especially after the 1979 accident at Three Mile Island, prompted the Nuclear Regulatory Commission (NRC) to promulgate regulations that effectively lengthened construction time and increased the cost of nuclear plants.[5] Furthermore, to retain a competitive advantage over coal, many utilities

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1. *See* Luce, *Where Is the Electric Utility Industry Headed in the 1980's?*, PUB. UTIL. FORT., June 23, 1983, at 15, 15. In 1970 the projected annual load growth rate was 7%, but the actual growth rate in the 1970's was approximately 3.5%. *Id.* The price of fuel oil increased from $2.00 per barrel in 1970 to $26.00 per barrel in less than ten years. *Id.*

2. *See* Massela, *Recouping Abandoned Construction Losses*, PUB. UTIL. FORT., February 26, 1981, at 60 (1970 National Power Survey by Federal Power Commission predicted recurrent and spreading power shortages); Cook, *Nuclear Follies,* FORBES, February 11, 1985, at 82, 88. During the 40 years prior to 1970, demand for electricity increased at an annual rate of seven percent. *Id.* To accommodate increasing demands a utility must double its capacity every 10 years at a seven percent annual growth rate, every 24 years at a three percent annual rate, and only every 70 years at a one percent annual rate. *Id.*

3. Comment, *Consumers' Counsel v. Public Utilities Commission: Who Shall Bear the Cost of Abandonment*, 11 CAP. UNIV. L. REV. 91, 91 (1981); *see* Massela, *supra* note 2, at 60. In a 1979 Ford Foundation report McGeorge Bundy stated that a worldwide energy gap, which experts had predicted would occur by 1985, was no longer a real danger. *Id.*

4. *See* Comment, *supra* note 3, at 91 (Arab oil embargo, milder weather, and economic recession stimulated consumers to reduce energy consumption); Luce, *supra* note 1, at 15 (documenting decline in growth rate).

5. *See* Urban, *Allocating the Cost of Failed or Abandoned Projects of Regulated Public Utilities,* PUB. UTIL. FORT., May 24, 1984, at 33, 37 (government pressure due to ecological and safety concerns, especially after Three Mile Island, raised price of building nuclear plants to point at which abandonment was more profitable than completion); Gilbert, Olson, Lockett, *Prospects for Foundering Utilities: Bankruptcy, Utility Regulation and Public Policy,* 90 COMMERCIAL L.J., 150, 151 (1985) (after Three Mile Island accident, regulation and public pressure made completion and licensing of nuclear plants nearly impossible); Cook, *supra* note 2, at 89 (between 1978 and 1983 the NRC issued hundreds of new safety regulations for nuclear plants).

enlarged the size of their nuclear projects without considering the uncertain cost of solving technological problems involved in building larger, more complicated plants.[6] As a result of energy conservation, expensive regulatory delays, and drastic increases in construction costs, many utilities cancelled construction plans after spending millions of dollars for planning, licensing, and equipment.[7]

Many utilities have attempted to recover the cost of cancelled projects through utility rate increases, but whether state and federal regulators should permit utilities to charge consumers for cancelled projects is a controversial issue. Utilities may recover cancelled construction losses through rate increases if the appropriate regulatory commission grants approval. The Federal Energy Regulatory Commission (FERC) is responsible for setting rates for the interstate sale of electricity.[8] Interstate sales of electricity typically occur between utility companies. State legislatures delegate the responsibility for intrastate regulation to regulatory commissions which set rates that utilities may charge to consumers.[9]

When a utility company requests a rate increase the regulatory commission uses the following standard ratemaking formula:

Revenue = Operating Costs + (Rate Base × Rate of Return).[10]

Revenue is the total amount the utility receives in rates from customers.[11] Operating costs include operating expenses such as salaries, wages, fuel, and

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6. *See* Cook, *supra* note 2, at 84. Manufacturers such as General Electric and Westinghouse built the first American commercial nuclear reactors as turnkey plants at fixed prices in order to demonstrate the cost effectiveness of nuclear power. *Id.* When utilities ordered larger plants on a cost-plus basis, no one anticipated the enormous design, engineering, and construction problems involved because the technology was still evolving. *Id.* Furthermore, utility executives were confident that regulatory commissions would approve rate increases to recover the costs when the new plants became operational. *Id.* at 88.

7. Bruder, *Recovery of Losses on Cancelled Projects: Basic Issues,* in ELECTRIC POWER: CURRENT ISSUES IN REGULATION AND FINANCING 167, 169 (1982); *see* Luce, *supra* note 1, at 15 (by early 1980's cost of nuclear plant started in 1970 had increased up to tenfold); Pierce, *The Regulatory Treatment of Mistakes in Retrospect: Cancelled Plants and Excess Capacity,* 132 U. OF PA. L. REV. 497 (1984) (utilities have cancelled large proportion of projects started in 1970's); ENERGY INFORMATION ADMIN., U.S. DEP'T OF ENERGY, NUCLEAR PLANT CANCELLATIONS: CAUSES, COSTS, AND CONSEQUENCES 4 (1983) (by end of 1982 electric utilities had cancelled 100 nuclear units at 56 sites); Yang, *The Albatross,* FORBES, April 22, 1985, at 120 (utilities cancelled more than 50 nuclear reactors between 1980 and 1985).

8. Note, *Statutes Prohibiting Cost Recovery for Cancelled Nuclear Power Plants: Constitutional? Pro-Consumer?,* 28 WASH. U.J. OF URB. & CONTEMP. L. 345, 347 (1985).

9. *Id.* at 348.

10. *See* C. PHILLIPS, THE REGULATION OF PUBLIC UTILITIES 157-58 (1984). Phillips expressed the ratemaking formula as follows:

$$R = O + (V - D)r$$

where R is the total revenue required,
O is the operating costs,
V is the gross value of the tangible and intangible property,
D is the accrued depreciation of the tangible and reproducible property, and
r is the rate of return.

Id. at 158.

