

CHAPTER 8

BENEFICIAL OWNERSHIP OF ALLOWANCES BY RATEPAYERS AND ITS REGULATORY IMPLICATIONS

As noted previously, § 403(f) of the Clean Air Act Amendments (CAAA) explicitly states that "allowances do not constitute a property right." Rather, §§ 402(3) and 403(f) provide that an allowance is merely a "limited authorization to emit sulfur dioxide." What's more, the Congress stated that the allowances are assets of the utility. The analysis in Chapter 1 led to the conclusion that an emission allowance was indeed a property right in the form of revocable licenses or permits, in which no reasonable expectation of a compensable property interest exists.

The more vital issue is who owns the property right. It is quite clear that Congress intended that the legal title and ownership of emission allowances be with the utility. Congress stated that the allowances are assets of the utility and directed the federal Environmental Protection Agency to issue the allowances to the owners (or the "designated representative") of the affected sources; that is the utilities. Stating that the utilities are legal owners of the allowances, however, is not the complete answer.

Ratepayers as Beneficial Owners of Emission Allowances

The system of allowance trading set up by Congress is an effort to balance both efficiency and equity concerns about the cost of acid rain compliance. Had Congress only been concerned about efficiency, it would have held an auction for the allowances, which would have helped set the market price of the externality (while reducing the federal deficit). Instead, Congress took into account equity issues such as who should bear the cost of acid rain clean-up. The allocation of allowances, including bonus allowances, reflects the equity judgement of Congress. Allocation is not meant as a give-away, a subsidy, or a "rob-Peter-to-pay-Paul" scheme, but an effort to cushion rate shock

related to the cost of acid rain compliance. At the same time, an allowance market should lower the overall cost of acid rain compliance nationwide.

The fiduciary duty of utilities to act as trustees of the public, in particular of ratepayers, traces its origins to the duty of common carriers.¹ Indeed, the most basic notions involved in the regulatory compact--that of prudent expenditures and investments--draws on the concept of prudence in trust law in characterizing public utilities as enterprises conducted as trust for the benefit of the public.² There appears to be no traceable **direct** origin of the use of the concept of prudent investment respecting public utilities from the concept of prudent investment pertaining to trust obligations. Nevertheless, it is clear from the literature that legal scholars--including Justice Brandeis, the architect of the prudent investment test--who played a role in the early articulation of the prudent investment standard for public utilities were aware of the long-standing use of the prudent investment concept in trust law and likely borrowed from it.³

The theory of beneficial ownership can be traced to the law of trusts and contract law. The legal term "beneficial" means "tending to the benefit of a person; yielding a profit, advantage, or benefit; enjoying or entitled to a benefit or profit." This term is applied both to estates (as a "beneficial interest") and to persons (as "the beneficial owner").⁴ Ratepayers have a beneficial interest in the utility's use of its emission allowances under the regulatory compact. A "beneficial interest" means "profit, benefit, or advantage resulting from a contract, or the ownership of an

¹ Edwin C. Goddard, *Cases on the Law of Bailments and Carriers of Service by Public Utilities* (Chicago: Callagan and Company, 1904 and 1928); and Edwin C. Goddard, *Cases on Principal and Agent* (St. Paul, MN: West Publishing Company, 1914).

² See Richberg, "A Permanent Basis for Rate Regulation," *Yale Law Journal* 31 263: 278-79 (1922). The connection between the law of trust and the prudent investment obligation of public utilities is discussed in greater detail in Robert E. Burns et al., *The Prudent Investment Test in the 1980s* (Columbus, OH: The National Regulatory Research Institute, 1985), Chapter 2.

³ *Ibid.*

⁴ *Black's Law Dictionary, Revised Fourth Edition* (St. Paul, MN: West Publishing Company, 1968), 198.

estate as distinct from the legal ownership or control."⁵

Because regulated utilities are imbued in the public interest and have certain fiduciary duties to their customers under the regulatory compact, ratepayers are the beneficial owners of the emission allowances. The utilities are merely the legal owners of the allowances. As such, they are always obligated to act in the interest of the beneficial owners of the allowances, the ratepayers.

