

Securitized Transition Costs: Rethinking Who Wins and Who Loses

Securitization of revenues is an efficient financial innovation that first reached electric utilities during their transition to competition. Because securitization is being used as a device for coping with stranded costs, the dialogue over its implementation has become mired in peripheral issues that cloud our evaluations of it. In all likelihood, it promises neither the salvation of utilities nor the death of competition.

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Utilities that face restructuring are coming to insist on stranded cost securitization as a *quid pro quo* for a rate freeze or roll-back. The utilities usually can show that the present value of the saving for small customers justifies the costs of issuing the securities. In response, consumer advocates often note that the undiscounted sum of a financed payment stream exceeds that of an unfinanced one, and potential competitors fear that the proceeds of a securitization will allow the utility to price below

cost and to eliminate them from the market. In reality though, the savings from securitization are small and highly sensitive to financial forecasts, and the predatory elimination of competitors may be an inferior use of the cash produced by the securities. In fact, some states (but not California) require utilities to use the bond proceeds to restructure their finances. Why, then, do utilities want securitization, and how will it affect future competition?

The financial and legal commu-

nities are now debating the answers to these very questions. It is difficult to answer them because, in important ways, securitization is a variant of secured lending, an institution whose logic we scarcely understand. (California's law calls the stream of payments that collateralizes rate reduction bonds "transition property.") Both economics and law lack theories that can explain the observed pattern of secured credit and definitively evaluate its economic efficiency.¹ Further complicating matters, securitization's effects on an industry's risk and cost of capital will depend on such institutional details as regulation.²

To help put securitization in perspective, I will begin by discussing its history, its scope, and the puzzles that the phenomenon presents to economic and legal experts. I will then apply the discussion to electric industry restructurings. Discussions of stranded cost securitization are often notable for their inattention to the securities themselves. They instead center on the still worthwhile topic of whether utilities should collect strandings at all.³ Perhaps inadvertently, this emphasis has led to analytical distortions and omissions that warrant the reexamination that follows.

I. Whence Came Securitization?

"Securitization" only entered the language of finance in 1977.⁴ The practice evolved over the 1970s to cope with a growing demand for mortgage funds in the then-prosperous housing indus-

try. Its logic was to aggregate a large group of illiquid individual mortgages by using them to collateralize securities that "passed through" their payoffs. The securities backed by those mortgages would be liquid and tradeable, earning a return for investors and supplying additional funds to mortgage lenders. Other securitizations of varying riskiness soon

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followed, including credit card receivables, home equity credit, equipment leases, Small Business Administration loans, third-world debt, and lower grade ("junk") corporate bonds.⁵ In 1996, total issuance of asset-backed securities in the United States was \$143.8 billion, 25 percent higher than in 1995.⁶ Because they are earmarked for payment from dependable income streams, these securities often carry higher ratings than other debt of their issuers.⁷

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reduction bonds (RRBs) are not backed by defined claims on identifiable debtors. However, the electricity industry is not alone in this; there are other securitizations (e.g., for motion picture receivables) that have similarly uncertain payments.⁸ Indeed, in the future, some utilities expect to explore the securitization of transmission and distribution revenues.⁹

II. Stranded Cost Securitizations in Electricity

A. The Experience Thus Far

As of this writing, only California's utilities have issued RRBs.¹⁰ Pursuant to "Financing Orders" from the California Public Utilities Commission (CPUC), the state's three large corporate utilities have issued approximately \$5 billion in RRBs that will finance 10 percent reductions in the rates of residential and small commercial customers through December 31, 2001.¹¹ Those customers will be solely responsible for paying off the bonds, a process that will end in 2008.¹²

These first California RRB issuances have been at interest rates commensurate with securitizations of similar maturities in other industries. Edison International's (Southern California Edison) \$2.463 billion December 1997 issue carried an "aaa" rating and an average yield of 6.38 percent on maturities ranging from 1 to 10 years, and Pacific Gas & Electric's (PG&E's) issue performed similarly.¹³ Moody's expects that utilities will issue between \$50 and \$75 billion of RRBs over the next