11. *Id.*

maintenance as well as annual charges for depreciation and taxes.[12] The rate base represents the depreciated value of property used to produce electricity, known as "used and useful" property, and an allowance for working capital.[13] The rate of return, expressed as a percentage, represents profit, interest on debt, dividends on preferred and preference stock, and earnings on common stock.[14] Multiplying the rate of return by the rate base yields the amount of money a utility may earn over and above operating costs.[15] In establishing a fair rate of return, a regulatory commission considers a variety of factors to determine whether a given rate is sufficient to maintain the company's credit rating to attract capital and is commensurate with returns in businesses with similar risks.[16] The commission's task is to balance these investors' interests against the consumers' interest in reasonable utility rates.[17] The commission's determination of a fair rate of return is a discretionary judgment that will be upheld unless utility rates are low enough to result in confiscation of the utility's property.[18]

In setting utility rates a regulatory commission uses the utility's costs during a designated test year to predict future revenue requirements.[19] To include any cost in the formula, a commission must characterize that amount as an operating cost or as property that is properly includable in the rate base pursuant to state regulatory laws. Some state regulatory laws prohibit including the cost of construction work in progress (CWIP) in the ratemaking formula because a facility under construction is not productive and, therefore, not used and useful.[20] The anti-CWIP statutes force the utility's shareholders to bear the risks and to carry the charges of construction capital until construction is complete.[21]

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12. *Id.*

13. *Id.* at 158-59. An alternative to the used and useful rate base is the invested-capital rate base which treats the capital employed in the business as property which earns a return for investors. *Id.* at 159.

14. *Id.* at 332.

15. *Id.*

16. Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944); *see* Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n of West Virginia, 262 U.S. 679, 692-93 (1923) (factors that regulatory commission should consider in setting fair rate of return include return earned by other businesses in same area of country with similar risks, financial soundness of utility, attraction of capital, efficiency of management, and current economic conditions).

17. C. PHILLIPS, *supra* note 10, at 331-32; *see Hope,* 320 U.S. at 603 (ratemaking involves balancing of investor and consumer interests); *Bluefield,* 262 U.S. at 692-93 (public utility has no right to same profits as highly speculative enterprise).

18. C. PHILLIPS, *supra* note 10, at 339.

19. *See id.* at 182 (regulatory commission uses reasonable expenses of utility in test period to estimate future expenses).

20. Dakin, *The Changing Nature of Public Utility Regulation: The Used and Useful Property Rate Base Versus the Capitalization Rate Base in the Nuclear Age,* 45 LA. L. REV. 1033, 1034 (1985).

21. *Id.* The Federal Energy Regulatory Commission (FERC) and some states allow partial inclusion of the cost of construction work in progress (CWIP) in the rate base when the cost

Normally when a new generating plant becomes operational, the regulatory agency adds to the rate base the total cost of construction including the accumulated return on the money invested in the new plant, which has become used and useful. The commission allows the utility to depreciate the cost of the new plant over a period of years. Each year during the amortization period the utility includes the amount of annual depreciation in operating costs while subtracting the same amount from the rate base.[22] For example, if the total cost of a new plant is $100 million, the commission might allow the utility to amortize the cost over a ten-year period. During the first year of amortization, the utility would include $10 million in operating costs and $90 million in the rate base. In the second year the utility again would include $10 million in operating costs, but only $80 million in the rate base.

Most state utility regulatory statutes require that property included in the rate base be used and useful property.[23] Technological advances, however, sometimes render generating plants obsolete. Many regulatory commissions have faced the question whether to allow utilities to recover the cost of abandoned or cancelled plants through rate increases.[24] Abandoned property consists of once productive property that a utility stopped using before the utility fully depreciated the cost.[25] Cancelled plants, however, never produced any benefit to the consumer.[26] The FERC has attempted to resolve the problem of cancelled plants by allowing amortization of the costs of cancelled plants while excluding the unamortized amounts from the rate base.[27] Each year during the amortization period the utility includes the depreciated amount of the loss in operating costs, but does not add any of the cost of the cancelled plant to the rate base side of the ratemaking formula. For

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of capital requires a return on equity substantially higher than the return paid by other similar utilities. *Id.* at 1041-42; *see* N.C. GEN. STAT. § 62-133(b)(1), (4) (1982) (allows inclusion of as much CWIP as commission considers to be in public interest and necessary to financial stability of utility).

22. C. PHILLIPS, *supra* note 10, at 157.

23. Howe, *The Used and Useful Standard: What Should the Criteria Be?*, PUB. UTIL. FORT., Feb. 7, 1985, at 54, 54.

24. Massela, *supra* note 2, at 60.

25. *See* Citizens Action Coalition v. Northern Indiana Pub. Serv. Co., 485 N.E.2d 610, 616 (Ind. 1985) (abandoned plants were once used and useful and then were retired from service).

26. *See id.* (cancelled plants never became used and useful).

27. Massela, *supra* note 2, at 60. The FERC allows partial recovery of the cost of cancelled plants. *Id.* For example, in 1979 the FERC permitted amortization over a five year period of a $13.6 million loss that the Louisiana Power and Light Company incurred upon cancelling plans to build the St. Rosalie project, a two-unit nuclear fueled generating plant. *Id.;* Louisiana Power and Light Co., 6 FERC ¶ 63,031 (1979). In 1975, the New England Power Company cancelled construction of an oil-fired generator at Salem Harbor after spending $13 million for site preparation, environmental studies, engineering services, and cancellation charges. Massela, *supra* note 2, at 60-61; New England Power Co., 8 FERC ¶ 61,054 (1979). The FERC agreed to amortization of New England Power's $13 million costs but denied rate base treatment. Massela, *supra* note 2, at 61; 8 FERC ¶ 61,054.

example, if a utility spend $1,000,000 on a cancelled project, the FERC might allow the utility to amortize the loss over a period of ten years. The utility would include $100,000 per year as operating costs while omitting the entire $1,000,000 from the rate base. The FERC's cost sharing solution allows the utility and the utility's investors to recover the capital invested, but denies investors any return on the investment. The FERC has limited the cost sharing approach to situations in which the utility demonstrated the prudence of the decision to cancel the project.[28]

Many state regulatory commissions have used the same cost sharing approach.[29] Other state commissions have placed the entire burden on consumers by allowing amortization and rate base treatment.[30] The full recovery approach requires ratepayers to reimburse investors for capital contributed to the cancelled project and to pay investors a return. Only in a few cases have regulatory commissions been willing to exclude completely amortization of the cost of cancelled plants, theoretically placing the entire burden on the company and investors.[31] The complete exclusion of a cancelled project's cost from the ratemaking formula bars a utility from recovering any of the project's cost from ratepayers.

