

CIVIL AERONAUTICS BOARD**14 CFR Part 389****Waiver of Filing-Fee Requirements****AGENCY:** Civil Aeronautics Board.**ACTION:** Waiver of Filing-Fee Requirements Under 14 CFR Part 389.

SUMMARY: Following requests on behalf of certain foreign carriers, the Director, Bureau of International Aviation, acting under delegated authority, has waived the requirements of Part 389 of the Board's Organization Regulations to the extent necessary to relieve the carriers of Switzerland (by letter dated 4/11/83), the People's Republic of China (by letter dated 4/14/83), Israel (by letter dated 4/15/83), El Salvador (by letter dated 5/11/83), Australia (by letter dated 5/18/83), and the Netherlands (by letter dated 5/20/83), from paying the filing fees set forth in § 389.15. Each action was effective immediately on the date of the letter and the filing of a petition for review will not alter its effectiveness.

FOR FURTHER INFORMATION CONTACT: Allen Brown, Regulatory Affairs Division, Bureau of International Aviation, Civil Aeronautics Board; (202) 673-5134.

Phyllis T. Kaylor,
Secretary.

[FR Doc. 83-14651 Filed 5-31-83; 8:45 am]

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DEPARTMENT OF COMMERCE**International Trade Administration****15 CFR Part 369****Restrictive Trade Practices or Boycotts; Interpretation****AGENCY:** International Trade Administration, Commerce.**ACTION:** Interpretation.

SUMMARY: The Department wishes to clarify the application of its antiboycott regulations (15 CFR Part 369) to situations in which companies located within the United States purchase or sell goods located outside the United States, when those goods never enter the U.S.

EFFECTIVE DATE: June 1, 1983.

FOR FURTHER INFORMATION CONTACT: Howard N. Fenton, Director, Compliance Policy Division, Office of Antiboycott Compliance, U.S. Department of Commerce (202/377-2381).

SUPPLEMENTARY INFORMATION: The antiboycott regulations apply to "activities in the interstate or foreign

commerce of the United States" as defined in § 309.1(d). This definition states, in relevant part,

... the activities of a United States person located in the United States are in the interstate or foreign commerce of the United States if they involve the sale, purchase, or transfer of goods or services (including information) between . . .

(i) Two or more of the several States (including the District of Columbia);

(ii) Any State (including the District of Columbia) and any territory or possession of the United States;

(iii) Two or more of the territories or possessions of the United States; or

(iv) A State (including the District of Columbia), territory or possession of the United States and any foreign country.

During the past five years the Office of Antiboycott Compliance has been asked its views on the application of this section to transactions involving the sale or purchase of goods by a person located within the United States and a foreign country, where the goods never physically enter a state or territory of the United States. The Office is taking this opportunity to make its informal position on this question available to the general public through this interpretation.

The principal author of this interpretation is Howard N. Fenton, Director, Compliance Policy Division, Office of Antiboycott Compliance.

List of Subjects in 15 CFR Part 369

Boycotts, Foreign trade, Reporting requirements, Restrictive trade practices, Trade practices.

Interpretation**PART 369—[AMENDED]**

The following appendix is added to Part 369 as Supplement 8.

Supplement 8

Appendix—Interpretation: Definition of Interstate of Foreign Commerce of the United States

When United States persons (as defined by the antiboycott regulations) located within the United States purchase or sell goods or services located outside the United States, they have engaged in an activity within the foreign commerce of the United States. Although the goods or services may never physically come within the geographic boundaries of the several states or territories of the United States, legal ownership or title is transferred from a foreign nation to the United States person who is located in the United States. In the case of a purchase, subsequent resale would also be within United States commerce.

It is the Department's view that the terms "sale" and "purchase" as used in the regulations are not limited to those circumstances where the goods or services are physically transferred to the person who

acquires title. The regulations define the activities that serve as the transactional basis for U.S. commerce as those involving the "sale, purchase, or transfer" of goods or services. In the Department's view, as used in the antiboycott regulations, "transfer" contemplates physical movement of the goods or services between the several states or territories and a foreign country, while "sale" and "purchase" relate to the movement of ownership or title.

This interpretation applies only to those circumstances in which the person located within the United States buys or sells goods or services for its own account. Where the United States person is engaged in the brokerage of foreign goods, i.e., bringing foreign buyers and sellers together and assisting in the transfer of the goods, the sale or purchase itself would not ordinarily be considered to be within U.S. commerce. The brokerage service, however, would be a service provided from the United States to the parties and thus an activity within the U.S. commerce and subject to the antiboycott laws. See Section 369.1(d)(13).

The Department cautions that United States persons who alter their normal pattern of dealing to eliminate the passage of ownership of the goods or services to or from the several states or territories of the United States in order to avoid the application of the antiboycott regulations would be in violation of § 369.4, the evasion section of the regulations.

William V. Skidmore,

Director, Office of Antiboycott Compliance.

[FR Doc. 83-14534 Filed 5-26-83; 2:53 pm]

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DEPARTMENT OF ENERGY**Federal Energy Regulatory Commission****18 CFR Parts 2 and 35**

[Docket No. RM81-38; Order No. 298]

Construction Work in Progress for Public Utilities; Inclusion of Costs in Rate Base**AGENCY:** Federal Energy Regulatory Commission, DOE.**ACTION:** Final rule.

SUMMARY: The Commission is establishing new regulations (18 CFR 35.26) to govern the inclusion of the costs of construction work in progress (CWIP) in the rate base of public utilities. The rule provides that any public utility engaged in the sale of electric power for resale may, subject to certain initial limitations, file to include in rate base up to 50 percent of CWIP associated with the investment in ongoing construction projects and nuclear fuel in process of refinement, conversion, enrichment, and fabrication.

The Commission retains its existing approach of allowing inclusion of all CWIP associated with pollution control and fuel conversion facilities. The Commission also amends the requirements of certain cost of service statements in § 35.13 in order to obtain information about construction programs pertinent to the utility's rate change filings. Under these filing requirements, requests for inclusion of CWIP in rate base shall include an assessment of the relative costs of adopting alternative strategies.

EFFECTIVE DATE: July 1, 1983.

FOR FURTHER INFORMATION CONTACT:

Ronald L. Rattey, Office of Regulatory Analysis, Federal Energy Regulatory Commission, 825 North Capitol Street, N.E., Washington, D.C. 20426, (202) 357-8154

Michael R. Postar, Office of the General Counsel, Federal Energy Regulatory Commission, 825 North Capitol Street, N.E., Washington, D.C. 20426, (202) 357-8033.

SUPPLEMENTARY INFORMATION:

Issued: May 16, 1983.

Introduction*

The Federal Energy Regulatory Commission (Commission) is amending its regulations that govern the inclusion of construction work in progress (CWIP) in the rate base of public utilities. The new rule replaces present CWIP policy, codified in 18 CFR 2.16, with a new § 35.26 which provides that any public utility engaged in the sale of electric power for resale may file to include in rate base up to 50 percent of CWIP, subject to a rate impact limitation in the first two years, and all CWIP associated with pollution control and fuel conversion facilities. The CWIP costs affected by the rule are those costs that are allocable to electric power sales for resale.

Under the new rule, utilities are eligible to file to include as CWIP in rate base the investment in construction projects and certain costs of nuclear fuel in process of refinement, conversion, enrichment, and fabrication. The rule allows filing for CWIP in rate base irrespective of the financial condition of the utility. The Commission also amends the requirements of certain cost of service statements in § 35.13 in order to obtain information about construction programs pertinent to the utility's rate change filings. Under these filing

requirements, requests for inclusion of CWIP in rate base will assist the Commission in evaluating the prudence of the claimed costs, including the element of the extent to which the investment is part of a least-cost power supply strategy.

I. Background

A regulated utility is entitled to an opportunity to recover its costs plus a reasonable return on investment. Among its costs is the cost of financing the construction of new facilities for the generation and transmission of electric power. This cost includes debt interest and a reasonable equity return on the capital investment used to finance construction. There are two mutually exclusive ratemaking methodologies by which these so-called "carrying charges" on construction capital are recovered in rates.

One method capitalizes the carrying charges incurred during the construction period as allowance for funds used during construction (AFUDC).¹ AFUDC is recorded in part as current income to the utility and in part as an offset to interest expenses, but no cash payments are made by ratepayers during construction. Payments from ratepayers to recover the carrying charges begin when the completed plant goes into operation. The cost of the completed plant at that time includes all carrying charges recorded during the construction period, as well as the direct costs of land, labor and construction materials.² The entire cost of the plant (including AFUDC) is added to rate base, and it earns a rate of return on investment and is depreciated over the life of that plant.

The second method for recovering carrying charges incurred during the construction period is to include CWIP in rate base. (CWIP includes accrued AFUDC on investment not in rate base.) The utility thereby recovers its carrying charges currently from ratepayers through the return component of its rates, rather than adding them to the cost of construction for recovery when the plant is in service. The return on CWIP is recorded as income on a current basis (like AFUDC), and actual cash payments are made by the ratepayers currently (unlike AFUDC).

¹ Commission Order Nos. 561 and 561-A govern the manner in which carrying charges are computed and added to the costs of plant under the AFUDC method (issued February 2, 1977 and August 1, 1977, respectively). 42 FR 9,161 (1977) and 42 FR 9,661 (1977), respectively.

² See Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act (Class A and Class B), Electric Plant Instructions, 18 CFR Part 101 (1980).

Each method is intended to assure the utility of an opportunity to recover from its ratepayers the carrying charges associated with construction investment. The two methods of recovery differ primarily according to when the investment is permitted in rate base, i.e., when the carrying charges are reflected in the cost of service and thus in rates charged to ratepayers. The courts generally defer to the administrative agency's choice of methods.³

This final rule responds to widespread concern over the need for adequate financing of the Nation's planned electricity generation capacity. With respect to both the nature of the problem and the appropriate regulatory response, the debate has been conducted over the last few years in the Congress,⁴ the state regulatory commissions,⁵ proceedings before the Commission,⁶ and among the commentators.⁷ Although the Commission regulates only a portion of electric power sales nationally, it has been actively engaged in a reexamination of ways in which it might ensure the future reliability of the electric power systems, avert the future imposition of unnecessarily high rates and encourage fuel-efficient generating capacity.

On March 6, 1981, the Commission convened an Informal Public Conference on the Financial Condition of the

³ *Goodman v. Public Service Commission*, 497 F.2d 661, 666 (D.C. Cir. 1974).

⁴ See, e.g., *Hearings on Financial Condition of Utilities and Their Future in the 1980's* before the Subcommittee on Energy Conservation and Power of the House Committee on Energy and Commerce, 97th Cong., 1st Session (April 6, 1981).

⁵ For example, a special committee of the National Association of Regulatory Utility Commissioners held a public hearing on the financial health of the electric utility industry in October of 1981.

⁶ EPC Order No. 555, *Order Adopting in Part Construction Work in Progress Rulemaking and Terminating Proceedings*, 41 Fed. Reg. 51,392 (1976), *reh. denied*, Order No. 555-A, 42 Fed. Reg. 3022 (1977), *aff'd sub nom. without opinion*, *Oglethorpe Electric Membership Corp. v. FERC*, 574 F.2d 63 (D.C. Cir. 1978) [rulemaking adopting existing § 2.16 allowing CWIP for pollution control and fuel conversion facilities and establishing criteria allowing consideration of CWIP in certain instances where utility is experiencing "severe financial difficulty"].

⁷ See, e.g., Electricity Consumers Resource Council, "Profiles in Electricity Issues: Should CWIP be Included in an Electric Utility's Rate Base?" (July 1981); U.S. General Accounting Office, "Construction Work in Progress Issue Needs Improved Regulatory Response for Utilities and Consumers," Report by the Comptroller General of the United States (EMD-80-75) (June 23, 1980). Copies of these documents, as well as 24 other articles, reports or expert testimony in state utility proceedings, were placed in the public record of this rulemaking in November of 1981, 46 FR 55,535 (November 10, 1981).

*The Appendix to the Preamble consisting of Table Nos. 1 through 5 is not being published in the Federal Register but is in copies of the order available in the Commission's Division of Public Information.

Electric Power Industry.* The conference was held in response to widespread concern among both federal and state regulatory bodies as to the deteriorating financial condition of the Nation's electric utilities. Sitting with members of a number of state regulatory commissions, this Commission heard voluminous testimony regarding the financial condition of the electric utility industry. Some of the comments at the conference evaluated the Commission's experience under the existing policy that permitted the inclusion of CWIP in rate base in only very limited cases. On the basis of that public conference, as well as on information available in reviewing the regular rate filings of jurisdictional utilities, the Commission commenced the present proceeding to revise the existing rules.

The Notice of Proposed Rulemaking (NPR) in this proceeding was issued on July 27, 1981.⁹ The NPR summarized relevant data on the financial condition of the electric utility industry and the need for utilities to acquire capital at reasonable costs. In addition, the NPR discussed possible effects that the inclusion of CWIP in rate base might have on the actual costs to utilities of obtaining capital. While much of the NPR was focused on a proposal to provide specific criteria a formula concerning the amount of CWIP that would be includable in rate base, the Commission stressed that it was actively considering several ways of treating construction-related costs in rates, as well as non-rate-related solutions to financing new plant construction. The Commission requested comment on all alternatives.

One of these alternatives specifically set forth in the NPR was to allow a fixed percentage of CWIP in rate base regardless of a utility's financial condition. As stated in the NPR:¹⁰

This alternative has the advantage of eliminating controversy over the appropriate standard for determining financial difficulty. However, it would require the Commission to depart significantly from its present policy by permitting CWIP in the rate base of utilities regardless of their financial health.

This is the proposal which the Commission adopts.

II. The Debate in a Nutshell

Two sharply divergent views of the electric utility industry emerged from the comments. According to privately-owned utility companies, the industry has been (and remains) in difficult financial straits which raise serious questions as to the industry's ability to finance today the construction of electrical generation capacity which will be needed later this decade and beyond. Under this view, utilities' inability to earn their allowed rate of return¹¹ reduces current cash flow, tending to increase the need for additional external financing. This tends in turn to increase risk and thereby to increase the actual cost of capital. These factors then tend to jeopardize the industry's ability to finance the major new facilities which the industry projects are needed to replace inefficient existing facilities and to satisfy increased consumer demands later this decade. These financial constraints are said to have caused the cancellation and deferral of substantial new capacity over the past few years. Financial concerns also have tended to bias the industry's investment in favor of smaller facilities which may require less construction capital (and thus are easier to finance) but which are more costly to consumers in the long run because of higher fuel and maintenance costs.

Thus the utility industry's comments, by and large, tend to view an increase in the inclusion of CWIP in rate base primarily as a partial answer to these financing difficulties. These comments deal extensively with the effect of CWIP in rate base on utility cash flow and the cost of capital. And they strongly recommend that we allow all utilities to include 100 percent of CWIP in rate base.

The utilities' wholesale power customers present a different view. While generally recognizing that the utility industry has faced financial difficulties over the last few years, these commenters contend that the situation has brightened considerably during the pendency of this proceeding as state regulatory commissions have increasingly recognized the need for higher rates.¹² Moreover, they claim that

¹¹ Many commenters refer to this inability as "earnings attrition." Academically more precise definitions or attrition might not include all reasons for earning shortfalls but only those stemming from increases in costs outpacing increased revenues.

¹² According to one recent estimate in a trade journal, some \$8 billion in rate increases were granted during 1981 and some \$6 billion in increases were anticipated in 1982. Foley, "Electric Utility

the extensive cancellations and deferrals of new capacity reflect a belated recognition of sharply reduced growth in electricity demand, not the utilities' inability to obtain adequate financing. The customers thus oppose the inclusion of CWIP in rate base as an unnecessary and unduly costly answer to yesterday's problem. They recommend strongly against inclusion of any CWIP in rate base.

We take an intermediate position. While the industry's financial picture has improved over the last year, difficulties remain. Moreover, as we have reviewed the comments, we have come to better appreciate the effects of the current regulatory approach to dealing with construction work in progress.

As detailed below, the present approach does add to financing difficulties and, therefore, tends to artificially reduce the supply of capital devoted to new capacity construction. But we agree with the customers that plant cancellations also (and perhaps even primarily) reflect recognition of reduced demand projections.

The present regulatory approach tends to separate the supply side of the question (including the incentives for increased capital investment) from the demand side (including the utilities' planning for new capacity to meet that demand). Put another way, due to the long lead times for planning and constructing new capacity, consumption trends reflect present costs rather than the higher costs of the new capacity which will be required to satisfy that demand as projected into the future. But at the higher prices resulting from additional capacity, demand will tend to be less. Accordingly, demand projections have consistently tended to overstate actual demand over the last decade.¹³

In an unregulated and freely competitive world, price movements would occur to ensure rough equilibrium in supply and demand in the aggregate. Utilities are regulated, of course, due to their historic position as natural monopolists. The regulator thus has the obligation to try to achieve through regulatory tools the rough supply/demand balance which translates into adequate and reliable electric service at the lowest reasonable cost.

The comments in this proceeding demonstrate that the present approach fails this test. According to utilities, the

Financing—Let's Ease Off The Panic Button," Pub. Util. Fortnightly (January 6, 1983) at 27.

¹³ See generally U. S. Department of Energy, Initial Comments.

* See Transcript of Informal Public Conference on the Financial Condition of the Electric Power Industry, Docket No. EL81-7-000 (March 6, 1981) (hereinafter cited as Public Conference).

⁹ Notice of Proposed Rulemaking, Construction Work in Progress for Public Utilities, Docket No. RM81-38, 46 FR 39,445 (August 3, 1981). In response to the NPR, the Commission received hundreds of initial and reply comments over a six-month period. As an additional means of exploring the issues and receiving comment from interested persons, the Commission, on December 7-8, 1981, heard oral presentations from some 25 representatives of various interest groups.

¹⁰ 46 FR 39,452.

present approach is inadequate because it tends to jeopardize adequate financing for needed facilities. This is to say that it fails the capital attraction test¹⁴ in that it fails to provide for supply of adequate capital. This is the thrust of much of the comment concerning adequacy of cash flow, low bond ratings, and the increased cost of capital. Customers, on the other hand, attribute current difficulties to reductions in demand forecasts. Yet these overstated demand projections are, to some degree, a natural consequence of a regulatory scheme which effectively conceals from consumers the high costs of new service until after those costs have already been incurred. Then, when customers have adjusted electricity consumption decisions to the higher prices, it begins to appear—too late—that too much supply has been made available.

In one sense, it is not possible for the utility and the customer commenters both to be right in their assessments: if supply is inadequate to meet demand, it is not possible at the same time for demand to greatly exceed supply.

But, in a more important sense, both sets of commenters are correct in that the status quo tends to send disparate price signals to suppliers of capital for electricity generation and consumers of that electricity. In this sense, the detailed debate in the comments as to CWIP's effect on cash flow, cost of capital, demand forecasting and related matters can be interpreted as part of this broader analysis.

Today's rule attempts to strike a balance between the competing views and takes a modest step at tying supply and demand together in a somewhat clearer fashion.

The purpose of the rule is thus threefold:

- To mitigate any bias which may discourage additional capital investment in needed facilities;
- To enable the need for those facilities to be more accurately evaluated by price signals which reflect today some of the costs associated with future facilities; and
- To mitigate the sudden price increases which tend to result under an AFUDC policy thereby furthering the goal of rate stability.

The remainder of this preamble expands upon these purposes and discusses the comments received in light of the analysis.

III. Basis for the Rule

Many of the issues coming before this Commission concern the balance between the interests of investors in the utilities that we regulate and the interests of those utilities' customers. The stakes in the issue of CWIP are different. The CWIP issue is for the most part not concerned with potential shifts in wealth between investors and consumers. If utility regulation functioned as it should—in particular, if electric utilities were able to earn returns equal to their cost of capital—the CWIP issue would not be concerned with such shifts at all. Even within the present context of imperfect utility regulation, the CWIP issue is principally concerned with time: for the company, a choice between cash receipts today and larger cash receipts in the future; for the company's customers, a choice between paying higher prices now and paying even higher ones tomorrow.

A. The Utility's Perspective: Tax Credits and Attrition

Debt interest and a reasonable equity return on the capital investment during construction are part of the cost of a utility plant. In one way or another, the utility must be given the opportunity to recover them. If investment in construction work is included in rate base, the utility recovers them through a current cash return just as it recovers the capital costs of facilities that are already providing service; if CWIP is not included in rate base, the carrying charges are capitalized as allowance for funds used during construction (AFUDC). AFUDC is recorded in part as current income to the utility and in part as an offset to interest expenses, but no cash payments are made by ratepayers during construction. Payments from ratepayers to cover the carrying charges begin when the completed plant goes into operation. Both the direct cost of the plant and the capitalized AFUDC are then added to rate base, earn a return, and are depreciated over the life of the plant. Because the investment is considered to include the capitalized AFUDC as well as the direct cost of the plant, the utilities' revenues and the customers' electric bills are higher than they would be if CWIP had been included in rate base.

If allowed returns were always set equal to the cost of capital and if the allowed returns were always expected to be earned, a utility would be indifferent as to whether CWIP was included in rate base. Its exclusion would mean delay in receiving a cash return on the utility's investment, but that delay would be compensated by a

return equal to the utility's cost of capital. Such a return would, by definition, fully compensate the utility for the delay and any associated incremental risk. To the extent that additional cash was needed, investors would willingly lend it on the strength of AFUDC's implicit promise of future cash revenues.

As explained below, utilities clearly are not in fact indifferent on the CWIP issue. If there had been any doubt on that score, the record in this rulemaking would remove it. Fifty-nine investor-owned utilities or utility groups submitted comments. Without exception, their comments favor the inclusion of CWIP in rate base. The same position was taken by the Edison Electric Institute and by the investment and accounting firms that assist the industry in raising the required capital.

These comments accurately portray the interests of the investor-owned utilities. Whatever might be the case in a different world, in this one, utilities would gain from the inclusion of CWIP in rate base. That gain has at least two sources. One is the interaction of CWIP policy with the federal income tax law. Under current Commission policy, the benefits of investment tax credits are shared between utility investors and ratepayers. The amount of the tax credit, and therefore the benefit to utility investors, is based only on the direct cost of plant; it does not include capitalized AFUDC.¹⁵ Exclusion of CWIP from rate base under the AFUDC alternative thus dilutes the investment tax credit benefit: that alternative increases the required investment, which must finance the carrying charges as well as the direct cost of the plant, but it does not increase the associated tax credit. Inclusion of CWIP in rate base eliminates this dilution, increasing the effective rate of return on new investment.¹⁶

The second source of gain to utilities from including CWIP in rate base derives from their current inability to earn a return equal to their cost of capital. Since about 1974, utilities have not realized returns at levels approximating their cost of capital.

¹⁵ To be more precise, it never includes the capitalized equity return portion of AFUDC. It may, however, include the interest portion of AFUDC if utilities choose to capitalize rather than expense this cost for tax purposes.

¹⁶ See *Environmental Assessment Related to Proposed FERC Rule Amendment Regarding Inclusion of CWIP in Rate Base* Section 4.2.2.1 (1983) (hereinafter cited as *Environmental Assessment*). (Empirical results presented indicate that over time, the earned return on common equity with CWIP in rate base would rise slightly above the earned return without CWIP in rate base.)

¹⁴ *Bluefield Waterworks and Improvement Company v. Public Service Commission*, 262 U.S. 679 (1923).

Assuming allowed rates of return on common equity approximate costs of common equity, by one estimate the authorized return on common equity to electric utilities averaged 13.2 percent for the period 1972 to 1980, while earned rates of return averaged 11.5 percent for the same period.¹⁷ Another indication of this disparity is utilities' market-to-book ratio which averaged 0.84 during the 1972-1980 period.¹⁸

A company's cost of capital constitutes by definition its indifference point; it is the level of return at which utility shareholders will neither gain nor lose from a new investment. By the same token, if a company earns less than its cost of capital, any additional investment constitutes a loss for its shareholders; they are poorer if the investment is made than if it is not.

Inclusion of CWIP in rate base reduces a utility's investment. Without CWIP, the company must invest not only in the direct cost of the facility but also in the carrying charges on that investment during the construction period. Inclusion of CWIP eliminates the latter investment and thus reduces the loss to the company's shareholders. So long as the company earns less than its cost of capital, the loss cannot be wholly avoided; under those conditions any investment at all, even one limited to the direct cost of the facility, leaves investors worse off than they would be if no investments were made. But the loss is smaller than it would be if CWIP were excluded from rate base.

There are other reasons why utilities may favor the inclusion of CWIP in rate base,¹⁹ but the two just discussed are sufficient to explain the position taken by investor-owned utilities in this proceeding. Inclusion of CWIP will leave the investors better off. It is, however, important to emphasize again the sources of their gain: a tax benefit, and

the reduction (but not elimination) of the loss resulting from investment in new facilities.

B. The Ratepayer's Perspective: Present and Future Electric Rates

For consumers as a group, inclusion of CWIP in rate base for any particular construction project or program raises current electric bills and lowers future ones. From this standpoint, the inclusion of CWIP has been analyzed as an investment: the return on the increase in current bills is the reduction in those paid in the future. If inclusion of CWIP resulted in no efficiency gains, the return would equal the utility's allowed rate of return; if, as we think likely, its inclusion resulted in the more efficient planning for the generation of electricity, the return would be higher.²⁰

To assess the wealth impact on consumers as a group of including CWIP in rate base (again relative to a specific

construction project or program), it is necessary to compare the return to consumers with an appropriate discount rate. The range of plausible discount rates for consumers is wide. At the lower end, it might be set equal to the return on investments broadly available to consumers of electricity, for example, the return on passbook savings accounts. At the upper end it might be set equal to the interest rate on consumer loans.

The allowed return for utilities averaged about 10 percent over the past decade.²¹ This return probably is higher than the return on investment broadly available to investors during the period, and probably also somewhat higher than the effective interest rate on mortgage loans, the most important category of consumer loans.²² The rate probably is, on the other hand, lower than the effective interest cost on other important categories of consumer loans during that period.²³

Thus, without assuming any efficiency savings, inclusion of CWIP in rate base appears to be economically equivalent to a reasonable investment. On more plausible assumptions concerning the anticipated efficiency benefits, inclusion of CWIP should be substantially more attractive. Yet the customer groups in this proceeding by and large have opposed the inclusion of CWIP in rate base. Those customers may, like anyone else, mistake their own best interests. It is, however, generally both presumptuous and foolish for a regulatory agency to assume that it knows parties' interests better than the parties themselves.

To understand the position taken by utility customers in this rulemaking, it is necessary to begin with the nature of this Commission's jurisdiction over the electric utility industry. Our jurisdiction is essentially a wholesale one. The Commission regulates sales of electricity for resale; regulation of sales to end users is left to the states.

¹⁷ Based on the average capital structure, embedded cost of debt and preferred stock, and allowed rates of return on common equity. That return may be lower in the future if reduced inflation brings lower capital costs, but lower inflation should also tend to reduce the nominal discount rate for consumers.

¹⁸ Mortgage interest costs are tax deductible while, for nonbusiness consumers, the lower future bills resulting from inclusion of CWIP constitute a tax-free return. For those consumers, the proper comparison is thus between the full allowed return to the utility and the after-tax cost of mortgages and other loans.

¹⁹ Bureau of the Census, U.S. Department of Commerce, *Statistical Abstract of the United States* at 541 (1980) (for example, the average interest rate on consumer credit cards for 1972-1980 was approximately 17.1 percent).

²⁰ In addition to promoting efficiency, it appears that including CWIP in rate base would also reduce utilities' financing costs. This can happen in several ways. First, it may reduce the risk borne by shareholders with respect to noncompletion or abandonment of plant. Under the Commission's policy on failed or abandoned projects, however, inclusion of CWIP should have relatively little effect on this risk. (See *New England Power Co.*, Opinion No. 49, 8 FERC ¶ 61,054 (July 19, 1979), *aff'd sub nom.* NEPCO Municipal Rate Comm. v. FERC, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 102 S. Ct. 2926 (1982)). Without CWIP, investors would bear a fraction of the direct cost of the failed project plus a fraction of any associated capitalized AFUDC; inclusion of CWIP would affect only the latter. Further, a reduction in this risk of failure may be achieved principally by shifting that risk from investors to ratepayers, and any resulting saving in capital costs is therefore a mixed blessing from the latter's standpoint.

Second, it may reduce the risk that a utility will default on interest payments or be unable to maintain dividends. This reduction in the risk of default does not appear to involve a shift in risk from investors to ratepayers, or at least it does not do so in any obvious way.

Third, by increasing cash flow, including CWIP in rate base may give utilities increased flexibility in their financing so as to make them better able to weather periods of high interest rates and minimize the stockholder losses arising from issuing common stock at prices below book value. Since inclusion of CWIP is likely to generate significant increases in cash flow (see Environmental Assessment, Section 4.2.2.1), this increased flexibility in financing may be an important source of savings in financial costs to utilities, even if there is no reduction in risk or in the marginal cost of capital.

A final source of cost reduction, though probably only of marginal value is the effect the CWIP policy may have on credit markets. Because the credit demands of the electric utility industry are large—one commenter (*Appalachian Power Co., et al.*) stated that the industry accounts for 25-40 percent of total public financing—and because CWIP in rate base will reduce the external financing needs of the industry, interest rates may fall generally.

The available empirical studies on the cost of capital reduction are not entirely conclusive on this point, because in practice it is not easy empirically to distinguish between (1) the effect of AFUDC and (2) the effect of the construction program itself. See also discussion *infra*.

¹⁷ *Appalachian Power Co., et al.*, Initial Comments at Figure 4 (the gap between authorized and earned rates of return averaged 1.7 percent for this period). During 1982 this trend appears to have continued. The gap between the earned rate of return on common equity and the allowed return on equity may have widened to 2.0 percentage points (15.8 percent allowed vs. 13.8 percent earned). See Argus Research Corp., *Returned and Amounts Authorized* (January-December 1982) (January 11, 1983).

¹⁸ *Appalachian Power Co., et al.*, Initial Comments, Figure 4. In 1982, the market-to-book ratio of electric utilities averaged 0.8, continuing the trend of a ratio of less than 1.0 over the last decade. See Argus Research Corp., *supra*. In recent months, with the surge in the stock market, the market-to-book ratios for electric utilities have improved.

¹⁹ As discussed below, inclusion of CWIP also improves cash flow and reduces the price increase when a new plant comes on line. Both the improved cash flow and the smoother price path are likely to assist utilities in assessing the demand for electricity, and this is likely to benefit utility investors as well as ratepayers.

The electric utility industry is for the most part vertically integrated. Electricity usually is generated, transmitted, and distributed by a single company. The first sale thus is to the end user, and since that is not a sale for resale, it does not fall within this Commission's jurisdiction.

The transactions involving electricity that this Commission does regulate are generally of two kinds, typically with two quite different kinds of purchasers. One kind of transaction consists of so-called coordination sales. These sales take advantage of temporary differences in cost or supply among electric utilities. Measured by the amount of energy involved, such sales constitute approximately two-thirds of electricity sold or exchanged that is under our jurisdiction. Any change in our CWIP policy would have little or no impact on the selling prices of coordination transactions.²⁴

The second kind of transaction consists of purchases by electric utilities that regularly depend on other utilities for part or all of the electricity that they distribute to their customers. Such sales are usually referred to as requirements sales. Buyers in these partial or full requirements sales are generally cooperatives or municipal utilities that either lack generating facilities or whose generating facilities are inadequate to meet all of their customers' needs. Requirements sales constitute less than eight percent of all revenues received from sales of electricity by privately-owned electric utilities in this country.²⁵ A change in our CWIP policy would affect the time pattern of revenues collected from requirements customers.

