CHAPTER III

RESOLVING THE CURRENT FINANCIAL STRESS

In general, those electric utilities with liquidity constraints incurred significant financial losses from investments in plants that may remain unfinished or whose production costs would exceed those of alternative supplies, such as power purchased from other utilities. To continue operating, many of these companies have undertaken a variety of cost-cutting measures, such as omitting dividend payments or reducing maintenance activities. They have also sought rate increases to help pay for plants still under construction, abandoned, or recently completed. Most of these rate cases are still pending. This chapter describes the efforts of financially troubled utilities to increase their liquidity and presents both nonfederal and federal options that could assist them.

State regulators are primarily responsible for distributing economic losses from power plant investments among ratepayers, utility stockholders, and creditors. Although the apportionment of these losses can generate considerable debate, both utility managements and their state regulators have the resources and the incentives to seek solutions to avert possible bankruptcies. If a default occurs, the federal bankruptcy process should ensure both continued electric service for utility customers and a reasonable resolution of the excess cost issue. It is not clear, however, whether a bankruptcy declaration would increase or decrease the ultimate costs of electric service for the utility and its ratepayers. The federal government possesses only limited options (including the bankruptcy process itself) to aid distressed utilities. In the absence of widespread threats to electric service or to the public health and safety, federal intervention appears inappropriate in addressing short-term problems of liquidity. However, the federal government might play a more appropriate role in addressing longer-term concerns about risk, uncertainty, and investment efficiency.

NONFEDERAL APPROACHES TO EASE FINANCIAL CONSTRAINTS

Faced with rising construction costs and inadequate revenues to cover their costs, including maturing debt, financially distressed utilities have several traditional, nonfederal alternatives to increase their liquidity. Many of these nonfederal options are already being employed, including:

- Austerity programs that cut labor and maintenance costs;
- Stock dividend reductions or omissions; and
- Rate relief plans that allow either construction work in progress (CWIP) to be included in electricity prices or cost recovery for cancelled or completed plants.

Other nonfederal options would be somewhat more drastic, supplying potentially more economic relief to a utility, but typically involving more difficult and far-reaching decisions by the firm's management, state legislators, and regulators. Such alternatives include:

- Mergers or sales of plants or firms;
- Refinancing of debt through private means; and
- State assistance efforts such as loans or direct subsidies.

These six measures--alone or in combination--appear to offer ample means to meet the immediate cash-flow requirements of distressed utilities.

Not all the options could be used by all the troubled utilities. Availability would depend largely on individual financial conditions and the stage of new plant construction. As a result, the relative effectiveness of each option in easing liquidity constraints would vary across firms. The costs of implementing these options--distributed among ratepayers, utility investors, utility creditors, and taxpayers (through unrecovered investment "write-offs")--would also vary. Some alternatives, such as reduced service, would primarily affect utility ratepayers, while the effects of other options, like dividend omissions, would be felt mostly by utility stockholders.

Austerity Programs and Service Reductions

About 20 percent to 25 percent of the cash-flow requirements of distressed utilities could be met, at least temporarily, by reducing operation and maintenance activities. In general, the traditional approach used is to reduce service levels by undertaking permanent or temporary reductions in the work force and by deferring maintenance of facilities. 1/ Consumers Power,

1. Utilities do have other austerity options which are not considered here. First, utilities might defer payments to fuel suppliers and other creditors for very short periods. Second, utilities might delay or cancel construction, thereby reducing their short-term cash requirements. Savings from deliberate construction delays could be eroded, however, by rapidly rising interest or construction costs. Cancellation savings would depend on regulatory approval of plant construction costs and could be eliminated altogether in the short term because the utility might be forced to repay all tax credits earned during construction immediately upon plant cancellation.

for example, cut operation and maintenance by 10 percent in 1984 and permanently eliminated 571 full-time positions. Public Service of Indiana (PSI), on the other hand, chose to reduce its full-time work force temporarily by 25 percent, saving the company about $49 million during a recent 12-month period. PSI has recently requested a permanent rate increase, however, to allow for the rehiring of some of these workers and for maintenance activities that can no longer be deferred. Similarly, the Long Island Lighting Company (LILCO) is seeking to reinstate 231 of the 700 positions it eliminated in 1984. This suggests that austerity measures may not be sustainable beyond one year because many maintenance requirements cannot be permanently eliminated or even postponed for long.

Austerity measures might also affect utility customers by lowering the quality of service. PSI, for example, argues that a failure to restore enough revenues to pay for deferred maintenance activities could lead to power line problems and, eventually, serious service breakdowns. Ultimately, it could affect investors and creditors. Austerity programs and service reductions, therefore, appear to offer only limited benefits to utilities, depending largely on existing service, maintenance, and labor contract requirements.

Dividend Omissions

Alternatively, utilities could increase retained earnings by deferring or suspending payments of cash dividends to common or preferred stockholders. Several utilities, in fact, have already employed such measures (see Table 4). For example, Long Island Lighting Company (LILCO) has not paid a quarterly dividend on its common stock since March 1984. This has saved the company roughly $45 million on an annual basis. More recently, Middle South Utilities has omitted its third quarter 1985 dividend to preserve $85 million in cash for company operations, while it awaits several pending requests for rate relief. The use of this option--assuming common stock dividend omissions only--by the remaining distressed utilities appears capable of meeting about half of these companies' short-term liquidity requirements.