Utilities and consumers may appeal the decision of a regulatory commission through the courts. Only three state supreme courts have construed state laws to deny recovery of the cost of cancelled plants through rate increases.[32] In 1981, in *Office of Consumers' Counsel v. Public Utilities Commission,*[33] the Ohio Supreme Court ruled that state law prohibited charging utility customers for any costs that were not service related.[34] The

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28. MASSELA, *supra* note 2, at 61. The FERC allows partial recovery only for prudently cancelled projects. *Id.* For example, when the Southern California Edison Company cancelled two nuclear plants, the FERC refused to permit amortization of the cost of one plant because the company failed to present specific evidence to justify the cancellation decision. *Id.;* Southern California Edison Co., 8 FERC ¶ 61,198 (1979).

29. *See* Pierce, *supra* note 7, at 518 (most regulatory commissions allocate costs of cancelled plants between investors and consumers by using cost sharing approach).

30. *Id.*

31. *Id.; see infra* notes 81-84 and accompanying text (discussing actual economic consequences of disallowing recovery of cost of cancelled plant).

32. *See infra* notes 33-40 and accompanying text (discussion of Ohio Supreme Court's decision in *Consumers' Counsel v. Public Util. Comm'n,* 67 Ohio St.2d 153, 423 N.E.2d 820 (1981)); *infra* notes 41-44 and accompanying text (discussion of *Pacific Power & Light Co. v. Public Serv. Comm'n of Wyoming,* 677 P.2d 799 (Wyo. 1984)); *infra* notes 45-71 and accompanying text (discussion of *Citizens Action Coalition of Indiana v. Northern Indiana Pub. Serv. Co.,* 485 N.E.2d 610 (Ind. 1985)).

33. 67 Ohio St.2d 153, 423 N.E.2d 820 (1981).

34. Office of Consumers' Counsel v. Public Util. Comm'n, 67 Ohio St.2d at 164, 423 N.E.2d at 826. In *Office of Consumers' Counsel v. Public Utilities Commission,* the Cleveland Electric Illuminating Company (CEI) had joined with four other electric companies to form the Central Area Power Coordination Group (CAPCO). *Id.* at 154, 423 N.E.2d at 821. In 1973 CAPCO decided to build four nuclear plants. *Id.* CAPCO, however, decided to cancel construction of the plants in 1980 due to increased energy costs, decreased demand, and new NRC regulations. *Id.* CEI's share of CAPCO's investment in the cancelled plants amounted to

Ohio court stated that expenditures for terminated plants were actually capital investments and, therefore, held that cancellation costs were not operating expenses.[35] The Ohio court decided that the legislature intended cost to mean the normal, recurring costs of rendering service and held that the Public Utilities Commission (PUC) had exceeded the commission's statutory authority in approving amortization of the utility's investment in a cancelled nuclear project.[36] Furthermore, the *Consumers' Counsel* court considered two policy arguments advanced by the utility and the PUC as justifications for allowing recovery.[37] The PUC had alleged that a utility needed to recover the costs of a cancelled plant to enable the utility to attract investment capital and to encourage management to terminate economically unfeasible projects.[38] The Ohio court concluded that only the legislature had the power to provide protection for utility investors.[39] Moreover, the court asserted that the PUC's power to investigate management policies and to disallow imprudent expenditures should provide sufficient incentive for management to terminate uneconomical projects.[40]

Similarly, in 1984 the Wyoming Supreme Court in *Pacific Power & Light Co. v. Public Service Commission*[41] affirmed a decision of the Public Service Commission of Wyoming (PSC) denying any recovery of a utility's share of the cost of a cancelled nuclear power project. The Wyoming Supreme Court refused to characterize the cost of cancelled plants as operating expenses since the cost of the plants, if completed, would have qualified as used and useful property, properly includable in the rate base.[42] The court agreed with the PSC's position that the risk of a project's failure properly should fall on the company and the company's stockholders because the utility considered and accepted the risk.[43] The Wyoming court, however, suggested that a utility company might shift some of the risk of failure to consumers by obtaining approval from the PSC prior to starting a new project.[44]

$56.4 million. *Id.*, 423 N.E.2d at 822. The Public Utilities Commission of Ohio (PUC) then authorized amortization of these costs over a ten-year period, resulting in a rate increase for CEI of $69.6 million. *Id.* at 153, 423 N.E.2d at 820-21. The Office of Consumers' Counsel, the Senior Citizens Coalition, and the City of Cleveland appealed the order granting the increase. *Id.*, 423 N.E.2d at 820-21.

35. *Id.* at 164, 423 N.E.2d at 827.

36. *Id.*, 423 N.E.2d at 827.

37. *Id.*, at 167-68, 423 N.E.2d at 828-29.

38. *Id.*, 423 N.E.2d at 828-29.

39. *Id.* at 167, 423 N.E.2d at 829.

40. *Id.* at 168, 423 N.E.2d at 829.

41. 677 P.2d 799, 809 (Wyo. 1984). In *Pacific Power & Light Co. v. Public Serv. Comm'n of Wyoming*, the Pacific Power & Light Company (PP&L) appealed a decision of the Public Service Commission (PSC) holding that the PSC would not allow rate recovery of any costs incurred by PP&L as a result of PP&L's investment in the unsuccessful projects of the Washington Public Power Supply System (WPPSS). *Id.* at 800-01.

42. *Id.* at 806.

43. *Id.* at 806, 809.