Opposition to the inclusion of CWIP in rate base is as uniform among the cooperatives and municipal utilities participating in this rulemaking as is support for its inclusion among the investor-owned utilities. The

cooperatives and municipals advance a number of arguments, but in our view the most telling one is that they will in some cases not enjoy the lower future rates that would result from the inclusion of CWIP today.²⁶ Although these cooperatives and municipals are not now self-sufficient, in many cases they plan to construct generating facilities that will reduce or eliminate purchases from other utilities. A policy of including CWIP in rate base thus confronts them with the prospect of paying for generating capacity twice: once from the inclusion of CWIP in their rates, and again through the cost of their own generating facilities.

This concern over not being able to receive the benefits of current payments is entirely understandable. It is, moreover, supported by the Commission's general policy favoring rates based on cost responsibility. As we said in the tax normalization rulemaking, "all costs should be allocated among customers and over time in a manner that matches the burdens of costs with the benefits received."²⁷ With respect to plant under construction, that policy militates in favor of placing the burden of carrying charges on the customers that the plant later serves.

The particular concerns of the cooperatives and municipals are peculiar to parties that generate or may generate electricity themselves. However, an analogous concern has been expressed with respect to the consumers that ultimately use the electricity, and that ultimately are the principal recipients of the benefits and burdens of any policy that we adopt here. This concern is that the lower future rates resulting from inclusion of CWIP in rate base will be so long delayed that many present consumers will never receive them.

In order to illustrate the basic principles, the above analysis has focused primarily on the rate effect of CWIP associated with a particular construction project or program. To assess the likely rate impact of a general policy of including 50 percent of CWIP in rate base, one must estimate the size of likely future construction programs. If new construction continues to increase at a sufficient rate over the period studied, then CWIP-based rates may remain higher than AFUDC-based rates

for a relatively long time as the lower rates resulting from a particular plant being completed are offset by the cost impact of continuing new construction on other facilities. If new construction slows sufficiently, however, CWIP-based rates will fall below AFUDC-based rates at some point in the future.

The comments do not contain studies which project CWIP-based rates over time. At our request, the Energy Information Administration (EIA) has conducted such a study (which forms part of the Environmental Assessment). As discussed in more detail in Section IV below, under plausible assumptions as to future nationwide construction programs, in some regions the CWIP-based rate would fall below the AFUDC-based rate as early as 1990. However, the national average rates would remain minimally higher than AFUDC-based rates (between one-half and one percent) over the next 12 years. We think that it is unlikely that CWIP-based rates would remain indefinitely above AFUDC-based ones.²⁸

²⁴ This judgment rests on three grounds. First, for methodological reasons the EIA study assumed that inclusion of CWIP would not reduce utilities' cost of capital or result in efficiency savings. As discussed elsewhere, we believe that inclusion of CWIP probably will do both, and if it does, the point at which CWIP-based rates are lower than AFUDC-based rates is brought closer to the present.

Second, even without any such cost savings over the long-term, CWIP-based rates apparently would remain above AFUDC-based rates only if the annual rate of growth in utility construction expenditures exceeded a utility's allowed rate of return. See Livingstone and Sherali, *Construction Work in Progress in the Public Utility Rate Base: The Effect of Multiple Projects and Growth*, 8 Fin. Mgmt. 1, 42 (1979), attached as App. A of Initial Comments of Oglethorpe Power Corp., et al. The authors of the cited article thought it likely that in fact the growth and expenditures would exceed utility's cost of capital. However, that view appears to have been based on their assumption that demand for electricity would grow at the rate of six percent annually. More realistic current estimates are in the neighborhood of three percent. If this lower estimates of growth is used and utility expenditures are assumed to increase at the same rate as demand for electricity, AFUDC-based rates will eventually be higher than CWIP-based rates provided that the utilities are allowed a real rate of return in excess of three percent.

Finally, CWIP-based rates that were permanently higher than AFUDC ones would imply that CWIP had in fact increased utilities' cost of capital. Since inclusion of CWIP does not increase utility costs, higher rates necessarily mean higher cash returns to shareholders. If CWIP-based rates later fall below AFUDC-based ones, those higher current cash returns are offset by lower future returns, but if CWIP-based rates were to remain permanently higher than AFUDC-based rates, there would be no later offset. But such permanently higher returns could be sustained only if: (1) inclusion of CWIP was perceived as increasing risk to utility investors, or (2) investment markets are incapable of anticipating the obvious interaction of inclusion of CWIP and utility growth. Neither of these hypotheses appears to us to be very plausible.

²⁵ Coordination sales may include a demand or reservation charge. Typically, that charge is keyed to the capital costs of one or more generating units operating on the seller's system. If CWIP is allowed in the rate base, the demand charge when the units are operating may be lower because it will not include a capitalized AFUDC component. Inclusion of CWIP will have no impact on the many other coordination sales that do not include a demand charge in the selling price.

²⁶ Energy Information Administration, *Statistics of Privately Owned Electric Utilities in the United States 1977*, at 37, 1301-02 (1979). Eight percent represents requirements sales revenues divided by the sum of revenues from sales for resale and revenues from sales to ultimate consumers for the year 1977 which is the latest year for which requirements sales data was completed. The denominator, however, excludes a substantial portion of resale revenues from coordination sales. If these excluded revenues were added to the denominator, the resulting requirements sales percentage would be less than eight percent.

²⁷ See, e.g., American Public Power Association, et al., Initial Comments at 39.

²⁸ Final Rule, Regulations Implementing Tax Normalization for Certain Items Reflecting Timing Differences in the Recognition of Expenses or Revenues for Ratemaking and Income Tax Purposes, Order No. 144, issued May 6, 1981, 46 FR 28,617-18 (May 14, 1981) (Emphasis added).

The point at which CWIP-based rates are lower could be long delayed, however, and on the present record it is not possible to exclude the theoretical possibility that the delay could continue indefinitely.

C. Striking a Balance

The cost responsibility principle is not controlling on all issues, however. Perhaps the most significant departure from that principle in the Commission's existing regulation is the use of an original cost rate base methodology, which places a disproportionate share of the burden of a facility on consumption in the early years of its useful life.²⁹ Commentators have argued for the abandonment of original cost in favor of replacement cost or trended original cost,³⁰ but original cost offers substantial advantages that have so far been deemed by this Commission and by most other regulatory agencies to offset its shortcomings.³¹

Similarly, we have concluded in this rulemaking that the public interest is on balance best served by a departure from the cost responsibility principle with respect to CWIP.³² We reach this conclusion because we believe including CWIP will advance three public interest objectives:

- (1) Mitigation of any bias against the construction of new generating facilities;
- (2) Providing for electric rates to more accurately reflect the costs of providing future service, allowing the need for new capacity to be tested, so far as possible, by the marketplace; and
- (3) Furthering the goal of rate stability by providing for smoother increases in electric rates to consumers.

We believe that under present conditions, these objectives are furthered by inclusion of substantial

amounts of CWIP in rate base. Arguably, they justify the inclusion of all CWIP, but we are not prepared to go that far at this time. In the rule adopted here, we generally permit utilities to include 50 percent of CWIP.³³

Experience or changed conditions may dictate that this rule should be modified in the future, either to reduce or to increase the amount of CWIP allowed. For the present and for the foreseeable future, however, we believe that the 50 percent level constitutes a reasonable balance between the principle of intertemporal cost responsibility and the need to create a regulatory setting within which the utility industry can supply the nation's need for electricity at the lowest reasonable cost. For the jurisdictional portion of individual companies, the rule adopted here should generally produce sufficient current cash income to cover the fixed interest and preferred dividend costs and a small part to the cost of common equity for the investment in the work under construction but will defer any cash return on the greater part of the equity investment until the plant begins to provide service.³⁴ At the industry level, the rule will restore the ratio of construction work outside the rate base to the total rate base to the level prevailing in the early 1970's; the ratio will still be, however, significantly higher than it was in the 1950's and 1960's.³⁵ The likely rate impacts

resulting from the rule are detailed below.

D. CWIP and the Problem of Financial Constraints

The history of the electric utility industry since the middle of the 1970's has been punctuated by frequent cancellations of planned generating capacity. Between 1974 and 1978, 184 generating units that would have provided 155,000 MW of capacity were cancelled. More than half of all powerplants coming into operation since 1974 have been delayed. The delay has increased from an average of 14 months in 1974 to an average of 23 months in 1978 to an average of more than 40 months in 1979.³⁶

Some have viewed these cancellations and deferrals as merely an adjustment to more realistic projections of future demand.³⁷ But this view is by no means universally shared. Several commentators argue that the resumption of growth in the demand for electricity even at a rate substantially lower than the one prevailing up to around 1973 would begin to strain available capacity by the end of the decade;³⁸ and even if new plants are not needed for added capacity, on some calculations they are still economically justified as replacements for costly oil-fired and gas-fired generating capacity.³⁹ On this

we prefer at this time not to rely wholly on other means of ensuring the expeditious completion of construction work.

²⁹ Appalachian Power Co., et al., Initial Comments at 27. See also North American Electric Reliability Council, 11th Annual Review of Overall Reliability and Adequacy of the North American Bulk Power Systems 14 (1981) (Between 1978 and 1981, at least 52 generating units—55,000 MW of capacity—were cancelled or indefinitely deferred); Electrical World, *Utility Capital Spending Rises in 1981*, August 1981, at 14 (In the first quarter of 1982, seven generating units or 8,700 MW of capacity were cancelled or deferred).

³⁰ Lovins, *Energy Strategy: The Road Not Taken*, 35 Foreign Affairs (1976) at 65-96.

³¹ See e.g., U.S. Department of Energy, Initial Comments at 16. This warning has also been sounded in much of the literature. See, e.g., 3 Energy Information Administration, U.S. Department of Energy, 1981 Annual Report to Congress 48-50 (1982); Energy Information Administration, U.S. Department of Energy, *Impacts of Financial Constraints on the Electric Utility Industry* (1981) (hereinafter cited as *Impacts*); Putnam Hayes and Bartlett, Inc., *An Economic Evaluation of the Replacement of Oil-Fired Generation Capacity With Coal-Fired Capacity*; Electrical World, 33rd Annual Electrical Industry Forecast, September 1982, at 75-86; Navarro, *Our Stake in the Electric Utility Industry*, Harv. Bus. Rev., May-June 1982, at 85. But see A. Kaufman, K. Nelson, *Do We Really Need All Those Electric Plants*, Cong. Research Service (August 1981).

³² See Appalachian Power Co., et al., Initial Comments at 30; Department of Energy, Initial Comments at 12. The argument for new capacity is not in fact entirely distinct from the preceding one. If additional capacity is needed, it may be possible

³³ This description must be qualified. The rule allows inclusion of up to 50 percent of CWIP allocable to electric power sales for resale. The 50 percent CWIP allowance would be computed after inclusion of 100 percent of the CWIP related to pollution control and fuel conversion facilities. In recent years, pollution control CWIP has averaged about 11 percent of total CWIP. No data are available on fuel conversion CWIP.

³⁴ See Environmental Assessment, *supra*, at Section 4.3.4. (A policy allowing recovery of only the CWIP-related interest expenses and preferred dividends would, on a national basis, increase rates by slightly less than a 50 percent CWIP policy.)

³⁵ In 1979 and 1980, CWIP constituted about 40 percent of net plant in service for Class A and B electric utilities. Allowing 50 percent CWIP in rate base would bring the ratio of CWIP to net plant down to about 20 percent which was the average level prevailing between 1970 and 1974. During 1950-1969 CWIP averaged only about eight percent of net plant in service; by the end of the second decade in this period, the CWIP percentage began to rise dramatically. A similar aggregate industry impact would be produced by including all CWIP in rate base above some threshold level. That alternative would also focus the impact of the rule more sharply on utilities with large amounts of construction work in progress in relation to their rate base. We have nevertheless rejected that alternative for two reasons. One is that it would be somewhat more complex to administer. The second is that it would mean that utilities with relatively large construction programs would be able to include 100 percent of any incremental investment in rate base. While we are not entirely convinced that it is necessary to leave a part of the cash return on equity dependent on completion of the project,

²⁹ The dollar value of return and associated taxes received on new plant in rate base is much higher in earlier years than in later years because of the use of straight line depreciation for ratemaking purposes. Other common departures from the principle include rate treatment for inventories, plant held for future use, prepayment of rent, etc., where such expenses are placed in rate base at the time they are incurred.

³⁰ See, e.g., Anderson & Mead, *A Comparison of Original Cost and Trended Original Cost: Ratemaking Methods*, Energy Journal (forthcoming); Navarro, Peterson, Stauffer, *A Critical Comparison of Utility-type Ratemaking Methodologies in Oil Pipeline Regulation*, 12 Bell Journal of Economics 392-412 (1981); Streiter, *Trending the Rate Base*, Pub. Util. Fort., May 13, 1982, at 32-37; Swanson, *The Critical Problem of Inflation in Utility Rate Making*, Pub. Util. Fort., Jan 7, 1982, at 29-31; Address by Alfred E. Kahn, Edison Electric Institute, in Phoenix, Ariz. (Jan. 14, 1982).

³¹ The two principal advantages of the original cost method are its simplicity in implementation and its positive effect on utilities' present-day cash flow.

³² See also *infra* at § IV.C.1.b.

latter view, the cancellations do not reflect the limited need for the new plants but the utilities' limited ability to finance them.

Projections of demand growth for electricity have been characterized by uncertainty, inaccuracy and controversy for over a decade. In this rulemaking we express no views on the future growth of the demand for electricity, or on the question whether new generating facilities may be economically justified even in the absence of demand growth. Now do we assume that such growth as may occur is best served by capital intensive coal or nuclear plants. It is not our object to influence electric utilities either to add new capacity or to select one technology over another. Rather, our purpose is to create a regulatory framework within which utilities can make an unbiased assessment of the need for new capacity and of the best means of meeting that need.

At present, economic regulation biases utility decisions in two respects: It creates a bias against the creation of new capacity; and to the extent that new capacity is built, it creates a bias in favor of minimizing capital costs, rather than minimizing total economic costs. Possibly the bias will not affect utilities' decisions; utilities may assess the need for capacity and the most economic means of providing that capacity without regard to the effect of their decisions on investors. If the bias does affect decisions, the result may nevertheless be one that serves the public interest; even a broken clock tells the correct time twice a day. However, we do not consider it sound regulatory policy to rely either on the eleemosynary inclinations of regulated companies or on the chance coincidence of regulatory bias and the public interest. It may be impossible to rely wholly on economic incentives to encourage efficient decisions by the companies that we regulate, but we can at least try to avoid creating incentives for them to make inefficient ones.

The regulatory bias has two sources. One is utilities' inability to earn a return equal to their cost of capital. When a utility's earned return is less than its cost of capital, its investors' interest are best served by avoiding investment in new capacity; to the extent that new capacity is built, they are best served by minimizing the investment made to provide that capacity. As discussed

to provide it within a relatively short time with gas-fired turbines. The result of the shortage of base-load capacity then would not be a shortage of electricity but rather unnecessarily costly electricity. See also Navarro, *Long Term Consumer Impacts of Electricity Rate Regulatory Policies* (January 1983) DOE/PE/701066-1.

earlier, inclusion of CWIP in rate base would reduce this source of bias but not eliminate it. In the end, the remedy for inadequate returns is adequate ones. This Commission has issued a notice of proposed rulemaking on generic rate of return, partly for the purpose of more accurately determining the cost of capital of the utilities that we regulate,⁴⁰ and we are continuing to study the relationship between the return that we allow and the one actually earned under the rates that we establish. The problem of inadequate earned returns also is being addressed by the state agencies that regulate the greater part of the electric utility industry.⁴¹ The result of these initiatives remains to be seen; the most recent studies available to this Commission continue to show earned returns well below utilities' cost of capital.⁴² Until this Commission and the state utility commissions succeed in closing this gap, the inclusion of CWIP can make a modest contribution towards offsetting this source of bias against new investment.

Inclusion of CWIP is more directly responsive to the second source of bias. This source is the cash flow problem created by the high cost of new base load plants in relation to the present rate base of some utilities. Since such companies generally earn a cash return only on rate base investments, it has often been difficult to finance these construction programs, particularly when the magnitude of CWIP is large in relation to rate base. As mentioned in the NOPR,⁴³ CWIP as a percentage of net electric plant in service grew from 17 percent in 1970 to 40 percent in 1979. For many companies, of course, the percentage is much larger. The financing difficulties arise because the internal cash flow generated by rate base investments is often insufficient to

support the required sales of debt and equity securities.⁴⁴

There are two ways of addressing the problem of cash flow inadequacy. One way is simply to increase the allowed rate of return to produce higher earnings and cash flow. The other way is to allow a cash return on construction investments by including CWIP in rate base. While both approaches have the immediate effect of raising rates, the allowance of CWIP in rate base causes the future rate base, and thus future rates to customers, to be lower than they otherwise would be. On the other hand, raising allowed returns would not be matched by future reductions in rate base and rates. For this reason the Commission has recognized that where increased cash flow is desirable, the allowance of CWIP in rate base "would be the least costly alternative to ensure a utility's financial integrity and to enable it to attract the capital necessary to meet its capital needs."⁴⁵

E. Inclusion of CWIP and the Assessment of the Need for New Facilities

Even an unbiased assessment of the need for new capacity must be based on some estimate of the future demand for electricity. Once such estimates were comparatively easy. Demand increased steadily with (but faster than) the growth of the economy, generally absorbing without difficulty the new capacity built by electric utilities.

The estimation of future demand has now become a much more difficult task. There are several causes for the increased difficulty. After the last decade it can no longer be safely assumed that demand will grow faster than the economy, but neither is it yet clear that we can assume that it will not do so. At the same time, the increased length of time between the beginning and the completion of new generating facilities requires that demand be projected further into the future.

Neither of the two causes just cited lies within this Commission's regulatory reach. There is, however, also a third cause for the increased difficulty in estimating future demand. This is the difference between the price of electricity at the time that demand estimates are made and the price at which electricity must be sold when the planned facility comes on line. Estimates of the future must begin with the present. To the extent that the future

⁴⁰ Notice of Proposed Rulemaking, Generic Determination of Rate of Return on Common Equity for Electric Utilities, (Docket No. RM80-36), issued August 26, 1982, 47 FR 38,332 (August 31, 1982).

⁴¹ Forecasted test years are generally being used more widely at the state level. Since 1960 approximately nine state commissions joined the 14 which were already using some variant of forecasted test years.

⁴² See Argus Research Corp., *supra* at n.17. But see Salomon Brothers Inc., *Electric Utility Regulation-Semiannual Review, Industry Analysis* 1, 3 (February 11, 1983) (Over the last year the gap appears to have narrowed due to increases in allowed rates of return on common equity and rapidly declining interest rates. However, this may be due to a regulatory lag in responding to declining capital costs.)

⁴³ Notice of Proposed Rulemaking, Construction Work in Progress for Public Utilities, (Docket No. RM81-38), issued July 27, 1981, 46 FR 39,445 (August 3, 1981).

⁴⁴ See Appalachian Power Co., et al., Initial Comments, at Appendix H (October 30, 1981); Appalachian Power, et al., Reply Comments, at Appendix C (January 15, 1982).

⁴⁵ 46 FR 39,445.

can be expected to bring not only general economic changes but also substantial increases in the price of electricity, the leap from current data to future projections becomes so much the more difficult.

There was a time when the price of electricity could be expected to decline as new generating facilities were brought on line. Economies of scale and technological progress easily outdistanced the modest rate of inflation. Today the addition of a new facility is more likely to mean higher prices than lower ones. For companies with large construction programs, this price impact is seriously aggravated by the exclusion of CWIP from rate base.

Without any CWIP in rate base, a new plant has no direct effect on consumer prices until it begins to provide service.⁴⁶ Then, when it does come on line, consumer's rates must be increased to give the company a cash return on both the direct cost of the plant and the capitalized AFUDC as well as a return of capital through depreciation. If the plant is large relative to the existing rate base, the result can be a rate increase that is both large and sudden, producing a so-called "rate shock."⁴⁷

In contrast, with all CWIP in rate base, the impact of a new plant is spread over the entire construction period, and the rates when the plant begins to provide service are lower because they do not include a return on and of capitalized AFUDC. The price increase is less smooth with the 50 percent policy adopted here, but the price path is still substantially smoother than it would be without any CWIP in rate base. We believe that this smoother and more gradual increase is likely to assist utilities in assessing the need for new capacity. To the extent that unnecessary capacity is thereby avoided, the inclusion of CWIP in rate base will not merely shift the burden on

consumers from the future to the present. It will also effect a clear reduction in that burden. Thus inclusion of CWIP will generally allow utilities to pursue least total cost strategies to meeting their customers' electric power demands.

F. The Inclusion of CWIP and Economic Regulation

The inclusion of substantial amounts of CWIP in rate base will not by itself solve the problems of the electric utility industry. We believe that it will, however, contribute to the goal of meeting the future need for electricity at the lowest possible cost. It perhaps would not be the means that we would choose for this purpose if we had an unlimited choice. However, the alternatives available to us are limited by the nature of public utility regulation.

Public utility regulation in the form that we know it is virtually unique to this country. The industries that are regulated public utilities in this country are elsewhere generally owned by the government. Public utility regulation is a compromise between nationalization on one hand and unregulated free enterprise on the other.

It is a compromise that on the whole has served this nation well. In price and quality of service, the performance of the public utilities of this nation compares well with that of comparable industries elsewhere in the world. However, the kind of cost-based regulation generally used for utility regulation closes off some solutions to financing large capital additions. In an unregulated market, the approach of capital constraints would allow companies to earn temporary excess profits. On the supply side, these profits would help to finance new additions; on the demand side, the associated high prices would help to test the need for additional capacity and to ration supply until new capacity was brought on line. On the other hand, if electricity was generated by government corporations, future new capacity could be financed by current tax revenues to the extent that it was not financed by current sales.⁴⁸

⁴⁸ Alternatively, a nationalized corporation may issue bonds to finance the need. Since the corporation is part of the state, it is able to borrow funds at lower rates than would be available to a private borrower. This subsidy tends to be financed through higher interest rates paid by non-government borrowers. In addition, the interest cost of the bonds would in general be paid out of current tax revenues; as with the CWIP alternative, therefore, the carrying charges on the construction work would be borne by present taxpayers or ratepayers.

Indeed, one representative of a number of municipally-owned systems which participated in the proceeding stated during the public hearing that it is "clear that in some instances municipals may in fact have a de facto CWIP" in rate base policy.⁴⁹

These other alternatives are not available to us. Although we are not strictly limited to cost in the rates that we set,⁵⁰ there are limitations on the extent to which we can cut ourselves free from cost-based standards, and we altogether lack the power to tax. These limitations were of no consequence so long as utilities could readily finance new capacity strictly on the promise of future cash revenues, but their ability to do so is now in doubt.

In this rulemaking we therefore have turned to the regulatory tools at our disposal, and in doing so we have concluded that the long-run public interest is best served by a departure from the general principle of cost responsibility. The departure is not total. We are allowing only 50 percent of CWIP to be included in rate base. The remaining amounts of CWIP will continue to receive AFUDC treatment and will not be directly reflected in rates until the plant begins to provide service. More importantly, present customers do derive significant benefits for capital expenditures for plants that are not yet providing service.

Utilities invest in additional facilities when customer needs indicate. By planning and constructing new facilities to meet customer requirements, utilities confer a present benefit on customers, namely, the reasonable assurance of a continuing quality of service. It is reasonable for current ratepayers to pay for this benefit.

⁴⁶ See Statement of Mr. McHugh, representing Electricities of North Carolina, et al., transcript of December 7-8, 1981 public hearing at 420. See also Statement of Mr. Ritts on behalf of APPA, transcript at 336 ("I must be frank with you that there are some of our systems that may currently charge customers for part of the cost of the plant"). See also Appalachian Power Co., et al., Reply Comments at 65-71.

⁴⁹ See, e.g., *Panhandle Eastern Pipe Line Co. v. FPC*, 324 U.S. 635 (1945) (in setting pipeline's jurisdictional rates, the Commission may properly take into consideration unregulated rates for direct industrial sales); *City of Detroit v. FPC*, 230 F.2d 810, 814 (D.C. Cir. 1955), cert. denied, 352 U.S. 829 (1956) (use of unregulated filed price is not necessarily excluded for purposes of setting rates for pipelines' own production, nor is rate base method mandatory in all circumstance); *Pennsylvania Basin Area Rate Cases*, 390 U.S. 747, 795 (1968) (FPC obligated to give continuing attention to values that may be reflected only imperfectly by costs); and *Texaco v. FPC*, 417 U.S. 380, 399 (1974) (Commission may take into account the market price of unregulated gas in determining the just and reasonable rate for regulated gas supplies).

⁴⁷ It will have an indirect effect if exclusion of CWIP from rate base increases a company's cost of capital.

⁴⁸ See, e.g., *Middle South Utilities, Inc.*, Initial Comments, at 5 (illustrates comparative time patterns of rates under a CWIP and an AFUDC policy). For example, for Long Island Lighting Company, the result of including the Shoreman plant in rate base when it is placed in service in the fall of 1983 would be to increase retail rates by approximately 38 percent. See *Electrical Utility Week*, January 31, 1983. A similar "rate shock" is predicted for Iowa-Illinois Gas & Electric Company (anticipated 29.7 percent increase due to bringing new coal-fired plant on line). Both these companies have filed proposals with applicable state agencies to phase-in the rate base additions over a period of several years after the plants go into service rather than include all the costs in rate base on the in-service date. Other utilities, including Public Service of Indiana and New Orleans Public Service Company are reported to be considering similar steps. *Id.*

The direct beneficiaries of construction expenditures are, however, the customers that will be served by the plant. The departure from the general principle of cost responsibility will not place the full burden of construction costs on these customers and might be analogized to the one that occurs even in a competitive unregulated market when price temporarily exceeds marginal cost during a period of limited capacity, but the closer analogue may be the use of current tax revenues to finance public works that will serve the future. We have cited the case of government-owned electric utilities but the analogy extends to virtually all public investment.

The needs of the future must be met.³¹ Those needs can to some extent be financed by the persons who will directly benefit, but such a nice alignment of benefit and burden is not always possible. We have concluded that it is not possible on the CWIP issue. Or, to state the point more precisely, we have concluded that a rigid adherence to the cost responsibility principle on this issue would not be consistent with our responsibility to further the maintenance of an adequate and efficient electric utility industry.

IV. Comment Analysis

A. Introduction

Due to the financial importance of the Commission's proposals in this docket, the Commission determined to provide for a thorough airing of opinions and an adequate opportunity for interested persons to submit comments. For nearly six months, ending January 15, 1982, the Commission received written initial and reply comments. Two days of oral presentations were also held. As a result of this process, the record in this proceeding contains, among other things, the comments of 33 Federal and state government representatives, 11 firms serving the accounting and financial needs of the electric utility industry, 57 investor-owned utilities or groups, 2 natural gas utilities or industry representatives,³² 51 wholesale

customers or groups of customers of jurisdictional utilities, 57 consumer representatives and consultants, and several hundred individuals (mainly in the form of postcard comments). At the hearings, 25 representatives of a variety of interests presented their views on the treatment of CWIP, responded to questions from Commissioners and staff, and debated many of the central issues in this proceeding. This rulemaking also attracted several letters and suggestions from Members of Congress.

Generally speaking, investor-owned utilities and the financial community support a policy of including a significant portion or all CWIP in rate base. The wholesale customers of investor-owned utilities, primarily municipal and cooperative-owned utilities, retail consumer organizations, large industrial customers, and individual retail consumers and small businesses oppose the inclusion of any CWIP in rate base and favor the use of AFUDC for financing costs. The comments of Federal departments and agencies, state and local regulatory authorities, and consultants were divided on the question of CWIP in rate base.³³

B. The Financial Condition of the Electric Utility Industry

1. *Source of the Problem.* In issuing the Notice of the Proposed Rulemaking, the Commission viewed the financial condition of the industry as an important reason for considering an

the basis of the length of construction periods and the financial condition of each industry. See Uniform Systems of Accounts for Public Utilities and Licensees and for Natural Gas Companies (Classes A, B, C and D): Inclusion of Construction Work in Progress in Rate Base (Docket No. RM75-13), issued November 8, 1976, 41 FR 51,392-51,394 (November 22, 1976). No change in Commission policy regarding this distinction has ever been contemplated in this proceeding. This proposal is therefore not adopted.

³¹ In the Notice of Proposed Rulemaking, the Commission defined CWIP as "amounts properly included in Accounts 107 (construction work in progress) and 120.1 (nuclear fuel in process of refinement, conversion, enrichment and fabrication) 46 FR 39,454. Both CWIP and nuclear fuel in process of refinement, conversion, enrichment and fabrication are investments in material which will later be used to serve consumers but which, during the development process, still require financial resources from the utility. Presently, nuclear fuel in Account 120.1 receives AFUDC treatment in the same manner as balances in Account 107. Moreover, nuclear fuel is typically removed from Account 120.1 when it becomes a usable fuel stock. This parallels the treatment of investment in new plant which is included in Account 107. The accrued financing costs which are capitalized in each account would be part of the balance eligible for rate base treatment. No commenter addressed the rate base treatment of nuclear fuel being processed. The statements submitted by several wholesale customers and consumer groups stating the general concern that nuclear facilities will comprise a significant portion of CWIP are addressed below.

expanded use of CWIP in rate base. Commenters, therefore, regarded analysis of that condition as central to this proceeding and the comments are sharply divided.

Investor-owned utilities, several financial institutions, and the U.S. Department of Energy (DOE) generally view the electric industry as facing serious financial problems that may be mitigated by the inclusion of a percentage of CWIP in rate base for all utilities. Most other commenters find that, while individual utilities may be in financial distress, the entire industry is not in distress. Rather, they point to recent indicators that show a general improvement in the ability of utilities to attract capital. These commenters favor a case-by-case consideration of any CWIP requests and no departure from the rule expressed in § 2.16 of the Commission's regulations. Even among commenters who recognize that the industry is facing general financial difficulty, some would allow for CWIP in rate base only on a case-by-case basis.

The source of current financial difficulties is debated by commenters. A sizeable contingent of commenters, mainly investor-owned utilities, financial organizations, the General Accounting Office (GAO) and DOE argue that the widespread financial distress in the industry is directly related to the need to finance ongoing construction. The crux of the argument is that cash flow shortfalls arise from the need to provide new generation plant in the face of inflation in construction costs, delays in construction due to regulation, and the rising cost of capital. Financing costs, in turn, have risen, in part because of reduced bond ratings, the reduced value of common stock, the lower percentage of internally generated funds available to pay for construction, and the increased size of AFUDC as a percentage of income.

Support for this view comes from a major financial rating agency which contends that the plight of the industry is such that it has suffered severe financial deterioration during the last decade because of spiraling fuel costs, double-digit inflation, reverse economies of scale in new construction costs, and increasing and more costly external financing requirements. These factors, this commenter argues, contributed to downgrading more than 150 bond issues since 1970. In 1970, for example, 60 percent of rated electric utility first-mortgage bond issues were rated "AA" or higher by Standard & Poor's (S&P). By 1981, less than 30 percent were in that

³¹ While utilities under our jurisdiction may not have an explicit obligation to serve requirements of customers, they would not be allowed to terminate such service unless they could show that it was in the public interest. Even if we made such a finding and the distribution utility went out of business, the supplying utility would, in most states, be obligated to provide direct service to the customers of the distribution utility because they would be considered retail customers in the supplying utility's service territory.

³² These commenters urge the Commission to extend the effect of this rule to natural gas utilities. The Commission has distinguished between natural gas and electric utilities with respect to the treatment of investment in construction projects on

category. Further, although allowed rates of return have increased from about 12.5 percent in the 1970's to 14 percent in 1980, the actual earned rates of return on investment have not moved proportionately. Indeed, by 1980, they were 11 percent compared with 11.8 percent in 1970.

The quality of earnings has also deteriorated substantially, according to investment analysts. In this regard, one commenter from the financial industry states that virtually all investors responding to a survey stated that the value of the AFUDC component of a utility's earnings is lower in quality than cash earnings. The non-cash nature of AFUDC earnings, essentially an IOU for future payment to present earnings, is said to be of inferior quality. Whereas in 1970 only 11.8 percent of utility earnings were AFUDC "paper earnings," fully 46.3 percent of earnings were AFUDC related in 1980, explains one commenter.