The ability of companies to employ such measures usually depends on company charter rules and SEC regulations. Generally speaking, a company can suspend common stock dividends permanently but can only defer preferred dividends for four quarters before preferred stockholders are allowed (by company charter) to replace existing management with a new board of directors. Clearly, utility investors bear the short-term cost of these types of measures not only through loss of dividends but also because dividend deferrals lead to a decline in stock value. Less obvious, however, is the longer-term consequence of dividend suspensions--the increased cost of capital, especially that raised through future stock sales. This cost will be borne by future ratepayers.

Rate Relief

Most, if not all, immediate cash requirements of distressed utilities could be met if state regulators allowed rates to rise enough to cover the costs of recent construction. Because of the high excess costs of these investments, however, state regulators are unlikely to force utility ratepayers to bear the full costs through large rate increases. State regulators will generally grant

TABLE 4. RECENT DIVIDEND DEFERRALS BY MAJOR UTILITIES

Company	Common Stock Dividend	Preferred Stock Dividend
Central Maine	Omitted since 4/85	Paid on schedule
Consumers Power	Omitted since 10/84	Paid on schedule
General Public Utilities	Omitted since 11/26/79	Paid on schedule
Long Island Lighting Company	Omitted since 3/84	Suspended declaration of preferred dividends payable after 9/30/84
Middle South Utilities	Omitted 3rd quarter 1985 dividend	Paid on schedule
Public Service of New Hampshire	Omitted since 4/19/84	Omitted since 4/19/84
Public Service of Indiana	Dividend cut 65% since 2/84	Paid on schedule
United Illuminating	Dividend cut 38% since 7/84	Paid on schedule

SOURCE: Congressional Budget Office.

rate increases for only that portion of the utility's investment that was prudently incurred--whether the plant is completed or not--and disallow investments or portions of investments that they consider imprudent. 2/

Distressed utilities, for their part, are seeking to recover plant construction costs as quickly as their regulatory agency will permit. The speed and nature of such cost recovery is an important element of utilities' revenue positions, and, as such, the outcomes of these pending rate cases are crucial to their financial well-being. The most useful type of cost recovery depends largely on the stage of plant construction. For a utility with a cancelled plant, rate increases to cover all or some portion of its lost investment are desired. Utilities with ongoing construction seek to include their construction costs in the rate base as soon as possible, through CWIP treatment. Finally, utilities with completed plants seek to have the full costs of the plant (not just the carrying charges) recovered through rate increases from the moment the plant is used and useful.

Cost Recovery for Deferred or Abandoned Plants. Plant cancellation by itself can help ease a utility's financial burden, but may not be enough to relieve financial stress fully unless some cost recovery for the abandoned facility is allowed. For example, both Consumers Power and Public Service of Indiana deferred or abandoned the construction of expensive nuclear power plants in 1984. Although future construction costs have been eliminated, the final distribution of these projects' sunk costs (about $3.4 billion for Consumers Power's Midland project and $2.5 billion for PSI's Marble Hill facility) will ultimately be decided by the relevant state regulatory commission. The state commission may decide that the utility acted prudently in building and later abandoning the project, and allow full recovery of the project's costs, including an earned rate of return on the investment. On the other hand, the regulator may determine that the entire project was imprudent and allow only limited cost recovery. Such a decision could lead to severe cash-flow shortages or perhaps bankruptcy in some cases. 3/ The most likely outcome in both examples is that the Michigan and Indiana com-

2. Rate base disallowances preclude a utility from earning a return on that portion of the investment that is disallowed. Excess plant expenditures are most often disallowed because of management imprudence that caused construction cost overruns or because the plant is deemed excess capacity. A utility that cancels construction in response to changing demand forecasts may, therefore, be considered more prudent by its regulators (and will fare better in a rate case) than a utility that successfully completes what turns out to be an unneeded plant.

3. See, for example, Consumers Power Company's Supplement to Amendment to Application (Revised Step 3 Rate Relief Request), Case No. U-7830, Filing of October 11, 1984.

missions will disallow some portion of each project's cost as imprudent, and allocate the sunk investment between utility stockholders, ratepayers, and federal taxpayers (through tax write-offs of the unrecovered investment).[4] In any event, proposals for additional federal or state aid may be premature until these cases are decided in 1986.[5]

Cost Recovery for Construction Work in Progess. Utilities involved in large-scale construction projects argue that all or some part of prudent expenditures for construction work in progress should be included in rates and earn a return, even before the plant is fully used and useful. Without CWIP treatment, utilities may incur higher borrowing costs to sustain cash flow and construction efforts. (See Appendix B for further discussion of the effects of CWIP treatment on utility cash flow.)