44. *Id.* at 808-09. In the *Pacific Power* case the Wyoming court reasoned that the

In November, 1985 Indiana became the third state to disallow recovery of a utility's cancellation costs by judicial decision. In *Citizens Action Coalition of Indiana v. Northern Indiana Public Service Co.*,[45] the Indiana Supreme Court ruled that state law did not empower the Public Service Commission of Indiana (PSCI) to authorize amortization of the costs of a cancelled plant.[46] In 1970, the Northern Indiana Public Service Company (NIPSCO) initiated the Bailly N-1 project, a nuclear generating plant, anticipating completion in 1976 at an estimated cost of $180 million.[47] Escalating costs and delays due to litigation and opposition to licensing provisions ultimately convinced NIPSCO to terminate the Bailly N-1 project in 1981 after spending $205,724,170.[48] When NIPSCO applied for a rate increase, the PSCI found that the Bailly project was a reasonable attempt by NIPSCO to comply with the utility's statutory mandate to provide adequate service and facilities.[49] Characterizing the sunk costs as an extraordinary cost of service loss, the PSCI authorized NIPSCO to amortize $190,746,580[50] over a period of fifteen years without including any of the unamortized costs in the rate base.[51] Essentially, the PSCI adopted the cost sharing approach.[52]

Consumer groups and the city of Gary, Indiana appealed the PSCI's order.[53] The Indiana Court of Appeals decided that the PSCI had acted contrary to law in authorizing the amortization of cancellation costs and ordered the PSCI to vacate any rate increase attributable to the Bailly project.[54] The appellate court construed applicable state statutes to require that service must be the basis of utility charges.[55] The court characterized the Bailly costs as capital expenditures, which NIPSCO could recover from

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regulatory commission could weigh a proposed project's risks and advantages for consumers. *Id.* at 806. The court construed the Wyoming utility regulatory statute to allow the commission to decide how much of the cost of failure the utility could charge to customers only if the Commission evaluated the risk prior to initiation of the project. *Id.* at 808-09.

45. 485 N.E.2d 610 (Ind. 1985).

46. *Id.* at 617.

47. Citizens Action Coalition of Indiana v. Northern Indiana Pub. Serv. Co., 472 N.E.2d 938, 940 (Ind. App. 1984).

48. *Citizens Action,* 485 N.E.2d 610, 611 (Ind. 1985); *see Citizens Action,* 472 N.E.2d 938, 950 (Ind. App. 1984) (when NIPSCO decided to cancel, estimated cost of completion of Bailly project was $2.1 billion).

49. *Citizens Action,* 485 N.E.2d 610, 612 (Ind. 1985).

50. *See Citizens Action,* 472 N.E.2d 938, 949 (Ind. App. 1984) (PSCI reduced amount of NIPSCO's original request by subtracting amount recovered in salvage).

51. *Citizens Action,* 485 N.E.2d 610, 612 (Ind. 1985).

52. *See supra* notes 27-29 and accompanying text (discussing cost sharing method of recovery).

53. *Citizens Action,* 472 N.E.2d at 939 (Ind. App. 1984).

54. *Id.* at 948.

55. *Id.* at 947-48. The Indiana Court of Appeals cited the Ohio Supreme Court's decision in *Office of Consumers' Counsel v. Public Util. Comm'n* as "directly on point." *Id.* at 943-44; *see supra* notes 33-40 and accompanying text (discussing Ohio case); *Office of Consumers' Counsel,* 67 Ohio St.2d 153, 423 N.E.2d 820 (1981).

ratepayers only after the plant became operable.[56] The court also rejected NIPSCO's argument that consumers should bear some of the risk of a cancelled project undertaken to provide utility service.[57] The appellate court, therefore, held that the utility could not charge customers to recover the sunk costs.[58]

On appeal, the Indiana Supreme Court affirmed both the decision and the reasoning of the Court of Appeals.[59] The Supreme Court noted that the Indiana statute governing utility rates states, "[t]he charge made by any public utility for any service rendered or to be rendered either directly or in connection therewith shall be reasonable and just."[60] The court construed the utility-rate statute to require that any operating expense must have a connection to service to be recoverable through retail rates.[61] After examining the statutory definition of "service,"[62] the court concluded that a cancelled

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56. *Citizens Action*, 472 N.E.2d 938, 946 (Ind. App. 1984). The Indiana Court of Appeals rejected NIPSCO's attempt to include the cost of a cancelled plant as an operating expense. *Id.* at 946-47.

57. *Id.* at 947-48. In *Citizens Action*, the appellate court concluded that the Bailly cost was a capital expenditure supplied by investors who assumed the risk. *Id.* at 946-47. According to the court's view, NIPSCO tried to make consumers partners in the project after it failed. *Id.* at 948. The court cited with approval rationales expressed by the supreme courts of Ohio and Wyoming. *Id.* at 948. *See supra* notes 33-44 and accompanying text (discussing *Consumers Counsel v. Public Util. Comm'n* and *Pacific Power & Light Co. v. Public Serv. Comm'n of Wyoming*).

58. *Citizens Action*, 472 N.E.2d at 948. The Indiana Court of Appeals stated that neither the court nor PSCI had statutory authority to expand Indiana's traditional ratemaking concepts. *Id.* at 946-48.

59. *See Citizens Action Coalition*, 485 N.E.2d 610, 615 (Ind. 1985) (PSCI's order characterizing Bailly cost as extraordinary cost of service loss was incorrect and allowing amortization was unlawful).

60. *Id.* at 613; IND. CODE § 8-1-2-4 (1982).

61. *Citizens Action Coalition*, 485 N.E.2d at 614.

62. *See id.* at 613-14. The Indiana Supreme Court referred to the following section:

> The term "service" is used in this act in its broadest and most inclusive sense and includes not only the use or accommodation afforded consumers or patrons but also any product or commodity furnished by any public or other utility and the plant, equipment, apparatus, appliances, property and facility employed by any public or other utility in performing any service or in furnishing any product or commodity and devoted to the purposes in which such public or other utility is engaged and to the use and accommodation of the public.

Id.; IND. CODE § 8-1-2-1 (1982).

The court then dissected the definition as follows:

> We discover three categories of "service" included therein:
> (1)The use or accommodation afforded customers or patrons;
> (2)Any product or commodity furnished by the utility; or
> (3)The plant, equipment, apparatus, appliances, property, and facility employed by the utility
> (a)in performing any service, or
> (b)in furnishing any product or commodity and devoted
> (a)to the purposes in which such utility is engaged and
> (b)to the use and accommodation of the public.