Additional perspective on the problem is supplied by a rating agency, which states that the industry's financial flexibility is limited by: (1) The existence of bond indentures that restrict many companies from issuing new debt; (2) common stock prices below book value whereby new stock issues at those low prices dilute the value of existing common equity; and (3) growing capital requirements of the electric industry in a contracting capital market. This picture is generally acknowledged to be accurate by several commenters from the private financial community. Government sources also concur in this regard.

The GAO states that the industry's poor financial performance is closely tied to inflation, high interest rates, and, in general, the swings in business cycles. It is compounded by long-term construction projects, unanticipated energy conservation, and the fact that current utility earnings are based on older generating plants which cost much less to build than today's plants. As a result of these factors, the GAO states that as of April 1981, the common stock of 98 out of 100 of the largest investor-owned electric utilities was selling below book value. Although only four of the largest 100 electric utilities had a BBB bond rating in 1970, about 30 percent are now rated BBB. The GAO also states that the financial community does not believe that utilities are receiving a rate of return that compensates adequately for the present cost of money. Additionally, GAO comments that a particular problem is that the utility industry is capital intensive. Generally speaking, inflation has had a more disruptive impact on this

industry than on others, it is argued, and utilities are now faced with the need to refinance, at current rates, maturing long-term debt originally issued at 2 to 3 percent.

The principal concern of DOE is the financial ability of utilities to undertake needed construction. DOE indicates that because of the present financial situation, utility management has adopted a "capital averse" behavior which avoids investment, wherever possible, by cancelling or deferring the construction of needed generating capacity in favor of less capital-intensive, and less than optimal, generating plant. This behavior arises, argues DOE, because of the rising cost of construction and the inability of utilities to cope effectively with the ensuing financial constraints. According to DOE, construction costs quadrupled between 1967 and 1979 while cash earnings declined to 30 percent of current expenditures, well below the 50 percent target cited by some Wall Street analysts as a recommended minimum. DOE also sees further deterioration in interest coverage ratios when non-cash AFUDC is excluded (4.0 in 1967, 2.0 in 1980), in realized rates of return, and in net earnings excluding AFUDC. The decline in cash earnings has been interpreted by some analysts and investors to signal a decline in the quality of earnings. Cash earnings of utilities now cover only two-thirds of dividend payments and there has been a marked decline in the ratio of the market price of common stock to its book value.

Several state utility commissions specifically state that utilities are experiencing financial difficulties due primarily to the increased cost of construction resulting from delays, the long lead time required for construction of base-load generation facilities, and inflation.

Numerous wholesale customers of investor-owned utilities present a different portrait of the industry's condition and its underlying causes. While acknowledging the difficult financial condition of some utilities, these commenters attribute the industry's difficulties to a decline in the quality of utility management and decision-making and to nuclear construction programs that are often adversely affected by federal regulation and technical problems. Moreover, these commenters argue that inclusion of CWIP in rate base will not improve the condition of utilities beset with such problems. However, some of these commenters argue that, if rate relief is used to combat the adversities facing

investor-owned utilities, it should take the form of higher rates of return.

Among the customer groups, many commenters simply doubt that all electric utilities are in financial difficulty and some argue that the financial picture of investor-owned utilities has improved markedly in recent months. These commenters point out that two-thirds of the investor-owned utilities have a bond rating of A or better and that the BBB rated bonds of utilities deemed to be in financial distress are still considered investment grade. Some individual public and cooperative systems believe that Commission actions, including tax normalization, future test periods, recovery of investment in abandoned projects, and fuel adjustment clauses, in addition to the Economic Recovery Tax Act of 1981 (ERTA), have in recent years greatly improved the financial picture for most utilities. In addition to increased regulatory sensitivity at the state and federal levels to potential utility problems, the wholesale customers claim that there has been a leveling in utility capital needs, arguably because there is an excess of future capacity. Moreover, these commenters foresee that decreased inflation will reduce capital financing requirements and costs to utilities causing market-to-book ratios to improve. Representatives of wholesale customers observe that the allowance of CWIP would be inflationary and that, as interest rates continue to decline and electric rates increase, fewer utilities will experience serious financial difficulties.

In summary, wholesale customers find the picture of industry-wide distress to be seriously overstated. Retail consumers, consumer groups, environmentalist organizations, and large industrial customers generally concur in this view.

We believe that the record in this proceeding clearly shows that the electric utility industry has been in a weak financial position. While general economic conditions may have exacerbated the financial difficulties of some companies, there is ample support that the electric utility industry has experienced particular difficulty in financing construction programs. Equally clear, this difficulty has led to general deterioration of the industry's financial posture.

The major indicators of the financial condition of electric utilities seriously deteriorated over the past decade. A decline in bond ratings was pervasive. Thirty percent of the industry is now BBB rated. Earned returns lagged behind capital costs, which increased sharply.

Internal cash generation as a percent of construction expenditures fell dramatically.

Perhaps this decline has leveled off and, as some commenters state, has reversed to some degree in the months since the Notice was issued in this proceeding. Even if we assume that it has, the Commission must do what it can to ensure that the financial picture will continue to improve. The financial condition of utilities should not be left totally subject to swings in business cycles. Our regulatory responsibilities do not permit us the luxury of simply relying on the hope that conditions will continue to improve. The Commission must take whatever steps will assist the process and to remove the existing bias against increased capital spending for new capacity.

Because the financial condition of the industry at a particular point in time is not necessarily indicative of the health of the industry, the Commission's concern is more with the long-term outlook in light of the service demands that are anticipated. If the investment necessary to meet that obligation can be expected to undermine the health of the industry, deterioration in service can be foreseen. To encourage the type of investment necessary to maintain infrastructure sufficient to meet service requirements, a regulatory remedy to offset the financial drain posed by construction is necessary.

2. Adequate and Economical Construction of Plant. Any consideration of the inclusion of CWIP in rate base naturally raises the question whether utilities need to build additional capacity either to replace worn out or inefficient plant or to meet the growth in the needs of the customers. Many commenters claim that new electric plant must be continually constructed to: (1) Improve or replace existing plant; (2) service increased demands from existing customers; (3) respond to changes in government policy, such as pollution control; and (4) meet service demands of new customers moving into the service area. However, utilities emphasize that an appreciation of the financial stress on them necessitates an understanding of the unique feature of their operations—the obligation to serve.

Electric utilities continually construct new facilities because they have an obligation to serve, even if expanding service may not be profitable. The pressure to anticipate and build for future demand leads to construction programs that have a direct impact on finances and, consequently, on the consideration of any CWIP policy. Several utility systems emphasize the

need to undertake construction at "optimal levels."⁴ Such construction, it is argued, enables a utility to switch from oil-fired generation to coal or nuclear generation and to stop building short-term, "band-aid" generation facilities which, though less expensive to build, invariably would represent a greater long-term cost to ratepayers. A number of utilities cite the delay or cancellation of such optimal construction programs because of financial constraints. They assert that this creates higher costs to consumers because of increased reliance on purchased power or the inflating costs of deferred construction. Arguably, the prospect is for a decline in service reliability if construction is not undertaken at optimal levels.

Investor-owned utilities claim that they face construction lead-times that have increased from roughly five years in 1960 to 10 or more years in 1981. They also cite significantly higher construction and financing costs for new projects. Some of these commenters view this deteriorating situation as exacerbated by burdensome regulatory requirements and the phenomenon that new plant no longer increases operating efficiency sufficiently to offset the higher cost of construction. As a result, the cost of constructing and replacing utility plant is escalating. There is therefore a significant trend in the industry toward cancelling or deferring capacity scheduled for the mid-1980's and early 1990's. Reflective of this, DOE states that over the last two years very large amounts of general capacity have been deferred or cancelled.

DOE states that it is unable to determine to what extent these delays and cancellations were caused by reduced demand and to what extent to risk of capital aversion. However, it predicts that, if delays and cancellations are caused by financial constraints, they will continue unless remedial action (such as CWIP) is taken. DOE cites examples of financial constraints that prohibit utilities from undertaking economically efficient construction programs. For example, in 1980, well over half of all planned capacity had announcements of delay or cancellation. This is cited as further evidence of the "capital averse" behavior by the utility industry which could result in dangerous shortages of capacity after the period of low demand growth in the early 1980's comes to an end. DOE anticipates that the current respite from demand growth will dissipate and utilities must be prepared to meet an upswing in demand

that could come as a result of economic recovery.

Commenters that oppose the rule have a different view of the prospects for, as well as history of, demand growth and the response to it by utilities. They claim that the cause of the current troubled state of the industry is the decline in growth of demand and that new large construction programs are unnecessary or not optimal. Several retail customer groups find that utility management acted imprudently in resorting to large construction programs in the past, particularly construction of nuclear generation. Because about two-thirds of current CWIP financing represents nuclear construction, much of which is allegedly beset with technical difficulties, these commenters generally resist the notion that construction programs should be afforded CWIP treatment. Objections to the rule are therefore raised in the context of disagreements over the composition and size of construction programs, as well as the overall need for future additions to capacity. Some commenters even fear that the proposed rule would encourage or vindicate management decisions that are allegedly unwise and contrary to the interests of ratepayers.

The rule we promulgate today, however, in no way immunizes utilities from allegations that particular management decisions are unwise or imprudent. Its effect in this regard is only to put a portion of construction work which is underway on a more equal footing with plant which is already in service. This does not prejudice any questions which may be raised in individual rate cases concerning the prudence of particular utility investment decisions.

With respect to the question of continued need for greatly expanded generating capacity, we again stress that the present rule is not predicated on an assessment that enormous new capacity is necessarily required. To the contrary, we believe, as stated earlier, that the need for new capacity should be tested by the market to the extent practicable. The present rule furthers this goal by smoothing out the price increases which are associated with additions to capacity, thereby giving both customers and utility management a clearer idea of current and future price levels and demand.

3. Impact of AFUDC. Under existing Commission policy, all costs of construction, including interest charged on amounts borrowed (the "cost of money"), are capitalized in a separate utility account and denied any rate treatment until the plant under

⁴ See, e.g., *Appalachian Power Co., et al.*, Initial Comments at 22.

construction is placed in service. The allowance for funds used during construction (AFUDC) and the cost of construction are put into rate base when the plant is placed in service. A limited exception to this approach is provided in § 2.16 for investment in pollution control and fuel conversion facilities and in cases of financial distress.

Investor-owned utilities and financial firms state that the problem with AFUDC is that it inevitably represents low quality earnings for utilities. In effect, AFUDC is not income but a promise-to-pay upon completion of construction. These commenters argue that, as AFUDC increases as a percentage of total utility income, debt and equity financing costs increase because investors and analysts tend to view AFUDC as more risky than cash earnings. In addition, they state that because accrual of AFUDC does not create current cash flow, it deprives the utility of funds when they are most needed, that is, during the period of construction of plant. Moreover, because AFUDC accruals are added to the total cost of the new facility included in rate base, the revenue requirements associated with the plant increase for the life of the plant. Finally, the AFUDC methodology creates a surge in rate base at the time a plant is placed in service. These commenters also state that an AFUDC policy hides the true cost of providing power from consumers, thus defeating conservation and making construction appear more necessary.

By way of analysis, one investor-owned utility states that AFUDC affects the cost of capital by decreasing bond ratings one grade and increasing the cost of equity 318 basis points³⁵ on average. A lending institution believes AFUDC amounts are discounted in evaluating income and equity accounts, thereby affecting a utility's creditworthiness. Moreover, the financial community ascribes to AFUDC policy the doubts of investors regarding the promise of future earnings, in contrast to cash earnings, if a utility must finance capital costs on construction projects until the in service date. This purportedly depresses the value of common equity. In any event, they argue CWIP has the advantage of providing cash flow during the construction cycle, when cash is most needed to complete major projects.

In contrast, a variety of retail consumers, including industrial consumers, and wholesale utility customers discount the importance of

AFUDC in the continuing financial situation of utilities. They point out that the FERC Uniform System of Accounts defines income (including AFUDC) as recorded revenues less expenses, not less cash, and that no studies demonstrate that investors back away from companies having AFUDC balances. There is, they argue, little impact on the cost of equity because AFUDC and retained earnings are, conceptually, sources of future income and both represent a deferral of current cash income to the investor. Finally, several customer commenters assert that an AFUDC policy has positive benefits. AFUDC accounting, for example, provides a financial incentive for a utility to minimize construction delays.³⁶

As indicated above, the Commission believes that the existing reliance on AFUDC should be modified. The AFUDC approach does not necessarily guarantee that utility plant will be constructed more economically or expeditiously. What it apparently does do, is mask from the ultimate consumer the real cost of power during the period when a new plant is being constructed, thereby encouraging demand which serves to distort estimates of future demand and the attendant need for new capacity.

AFUDC was a useful tool when construction periods were short, inflation moderate, and the competition for capital less intense. However, the aggravation of these three factors brings into question the viability of the AFUDC method. Also of importance is the timing of AFUDC and CWIP income relative to a utility's cash needs. CWIP in rate base has the distinct advantage of providing cash at the time the utility is in most need of cash flow, that is, during construction.

C. Several Legal and Policy Considerations

1. *Presumption Against Inclusion of CWIP in Rate Base.* In the Commission's rate regulation of electric utilities, capital costs are generally included in rate base only if the investment is in plant that is "used and useful," or, to put it another way, only if the ratepayers who are paying the costs are getting the benefits.

Commenters are divided with respect to whether this presumption against CWIP in rate base is correct and, perhaps more importantly, whether it

remains relevant. Wholesale and retail ratepayers support this as an operative and controlling ratemaking principle predicated on the concept of "used and useful" in the law, the notion that there must be equity between generations of ratepayers, and the claim that retention of the presumption best duplicates a competitive market. In contrast, investor-owned utilities and financial organizations state that the presumption against the inclusion of CWIP in rate base is based upon an archaic and erroneous interpretation of the "used and useful" concept. They controvert the conclusion that plant must be in service to be "used and useful" to current ratepayers or that inequities result if ratepayers pay for plant under construction. Nor, argue several but not all companies, should the electric utility industry be treated in a manner analogous to unregulated business operating in a free market.

a. *"Used and Useful".* Public utility plant under construction historically has been excluded from rate base prior to its providing actual service to utility ratepayers. The "used and useful" concept supposedly originated with the decision in *Smyth v. Ames*, 169 U.S. 466 (1898) in which the Supreme Court, finding that a Nebraska law fixed unreasonably low freight rates, held that rates must be computed according to the fair value of property used to service the public.³⁷ The principle that a utility is entitled to earn a return on property that is "used and useful" in serving the utility's ratepayers is generally used by this Commission, despite widely recognized exceptions and departures from this rule, particularly when there are countervailing public interest considerations.³⁸ In this regard, the Commission agrees with the courts:

The legal system does not compel rigidity, or bureaucratic inflexibility, least of all in an area like energy policy where flexibility may be essential to the public interest.³⁹

³⁷ For relationship of the used and useful theory to the prudent investment theory, consider *Washington Gas Light Co. v. Baker*, 188 F. 2d 11, 18-19 (D.C. 1950).

³⁸ See *Tennessee Gas Pipeline Co. v. FERC*, 606 F. 2d 1094, 1100 (D.C. Cir. 1979); *NEPCO Municipal Rate Committee v. FERC*, 668 F. 2d 1327 (D.C. Cir. 1981). Departures from the "used and useful" principle are, in some cases, routine practice. For example, land held for future use has been regularly included in the rate base upon which the utility earns its return. Moreover, the use of a future test period allows inclusion in rate base of plant which will be in service during the test period but which may not be operable on the effective date of the new rates. Somewhat akin, are purchase gas adjustment clauses and fuel adjustment clauses which charge a projected cost to customers for service rendered.

³⁹ *Consolidated Gas Supply Corp., et al. v. FPC*, 520 F. 2d 1176, 1185 (D.C. Cir. 1975) quoting Public

³⁵ A "basis point" is equivalent to 1/100th of one percent. It is a measure of increases or decreases in the cost of borrowed money or the yield on loans.

³⁶ In response, utilities state that it is the AFUDC method that inhibits project financing and causes expensive construction delays. This is because of such factors as the financial constraints utilities experience when interest coverages fall below indenture requirements for issuing new debt.

In light of lengthening construction cycles, relatively high inflation, and the proportional significance of capital financing costs in relation to overall project costs, this Commission—as well as many state regulatory authorities—have reexamined the basis for the exclusion of CWIP from rate base and have often disregarded the “used and useful” concept when the reliability of future service is in doubt. This was, in fact, one basis of the FPC’s Order No. 555 which ventured to provide some CWIP relief to financially distressed utilities,⁶⁰ in addition to rectifying anticipated intergenerational inequities by encouraging expenditures for pollution control and fuel conversion facilities through rate base treatment.

Few commenters in this proceeding analyze the legal significance of the “used and useful” test. Comments focus on equitable and economic considerations. Investor-owned utilities and others suggest that the Commission abandon the concept and financial organizations state that the concept has little applicability to the needs of a financially weakened industry or to those of the Nation. Supporters of CWIP in rate base emphasize that current ratepayers benefit from ensuring the future supply of electric power. Predictably, other commenters believe that any deviations from “used and useful” will cause interperiod ratepayer subsidization, that is, current ratepayers would subsidize future ratepayers by contributing to future plant additions. These commenters agree that it is essential to match costs with benefits, regardless of the financial condition of the industry.

The Commission need not, in this proceeding, pronounce further on the validity of the “used and useful” concept. However, it must be reemphasized that the “used and useful” concept, if administered inflexibly and without regard to other equitable and policy considerations, may fail the interests of both the electric utility industry and its ratepayers. Therefore, a more fruitful discussion of this issue may be conducted in terms of the economic equities upon which most commenters focus.

The fundamental debate over whether allowing CWIP in rate base is consistent with the “used and useful” doctrine is, in this proceeding, really a debate over the question of intergenerational equity, the point to which we now turn.

b. Intergenerational Equity—Matching Costs and Benefits. Several commenters state that the inclusion of CWIP in rate base violates the concept that current ratepayers should not bear the cost of future electric service. The inclusion of CWIP in rate base, several commenters contend, would create an interperiod mismatch of costs and benefits whereby current ratepayers would subsidize future electric power customers. This is labeled an “intergenerational inequity.” These commenters believe that capitalizing AFUDC is fair for both present and future ratepayers because the cost of plant under construction is recovered from those ratepayers that are served by the facility.

Investor-owned utilities dispute the contention that current ratepayers do not benefit from the construction of new generation facilities. First, these commenters state that it is more the increasing demands of existing customers rather than the obligation to provide service to new customers that necessitates large construction programs. This obscures the significance of any distinction between present and future customers. The argument concludes that in theory, the cost of new plant is assigned to all customers served by the utility rather than to the specific customers that create increased demand for power.

Second, investor-owned utilities argue that the persons or groups that currently would pay for CWIP will generally tend to be the same people who receive service from the facilities under construction. According to the utilities, not only are ratepayers recognizable as utility’s customers for decades at a time, they also tend to commit actions (such as making capital investments in electricity-using appliances and equipment) that presume a reliable, continuous, and sufficient supply of electric power into the future. As a result, current ratepayers are arguably very likely to be direct beneficiaries of CWIP in rate base.

The comments on the relative equities of CWIP in rate base muster additional arguments that (1) such a policy leads to a more accurate pricing policy that signals the real cost of meeting future ratepayer requirements and the real incremental cost of current usage; and (2) a CWIP policy would reduce the current cost of capital, thereby reducing current revenue requirements, and benefiting current ratepayers.

In contrast, a variety of wholesale power customers contend that the inclusion of CWIP in rate base is inequitable in many ways. They

strenuously disagree that present and future customers tend to be identical, pointing to the mobility of the American public and the phenomenon of municipalities or cooperative systems moving off system to establish their own generating capacity. In those cases, larger numbers of people would allegedly be deprived of the fruits of their investment in CWIP. In addition, numerous groups and individuals perceive that CWIP in rate base would put an undue burden on the elderly, whose prospect of being served by plant under construction are less than those of the general population. Wholesale and retail consumer interests also assert that CWIP does not provide appropriate price signals, in part because any higher rates reflecting CWIP in rate base do not generally include the offset for variable cost (fuel) savings necessary to provide an appropriate price signal to current ratepayers.

The question of intergenerational equity presents the Commission with difficult theoretical problems and compelling human issues. No public policy is perfectly equitable. The Commission is required nevertheless to strike a balance between investors and ratepayers. Likewise, it must balance the interests of present ratepayers and future ratepayers. Even under a strict application of the “used and useful” doctrine, current ratepayers pay for facilities necessitated by past demand and for the capital costs of unused capacity. Moreover, even if CWIP-based rates reduce total costs to the ratepaying public over a period of time, the intergenerational question remains because the question of who pays is distinct from the question of how much. In balancing the various interests involved here, certain observations can be made.

From the standpoint of federal regulation of wholesale rates as opposed to state retail regulation, there is less likelihood that individual ratepayers will bear costs for which no benefit is derived simply because a wholesale CWIP-based rate affects a broad segment of the public. It is reasonable to presume that the chances are relatively great that, in this national community of ratepayers, the person funding CWIP in rate base would also benefit from the contributions of others—no matter where or how often that person might change service areas. Far more important, the Commission believes that the Nation as a whole has a critical interest in continuing service reliability at the most reasonable costs. The capital averse behavior of utility management, induced largely by

Service Commission v. FPC, 511 F.2d 338, 353 (D.C. Cir. 1975).

⁶⁰ “Inclusion of Construction Work in Progress in Rate Base” (docket No. RM75-13), issued November 8, 1976, 41 FR 51,392-51,394 (November 22, 1976).

escalating costs and long construction times, threatens to undermine that reliability.

If CWIP will help management to more accurately gauge the need for future capacity while alleviating the current bias against additional investment,⁴¹ it is equitable for some portion of the increased costs of future service to be borne by present ratepayers. As noted in Section III, in nations where utilities are nationalized, current tax revenues are available to finance public works designed to serve the future. The Commission foresees long-term benefits arising from inclusion of at least some CWIP in rate base that are sufficient to offset the short-term costs that wholesale and retail customers may experience. Moreover, CWIP may reduce the exposure of utilities to the vicissitudes of business swings which may threaten the ability of utilities to meet their public service obligation.

C. Analogy to Non-Regulated Industries. The third discrete issue relating to presumptions against CWIP in rate base involves the argument made by retail ratepayers and consumer groups that AFUDC is a preferable treatment for construction costs because it most closely replicates the way unregulated businesses, which do not have an obligation to serve as do regulated utilities, recover costs. These commenters therefore find CWIP in rate base objectionable because it contravenes the conventions of competitive markets in which construction financing costs are not charged to current customers.⁴² Moreover, these commenters view CWIP policy as removing risk which investors normally assume by shifting risk to ratepayers. It is argued that this makes ratepayers into involuntary investors in the utility.

In response to this defense of AFUDC, investor-owned utilities state that regardless of the rate policy, the electric utility industry is not comparable to a competitive market. They contend, for example, the (1) regulated entities base rates on costs, whereas supply and demand controls prices in a competitive market; (2) unregulated entities are not affected with the public interest and have no obligation similar to a utility's

obligation to serve all customers within its service territory; (3) a utility must compete with unregulated companies for capital to construct new facilities in spite of the prospect of lower rates of return; and (4) while competitive markets price products at their current capital costs, generally approaching the full cost of marginal production, electric utilities price their power at average cost.

In the Commission's opinion, there are significant differences between free market operations and the conditions under which regulated utilities operate. Accordingly, it may not be fruitful to attempt to defend either AFUDC or CWIP policies on the basis of a similarity to competitive markets, and we decline to do so. What is important, however, is to enable the demand of customers for new capacity to be more accurately reflected in the planning forecasts of the utilities. A ratemaking approach such as AFUDC which shields ratepayers from the impact of higher cost capacity until it is completed cannot serve this goal.

2. Risk-Sharing Between Ratepayers and Investors. Commenters agree that inclusion of any amount of CWIP in rate base requires ratepayers to shoulder a financial risk generally only borne by investors, that is, the risk of supplying capital in anticipation of some return or benefit. However, the commenters disagree about the extent and significance of the shift. Currently, investors and ratepayers share some of the risks of public utility operations, for example, with respect to pollution control and fuel conversion facilities under the Commission's existing CWIP policy.

Wholesale and retail ratepayers state that investors should bear both the risk of the profitability of an enterprise and the risk that a plant might never be completed, thereby losing its potential to serve or produce revenues.⁴³ These commenters urge the Commission to retain the status quo rather than force ratepayers to be involuntary investors. These ratepayers state that if investors

are shielded from the risks of the enterprise, the market will be dramatically altered and will disrupt its efficient operation.

In contrast, investor-owned utilities and financial organizations state that, even under a CWIP policy, most of the risks associated with a utility operation belong to the utility's investors; they are the principal source of capital for the utility. If CWIP were in rate base, these commenters state that ratepayers would only be required to pay financing costs on a current basis, and would not be obligated to invest capital in the utility. Utilities nevertheless claim that it may be appropriate and socially useful for ratepayers to assume some risks; this would reduce capital costs and the revenue requirement of the utility. Utilities generally believe that the obligation that a utility has to provide power within its service area, even when the economics of such service do not justify added investment, warrants having ratepayers assume a greater share of the associated risk.

It is important to differentiate the role of investor and ratepayer. Neither the proposed or final rules in this docket make ratepayers a primary source of capital. That is not to say, however, that regulated rates contain or should reflect only the value of providing an immediate benefit to ratepayers. Ratepayers, to a greater or lesser extent, have an interest in the financial health of companies charged with serving their needs.

The degree to which it is appropriate for ratepayer funds to be used to help finance the construction of plant for future use is a matter of judgment. The Commission believes that ratepayers should share with investors today the carrying costs of plant under construction. This is, as some commenters point out, analogous to the universal support given public schools through taxes, regardless of whether one is the parent of a student or the likelihood of remaining in the district. Risks and benefits are shared throughout the community at large.

CWIP in rate base does not portend any fundamental realignment of the roles of investors and ratepayers. Regulations must nevertheless recognize certain economic and technical facts of life that make it more difficult for utilities to plan and finance capital investment over long periods of time, including high capital costs, the prospect of demand growth, and protracted construction times. In light of the tendency of utilities to seek short-term and probably ineffectual solutions, the Commission views CWIP in rate base as

⁴¹ The question of whether CWIP in fact encourages unwise managerial choices is a separate issue, discussed in Section IV.D., *infra*.

⁴² In the NOPR, the Commission also stated: "The exclusion of CWIP from rate base also most closely duplicates the operation of an unregulated competitive market. In such a market, the price at which the company can sell the production of its existing facilities is unaffected by the fact that new facilities are under construction." 46 F.R. 38,448.

⁴³ Utilities and financial firms also address the question of the risk of noncompletion of a facility under construction. Under an AFUDC policy, utility investors recover, from ratepayers, capital and accrued AFUDC which is prudently invested in plants abandoned prior to completion. The final rule does not vary this result. The question of how delayed or deferred plant is treated under the rule is determined by whether delayed or deferred plant qualifies as plant under construction which is properly includable in Accounts 107 or 120.1. If CWIP is included in rate base, utility investors are nonetheless allowed to recover prudently invested capital. Because the carrying cost on the capital invested in the projects is recovered currently under a CWIP in rate base policy, a utility would be allowed to amortize only the principal.

a balanced and modest means of sharing the risks inherent in the need for adequate future capacity.

3. *The Financial Distress Standard for Inclusion of CWIP in Rate Base.* In FPC Order No. 555, which established existing § 2.16, the Commission adopted a policy that permits inclusion of CWIP in rate base for any electric utility that makes a "clear and convincing" showing of severe financial difficulty. Although the financial conditions of the electric utility industry weakened in recent years, few utilities have filed requests for CWIP rate relief under the severe financial distress standard and no final order granting CWIP under this standard has ever been issued. Although a major alternative proposed in this docket involved a threshold criteria for CWIP eligibility predicated on a utility's financial condition (e.g., bond ratings), the rulemaking also called into question the viability of the severe financial distress standard.

In response to that proposal, commenters dispute whether such a standard is serviceable. Investor-owned utilities and financial firms state that such a test fails to provide timely relief to an ailing utility and permits substantial financial deterioration before relief is available. Moreover, the severe financial distress standard limits relief to particular utilities.

Wholesale and retail ratepayers generally support the retention of a financial distress test, primarily because some test ought to be imposed before any extraordinary rate relief is afforded utilities. They argue that CWIP relief is a last resort and that any relaxation of the severe financial distress standard would undermine that purpose. These commenters therefore advocate case-by-case determinations for any rate relief, as necessary to preserve the financial integrity of a utility. Generally speaking, ratepayers view any rule that includes CWIP in rate base generically as an unwarranted departure from the present policy, the merit of which is purportedly demonstrated by the paucity of CWIP rate requests made under § 2.16 and the precision of judgment which a case-by-case method permits.

In short, these commenters questioned the need for a broader rule allowing CWIP in rate base. Indeed, upon reviewing the final rule we adopt today, these commenters will likely ask: when only a handful of utilities have even requested CWIP under the current rules, on what basis does the Commission allow all utilities to file to include CWIP?

The answer is straightforward. At the time the existing rule was proposed, the primary concern was with providing a

vehicle for rate relief to utilities that faced such financial distress. In the ensuing year and a half, however, we have gained a much better understanding of the effects of AFUDC treatment on utility financing, the investment bias created by inadequate returns and the unnecessary future costs which may be imposed by decisions reflecting that bias. At the same time, each cancellation of a power plant on which substantial investment has already been made has underscored the extent to which past price signals for electric power have distorted estimates of future demand and contributed to faulty planning.

These are the primary concerns for the future. Our purpose in this rule is thus considerably broader than merely providing rate relief for utilities in a financial bind. Accordingly, the paucity of requests for CWIP under the existing rule does not itself argue against the course we adopt today.

4. *Inclusion of CWIP in Rate Base Subject to Refund.* Under the Commission's existing regulation, CWIP for pollution control and fuel conversion facilities may be collected subject to refund, just as other rate base items. An allowance of additional CWIP under the financial difficulty test, however, may be included in rate base only following the Commission's final order on the proposed rates and the ensuing litigation over the meaning of financial distress and the nature of appropriate relief. Investor-owned utilities, several state regulatory bodies, and an accounting firm state that CWIP should be included in rate base at the time rates become effective, even if made subject to refund. These commenters argue that the refund obligation relating to CWIP should be the same as that established for the rate filing generally. To delay collection of CWIP-related expenses would allegedly be counter-productive with respect to the financial problems CWIP is intended to alleviate.

Wholesale customers generally disapprove of CWIP collected subject to refund. Several commenters state that allowing CWIP in rate base subject to refund would result in a price squeeze and litigation that could leave the "squeezed" customers financially devastated before a refund based on price squeeze would be made. In other words, these commenters fear that rates may be collected subject to refund for years until a final decision is issued by the Commission. Several partial remedies are proposed by the commenters, such as segregating the CWIP portion of rates collected subject to refund for accounting purposes, repaying a customer for any CWIP

contributions if that customer leaves the service territory during the period that rates are collected subject to refund, allowing CWIP in rate base subject to refund only after the initial decision of the administrative law judge, or expediting that portion of any rate proceeding that involves CWIP in rate base in order to minimize the retail impact.

As a matter of policy, the Commission will allow utilities to collect CWIP-related revenues even if rates are subject to refund in order that relief be immediately available to companies with larger construction programs⁶⁴ and concomitant capital needs and that cash flow rates achieve more stability over time. After all, two of the main objectives of allowing CWIP in rate base are, first, to prevent unpredictable steep jumps in wholesale rates and, second, to provide consumers with more timely signals about the real cost of every additional increment of power used. These objectives argue for continuity in including CWIP in rate base as close to when costs are incurred as possible. Moreover, by allowing CWIP subject to refund, utilities will find frequent filings less necessary. Finally, the Commission recognizes the surface appeal of the equity notion of refunding CWIP contributions to those parties leaving the systems before a plant becomes operable. Its impracticalities notwithstanding, the Commission does not view the rates that might be paid for future utility plant as fundamentally different than rates for other costs that the utility incurs in the course of maintaining healthy, ongoing operations.