Regardless of the claims of either CWIP advocates or opponents, little question exists that the inclusion of CWIP in the rate base helps a utility continue construction, especially when CWIP represents a large portion of the utility's assets. The injection of new rate revenues through CWIP reduces the need to seek additional outside financing at high interest rates. A prime example is El Paso Electric Company, a partner in the three-unit, $9.3 billion Palo Verde nuclear project. El Paso's construction practices differed relatively little from other utilities that eventually incurred liquidity problems. Indeed, El Paso had the highest percentage of its assets tied to nuclear construction of any utility in the nation, yet its performance in other key financial ratios was superior to other utilities that were less exposed (reflecting higher investor confidence). A principal reason for its good financial position is that the Texas regulatory commission granted significant amounts of CWIP in El Paso's rate base in August 1984.[6] This suggests that without CWIP El Paso might have found itself in the same position as the distressed utilities, which typically did not have CWIP in their rate base.

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4. Among previous nuclear plant cancellations involving sunk costs of greater than $50 million, state commissions have mostly permitted either full or partial cost recovery. See Robert Borlick, "Nuclear Plant Cancellations: Causes, Costs, and Consequences," U.S. Department of Energy, Energy Information Administration, DOE/EIA-0392 (April 1983), and Edison Electric Institute, "Regulatory Treatment of Cancelled Plants: Survey Update of Cases in 1983," Special Report, SR 84-01 (March 1984).

5. So far, both the Michigan and Indiana utility commissions have addressed only the companies' emergency rate relief requests, which are designed to assure that normal day-to-day electric service is maintained. The companies' permanent rate requests--to recover sunk plant costs--will be decided after the emergency rate cases are settled.

6. It is also important to note that El Paso had a higher than average demand growth rate.

Including some degree of CWIP expenditures in the rate base could provide significant revenues to several of the distressed utilities. Full CWIP inclusion generally would provide as large a new liquidity source as employee cutbacks or service reductions. Companies with completed or abandoned plants (Kansas City Power and Light, Kansas Gas and Electric, Middle South, Long Island Lighting, Union Electric, Public Service of Indiana, and Consumers Power) are now seeking alternative forms of rate relief through rate base treatment of completed plants or cost recovery of abandoned plants. Compared with the dividend omission measures, which could erode investor confidence in the company, CWIP inclusions could send positive signals to the investment community regarding the company's cash position and its future regulatory treatment. This could serve to reduce additional financing costs in the period required to complete the plant, which, in turn, could lower future plant costs to both ratepayers and utility investors. Combined with common dividend omissions and short-term austerity measures, CWIP treatment for eligible distressed utilities could have satisfied most of these utilities' incremental (above 1984 levels) cash-flow needs for 1985.

Cost Recovery for Completed Plants. For distressed utilities with recently completed plants, full and immediate recovery of plant costs through rate increases would improve the utilities' financial positions in the short term. However, the high costs of these plants, some of which exceed the size of the utilities' rate base, would lead to price increases ranging from 10 percent to 67 percent. Such "rate shocks" could depress economic activity in the affected service area and reduce the demand for electricity in the long run. Thus, state regulators will usually employ a phase-in plan to lessen the price effects of bringing completed power plants into the rate base all at once. [7]

Generally speaking, phase-in plans gradually introduce the costs of the plant into the rate base, with the unincluded portion of the plant accumulating both interest and the allowed return on equity until it enters the rate base. This approach delays the full return on the stockholders' investment, but, because interest accumulates on the unincluded portion of the plant, there is no net loss to stockholders. [8] For current ratepayers, phase-in plans offer some relief from the potential inequity of subsidizing rates paid by future customers. Moreover, phase-in plans offer two other potential

7. These phase-in plans are also being linked in some cases with gradual CWIP treatment of plant costs (before completion of the plant) to help smooth the rate shock effects.

8. Stockholders could lose a portion of their investment if--as part of a phase-in plan--a state PUC disallows certain construction expenditures as imprudent or some percentage of plant capacity as excess.

advantages (relative to full and immediate plant cost recovery) to utilities themselves: first, they can reduce public opposition to higher rates; and second, they may lessen the possibility that higher rates will lower demand enough so that total revenues to the company in fact decline after the rate increase.

On the other hand, phase-in plans may force the utility to issue additional stock or borrow additional capital to offset the lost income from that portion of the plant excluded from the rate base. This has the effect of reducing utility cash flow in a period when many companies already rely too heavily on external capital sources. In addition, utilities and investors are concerned about the risks of future regulatory actions that could further delay full recovery of plant investment. In the worst case, their investment might never be recovered. This added risk disturbs investors and could be reflected in stock market prices.

Rate base phase-in plans have been instituted for Union Electric and the Kansas utilities, and are likely to be employed for those distressed utilities that will soon complete plant construction. The relative success of these phase-in plans in stabilizing the utilities' financial positions depends on how they affect utilities' cash flow. Most distressed utilities need substantial cash now. Large amounts of plant expenditures not included in the rate base immediately could weaken already distressed companies. 9/ Given adequate rate relief by the relevant state commissions (and realized added revenues despite the rate shock), however, this alternative appears capable by itself of providing enough financial stability for eligible utilities.

MORE RIGOROUS APPROACHES TO AID CASH FLOW

The previous section explored readily available schemes to aid cash flow, some of which are already used. Use of these approaches--austerity programs, stock dividend omissions, and allowing plant cost recovery through rate increases--could have provided nearly all the additional cash necessary in 1985 (above 1984 levels) to meet utilities' short-term liquidity requirements. For any remaining cash needs, more severe measures, such as merging with another firm, debt refinancing, or state assistance, might be necessary.