485 N.E.2d 610, 613-14 (1985).

project, which never became operational, provided no service to the utility's customers.[63] Consequently, the court stated that a utility could not include the cost of a cancelled project as an operating expense.[64] The Indiana Supreme Court recognized that the PSCI characterized the Bailly cost as an extraordinary cost of service loss—not as an operating expense.[65] The Indiana court, however, held that by authorizing amortization of the cost of a project that never became used and useful property, the PSCI had expanded unlawfully the statutory definition of service to include the utility's unsuccessful attempt to provide service.[66]

Both NIPSCO and the PSCI argued that the Bailly costs were an extraordinary cost of service loss because NIPSCO's undertaking to build the nuclear plant constituted a prudent and reasonable attempt to comply with the utility's statutory mandate to meet a predicted increase in demand for electricity.[67] Considering the lengthy construction time required for generating facilities, the PSCI claimed a responsibility to reduce the utility's risk of beginning construction so that the risk would not discourage prudent attempts to meet demand.[68] In rejecting the arguments of both NIPSCO and the PSCI, the court asserted that the purpose of regulating monopolies is to provide a substitute for competition.[69] Comparing a utility to a competitive industry, the court explained that part of the purchase price of a competitive product goes to repay investors for capital contributed and to pay investors an additional return as compensation for the risk of investing in the company.[70] The court reasoned that the PSCI's action effectively would force

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63. *Citizens Action Coalition,* 485 N.E.2d 610, 614 (Ind. 1985).

64. *Id.*

65. *Id.* Although the PSCI characterized the Bailly cost as an extraordinary cost of service loss, the PSCI essentially included the Bailly cost in operating costs by adding approximately $12,716,000 to the annual depreciation charges for 15 years. *See id.* at 611 (PSCI permitted amortization of $190,746,580 over 15 year period); *supra* notes 10-13, 19-20, 23-28 (discussing inclusion of amounts in ratemaking formula).

66. 485 N.E.2d at 614. In *Citizens Action Coalition,* after explaining the statutory definition of service, the Indiana Supreme Court addressed a related issue raised by the dissent in the appellate court. *Id.* at 616. The statutory definition of service includes the use or accommodation afforded consumers. *Id.; see supra* note 62 (statutory definition of service). Employing a dictionary definition of accommodation as something supplied for convenience or to satisfy a need, the dissent maintained that the law would allow amortization of the part of the Bailly costs that the utility prudently spent to satisfy a need. 472 N.E.2d at 954-55. The Indiana Supreme Court rejected the dictionary definition in favor of a specific legal meaning used in the context of public utility regulation. 485 N.E.2d at 616. Referring to statutes governing the regulation of railroads, the court defined accommodation to preclude anything that did not provide an actual benefit to the consumer. *Id.* at 616-17.

67. 485 N.E.2d at 614.

68. *Id.* at 611. In *Citizens Action Coalition* the PSCI's order noted that construction of nuclear powered facilities takes longer than the eight to ten years required to build coal-fired facilities. *Id.*

69. *Id.* at 614.

70. *Id.*

consumers who received no product or benefit to reimburse investors' capital.[71]

In addition to arguing that the amortization of the Bailly costs should be included as an operating cost or as an extraordinary cost of service loss, NIPSCO also claimed the existence of a strong presumption of legislative acquiescence in the PSCI's longstanding practice of allowing amortization of abandoned and cancelled plants.[72] Noting that four of the five cases cited by NIPSCO involved abandoned plants, the court distinguished between abandoned plants and cancelled plants.[73] The court concluded that the precedents that NIPSCO cited did not constitute a longstanding practice with reference to cancelled plants and would not support a principled reliance by lenders.[74]

In construing state law to require that all utility rates include only costs that a utility incurred in actually providing service, the Indiana Supreme Court indicated that the PSCI should not require consumers to act as insurers of the investors' risk.[75] The dissent in *Citizens Action* argued that ultimately consumers provide the revenue to pay the debts of any business that continues to exist because a company will fail if the company's stockholders cannot recoup their original investment and earn a reasonable return.[76] A competitive industry may cover losses from an unsuccessful project by realizing enormous profits from a successful one.[77] While a regulated utility has no opportunity

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71. *Id.* at 615. In comparing a regulated utility to a competitive industry, the *Citizens Action Coalition* court analogized NIPSCO's loss to that of an automobile manufacturer who cancelled a project to produce a new sports car. *Id.* The court reasoned that the automobile company would be unable to recover the company's loss from the consumers of the company's other cars. *Id.* One dissent, however, contended that the hypothetical company either must recover the company's losses from customers or face bankruptcy. *Id.* at 620 (Givan, C.J., dissenting).

72. *Id.* at 615. In *Citizens Action Coalition v. NIPSCO,* the *amicus* briefs of four banks supported NIPSCO's estoppel argument based on legislative acquiescence in the PSCI's past practices. *Id.* at 615 n.1.

73. *Id.* at 616; *see supra* notes 23-27 and accompanying text (discussing differences between abandoned and cancelled plants).

74. 485 N.E.2d 610, 616 (Ind. 1985). One concurring opinion in *Citizens Action Coalition* suggested that the court should allow the PSCI to approve the amortization of some of the Bailly costs, such as expenses for planning, analysis, and investment, based on the PSCI's past practices. *Id.* at 619 (Shepard, J., concurring).

75. 485 N.E.2d 610, 615 (Ind. 1985); *see* Citizens Action Coalition v. NIPSCO, 472 N.E.2d 938, 946 (Ind. App. 1984). The appellate court cited the Wyoming Supreme Court's observation in *Pacific Power & Light Co. v. Public Service Comm'n* that consumers deserve an opportunity to consider a risk before assuming the risk. 472 N.E.2d at 946. Furthermore, the Wyoming court noted that the company's stockholders took no risk at all if the company embarked on a venture intending for the risk to fall on consumers. Pacific Power & Light Co. v. Public Service Comm'n, 677 P.2d 799, 806 (Wyo. 1984); *see supra* notes 41-44 and accompanying text (discussing holding of Wyoming Supreme Court).

76. *See Citizens Action Coalition,* 485 N.E.2d 610, 620 (Ind. 1985) (Givan, C.J., dissenting) (consumers eventually pay for all losses of company).