D. Impact of Including CWIP in Wholesale Rate Base

The final rule will affect the financial condition and investment decisions of utilities. In addition, a 50 percent CWIP policy will likely be reflected in actual rates fairly quickly as a result of our decision to allow CWIP-based rates to be collected subject to refund. Accordingly, we evaluate the actual impact this rule may be expected to have on wholesale rates. While the following analysis will help put the Commission's decision in perspective, it

⁶⁴ Several commenters question the effect of the final rule on potential price squeeze situations. Although more will be said about price squeeze later, there is no indication that this final rule will dramatically exacerbate the possibility of such discriminatory rate structures. See the Environmental Assessment at § 4.2.5. It appears the CWIP does not generally create price discrimination where it does not otherwise exist although, as the percentage of CWIP in rate base increases, the greater the likelihood of some price discrimination.

is essential to remember that the impacts to which the Commission looks are not merely dollars and cents effects, by behavioral changes in utility operations, capital markets, and power consumption. We have sought answers to these difficult questions in the comments submitted in this proceeding as well as in our own detailed analyses. While the following discussion summarizes much of this information, we emphasize that we have reviewed all of the analysis in the comments on these difficult questions.

1. *Impacts on Utilities. a. Cash Flow.* The final rule will allow utilities to include up to 50 percent of CWIP in rate base and effectively to convert a proportionate amount of current paper earnings, included as AFUDC, into cash earnings.

Investor-owned utilities state that CWIP increases cash flow, thereby improving the ability of utilities to undertake and complete needed construction programs. They contend that the increased cash flow will be exhibited in higher interest coverage ratios⁶⁵ and other financial statistics relied upon by investors and rating agencies in evaluating the creditworthiness of a utility. According to this view, the increased cash flow will improve flexibility in financing as the industry's dependence on external capital markets is reduced and will therefore reduce financing costs. Moreover, as cash flow improves, debt investors are said to face a lower risk of default and common stock investors are more assured that dividend payments will be maintained.

In contrast, several wholesale customers and a trade association state that, because the Commission regulates a small proportion of total utility rates, inclusion of CWIP in rate base will not result in an appreciable increase in cash flow. For example, the association states that, because one-half of the utilities with bond ratings of BBB+ or below derive less than four percent of their revenues from wholesale transactions, the financial impact on this substantial portion of the industry as a result of CWIP in rate base will be minimal.

The statistical record in this proceeding on how CWIP in rate base affects utility cash flow can be

summarized as follows. The utility impacts of including CWIP in rate base are presented in five statistical studies, two of which deal with initial financial impacts on actual utilities and three of which simulate the impacts on hypothetical companies over a much longer period. The initial effects on 50 electric utilities of including all CWIP in rate base are also estimated by one utility commenter⁶⁶ in terms of three financial parameters—interest coverage, internal cash flow as a percent of construction expenditures, and percent change in external financing requirements.

The latter study shows that the average pre-tax interest coverage ratio (excluding AFUDC) would have increased in 1980 from 1.99 to 2.93 if 100 percent of CWIP balances had been included in rate base. A similar improvement is shown with 1979 data. Moreover, the study shows that 30 utilities with interest coverage ratios of less than 2.0 under an AFUDC policy would have improved coverages to greater than 2.0 with 100 percent CWIP in rate base. The study also shows that the ratio of internal cash flow (excluding dividends) to construction expenditures would have increased, on average, from 29 to 44 percent in 1980. Also, 16 of the 17 companies in the sample with a ratio of internal cash flow (excluding dividends) to construction expenditures below 20 percent would increase to above 20 percent with the inclusion of 100 percent CWIP in rate base. Finally, this study finds that if all CWIP had been included in rate base, external financing requirements would have been reduced by about 23 percent in 1980. The stated reasons for this significant reduction are that CWIP in rate base improves the utilities' ability to meet current expenses through cash flow and that this reduces their dependence on external sources of capital.

A wholesale customer⁶⁷ presented a statistical analysis of initial financial impacts of including 100 percent CWIP in rate base on 42 utilities with bond ratings of BBB/Baa as of 1979. The study concludes that these utilities would realize only a 1.5 percent increase in cash flow when both jurisdictional and non-jurisdictional portions of the utility's operation were combined. This conclusion is based on a comparison of the increased cash flow derived from allowing CWIP in jurisdictional rates to the cash needs of the entire company, including those associated with non-

jurisdictional services. The small increase in cash flow shown is considered by this commenter too insignificant to support the contention that any utility will be substantially better off with CWIP in rate base.

The simulation analyses evaluate the long-term financial impacts of including zero and 100 percent CWIP in rate base.⁶⁸ One study, presented by an investor-owned utility, considers three scenarios applied to a "strong" (AA-bond rated) utility and a "weak" (A-bond rated) utility: (1) No CWIP in rate base and attrition of earnings; (2) 100 percent CWIP in rate base and attrition; and (3) no CWIP in rate base no attrition, and a higher allowed/earned rate of return. Both utilities are assumed to be engaged in construction programs to complete five 750 MW coal-fired plants and to begin two more plants over a 20-year study period. Under the first scenario, where CWIP is excluded from rate base and there is continued attrition, the study concludes that over the study period, the "strong" utility would experience a decline to a BBB bond rating. In this case, interest coverage (excluding AFUDC) drops from an average of 2.45 in the first five years to an average of 1.83 in the last five years. The ratio of internal cash flow to construction expenditures also falls dramatically and there is significant dilution of common equity. A similar experience is forecasted for the "weak" (A-rated) utility. In contrast, under the second scenario, if 100 percent CWIP is included in rate base and attrition continues, both utilities are projected to maintain their initial bond ratings. The "strong" utility would generally maintain an average interest coverage of 3.34 over the 20-year study period and internal cash flow as a percent of construction expenditures would average 62 percent compared to 41 percent without CWIP. Comparable results are forecasted in terms of maintaining a higher interest coverage for the "weak" utility. The third scenario involves higher rates of return. Although this alternative tends to increase cash flow and interest coverage, the improvement is less than that which occurs under the second scenario.

⁶⁵ See Appalachian Power Co., et al., Initial Comments, at Appendix H; Reply Comments, at Appendix C; Edison Electric Institute, Reply Comments, at Appendix V; Eugene F. Brigham, Public Utility Research Center, University of Florida, Initial Comments, at page 17. (The results of the University of Florida study are very similar to that derived by the Appalachian and Edison Electric studies and are not discussed in the text.)

⁶⁶ Under the 100 percent CWIP case, the study assumes a reduction in the cost of capital for both utilities.

⁶⁷ An "interest coverage ratio" is earnings before taxes and interest expenses divided by interest expenses. Its significance is that the ratio is a widely-used measure of how utilities are able to meet one particular cash flow requirement, namely, interest expense. The ratio is critical to financing because trust indenture provisions applicable to the utilities commonly prohibit the issuance of new long-term debt unless the interest coverage ratio is maintained at or above a specified minimum level, typically 2.0.

⁶⁸ Appalachian Power Co., et al., Reply Comments at Appendix D.

⁶⁹ Oglethorpe Power Corp., Initial Comments at 24 and Exhibit SEC-5.

An investor-owned utility trade association study estimates the effects of 100 percent CWIP on two hypothetical utilities that are undertaking what is assumed to be representative multi-project construction programs. The hypothetical utilities vary in size and in the technology mix of existing plants. The study does not assume a reduction in the cost of capital when CWIP is included in rate base. Consistent with the utility simulation study, this study finds that, without allowing any CWIP in rate base, interest coverage ratios for these companies were not maintained at the 2.0 minimum level (for issuance of new debt) for the entire study period. However, inclusion of 100 percent of CWIP in rate base maintained the ratio above the minimum level. The study also finds that, if all CWIP is included in rate base, the percent of external financing decreases and the quality of earnings (measured by the ratio of AFUDC to net income) improves.

Tables 1, 2, and 3, attached Appendices to this rule, are graphic illustrations of the results of two additional studies, one conducted by the Energy Information Administration (EIA), the other by FERC staff,⁷⁰ which confirm the findings of the studies described above, i.e., that inclusion of 50 percent of CWIP in rate base would measurably improve the jurisdictional portion of utilities' internal cash flow and interest coverage ratios.⁷¹

The Commission finds that the CWIP policy presented in the final rule will have a salutary effect on cash flow. No commenter disputes that the inclusion of CWIP in rate base will increase cash flow. Only the extent to which cash flow will increase is at issue. The Commission believes that the resolution of this issue must be determined with respect to the effect of including CWIP in rate base on the jurisdictional portion of a utility's operations, as if the federally-regulated portion of the utility's operations "stand alone." The Commission's decision to alter its existing CWIP policy should not be

dependent on the limited extent of its jurisdiction over most utilities. The assertion by investor-owned utilities that cash flow will be significantly improved appears to be correct, at least with respect to the jurisdictional portion of the utilities. The objection to CWIP put forth by wholesale customers that the size of the federal jurisdiction over BBB rated utilities augurs for only limited impacts, is, therefore, somewhat wide of the mark.

In general, the simulation studies confirm the Commission's expectations regarding the effect that CWIP in rate base has on cash flow and other financial indicators. The studies are useful in evaluating the relative magnitude of the financial impacts of including CWIP in rate base. However, since they are based on 100 percent CWIP in rate base, they overstate the likely impact of including 50 percent of CWIP in rate base by a factor of two. By taking only half of the increase in cash flow and converting this into interest coverage ratios, and other financial measures, one can ascertain the effect of 50 percent of CWIP in rate base. Under a 50 percent CWIP case, the effect on cash flow, interest coverage ratios, etc., is still significant.

In sum, there is convincing evidence in the record including a study prepared by the FERC and a study prepared for the Commission by EIA which shows an increase in cash flow from including 50 percent of CWIP which is sufficient to affect most utility financial indicators in a very positive fashion.

b. *Cost of Capital.* The projected increase in cash flow and reduction in external financing requirements relates to the second major direct financial consequence of CWIP in rate base, namely, the impact on the cost of capital to utilities. Commenters present and analyze numerous studies on the effect of CWIP on the cost of capital. Investor-owned utilities present studies which support the hypothesis that CWIP in rate base reduces capital costs. Wholesale electric power customers present analyses showing the contrary position. As one might suspect, there are strengths and weaknesses in all of the empirical analyses of this issue, thus indicating the elusiveness of any definitive answers. The studies supported by investor-owned utilities conclude that: (1) AFUDC accounting tends to depress market-to-book ratios of electric utility stocks; and (2) putting CWIP into rate base clearly improves the financial integrity of utilities and lowers capital costs.

Wholesale customers and their trade associations present three of their own

analyses which conclude that: (1) empirical evidence does not support the conclusion that AFUDC earnings make utilities more risky as investment; (2) a quality-of-earnings index based upon AFUDC showed no significant effect on the cost of capital in eight out of 10 years studied; and (3) if dividend payments are available in the proper magnitude, investors are relatively unconcerned about AFUDC amounts.

All of the cost of capital analyses have some common weaknesses, such as the failure to adequately separate the effects on riskiness of a construction program from the effects of the CWIP policy. These studies offer conflicting and widely diverging estimates of the cost of capital effects of CWIP in rate base. The investor-owned utilities' studies estimate that debt costs will be reduced by up to 100 basis points and equity costs by up to 300+ basis points.

The studies rely predominantly upon the ratio of AFUDC to net income as a measure of the effect that the inclusion of CWIP in the rate base would have on utilities. These studies rely upon the ratio of AFUDC to net income because, all things being equal, as the investment in plant under construction increases, this ratio rises. Since utilities are affected with the public interest, their obligation to serve drives the need to construct facilities even when such investment may not be economic from the investors' standpoint. This measure, however, has some major shortcomings. For example, it may more accurately relate to the relative size of a company's construction program rather than to whether CWIP is included in rate base. As a result, the studies may merely be reflecting that as the size of a company's construction program increases the company becomes more risky from an investor's perspective. The AFUDC to net income ratio may also be questionable because two companies with identical construction programs and CWIP policies could have significantly different ratios due to (1) the use of a gross-of-tax AFUDC rate rather than a net-of-tax rate, or (2) significantly different earned returns on plant-in-service due to attrition.

Several commenters note, in reply, that the various econometric and statistical studies have shortcomings of a technical nature, such as a lack of independence among variables (i.e., multicollinearity). In addition, the studies extrapolate from historical data, and this may bias the results.

The Commission understandably finds it difficult to draw from the analytic studies submitted in this proceeding any definitive conclusions

⁷⁰ The FERC model was issued for public comment in "Proposed Computer Model for Evaluating Impact of Alternative CWIP Policies and Staff Study on Cost of Capital," (Docket No. RM81-38) 46 FR 58,148 (November 30, 1981). The Commission also identified the input data which would be used for this model. This model has been adapted to estimate impacts under a 50 percent CWIP in rate base approach. See also Environmental Assessment, *supra*, at §§ 4.2.2, 4.4.

⁷¹ With regard to the wholesale customers' estimated 1.5 percent increase in cash flow, the Commission believes that, if the increase were related to an estimate of the jurisdictional portion of cash flow, the percent increase would be much higher. See discussion below.

regarding the effect of a CWIP in rate base policy on the cost of capital. The cost of capital studies arrive at often contradictory results from what appear to be similar data bases and modeling techniques. Consequently, our conclusion, which is admittedly no more than a matter of judgment, is that we believe whatever the size of any effect that the inclusion of CWIP in rate base will have on the cost of capital, the rule will generally provide a downward pressure on those costs.⁷²

c. *Prudent Decisionmaking and Management Efficiency.* Utility management decisions are constrained by both the financial condition of the utility and the regulatory atmosphere in which the utility operates. If a regulatory policy precludes a regulated utility from earning its cost of capital or maintaining an adequate cash flow, management may be inhibited from undertaking optimal construction projects, meaning simply that management may opt for short-term economies at the expense of effective long-range planning.⁷³ It is also conceivable that if a regulatory policy produces excess earnings a utility may be encouraged to engage in unneeded or uneconomic construction. Commenters discuss several of these countervailing aspects of the dynamics between management behavior and rate regulation.

Wholesale and retail customers generally express the fear that a CWIP policy will reduce management efficiency and will encourage the construction of larger and economically inefficient facilities. These commenters state that CWIP will not provide a sufficient incentive for utilities to complete projects quickly, efficiently, or to avoid unworthy projects because cost overruns and inefficiencies will be subsidized by the ratepayers. Rather wholesale and retail customers argue that the inclusion of CWIP in rate base serves to reward management inefficiencies.

Many consumers believe that utilities presently construct unnecessary or inefficient generation facilities and that CWIP will promote large scale, and in particular nuclear, construction programs instead of least-cost alternatives. They argue that inclusion of CWIP in rate base exacerbates this condition. Under this view, the burden of establishing management imprudence with respect to a construction program would be shifted to the customer to a greater degree under a policy that routinely includes CWIP in rate base.

Most customers, it is argued, do not have the resources or information to shoulder that burden. As a result, utility management would be insulated from challenges to the exercise of its discretion, its accountability will decline, and a major incentive for efficiency will disappear.

Several wholesale customers and consumer representatives argue that the efficiency of management and the need for the construction program should be examined in conjunction with all requests for inclusion of CWIP in rate base. One consumer group states that the consideration of management efficiency should focus on whether management is inflexible or short-sighted. Several wholesale customers stress the need for a thorough review of the economics of construction programs, including the likelihood that a plant will never be placed in service, before CWIP is allowed in rate base. These commenters generally agree that the rate case is the proper context for this inquiry. They conclude that CWIP should not be allowed in rate base if management is found to have acted imprudently with respect to the construction of new facilities.

In contrast, investor-owned utilities, DOE, and several financial firms state that a CWIP policy will actually improve management efficiency by freeing its hand to undertake optimal construction projects. DOE contends that, without CWIP, management will be constrained in raising debt and equity capital and in response will adopt a "capital averse" strategy. This strategy, DOE states, will not yield a least-cost result over the long-term. DOE states that its national load forecasts indicate that, with a modest upsurge, demand could outstrip capacity, especially in light of the increase in cancelled and deferred units.

Investor-owned utilities state that a CWIP policy will give management and investors sufficient confidence in a utility's financial ability to undertake needed investments. This will allow management to pursue an optimal expansion plan and undertake construction of efficient generation units. However, most investor-owned utilities state that a review of the utility's construction program is unnecessary in each rate case because each project is generally reviewed by state or federal agencies prior to commencement of construction. They argue that a review suggested by wholesale customers will impair the availability of CWIP and, based upon the experience under the existing regulations under § 2.16, would

unnecessarily complicate and lengthen rate proceedings. Several investor-owned utilities acknowledge that a review of the construction program would not be inappropriate.

In response to this discussion, the Commission emphasizes that encouraging construction is not a goal of this rulemaking. Rather, a CWIP policy should enable management to exercise its discretion in a prudent and rational manner. The present AFUDC policy, however, has not served the industry or its consumers well in this regard. A CWIP rule would allow management to make optimal decisions in light of market conditions, including projections of future demand.

The Commission finds no basis for the contention that CWIP will breed management inefficiency and encourage deliberate delays in construction times. There remain strong incentives for management to seek speedy completion of construction projects. For example, the cash flow to a utility for a completed plant far exceeds that for a plant under construction, even with a 50 percent CWIP policy. This occurs because a utility is able to depreciate only completed plants. In addition, once completed, 100 percent of the plant is included in rate base as opposed to the maximum of 50 percent under this final rule. Therefore, the Commission believes that a CWIP policy does not necessarily undermine existing incentives for management efficiency regarding construction projects.

That is not to say that the Commission need not consider management efficiency and the need for construction programs. A regulated utility is entitled to an opportunity to recover its prudently incurred costs. Allowing utilities to file to include CWIP in rate base neither adds to nor detracts from this fundamental rule of utility ratemaking. With the proliferation of construction projects and the elongation of construction cycles, management prudence loses none of its significance. However, since the prudence of investment decisions and associated costs is a matter of fact in each case, the Commission agrees with those commenters who contend that imprudently incurred costs reflected in CWIP may be disallowed on the same grounds as other imprudently incurred costs proposed for inclusion in rate base.

The final rule adopted will fundamentally reorient the Commission's assessment of the reasonableness of construction programs. It affords in effect an opportunity to review and judge the

⁷² See n.20, *supra*.

⁷³ See The Commission's discussion of this issue in Section III, *supra*.

prudence of costs as those costs are incurred and claimed in rate base, rather than at a later point in time when a project is completed or abandoned and a potentially unwise investment has already been made.

To facilitate the review of the prudence of CWIP costs in rate cases, the final rule expands the filing requirements under § 35.13 of the Commission's regulations to require a general statement of the utility's program for providing reliable and economic power. While the filing required by § 35.13 is brief and will not obviate further data gathering, including discovery, Commission staff and intervenors will be better able to review the prudence of the construction and related costs that may be included in rate base.

In evaluating prudence, additional information, if reasonably available, may be called for. For example, staff or intervenors may request and be entitled to receive the utility's current plans for expansion by year; current and previous construction schedules and cost estimates for major projects; and annual summer and winter reserve forecasts (with available dependable capacity identified by plant and fuel type for internal generation and by source for external capacity). Additional relevant data could include the utility's current economic and financial studies (e.g., production cost simulations or load flow studies), along with technical and economic assumptions (including fuel costs and energy projections), which show the impacts of the utility's capacity and energy plan or which evaluate relative costs of alternative plans. If the filing utility does not have available any of the information specified, it shall submit instead any pertinent information upon which it relied in deciding to replace or expand its power supply facilities.

A finding of a market for power by another agency will, of course, be relevant to any such consideration although such findings seldom deal with prudence related concerns. If the Commission finds construction costs were not prudently incurred, disallowance of rate base treatment may be appropriate.⁷⁴

There has been considerable interest expressed in recent years concerning "least-cost" energy strategies.⁷⁵ The Commission understands a least-cost approach to mean one which seeks to provide reliable service over time at the lowest reasonable cost.⁷⁶ This, of course, is one element of the prudence standard, and is entirely consonant with fundamental principles of public utility regulation.⁷⁷ As such, we fully endorse the least-cost principle as one important component of a prudence determination and intend to apply it to reviewing claimed construction costs as we do to other claimed utility costs.

The contention that the final rule will encourage management to overcapitalize (i.e., build too much capacity or generation plant of excessive size), the so-called Averch-Johnson effect,⁷⁸ is similarly flawed. The A-J effect is said to occur if earned rates of return exceed the opportunity cost of capital. Except for the minor effects due to investment tax credits, as noted earlier in the preamble, allowing CWIP in rate base will have no effects on earned returns.

Many commenters that utilize this proceeding as a forum for criticizing nuclear power misconstrue the Commission's objectives. As previously stated, this rule seeks to mitigate the aversion to capital investment. The final rule should help create a more evenly-balanced environment for investment decisions. It follows that the rule will not encourage construction of any particular kind of generation facilities, including nuclear plants.

⁷⁴ See e.g., Sant, *The Least-Cost Energy Strategy: Minimizing Consumer Costs Through Competition* (published by the Energy Productivity Center) (1979); Sant and Carhart, et al., *Eight Great Energy Myths: The Least-Cost Energy Strategy—1978-2000* (Energy Productivity Report No. 4 of the Energy Productivity Center) (1981). (Apparently, the terms "Least-Cost" and "Least-Cost Energy Strategy" are trademarks of Applied Energy Services, Inc.) See also Hearings before the Subcommittee on Energy and Conservation of the House Committee on Energy and Commerce, 97th Cong., 1st Sess. (April 23, 1982).

⁷⁵ See our discussion of "least cost energy strategy" in *Treatment of Purchased Power in the Fuel Cost Adjustment Clause for Electric Utilities*, Docket No. RM83-62-000, Notice of Proposed Rulemaking, 23 FERC ¶ 61,171, at n. 11 (May 3, 1983).

⁷⁶ See e.g., *Midwestern Gas Transmission v. FPC*, 388 F.2d 444, (7th Cir. 1968), cert. denied, 392 U.S. 928 (1968); *Atlantic Refining Co. v. Public Service Commission*, 360 U.S. 378, 388 (1959) (intent of Congress under Natural Gas Act that service should be provided at the "lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest").

⁷⁷ Averch, H., and Johnson, L. L., "Behavior of the Firm Under Regulatory Constraints," *American Economic Review*, Vol. 52, (December 1962); See also Bailey, E. E., *Economic Theory of Regulatory Constraint*, Heath—Lexington, 1973.

It is ironic that wholesale and retail customers find that an AFUDC policy provides greater incentives for completing plant under construction. In fact, the massive delays experienced in the construction of electric utility plant over the last decade have occurred in spite of an AFUDC policy being predominantly employed by both federal and state regulatory agencies. The Commission does not believe that a CWIP in rate base policy will cause further deterioration in this regard, but to the contrary finds that it will provide the necessary capital which may permit faster completion of major projects.

In any case, utility management will be held accountable for the prudence and costs of its construction programs. Both federal and state regulatory procedures provide safeguards for consumers from management imprudence. In fact, the Commission has the authority to disallow the recoupment in rates of higher costs incurred as a result of negligence, mismanagement or inefficiency.⁷⁹ The new rule will enable the Commission to consider the prudence issue earlier in a construction program than under an approach that only permits capitalization of AFUDC prior to a plant's in-service date.⁸⁰

2. *Impact on Consumers. a. Rates.* The rate impact of including CWIP in rate base will vary among utilities, regions of the country, and over time. However, commenters attempted to portray the overall effects of a change in CWIP policy. Predictably, commenters do not always agree. Wholesale and retail consumers generally state that rates based in part on CWIP will be higher in the foreseeable future and may be higher than rates under an AFUDC policy indefinitely. Investor-owned utilities state that, although short-term rates would be higher, rates will decline sufficiently over time to offset (in terms of economic value) the short-term rise in rates.

The trade association of municipal utilities analyzes the short-term impact of including 100 percent CWIP in rate base on jurisdictional rates.⁸¹ The study uses industry aggregate data for 1980 and assigned the FERC jurisdiction over 10 percent of the industry. The study estimates that aggregate impact on

⁷⁸ See Opinion No. 118, *Virginia Electric Power Company*, 15 FERC ¶ 61,052, 61,112 (1981), citing *Public Service Company of New Hampshire*, 6 FERC ¶ 61,299 (1979).

⁷⁹ Moreover, the requirements of new Statement BM will permit consideration of the reasonableness of the filing utility's construction program earlier in most rate proceedings.

⁸⁰ See *American Public Power Association*, Initial Comments, at 45.

⁷⁴ Absent a showing of inefficiency or improvidence, the Commission is bound to presume that the utility operations were conducted in good faith consistent with principles of "efficient and economical management." *Bluefield Waterworks and Improvement Company v. Public Service Commission*, 262 U.S. 679, 693, (1923); *West Ohio Gas Company v. Public Utility Commission*, 294 U.S. 63, 73 (1934).

jurisdictional revenues would have amounted to \$1.17 billion for 1980, if 100 percent CWIP had been included in rate base. A group of wholesale customers prepared a similar analysis, using 1979 aggregated data for the 42 utilities whose bonds were rated BBB/Baa.⁸² Under this analysis wholesale customers found that a 100 percent CWIP policy would increase rates initially by an average of 17.4 percent.

Another study prepared by the trade association of investor-owned utilities simulates the effect on rates of two hypothetical utilities of including 100 percent CWIP in rate base.⁸³ The two utilities differ according to financial resources, technology, and the mix of existing generation plants. The study concludes that inclusion of 100 percent CWIP in rate base would typically result in initial rate increases of less than 10 percent and, over time, lead to rates that fall below AFUDC-based rates.

The Commission finds that these analyses are not unreasonable, given their intended purpose of evaluating the rate impact of a 100 percent CWIP policy. However, this approach necessarily overstates the impacts that could be expected from the final rule. If 50 percent of CWIP were included in rate base, the impacts found in these studies would be essentially half those predicted. However, since the amount of CWIP which may be included in rate base is further limited in the initial years following the effective date of the final rule, these effects will be further restrained at the outset. The final rule phases-in the amount of CWIP allowable in rate base over a two-year period by limiting the rate impact associated with CWIP to six percent in the first year and an additional six percent in the second year. Thereafter, a utility may include up to 50 percent of all CWIP in rate base. This initial limitation on CWIP in rate base ensures that, in those instances in which utilities have disproportionately large construction programs, the initial impacts of the final rule on consumers will not be severe.⁸⁴ The Commission's

analysis indicates that, without the initial rate increase ceilings, there would be some cases in which relatively large amounts of CWIP costs could initially be included into rate base. Most utilities have modest amounts invested in ongoing construction and will be able to include the maximum allowable amount of CWIP in rate base without approaching the rate increase limitation in the rule.⁸⁵

If all utilities subject to the Commission's jurisdiction received the maximum rate base treatment of CWIP permitted by the final rule (absent any six percent initial limitation), the study submitted by the municipal trade association suggested that the resulting rate impacts would have been \$580 million. As a percentage of 1980 wholesale revenues (\$9.71 billion), this would have amounted to a rate increase of less than 6 percent to affected customers, less than the limitation which the Commission imposes under § 35.26(d) on utilities individually. Under the 50 percent CWIP in rate base approach adopted in the final rule, the impact on the sample of 42 BBB/Baa rated utilities analyzed by the other wholesale customer group would have been 8.7 percent. Under the study supported by investor-owned utilities through their trade association, the initial rate increase, assuming 50 percent of CWIP in rate base, would have been less than 5 percent on average.⁸⁶

These projected rate increases do not, of course, reflect the 6 percent limit on CWIP-related rate increases for individual utilities. This limitation is established in order to restrain any severe effects that could be experienced in the early years of the new rule due to the potential inclusion in rate base of

requesting CWIP. However, some utilities recognize that a phase-in of any CWIP relief would reduce the immediate rate impact and would provide a smoother price path with more predictable rates. Wholesale customers state that the four bases for limiting CWIP in rate base should be retained if the final rule does not provide a case-by-case determination of the CWIP request. The final rule provides expressly for an initial limit on rate impacts. The other factors are provided for in the course of Commission proceedings (e.g., price squeeze and prudence considerations).

⁸² See Table No. 4 of the Appendix to this rule.

⁸³ On average, the long-term impact estimated in the investor-owned utilities trade association study is unclear. That study finds that CWIP-based rates will fall below AFUDC-based rates but does not present any time series on these prices. The conclusion that CWIP-based rates will be lower in the long-term is supported only by present value analyses which, in turn, are based upon evaluating rates beyond the period during which plants were being constructed. The Commission is thus able to ascertain whether their conclusion is based upon the assumed reduction in construction activity or whether CWIP-based rates fall below AFUDC-based rates even if there is a continuation in construction.

large amounts of CWIP previously excluded from rate base. In the first two years under the rule, CWIP-related rate impacts are limited to six percent annually. The results of all the studies submitted by commenters also presuppose that the utilities will file immediately to include a maximum allowable amount of CWIP in rate base. The prospect for this is by no means certain. In sum, the wholesale customers and investor-owned utilities trade association's studies, if similarly adjusted for a policy of 50 percent of CWIP in rate base generally reflect rate increases of between five and six percent. The more limited sample used by wholesale customers which yielded an adjusted impact of 8.7 percent is an aberration because BBB/Baa rated utilities are not representative of the industry. Nonetheless, the three studies yield roughly similar estimates of initial rate impacts. Methodologically, there may be other ways of ascertaining the relative value to consumers of CWIP and AFUDC policies, as the commenters suggest.

Utilities and their customers hotly debate the impact of CWIP in rate base in terms of whether CWIP in rate base is less costly to ratepayers than the accrual of AFUDC under a present value analysis. Present value analysis is a means of evaluating the relative value of alternative investments where differences exist in the time pattern of cash flows. It takes into consideration the time value of money—i.e., that a dollar now is worth more than a dollar some time in the future—by discounting the cash flows with a discount rate reflecting alternative uses of money. This analysis is typically performed to ascertain the value of the revenues paid to utilities by consumers both with and without CWIP in rate base. Depending on whether the present value of revenue requirements with CWIP in rate base is less than, greater than or equal to that without CWIP in rate base, consumers should (solely on the basis of cost) prefer, not prefer or be indifferent to CWIP being included in rate base.

For the most part this debate has centered upon the appropriate consumer discount rate to use in evaluating the required revenue streams. In this respect, commenters argue whether the rate should reflect returns available to consumers on high risk (speculative investments) or low risk (passbook savings), and on large or small-sized and on long or short-term investment alternatives. They debate whether these alternative returns should be placed on a before or after-tax basis. In general, wholesale customers tend to argue for

⁸² See Oglethorpe Power Corp., *et al.*, Initial Comments, at 24 and Exhibit SEC-5.

⁸³ See Edison Electric Institute, Reply Comments, at Appendix V.

⁸⁴ In the Notice of Proposed Rulemaking, the Commission delineated four factors relevant to determining whether the amount of CWIP allowed in rate base under the proposed mechanical rule should be reduced or phased-in. See 48 FR at 39,455. These considerations, which could involve protracted case-by-case review, are short-term rate impacts, price squeeze, management prudence, and the need for power. In response to this proposal, several investor-owned utilities and an accounting firm state that such an open-ended provision would subject requests for CWIP in rate base to a volume of challenges that would deter utilities from even

factors that support the use of a high consumer discount rate while utilities argue toward a low discount rate. Some commenters further question the feasibility of establishing a single rate that could reasonably represent the interests of the spectrum of ratepayers affected by CWIP policy.