4 years, against total strandings that Moody's estimates at \$132 billion.¹⁴

Pennsylvania's Public Utility Commission recently authorized PECO Energy to securitize up to \$4 billion of its stranded costs, with a claimed savings to ratepayers of approximately \$200 million per year.¹⁵ This was part of a settlement to end litigation that had delayed issuance of previously authorized RRBs.¹⁶ New laws in Massachusetts and Illinois allow those states' utilities to securitize their strandings, but bonds have yet to be issued.¹⁷

California's RRBs have been issued under the auspices of the state's Infrastructure and Redevelopment Bank, a hitherto idle agency established prior to electrical restructuring.¹⁸ In Pennsylvania, state agencies (other than the PUC) will not participate in the issuance of RRBs. In the language of securitization, California's bank is a "credit enhancer," which will lower the necessary interest on the RRBs, while its own riskiness will presumably increase as they are issued.¹⁹ The most important difference between California and Pennsylvania is in their strictures on expenditure of the proceeds. Pennsylvania requires the issuing utility to subject its planned disposition to the PUC, and the Commission is to specify that the funds will be used primarily to reduce stranded costs and "the related capitalization."²⁰ California's law specifies no allocation of the receipts and provides for no regulatory oversight of the utility's use of them.

B. Risk and the Cost of Capital

Secured financing generally raises the riskiness of both the borrower's existing and future debt. The priority of secured amounts forecloses those amounts from claims by other creditors. For low-risk income streams, however, some have argued that the major effect of securitization is to transform balance sheet receivables into

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cash, since minor amounts of reserves will be sufficient to cover what risk remains.²¹ Isolating securitization's contribution to risk in electric utilities is difficult, because they are recovering strandings at the same time that they are changing their financial structures (and inherent riskiness) to prepare for competition. If adjusting to competition raises the cost of capital, we cannot view this as a "cost" of securitization. The market's reception of California utilities' RRBs indicates that, by itself, securitization will have little impact on creditworthiness.²² California's regulators also expect the bonds to have

minimal effects on risk, at least for the amounts that have been issued.²³

Unless the financial markets are wildly inefficient, securitization's effect on a utility's cost of capital is likely to be small. If regulators have done their job properly, its outstanding bonds will carry interest charges that adequately reflect a competitive financial market's beliefs about their riskiness. Securitization will only lower a utility's cost of capital if bond raters have systematically overestimated its riskiness in the past, and it will raise that cost only if they have underestimated it. Any effect on the cost of capital is difficult to measure because the bonds are being issued in an environment that analysts cannot "hold constant." Competition brings added risks, but securitization is a new financing "technology" that brings benefits of its own.

C. The Effect on Rates

Energy will be procured at market prices in the future, but cost-of-service regulation will remain in force for most transmission and distribution services. Whether or not RRBs retire some existing debt, securitization can only cut rates if it procures capital at a lower cost than before. A cut in rates can only come from this interest differential. In practice, lower monthly bills result primarily from the longer payback period rather than from the interest differential.²⁴ Securitization's critics often make their cases by adding up undiscounted amounts over the financing period, and, as expected, coming up with

an appallingly high total.²⁵ Instead of disregarding the basic mathematics of finance, they might be better off to concern themselves with the potential loss of options that results when an overly long payback period forecloses them from chances to benefit from changes in markets that cannot be foreseen today.²⁶ But, if these lost options are not a serious matter and utilities can, in fact, lower rates by issuing the bonds, why should anyone want to stand in the way?²⁷

While there is general agreement that present values must be the standard for examination, a gulf separates concept and reality. The hundreds of billions of dollars that separate low and high estimates of stranded costs stem from seemingly minor differences in assumed prices and discount rates. California's Commission has attempted to get around the problem by requiring a showing of savings under a range of assumptions about power prices and interest rates. Forecasts of energy prices 5 or 10 years ahead, are, as always, anyone's guess, and so are future regulatory actions and tax policies. Perhaps the most problematic figure of all is the discount rate.²⁸ Since consumer benefits are at issue, discounting them by the utility's cost of capital is inappropriate. The range of rates on consumer debt, however, is incredibly wide, and high discount factors that give disproportionate weight to near-term savings will swing the conclusions in favor of securitization.