77. *See id.* at 623 (Prentice, J., dissenting) (successful manufacturer can charge whatever market will bear and earn excessive profits).

to engage in highly profitable ventures, a utility's failure to pay a return to investors will result in increased cost of capital.[78] Regulatory commissions probably will transfer capital costs to consumers by providing for a higher rate of return in the ratemaking formula. For example, shortly after the Ohio Supreme Court's *Consumer's Counsel* decision disallowing amortization of the cost of a cancelled project, the regulatory commission granted the utility's request for a higher rate of return based on an increase in cost of capital.[79] Consequently, the question is not whether consumers will pay higher rates, but when and how much consumers will pay.

An analysis of the different methods of dealing with the problem of the cost of cancelled utility projects involves multiple interacting variables. From a policy standpoint, the most important factors include the effect of each method on those groups that bear some part of the cost and an evaluation of how well each method achieves the purpose of utility regulation. When cancellation of a project occurs, the utility writes off the full cost of the project as a loss for tax purposes.[80] The resulting reduction in tax revenue to federal and state governments transfers a substantial part of the financial burden of the cancellation to taxpayers.[81]

The full recovery method, which includes amortization of cancellation costs as operating costs and affords rate base treatment to the unamortized balance, places the greatest burden on ratepayers.[82] Investors continue to earn a return on their investment. Taxpayers benefit because investors pay taxes on dividends and the utility pays taxes on the utility's increased income.[83] The utility's tax burden, however, is passed to ratepayers as an operating cost.[84]

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78. *See id.* (if investors lose confidence in company, return required to attract capital will rise); Robinson, *Utility Fiascoes—Who Should Pay?*, PUB. UTIL. FORT., December 17, 1981, at 17, 19. Robinson explains that when a regulatory agency shifts the cost of an unsuccessful project to the company's shareholders, investors can depress the price of the company's stock and raise the cost of capital. *Id.* The unfavorable action of the agency also may increase the cost of capital for all utilities within the jurisdiction of that regulatory agency. *Id.*

79. *See* Consumer's Counsel v. Public Utilities Comm'n of Ohio, 4 Ohio St.3d 111, 114-15, 447 N.E.2d 749, 753-54 (Ohio 1983). After the 1981 *Consumer's Counsel* decision, the Public Utilities Commission (PUC) increased the utility's return on common equity from 17.02% to 17.30%. *Id.* at 117, 447 N.E.2d at 755. The PUC based the increase on the decline of the price of CEI's common stock and on Standard & Poor's decision to lower CEI's bond rating. *Id.* at 115, 447 N.E.2d at 753. The Ohio Supreme Court approved the increased rate of return. *Id.*, 447 N.E.2d at 754; *see also* Bruder, *supra* note 7, at 173 (one day after Ohio Supreme Court's 1981 decision in *Office of Consumers' Counsel v. P.U.C.*, Moody's lowered CEI's bond rating from AA to A); *supra* notes 33-40 and accompanying text (discussing holding of Ohio Supreme Court in 1981).

80. ENERGY INFORMATION ADMIN., NUCLEAR PLANT CANCELLATIONS, *supra* note 7, at 1.

81. *See id.* (taxpayers pay for utilities' cancellation costs through compensatory tax increases or through foregone tax reductions).

82. *See supra* notes 22-24, 30 and accompanying text (describing full recovery method).

83. ENERGY INFORMATION ADMIN., NUCLEAR PLANT CANCELLATIONS, *supra* note 7, at 39-40.

84. *Id.; see supra* text accompanying note 12 (taxes are included in operating cost in ratemaking formula).

The no recovery method, which disallows the inclusion of cancellation costs in the ratemaking formula, increases the burden on investors, but also decreases tax revenues.[85] When the utility writes off the loss, the resulting tax savings reduces the actual cost to investors and shifts much of the cost to taxpayers.[86] In addition, reduced or suspended dividend payments reduce investors' taxable income. While the utility's write-off is theoretically a tax deferral, the process actually results in an overall tax reduction if the incremental value of future tax payments is less than the present value of the tax savings incurred by the write-off.[87] Moreover, the no recovery method results in lower utility rates, producing less revenue for the company, which consequently pays less taxes. If, however, the denial of recovery causes an increase in cost of capital with a concomitant increase in utility rates,[88] future ratepayers will pay higher rates to enable investors to earn a greater return. The utility can avoid paying taxes on much of the utility's increased income because the utility's interest payments are deductible. The no recovery method apparently increases the burden on taxpayers without completely removing the burden from consumers.

The partial recovery or cost sharing method, which allows amortization of cancellation costs as operating costs, but denies rate base treatment, purports to allocate the cost more fairly between consumers and investors.[89] Actually, the effect of tax laws and the time value of money operate to distribute the loss among investors, consumers, and taxpayers.[90] The percentage of the cost borne by each group depends on the length of the amortization period.[91] A 1983 study published by the Department of Energy reveals that consumers may pay more than half of the cost of a cancelled plant if the amortization period is very short.[92] As the length of the amortization period increases, the ratepayers' share decreases while investors and taxpayers experience a corresponding increase.[93] Regardless of the length

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85. *See* ENERGY INFORMATION ADMIN., NUCLEAR PLANT CANCELLATIONS, *supra* note 7, at 40 (the no recovery method places entire burden of cancellation costs on utility investors and taxpayers); *supra* notes 31-68 and accompanying text (description of no recovery method and court decisions adopting no recovery method).

86. *See* ENERGY INFORMATION ADMIN., NUCLEAR PLANT CANCELLATIONS, *supra* note 7, at 40 (utility's tax write-off under no recovery method may shift up to 50% of cancellation cost from investors to taxpayers).

87. *Id.* at 55.

88. *See supra* notes 78-79 and accompanying text (depriving investors of return can result in increased cost of capital to utility).

89. *See supra* notes 27-28 and accompanying text (description of partial recovery method).