In this case, the benefit resulting from the regulatory compact (or, stated another way, the fiduciary duty of the utility that benefits the customers) is the ability of the utility to use its emission allowances to lower its cost of compliance. The fiduciary duty of the utility to engage in compliance planning and allowance trading is consistent with its overall obligation to provide reliable service to customers at the lowest reasonable cost. In return, the public utility receives an opportunity to recover its prudently incurred expenditures and to earn a reasonable return on its prudently incurred investment.⁶

As beneficial owners of the emission allowances, ratepayers are third-party beneficiaries to any sale or use of the allowances. Although ratepayers are not, as a group, privy to any contract entered into by a utility for the sale or purchase of allowances, they are beneficiaries because the contract was made to benefit them by allowing the utility to fulfill its regulatory compact to provide service at the lowest reasonable cost. However, ratepayers might not necessarily rise to the status of third-party beneficiaries able independently to maintain a breach-of-contract-suit civil action. Instead, the status of ratepayers as beneficiaries might be considered incidental by the courts in cases where a breach of contract for the purchase or sale of an emission allowance is alleged. In such a case, the utility would stand in the ratepayer's stead, just as in the case of a breach of a fuel procurement or construction contract.

⁵ Ibid., 199.

⁶ For a discussion of the regulatory compact, see Robert E. Burns, "Sorting Out Social Contract, Deregulation, and Competition in the Electric Utility Industry," *The Proceedings of the Sixth NARUC Biennial Regulatory Information Conference*, ed. David Wirick (Columbus, OH: The National Regulatory Research Institute, 1988).

This does not mean, however, that ratepayers have no enforceable rights should the utility fall short of its fiduciary duties to ratepayers to fulfill its end of the regulatory bargain. Instead, consumer advocates, state commission staffs, or the attorney general could advocate downward rate adjustments under the prudent investment or prudent expenditure test to remedy the utility's breach of its fiduciary duties and to readjust rates to a "just and reasonable" level.⁷

As noted in Chapter 3, emission allowances enable those utilities with a relatively low marginal cost of compliance to "overcomply" with the requirements of a single company stand-alone model and to generate "excess" allowances which then can be bought by utilities and other purchasers with a relatively high marginal cost of compliance to bring them into compliance. Given perfect knowledge of the marginal cost of compliance strategies and the market price of emission allowances, one would expect a utility to invest in compliance strategies to the point where the marginal cost of a compliance strategy equals the market price of an emission allowance. Any excess allowances could be sold on the market or banked for future use. If the utility was not in compliance and its control cost was already above the expected market price, the utility would buy allowances. By engaging in these strategies, a utility engages in an acid rain compliance strategy consistent with its duty to provide reliable service at the lowest reliable cost.

This simplistic conclusion is based on three faulty assumptions. The first, that the utility has perfect information, has already been pointed out. Although the marginal cost of well established compliance strategies can likely be forecasted with a reasonable degree of accuracy, in reality the ex ante market price of allowances is uncertain. Other problems related to uncertainty are discussed elsewhere. The second assumption is that the utility will be unaffected and neutral in its choice of compliance strategies by the state commission regulatory treatments. Chapter 7 shows that if state commissions simply graft emissions trading onto a traditional regulatory treatment of capital investment and expenditures there may be a significant bias against buying allowances for compliance.

The third serious problem relates to the problems of principal and agent. Even though the utility has a fiduciary duty to act in the interest of the ratepayer in its compliance choices, it will

⁷ For examples, see Burns, *The Prudent Investment Test in the 1980s*.

lack a sufficient incentive to do so with vigilance because any gains from its business choices will be passed through to ratepayers. Instead, there will be an incentive to do the minimum necessary to pass a prudence test. And, if the state commission has a form of preapproval of planned actions (Chapter 6), the utility will be reluctant to stray from the approved plan even if it makes sense to do so. In short, traditional regulatory treatment of allowances may not create sufficient incentive compatibility between the utility and the ratepayer to motivate the utility to act efficiently in its compliance planning and emission allowance trading.

The authors propose in the next chapter a regulatory treatment of allowances which would provide for a more neutral regulatory treatment of the allowances and would achieve the objective of incentive compatibility. The key to the proposal (explained in greater detail later) is the early uncoupling of the fiduciary relationship between the utility and ratepayers by having the utility buy out the ratepayers' beneficial interest in the allowances so the utility has complete ownership of the allowances, not just legal ownership. Then, the utility would have a greater incentive to act efficiently in its compliance planning and allowance trading.

Beneficial Ownership and Accounting for Gains on the Sale of Utility Property

The regulatory compact is not the sole source of authority for concluding that utilities are merely the legal owners of allowances. Historically, state public utility commissions have used a "burdens and benefits" or "risks and rewards" test in deciding how to treat the gain from the sale of utility property.⁸ The relevant factors under that test are (1) who financed the investment in the asset, (2) who actually owned the asset, and (3) who bore the risk of any decline in the value of the asset. The use of the "burdens and benefits" and "risks and rewards" test shows that state public utility commissions have long treated ratepayers as beneficial owners of utility property, although they may have not used those precise words.