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9. As an example, the Kansas Corporation Commission, in granting phased-in rate relief to Kansas Gas and Electric and Kansas City Power and Light, allowed the companies to earn a return on less than one-third of their investment. Because of this decision, these companies can be expected to experience cash-flow shortages and may need to suspend payment of stock dividends. See "Utilities to be Denied Profit on Two-Thirds of Wolf Creek Investment," *Associated Press*, September 12, 1985.

Mergers and Sales

One solution for a utility whose construction program is threatened by poor financial health could be the sale of the plant to another utility or merger with another company that is able to continue construction. For a utility that will need additional power in the future, purchase of all or some of the plant's future output might be an attractive alternative to beginning a new facility from scratch. This alternative is probably limited, however, because adequate transmission lines may not exist, and significant regulatory hurdles may face any such proposal (see Chapter IV discussion of option to liberalize the Public Utility Holding Company Act to allow for mergers and diversifications). The greatest impediment to sale or merger, however, is the unattractively high cost of the plants under construction. The high cost of the Seabrook plant, for instance, made it difficult for the Maine utility co-owners to sell off their share of the plant when compelled to do so by the Maine Public Service Commission (PSC). 10/

Despite similar difficulties, however, Cleveland Electric Illuminating Company has recently announced plans to merge with Toledo Edison (one of the troubled utilities identified earlier), subject to stockholder and regulatory approval. The two companies are already co-owners of the Perry 1 and 2 and Beaver Valley 2 nuclear units now under construction. Moody's Investors Service Inc. believes that the proposed merger could improve the combined company's credit quality in the long run. Moody's lowered its rating on Toledo Edison's preferred stock in May 1985. 11/

Although the possibility of similar mergers with financially troubled utilities appears rare, each of the distressed utilities, because of their large capital investment programs, has substantial quantities of unused tax benefits, such as investment tax credit carryovers. These tax benefits potentially could be used by profitable utilities or other nonutility companies by merging with the utility. A similar option using selective safe harbor leasing (through which the utilities could effectively "sell" these tax benefits) would have the same potential benefit for utilities without the need to seek a merger partner. This option is discussed later in this chapter. All these options are essentially neutral from the standpoint of investors (who could

10. In late 1984, the Maine PSC ordered Central Maine Power, Bangor Hydro Electric Company, and Maine Public Service to sell their combined 10 percent share in Seabrook 1. Most recently, Eastern Utilities Associates, a Boston-based holding company, has offered the Maine companies about 14 cents to 15 cents on the dollar for their Seabrook investment. See "A New Gamble on Seabrook," *New York Times*, August 6, 1985.

11. See *Wall Street Journal*, June 26-27, 1985.

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actually benefit from a merger) and ratepayers. Options that would use tax benefits not otherwise employed would, of course, increase taxpayer costs.

Private Refinancing

Utilities unable to meet immediate liquidity needs through internally generated cash usually seek external sources of capital. Troubled utilities facing cash-flow shortages often rely on banks to provide this type of short-term (one year) relief. Most of the utilities identified in Chapter II have exhausted this option, however, and commercial banks are reluctant to extend any further aid.

Most of the firms still retain some access to capital bond markets, though with high-risk premiums. Both Consumers Power, which issued $100 million in bonds in late 1984, and Public Service of New Hampshire (PSNH), which issued $450 million in bonds in 1984, were able to sell their latest series of bonds. The concern here is whether the companies (particularly PSNH's issuance of securities with a 23 percent return on a delayed repayment plan) can eventually generate the revenues to pay back such burdensome borrowings. In PSNH's case, the company will need growth in electricity demand of 5 percent to 6 percent per year to generate enough revenue to repay its latest borrowings. 12/ The primary risk here is for new investors. Utility consumers are also likely to bear the burden of repayment through rate increases.

Utilities may also form subsidiaries to carry on construction separate from the operations of the parent company. Middle South Utilities has functioned in this manner. Generally speaking, this approach can allow a utility to obtain lower-cost capital than might otherwise be available by using the parent firm's larger base of operating assets. From some utilities' perspectives, another advantage of forming subsidiaries or holding companies is that such activities are subject to regulation by the Federal Energy Regulatory Commission (which regulates interstate wholesale sales) rather than by the state regulatory commissions. 13/ As shown in Table 3 in Chapter II, FERC regulation is currently considered somewhat more favorable from an investor's standpoint than most state commissions.

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12. Robert Hildreth, *Electric Utility Financing: A View to the Future*, Energy Daily Conference (October 1984).

13. See "Utilities Seek to Skirt State Rulings," *Wall Street Journal*, June 17, 1985. Also see *Northern States Power v. Minnesota Public Utility Commission*, Minnesota Supreme Court, January 27, 1984. One of the advantages of FERC rulemaking from the utilities' viewpoint is that they will allow up to 50 percent of CWIP to be included in the rate base.

State Assistance

In extreme cases when other nonfederal options are not effective or have not been employed, states might decide to provide special financial aid to a utility or utilities in financial trouble. Aid could take several forms, including loans or the actual purchase (with eventual leaseback of the plant to the utility) of a plant under construction. The choice of state assistance would depend largely on the available mechanisms to provide aid. Thus, a state with an independently financed power authority might have greater flexibility than a state that must seek special legislative authority to assist a private utility.

