THREE UTILITY FINANCING ISSUES

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AUTHOR:

Sylvia Morrison

Economics Division

Kevin Flaherty

Economics Division

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ISSUE DEFINITION

This paper addresses three electric utility issues that all speak to the issue of improving cash flow for utilities at a time when costly construction programs, consumer-conscious regulation, and uncertain demand projections, have made it difficult for utilities to meet the requirements of investors. To summarize, the three issues are: (1) whether Congress should require the Federal Energy Regulatory Commission (FERC) to insist that companies applying for inclusion of construction work in progress (CWIP) in their rate bases demonstrate that all less expensive alternatives to building new plants have been tried; (2) whether Congress should amend the Public Utility Holding Company Act (PUHCA) to permit registered holding companies to own subsidiaries which are not related to electricity generation and to invest up to 10% of their assets in these subsidiaries without Securities and Exchange Commission (SEC) approval; and (3) whether Congress should take action to finance completion of Washington Public Power Supply System (WPPSS) nuclear plant #3.

BACKGROUND AND POLICY ANALYSIS

Admitting Construction Work in Progress (CWIP) to the Rate Base

Should Congress act to limit the conditions under which FERC may admit CWIP to the rate base? When CWIP is admitted to the rate base, utilities may charge ratepayers for the cost of plants still under construction. When CWIP is not admitted to the rate base, utilities may not charge customers for the cost of a new plant until it begins operation.

Since FERC regulates only interstate and wholesale power sales (about 12% of U.S. power revenues), admission of CWIP to the FERC-regulated rate base would only apply to that portion of CWIP which would eventually generate power for wholesale or interstate sale. However, more than half the States now admit CWIP to the State-regulated rate base under specific conditions.

From 1976 to 1983, FERC had admitted CWIP only for pollution control, for fuel-switching and, according to its stated policy, in cases where severe financial difficulty could be demonstrated. However, over this 7-year period, the Commission did not admit any CWIP for severe financial difficulty.

In May 1983, the FERC commissioners issued a new rule that would change FERC's standards for admitting CWIP to the FERC-regulated rate base. Under the new rule, FERC will allow utilities under its jurisdiction to file for rates that include a return on up to 50% of their investment in CWIP. The extent of the inclusion, however, would be limited to amounts that would increase rates by no more than 6% per year above what they would otherwise be.

H.R. 555 (passed by the House in February 1984) restricts FERC to its pre-1983 standard in allowing CWIP, with the extra provision that a utility filing for inclusion of CWIP must demonstrate that there is no more cost-effective way to augment its capacity than to build new plants. A similar bill, S. 1069, is before the Senate Committee on Energy and Natural Resources. This bill is described in detail under Legislation.

Since the late 1970s, increasing costs linked with declining demand for electricity have put many utilities under intense financial pressure. Particularly hard-pressed are those companies that are building nuclear plants, which require long-term commitments of large (and growing) amounts of capital. Without including CWIP in the rate base, companies cannot reclaim these large expenditures (running more than a billion dollars per plant over a period of 8 to 14 years) from the ratepayers until the plant goes into service.

Although, when CWIP is not admitted, the amounts spent on construction are listed on income statements as income in the form of Allowance for Funds Used During Construction (AFUDC), they do not constitute cash income for the company. The effect on a company's cash flow, since the generation of electricity is a particularly capital intensive operation, is equivalent to having a significant portion of its assets in long overdue accounts receivable. This situation is referred to as "poor quality of earnings," and inevitably has a negative effect on a company's bond ratings.

A utility company which has poor cash flow often also has a low ratio of pretax earnings to fixed interest charges, a problem referred to as "low interest coverage ratio." Since utility bond indentures typically require an interest coverage ratio of 2.0 as a minimum, a falling interest coverage ratio will probably result in a lowered bond rating for the utility. Low bond ratings mean that a company must pay a higher interest rate to secure capital. Thus, the inability to charge ratepayers immediately for funds spent for construction can result in higher construction costs.

Those who object to the admission of CWIP to the rate base do so on grounds that admitting CWIP (1) contradicts the regulatory principle that ratepayers should pay for plants only when they are used and useful; (2) may ease the way for power companies to build unneeded capacity in a period when most regions of the United States have excess capacity; and (3) may encourage utilities to expand plant as rapidly as possible in order to enlarge their rate bases and thereby increase both cash flow and profits. In a period of uncertain growth in demand for electricity and numerous plant cancellations, critics of CWIP want to be certain that utilities are building only those plants which are needed and that they will not have to cancel them after millions have been spent for partial completion.