III. Is There a Dark Side?

A. Free Cash

However securitization changes the utility, it generates a large fund to be repaid by customers who have few choices in the matter. California's utilities (unlike Pennsylvania's) are free to spend RRB proceeds (as well as unsecuritized transition charges) as they desire.

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They are dedicating large amounts of the inflow to financial restructurings, but the recovery is also freeing substantial funds for other investments. A year ago, San Diego Gas & Electric's President noted that cash from recovered strandings was opening a billion dollars in new investment opportunities for his company.²⁹ More recently, Pacific Gas & Electric paid 40 percent over book value for New England Electric System's divested generation, acknowledging that healthy cash inflows no longer needed for reinvestment in local generation facilitated the deal.³⁰ Securitization reshapes the

time pattern (and changes some algebraic signs) of cash flows that a utility will receive on recoveries that regulators have approved. How efficiently the utility spends the money is a matter for the market to determine.

Perhaps in a perverse way, recent research by financial economists should hearten opponents of securitization.³¹ Economists have found that firms holding large amounts of cash not needed for reinvestment in established activities generally spend them ineptly.³² Free cash flows give managers resources to use in ways that may conflict with the interests of shareholders, e.g., on diversifications that are destructive of corporate value.³³ They allow managers to invest in projects that the capital markets would be reluctant to fund on reasonable terms.³⁴ One major indication that a firm is a candidate for acquisition or takeover is the presence of large cash flows that allow management to bypass Wall Street when deciding on investments.³⁵ Instead of building competitors, free cash inflows, securitized or not, might well produce the same weak, unfocused companies that they have in other industries.³⁶

B. Predatory Pricing

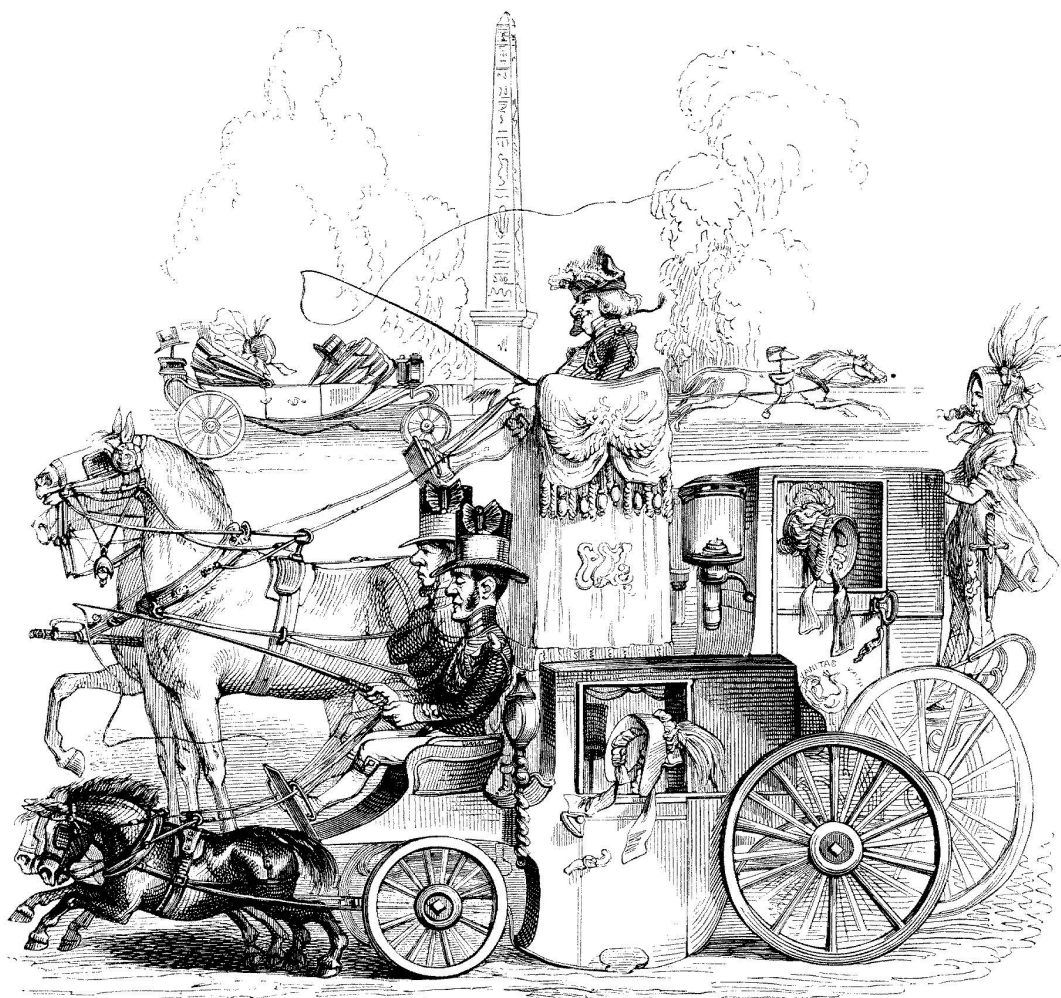
Predatory pricing is problematic both in theory and practice. Economic folklore contains numerous stories that turn out to have little basis in the record.³⁷ Factually, it is difficult to separate anti-competitive predation from the desirable competition that happens when a low-cost seller successfully under-