The major precedent in this area probably is the Consolidated Edison case of 11 years ago. Caught between sharply increased oil prices following the oil embargo in 1973 and a large construction program for coal- and nuclear-power plants, Con Ed omitted its first quarter common dividend in 1974. The company's bond rating and stock price plunged, and it was unable to obtain bank loans, sell its plants under construction to other utilities, or raise other sources of outside funds. In the end, the New York legislature approved the sale of the two Con Ed plants under construction to the Power Authority for the State of New York (PASNY). A loan was also considered, but eventually rejected in favor of the sale alternative, which provided the needed injection of cash for Con Ed to resolve its cash-flow problems.

Because of the speedy resolution of the Con Ed crisis, no substantial documentation exists to explain why one alternative assistance plan was considered better than another. Con Ed's financial condition, however, was much less grave than several of the utilities identified in Chapter II. The two plants involved, one coal and one nuclear, actually were good "buys" for the PASNY in that their costs had not outrun their worth. This is hardly the case with most of the troubled utilities, whose plants under construction are worth on the open market (or in a state rate case) only a fraction of the costs already incurred by the utility.

More recently, the allocation of project costs for Middle South's Grand Gulf nuclear plant among the states of Louisiana, Arkansas, and Mississippi, and the City of New Orleans has engendered proposals for government-sponsored buy-outs. [14] Both the state of Arkansas and the city of New Orleans are considering plans to buy out Grand Gulf partners (Arkansas Power and Light and New Orleans Public Service) as a means of avoiding paying for the

14. For a description of the Grand Gulf controversy, see *Potential Impact of the Grand Gulf Nuclear Power Plant on Small Businesses*, Hearing before the Senate Committee on Small Business, 98:2 (December 7, 1984).

high costs of the Grand Gulf project. Such actions are on hold, however, pending the final allocation of costs by the Federal Energy Regulatory Commission and the courts. 15/

THE FEDERAL ROLE IN EASING UTILITY FINANCIAL STRESS

The many ongoing and available nonfederal solutions described above appear sufficient, if employed, to relieve the short-term financial stress of troubled utilities. In some circumstances, however, utilities, state regulatory commissions, and state legislatures might fail to exercise these options fully, creating the conditions for a potential utility bankruptcy. The federal government will bear a part of any short-term financial losses through provisions of the tax code that allow such losses to be deducted from the income on which taxes must be paid. At issue, however, is whether any further federal assistance is desirable to prevent possible electricity supply shortages or severe rate increases resulting from a bankruptcy. Both adverse results are untested. Regarding the first concern, the federal bankruptcy process appears able to ensure electricity service by the utility operating through the Chapter 11 reorganization process. As to the second concern, it is not clear that electricity rates must necessarily increase after a bankruptcy. Nevertheless, the uncertain outcome of a utility bankruptcy remains a strong motivation to avoid it.

This section explores federal options--including loans, grants, or additional tax relief--to aid distressed utilities that could be threatened with bankruptcy. These options could meet the immediate cash-flow needs of distressed utilities. They would do little, however, to rectify the long-term investment concerns of the utility industry or to provide signals to consumers regarding the true resource cost of electricity.

Pros and Cons of Federal Intervention to Prevent Utility Bankruptcies

Proponents of federal intervention believe that federal assistance to utilities might be necessary, because the direct and indirect costs of a utility bankruptcy could cause economic disruption. (See box for description of federal bankruptcy process.) The magnitude of direct bankruptcy costs are

15. The FERC issued an administrative ruling on June 13, 1985, allocating Grand Gulf costs among Middle South operating companies as follows: Arkansas Power and Light (36%), Louisiana Power and Light (14%), Mississippi Power and Light (33%), and New Orleans Public Service (17%). Middle South Utilities has recently proposed that each operating company (and its respective ratepayers) be charged one-third less than the FERC allocation. If the proposed settlement is adopted, Middle South investors would absorb a revenue loss estimated at $1.1 billion over 10 years.

THE FEDERAL BANKRUPTCY PROCESS

How likely is it that an investor-owned utility will go bankrupt? Until the Wabash Valley (an electric cooperative) declared bankruptcy in May 1985, a utility bankruptcy of any type (investor-owned or co-op) had not occurred for over 50 years. Although an investor-owned utility could itself declare bankruptcy, it is unlikely to do so until its managers have exhausted all the available options reviewed in this chapter. Instead, an investor-owned utility is likely to face bankruptcy only when its creditors force it to do so. Creditors' actions will be motivated by their perceptions of the relative cost to them of bankruptcy, compared with the cost of the continued utility operations. The creditors' actions are necessarily affected by how the state regulatory commission responds to the liquidity problems facing a distressed utility, their perceptions of demand growth, and prospects for cost recovery of plants under construction. Not all creditors, however, may be in the position of extending debt or voluntarily reducing interest payments to prevent bankruptcy. Many smaller bondholders cannot renegotiate changes in the terms of the utility's loans, and defaults may occur without the larger creditors' being able to prevent them.