Reevaluating the Public Utility Holding Company Act

Should Congress amend the Public Utility Holding Company Act of 1935 (PUHCA) to remove the restrictions on the registered public utility holding companies against acquiring subsidiaries that are not related to the generation and delivery of electricity? Supporters of proposed reform legislation (S. 1174 and H.R. 2994) say its purpose is to lower the cost of capital to the registered utility holding companies by permitting them to diversify their activities.

The plan of some utilities to diversify is based on the assumption that a non-utility would earn a greater return on equity than a utility and would thereby qualify for lower interest rates on borrowed capital than the utility. If the subsidiary business did earn a higher return on equity, the effect might be to lower the average cost of capital to the holding company, benefiting ratepayers as well as the utility.

The proposed reform bills would remove the requirement that subsidiaries of registered holding companies perform only functions related to electricity generation and transmission, and would require the Securities and Exchange Commission (SEC) to approve or disapprove holding company security issuances within 20 days of application for approval.

The reform bill also exempts certain issues of securities from SEC review. For example, holding company financing of each non-utility subsidiary in amounts up to 10% of the holding company's outstanding securities or assets would be exempt from SEC review. Investments greater than 10% of the holding company's assets could be approved by the SEC if it determined that such would not constitute an unreasonable risk to consumers or investors. Hence, under the reform act, a utility could gain a possible, but by no means guaranteed, reduced cost of capital. On the other hand, since the 10% ceiling on investment in subsidiaries would apply to the assets of the holding company and not to those of the subsidiaries (some of which would be utilities), a holding company could, unquestioned by Federal regulators and perhaps unquestioned by State regulators, risk utility capital in amounts considerably larger than 10% of the utility's assets.

Those who object to the reform measure do so because originally PUHCA was enacted to correct certain abuses which holding companies were able to inflict on utility ratepayers and investors because they were, in effect, unregulated holding companies. Lack of interstate regulation made it possible, before 1935, for 13 large holding companies to control three-fourths of the privately owned electric utilities, and for 11 holding companies to own more than 80% of the natural gas pipelines in the United States. The multi-State structure of the holding company made it impossible for the regulators of any one State to track its activities. In this period, holding companies acquired subsidiaries scattered about the Nation; withheld vital information from investors, charged utilities unreasonable rates for services from subsidiaries, extended systems and investments without regard for the financial effect on the utilities, and obstructed State regulation.

PUHCA, as enacted in 1935, empowered the SEC to limit the makeup of holding companies to integrated systems; required all services provided by affiliated companies to be provided at reasonable cost; required SEC approval of acquisitions of other utilities; and prohibited use of utility funds to finance non-utility ventures. The Act required companies which had subsidiaries that were not in States geographically contiguous with the home State of the parent company to register as holding companies and permitted registered holding companies to maintain only those subsidiaries that carried out activities related to the generation and transmission of electricity (for example, fuel supply).

The reason for introduction of the reform act now is a set of circumstances which led to increased costs of capital for utiilty companies in the 1970s. These circumstances include the effects of high inflation and high interest rates on the cost of utility construction. The rising cost of fuel oil and the cost of environmental protection devices that are required to accompany coal-fired plants led many utilities to decide to build nuclear plants. These require nearly twice as long to build as coal plants, and under conditions of high interest and inflation rates cost several times as much. In States where construction work in progress was not admitted to the rate base and rate increases often came too little and too late because of regulatory lag, some utilities found themselves desperately short of cash. Under these circumstances, the bond ratings of many utilities suffered, increasing the cost of capital to these companies. The present efforts to

reform PUHCA are designed to reduce the cost of capital to utilities.

Sponsors of S. 1174 and H.R. 2994 say that many of the abuses perpetrated by the holding companies prior to passage of PUHCA in 1935 were accounting practices which currently accepted accounting standards make impossible to repeat. Sponsors also say that the effects of those provisions of PUHCA that deal with public disclosure of information about companies and their securities are substantially duplicated in the SEC's implementation of the Securities Act of 1933 and the Securities Exchange Act of 1934. Hence, if PUHCA is changed, the protections against the abuses PUHCA was enacted to prevent will remain in effect. They add that reform will provide for examination of the books of utility subsidiaries by State public utility commissions (thereby preventing the draining off of utility revenues by unregulated subsidiaries) and will empower the SEC to review cases in which it is alleged that utility revenues are being invested in subsidiaries, when the State commission requests the SEC to do so.

Opponents of the reform act note that many State commisssions are neither empowered nor equipped to oversee diverse business activities, and for those that are the degree varies widely. SEC examination of records concerning non-utility activities is required under the provisions of the reform bills (S. 1174 and H.R. 2994) only at the request of State authorities. Many fear that under these circumstances, the holding companies may funnel utility revenues into unregulated businesses that could lose money because utility managers are not experienced in managing non-utility businesses or in dealing with risk.