90. ENERGY INFORMATION ADMIN., NUCLEAR PLANT CANCELLATIONS, *supra* note 7, at 55.

91. *Id.*

92. *See id.* at 56. When the amortization period is only two years, the present value of the cost of a cancelled plant borne by ratepayers ranges from 64% to 69% when the discount rate ranges from 20% to 5.5%. *Id.*

93. *See id.* Using the partial recovery method and an amortization period of 30 years, ratepayers actually derive a small net monetary benefit because monetary benefits provided by income tax savings on debt financing of the plant before amortization outweighed rate increases due to cancellation. *Id.* at 55.

of amortization, taxpayers always pay a larger proportion of the cost than investors. For example, if the amortization period is five years, investors pay nineteen percent, ratepayers pay forty-nine percent and taxpayers pay thirty-two percent of the cost of a cancelled plant.[94] If a utility amortizes the costs over a twenty-year period, the investors' share is thirty-eight percent, ratepayers' six percent, and taxpayers' fifty-six percent.[95] Of course, the impact on individual investors and consumers is greater than the burden on individual taxpayers who comprise a much larger group.[96]

Aside from financial consequences, a comparison of the effects of alternative treatments of cancellation costs must include an evaluation of the probable effect on utility management policies. As a substitute for competition, regulation should encourage utilities to provide services efficiently and at minimum cost.[97] The goals of regulation should include encouraging utility management to adopt new methods, reduce costs, and expand capacity to meet increased demand.[98] The full recovery method may encourage management to risk experimentation with new methods and construction of new generating facilities by guaranteeing recovery of the cost of mistakes.[99] While full recovery provides no incentive to cut costs, regulatory commissions can discourage unnecessary spending by monitoring closely a utility's expenditures and disallowing imprudent costs.

In contrast to full recovery, the no recovery method encourages efficiency, cost reduction, and conservative estimates of future demand, but discourages risktaking and innovation. A regulatory policy that denies any recovery of the cost of mistakes or cancelled projects may prompt utility managers to postpone construction of new plants until demand exceeds capacity, resulting in power shortages.[100]

The partial recovery method offers the best compromise approach to provide the desired combination of incentives. Investors, who must share the loss, will pressure management to minimize mistakes without completely discouraging innovation.[101] Regulators also can encourage efficiency by dis-

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94. *Id.* at 56.

95. *Id.*

96. *Zitser, The Nuclear Plant Problem Needs a Federal Solution*, PUB. UTIL. FORT., March 29, 1984, at 22, 26.

97. C. PHILLIPS, *supra* note 10, at 154; *see* Urban, *supra* note 5, at 34 (regulatory agency functions as substitute for competition when market price conditions require natural monopoly).

98. C. PHILLIPS, *supra* note 10, at 154.

99. *See* Cook, *supra* note 2, at 83. Cook maintains that inadequate oversight by state regulatory commissions coupled with inadequate supervision of nuclear plant construction by utility managers created an atmosphere conducive to cost overruns. *Id.; supra* note 6 and accompanying text (discussing reasons for unanticipated cost increases of nuclear plant construction).

100. *See* Yang, *supra* note 7, at 120. Referring to the Indiana appellate court's decision disallowing recovery of cancellation costs in *Citizens Action Coalition v. NIPSCO*, the writer warned that the court's decision, if upheld by the Indiana Supreme Court, might encourage cautious utilities to postpone new plant construction "until the lights start dimming." *Id.*

101. *See* Robinson, *supra* note 78, at 21-22. Although the ability of stockholders to control

allowing recovery of imprudent expenditures, including all costs incurred in continuing construction after more prudent management would have recognized the economic unfeasibility of the project.[102] Proving that a utility's decision to continue a project was imprudent may be so difficult and expensive, however, that most consumer groups and government agencies lack the resources to successfully challenge a utility's decision on prudency grounds.[103]

The courts in Indiana and Ohio decided essentially that state legislatures should determine whether consumers should pay for cancelled plants through amortization of the cost or through an increased rate of return.[104] Legislators may prefer the no recovery method because prohibiting amortization of cancellation costs keeps rates down temporarily, appears to provide some incentives for more prudent utility management, and seems to penalize stockholders for lax control over management decisions.[105] Legislators, however, must weigh these apparent short-term benefits against the long-term reality of rising utility rates caused by higher returns demanded by disillusioned investors.[106] Moreover, utility companies must continue to undertake construction projects to replace deteriorating facilities and to accommodate

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utility management is more theoretical than real, regulatory disallowance of costs provides some incentive to management to minimize mistakes. *Id.* Disallowance reduces cash flow and makes management's job more difficult. *Id.* at 22.

102. *See* Wolf Creek Nuclear Generating Facility, 70 PUR 4th 475 (Kan. 1985). The recent decision of the Kansas State Corporation Commission (KSCC) represents an example of a regulatory decision to disallow some of the costs of a nuclear plant because of inefficient utility management. *See id.* Construction of the Wolf Creek nuclear plant began in 1973 at a projected cost of $525 million, but by the time the plant became operational in 1985, Wolf Creek had cost more than $3 billion. *Id.* at 530. The KSCC found that management of the construction project prior to 1981 was ineffective and inefficient, resulting in delays and increased costs. *Id.* at 494-95. While the KSCC stopped short of concluding that the utility should have cancelled Wolf Creek, the commission refused to allow the utility to depreciate the portion of the project's costs caused by construction cost overruns and schedule delays. *Id.* at 534, 539. In addition, the KSCC excluded part of the cost of the plant from the rate base not only because of the plant's excess physical capacity, but also because full rate base treatment would result in unreasonably high utility rates. *Id.* at 512.

103. *See* Pierce, *supra* note 7, at 512. Professor Pierce noted that his research had uncovered no case in which a regulatory agency had disallowed a utility's entire investment in an operating plant as imprudent. *Id.* at 512 n.78. In light of the extraordinary expense of litigation, the practical burden of proving a utility's decisions imprudent is so high that the burden acts as a deterrent. *Id.* at 512.

104. *See Citizens Action Coalition,* 485 N.E.2d at 617 (regulatory commission acted without statutory authorization in allowing amortization of utility's cost of cancelled plant); *Consumers' Counsel,* 423 N.E.2d at 829 (only legislature can change ratemaking structure to provide extra protection for investors).

105. *See* Urban, *supra* note 5, at 35 (disallowance of cancellation costs gives illusion of passing costs to stockholders).