A utility filing for bankruptcy (or forced to file for bankruptcy) petitions the federal bankruptcy court under Chapter 11 of the Bankruptcy Act (U.S.C. Section 1129). The federal bankruptcy judge then appoints committees to represent different classes of creditors--preferred stockholders, secured and unsecured bondholders, and common stockholders. A court appointed utility representative (the trustee) presents a reorganization plan to the court within a specified time period. The trustee also operates the company during the reorganization period to assure both continued electricity service and electricity sales revenues. This trustee is obligated to protect the rights of the creditors, not the consumers or taxpayers. The plan must discuss disposition of all property contemplated mergers or consolidation with other public or private utilities, disposition of debts, and outstanding securities.

If creditor committees can agree on a reorganization plan, each class of creditors reviews the plan. A class of creditors is judged to have approved the plan if a majority of individuals in a class deem it acceptable and credit holders owning two-thirds of the dollar amount of each class accept the plan.

If one or more classes do not approve the reorganization, the court is required to provide a "fair and equitable" solution. A fair and equitable plan usually means that creditors have been paid "all they could reasonably expect given the circumstances." The plan must give priority to secured bondholders, followed by unsecured bondholders, preferred and common stockholders, in that order. Consumers may or may not directly play a role in the reorganization, although the state regulators have to approve rate adjustments, and sales and/or mergers. (The important role played by regulation is the major difference between the bankruptcy process for electric utilities and non-regulated corporations.) If no acceptable reorganization plan can be developed, the trustee could choose to initiate Chapter 7 liquidation proceedings. Liquidation of assets is an unlikely possibility, however, for a major utility with a large service area that cannot easily be replaced by another utility.

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difficult to estimate, however, apart from the high litigation costs likely to be experienced in the reorganization process. 16/ Two recent studies of the effects of a potential bankruptcy examined one utility, Public Service of Indiana. The studies suggest that rate increases borne by consumers would be higher if bankruptcy occurred, primarily because of two assumptions: that the costs of refinancing would be higher to the post-bankruptcy firm, and that these costs would be borne strictly by consumers through electricity price rises. 17/ This outcome might not occur, however, if the state regulators denied full rate increases and creditors were forced to absorb some of the economic losses of bankruptcy.

Proponents of federal intervention also believe that a utility bankruptcy could produce severe regional economic losses and potentially lead to a chain of bankruptcy petitions by other utilities in financial distress. Moreover, indirect bankruptcy losses could be shared nationwide by investors and creditors, resulting in costs that exceed the benefits of weeding out inefficient firms and, presumably, reducing overall income subject to federal taxation. Federal assistance could, therefore, be justified by economic disruption or national security reasons--as in the $1.5 billion federal loan guarantee to Chrysler Corporation in 1979 or the $250 million loan to Lockheed in 1971. 18/ Finally, advocates of federal assistance note that a utility

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16. Legal costs arising from the Washington Public Power Supply System default, for example, could approach $250 million. See "The High Costs of Suing--Or Being Sued By--WPPSS," *Credit Markets*, July 1, 1985.

17. See Congressional Research Service, "Utility Bankruptcy: Thinking the Unthinkable?"; and David Lantz, "Paying for Marble Hill: How the Bankruptcy of PSI Could Affect Indiana's Economic Development" (Hoosiers for Economic Development February 1985).

18. None of these cases offer an exact analogy for utilities, however. The loan guarantee granted to the Chrysler Corporation in 1979 was directed primarily at preventing the potential loss of 140,000 to 400,000 jobs. In that case, the company argued successfully that the psychological impact of a bankruptcy declaration would erode consumer confidence in the long-term ability of the company to service its products, leading to near total loss of market share and liquidation of the company and its dealer network. Unlike Chrysler, utilities (as monopolies) would not risk losing their market shares during the reorganization period. See *Chrysler Corporation Loan Guarantee Act of 1979*, House Report No. 96-690 (December 6, 1979). After Penn Central and seven other northeastern railroads went bankrupt in 1970, the federal government formed a publicly owned railroad system in order to maintain freight and commuter service and prevent economic disruption. Eventually the federal government reimbursed previous creditors of these bankrupt rail systems under terms set by the special bankruptcy court. Similarly, the federal government came to the aid of the financially strapped Lockheed Corporation in 1971 to prevent the collapse of an industry deemed essential to national security. Finally, the federal government, through the Federal Deposit Insurance Corporation, took over the assets of the Continental Bank of Chicago--absorbing as much as $3.8 billion in potential losses in bad loans--to protect the depositors and prevent widespread disruption in the financial community. See CBO, *The Budgetary Status of the Federal Reserve System* (February 1985).

bankruptcy could have severe long-term consequences, by reducing the ability (or willingness) of the industry to raise capital for large, baseload plants when they are needed.

Assuming that a utility bankruptcy would not affect public health and safety through widespread disruptions in electricity supply, the only other condition that would warrant special federal relief to individual utilities is the threat of economic disruption. But according to available evidence the adverse economic effects of a bankruptcy probably would be small. Current financial problems are limited to the small group of firms that have experienced construction difficulties in recent years. These utilities' low stock prices and bond ratings indicate that national markets have already responded to the higher risks of investing in such firms. National investor markets would therefore be relatively unaffected if one of these companies were forced into bankruptcy. Bankruptcy effects on consumers--which would also influence regional economic activity--also appear limited since investors would bear most of the loss.