In the case of nondepreciable property, a majority of state commissions favor an above-

⁸ For a more thorough discussion, see Diane Sponseller, "Accounting for Gains on the Sale of Utility Property," *Public Utilities Fortnightly* (May 16, 1985), 49-52.

the-line accounting treatment, holding that gain from the sale of land and other nondepreciable property should be the ratepayers because they have borne the risk of carrying the property. In such a case, the ratepayers become the beneficial owners of the property. This approach was endorsed as not being an uncompensated taking of utility property by the District of Columbia Circuit Court of Appeals in Democratic Central Committee v. Washington Metropolitan Area Transit Commission.⁹ The case held that ratepayers are entitled to the appreciation in value of transferred properties because they bear the burden of maintenance, loss through normal wear and tear, and capital losses, while shareholders are uniquely protected from loss on nondepreciable property.

One might argue that emission allowances are a utility's nondepreciable property because they retain their usefulness until used, either in their year of issuance or in some future year. One might also argue that the burdens and benefits associated with the allowances ought to be borne by the utility so that the allowances become the property of the utility, because the utility bears the risk of a loss in value. However, if allowances are given above-the-line rate-base treatment until used, ratepayers who then bear the burdens and risks are entitled to the benefits and rewards.

Using a traditional ratemaking approach, however, many of the initial (nonbonus) allowance allocations might be put into rate base at a zero value, their original cost. For those allowances, there is no risk of loss and only possible gains. Because the utility might be risk averse, it might tend to bank zero-cost allowances and use them internally, even if it otherwise would have made economic sense to overcomply and sell the allowances. If the utility overcomplied and sold the allowances, ratepayers would have been allowed to benefit from the gain from the sale of a nondepreciable asset. In either event the allowances are intangible nondepreciable assets initially given to the utility because the utility owns an affected source, an existing generating plant. Typically, ratepayers are considered the beneficial owners of nondepreciable property because they ultimately bear the full risks and burdens of any losses from the sale of the property.

Because the emission allowances are issued to the utilities as owners of affected sources,

⁹ Democratic Central Committee v. Washington Metropolitan Area Transit Commission (D.C. Cir., 1973), cert. denied, 415 U.S. 935 (1974).

an argument might be made that they should be treated the same as the affected source, that is, the generating unit that brought about their issuance. According to this argument, emission allowances should be treated not as nondepreciable property, but as an asset incidental to depreciable property. In such a case, one would expect state commissions to take the same approach on the sale of allowances as on the sale of depreciable plant. In the case of depreciable plant, state commissions tend to consider (1) who paid for the construction (including payments by means of a depreciation expense) and (2) the management prudence of making the sale. Then, the commission balances the benefits and burdens both to utility ratepayers and shareholders.

One typical example of a state commission treatment of gains on a depreciable asset can be found in Re Carolina Power & Light Co. decided by the North Carolina Utilities Commission.¹⁰ In that case, the Commission ruled that gains from the sale of an interest in a generating unit should be used to benefit ratepayers through a reduction in rate base. The Commission rationale was that the gain represents cost-free capital upon which the ratepayer should not be expected to pay a return. Because the sale was an extraordinary and significant event, the Commission allowed it to be amortized over a three-year period.

¹⁰ Re Carolina Power & Light, 55 PUR4th (NCUC 1983).

A similar approach was taken by the New Hampshire Public Utilities Commission in deciding whether and how ratepayers should benefit from the sale of investment tax and energy tax credits associated with a plant.¹¹ The Commission determined that ratepayers should benefit through a reduction in the company's rate base rather than through a recovery over an amortization period. The Commission's rationale was that the gain from the sale of the tax credits was a source of zero-cost capital for which no return should be allowed. Thus, a reduction in the company's rate base was appropriate because it was consistent with prior treatment of zero-cost capital, was not confiscatory, and would burden neither ratepayers nor shareholders.

Here is how this approach would apply to emission allowances. A state public utility commission would recognize the gain from the sale of an emission allowance. If that emission allowance was not one that had been acquired but was part of the initial allowance issuance by the EPA, the commission would use the gain on the sale of the allowance to reduce the utility's rate base. Because there would be no cost for the allowance, the gain from the sale of the allowance would be the sale price less any broker fees or transaction costs, if any.

This approach would seem sensible if the allowances were "freed up" for sale because of a capital expenditure on the part of the utility. The sale of excess allowances to offset the capital cost of a scrubber or other capital expenditure for pollution control abatement seems sensible. However, it might prove less sensible to decrease the rate base if the sale of allowances was made possible because the allowances were freed due to a compliance action that was not a capital expenditure in rate base (for example, if the allowances were freed because of the use of low-sulfur coal or cofiring with natural gas). A public utility would be hesitant to take any action to reduce its rate base, and, all things being equal, will tend not to sell allowances but to bank them. This would be the case especially when the source of the freed allowances is an expenditure. It might be more palatable to the utility if an expenditure "freeing up" allowances was offset by the revenue generated by the sale of the emissions market.