Comments from both utilities and customers contain present value analyses for single projects using varying discount rates which yield conflicting conclusions. A number of commenters point out that, assuming no cost differences between the two policies (such as a lower cost of capital), consumers would be indifferent to the policies assuming their discount rate was equal to the utility's after-tax cost of capital. With a discount rate below the utility's after-tax cost of capital, consumers would prefer CWIP in rate base over the capitalization of AFUDC, and would not prefer CWIP in rate base if the consumers' discount rate is higher. Further, if the inclusion of CWIP in rate base reduces some costs, such as capital costs, the discount rate would make consumers indifferent to CWIP or AFUDC may be lower than the utility's after-tax cost of capital.⁸⁷ Some wholesale customers also argue that present value analyses assume that customers remain on the system throughout the operating life of the plant. Otherwise they would not receive the full benefits of lower prices during the operating life.

Some wholesale customers comment that it is more appropriate to evaluate present value in the context of a utility involved in multiple construction projects over time. One commenter submitted a study that it claims shows that, under certain conditions, the present value of CWIP-based revenue requirements will exceed the present value of AFUDC-based revenue requirements.⁸⁸ This study finds that, as long as either the nominal percent growth in CWIP (reflecting growth as a function of physical growth and inflation), or the consumers' discount rate is greater than the utility's after-tax cost of capital, the present value of CWIP-based revenue requirements will exceed the present value of AFUDC-based revenue requirements. Under these circumstances, this study concludes that consumers would be penalized if CWIP were included in rate base. The commenter alleges that the

conditions for this occurrence are fairly likely but presented no support for this other than citing the hypothetical values used in the 1978 study.

The utility trade association⁸⁹ responds to this study by arguing, on various grounds discussed above, that the utility's cost of capital exceeds the consumers' discount rate. Further, this commenter states that it is not logical to expect that the growth rate in CWIP will exceed a utility's cost of capital forever, as the study assumes. Data is presented for the 11 largest bulk power suppliers to REA borrowers which shows, among other things, that seven of the 11 exhibited negative growth in CWIP for at least one year of the last five.

The Commission finds merit in the arguments on both sides of the issue of the present value of CWIP-based versus AFUDC-based rates. For example, the range of reasonable consumer discount rates is arguably wide since the customers affected by the rule are diverse. Some positions are persuasive. For example, the Commission agrees with the wholesale customers that single project analyses may be misleading since most utilities are continuing to add facilities over time and customers pay rates based on the appropriate share of all of a company's power supply facilities. A present value analysis should reflect whole company or industry conditions, including growth in capital investment.

Rates that include CWIP in rate base may eventually fall below AFUDC-based rates for some companies and thus be less costly for their consumers (as a group) than AFUDC-based rates, on the basis of present value analysis. However, this eventuality will depend on the pattern of investment of each utility, as well as such factors as efficiency gains and rates of return.⁹⁰

For the industry as a whole, the Commission believes that, under plausible assumptions of future demand growth and inflation,⁹¹ CWIP-based rates may remain somewhat higher than AFUDC-based rates for the foreseeable future. This conclusion is based on a comparison of rates made in terms of absolute dollars. Assuming CWIP-based

rates are slightly higher for the foreseeable future, as the Commission concedes is plausible, no present value analysis will show that CWIP-based rates are less costly to customers than AFUDC-based rates, regardless of the consumer discount rate utilized.⁹² Accordingly, it is not necessary for us to attempt to resolve the difficult question of the appropriate consumer discount rate. With respect to the separate question of how large the difference between CWIP-based rates and AFUDC-based rates may be, however, the Commission turns to analyses that are based on the absolute dollar levels of these rates that provide a clearer picture of probable future rate impacts.

The Commission had independently analyzed the rate impact of a 50 percent CWIP policy in two studies. In one study (the FERC staff study), a model⁹³ is used to calculate the initial-year rate impacts of a 50 percent CWIP policy on 141 electric utilities. The FERC study produced initial-year rate impacts for individual utilities by computing the incremental effects on rates, cash flow, and certain financial ratios that would occur if 50 percent of CWIP were included in rate base. The first year rate impacts calculated are an average increase of 4.70 percent with a standard deviation of 4.04 percent. This analysis did not incorporate the initial rate impact limitation provision of the final rule based upon a maximum rate increase of six percent in each of the first two years of the rule's effectiveness. When the six percent ceiling is considered, the average initial price increase to affected customers predicted by the FERC study is reduced to 3.57 percent. The distribution of rate impacts for the 141 utilities studied indicates that the great bulk of utilities would experience a very modest initial increase in rates although four individual utilities could experience initial year increase in jurisdictional rates on the order of 16 or 17 percent absent the 6 percent limitation. The distribution of these impacts is presented in Table 4. The FERC study indicates that, even with a 6 percent limitation on rate increases for the first two years, all jurisdictional utilities would be eligible for the maximum 50 percent CWIP in rate base by the end of the third year.

⁸⁷ This is consistent with a FERC staff study. See "Proposed Computer Model," *supra*.

⁸⁸ Oglethorpe Power Corp., *et al.*, Initial Comments, at 34 citing Livingston and Serali, *Construction Work in Progress in the Public Utility Rate Base: The Effects of Multiple Projects and Growth*, 8 Fin. Mgmt. 1 (1979).

⁸⁹ Edison Electric Institute (EEI), Reply Comments, at Appendix III.

⁹⁰ In this connection, the Commission believes that EEI is in error when it states that growth rates in CWIP must always exceed the utility's after-tax cost of capital in order that the present value of CWIP-based revenue requirements exceed that of AFUDC-based revenue requirements. While a drop in growth for one year may cause CWIP-based rates to fall temporarily below AFUDC-based rates, average CWIP-based rates may remain above AFUDC-based rates as long as the average growth rate exceeds the utility's after-tax cost of capital.

⁹¹ See Section III, *supra*, and Chart No. 1, *infra*.

⁹² Present value analysis has other limitations. It measures value only in terms of the cost of money discounted to present value. Present value analysis does not account for occurrences, such as efficiency gains or enhanced reliability, that may cause CWIP-based rates to benefit consumers in other ways.

⁹³ See Proposed Computer Model, *supra*; see also the Environmental Assessment § 4.1.2.

The second study of the rate impact of including 50 percent CWIP in rate base is the EIA study. The study estimated national and regional average price impacts of a 50 percent CWIP policy (without the phase-in provision) for the period 1982 to 1995. It found that the increase in prices attributable to including CWIP in rate base would be greatest in the early years and diminish over time (see Chart No. 1 below).^{*} While this trend is predicted for each of the regions and nationwide, the level of rates would vary among regions.

The Commission believes that the methods and assumptions used in the EIA Study bias the initial impacts downward but that the nationwide impact estimates for 1985 and beyond are probably reasonable. The FERC model probably provides more accurate estimates of initial impacts and these impacts are consistent with the results of the studies submitted by commenters.

While in some regions, according to the EIA Study, CWIP-based rates fall below AFUDC-based rates prior to the end of the study period, as shown in Chart No. 1 no crossover was predicted for the nation as a whole. The lack of a crossover point results from the assumptions built into the model regarding growth in capacity additions, inflation, and cost of capital. Given the small difference between CWIP-based rates and AFUDC-based rates beyond 1990, it would appear reasonable to presume that some combination of relatively small reductions in growth rates, inflation or capital costs below those assumed in the model would result in a crossover.

It may well be that, with more accurate price signals, more accurate forecasting, and more efficient construction planning made possible by this rule, the nationwide average rates under this rule by 1990 will in fact fall below those that would result if no change were made. But we are prepared to proceed even if they do not, particularly in view of the generally modest rate impact which this rule may be expected to generate. The reason, as stated in Section III above, is that our regulatory responsibility is both to protect the rate-payer from high rates, while at the same time ensuring that utilities will continue to provide economic and reliable utility services, now and in the future. Accordingly, even if rates are somewhat higher over time under the final rule, the Commission believes that the rule is in the public

interest because it will enhance the quality and reliability of service and the more efficient use of our nation's scarce capital and natural resources.

b. *Consumption; Price Signals.* The inclusion of CWIP in rate base has the potential to affect the management practices of utility companies. It also has another significance for economic behavior—that is, it may affect how ratepayers use and pay for power. Commenters dispute whether the inclusion of CWIP in rate base provides ratepayers with more accurate signals about the real cost of power than does an AFUDC policy. Investor-owned utilities and their trade association state that electric rates which are based on substantial amounts of the old plant, and which often cost a fraction of the new plant do not account for the utility's plant under construction, and do not reflect the true cost of providing service. This view suggests that an AFUDC policy leads ratepayers to think that electric power is and will remain less costly than is the case at any one time. An industry observer states that partly as a result of an AFUDC policy, electricity is currently priced at 70 percent of its actual marginal cost. This commenter concludes that rates that do not reflect marginal costs, incorrectly signal consumers as to both present and future cost of electricity. These inaccurate price signals perpetuate excessive use of electric power, artificially inflates demand, and defeats conservation objectives.

In response to the contention that CWIP provides more accurate price signals, wholesale customers state that an AFUDC policy provides the more accurate price signals. Wholesale customers raise two points in this regard. First, they argue that the facility under construction will generally operate at a lower fuel cost than the utility's average current fuel cost. Therefore, when the new plant becomes operable, the increased fixed costs are somewhat offset by reduced fuel costs. However, these commenters argue that because CWIP in rate base will not be offset by these anticipated fuel cost savings, the price of power which includes CWIP will overstate the actual future costs. Second, wholesale customers state that, if the cost of power generated by new facilities is less than from existing facilities,^{**} the future cost

of power will decline. If CWIP is included in rate-base, these commenters argue, the price signal supplied to ratepayers is that costs are rising, when in fact they are not.

Because consumers should be expected to use power rationally, the Commission believes accurate price signals are important. The Commission believes that CWIP-based rates provide a more accurate picture of trends in power costs. As we stated above, demand for power will increase in the future requiring some new capacity construction. Capacity costs in real terms have been increasing over the last decade. By pricing electricity at average system costs, trends in costs and therefore in rates tend to be understated. Because rates do not reflect the cost of providing the incremental unit of electricity required to serve new demand, a customer receives a price signal which may vary from the true cost to the utility of providing service.

Undeniably, CWIP in rate base, to varying degrees, will increase present rates. Those rate increases inform purchasers of power of the increased costs of providing service to them. As stressed above, we anticipate that including CWIP in rate base will tend to provide more accurate price signals to consumers leading to more efficient consumption (and investment) decisions.

3. *Other Rate-Related Issues.* a. *Price Squeeze and Undue Price Discrimination.* Among its responsibilities, the Commission is obligated to foster competition in the electric utility industry, particularly at the wholesale level. Price squeeze is the term used to describe price discrimination that has an anticompetitive effect and that is directed against an electric utility's wholesale customers. A price squeeze exists if a utility's price for wholesale service is higher in relation to wholesale costs than is the utility's price for retail service in relation to retail costs, resulting in actual or potential impairment of the wholesale customer's ability to compete with the utility for that retail service.

In the Notice of Proposed Rulemaking, the Commission stated that it would explore, in each case in which the "price squeeze" issue is raised, the factors which can contribute to a finding of "price squeeze" and undue discrimination, including the inclusion of CWIP in rate base.^{**} The Commission

^{*} Chart No. 1 is not being published in the Federal Register, but is in copies of the order available through the Commission's Division of Public Information.

^{**} DOE states that a nuclear plant which is intended to replace base load oil-fired capacity is an example of a new plant which will reduce the overall price of electricity to consumers.

^{**} 46 FR 39,450.

also stated that it intends "to retain the flexibility to deny CWIP in rate base or modify other cost of service methods as possible remedies after a finding of undue discrimination" and that it will not limit the denial of CWIP in rate base to those circumstances in which the CWIP policy of the relevant state differs from the Commission's policy. Nevertheless, the potential for a price squeeze or other undue price discrimination in particular cases is not an obstacle, in the Commission's view, to a change in its CWIP policy.

With respect to retail power sales, several wholesale customers believe that the inclusion of CWIP in rate base will create a price squeeze and that a final rule should be drafted so as to avoid any possibility of such a price squeeze. Others among this group of commenters pointed out that the potential for price squeeze precludes the inclusion of CWIP in rate base altogether, except in specific cases where price squeeze would not occur. Other wholesale customers state that the rule should operate to limit the inclusion of CWIP in rate base if a price squeeze is found to exist.

Wholesale customers also view CWIP in rate base as an impairment to competition in the wholesale power market in other respects. These commenters anticipate that CWIP in rate base will require wholesale power customers to invest in the plant of their power suppliers, thereby deterring them from changing power suppliers for fear of losing "their" investment. Wholesale customers also argue that CWIP in rate base will make joint ownership of generation facilities impossible for municipal and cooperative utilities whose resources will be strained by having CWIP in their rates.

Investor-owned utilities claim that CWIP in rate base will not cause a price squeeze because of its small impact in relation to the total cost-of-service and the fact that the majority of states already allow varying amounts of CWIP in rate base, thereby lowering the chance of price squeeze occurring when the Commission allows CWIP in rate base. Commenting utilities state that, in any case, consideration of the issue should await a *prima facie* showing of price squeeze in individual cases, rather than be dealt with in a generic rulemaking. In sum, these commenters maintain that CWIP should be addressed in the same manner as any other cost-of-service or rate base item which may cause a price squeeze.

The Commission has considered the potential for price squeeze from this rule. No substantive evidence establishing the occurrence or likely

occurrence of a price squeeze was submitted in this record. The Commission's own analysis confirms that the final rule does not generally create price discrimination where it does not otherwise exist, although, as the percentage of CWIP in rate base increases, the likelihood of some price discrimination also appears to increase.⁹⁶ Accordingly, with respect to the arguments of wholesale customers, the Commission finds no indication that undue price discrimination or other anticompetitive effects will occur necessarily as a result of implementing the final rule.

Price squeeze or undue discrimination issues may be examined as they might arise in particular cases. The Commission, of course, retains flexibility to deny inclusion of CWIP in rate base or to modify rate treatment of other cost-of-service items as a means of remedying a problem after a finding of undue discrimination. But we do not believe that the rule must operate to automatically deny CWIP simply because a price squeeze is found to exist. If such action is appropriate, it will be based on determinations made on a case-specific basis.⁹⁷

b. *Rate Stability.* Investor-owned utilities, an accounting firm, and a university-sponsored analysis show that the sudden increase in rates which under an AFUDC policy accompanies the completion of a new facility, is lessened if CWIP is included in rate base. These commenters state that the inclusion of CWIP in rate base helps smooth the price path of electricity for two reasons. First, as a utility proceeds to construct a new plant, CWIP is gradually included in rate base with a consequent gradual increase in rates and a relatively stable rate pattern. Under an AFUDC policy, the total costs of the completed plant, including the accumulated financing costs, is included in rate base at the time the plant is made operational. As a result, the next rate filing by the utility will reflect a sudden jump in rates. Second, CWIP in rate base results in quantitatively smaller total additions to rate base than under AFUDC, because the financing costs capitalized over time are included in rate base as part of the total cost of the plant. Under a CWIP policy financing costs are recovered currently.

Wholesale and retail customers state their preference for lower current rates

and do not express a concern with regard to the price path that results from an AFUDC policy. Rather, these commenters focus on the relative value of the rates and not the stability of rates over time.

The CWIP approach reduces the total addition to rate base at the time of completion and helps stabilize rates. The lumpiness in rates which occurs under an AFUDC policy is ameliorated by the gradual inclusion of CWIP over a longer period of time. To further smooth the price path of rates under a CWIP in rate base policy, the final rule incorporates a phasing provision which limits the rate increase attributable to CWIP to six percent in the first year and another six percent in the second year after the effective date of the rule. This provision responds to the Commission's concern which was expressed in the short-term price impact "safety-value" of the proposed rule and will ensure that the initial rate impact of the final rule will not be severe. As a result, consumers will be protected from financial shock or economic dislocation as a consequence of any precipitous increase in rates that may occur when the final rule takes effect.

E. Alternative Methods of Providing CWIP Relief

The Commission approached with an open mind the question of how its policy on CWIP in rate base might be improved. The Notice of Proposed rulemaking presented a number of alternative CWIP policies and requested that commenters propose additional alternatives. One approach discussed in the Notice was a mechanical rule which utilizes a threshold test of whether a particular utility is experiencing financial distress attributable to a construction program. Virtually all commenters are critical of this approach and, for a variety of reasons, favored other alternatives.

Investor-owned utilities generally support inclusion of a fixed percent of CWIP industry-wide, with 100 percent as the preferred percentage. In contrast, wholesale and retail customers generally oppose all of the proposed CWIP alternatives, urging retention of the present rule in § 2.16 of the Commission's regulations. Some customers also suggest that, if the Commission is determined to allow CWIP, consideration should be given to including only the interest costs associated with CWIP or some alternative that would make clear the ratepayers are investing in the utilities (contributions in aid of construction or capital certificates methods).

⁹⁶ See Environmental Assessment, *supra*, at § 4.2.5.

⁹⁷ This is consistent with our stated policy not to remedy a price squeeze if it is due solely to state regulatory action or inaction. See Opinion No. 157, Pennsylvania Power Co., Docket No. ER77-277-002, *et al.*, 21 FERC ¶ 61,313 (December 21, 1982).

The Commission stated in the Notice that "the specific formulation * * * in § 2.16 has not proven to be satisfactory." The present "financial distress" rule has produced "protracted and complex litigation" that, in several cases, lasted three or more years. In addition, few requests for CWIP relief have been made under the rule and in only one recent case has CWIP actually been allowed in rate base to relieve financial distress, subject to refund pending final determination of the rates.⁹⁸ Although utilities have not made extensive use of the financial distress provision for CWIP, the Commission noted that since the inception of this rule, the financial condition of the electric utility industry had deteriorated.

The comments focus on six alternative methods for treating construction financing costs: three that would include various amounts of CWIP in rate base, one that would track individual state CWIP policies, and two that are alternatives to including CWIP in rate base. Although other methods are discussed in the record of this proceeding, the range of approaches that commenters critically evaluate are: (1) Inclusion of a portion of CWIP in rate base according to a formula, including a threshold eligibility criterion; (2) CWIP included at a specific time in the construction of particular facilities; (3) a fixed percentage of all CWIP in rate base; (4) deference to the treatment of CWIP in rate base afforded by the relevant states; and (5) contributions in aid of construction.

1. *Mechanical Inclusion of CWIP in Rate Base: Low Bond Ratings Test and the Ratio of CWIP to Rate Base.* The alternative most prominently highlighted in the Notice is a formulary approach predicted upon a showing of financial distress. Under this approach, the financial distress standard is restated as a two-pronged test. This test requires, first, that utility's first mortgage bonds be rated BBB/Baa or lower, and second, that CWIP exceed 40 percent of jurisdictional rate base. Having met these tests, a utility would be presumptively eligible for rate base treatment of sufficient CWIP to reduce CWIP outside rate base to not more than 40 percent of the whole. However, the Commission could limit or deny rate base treatment on certain specified grounds.

All interests represented in this proceeding were critical of this approach, including investor-owned utilities that oppose any financial distress standard. Wholesale customers

contend that a formulary approach is imprecise and would lead to inequities, such as providing relief to utilities whose financial difficulties are not caused by construction programs.

Commenters on all sides of the issue criticize bond ratings as unreliable indicators of a utility's financial condition. They point out that the Commission is obligated to exercise its independent judgment rather than rely upon the decisions of private rating agencies. Investor-owned utilities, on one hand, criticize the level of bond rating (BBB/Baa) that triggers the rule as too low to provide adequate relief. Wholesale customers, on the other hand, argue that such a rule would aid utilities that are not in distress. With respect to the second prong of the proposed rule, that is, the ratio of jurisdictional CWIP to jurisdictional rate base, both investor-owned utilities and wholesale customers find this standard to be arbitrary, lacking any basis in economic fact, and inappropriate for measuring the needs of individual utilities.

Overall, investor-owned utilities believe that the proposed mechanical rule is subject to many of the same criticisms of the existing rule, namely, that it would not grant adequate or timely relief. In other words, such a rule would create uncertainty regarding the ultimate availability of relief and would provide too little revenue to protect the financial integrity of the utility. An investor-owned utility states that the proposed rule would initially provide CWIP relief to as few as 11 utilities and would only minimally increase cash flow. Other investor-owned utilities state that requiring a utility to experience severe financial distress before relief is available is a poor regulatory practice because it needlessly exposes utilities to the vagaries of the capital markets. In addition, these commenters criticize the proposal because CWIP rate relief would be reevaluated in each subsequent rate case to determine continued eligibility adding uncertainty regarding the continuity of relief.

Several investor-owned utilities, state regulators, and accounting firms suggest that other financial criteria, such as market-to-book ratios, the ability to pay dividends from current earnings, or average industry financial ratios, would better represent the financial condition of a utility than the two tests proposed in the Notice. One state regulatory authority states that any viable formula should (1) limit AFUDC to 20-40 percent of income available to common stock; (2) require that interest coverage ratios be 3.5 to 4.0, excluding AFUDC; and (3)

specify that a minimum of 40 percent of the utility's capital requirements be internally-generated cash.

The Commission continues to believe that the existing mechanism for including CWIP in rate base is inadequate. The main approach articulated in the Notice is a refinement of that policy developed in light of the industry's financial difficulties perceived at the time that the Notice was issued. The strong criticism by all groups of commenters suggests that incremental adjustments to the existing CWIP policy will not substantially increase the effectiveness of the rule. A financial distress test limits relief to utilities that are already experiencing a deteriorating financial condition that invariably impairs credit-worthiness and raises capital costs. As a result, the timely completion of construction projects may be jeopardized. Moreover, a financial distress test creates uncertainty in terms of the availability of relief. By attempting to discriminate among utilities, a financial distress test may not clearly signal when and where rate relief is likely. Since financial health is not easily restored to a company, it may not serve the public interest to withhold rate relief until after the financial condition of a utility has deteriorated.

Another problem with the proposed rule is its failure to provide adequate rate relief to utilities in severe financial difficulty. The Commission's own analysis⁹⁹ confirms the contention of commenters on both sides of the CWIP issue that under the proposed rule, qualifying utilities would receive only a minimal increase in cash flow. This would be a wholly inadequate remedy to utilities in severe financial difficulty. The limited nature of the Commission jurisdiction exacerbates this problem. A policy that is reactive to financial difficulty is, therefore, flawed insofar as the available relief will likely be inadequate.

2. *CWIP at a Specified Time Before a Facility is Placed in Service.* An alternative to the mechanical CWIP rule set forth in the Notice is the inclusion in rate base of some or all CWIP at a specified time before the particular facility is placed in service. Several states currently permit the inclusion of CWIP in rate base for projects that are one or two years from being completed. Few commenters directly analyze this approach. Several wholesale customers suggest that this timed inclusion of CWIP in rate base should pertain only to

⁹⁸ See Montaup Electric Co., Docket No. ER82-325-000, 19 FERC ¶ 61,062 (April 20, 1982).

⁹⁹ See Environmental Assessment, *supra* at ¶ 4.3.2.

certain types of plants—namely, conservation programs, load management equipment, and transmission plant. An investor-owned utility suggests limited CWIP in rate base to base load generation facilities. The wholesale commenters state that allowing CWIP at a specified time before completion of the facility would increase cash flow late in the construction cycle, when carrying costs and the need for rate relief are greatest. Moreover, this approach is said to ameliorate the sharp increase in rates that typically results under an AFUDC policy when new generation facilities become operable. These commenters state that limiting CWIP in rate base until late in the construction cycle will provide management with an incentive to complete construction projects.

The primary criticism of this approach from investor-owned utilities is that it fails to substantially improve utility cash flow or interest coverage ratios. Although one investor owned utility states that if all CWIP were allowed after the plant was 50 percent completed there would be effective relief, the prevailing view is that the relief afforded would be inadequate.

In the Commission's view, this alternative, while having some of the advantages of the 50 percent rule, is not the best approach. This alternative may lessen but will not prevent potentially steep rate increases similar to those under an AFUDC policy that occur when new plants go on line. With the long lead times on certain types of generating plants, CWIP balances may grow to very high levels before being placed in rate base under this alternative.

3. Fixed Percentage of CWIP in Rate Base. The Notice proposed a third distinct method of including CWIP in rate base. This approach would allow all utilities to file to include an amount of CWIP not to exceed a uniform percentage of jurisdictionally-allocated CWIP. There would be no case-by-case determination of financial need, as under both the present rule and other proposed alternatives. This type of CWIP relief would be available to any utility, regardless of financial condition, thereby obviating debate over the appropriate standard for determining financial difficulty.

Commenters on both sides of the CWIP issue analyze the fixed percentage approach extensively. Investor-owned utilities strongly support placing 100 percent of CWIP in rate base and they appear to contend that any fixed percentage approach will provide greater relief to utilities than other proposals. They also believe that a fixed percentage approach will give the

clearest signal of, and regulatory impetus toward, the financial recuperation of utilities.

In response, wholesale customers and retail consumers oppose the inclusion of a uniform amount of CWIP in rate base. Because wholesale customers believe the overall financial condition of the industry to be improving, they view this alternative as unnecessarily costly, particularly with respect to utilities that have adequate cash flow, interest coverage ratios and, in general, a strong financial condition. These commenters state that, because the problems of individual utilities can be traced at least in part to management failures, this approach will only reward ineffective management. These commenters view CWIP in rate base as an extraordinary remedy, the availability of which should be limited. This suggests that only a rule that interposes threshold criteria for CWIP relief would be acceptable. Given this viewpoint, opponents of CWIP do not examine whether a fixed percentage of CWIP under 100 percent would be equitable.

The final rule in this docket adopts a fixed percentage approach that allows any utility to file to include up to 50 percent of all CWIP in rate base in addition to any CWIP related to fuel conversion or pollution control facilities. This formulation has definite advantages for both utilities and ratepayers. A utility will receive a predictable quantum of rate relief over the entire construction period that will likely improve the cash flow, interest coverage, and other financial variables of utilities.

One main consideration supports including a uniform amount of capital investments in rate base. That factor is predictability. A fixed amount of CWIP in rate base provides adequate cash flow in a way that is most valuable to utilities during a construction cycle and in a way that minimizes the potential for repeated litigation of a utility's conformance to threshold standards. It affords utility management a predictable return on current investment and thereby an opportunity to choose construction projects that best serve long-term needs rather than projects that are merely affordable in the near-term because their carrying costs are least oppressive. A fixed percentage of CWIP in rate base, included irrespective of a utility's financial condition, constitutes preventive medicine rather than a curative measure. The overall impact will be an improved outlook for electric supply and reliability. If rate stability and optimal planning for capacity are desired objectives, a fixed percentage of CWIP in rate base has the

advantage of carrying forth those objectives with certitude and consistency.

Finally, the Commission chooses the 50 percent approach because it more evenly balances the equities due present and future ratepayers. The final rule requires present ratepayers to be responsible for a portion of a financial burden which traditionally was borne by future ratepayers. Both present and future ratepayers share an interest in continued service reliability. By implementing a 50 percent CWIP policy, the Commission is opting to split this cost responsibility.

4. Inclusion of CWIP in Rate Base to the Extent Permitted by States. Under this approach, as presented in the Notice, the inclusion of CWIP in a utility's wholesale rate base would depend upon the CWIP policy of the state regulatory authority that regulates the retail rates of the utility. The objective of such an approach, from the Commission's perspective, would be a uniform treatment of CWIP in the utility's wholesale and retail rates. In those cases where the utility is wholly or predominantly regulated at the federal level, the Commission would independently determine the appropriateness of a request for CWIP rate relief.

Several commenters, including two state regulatory authorities, support this approach because, in their view, it defers to state policies. These commenters state that, at least in those states that allow substantial amounts of CWIP in rate base, this approach would have the advantage of combining federal and state CWIP to achieve a maximum impact. Moreover, this approach eliminates the possibility of price squeeze resulting from differing federal and state CWIP policies and is claimed to reduce the unfair burden on retail customers that heretofore have been subsidizing wholesale customers.

The Commission has chosen not to adopt this approach for several reasons. The Commission must exercise independent judgment in all matters assigned to it by statute. By deferring to the disparate CWIP policies of the states, the Commission might be viewed as having abdicated its responsibility. The significance and impact of deference to state policy would vary dramatically from state to state. In formulating the new rule, the Commission has nevertheless considered CWIP approaches employed by the states.

5. Contributions In Aid of Construction and Capital Certificates. As alternatives to CWIP in rate base,

several commenters propose the use of either contributions in aid of construction (CIAC) or capital certificates. These alternatives involve ratepayers directly supplying capital to finance utility construction programs rather than compensating utilities for the carrying costs on capital obtained from capital markets as under the CWIP in rate base alternative. Both the CIAC and the capital certificates alternatives involve mandatory loan assessments from ratepayers. The primary difference between CIAC and capital certificates is whether the loans are refunded to ratepayers. The CIAC approach requires that contributions be nonrefundable which is a requirement for obtaining nontaxable status. In contrast, the capital certificates approach requires the issuance of ownership certificates that earn a return and are redeemable at the time the associated plant is placed in service.

Several commenters state that, given favorable tax treatment, the CIAC method could provide utilities with the same amount of dollars during construction as the CWIP in rate base method but CIAC would further lower the long-run cost to ratepayers because of a reduction in utility tax expenses. One state regulatory commission supplies a plan for implementing the CIAC method. This commenter states that the amount assessed against ratepayers could vary to enable utilities to achieve the same cash flow as under a policy of including varying amounts of CWIP in rate base. Capital derived from CIAC would be placed in a restricted account to be used solely for construction and would also have to meet all Internal Revenue Service requirements for nontaxable status. This commenter also presents a numerical example which, it states, shows that the CIAC method would produce lower revenue requirements over the life of a plant than the AFUDC and CWIP methods based on both absolute or present value dollars.

A group of wholesale customers proposes the capital certificates method. One benefit of the capital certificate method is that customers are treated as investors and do not have to remain customers to receive a return on their investment. This is said to resolve the problem of interperiod equity. The certificates would be redeemable when construction on the new facility is completed. The interest rate on the certificates could be based upon the rate the utility is paying other lenders, the prime rate, or some formula. However, this commenter states that purchase of capital certificates by ratepayers should

be required only when a utility shows that normal capital market alternatives are unavailable.

Investor-owned utilities state that the CIAC and capital certificates approaches are inappropriate and ineffective as alternatives to CWIP in rate base. They argue that while CIAC is appropriate to finance unique service requirements to specific customers or customer groups, it is not an appropriate mechanism for capital investments that are intended to benefit the system generally. These commenters state that CIAC would not ensure investors and utility management of long-term stability in cash flow since such funds are generally viewed by investors as one-time cash advances from ratepayers.

A group of investor-owned utility commenters state that CIAC is less effective than CWIP in rate base because CIAC only reduces the amount of capital a utility would otherwise obtain from the capital markets. This commenter states that the reduction would affect only a fraction of a utility's construction requirements. Under the CIAC approach, this commenter states that earnings quality would remain poor and external financing needs would continue to erode interest coverage. However, the commenter states that CWIP in rate base is an efficient way of improving interest coverage and quality of earnings.

Several investor-owned utilities argue that the Internal Revenue Service will not grant the contributions nontaxable status. They further argue that the CIAC approach suffers from the same interperiod equity problems as CWIP in rate base.

Several observations can be made with respect to CIAC and capital certificates. In this proceeding, the proposal to use CIAC goes far beyond its historical purpose. For instance, all customers would be required to supply capital as CIAC. Moreover, the assessment of CIAC would be based upon the cost of plant intended to serve the needs of all customers, rather than an individual customer or a defined customer group. These deviations from the conventional use of CIAC bring into question the federal tax treatment that will be accorded capital provided by ratepayers in the form of CIAC. Because tax-exempt status is necessary for CIAC to be less costly than CWIP in rate base, the uncertainty of this issue raises doubts as to the probable outcome were CIAC to be adopted. Moreover, if capital collected through CIAC and capital certificates are not revenues to utilities, there will be no direct changes in either the quality of earnings or interest

coverage ratios. This is a significant drawback to the CIAC and capital certificates alternatives. While they may reduce the extent to which a utility must rely on conventional capital markets to obtain capital, these approaches may not improve a utility's ability to access capital markets.