Further, the prospect of federal aid could lead to less efficiency if state regulators and electric utilities believed they could pass on local losses to the nation at large. This would reduce incentives to minimize losses and to work out their distribution in a manner generally seen as fair. Also, any precedent established for federal assistance would have to be applied throughout the utility industry, possibly leading to greater federal deficits at a time when the intent of Congress is to reduce them.

In addition, aiding the few utilities that have had construction difficulties would be discriminatory, because most utilities have built their own generating capacity without special assistance. In the long run, a policy of intervention would artificially reduce the costs of excess generating capacity, thus distorting the economic signals to both the buyers and the sellers of electricity.

Federal Options to Aid Cash Flow in Distressed Utilities

If distributional considerations do warrant intervention, the options with the greatest applicability to improve utilities' problems with short-term cash flow include loans, loan guarantees, direct grants, and selective tax relief. These measures could relieve current financial problems but would do little to discourage inefficient future investment, since they would relieve today's excess costs without addressing the problems behind them. Direct aid, for example, would not correct the causes of construction cost overruns.

Subsidized Loans, Guarantees, and Grants. Loans or grants to assist distressed electric utilities include:

- Providing low interest loans or loan guarantees at rates higher than the Rural Electrification Administration's current rate of 5 percent, but presumably lower than the going market rate; and

- Providing grants to utilities in financial distress in order to allay fears about the long-term supply of electricity. Such grants, for example, could take the form of electricity price supports to increase the utilities' rate of return.

The ultimate costs of such federal subsidies would vary with the number of utilities made eligible for benefits and the length of support. (The costs of completing just the nuclear plants under construction by the 15 distressed utilities discussed in Chapter II would be about $11 billion while the purchase of all plants now under construction would cost about $120 billion.) In the short term, these federal options could provide important relief for the current difficulties of troubled utilities. Firm-specific assistance, however, would effectively penalize those companies that succeeded in constructing facilities and maintaining normal operations without subsidies. By subsidizing these overly expensive plant investments, federal loans or loan guarantees could encourage inefficient future utility investments.

Identifying the proper subset of utilities to assist would also be difficult. Some believe that the sole precondition for federal intervention should be an actual bankruptcy declaration, so as to limit assistance to companies that had truly run out of financial alternatives. Unfortunately, significant financial and legal damages would accrue if federal assistance was withheld until this stage. As an alternative, objective "distress criteria" could be used to target utilities meriting federal assistance before an actual Chapter 11 bankruptcy occurred. The Federal Energy Regulatory Commission proposed a financial distress test in 1983 as a precondition for the commission's granting construction expenditures in the rate base. To qualify for consideration utilities had to have a bond rating of BBB or lower from Standards and Poors or Baa or lower from Moody's. 19/

Tax Relief. For many years, utilities have received significant federal tax benefits such as the accelerated depreciation and investment tax credit,

19. The Commission also proposed alternative indicators of financial distress: quality of earnings (ratio of cash income to total income) and interest coverage (ratio of earnings to interest payments). See FERC Order 555 (July 1983) and Congressional Research Service Commission on Energy Report (June 1982).

designed to encourage capital investment. [20] Nevertheless--in recognition of the highly capital-intensive nature of the industry--additional tax relief could provide some needed liquidity for utilities suffering from cash-flow difficulties. It would, however, provide a windfall for other, more financially successful utilities.

In general, additional tax deductions or credits would be of little use to the most distressed utilities, since many have already accumulated large tax benefits which they are unable to use (such as unused investment tax credits) or lack sufficient pretax profits with which to use additional deductions. For example, the average federal effective tax rates are relatively low for most of the troubled utilities (see Table 5). Only Middle South, Ohio Edison, Public Service of New Hampshire, and Toledo Edison paid more than 10 percent in the 1982-1983 period.

Allowing utilities to sell their unused tax credits or borrow against them to increase cash flow could aid many of the troubled firms. Although the utility industry as a whole made extensive use of the investment tax credit (ITC) provision in the past (the estimated revenue loss to the U.S. Treasury was $2.3 billion in 1983), this provision is now of limited worth to many of the distressed utilities because the available credits more than offset pretax profits. Of the $3.6 billion worth of unused ITCs available to the electric utility industry at the end of 1983, almost $1 billion was held by the distressed utilities (see Table 6). Without sufficient pretax profits, however, such tax credits cannot be used until sometime in the future when profitability resumes and tax write-offs are needed. [21] Options that allow utilities to use these benefits more quickly could provide short-term help to certain companies like Consumers Power. Two such alternatives include selective safe harbor leasing and a reinvestment credit program.

Selective safe harbor leasing would allow utilities to sell some of their tax benefits to other corporations through partial sale of property. In turn, through a leasing arrangement, the utilities could still operate the plant.

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20. Like other businesses, utilities are allowed a 10 percent investment tax credit on new plants and machinery and tax deductions for plant and equipment depreciation. Some tax provisions apply only to utilities, however, such as the provision in the Economic Recovery Tax Act of 1981 allowing utility shareholders to defer federal income taxes by reinvesting dividends.