Moreover, opponents of the reforms say that if the subsidiary business should be successful in bringing higher profits to the holding company than the utility, holding company managers may lose the incentive to give top priority to providing utility service to customers. Under such circumstances, utilities might be less responsive to State commissions, upon which the companies would no longer depend for revenues.

Default of the Washington Public Power Supply System

On June 15, 1983, the Supreme Court of the State of Washington ruled that the Washington municipalities participating in the construction of the cancelled nuclear power plants of the Washington Public Power Supply System (WPPSS) are not responsible to pay the $2.25 billion debt on the plants. With the participants released from their obligations to pay the supply system, the supply system could not make additional interest payments to the bondholders for plants #4 and #5. Thus, the supply system has defaulted on the bonds. Default on the bonds of plants #4 and #5 makes it impossible for the supply system to sell bonds to complete plant #3, which is now 75% complete. The Bonneville Power Administration (BPA) estimates that placing the cost of completing plant #3--just under $1 billion--in its rate base would necessitate rate increases of 20% over the next 3 years. Senator McClure has introduced S. 1701, a bill which would create a financial entity separate from WPPSS to raise money to complete plant #3. Opponents of the bill say the rate payers, who will eventually have to pay for completion, would be wasting their money to complete plant #3 since they say, its power will never be needed. Congressman Hausen has submitted a bill (H.R. 3152) which would empower the BPA to buy all five of the WPPSS nuclear plants.

The financial problems of WPPSS began in 1976. At that time, the Supply System had already begun work on three nuclear plants with the support of the

Bonneville Power Administration (BPA), the Federal power marketing agency in the region, which had contracted to buy the power the first three plants would produce.

As was generally the case across the United States in the 1970s, regional projections made in the Pacific Northwest indicated that demand for electricity would rise in the early 1980s to a much higher level than it has. In 1976, on the premise that demand would rise sharply, 88 WPPSS Participants undertook the construction of two additional nuclear plants (#4 and #5). According to the Participants, the BPA had urged them to build plants #4 and #5 for the good of the region despite the fact that BPA could not, because of an IRS ruling, guarantee the support in the form of net billing it had committed to the first three plants. The Participants assert, therefore, that since the plants were undertaken for the good of the region under Federal leadership, the region and the Federal Government should help resolve the problem.

In January 1982, plants #4 and #5 were cancelled when 15% and 24% complete, respectively. Cancellation was caused partly by plummeting demand projections, and partly by escalating costs engendered by delays in construction combined with rising interest rates and inflation. The passage of Initiative 394 in Washington State in November 1981 also played a role in the cancellation (though in later court tests Initiative 394 was found to be unconstitutional). Initiative 394 forbade the Supply System to issue bonds after July 1982 for any of the five nuclear plants under construction.

Cancellation of plants #4 and #5 left the 88 Participants with only the revenues from their existing systems with which to pay the $7 billion debt on the cancelled plants. This would have required rate increases which many ratepayers refused to pay, since the plants were not expected ever to generate power. For this reason, the majority of Participant utilities refused to make payments to the Supply System's fund for debt repayment. In response, the Chemical Bank of New York (the bond trustee) sued the participants to establish their liability for the debt. It was in this suit that the Washington Supreme Court ruled that the contracts were invalid because the Participants were not authorized by Washington State law to make such agreements.

In December 1983, a blue ribbon (Luce) commission authorized by the governors of Washington and Oregon proposed a settlement of the issue. The commission proposed that Congress establish a new Federal entity to take over management of all WPPSS projects. This entity would complete WPPSS plants 1 and 3, and would levy a surcharge on all BPA ratepayers averaging $1 per month, which would serve to pay off the bonds sold to finance WPPSS 4 and 5 at 36 cents on the dollar. Press reports indicated that reaction to the proposal was negative among both rate payers and shareholders. The proposal has not yet been presented as legislation.

LEGISLATION

H.R. 555 (Harkin)/S. 1069 (Chafee et al.)

Amends the Federal Power Act by altering the FERC's criteria for admitting construction work in progress to a public utility's rate base. Requires the FERC to approve any rate increase that is based on the proposed or ongoing construction of pollution control facilities or conversion of oil- or gas-fired facilities to the use of other fuels, so long as the increase is

just and reasonable. As to other types of construction, the FERC must allow rate increases based on CWIP only if it determines, after a hearing, that the construction is necessary to meet consumer energy demand at the lowest possible cost; that those charged for CWIP would benefit from the construction and have been given a fair opportunity to acquire an ownership interest in the facility in question; and that, without the rate increase, the utility would be in severe financial difficulty not attributable to mismanagement. H.R. 555 introduced Jan. 6, 1983; passed by the House of Representatives, Feb. 8, 1984. S. 1069 introduced Apr. 15, 1983; referred to Committee on Energy and Natural Resources, Subcommittee on Regulation. Hearings scheduled Apr. 12, 1984.