prices a higher cost seller. Economists and lawyers continue to debate which measure of cost (marginal or average variable, among others) should be the baseline for predation, and how long a price below cost must persist to harm competition.³⁸ Economic theory postulates prerequisites for successful predation that are seldom met in the real world.³⁹ Neither facts nor theory have deterred some critics from asserting that securitization will facilitate predation by incumbent utilities that will thereafter enjoy long and prosperous monopolies.⁴⁰

Securitization and predation are at best tenuously linked. Whatever a utility's recovery on a stranded plant, it will bid that plant's energy into a regional market as long as the price covers the marginal cost. The company's shareholders may be happier if they recover their investments, but neither success nor failure at recovery will affect its rational strategy for bidding into the market.⁴¹ The price in an energy exchange will be set by the marginal generator and will often exceed the operating cost of, for example, a stranded nuclear unit.

Inefficiency in a power exchange only occurs if units with low marginal costs do not bid into it while units with high marginal costs do.

To assert that cash from securitization increases the likelihood of predation is to assert that any firm with substantial cash, however gotten, will want to use it in that way. By these standards, the antitrust authorities should question almost any securitization (or any financing) in any industry. In reality, most securitizations provide additional funds for the issuer's main line of busi-



I hear his securitization bond sale went quite well.

ness, as they have for mortgage-backed instruments. If securitization produces truly excess liquidity, it should go where it can earn a high return, adjusted for risk. Shareholders might prefer that return in the form of cash for repurchased stock. Predatory pricing is only one of many possible investments, and undertaking it is worthwhile only if the expected profit, discounted over the future, exceeds that of alternative investments.⁴² Profitability depends heavily on the likelihood that the expenditure will succeed in driving out incumbent producers or discouraging the entry of new ones, when all parties know that there are limits on what the predator can feasibly spend.

Electricity is an unlikely industry in which to expect successful predation against existing competitors, although in some circumstances it may profitably deter or delay the entry of new rivals.⁴³ Pricing below cost is unlikely to induce the permanent exit of competitors whose plants are durable, fixed in location, and useless for producing anything other than power. These plants will run as long as price exceeds their operating costs, and the costs of technologies used by newcomers may be less than those of the utility contemplating predation. To keep market prices down, the predator must bid both its efficient and its inefficient plants into the power exchange at low prices. Sustaining post-predation monopoly power requires that imports of inexpensive power be unobtainable (e.g., because of transmission limits) or

unusable (e.g., because loads have been locked in by long-term contracts).⁴⁴ Utilities flush with cash from stranding recovery, whether securitized or not, have numerous choices about its use. Predation is but one of those choices, but it can only be undertaken by a company ready to forsake other potentially profitable (and indisputably legal) investments.