21. For example, Consumers Power had accumulated $263 million in unused investment tax credits by the end of 1982, but the company was unable to use these credits as an offset to its federal income tax liability in that year because its effective tax rate was already less than zero without these ITCs. As a result, Consumers Power accumulated even more unused ITCs in 1983 (for a total of $340 million).

TABLE 5. AVERAGE FEDERAL BOOK INCOME TAX RATES, 1982-1983 (In percents) a/

Company	1982 Average Federal Tax Rate	1983 Average Federal Tax Rate
Central Maine	0.3	1.9
Consumers Power	-1.7	0.6
Dayton P&L	7.8	8.5
Gulf States	1.9	2.0
Kansas City Power & Light	0.6	1.6
Kansas Gas & Electric	0.6	0.9
Long Island Lighting Company	0.6	b/
Middle South	15.8	15.3
Ohio Edison	10.3	11.2
Philadelphia Electric	9.8	6.9
Public Service of Indiana	0.7	1.2
Public Service of New Hampshire	14.4	12.9
Toledo Edison	9.7	11.1
Union Electric	2.0	1.1
United Illuminating	8.1	9.4
Industry Average (137 Major Utilities)	7.9	7.0

SOURCE: Congressional Budget Office, based on data from Standard and Poors Co., *Utility Compustat II*.

a. Computed rates based on method proposed by Donald J. Kiefer, "The Diminishing Federal Income Tax Burden on Public Utilities: Measurement and Analysis," *National Tax Journal* (December 1980).

b. Data not available.

Such provisions would allow the transfer of utilities' unused tax benefits (such as ITCs) to more profitable companies in need of tax relief. For example, a utility could sell a small generating plant to a profitable company that would reap the tax benefits of ownership. In turn, the company would lease the property back to the utility, which would then operate the plant, thereby creating a tax benefit transferred through lease rental. At the end of the lease period, utilities would contract to buy back the leased plant for a small token amount.

TABLE 6. UTILITIES' UNUSED INVESTMENT TAX CREDITS (In millions of dollars)

Company	Calendar Year 1980	1981	1982	1983
Central Maine	4	12	16	16
Consumers Power	174	187	263	340
Dayton Power & Light	38	43	29	12
Gulf States Utilities	70	41	90	112
KC Power and Light	37	28	35	32
Kansas Gas and Electric	44	60	79	88
Long Island Lighting Company	77	82	75	66
Middle South	291	389	503	581
Ohio Edison	83	91	98	63
Philadelphia Electric	45	53	19	140
Public Service of Indiana	N.A.	19	40	39
Public Service of New Hampshire	30	38	58	78
Toledo Edison	52	54	40	33
United Illuminating	20	20	14	14
Union Electric	N.A.	N.A.	79	90

SOURCE: Congressional Budget Office, based on Compustat II (Standard and Poors).

NOTE: N.A. = Not Available.

The use of this option for other industries has led to criticism in the past. The Congress ended an experiment with safe harbor leasing in September 1982 after $37 billion in industrial and commercial properties were leased in 1981 and 1982; utilities were the leading industry employing this benefit, representing about 10 percent of the leasing activity. 22/ This option might therefore be applied only to certain utilities to avoid large Treasury tax losses. The Congress might also consider whether a portion of such tax benefits should be immediately passed through to ratepayers, or whether the entire amount should be held by the utility itself for plant construction expenditures and so forth.

A reinvestment credit program would allow companies to receive interest free loans from the federal government based on the company's quantity of unused investment tax credits. For example, H.R. 3434, introduced in the 98th Congress, proposed the transfer of unused ITCs into reinvestment credits. Once a company declared its ITCs for this purpose, any qualified investment made by the company would be shared by the Treasury (up to 85 percent in H.R. 3434). The company would then pay back the reinvestment over a predetermined time period, yielding, in effect, a discounted federal loan through the tax system. The size of the loan, qualifying investments, and eligible industries (utilities were, in fact, to be excluded under H.R. 3434) could, of course, be varied. This option would not help many of the distressed utilities if reinvestment credits were not retroactive to facilities recently completed or still under construction, however. Further, tax options in general tend to clutter an already complicated tax code. The precedent that would be set by further special assistance to the utility industry could be applied throughout the economy, since many industries, such as airlines, have similar problems from time to time. The consequent overuse of special exemptions could lead to tax laws that do nothing well, including raising revenues.

For the 15 distressed utilities examined by CBO, use of these tax options could provide up to 10 percent of their immediate cash needs. This assumes that utilities could sell a safe harbor lease at 10 percent of plant value or that a reinvestment credit program would provide an interest free loan to the company (thus saving the company 10 percent over one year). According to this estimate, Middle South Utilities would receive the largest potential benefits--$58 million. Because the ITC program may be changed by the Congress this year, it is uncertain how these programs would affect the long-term investment profile of the industry. Considering the experience with safe harbor leasing in the past, limiting either option to short-term use (one to two years) might be advisable to avoid excessive costs to the federal government.

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22. See Joint Committee on Taxation, *Analysis of Safe Harbor Leasing* (June 14, 1982); and Margaret Riley, "Safe Harbor Leasing, 1981 and 1982," *Tax Notes* (November 21, 1983).