The Commission believes that CIAC and capital certificates are not reasonable alternatives to placing CWIP in rate base. The tax treatment of CIAC, which is crucial to this approach, is unresolved. Moreover, the benefits to the utility industry appear to be far less than under a CWIP approach.

6. Other Alternatives. Commenters suggest several additional alternatives to the proposed rule. In particular, several environmental and consumer organizations propose a "soft-paths" approach as an alternative to CWIP in rate base, including enhanced efficiencies through power pooling or brokering, conservation, innovative load management programs, and cogeneration and small power production. These commenters state that the long lead time that creates the financial difficulties experienced by utilities that construct large generation facilities could be avoided through a "soft-paths" program.

Several investor-owned utilities state that utilities are vigorously pursuing conservation and alternative energy programs. However, these commenters argue that these alternatives do not supplant the need for CWIP. The potential for these programs may be vast, but the present realities require continued large scale construction programs. Moreover, one investor-owned utility argues that the financial need of utilities is for immediate aid, which this alternative does not offer.

The Commission is strongly committed to providing a regulatory framework which enables and encourages utilities to pursue "least-cost" energy strategies. In this vein, we applaud the increased efficiencies of power pooling and the development of economical energy resources, including cogeneration and small power production. Moreover, the Commission recognizes the importance of conservation. These are all areas where the Commission intends to continue its efforts wholly apart from the present rule.

Another alternative that wholesale commenters suggest is joint ventures between investor-owned utilities and public and cooperative utilities for constructing and operating large generation facilities. Several wholesale customers state that many successful

joint ventures have already been undertaken, particularly in cases where such development cannot occur without the participation of cooperatives and municipalities. These commenters state that joint ownership would ameliorate the anti-competitive aspects of the buyer-seller relationship in the wholesale power market.

Several investor-owned utilities state that they presently participate in joint ventures in constructing large generation facilities. However, one investor-owned utility criticizes joint ventures as distress sales by utilities which can be ascribed to mounting financial pressures. This commenter argues that such sales to public systems to achieve current solvency adversely impact the future cost of power. Several of these commenters state that, even to the extent joint ventures are feasible, they do not directly address the problems facing the industry today. The Commission need not address this question in the present rule, however. Our regulations neither prohibit nor require the formation of joint ventures in new plant construction.

F. Administrative Law Issues

1. *Environmental Considerations.* Subsection 102(c) of the National Environmental Policy Act of 1969 (NEPA) requires federal agencies to assess the environmental impact of "major Federal actions significantly affecting the quality of the human environment." NEPA requires that an Environmental Impact Statement (EIS) be part of any record of decision for such major Federal actions. An EIS is a detailed analysis of the environmental effects (including socio-economic impacts) of the proposed action and the evaluation of alternatives to the proposed action.

In order to determine the need for an EIS, Federal agencies prepare an Environmental Assessment (EA). An EA is a brief overview of the nature and probable effects of a Federal action. An EA has three principal functions. It aids the agency in determining whether to prepare an EIS. When an EIS is not necessary, it provides the basis for preparation of a Finding of No Significant Impact (FONSI). It also facilitates preparation of an EIS when one is necessary. Incidentally, the EA may bring to light technical facts of substantive importance for the underlying decisions.

Several commenters state that the CWIP rulemaking is a major Federal action which requires preparation of an EIS. In order to determine the need for an EIS, an EA was prepared for this

final rule.¹⁰⁰ The EA concludes that the final rule is not a major Federal action significantly affecting the quality of the human environment. An EIS is therefore not needed in this rulemaking. The Commission makes a Finding of No Significant Impact below.

2. *Regulatory Flexibility Act.* The Regulatory Flexibility Act (RFA) requires Federal agencies to consider whether the rule, if promulgated, will have a "significant economic impact on a substantial number of small entities." The Notice of Proposed Rulemaking contained a certification that the proposed rule would not have a significant impact on a substantial number of small entities. Several commenters, including the U.S. Small Business Administration (SBA), contend that the certification is in error and that an Initial Regulatory Flexibility Analysis (IRFA) should be prepared for this rule.

SBA argues that the Commission should have considered the impact of the proposed rule on wholesale and retail customers of the jurisdictional entities subject to rate regulation by the Commission. SBA also argues that because state regulatory authorities may follow the Commission's CWIP policy, this rule will economically affect ultimate retail electric consumers, many of which can be small businesses. SBA suggests that the Commission must prepare an IRFA that analyzes these possible impacts.

Contrary to SBA's assertion, the RFA does not require the Commission to consider the effect of this rule, a federal rate standard, on non-jurisdictional entities whose rates are not subject to the rule. The Commission, therefore, is not under a statutory obligation to study the impact of the CWIP rule upon wholesale or retail customers of any jurisdictional utility or upon other ultimate retail electric consumers. The certification in the NOPR did consider the effect of the proposed rule on jurisdictional utilities. No commenter stated that the analysis was incorrect with respect to these entities.

Second, in disagreement with SBA, several commenters, including two state regulatory authorities, maintain that states will not follow the federal policy. This will significantly limit the national impact of this CWIP rule. The Commission has no other information by which to anticipate the course of action which states may adopt for CWIP.

The final rule will affect the same jurisdictional entities as the proposed rule, although the impact may differ with respect to individual utilities. In the

NOPR, the RFA certification stated, in the text and footnotes,¹⁰¹ as follows:

Since nearly all of the jurisdictional utilities which must comply with the rule proposed here are too large to be considered "small entities,"⁴⁴ the Act is not applicable. Further, since the utilities regulated by the Commission hold exclusive selling rights within their service areas and are presumed to be natural monopolies, they dominate their respective fields of operation and, thus, cannot be considered to be "small entities" as that term is defined in the Act.⁴⁵

⁴⁴ Currently, 211 entities have rate schedules on file with the Commission. Of these, 184 are Class A or B utilities (having annual electric operating revenues of more than \$2,500,000 or \$1,000,000 respectively). 20 are other investor-owned utilities, 3 are industrially-owned, two are cooperatives, one is a state agency, and one is a non-profit organization. Thus, only 27 regulated entities complying with this rule have annual electric operating revenues of less than \$1,000,000.

⁴⁵ Section 601(6) of the Act defines a "small entity" as a small business, a small not-for-profit enterprise, or a small governmental jurisdiction. A "small business" is defined, by reference of Section 3 of the Small Business Act, as an enterprise which is "independently owned and operates [sic] and which is not dominant in its field operation." 15 U.S.C. 632(a) (Supp. 1981).

This analysis holds true for the final rule. The Commission considered the impact of the final rule on all jurisdictional utilities and on wholesale and retail customers and concludes that the impact would not be significant.¹⁰² Based upon the above reasons as well as the reasons stated in the NOPR, the Commission is again certifying that the final rule has no significant economic impact on a substantial number of small entities.

V. Finding of No Significant Impact

The Commission has prepared an Environmental Assessment (EA)¹⁰³ to determine the need to prepare an Environmental Impact Statement for the CWIP final rule. Based on the Environmental Assessment, the Commission has determined that the proposed action does not constitute a major federal action significantly affecting the quality of the human environment within the meaning of the National Environmental Policy Act of 1969, 42 U.S.C. 4321, *et seq.*

¹⁰⁰ 46 FR 39,453.

¹⁰² See Section IV, *supra*.

¹⁰³ The Environmental Assessment has been placed in the record of this proceeding and is available in: Office of Public Information, Federal Energy Regulatory Commission, 825 North Capitol Street, N.W., Washington, D.C. 20426.

¹⁰⁴ See Section V, *infra*.

No significant adverse impacts associated with implementation of the CWIP rule change are identified in the EA. Anticipated effects of the rule change are summarized below.

1. The rate impact of a 50 percent CWIP policy on wholesale customers would be highest in the early years of the policy change and diminish over time. One study—the EIA study—found that, nationally, the average rate increase to wholesale customers would be 1.10 percent, 2.27 percent, 0.56 percent, and 0.69 percent in 1983, 1985, 1990 and 1995, respectively. This trend would also occur in each of the regions studied although the level of rate impacts would vary. The initial impacts predicted by this study are biased downward. Another study—the FERC study—which evaluated only initial impacts found that the average initial impact would be about a 4.70 percent increase in wholesale rates with a wide variation among utilities. The estimated initial impacts of the FERC study overstate the true impacts. With the six percent ceiling on annual price increases attributable to CWIP during the first two years of the policy change, the average initial price increases predicted by the two studies would be reduced. With the six percent ceiling, the average price increase predicted by the FERC study would fall to 3.57 percent.

2. It is estimated that nationwide only one in 13 retail utility customers—households, commercial, and industrial establishments—would be affected by the Commission's rule change. Only one in 77 would experience an initial rate increase at about the six percent ceiling level. The proportion of retail customers affected would vary regionally. The impact on the retail customers of total and partial-requirement wholesale customers would be different. The retail customers of total-requirement wholesale customers would experience impacts roughly comparable to those of the wholesale customers. In comparison, the retail customers of partial-requirement wholesale customers would experience a lesser impact. The actual impacts on the different classes of retail customers also depend upon the procedures used by state and local authorities for passing on wholesale rate changes to retail customers.

3. In general, the financial condition of the FERC-jurisdictional portion of utilities would be measurably improved by a 50 percent CWIP policy. At the national level, the EIA study shows that internal cash flow would improve by an average of 5.38 percent, 9.69 percent, 4.18 percent and 4.32 percent in 1983, 1985, 1990 and 1995, respectively. The

FERC study shows an even more positive initial impact, *i.e.*, an average increase of 13.08 percent. As indicated above, the initial impacts predicted by the EIA study understate the true impacts while the FERC study overstates the initial impacts. There would be corresponding improvements in interest coverage ratios and internal cash flow as a percent of construction expenditures. As with the price impacts, these impacts would vary widely among individual utilities and regions, depending upon the level of construction activity and its relation to rate base. The total company impacts would vary depending on the ratio of FERC-jurisdictional sales to total sales and to the extent that state and local commissions follow the FERC's CWIP policy.

4. Allowing CWIP in rate base would produce savings in financial costs to utilities although the magnitude of such savings is uncertain. Such savings would occur either through reductions in the costs of debt and equity capital or through increased flexibility in timing and choice of security issuances.

5. The Commission's final rule would affect utility investment decisions and fuel choices, although this impact would be small on an industrywide basis. This impact would vary among utilities in relation to the percentage of their sales regulated by the Commission. If the Commission allowed 100 percent of jurisdictional CWIP in rate base and state commissions did not change their policies accordingly, only coal and turbine plant additions would be affected and to a relatively minor degree. If, on the other hand, the Commission allowed 50 percent of jurisdictional CWIP in rate base and state commissions followed the Commission's precedent such that utilities averaged inclusion of 50 percent of all of their CWIP in rate base (jurisdictional and nonjurisdictional), there would also be minor changes in oil-steam, gas-steam, and hydro plant addition categories. With regard to fuel choices, reductions in demand brought about by higher prices would generally reduce oil, gas, and coal consumption initially. Changes in fuel choice in later years would depend critically upon the relative prices of these fuels.

6. Probable environmental impacts resulting from plant, fuel, and demand changes in response to the CWIP rule implementation would be negligible but predominantly beneficial, and would primarily result from a general decrease in demand and cut back in coal utilization in most regions. Environmental changes would not be

detectable at a national level of analysis but could be at the regional or local level.

7. The major socioeconomic impact of the FERC's final rule on CWIP would be the initial rise in the cost of electricity and thus the greater proportion of budgets allocated to electricity by those retail customers of utilities which purchase some or all of their electric power at wholesale—about one in 13 retail consumers of electricity. The socioeconomic impacts on these consumers at the average national and regional levels would be minor in terms of percent increases in rates, *i.e.*, average national, regional, and individual utility rate increases would generally be less than five percent. Only about one-sixth of the affected retail customers—one in 77 retail customers nationally—would experience the six percent ceiling on initial rate increases (assuming all jurisdictional utilities applied for and received the maximum CWIP allowance under the final rule). Socioeconomic impacts would be unequally distributed among and within customer classes and regions. A small number of households and businesses could be adversely affected, but overall regional and national effects would be insignificant.

8. The impacts of a wide range of alternatives to the 50 percent CWIP rule were considered in this study. The impacts of alternatives considered varied both qualitatively and quantitatively from those of the 50 percent CWIP case.

VI. Regulatory Flexibility Act Certification

For the reasons set forth above in Section IV.F.2. of this preamble, the Commission certifies, pursuant to section 605(b) of the Regulatory Flexibility Act of 1980, that this final rule will not have a significant economic impact on a substantial number of small entities.

VII. Summary of the Rule and Information Regarding Implementation

Under the new rule, § 2.16 is deleted from the regulations and a new § 35.26, entitled "Construction Work in Progress" is inserted. Under § 35.26, utilities may continue to file to include in rate base any CWIP costs incurred for pollution control facilities and fuel conversion facilities. The new rule makes no change in Commission practice in this regard. In addition, the new rule provides that a utility may file to include in rate base up to 50 percent of all CWIP in excess of that actually included in rate base as pollution control

or fuel conversion facilities, regardless of the utility's financial condition. Any CWIP that is or may be properly included in Accounts 107 or 120.1, including construction expenditures and any AFUDC already recorded by the utility, is eligible for rate base in accordance with the new rule.

Paragraph 35.26(a) specifies that the rule will apply to any rate schedules filed by any public utility, as defined in subsection 201(e) of the Federal Power Act. No utility may include CWIP in rate base unless a request is made under this section.

Paragraph 35.26(b) sets forth the definition for the term "CWIP." CWIP includes both the expenditures in the construction project and accrued AFUDC (Account 107). Moreover, CWIP includes investment in nuclear fuel in process of refinement, conversion, enrichment, and fabrication and all accrued AFUDC (Account 120.1). This paragraph also defines "pollution control facility" and "fuel conversion facility."

Paragraph 35.26(c) sets out the general rule. The general rule provides that CWIP may be included in rate base in any initial rate schedule or any rate schedule change filed under § 35.12 or § 35.13. Under subparagraph (c)(1), the Commission retains the existing treatment of CWIP for pollution control facilities by allowing the inclusion of such CWIP in rate base. The description of pollution control facilities has been revised to reflect changes in the language in the Internal Revenue Service laws, 26 U.S.C. 169, and the Commission's Form No. 1. Under subparagraph (c)(2), the existing rule allowing inclusion of CWIP for fuel conversion facilities is retained.

Subparagraph (c)(3) sets forth the new rule allowing utilities to include in rate base not more than 50 percent of any CWIP allocable to electric power sales for resale which is not otherwise included in rate base under subparagraphs (c)(1) and (2) of the new § 35.26.¹⁰⁴ This is intended to permit the inclusion of 50 percent of the 13-month average balance¹⁰⁵ of CWIP in addition

to CWIP already included in rate base for pollution control or fuel conversion facilities.

Paragraph 35.26(d) limits the amount of CWIP allowed in rate base under subparagraph (c)(3) in the first two years after the effective date of the rule. The limitation applies to requests for rate schedule changes filed under § 35.13, but not to initial rate schedules filed under § 35.12. Although the Commission recognizes that a utility may file a rate schedule change at any time, if a utility proposes to include CWIP (other than for pollution control and fuel conversion facilities in rate base), there are two conditions which must occur for such a filing to be acceptable insofar as CWIP is concerned.

First, any individual rate filing must not propose more than a six percent CWIP-related rate increase pursuant to § 35.26(c)(3). This increase will be measured in terms of the total wholesale revenues of the utility rather than by reference to individual customers or customer classes.¹⁰⁶ Second, any prior rate schedule that included CWIP under subparagraph (c)(3) of this section must be in effect for not less than 10 months.¹⁰⁷ This provision is intended to restrict rate increases directly related to CWIP in rate base to six percent in the first year of the rule and 12 percent over the first two years. In the third year, a utility may include any amount of CWIP consistent with the other provisions of rule.¹⁰⁸

Paragraph 35.26(e) implements the Commission's determination to permit the allowable CWIP expenses to be collected beginning when the general rate becomes effective, whether or not the rates are subject to refund.

Paragraph 35.26(f) continues, in substance, the present Commission rules regarding the books of account by

requiring a utility including CWIP in rate base to discontinue the capitalization of any allowance for funds used during construction (AFUDC).

Paragraph (g) requires utilities to propose accounting procedures as part of rate filings in Statement AO, which include CWIP in rate base, to ensure that wholesale customers will not be charged for both capitalized AFUDC and a corresponding return on CWIP in rate base and that wholesale customers will not be charged for any corresponding AFUDC capitalized as a result of differing accounting or ratemaking treatments accorded to CWIP by state or local regulatory authorities. The accounting procedures proposed by the utility should include a consideration of any adjustments that are necessary to reflect a lack of coincidence between proposed and actual effective dates for CWIP-based rates and monthly differences between test period and actual CWIP balances.¹⁰⁹

¹⁰⁹ In order to ensure the appropriate discontinuance of AFUDC capitalization, the Commission instructs any utility that requests CWIP in rate base under this rule as follows:

1. The average amount of CWIP requested in rate base in the utility's rate filing should be excluded from construction balances for purposes of calculating book AFUDC accruals, beginning on the effective date of the new rates, except to the extent that the stipulation of the parties or the Commission's order provide for a different amount of CWIP in rate base. This will ensure that in settled cases, a utility's rates will be presumed to include CWIP in rate base to the extent requested in its rate filing, except as noted above.

2. In calculating the AFUDC rates used for book purposes under the Uniform System of Accounts (Electric Plant Instructions, Instruction 3(17)), the average jurisdictional amount of CWIP and nuclear fuel in process of refinement, conversion, enrichment, and fabrication requested in the utility's rate filing for rate base treatment must be excluded from the "W" component of the AFUDC formula beginning on the effective date of the new rates, except to the extent that the stipulation of the parties or the Commission's order provide for a different amount of CWIP in rate base.

3. For purposes of calculating rate base, the accrual of AFUDC on CWIP balances added to test period rate base must cease on the proposed effective date of the new rates.

4. The Commission makes the following observations with respect to the question of how timing differences between the test period and the effective date of CWIP-based rates ought to be handled by utilities. As previously described, CWIP-based rates may become effective before, after, or at any time during the test period. The rule therefore requires utilities to provide accounting procedures to ensure that wholesale customers will not be charged for both capitalized AFUDC and corresponding amounts of CWIP proposed to be included in rate base. While the actual level of CWIP will change over time, the average level of CWIP included in rate base remains unchanged until a new rate change becomes effective. Because of this, the amount of CWIP placed in rate base may exceed the actual balance of CWIP at the time of filing or when the test year begins. This phenomenon may occur, for example, if a construction program is just beginning, if costs are anticipated to rise in the immediate future, or if the

¹⁰⁴ The inclusion of CWIP in rate base may eliminate some timing differences associated with interest expense and, therefore, income tax allowable for ratemaking may be affected.

¹⁰⁵ The Commission expects that for purposes of determining the amount of CWIP includable in test period rate base, utilities will use the traditional rule of the 13 monthly average balances, meaning the beginning and end of each month in the test period. See *Louisiana Power & Light Co.*, Opinion No. 110 (Docket No. ER77-533) 14 FERC ¶ 61,075 (1981).

¹⁰⁶ The rule requires utilities to derive revenue requirements both with and without CWIP in rate base. The aggregate CWIP-based revenue requirements and attendant revenue levels will be compared to the aggregate annualized revenue level of the superseded rates.

¹⁰⁷ A utility that has requested CWIP in rate base under § 2.15 is not precluded by the initial 10-month limitation under subparagraph (d) of this rule from first filing for CWIP in rate base as it wishes following the effective date of the rule. However, under the new rule, once such a utility has requested CWIP in rate base for any rate filing, the limitation in subparagraph (d) will apply according to its terms.

¹⁰⁸ In order to enable the Commission to measure CWIP in rate base in those cases in which the rate is settled and made effective in terms only of agreed-upon dollar amounts, without reference to the amount of CWIP rate base, the Commission will presume the rate to be based upon CWIP if, and to the extent that, the utility's rate schedule filing requests CWIP under subparagraph (c)(3) of this section.

Finally, conforming changes are made to § 35.13 which govern cost of service statements filed in conjunction with changes in rate schedules. The rule amends certain statements in existing § 35.13(h) to reflect the fact that utilities will now be able to include in rate base CWIP amounts, in addition to those for pollution control and fuel conversion facilities. Subparagraph (h)(7) is revised to additionally require functionalization of facilities including by indicating whether particular facilities are dedicated to a particular customer or group of customers, such as unit sales transactions.

A new subparagraph (h)(38)—Statement BM Construction Program Statement—is added which requires utilities that file to include CWIP in rate base under subparagraph (c)(3) to file information useful in evaluating the need for power and the alternative methods of meeting that need. Any rate filing which includes CWIP under § 35.26(c)(3) must include statement BM. The new Statement BM requires a utility to describe its long-range program for providing reliable and economic power, to include an assessment of the relative costs of adopting alternative strategies and an explanation of why the program adopted is prudent and consistent with a least-cost energy supply program. This information will assist the Commission in evaluating prudence, including the extent to which utilities seeking rate base treatment of CWIP are utilizing least-cost strategies.

VIII. Effective Date

This final rule is effective July 1, 1983. Pursuant to the Paperwork Reduction Act of 1980, 44 U.S.C. 35 the information collection requirements of this rule have been transmitted to and cleared by the Office of Management and Budget under the existing OMB Control No. 1902-0096.

(Federal Power Act, 16 U.S.C. 791-828c; Department of Energy Organization Act, 42 U.S.C. 7101-7352; E.O. No. 12009, 3 CFR 142 (1978))

List of Subjects

18 CFR Part 35

Electric power rates, Electric utilities. Reporting and recordkeeping requirements.

18 CFR Part 2

Administrative practice and procedure, Electric power.

In consideration of the foregoing, the Commission amends Chapter I, Title 18

of the Code of Federal Regulations, as set forth below, effective 30 days after publication in the Federal Register.

By the Commission.
Kenneth F. Plumb,
Secretary.

PART 35—FILING OF RATE SCHEDULES

1. Part 35 is amended in the Table of Contents by adding at the end of Subpart C a new § 35.26, to read as follows:

Subpart C—Other Filing Requirements

Sec.
35.26 Construction work in progress.

2. Part 35 is amended by adding a new § 35.26, to read as follows:

§ 35.26 Construction work in progress.

(a) *Applicability.* This section applies to any rate schedule filed under this part by any public utility, as defined in subsection 201(e) of the Federal Power Act.

(b) *Definitions.* For purposes of this section—

(1) "Construction work in progress" or "CWIP" means any expenditure for public utility plant in process of construction that is properly included in Accounts 107 (construction work in progress) and 120.1 (nuclear fuel in process of refinement, conversion, enrichment, and fabrication) of Part 101 of this chapter, the Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act (Class A and Class B).

(2) "Pollution control facility" means an identifiable structure or portions of a structure that is designed to reduce the amount of pollution produced by the power plant, but does not include any facility that reduces pollution by substituting a different method of generation or that generates the additional power necessitated by the operation of a pollution control facility.

(3) "Fuel conversion facility" means any addition to public utility plant that enables a natural gas-burning plant to convert to the use of other fuels, or that enables an oil-burning plant to convert to fuels other than natural gas. Such facilities include those that alter internal plant workings, such as oil or coal burners, soot blowers, bottom ash removal systems and concomitant air pollution control facilities, and any facility needed for receiving and storing the fuel to which the plant is being converted, which facility would not be

necessary if the plant continued to burn gas or oil.

(c) *General rule.* For purposes of any initial rate schedule or any rate schedule change filed under § 35.12 or § 35.13 of this part, a public utility may include in its rate base any costs of construction work in progress (CWIP), including allowance for funds used during construction (AFUDC), as provided in this section.

(1) *Pollution control facilities.* (i) Any CWIP for pollution control facilities allocable to electric power sales for resale may be included in the rate base of the public utility.

(ii) In determining whether a facility is a pollution control facility for purposes of this section, the Commission will consider:

(A) Whether such facility is the type facility described in the Internal Revenue Service laws, 26 U.S.C. 169(d)(1), as follows: "a new identifiable treatment facility which is used * * * to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, storing, or preventing the creation or emission of pollutants, contaminants, wastes or heat";

(B) Whether such facility has been certified by a local, state, or federal agency as being in conformity with, or required by, a program of pollution control;

(C) Whether such facility is the type facility described in the schedule of "Environmental Protection Facilities," sections 4(A) through 4(D), page 428, FERC Form No. 1, Annual Report of Electric Utilities, Licensees and Others (Class A and Class B) (Revised 12-81); and

(D) Other evidence showing that such facilities are for pollution control.

(2) *Fuel conversion facilities.* Any CWIP for fuel conversion facilities allocable to electric power sales for resale may be included in the rate base of the public utility.

(3) *Other CWIP.* Not more than 50 percent of any CWIP allocable to electric power sales for resale not otherwise included in rate base under paragraphs (c)(1) and (2) of this section, may be included in the rate base of the public utility.

(d) *Initial limitation.* (1) *Limit.* Beginning on July 1, 1983 and ending on July 1, 1985, a public utility may file to include CWIP in rate base under paragraph (c)(3) of this section only if:

(i) Any increase in the utility's test period aggregate wholesale revenues that is directly attributable to CWIP included in the filed rates in accordance with subparagraph (c)(3) of this section is not more than six percent of the test

proposed effective date is prior to the test period upon which the rate filing is based. In these cases, a utility will record a negative AFUDC to ensure a proper charging of costs to ratepayers.

period aggregate wholesale revenues under the rate schedules to be superseded; and

(ii) The superseded rate schedules, if based in part on CWIP included in rate base under paragraph (c)(3) of this section, has been effective for not less than 10 months.

(2) *Filing.* For purposes of determining the size of any rate increase attributable to CWIP proposed to be included in rate base under paragraph (c)(3), a public utility must derive and adequately support, in Statement BK under paragraph (h)(36) of this section, aggregate jurisdictional revenue requirements both with and without such CWIP in wholesale rate base.

(3) *Initial rates.* The limitation in this paragraph does not apply to initial rate schedules filed under § 35.12.

(e) *Effective date.* If a public utility proposes in its filed rates to include CWIP in rate base under this section, that portion of the rate related to CWIP is collectable at the time the general rate becomes effective pursuant to Commission order, whether or not subject to refund.

(f) *Discontinuance of AFUDC.* On the date that any proposed rate that includes CWIP in rate base becomes effective, the public utility must discontinue the capitalization of any AFUDC related to those amounts of CWIP in rate base.

(g) *Accounting Procedures.* At the time that a public utility files to include CWIP in rate base pursuant to this section, it must propose accounting procedures in that rate schedule filing that:

(1) Ensure that wholesale customers will not be charged for both capitalized AFUDC and corresponding amounts of CWIP proposed to be included in rate base; and

(2) Ensure that wholesale customers will not be charged for any corresponding AFUDC capitalized as a result of different accounting or ratemaking treatments accorded CWIP by state or local regulatory authorities.

3. In § 35.13, the Table of Contents is amended by adding at the end a new Statement BM, to read as follows:

§ 35.13 Filing changes in rate schedules.

Contents

(38) Statement BM—Construction program statement.

4. Section 35.13 is amended by revising paragraphs (h)(7)(ii) and (h)(13), to read as follows:

§ 35.13 Filing of changes in rate schedules.

(h) *Cost of service statements.* * * *
(7) *Statement AG—Specified plant accounts (other than plant in service) and deferred debits.* * * *

(ii) The utility shall state the electric utility component balances in Accounts 107 and 120.1, individually and in total, for each item of construction work in progress for pollution control facilities, fuel conversion facilities, or any other facilities that qualify for inclusion in rate base under § 35.26. The utility shall state such balances for each major functional and subfunctional classification under Statement AD as of the beginning of the first month and the end of each month of Period I and Period II with an average of the 13 balances for each period.

(13) *Statement AM—Construction work in progress.* Statement AM is a statement of the amount of construction work in progress described according to functional classification for Period I and Period II. For production plant and transmission plant, the utility shall state the balances as of the beginning of the first month and the end of each month of both Period I and Period II, with an average of the 13 balances for each period. For each function of plant identified in Statement AD other than production or transmission, the utility shall state the balances as of the beginning and the end of both Period I and Period II, with an average of the beginning and end balances for each period. If any Period I or Period II balance is not available, the utility shall include monthly estimates and an explanation of the relevant circumstances. Pollution control facilities, fuel conversion facilities, or other construction amounts reported in Statement AG shall be excluded from amounts reported in this Statement.

5. In § 35.13, the references to Statement BL that appear in paragraphs (d) (1), (2), and (4) and (e)(1) (i), (ii), and (iii) and in the introductory clause in paragraph (h) are replaced by reference to Statement BM.

6. In § 35.13, paragraph (a)(2)(i) introductory text is revised to read as follows:

§ 35.13 Filing of changes in rate schedules.

(a) *General rule.* * * *
(2) *Abbreviated filing requirements.*

(i) *For certain rate increases.* Any utility that files a rate schedule change that provides for a rate increase may submit

with its filing only the information required in paragraphs (b), (c), and (h)(37) of this section and in § 35.12(b) (2) and (5) of this part and, for any rate increase described in clause (B) of this subparagraph, the information required in paragraph (h)(38) of this section, in accordance with paragraph (g) of this section, if the rate increase is:

7. Section 35.13 is amended by adding a new paragraph (h)(38), to read as follows:

§ 35.13 Filing of changes in rate schedules.

(h) *Cost of service statement.* * * *
(38) *Statement BM—Construction program statement.* Statement BM is a summary of data and supporting assumptions relating to the economics of any construction program to replace or expand the utility's power supply that shall be filed if the utility is filing for construction work in progress in rate base under § 35.26(c)(3) of this chapter. The filing utility shall describe generally its program for providing reliable and economic power for the period beginning with the date of the filing and ending with the tenth year after the test period. The statement shall include an assessment of the relative costs of adopting alternative strategies including an analysis of alternative production plant, e.g., cogeneration, small power production, heightened load management and conservation efforts, additions to transmission plant or increased purchases of power, and an explanation of why the program adopted is prudent and consistent with a least-cost energy supply program.

§ 2.16 [Removed]

8. Section 2.16 is removed.

Statement of C. M. Butler III, Chairman in Response to "Motion Requesting Recusal" in Docket No. RM81-38, Construction Work in Progress for Public Utilities

After careful review of the arguments presented, I have concluded that grounds do not exist for me to recuse myself or be disqualified from the CWIP rulemaking. This conclusion is supported by a memorandum of the FERC General Counsel advising that my statements, about which movants complain, do not require my recusal or disqualification. That memorandum is attached as Appendix A.

Before addressing the merits of the recusal motion, however, I would like to dwell briefly on the matter of procedures for handling such motions. I feel some responsibility to do so because when the motion was filed, I was asked for a reactive statement. In that statement I indicated that the matter would be put to my colleagues for a decision with my abstention. While that seemed an

appropriate way in which to dispose of the matter.¹ I have since been advised that at least one Commissioner feels strongly against putting the matter to a vote. It is feared that the precedent could lead to unnecessary division among the Commissioners should more difficult questions of recusal arise in the future. Upon reflection I agree. The prospect of such division among the Commissioners would probably outweigh the value of the procedure. The procedure which I have adopted might be criticized as unfair if there were no appeal from my decision. Obviously, however, if the participants in this proceeding are disappointed in my resolution of the matter, they will have the opportunity to raise their arguments in the Court of Appeals should they be aggrieved by the Commission's final order in this case.² This procedure basically follows the judicial model, and I expect it will be followed in the future.