IV. Conclusions

Securitization will come to the table in almost every jurisdiction with significant strandings. Utilities appear to place great value on it for reasons that are unclear. Maybe they see greater risks in “nonbypassable” charges than do outsiders, or maybe executives simply want large pools of up-front cash to invest in projects that the capital markets might reject. Small users will only realize relatively small savings from securitization over the long haul, and those savings depend on industry and capital

market developments that no one can foresee. California’s RRBs do not affect large users, whose rates will be frozen during a transition period that terminates in 2001 (with qualifications). If utilities do not collect the allocated transition charges from “headroom” in the frozen rates during that period, the loss is theirs.

Securitization is neither a panacea nor a plague, and most objections to it arise from misunderstandings or are simply another attempt to revisit the issue of stranded cost recovery in a different forum. Since utilities seem to value recovery very highly, however, it can probably be turned into a bargaining chip to speed up the coming of competition or to make the playing field more level.⁴⁵ Because securitization imposes a long-term commitment on ratepayers for a questionable benefit that some of them do not want, regulators may treat it as a bargaining chip of their own. At the CPUC meeting approving the issuance of RRBs, Commissioner Jessie J. Knight Jr. told the utilities “As far as I’m concerned you have an advantage,” and that in future decisions “I’m going to skew toward your competitors because they don’t have this advantage.”⁴⁶ The real benefits of securitization are quite small, and might turn out to be ironic for utilities. If enough regulators have Commissioner Knight’s attitude, the utilities that securitized might end up envying the utilities that did not. ■

Endnotes:

1. Re lack of a theory, see Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625-80 (1997). Re the possible efficiency of secured credit, see Thomas H. Jackson and Anthony T. Kronman, *Secured Financing and Priorities among Creditors*, 88 YALE L. J. 1143-82 (1979). Re its inefficiency and inequity, see Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887-1963 (1994).
2. See, for example, George J. Benston, *The Future of Asset Securitization: The Benefits and Costs of Breaking Up the Bank*, J. APPLIED CORP. FIN., Spring 1992, at 71-82.
3. This necessary point is made by utility representatives Ward L. Smith and James W. Durham, *Securing Lower Costs for the Present and Future*, ELEC. J., Oct. 1997, at 20-26.
4. Lewis S. Ranieri, *The Origins of Securitization, Sources of Its Growth, and Its Future Potential*, in LEON T. KENDALL AND MICHAEL J. FISHMAN (EDS.), *A PRIMER ON SECURITIZATION* 31 (MIT Press, 1996).
5. Lewis S. Ranieri, *id.*, at 4.
6. J.P. Morgan Securities (June 2, 1997) (Presentation to Energy Daily Finance Forum, Washington D.C., transparency).
7. Joseph C. Shenker and Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues, and New Frontiers*, 69 TEX. L. REV. 1369-1429, at 1371 (May 1991).
8. *Lights, Camera, Securitize*, WALL STREET JOURNAL, Sept. 11, 1997, A1.
9. Smith and Durham, *supra* note 3, at 26.
10. In the only pre-California securitization by an American utility, Puget Sound Power & Light Co. issued \$202 million of bonds collateralized by its right to collect compensation for conservation expenditures from consumers. See Fitch Investors' Service, *Guidelines for Rating Debt Backed by Regulatory Assets*, Sept. 30, 1996, at 7.
11. See, e.g., California Public Utilities Commission (CPUC), Decision 97-09-056, Application of Southern California Edison Co., Sept. 3, 1997. The legalisms of securitization in California are dis-

cussed in detail by Walter R. Hall III, *Securitization and Stranded Cost Recovery*, ENERGY L. J., Vol. 18, No. 2, 363-404 (1997).