106. *See* Tamietta, *Chemical Bank v. WPPSS: A Case of Judicial Meltdown,* 5 J. OF ENERGY L. AND POLICY 273, 292 (1984). If investors bear the risk of project failure, investors will demand higher returns, resulting in higher utility rates to consumers. *Id.* If the ratepayers bear the risk, the result should be a lower rate of return to investors and lower utility costs. *Id.*

future demand.[107] Even though the current problem of cancellations resulting from events of the last decade may be short lived, utilities continued to face difficult and risky choices. Public sentiment and federal regulatory responses to the environmental and health problems associated with coal, oil, and nuclear powered generating facilities are uncertain and unpredictable. Utilities that fail to guess correctly will have to cancel projects in the future.

In light of the Indiana Supreme Court's decision in *Citizens Action Coalition v. NIPSCO,* the Indiana legislature should consider expanding explicitly the PSCI's discretionary power to consider the long term effect of a ratemaking decision on a utility's financial integrity and the consumer's utility bill.[108] Another Indiana utility, Public Service of Indiana, faces the threat of bankruptcy as a result of the Indiana court's decision regarding NIPSCO.[109] NIPSCO's cancellation loss of $190 million pales in comparison with Public Service Company's $2.3 billion cancellation cost.[110]

Public Service of Indiana is not the only utility precariously close to bankruptcy after embarking on construction projects that later became economically unfeasible.[111] Utilities heavily involved in nuclear plant con-

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107. *See* Luce, *supra* note 1, at 16. Luce predicts that by the year 2000, American utilities will require 100,000 megawatts of new generating capacity to replace worn-out or obsolete generators. *Id.* Forecasts for annual growth in demand for electricity range from 1.5% to 3.5%. *Id.* To accommodate a growth rate of 1.5%, utilities will need to generate 62,000 additional megawatts by the year 2000. *Id.*

108. *See* Robinson, *supra* note 78, at 20. While recognizing that a regulatory commission may be unable to quantify the capital cost effects, Robinson suggests that regulators should direct disallowance of the cost of cancelled or abandoned plants only when the reason is sufficiently compelling to warrant increased cost of capital. *Id.* Robinson also warns that bond raters are reluctant to raise bond ratings once the ratings have dropped. *Id.*

A utility may not complain that a rate is confiscatory merely because the rate does not guarantee a fair return to investors. C. PHILLIPS, *supra* note 10, at 338-39; *see* Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944). " 'Regulation does not insure that the business shall produce net revenues,'" *Hope,* 320 U.S. at 603, *quoting* Federal Power Comm'n v. Natural Gas Pipeline Co., 315 U.S. 575, 590 (1942); *see also* Pennsylvania Elec. Co. v. Pennsylvania Pub. Util. Comm'n, 502 A.2d 130, 133-34 (Pa. 1985) (regulated utility has no constitutional right to rates high enough to ensure financial integrity of company). The regulatory agency, however, should consider the effect of a given rate on the utility's financial integrity as a factor in the balancing test. *Hope,* 320 U.S. at 603; *see Pennsylvania Elec. Co.,* 502 A.2d at 134 (legitimate investor interests are appropriate factors to weigh in balancing test).

109. Richards, *P.S. Indiana to Omit Dividends in Plan to Write Off $2.7 Billion Nuclear Plant,* Wall St. J., Feb. 3, 1986, at 6, col. 3; *see Indiana: Rate Relief Still Needed, Utility Says,* PUB. UTIL. FORT., Feb. 7, 1985, at 52-53. In February, 1985, Public Service of Indiana's (PSI) stock was selling at one-quarter of PSI's book value and the utility's securities were rated as speculative or highly speculative. *Indiana: Rate Relief Still Needed, supra* at 52-53.

110. *See* Richards, *supra* note 105, at 6, col. 2. Public Service of Indiana cancelled its two-unit nuclear project at Marble Hill in 1984. *Id.; see* PUBLIC SERVICE INDIANA, 1984 ANNUAL REPORT 12 (1985) (PSI was unable to obtain financing for Marble Hill project after Governor of Indiana endorsed recommendation of his task force to cancel project).

111. *See* Gilbert, *supra* note 5, at 150. At least a half-dozen major utilities, which were prime low-risk investments ten years ago, teetered on the edge of bankruptcy by 1984. *Id.* Cancellations of nuclear power projects played a major role in these financial failures. *Id.* at 159-61. *See also* Yang, *supra* note 7, at 120 (Consumer Power in Michigan cancelled its Midland nuclear plant in 1984 after accumulating $4 billion in sunk costs).

struction pay substantially higher yields than utilities with little or no investment in nuclear construction.[112] Payment of higher yields indicates that investors may perceive those companies as riskier investments.[113] Investors also have less confidence in utilities located in jurisdictions having harsh regulatory environments.[114] Furthermore, industry may avoid states whose regulatory policies effectively increase rates while creating a danger of too little generating capacity to accommodate new demand.[115] The Indiana Supreme Court's interpretation of state regulatory law ultimately may cause higher utility rates by increasing the cost of capital and may frustrate the goals of regulation by encouraging over-cautious utility management. Consequently, the Indiana legislature would be wise to consider granting sufficient discretion to enable the regulatory commission to formulate solutions based on a policy that encourages efficient utility management and promotes customer satisfaction with utility service as well as rates.

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112. *See* Studness, *Recent Development in the Market for Electric Utilities Stocks,* PUB. UTIL. FORT., March 29, 1984, at 47, 47. According to a sample of 85 utilities, which account for 95% of the market capitalization of investor-owned utilities, those utilities with heavy involvement in nuclear plants under construction paid a yield of 14.6% while those utilities with no involvement in nuclear construction paid a yield of only 9.4%. *Id.*

113. *See id.* (crisis in investor confidence in electric utilities has raised cost of capital).

114. Urban, *supra* note 5, at 36.

115. *See* Public Service Indiana Investors, Inc., 2 PSII Report, No. 2 (questions whether a manufacturing company would want to build plant in Indiana where political leaders are reluctant to guarantee adequate supply of electricity); Luce, *supra* note 1, at 16 (electronic and robotized economy will create increased demand for electricity).