Unfortunately, no immediate case law guidance is available to show how to treat gains from the sale of plant that is not in rate base or that is being phased in, although logically any

¹¹ Re Public Service Co. of New Hampshire, 57 PUR4th 563 (1984).

below-the-line treatment or exclusion of a plant from rate base would result in below-the-line treatment for gains on the sale of the utility asset. If a plant is excluded from rate base, fully or partially, and no construction work in progress was collected from ratepayers during the plant's construction, then there would be no basis for contending that the ratepayers are beneficial owners of the plant or its associated assets; that is, the emission allowances associated with the plant. A knottier problem would be if a plant is partially (say as a result of a phase-in) or fully excluded from rate base because it is considered overcapacity and not "used and useful" even though the plant is on line and in service, generating electricity at a low variable cost so that it displaces in the dispatch order older, fully depreciated plants with emission allowances associated with them.

Who should benefit by any gain from the sale of freed emission allowances? Should it be the ratepayers who bore the burden of the older, fully depreciated coal plant that the freed allowances are associated with or should it be the shareholders who are bearing most, if not all, of the burdens and risks of financing the below-the-line asset that enables the allowances to be freed? The principle that benefits should follow burdens and rewards follow risks is tested by this example. On the one hand, the burden and risk of the affected plant fell on the ratepayers. On the other hand, the burden and risk of the more efficient plant that frees allowances is partially or wholly on the utility.

There are several different methods of handling the benefits, such as treating the purchase of power from a plant not fully in rate base as though it came from a third party. This method would result in ratepayers retaining the benefit of the allowances, because the gain from the sale of the allowances might be used to offset the price of purchased power. However, the utility is likely to contend that because the allowances were freed as a result of the power purchased from a plant not in rate base, the benefits belong to the company. Unless the utility can show that purchased power is typically traded for allowances on a one-to-one basis, it is unlikely that the utility will prevail. However, there remains a problem if allowances are freed up when there is no capital recovery in the purchased power rate. There is no simple way to untangle this Gordian knot, so the best course of action might be to split the benefits from the sale of the emission allowances.

A second method of allocated gains from the sale of depreciable property has been used by the Idaho Public Utilities Commission.¹² In a case involving the sale of coal-fired units, the Commission held that the gain from the sale should be allocated in proportion to the depreciation that has taken place on the plant. The theory is that the depreciation expense represents the extent to which ratepayers have assumed the burden by buying into the plant. Thus, when a plant is sold before it is fully depreciated, shareholders benefit proportionately to the extent that the plant *has not* been fully depreciated, and ratepayers benefit to the extent it *has* been depreciated. The Commission's rationale for using this method was that it was the only reasonable means of apportionment to make compensation of the rewards and benefits of gain commensurate with the risks and cost burdens of shareholders and ratepayers. The Commission also recognized that using this method would require it to ensure that assets are not prematurely sold by the utility to acquire gain on the sale while requiring new, more expensive assets to be built or bought. Of course, this method assumes that the plant was or is in the rate base.

Here is how this method would work for emission allowances. As an asset associated with a particular affected plant, the commission would examine the proportion to which the plant is depreciated to determine what part of the gain on the sale of emission allowances goes to the stockholder and what proportion goes to the ratepayers. One would expect that most of the gain would be issued to the ratepayers because of the utility's ownership in an older underlying asset--for example, an older coal-fired plant--is likely to be fully depreciated. In this case, the gain on the sale of the emission allowances associated with the fully depreciated plant would go entirely to ratepayers. Again, however, this treatment, absent any other action from the commission, might bias utilities into banking allowances that otherwise would have made better economic sense to sell.

We have shown that although the utilities are the legal owners of the emission allowances, ratepayers are, to some extent, the beneficial owners of the allowances. State commissions' regulatory treatment of the gain from the sale of the allowances that assigns all or part of the gain to ratepayers is consistent both with the theory of beneficial ownership and prior state commission

¹² See Utah Power & Light Co., Case No. U-1009-114, Order No. 16788 (Idaho PUC, September 30, 1981).

treatment of gains from the sale of utility assets. However, the typical regulatory treatments noted above could result in uneconomical banking (hoarding) of allowances as well as in a possible bias favoring capital-intensive investments to "go-it-alone" and free allowances rather than adopting compliance strategies that require a low capital investment or that can be expensed.