12. Large commercial and industrial customers are not benefited by the RRBs. Instead, their rates will be frozen and utilities must collect what transition charges they can from them by Dec. 31, 2001, with minor amounts extending past that date.

13. Southern California Edison news release, at www.sce.com/html/news/



[press/97-229.htm](http://www.sce.com/html/news/press/97-229.htm); *Market Grabs \$2.9 billion in Bonds on PG&E Stranded Costs*, at 6.42 %, ELEC. UTIL. WK., Dec. 1, 1997, at 1.

14. Susan Abbott, *Stranded Cost Securitization: Analytical Considerations*, ELEC. J., Oct. 1997, at 15. The text says "132 million."

15. *Penn. Forges Final Choice Plan for PECO with Landmark Settlement*, ELEC. POWER ALERT, May 6, 1998, 8.

16. PECO Energy Files Appeals to PUC Restructuring Order, Jan. 22, 1998 press release at www.peco.com/investor/press.html.

17. *Massachusetts Competition Bill Passed and Governor's Signature is Expected*, ENERGY REP., Nov. 24, 1997, at 1; *ComEd Plans \$6.8 billion Securitization*

Issue, MEGAWATT DAILY, Mar. 25, 1998, at 1.

18. CPUC, Decision 97-09-056, 2. The bonds are not debt of the State of California. Investors must be informed that the bonds are not backed by the State's "full faith and credit."

19. See Benston, *supra* note 2, at 76.

20. Pennsylvania House Bill 1509 (1995), § 2812(B)(2). Objections to the plan have included the possibility that the cash inflow retires "stranded" debt, but allows issuance of replacement debt, in effect a "laundering." See IPALCO Enterprises, Inc., *The Securitization Swindle*, A White Paper (May 1997), 25. A more accurate and less inflammatory term is "refinancing," a process whose interest rate benefits will be passed through to ratepayers.

21. California utilities' bonds are over-collateralized by 0.5 percent more committed revenues than required to pay off the face value of the bonds. *Calif Securitization Fees Alone Could Hit \$1 Million*, ELEC. DAILY, Nov. 14, 1997, at 1.

22. Lori A. Burkhart, *Credit Rating Firms Savor Restructuring, Search for a New Formula*, PUB. UTIL. FORT., Feb. 1, 1997, at 27-30.

23. The CPUC noted that the increase in recorded debt in Southern California Edison's consolidated financial statements (because the bankruptcy-remote issuing entity must be aggregated with the company for reporting purposes) "is not expected to affect Edison's utility credit ratings, as it is expected that the rating agencies will determine that the RRBs, which are not supported by Edison's general revenue stream, do not affect Edison's creditworthiness." Decision 97-09-056, 19.

24. Some California customers are finding that the first bond-related collections they must pay have exceeded the mandated rate reductions. In the first month of the securitized reduction, PG&E's customers found themselves paying \$71.8 million to finance \$33.8 million in savings. Southern California Edison's customers paid \$8.6 million for \$13.4 million in reductions. Ironically, con-

sumer groups have pointed out that under traditional ratemaking, PG&E's customers would have enjoyed a 10% reduction for the current year without the financing because of drops in mandated payments to cogenerators under certain standard offer contracts. *Restructuring Countdown: Finance Charges for 10 Percent Rate Reduction Exceed Reduction*, CALIF. ENERGY MARKETS, Mar. 6, 1998, at 10.

25. See, e.g., Hon. Frank J. Kelley, *Securitization: A State Attorney General's Perspective*, ELEC. J., Oct. 1997, at 39.

26. Robert S. Pindyck, *Irreversibility, Uncertainty, and Investment*, 21 J. ECON. LIT. 1110-48 (Sept. 1991).

27. This also raises the question of why regulators have not considered securitization of other utility income as a more general policy. See Shimon Awerbuch and Leonard S. Hyman, *Demystification—The Economic Realities of Securitization*, ELEC. J., Oct. 1997, at 28. One possibility is that more general securitization will exempt important utility functions from regulatory oversight on grounds of financial commitment. See Kenneth Rose, *Securitization of Uneconomic Costs: Whom Does it Secure*, PUB. UTIL. FORT., June 1, 1997, at 32-37.