The General Counsel's opinion deals at length with the merits of the arguments advanced in support of my recusal. I do not intend to repeat them here. However, I wish to add a few words of my own in connection with the matter. The ground for recusal proffered in the motion is prejudgment of issues in a pending rulemaking. Despite the existence of a relatively rich trove of legal scholarship on the general subject, there appears among practitioners before the Commission, members of the Commission staff, and, indeed, members of the House and Senate and their staffs, considerable confusion over the questions of what is at stake in such matters and how to systematically analyze the factual context when a motion for recusal or disqualification is filed against a decisionmaker in an administrative rulemaking.

Rulemaking typically requires the decisionmaker to choose between competing priorities in proposing rules. That responsibility suggests a general duty to acquire knowledge and perspective as to matters about which he or she is to act. Such matters are frequently, if not universally, controversial.³ Simply stated, ordinary rulemaking is impossible without some prejudgments by the rulemaker. Among other things, a rulemaker must form a preliminary view if he is to make rational allocations of resources (i.e., establish priorities) among competing candidates for rulemaking.⁴ In

Judge Leventhal's words, "One cannot even conceive of an agency conducting a rulemaking proceeding unless it had delved into the subject sufficiently to become concerned that there was an evil or abuse that required regulatory response."⁵

Thus, the law is clear that not all prejudgments subject quasi-legislative decisionmakers to disqualification. Such distinctions are familiar in the law, and the real question is *what kinds of prejudgments necessitate recusal*. The strictest legal standard is as follows: A decisionmaker must recuse himself if he has an irrevocably closed mind about an issue of adjudicative fact material to the decision in a matter pending before him. *FTC v. Cement Institute*, 333 U.S. 683 (1948).⁶ The *Cement Institute* case was decided in the context of an adjudication. It is generally accepted that a stricter standard should apply to a decisionmaker acting in a quasi-judicial matter (adjudication), than to one acting in a quasi-legislative matter.⁷ The rationale is simple. Fundamental notions of fairness require openmindedness about issues specifically provable and subject to meaningful cross-examination. In contrast, issues of predictive or judgmental fact (quasi-legislative issues) are decided in the context of experience, general philosophy, and the like; and it is virtually impossible for such facts to be decided with a complete *tabula rasa*. In that sense, the quasi-legislative decision is similar to judgments about constitutional policy or law.⁸ Thus, the analogous model is not the judge, but the lawmaker. The question that is accordingly presented is when, if ever, is a legislator required to disqualify himself from a matter; and to what extent do those rules of conduct apply to the quasi-legislator?

Perhaps unfortunately, this question need not be reached,⁹ because even when the strictest standard—that applicable to quasi-judicial decisionmaking—is applied to the remarks of which movants complain, the standard is not satisfied. When those remarks are read in the context in which they were presented, they clearly are not reflective of an unalterably closed mind.¹⁰

It would be not merely unusual, but extraordinary, if they had not at least given opinions as to constitutional issues in their previous legal careers. Proof that a Justice's mind at the time he joined the Court was a complete *tabula rasa* in the area of constitutional adjudication would be evidence of lack of qualification, not lack of bias.

⁵ Association of Nat'l Advertisers, Inc. v. FTC, supra n.2, at 1174.

⁶ Accord, *id.*; United Steel Workers of America v. Marshall, 647 F.2d 1189, cert. denied, 101 S. Ct. 3148 (1981).

⁷ See generally Strauss, supra, n.3.

⁸ Laird v. Tatum, supra, n.4. See also D. DAVIS, ADMINISTRATIVE LAW TREATISE § 19.3 (2d ed. 1980); Strauss at 1016-17. I do not suggest that regulatory officials should not have an open mind about all issues in a pending matter, even the state of the law. I merely make the inescapable observation that it would be impossible, and in fact undesirable if possible, to ignore one's experience in deciding cases.

⁹ But see ACUS Recommendation No. 80-4, 1 CFR § 305.80-4 (Decisional Officials' Participation in Rulemaking Proceedings).

¹⁰ Cf. United Steel Workers of America v. Marshall, supra, n.6. In this connection, I choose to

I wish also to make a general observation. I subscribe strongly to the view that agency decisionmakers should openly discuss policy issues pending before them in order to inform interested persons, to the greatest extent possible, of their policy views. To do so tends to maximize, if not optimize, the opportunity for debate of the issues and for feedback to the decisionmaker. The consequence is movement in the direction of better shaping of issues and higher quality of input, hopefully leading to better reasoned and articulated agency decisions. In addition, that approach is consistent with the spirit of much recent legislation designed to bring government into the sunshine. In contrast, a liberal policy of disqualification would have a chilling effect on the public's opportunity to learn the nature and extent of an agency's concerns about important issues of public policy, and would tend to discourage debate of the issues. The public's ability to understand and participate meaningfully in the agency's decisional process, and predictably the quality of the agency's decisions, would be to a significant extent diminished.

Next, I would like to address some of my specific concerns with the Motion Requesting Recusal. First, the motion's discussion of the law is characterized by such an absence of legal scholarship as to be of concern.¹¹ Second, the mischaracterizations of parts of the speech through omission of material parts of it are plausibly knowingly false.¹² That raises substantial questions under the Code of Professional Responsibility.¹³ Finally, at

deal with the facts as they are presented as objectively as I can. Although I know my mind is open about all issues in this proceeding, to rest this decision there seems inadvisable because my claim will predictably be dismissed as self-serving.

¹¹ For example, no distinction is drawn between prejudgments of issues of specific fact and policy, legal, and legislative fact issues. See, e.g., *FTC v. Cement Institute*; Strauss. Furthermore, there is no reference to the reasonably abundant judicial literature and commentary on the issues raised in general. E.g., Strauss. Nor is there any reference to the recommendations of the Administrative Conference of the United States on the matter, 1 CFR 305.80-4 (Decisional Officials' Participation in Rulemaking Proceedings) (disqualification as inappropriate " * * * for factual judgments that are the consequence of earlier stages of the proceeding, or for prejudgments of policy." *Id.* § 305.80-4C.1.). How does that square with the following ethical consideration?

Where a lawyer knows of legal authority in the controlling jurisdiction directly adverse to the position of his client, he should inform the tribunal of its existence unless his adversary has done so; but, having made such disclosure, he may challenge its soundness in whole or in part.

D.C. CODE OF PROF. RESP. EC 7-23 (ABA 1976) (Code) (Footnote omitted). It strains credulity that of the lawyers signing the motion, none knew of the rich body of law and commentary on the matter, or, even worse, that in the exercise of ordinary care as lawyers could not find it. In this connection, the contrast between the opinion letter of the General Counsel and the motion is stark, indeed.

¹² Cf. RESTATEMENT (SECOND) OF TORTS

§ 526-30 (1977) (Title A. Fraudulent Character of Misrepresentation).

¹³ See Code, DR7-102(A)(5): "In its representation of a client, a lawyer shall not knowingly make a false statement of law or fact." This disciplinary

¹ See, e.g., Area Rate Proceeding (Permian Basin Area), 33 FPC 43 (1965).

² See Association of Nat'l Advertisers, Inc. v. FTC, 827 F.2d 1151 (D.C. Cir. 1979), cert. denied, 447 U.S. 921, (1980) (concurring opinion of Leventhal, J.) (The Court of Appeals has jurisdiction of the issue and should hear it with the merits of the case). Cf. *Firestone Tire & Rubber Co. v. Risjord*, 449 U.S. 368 (1981).

³ See generally Strauss, *Disqualification of Decisional Officials in Rulemaking*, 80 COL. L. REV. 990 (1980) (Strauss).

⁴ Cf. *Laird v. Tatum*, 409 U.S. 824, 835 (1972), where Justice Rehnquist made an analogous observation about federal judges:

Since most Justices come to this bench no earlier than their middle years, it would be unusual if they had not by that time formulated at least some tentative notions that would influence them in their interpretation of the sweeping clauses of the Constitution and their interaction with one another.

least one of the allegations of the movants is disingenuous on its face. It is claimed that rejection of the presumption against allowing CWIP in rate base is a forbidden prejudgment. How is the rejection of a prejudgment itself a forbidden prejudgment? It seemed to me at the time more an expression of agnosticism about the issue, to plagiarize from a former colleague. In sum, I believe that the credibility of the motion itself is a matter for careful scrutiny should this aspect of our rulemaking in Docket No. RM81-38 be reviewed by the Courts of Appeal.

C. M. Butler III.

Appendix A

March 10, 1982.

Memorandum To: Chairman Butler

From: Charles A. Moore, General Counsel

Subject: Request for Recusal in Docket No.

RM81-38, Construction Work in Progress for Public Utilities

You requested my views on whether you must withdraw from consideration of Docket No. RM81-38, Construction Work in Progress for Public Utilities (CWIP), because of expressions in a speech delivered at "A Seminar on Utility Finances" sponsored by the U.S. National Committee, World Energy Conference and Edison Electric Institute. In my opinion, recusal is not necessary.

RM81-38 is a proposal to include, under certain circumstances, the costs of CWIP in the rate base of electric utilities. The proposed rule, published in an NPR in July 1981, would establish more precise criteria for determining whether a utility qualifies for inclusion of CWIP in the rate base and for assessing the amount of CWIP that a qualifying utility may include. It would establish specific grounds upon which the Commission may limit the amount of CWIP that would otherwise be included and would permit a utility on a claim of severe financial difficulty to collect CWIP subject to refund (NPR, p. 2). The NPR also invited the public to submit alternative proposals, supported by empirical data or other substantial evidence. (NPR, p. 35).

The speech was delivered on October 27, 1981, before comments were due in RM81-38 or oral hearings were held.¹ The speech discussed the overall financial health of the electric utility industry and various policy options to address the industry's financial problems. The options fell into two broad categories: deregulation and improved regulation. The CWIP rulemaking was discussed as a target for improved regulation.

The American Public Power Association (APPA) requested that you withdraw from consideration of RM81-38 because "it appears that Chairman Butler already has

rule raises similar questions in connection with movants' representations as to the state of the law. Cf. *id.* EC 7-26: "A lawyer should . . . present any admissible evidence . . . unless he knows, or from facts within his knowledge should know, that such testimony or evidence is false . . ." *id.* Legal Ethics Committee Opinion No. 79: "[A] lawyer may not ethically participate in the preparation of testimony that he or she knows, or ought to know, is false or misleading." (Emphasis added.)

¹ Initial comments were due on October 30 and oral hearings were held on December 7 and 8.

prejudged two of the fundamental issues in this case—intergenerational inequities and the presumption against inclusion of CWIP [in the rate base]" (motion, p. 6). APPA cited the following remarks as evidence that you summarily dismissed other views, failed to recognize alternatives and have "an unalterably closed mind" on this issue" (*id.*, footnote omitted):

"I shall accept . . . that the electric utility industry is, indeed, in poor financial shape. I shall also disregard the claims . . . that the financial condition of the utilities is improving" (emphasis in APPA, motion, p. 5).

" . . . there seems to me to be little merit to arguments about intergenerational inequities" (motion, p. 6).

"I disagree with the staff position—contained in our notice of proposed rulemaking—that there should be a presumption against the inclusion of CWIP in rate base" (motion, p. 6).

"There appears to be three reasons why . . . CWIP might be . . . desirable . . . Those reasons were: adequately compensating the company for lack of receipt of cash earnings, receiving revenues if a generating project fails or does not go on line, and meeting the capital market's preference for cash income" (motion, p. 6).

Parties to an administrative proceeding have the right to a fair hearing before an impartial decisionmaker. *Joint School District No. 1 v. Hortonville Education Association*, 426 U.S. 482, 493 (1976). But "impartial . . . does not mean uninformed, unthinking or inarticulate." *Association of National Advertisers, Inc. v. FTC*, 627 F.2d 1151, 1174 (D.C. Cir. 1979), cert. den., 447 U.S. 921 (1980). The requirements of due process recognize the necessity for rulemakers to formulate policy in a manner similar to legislative action and to delve into a subject sufficiently before initiating a rulemaking proceeding to conclude tentatively that some agency action is needed (*id.*).

Because the object of rulemaking is the implementation of law or policy for the future, an agency member functions very much like a legislator when participating in rulemaking proceedings. *Action For Children's Television v. FCC*, 564 F.2d 458, 471 (D.C. Cir. 1977). The factual components of such decisions often cannot be separated from their policy foundations. *American Airlines, Inc. v. CAB*, 359 F.2d 624, 633 (D.C. Cir. 1966), cert. den., 385 U.S. 843 (1966). Disqualification of a Commissioner in a rulemaking proceeding, therefore, has a serious policy effect which does not come into play when disqualification is in an adjudicatory setting.

For judges put aside personal views on the desirability of a law or program when adjudicating specific rights of specific parties.²

² But even judges need not disqualify themselves from cases involving points of law with respect to which they previously had expressed an opinion. *Laird v. Tatum*, 409 U.S. 824, 831 (1972), memorandum of Rehnquist, J.

Generally, under 28 U.S.C. 455(a), a federal judge is required to disqualify himself where his "impartiality might reasonably be questioned." But lack of impartiality is measured by an objective standard of reasonableness. A Federal judge has a

In agency rulemaking, on the other hand, the administrator is expected to bring his views, policies and insights to bear on the issues confronting the agency. *Sierra Club v. Costle*, 657 F.2d 298, 400-01 (D.C. Cir. 1981). The administrator's view, in turn, will continue to be reshaped through contact with the public (*id.*).³ Disqualification of a Commissioner in a rulemaking proceeding is required "only when there has been a clear and convincing showing that an agency member has an unalterably closed mind on matters critical to the disposition of the rulemaking." *Association of National Advertisers, Inc. v. FTC*, supra, 627 F.2d at 1154.⁴ In applying this standard, the

clear obligation not to recuse himself without a valid reason. *Simonson v. General Motors Corp.*, 425 F. Supp. 574 (E.D. Pa. 1976). Prior expressions of opinion on the legal issues involved in a proceeding do not serve as a basis for disqualification. "And even a judge's public comment giving a general impression of a state of facts does not present a rigidity against refinement and reflection that disqualifies him from sitting in judgment on a particular fact issue." *Association of National Advertisers, Inc. v. FTC*, supra, 627 F.2d at 1177 (concurring opinion of Judge Leventhal).

³ "[T]he very legitimacy of general policymaking performed by unelected administrators depends in no small part upon the openness, accessibility, and the amenability of these officials to the needs and ideas of the public from whom their ultimate authority derives and upon whom their commands must fall" (*id.*). Since public contacts, like the speech at issue here, nourish an administrator's body of ideas—indeed are the "bread and butter of the process of administration,"—such contacts do not routinely lead to disqualification in the rulemaking setting.

⁴ That case involved the disqualification of Chairman Pertschuk of the F.T.C. on the basis of public statements he had made expressing his strong belief in the harm advertising caused small children and in the need for stringent rules to curb that harm. For example, he stated in an interview that he "was committed to taking action on the problem of commercialization of children" and that "advertisers seize on the child's trust and exploit it as a weakness for their gain" (*id.* at 1173, n. 56). In a television interview Chairman Pertschuk stated that "There's a very basic question in our society, and that is . . . the extent to which children are to be treated as commercial objects . . ." He expressed "some serious doubt as to whether any television advertising should be directed at a three or four or five-year-old, or a preschooler."

They're not competent to understand the nature of the message. We've never treated children as commercial objects in our society . . . (*id.* at 1174, n. 56).

In addition, in a letter to the head of the Food and Drug Administration, Chairman Pertschuk stated that "[s]etting legal theory aside, the truth is that we've been drawn into this issue because of the conviction, which I find you share, that one of the evils flowing from the unfairness of children's advertising is the resulting distortion of children's perceptions of nutritional values . . ." (*id.* at 1191, emphasis in dissenting opinion of Judge Mackinnon). The FTC subsequently issued an NPR concerning children's advertising.

The district court found that Chairman Pertschuk had prejudged issues involved in the rulemaking and ordered him disqualified. The court of appeals reversed, finding that Chairman Pertschuk's remarks represented discussion and perhaps advocacy of a legal theory that might support the exercise of the Commission's jurisdiction over children's advertising but that the Association had failed to demonstrate by these statements that he

statements offered as grounds for disqualification must be viewed as a whole (Id. at 1170). Your speech as a whole does not reveal an unalterably closed mind on the issues involved in the CWIP rulemaking.

The speech opened with a review of FERC rate jurisdiction over the wholesale sale of electric power. It indicated that the agency's impact on the privately-owned sector of the industry was limited. You stated that "the Commission has a regulatory obligation to treat all of its jurisdictional companies fairly, just as it has an obligation to see that consumers are treated fairly" (speech, p. 2). The speech also revealed an unfixed view about CWIP, or the rulemaking and its effects (speech, pp. 7-8):

The Commission currently has under way a rulemaking dealing with Construction Work In Progress (CWIP) to determine whether such construction should be placed in the rate base even though the plant has not yet begun to provide service . . .

What is at stake in this rulemaking? In one sense, a very great deal. On one hand, if all CWIP were immediately put into the rate base, the impact on rates would probably be substantial, and in some cases very substantial. On the other hand, if CWIP is not put in the rate base, AFUDC is accrued and added to the direct construction cost when the plant, in fact, comes on line. With the current high interest rates, it is quite probable that the accrued AFUDC will double the value of the plant in the rate base and if the plant is large in relation to the size of the utility, the effect on electric rates could be dramatic . . .

In another sense, however, it is not at all clear that something important is at stake . . . From the standpoint of the company, the question therefore is, would it prefer to have an increase in cash earnings now or a larger increase in cash earnings in the future? For consumers, the question is, would they rather have an increase in electric rates now or a still larger increase in the future? The answer to those questions is not at all obvious . . .

The specific remarks that APPA cited do not demonstrate a closed mind on any of the issues involved in the rulemaking. APPA deleted important qualifying words from the remark it challenged first. The complete statement is as follows (speech, p. 3):

Rather than engage in a long discussion about such financial arcana as market-to-book ratios and interest ratios, I shall accept for the purposes of these remarks, that the electric utility industry is, indeed, in poor financial shape. I shall also disregard the claims—which seem usually to be followed by the post hoc conclusion that the Commission should therefore do nothing—that the financial condition of the utilities is improving. On that basis, the fundamental question raised by the current financial problems of the electric utility industry is, can effective price regulation be reconciled with the financial needs of an electric

industry supported by private capacity? (emphasis supplied).

The presumption that the electric utility industry is in poor financial condition and the dismissal of claims that it is improving were assumptions that you clearly limited to the context of the speech.

The discussion of policy or advocacy of a legal theory is not sufficient to disqualify an administrator. *Association of National Advertisers*, supra, 627 F.2d at 1171. An agency could not exercise its broad policymaking powers if administrators were unable to discuss the wisdom of various regulatory positions. (Id. at 1170). Such discussion necessarily involves broad general characterizations of reality that are labelled "legislative fact."⁵

Statements of legislative fact are often employed when legal and policy arguments are presented. (Id. at 1172). For example, the speech expressed the legislative fact that incurrence of certain costs is associated with the utilities' obligation of continued adequate service (speech, p. 8). Next, the speech expressed the legislative fact that the benefits of that obligation inure as much to the present consumers of electrical service as to future consumers. The statements to which APPA primarily object ("there seems to me to be little merit to arguments about intergenerational inequities" and "[i]n that connection, I disagree with the staff position—contained in our notice of proposed rulemaking—that there should be a presumption against the inclusion of CWIP in rate base") were made on the basis of those two legislative facts (speech, p. 9). *Association of National Advertisers* teaches that expression of viewpoints based on legal and factual assumptions do not bind an administrator to them.

As long as the administrator is free to change his mind upon consideration of the presentations made by those who would be affected, there is no basis for disqualification (Id. at 1172; concurring opinion of Judge Leventhal at 1176-77).⁶

The timing of the speech is also a factor bearing on continued participation. In *Association of National Advertisers*, the court noted that Chairman Pertschuk made the challenged comments prior to issuance of an NOPR and that the Chairman "remained free, both in theory and in reality, to change his mind upon consideration of the presentations made by those who would be affected" (Id. at 1172). Although your speech

⁵ The nature of legislative fact is ordinarily general, without reference to specific parties.

Legislative facts are the facts which help the tribunal determine the content of law and of policy and help the tribunal to exercise its judgment or discretion in determining what course of action to take. (Id. at 1161-62, quoting Davis, *Judicial Notice*, 55 Columbia L. Rev. 945, 952-59 (1955)).

⁶ Judge Leventhal explained:

It is appropriate and indeed mandatory for agency heads and staff to maintain contacts with industry and consumer groups, trade associations and press, congressmen of various persuasions and to present views in interviews, speeches, meetings, conventions, and testimony. The agency gathers information and perceptions in a myriad of ways and must use it for a myriad of purposes. With capacity and willingness to reconsider, there is no basis for disqualification (footnote omitted).

was given after the publication of the NOPR, it preceded both the due date for the comments and oral hearings in RM81-38. There was ample opportunity for individuals to present their views after the speech was delivered and there was no showing of unwillingness to change your views upon consideration of the public presentations. Indeed, the NOPR requested that the public submit alternative CWIP policies for agency consideration. The speech does not express any views about the theories or policies suggested by the parties.⁷ Accordingly, it does not demonstrate a closed mind on the CWIP rulemaking.

A comparison of your speech with those found not to warrant disqualification in other cases further supports the conclusion that disqualification is not warranted here. For example, although Chairman Pertschuk stated that he was "committed" to taking action on the problem of commercialization of children, the court ruled that such statements did not demonstrate that he was unwilling or unable to consider rationally argument that a final rule was unnecessary.

The court reached a similar result in *United Steel Workers of America v. Marshall*, 647 F.2d 1189, 1208 (D.C. Cir. 1980), cert. den., 101 S.Ct. 3148 (1981). There, Assistant Secretary of Labor Bingham discussed the OSHA lead standard then pending before the Department of Labor in a speech delivered to a union group which was "passionately involved" in the rulemaking proceeding (Id. at 1208). Her remarks referred to the dangers of lead,⁸ the economic feasibility of the lead standard,⁹ and the need for a "medical removal protection provision,"¹⁰ which were contested issues in the proceeding. Although the court believed that she served her agency poorly by making statements so susceptible to an inference of bias, it ruled that the statements represented discussion and she had not demonstrated an unalterably closed mind. The court reasoned that mere proof that she had taken a public position, or expressed strong views, or held an underlying philosophy with respect to an issue in dispute did not overcome the presumption that an administrative official is objective and "capable of judging a particular controversy fairly on the merits" (Id., quoting

⁷ In a subsequent speech delivered January 22, 1982, to "Wall Street Utility Group," you specifically noted the following in regard to the CWIP rulemaking:

We have received numerous written comments in response to our Notice of Proposed Rulemaking, and have also heard oral presentations. Reply comments were due January 15, 1982. We will carefully consider these written and oral pleadings in arriving at a decision.

⁸ "I bet I could go down to the hospitals of this city and find a worker that is undergoing kidney dialysis, and I'll bet you a dinner that some of those workers have been in lead plants" (Id.).

⁹ "I tell you I can smell a phony issue when I see one . . . and to say that safety and health regulations are inflationary is phony" (Id.).

¹⁰ "Well, I learned to spell those words a long time ago on the Coke Oven Advisory Committee, and if you want to know how I feel about it, you need only look up my comments during those Committee hearings. As far as I am concerned it is impossible to have a lead standard without it" (Id.).

United States v. Morgan, 313 U.S. 409, 421 (1941)). APPA tries to distinguish the *United Steel Workers* case on the basis that the Assistant Secretary gave the speech after she had voted on the standard (but before the Secretary of Labor had signed it). However, the court noted that "[h]ad she made these remarks before the rulemaking began or while OSHA was still receiving public comments, we might still have had to strain precedent to find grounds for her disqualification" (*Id.*, at 1210).

In a somewhat different context, the Supreme Court found that a schoolboard's participation in teacher contract negotiations that preceded and led to a strike did not prevent the board from conducting impartial disciplinary hearings against the striking teachers. *Joint School District No. 1 v. Hortonville Education Association*, *supra*, 426 U.S. at 493. The court held that mere familiarity with the facts of a case gained by an agency in the performance of its statutory role did not disqualify a decisionmaker, nor was he disqualified simply because he took a public position on a policy issue related to the dispute.

The Supreme Court also rejected claims that statements to Congress by FTC Commissioners in which they equated a particular trade practice with illegal price fixing showed fatal prejudgment of the issue when it arose in a subsequent investigation proceeding before the agency. *FTC v. Cement Institute*, 333 U.S. 683, 701 (1948). The Court held that the earlier statements did not necessarily mean that the minds of the members were irrevocably closed. The Court found significant the fact that the industry had an opportunity after the statements to Congress were made to present evidence and argument to persuade the FTC that its business practices were legal.

In sum, because your speech indicated neither unwillingness to consider comments in the RM81-38 proceeding, nor unwillingness to abandon any of the views expressed in the speech in light of those comments, there is no reason to infer an unalterably closed mind on the issues in the CWIP proceeding.

[FR Doc. 83-13713 Filed 5-31-83; 8:45 am]

BILLING CODE 6717-01-M

18 CFR Part 2

[Docket No. RM83-21-000; Order No. 303]

Interpretation of Authority To Suspend Initial Rate Schedules

Issued: May 24, 1983.

AGENCY: Federal Energy Regulatory Commission, DOE.

ACTION: Final rule.

SUMMARY: The Federal Energy Regulatory Commission is amending its "Statements of General Policies and Interpretations" in 18 CFR Part 2, to provide for suspension of initial rate schedules under section 205 of the Federal Power Act and section 4 of the Natural Gas Act. These amendments conform the Commission's interpretative

rules to conclusions it drew in *Middle South v. Energy, Inc.* The Commission concluded that the Federal Power Act does not prohibit it from suspending initial rate schedules, establishing interim rates during the suspension period, and establishing contingent refund obligations.

DATES: This final rule is effective May 24, 1983.

FOR FURTHER INFORMATION CONTACT: Kenneth J. Malloy, Rulemaking and Legislative Analysis, Office of General Counsel, 825 North Capitol Street, NE., Washington, D.C. 20426, (202) 357-8033

SUPPLEMENTARY INFORMATION:

I. Introduction

The Federal Energy Regulatory Commission (Commission) is amending its regulations to set forth a revised interpretation of the Commission's authority to suspend initial rate schedules under section 205 of the Federal Power Act (FPA) and section 4 of the Natural Gas Act (NGA), and to establish interim rates during the suspension period if necessary. In *Middle South v. Energy, Inc.*, Docket No. ER82-66-001, 22 FERC ¶— (May 24, 1983), the Commission concluded that the Federal Power Act does not prohibit the Commission from suspending initial rate schedules, establishing interim rates during the suspension period and establishing contingent refund obligations. This amendment conforms the Commission's interpretative rules to reflect these conclusions.

The Commission's interpretation reverses the conclusion of the Federal Power Commission (FPC) in 1945 that an initial rate schedule cannot be suspended. The new interpretation is based upon a reexamination of the legislative history of the FPA, the well-recognized historical relationship between the FPA and the Interstate Commerce Act (ICA), and upon the Supreme Court's interpretation of comparable language in sections 6 and 15 of the ICA in the *Trans Alaska Pipeline Rate Cases*, 436 U.S. 631 (1978) (TAPS). The Commission also found in *Middle South* that the ability to suspend initial rate schedules under the FPA will enable the Commission to better meet its general charge to protect the public interest insofar as it is affected by jurisdictional transactions involving electric power. Since the pertinent statutory provisions of the FPA are substantially identical to the comparable provisions of the Natural Gas Act (NGA)¹ and since the

interpretative rules regarding suspension under the NGA track those under the FPA, the NGA rules are also being amended to conform to the Commission's interpretation in *Middle South*.²

II. Background

Under section 205(e) of the FPA, the Commission has the authority to suspend electric rate increases for up to five months, after which the rate will go into effect.³ After a hearing, the Commission may order a refund of such portions of an increased rate found not to be justified.

In interpreting the suspension and refund authority under section 205(e), the Commission has historically distinguished between an "initial" rate schedule and a "change" in a rate schedule for purposes of suspension.⁴ Section 2.4(d) of the Commission's regulations makes this interpretation of section 205(e) explicit by stating the "[a]n initial rate schedule cannot be suspended." Section 2.4 of the Commission's regulations reflects the conclusion of the FPC on May 29, 1945, concerning its suspension powers under section 205(e) of the FPA. This conclusion was similarly applied to the Natural Gas Act in § 2.52.

Since May 29, 1945, the Commission has allowed initial rates to become effective without suspension. The Commission viewed the prospective corrective measures under section 206 of the FPA and section 5 of the NGA as comprising the exclusive remedy for

identical." *FPA v. Sierra Pacific Power Co.*, 350 U.S. 348, 353 (1956). . . . [W]e therefore follow our established practice of citing interchangeably decisions interpreting the pertinent sections of the two statutes. . . .

Arkansas Louisiana Gas Co. v. Hall, 453 U.S. 571, 577 n.7 (1981).

² The Commission expects that suspension of initial rates under the NGA will not frequently occur because of the Commission's certificate authority under section 7(e) of the NGA. Under section 7(e), the Commission may condition a certificate with an adjustment to the proposed initial rate to ensure that service is initiated under rates consistent with the public interest. Refunds of amounts collected under temporary certificates may also be conditions of permanent certification.

³ Section 205(e), 16 U.S.C. 824d(e) (1976), states in pertinent part:

[T]he Commission . . . may suspend the operation of such schedule . . . but not for a longer period than five months . . . [T]he Commission may . . . require such public utility . . . to refund with interest . . . such portion of such increased rates or charges as by its decision shall be found not justified. . . .

⁴ The Commission's regulations concomitantly distinguish between a change in rate schedule and an initial rate schedule in 18 CFR 2.4, 35.1 (b) and (c). Sections 35.12 and 35.13, respectively, contain the filing requirements for initial rate schedules and changes in rate schedules.

¹ The Supreme Court recently stated:

[T]he relevant provisions of the [FPA and the NGA] "are in all material respects substantially

potentially unjust or unreasonable initial rates.

III. Discussion

The Commission determined in *Middle South* that the interpretation and conclusions reached in 1945 regarding its suspension power were and are overly narrow. Upon reexamination of the statute and legislative history in light of the *TAPS* case, the Commission concluded in *Middle South* that the historic distinction between initial and changed rates was overly restrictive and unnecessarily hampers the Commission in carrying out its statutory mandate.

The Commission found that the previous interpretation of section 205 of the FPA, expressed in 18 CFR 2.4(d), rests on a narrow reading of subsections (c), (d), and (e) of section 205. Subsection (e) provides for suspension of "any such new schedule." The traditional interpretation holds that this phrase refers back to the immediately preceding subsection (d), which provides that:

Unless the Commission otherwise orders, no change shall be made by any public utility in any such rates, charges, classification, or service, or in any rule, regulation, or contract relating thereto, except after sixty days notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force. . . .

16 U.S.C. 824(d) (1976) (emphasis added).

Thus, the phrase "such new schedule[s]" in section 205(e) has been interpreted to mean only the changed rate schedules referred to in subsection (d). The alternative reading, which the Commission here adopts, is that "such new schedule" most logically applies to both sections 205(d) and 205(c). Section 205(c) requires the utility to file "schedules showing all rates and charges for any transmission or sale subject to the jurisdiction of the Commission. . . ." (emphasis added). Thus, under the more expansive reading, the suspension authority extends to new initial rates as well as to newly changed rates.

The Commission found that the reference to a change of rates in section 205(e) most logically relates to changes in those preexisting rate schedules filed with the Commission for the first time as a result of the enactment of section 205. Under this reading, any rate schedule for a new service filed after the first-ever filing would be regarded as a change of service or rate. In effect, section 205 permits "grandfathering" of

rate schedules existing at the time of enactment.⁵

The Commission stated that this reading is consistent with the fundamental purpose of the Federal Power Act, that is, to maintain rates that are just and reasonable to both the utility and the consumer. The Commission took as its guide the reasoning of the Supreme Court in *TAPS*. In *TAPS*, the Court found that the Interstate Commerce Commission (ICC) possessed necessarily implied authority pursuant to section 15(7) of the ICA⁶ to suspend initial rates of oil pipeline companies under the rate setting scheme of Title I of that Act, which is similar in language, structure, and purpose to the FPA.⁷

The keystone of the Court's analysis was its conclusion that the absence of authority to suspend initial rates is not consistent with the primary purpose of the ICA to maintain reasonable charges for the regulated services. The Court reasoned that absent such suspension authority, the Act would provide no mechanism tending to make initial rates reasonable. This would be particularly the case where (as in *TAPS*) the shippers and the pipeline owners were affiliates. The Court was not deterred in this regard by its admission that the suspension authority was added⁸ to deal with the "mischief of unchecked changes in rates." 436 U.S. at 644. It found that unless the legislative history of the statute compelled the opposite

conclusion, the suspension power would necessarily apply to initial as well as changed rates because the mischiefs flowing from each are the same.