S. 817 (Metzenbaum)

Bars admission of CWIP to rate base for any cost other than fuel-switching or pollution control. Introduced Mar. 16, 1983; referred to Committee on Energy and Natural Resources, Subcommittee on Regulation. Hearings scheduled Apr. 12, 1984.

H.R. 3152 (Hansen)

Provides the Administrator of Bonneville Power a $1 billion fund with which to buy outstanding bonds for WPPSS plants #1, #2, #3, #4 or #5. The Administrator shall pay the lowest of (1) par value of bond, (2) price paid for the bond by the owner, or (3) average price for the bond on Mar. 1, 1983. Requires BPA Administrator to maintain all five plants in condition at purchase until directed by Congress to use or dispose of them. Introduced May 26, 1983; referred to Committee on Energy and Commerce.

S. 1174 (D'Amato)/H.R. 2994 (Corcoran)

Amends PUHCA to permit registered public utility holding companies to own subsidiaries that are not functionally related to electric generation and permits the holding company to invest up to 10% of its assets in such companies without SEC oversight and more than 10% if the SEC approves. Requires the SEC to approve or disapprove holding company security issuances within 20 days of application and removes the requirement for the SEC to review certain kinds of stock issuances. S. 1174 introduced Apr. 28, 1983; referred to Committee on Banking. H.R. 2994 introduced May 12, 1983; referred to more than one committee.

S. 1701 (McClure)

Empowers BPA Administrator to enter BPA into contracts to pay costs of the Federal Base System. Introduced July 28, 1983; referred to Committee on Energy and Natural Resources. Hearings held Aug. 3, 1983.

HEARINGS

Admitting CWIP to the Rate Base

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U.S. Congress. House. Committee on Energy and Commerce. Subcommittee on Energy Conservation and Power. Public Utility Holding Company Act. Hearings, 97th Congress, 2d session. June 9, 1982. Washington, U.S. Govt. Print. Off., 1982. 762 p.

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At head of title: 97th Congress, 2d session. Committee print 97-FF.

U.S. General Accounting Office. Construction work in progress issue needs improved regulatory response for utilities and consumers; Report to the Congress by the Comptroller General of the United States. June 23, 1980.
EMD-80-75.

CHRONOLOGY OF EVENTS

Admitting CWIP to the Rate Base

1983 -- FERC changed its rule on CWIP, now allowing utilities under its jurisdiction to file for rates that include a rate of return on up to 50% of their investment in CWIP. The extent of the inclusion would be limited to amounts that would increase rates by no more than 6% per year above what they would otherwise be.

1976 -- FERC ruled that CWIP may be admitted to the FERC-regulated segment of the rate base only for construction related to fuel-switching, pollution control, or severe financial difficulty.

Default of the Washington Public Power Supply System

1983 -- Washington State Supreme Court ruled that the Participants are not responsible to pay the $2.25 billion debt for cancelled plants #4 and #5.

-- --Supreme Court declined to review 9th Circuit of Appeals ruling that Initiative 394 is unconstitutional.

1982 -- Plants #4 and #5 were cancelled.

1981 -- In reaction to rapidly multiplying costs, initiative 394 was passed, barring WPPSS from selling additional bonds to

complete any of the five nuclear plants without another initiative.

1980 -- Congress passed Pacific Northwest Electric Power and Conservation Act requiring all new means of generating capacity to be cost-effective compared with conservation.

1976 -- WPPSS began construction of two additional nuclear plants (#4 and #5), securing financing through take-or-pay agreements.

1969 -- Bonneville Power Administration (BPA) and Washington Public Power Supply System (WPPSS) established net billing arrangement for nuclear plants #1, #2, and #3.

Reevaluating the Public Utility Holding Company Acts

1982 -- Attempt to pass reform and then repeal of PUHCA unsuccessful.

1935 -- Public Utility Holding Company Act (PUHCA) passed primarily to end holding company abuses of investors and ratepayers made possible by multi-state holding company structures, which made regulation ineffective.

ADDITIONAL REFERENCE SOURCES

Default of the Washington Public Power Supply System

Pacific Northwest Power Planning Council. Draft regional conservation and electric power plan. Portland, Oregon, January 1983.

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National Association of Regulatory Utility Commissioners. 1982 Report of the Ad Hoc Committee on Utility Diversification. Washington, October 1982.

Profozich, Russell. The Public Utility Holding Company Act and electric utility diversification. Washington, Electric Consumers Resource Council, June 1982.