28. The CPUC approved Southern California Edison's issue upon a showing by the company that 10-year bonds discounted at 10 percent (rather than the 6.3 percent coupon interest) would result in net present value benefits that met the rate reduction criteria. See CPUC Decision A.97-05-018, 17.

29. *Enova, Pacific Enterprises Unveil New Joint Venture*, CALIF. ENERGY MARKETS, Mar. 14, 1997, at 9.

30. *U.S. Gen Gets NEES Plants for \$1.59 Billion*, ELEC. DAILY, Aug. 7, 1997, at 1.

31. Robert Michaels, *After Stranding Recovery, What?*, PUB. UTIL. FORT., June 1, 1996, at 24-28.

32. Olivier Jean Blanchard, Florencio Lopez-de-Silanes, and Andrei Schleifer, *What do Firms Do with Cash Windfalls?* 36 J. FIN. ECON. 337-60 (1994).

33. This was the outcome of numerous diversifications spawned by free cash flows that came with the nuclear completions of the mid-1980s. One author found that his representative sample of diversifications had an aggregate return of approximately zero. Charles M. Studness, *Earnings from Utility Diversification Ventures*, PUB. UTIL. FORT, Sept. 1, 1992, at 28.

34. Free cash can just as well come from generation divestitures as from stranded recovery.



35. Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831-80 (Sept. 1993).

36. For a list of examples and data on their performance, see Blanchard, *supra* note 32, at 337-60.

37. The first in a long literature of case studies that debunk predation is John McGee, *Predatory Pricing: The Standard Oil Case*, J. L. & ECON., Oct. 1958, at 137-69.

38. Philip Areeda and Donald Turner, *Predatory Pricing and Related Practices Under the Section 2 of the Sherman Act*, 88 HARV. L. REV. 697-733 (Feb. 1975); Paul L. Joskow and Alvin K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L. J. 213-70 (Dec. 1979); William J. Baumol, *Quasi-*

Permanence of Price Reductions: A Policy for Prevention of Predatory Pricing, 89 YALE L. J. 1-26 (Nov. 1979).

39. Frank H. Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. CHI. L. REV. 237-63 (1981); John McGee, *Predatory Pricing Revisited*, J. L. & ECON. 23 (Oct. 1980), 289-330; JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* Ch. 9 (MIT Press, 1988).

40. "With their high cost assets paid for the utilities will be better able to drive out their competitors. After the transition period, they will be able to charge what the market will bear." Kelley, *supra* note 25, at 42.

41. Paul L. Joskow, *Does Stranded Cost Recovery Distort Competition?*, ELEC. J., April 1996, at 31-45.

42. One set of antitrust defendants successfully used such a calculation to show the unprofitability of plaintiff's charge of predation. *Matsushita Electronic Industries Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986). Also see Kenneth G. Elzinga and David E. Mills, *Testing for Predation: Is Recoupment Feasible?* 34 ANTITRUST BULL. 869-93 (Win. 1989).

43. One independent power producer has recently filed such a complaint over long-term antibypass contracts between industrial customers and an incumbent utility. See *Indeck Energy Services, Inc. v. Consumers Energy Co.*, Case No. 97-10366. (E.D. Mich.)

44. This full loading of Michigan's interconnections at important times makes Attorney General Kelley, note 25 *supra*, particularly concerned about predation in his state. *Indeck Corp., id.*, is claiming that such contracts between defendant utility and large users help render predation profitable.

45. The fact that utilities value recovery highly is no indication that they know something the rest of us do not. If utilities knew that much more than the rest of us, competition might never have come along.

46. *Restructuring Countdown*, CALIF. ENERGY MARKETS, Oct. 3, 1997, at 15.