The Court did not find any significance in the phrase "change of rate" in section 15(7). It noted that Congress, in enacting Titles II, III, and IV of the Act to extend the ICC's original ratemaking jurisdiction to additional modes of transportation, unequivocally indicated that initial rates were new rates capable of being suspended, and yet references to "changed" rates appear in the same places they appear in Title I.⁹

The Commission found that the applicability of the reasoning in the *TAPS* case to this Commission's authority under the FPA is clear.¹⁰ Absent authority to suspend initial rates, the Commission's ability to ensure their reasonableness would be limited to orders with prospective effect made pursuant to section 206. Thus the filing utility's customers would be forced to pay any initial rate ultimately found to be unreasonable until the Commission issued an order pursuant to section 206. In the formal hearing context, this could be a lengthy period. In this respect, absence of initial rate suspension authority is inconsistent with the fundamental requirement of section 205(a) that "all" rates shall be just and reasonable. The Commission stated that it was aware of no rationale in the legislative history to explain why an unlawful initial rate should be viewed as less onerous than an unlawful change in rate.

The Commission next considered the issue of whether suspension of initial rates would be prejudicial to the utility. It noted that the Court in *TAPS* considered this matter and concluded that the ICC has power ancillary to its authority to suspend initial rates under the ICA to set maximum interim rates

⁵ The legislative history is not clear on this point. See H.R. 5423, 74th Cong., 1st Sess. (1935): S. 2706, 74th Cong., 1st Sess. (1935); S. Rep. No. 621, 74th Cong., 1st Sess. 15 (1935); H.R. Rep. No. 1318, 74th Cong., 1st Sess. 29 (1935).

⁶ 49 U.S.C. 15(7) (1976). Authority to suspend oil pipeline rates was transferred from the ICC to this Commission pursuant to the Department of Energy Organization Act, 42 U.S.C. 7101-7352 (Supp. IV 1980), and Executive Order No. 12,009, 3 CFR Part 142 (1978). The relevant language of section 15(7) pertaining to suspension is as follows:

Whenever there shall be filed with the Commission any schedule stating a new individual or joint rate, fare, or charge, . . . the Commission shall have . . . authority . . . to enter upon a hearing concerning the lawfulness of such rate, fare, [or] charge . . . and pending such hearing and the decision thereon the Commission, upon filing with such schedule and delivering to the carrier or carriers affected thereby a statement in writing of its reasons for such suspension, may from time to time suspend the operation of such schedule and defer the use of such rate, fare, [or] charge . . . but not for a longer period than seven months beyond the time when it would otherwise go into effect

⁷ These parallels are obvious upon reading the two statutes and have been frequently noted by the courts. See *Aberdeen & Rockfish Ry. Co. v. SCRAP*, 409 U.S. 1207, 1215 (Opinion in chambers (1972)); *Arrow Trans. Co. v. Southern Ry. Co.*, 372 U.S. 658, 666 (1963); *Papago Tribal Util. Auth. v. FERC*, 628 F.2d 235, 243 N.19 (D.C. Cir. 1980).

⁸ Subsection 15(7) was added to the Act by the Mann-Elkins Act of 1910, 36 Stat. 552 (1910).

⁹ A second line of reasoning was that if the ICC were not given authority to suspend initial rates, Congress must not have intended to foreclose any equity powers of the courts to enjoin common carrier rates. This could lead to diverse conclusions by the courts, thwarting the regulatory purpose of uniformity of rates. Although the FPA does not require uniformity of rates, it does prohibit undue discrimination in rates, which was also a concern noted by the Court in *TAPS*, 436 U.S. at 641. Thus, the exercise of injunctive authority by the courts in likewise inconsistent with the scheme of the FPA. Further, as noted by the court in *Papago Tribal Util. v. FERC*, 628 F.2d 235, 242 (D.C. Cir. 1980), any judicial authority to suspend rates "would create the hazard of forbidden intrusion into the administrative domain. . . . because it necessarily would involve inquiry into the reasonableness of rates." (Citing *Arrow Transp. Co. v. Southern Ry. Co.*, 372 U.S. 658 (1963) (footnote omitted)).

¹⁰ These Titles of the ICA were enacted in the 1930's contemporaneously with FPA.

during the suspension period. The Court further held that part of that ancillary power is the power to order refunds of amounts collected under the interim rates during the suspension period and under the initial rates collected after the suspension period expires where such rates are found to be unreasonable. 436 U.S. at 654-657. This was held to be the case notwithstanding the lack of any express authority to do so in the Act and that the express refund authority of section 15(7) is limited to increased rates or changes at the end of the suspension period.

The Commission found one contrary argument that merited discussion. In *United Gas Pipeline Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956) (*Mobile*), the Supreme Court noted a marked contrast between the ICA and the NGA, in that the former in effect "precludes private rate agreements by its requirement that the rates to all shippers be uniform," whereas "the [NGA] permits the relations between the parties to be established initially by contract." *Id.* at 338-39. The reason for the ICA scheme was the administrative impossibility of policing thousands of individual railroad retail transactions. The Court noted by contrast the relatively few wholesale natural gas transactions and the substantial investment that may be required for the service of a particular customer, creating a need for "individualized arrangements." *Id.* The same reasoning, of course, would apply to wholesale transactions under the FPA. Thus, the argument would go, Congress could not have intended to give the parties authority to negotiate individualized contracts for new services and, at the same time, undercut that authority by permitting the Commission to suspend the initial rates resulting therefrom. The mechanism for ensuring the reasonableness of the initial rates would be the parties' arms length negotiations.

The Commission found that the problem with this argument is that the logic would apply equally to changes in contracts negotiated at arms length. Such contract changes are clearly subject to suspension and refund. The more salient consideration was found to be that, notwithstanding that private rate agreements are authorized by the FPA, the Commission is given final authority to modify those agreements in order to carry out its mandate to ensure that all rates be just and reasonable. See *Mobile*, *id.* at 340-41 (construing the Commission's authority under the parallel provisions of the NGA). Furthermore, while an initial rate may represent the product of negotiations

between the parties, this is not necessarily the case. The reality is that a new rate for new service may be proffered unilaterally by a utility just as in the case of a changed rate.

Finally, the Commission noted that the Supreme Court found in *TAPS* that the ICC's authority to order "reparations" under the ICA for charges ultimately found to be unreasonable was not an adequate remedy because (1) the damage suffered through loss of competitive advantage would likely exceed the difference between the charged rate and the just and reasonable rate, and (2) the shippers have more incentive to pass along unreasonable rates in the prices of their goods than to seek reparations, thus shifting the burden to the consumer. 436 U.S. at 640-41. The Commission found that the case for its authority to suspend initial rates under the FPA on this basis is even stronger because the Commission, unlike the ICC, has no authority to order "reparations." It is thus that much more difficult for the Commission to enforce the just and reasonable standard absent suspension and refund authority with respect to initial rates.

The Commission noted that there are judicial statements supportive of the restrictive interpretations it had followed in the past. See *Mobile*, *supra*; *Indiana & Michigan Mun. Distrib. Assoc. v. FERC*, (IMMDA) 659 F.2d 1193 (D.C. Cir. 1981); *Florida Power & Light Co. v. FERC*, 617 F.2d 809 (D.C. Cir. 1980); *Otter Tail Power Co. v. FERC*, 583 F.2d 399 (8th Cir. 1978). It concluded, however, that these statements are *dicta*. In *Florida Power* and *Otter Tail* the courts stated that they were addressing only the question of whether the Commission had correctly classified the rate schedules as changed rather than initial rates. The Court in *Mobile* made a passing reference to the Commission's suspension authority under the NGA during the course of a discussion of the general statutory scheme, included to highlight a different question which was at issue in that case.¹¹ In *IMMDA*, the court, while strongly agreeing with the Commission's view that it could not suspend initial rates, made it clear that the basic statutory scheme was not in dispute in that case, 659 F.2d at 1196.

¹¹ The Commission noted that in *Mobile*, the Court focused on the distinction between "existing" rates and "new" rates (350 U.S. at 340) and between "long established" versus "newly change" rates (*id.* at 341) rather than on a distinction between "initial" and "changed" rates. The fact that a rate was "new" seemed more important in the Court's discussion than the fact that it was "changed."

The Commission also concluded in *Middle South* that it has concomitant authority to establish interim rates during the suspension period of an initial rate. This view is premised on the holding of the Supreme Court in the *TAPS* case that exercise of a similar authority to set interim rates by the I.C.C. when it suspended an initial rate was "an intelligent and practical exercise of its suspension power," particularly in light of the alternative, *viz.*, requiring a filing company to submit and resubmit rates until it hits upon one which is allowed to take effect. 436 U.S. at 651-654.

Likewise, the Commission asserted and exercised its ancillary power to make MSE's initial rates subject to refund, again citing the Supreme Court's discussion of section 15(7) of the Interstate Commerce Act which is virtually identical in its pertinent provisions to section 205(e) of the FPA. In the *TAPS* case, the Court found the refund conditions imposed on both the interim and filed initial rates to be a "legitimate, reasonable, and direct adjunct to the Commission's explicit statutory power to suspend rates pending investigation. . . ." 436 U.S. at 654-657.

IV. Conclusion

In light of the Commission's decision in *Middle South*, the FPC's post-1945 policy, as now stated in 18 CFR 2.4(d), can no longer be considered a proper interpretation of the scope of the Commission's statutory suspension authority under section 205(e) of the FPA. Because section 4 of the NGA is identical in its pertinent provisions to section 205 of the FPA,¹² the Commission now interprets both the FPA and NGA to permit suspension of initial rates. The Commission also believes that it has the correlative authority to establish interim rates, if necessary, in those instances in which it suspends an initial rate, and to make both the interim and initial rates subject to refund. Sections 2.4(d) and 2.52 of the Commission's regulations are, therefore, being amended to reflect this interpretation.

V. Effective Date

The Administrative Procedure Act exempts interpretative rules from both the notice and comment requirements, 5

¹² The rate setting provisions of the NGA have been found by the courts to be substantially identical to those of the FPA. *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348, 350-51, 353 (1956); *Indiana & Michigan Power Co. v. FPC*, 502 F.2d 336, 341 (D.C. Cir. 1974); *Borough of Lansdale, Pa. v. FPC*, 494 F.2d 1104, 1110-11 (D.C. Cir. 1974).

U.S.C. 553(b)(A) (1976), and the requirement that publication be made thirty days before the effective date of the rule, *id.* at section 553(d). Since this rule conforms the statements of interpretation of the Commission's statutory authority under both the FPA and the NGA to the decision reached in *Middle South*, this rule shall be effective May 24, 1983, without prior notice and comment.

List of Subjects in 18 CFR Part 2

Administrative practice and procedure, Electric power, Environmental impact statements, Natural gas, Pipelines.

(Natural Gas Act, 15 U.S.C. 717-717w (1976 & Supp. IV 1980); Federal Power Act, 16 U.S.C. 791a-828c (1976 & Supp. IV 1980); Department of Energy Organization Act, 42 U.S.C. 7101-7352 (Supp. IV 1980); Executive Order 12,009, 3 CFR Part 142 (1978); 5 U.S.C. 553 (1976))

In consideration of the foregoing, the Commission amends Part 2, Subchapter A, Chapter I of Title 18, Code of Federal Regulations, as set forth below.

By the Commission.
Kenneth F. Plumb,
Secretary.

PART 2—[AMENDED]

1. In § 2.4, paragraph (d) is revised to read as follows:

§ 2.4 Suspension of rate schedules.

(d) An initial rate schedule can be suspended and an interim rate established; both can be made subject to refund.

2. Section 2.52 is revised to read as follows:

§ 2.52 Suspension of rate schedules.

The interpretation stated in § 2.4 applies as well to the suspension of rate schedules under section 4 of the Natural Gas Act.

[FR Doc. 83-14423 Filed 5-31-83; 8:45 am]

BILLING CODE 6717-01-M

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Office of the Assistant Secretary for Fair Housing and Equal Opportunity

24 CFR Part 111

[Docket No. R-83-1082]

Fair Housing Assistance Program; Program Description and Eligibility Criteria

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Interim rule; request for comments.

SUMMARY: This interim rule amends the regulations in 24 CFR Part 111, which describe the program components for State and local Fair Housing agencies and set forth the threshold eligibility criteria for their participation in the Fair Housing Assistance Program (FHAP). The purpose of the amendment is to permit State and local Fair Housing agencies to qualify for training support funding, without regard to the number of years the agency has participated in the Fair Housing Assistance Program.

DATES: The rule is effective July 15, 1983. Comments are due August 1, 1983.

ADDRESS: Interested persons are invited to submit comments regarding the rule to the Office of General Counsel, Rules Docket Clerk, Room 10278, Department of Housing and Urban Development, 451 7th Street, S.W., Washington, D.C. 20410. Comments should refer to above docket number and title. A copy of each comment submitted will be available for public inspection and copying during regular business hours at the above address.

FOR FURTHER INFORMATION CONTACT: Steven J. Sacks, Director, Federal, State and Local Programs Division, Room 5214, Department of Housing and Urban Development, 451 7th Street, S.W., Washington, D.C. 20410 (202) 426-3500. This is not a toll-free number.

SUPPLEMENTARY INFORMATION: The Department is modifying the noncompetitive component of its Fair Housing Assistance Program to make training support funds available to all participating agencies, regardless of the number of years an agency has participated in the program. The current rule provides training support funds to agencies only during their first and second years of participation.

Financial assistance for training is provided to assure that the State and local agencies have the skills and technical knowledge required to carry out their enforcement responsibilities. An essential element in administering an effective State or local fair housing program is the training of personnel. Fair Housing Law is a rapidly changing area, and the Department recognizes that intermittent, informal training is unlikely to provide the assistance and support necessary for State and local agencies to process housing discrimination complaints effectively, and in conformity with Federal standards. In order to assure consistency in the administration of, and approaches to, fair housing enforcement, the training component of the Fair

Housing Assistance Program is used for the expenses associated with providing training to State and local agency personnel. Currently, agencies participating in the program after their second year are required to attend training in order to meet the performance requirements of their cooperative agreements, but are not eligible to receive training support funds. This amendment will allow agencies to apply for these funds.

The Department regards this rulemaking as a rational response to a perceived problem in its funding policy, and believes that it is in the public interest to make this rule effective as quickly as possible, so that all participating agencies will be eligible to receive training support money during fiscal year 1983. Accordingly, this rulemaking is being promulgated as an interim rule. However, the Department invites public comment on this policy change and will take that comment into account in promulgating the final rule.

Information collection requirements contained in this regulation (§ 111.105(b)) have been approved by the Office of Management and Budget under the provisions of the Paperwork Reduction Act of 1980 (Pub. L. 96-511) and have been assigned OMB control number 2529-0005.

This rule does not constitute a "major rule" as that term is defined in section 1(b) of the Executive Order on Federal Regulation issued by the President on February 17, 1981. Analysis of the rule indicates that it does not: (1) Have an annual effect on the economy of \$100 million or more; (2) cause a major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (3) have a significant adverse effect on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic or export markets.

A Finding of No Significant Impact with respect to the environment has been made in accordance with HUD regulations in 24 CFR Part 50 that implement section 102(2)(C) of the National Environmental Policy Act of 1969, 42 U.S.C. 4332. The Finding of No Significant Impact is available for public inspection and copying during regular business hours in the Office of the Rules Docket Clerk, Room 10278, 451 7th Street, S.W., Washington, D.C. 20410.

Pursuant to the provisions of 5 U.S.C. 605(b) (the Regulatory Flexibility Act), the Undersigned hereby certifies that

this rule would not have a significant economic impact on a substantial number of small entities, because the training support funds afforded to State and local agencies to enable their participation in HUD-sponsored training should benefit all governmental jurisdictions, irrespective of their size.

The Catalog of Federal Domestic Assistance Program number and title is 14.401, Fair Housing Assistance Program.

This rule is not listed in the Department's Semiannual Agenda of Regulations published on October 28, 1982 (47 FR 48422) pursuant to Executive Order 12291 and the Regulatory Flexibility Act.

List of Subjects in 24 CFR Part 111

Fair housing, Cooperative agreements, Grant programs—housing and community development.

PART 111—[AMENDED]

Accordingly, 24 CFR Part 111 is amended as follows:

1. In § 111.102 paragraph (c) is revised to read as follows:

§ 111.102 Program description for type I—non-competitive funding.

(c) Training. Funding will be available to support training designed to provide skills and technical knowledge in the administration of fair housing laws and programs. HUD-sponsored training support funds will be available on a non-competitive basis to participating agencies as a fixed percentage of their levels of funding under paragraph (a) or (b) of this section, not to exceed a set maximum. Any agency otherwise eligible to receive funding under paragraph (a) or (b) of this section, but electing not to apply for such funding, may apply for training support funds up to the level to which the agency would have been entitled, had it applied for funding under paragraph (a) or (b) of this section.

2. Section 111.105 is amended by revising paragraphs (a)(2), (a)(3) and (b), and by adding a new paragraph (a)(4), as set forth below:

§ 111.105 Criteria for type I-non-competitive funding.

(a) * * *

(2) Be prepared to develop procedures acceptable to HUD for cooperating with

other substantially equivalent agencies having concurrent jurisdiction;

(3) Not unilaterally reduce the level of financial resources currently committed to fair housing complaint processing. Budget and staff reductions occasioned by legislative action outside the control of the agency will not result in a per se determination of ineligibility. HUD will, however, take such actions into consideration in assessing the ongoing viability of an agency's fair housing program; and

(4) Participate in training sponsored by HUD and designed in consultation between HUD and agency representatives to provide uniform skills and technical knowledge.

(b) In addition, all first and second year program participants seeking capacity building support must demonstrate that there is, within the geographic jurisdiction of the agency, a sufficient volume of current or potential complaint activity to justify the requested allocation of funds.

(OMB control number 2529-0005).

(Title VIII, Civil Rights Act of 1968, 42 U.S.C. 3601-30 Section 7(d), Department of Housing and Urban Development Act, 42 U.S.C. 3535(d))

Dated: May 9, 1983.

Antonio Monroig,

Assistant Secretary for Fair Housing and Equal Opportunity.

[Fr Doc. 83-14593 Filed 5-31-83; 8:45 am]

BILLING CODE 4210-26-M

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[A-9-FRL 2343-4]

Approval and Promulgation of Implementation Plans; California State Implementation Plan Revision

AGENCY: Environmental Protection Agency.

ACTION: Notice of Final Rulemaking.

SUMMARY: The Environmental Protection Agency (EPA) takes final action to approve revisions to rules of seven Air Pollution Districts submitted by the California Air Resources Board (CARB) as revisions to the California State Implementation Plan (SIP). These revisions are generally administrative and retain the previous emission control requirements. EPA reviewed these rules with respect to the Clean Air Act and determined that they should be

approved. In addition, this notice corrects an administrative error by updating 40 CFR 52.222, *Extensions*, to be consistent with recent updates to 40 CFR 52.238, *Attainment dates for national standards*.

DATE: This action is effective August 1, 1983.

ADDRESSES: A copy of the SIP revisions are available for public inspection during normal business hours at the EPA Region 9 office and at the following locations.

Public Information Reference Unit,

Environmental Protection Agency,

Library, 401 "M" Street SW., Room

2404, Washington, D.C. 20460

Library, Office of the Federal Register,

1100 "L" Street NW., Room 8401,

Washington, D.C. 20460.

FOR FURTHER INFORMATION CONTACT:

Douglas Grano, Chief, State Implementation Plan Section, Air Programs Branch, Air Management Division, Environmental Protection Agency, Region 9, 215 Fremont Street, San Francisco, CA 94105, (415) 974-7641.

SUPPLEMENTARY INFORMATION: The CARB submitted the following rules as SIP revisions on the indicated dates:

August 6, 1982

Butte County

Rule 4-6 State Ambient Air Quality Standards

Rule 4-6A Implementation Plans

November 8, 1982

Sacramento County

Rule 59 Appeals

Rule 70 Stationary Source Permit Fees

Santa Barbara County

Rule 210D Permit Fees

Stanislaus County

Rule 110 Equipment Breakdown

Rule 202 Exemptions

Rule 302 Permit Fee Schedules

South Coast AQMD

Rule 708.3 Transportation Management Plans

Rule 1105 Fluid Catalytic Cracking Units—Oxides of Sulfur

Tulare County

Rule 519 Emergency Variance

Yolo-Solano County

Rule 6.1 Agricultural Burning

As described below, these rule revisions are administrative and do not significantly impact current emission control requirements.

Butte County—Rule 4-6 (State Ambient Air Quality Standards) states that all references in Section 4-5 to national ambient air quality standards shall be interpreted to include state ambient air quality standards. Rule 4-6A (Implementation Plans) allows the District to issue a permit to construct for new stationary sources (which are subject to Section 5 of Section 4-5) only if all district regulations are being carried out in accordance with the presently approved State Implementation Plan.

Sacramento County—Rule 59 (Appeals) expands the existing appeal procedures. Rule 70 (Stationary Source Permit Fees) reduces fees for gas stations not subject to Phase II vapor recovery.

Santa Barbara County—Rule 210D (Permit Fees) exempts the district itself from permit fees.

Stanislaus County—Rule 110 (Equipment Breakdown) adds Phase II vapor recovery to the breakdown requirements. Rule 202 (Exemptions) deletes permit rule exemptions for brazing, soldering and welding equipment. Rule 302 (Permit Fee Schedules) allows an increase in permit fees.

South Coast AQMD—Rule 708.3 (Transportation Management Plans) changes the title from Traffic Abatement Plan to Transportation Management Plans. Rule 1105 (Fluid Catalytic Cracking Units—Oxides of Sulfur) postpones the implementation dates for Phase II by two years in order to provide enough time for catalyst manufacturers and refineries to resolve remaining problems with the application of sulfur dioxide (SO₂). The rule also requires the calculation of mass emissions of SO₂ from the regenerator based on the SO₂ concentration obtained from SO₂ monitors.

Tulare County—Rule 519 (Emergency Variance) now provides that no emergency variance shall be granted unless the attainment or maintenance of the national ambient air quality standards will not be endangered.

Yolo-Solano County—Rule 6.1 (Agricultural Burning) removes limitations on the County and allows the District to fully participate in the Sacramento Valley Air Basin experimental agricultural burning program. The experimental program is designed to allow burning while decreasing the particulate emissions.

Under Section 110 of the Clean Air Act as amended, and 40 CFR Part 51,

EPA is required to approve or disapprove these regulations as SIP revisions. EPA has evaluated all rules submitted by the CARB and they have been found to be in accordance with EPA policy and 40 CFR Part 51. EPA's evaluation of the submitted rules is available at the EPA Library in Washington, D.C. and the Region 9 office.

The purpose of this notice is to approve all the rule revisions listed above and to incorporate them into the California SIP. EPA is approving these rule revisions without prior proposal because the revisions are noncontroversial, have limited impact, and no comments are anticipated. The public should be advised that this action will be effective 60 days from the date of this Federal Register notice. If EPA receives notice within 30 days that someone wishes to submit adverse or critical comments, the approval will be withdrawn and a subsequent notice will be published before the effective date. The subsequent notice will indefinitely postpone the effective date, modify the final action to a proposed action, and establish a comment period.

This notice also corrects an administrative error made in final notices on the Santa Barbara and Stanislaus County 1979 nonattainment area plans (NAPs). Although the attainment date extension requests for carbon monoxide or ozone in these California NAPs were approved, they were only codified in 40 CFR 52.238, *Attainment dates for national standards*. This notice corrects 40 CFR 52.222, *Extensions*, to be consistent with § 52.238 and the Santa Barbara NAP. For Stanislaus County, § 52.238 is also corrected with respect to carbon monoxide. This notice also corrects an administrative error made in the July 1, 1982 (47 FR 28622) Notice of Final Rulemaking, 40 CFR 52.255, *Gasoline transfer vapor control*, to reinstate subparagraphs which were inadvertently omitted.

Under 5 U.S.C. 605(b), the Administrator has certified that SIP approvals do not have a significant economic impact on a substantial number of small entities. (See 46 FR 8709.) The Office of Management and Budget has exempted this rule from the requirements of Section 3 of Executive Order 12291.

Under the Clean Air Act, any petitions for judicial review of this action must be filed in the United States Court of Appeals for the appropriate circuit by (60 days from today). This action may not be challenged later in proceedings to enforce its requirements.

Incorporation by reference of the State Implementation Plan for the State of California was approved by the Director of the Federal Register on July 1, 1982.

List of Subjects in 40 CFR Part 52

Air pollution control, Ozone, Sulfur dioxides, Nitrogen dioxide, Lead, Particulate matter, Carbon monoxide, Hydrocarbons, Intergovernmental relations.

(Sec. 110, 172, and 301(a), Clean Air Act, as amended (42 U.S.C. 7410, 7502 and 7601(a)))

Dated: May 10, 1983.

Lee L. Verstandig,
Acting Administrator.

PART 52—[AMENDED]

Subpart F of Part 52, Chapter I, Title 40 of the Code of Federal Regulations is amended as follows:

Subpart F—California

1. Section 52.220 is amended by adding paragraphs (c)(124)(xii)(A) and (c)(126)(i)(A)–(vi)(A) to read as follows:

§ 52.220 Identification of plan.

(c) * * *

(124) * * *

(xii) Butte County APCD.
(A) New or amended Rules 4-6 and 4-6A.

(126) Revised regulations for the following APCDs submitted on November 8, 1982 by the Governor's designee.

- (i) Sacramento County APCD.
(A) New or amended Rules 59 and 70.
- (ii) Santa Barbara County APCD.
(A) New or amended Rule 210D.
- (iii) Stanislaus County APCD.
(A) New or amended Rules 110, 202, and 302.
- (iv) South Coast AQMD.
(A) New or amended Rules 708.3 and 1105.
- (v) Tulare County APCD.
(A) New or amended Rule 519.
- (vi) Yolo-Solano County APCD.
(A) New or amended Rule 6.1.

2. Section 52.222 is amended by revising paragraph (b)(6)(i) and by adding paragraph (d)(3)(i) as follows:

§ 52.222 Extensions.

- (b) * * *
- (6) * * *
- (i) Santa Barbara County Nonattainment Area for TSP and CO.

(d) * * *

(3) South Central Coast Air Basin.

(i) Santa Barbara County

Nonattainment Area for O₃.

3. In § 52.238 the entries for the San

Joaquin Valley Intrastate are revised as follows:

§ 52.238 Attainment dates for national standards.

Air quality control region and nonattainment area	Pollutants				NO _x	CO	O ₃
	TSP		SO ₂				
	Primary	Secondary	Primary	Secondary			
San Joaquin Valley Intrastate	.	.	.	.	.	.	.
g. Stanislaus County	h.	h.	e.	e.	e.	h.	i.

4. Section 52.255 is amended by redesignating paragraph (b)(1)(x) as paragraph (b)(1)(i) and removing paragraph (b)(1)(ii)-(ix) reserved and adding a new paragraph (b)(2), to read as follows:

§ 52.255 Gasoline transfer vapor control.

- (b) * * *
- (1) * * *
- (i) Ventura County APCD.
- (2) The control requirements of this section are rescinded in the following air pollution control districts.
- (i) South Coast AQMD.
- (ii) Santa Barbara County APCD.
- (iii) Placer County APCD (Mountain Counties Air Basin portion).
- (iv) Sacramento County APCD.
- (v) Yolo-Solano County APCD.
- (vi) Butte County APCD.
- (vii) Glenn County APCD.

[FR Doc. 83-13335 Filed 5-31-83; 8:45 am]

BILLING CODE 6560-50-M

40 CFR Part 180

[PP 9E2166/R562; PH FRL 2374-7]

Tolerances and Exemptions From Tolerances for Pesticide Chemicals in or on Raw Agricultural Commodities; Dicamba

AGENCY: Environmental Protection Agency (EPA).

ACTION: Final Rule.

SUMMARY: This rule establishes tolerances for the combined residues of the herbicide dicamba and its metabolite in or on the raw agricultural commodities proso millet grain and straw. The regulation to establish maximum permissible levels for residues of the herbicide in or on the commodities was submitted, pursuant to

a petition, by the Interregional Research Project No. 4 (IR-4).

EFFECTIVE DATE: Effective on June 1, 1983.

ADDRESS: Written objections may be submitted to the: Hearing Clerk (A-110), Environmental Protection Agency, Rm. 3708, 401 M St., SW., Washington, D.C. 20460.

FOR FURTHER INFORMATION CONTACT:

Donald Stubbs, Emergency Response and Minor Use Section, Registration Division (TS-787C), Office of Pesticide Programs, Environmental Protection Agency, R. 716B, CM #2, 1921 Jefferson Davis Highway, Arlington, VA 22202; (703-557-1192).

SUPPLEMENTARY INFORMATION:

EPA issued a proposed rule published in the *Federal Register* of April 20, 1983 (48 FR 16912) which announced that the Interregional Research Project No. 4 (IR-4), New Jersey Agricultural Experiment Station, P.O. Box 231, Rutgers University, New Brunswick, NJ 08903, had submitted pesticide petition 9E2166 to EPA on behalf of the IR-4 Technical Committee and the Agricultural Experiment Stations of Colorado, Kansas, Minnesota, Nebraska, North Dakota, South Dakota, and Wyoming.

This petition requested that the Administrator, pursuant to section 408(e) of the Federal Food, Drug, and Cosmetic Act, propose the establishment of tolerances for the combined residues of the herbicide dicamba (3,6-dichloro-o-anisic acid) and its metabolite, 3,6-dichloro-5-hydroxy-o-anisic acid in or on the raw agricultural commodities proso millet grain and straw at 0.05 parts per million (ppm). The petition was later amended to propose tolerance levels of 0.5 ppm in or on the commodities.

There were no comments or requests for referral to an advisory committee

received in response to the proposed rule.

The data submitted in the petition and other relevant material have been evaluated and discussed in the notice of proposed rulemaking. The pesticide is considered useful for the purpose for which the tolerances are sought. It is concluded that the tolerances would protect the public health and are established as set forth below.

Any person adversely affected by this regulation may, within 30 days after publication of this notice in the *Federal Register*, file written objections with the Hearing Clerk, at the address given above. Such objections should specify the provisions of the regulation deemed objectionable and the grounds for the objections. If a hearing is requested, the objections must state the issues for the hearing and the grounds for the objections. A hearing will be granted if the objections are supported by grounds legally sufficient to justify the relief sought.

The Office of Management and Budget has exempted this rule from the requirements of section 3 of Executive Order 12291.

(Sec. 408(e), 68 Stat. 514 (21 U.S.C. 346(a)(e)))

List of Subjects in 40 CFR Part 180

Administrative practice and procedure, Agricultural commodities, Pesticides and pests.

Dated: May 25, 1983.

Edwin L. Johnson,

Director, Office of Pesticide Programs.

PART 180—[AMENDED]

Therefore, 40 CFR 180.227(a) is amended by adding and alphabetically inserting the raw agricultural commodities proso millet grain and straw to read as follows:

§ 180.227 Dicamba; tolerances for residues.

(a) * * *

Commodities	Parts per million
Millet, proso, grain	0.5
Millet, proso, straw	0.5

[FR Doc. 83-14738 Filed 5-31-83; 8:45 am]

BILLING CODE 6560-50-M