Exhibit No. 200

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Prudent Investment Test
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EXHIBIT 200

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THE PRUDENT INVESTMENT TEST IN THE 1980s

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EXECUTIVE SUMMARY

Prudence is an old regulatory concept being put to new use. The frequency of use of the concept by state utility regulatory commissions has increased greatly in the last 10 years. Under one way of counting, there were forty-two state commission cases that made significant use of the concept in the 1974-83 period and nine such cases in the 30-year period before that. The immediate occasion for most recent uses of prudence has been the turmoil in the electric utility industry: construction cost overruns in completed plants, abandonment of plants, and excess capacity.

Recent public discussions of prudence have often loosely referred to "the prudence of a nuclear power plant" or the "prudence of a cost overrun," as if an object or a cost were prudent or imprudent. In our view, prudence always relates to a decision--or the absence of a decision where one is needed--such as a decision to construct a nuclear unit, to abandon a coal unit, or to use certain construction management practices.

For a state commission judging the prudence of a utility investment decision, it is useful to understand the concept of a prudent investment decision not only in public utility law, but also in related areas of law and in finance and management science. Investment decision rules in finance and management science determine a generally accepted mode of behavior for managers making large capital investment decisions in any industry. For competitive companies, investment decisions are intended to maximize profits for investors. All financial authorities agree that the best way to determine whether a capital investment in a project is prudent from the stockholders' point of view is on the basis of the discounted after-tax cash flows to be expected. For an unregulated company, investment decisions are simply a matter of calculating such cash flows.

For a regulated utility, investment decisions must also take into account the franchise obligations to provide all the service demanded, to ensure adequate and reliable service, and to provide service at a reasonable price. Utility decision makers evaluating probable future cash flows must assess the probable regulatory treatment of their investment decisions, a treatment now frequently determined on the basis of prudence.

The concept of prudence is used throughout the law as a standard of conduct owed to others. It seems likely that the concept of prudence in public utility law was borrowed from other areas of law that use the concept. The "prudent man" concept is well known as a standard of care expected in avoiding injury to another person or damage to his property. Other areas of law use the concept of prudence as a standard of care in the conduct of business, particularly where the economic use of property is involved and a legal duty of care is owed to other persons. Here the legal obligations are analogous to the obligations of public utilities for prudent investment decisions. These include the legal obligations associated with mineral development leases and trust and estate management. In these areas of law, the concept of prudence protects the rights of individuals not in control of investment decision making. It does not require

perfection in decision making but does require, for example, avoidance of deliberate exposure to substantial risk where the individuals not in control could suffer financially.

The concept of a prudent investment in public utility law is a regulatory oversight standard that attempts to serve as a legal basis for judging whether utilities meet their public interest obligations. It was used as early as 1914 by the public service commission in Massachusetts. The concept first achieved wide recognition in public utility law after it was used by U.S. Supreme Court Justice Brandeis in a concurring opinion in 1923. Brandeis introduced the concept of a prudent investment as a rate base valuation method in an ongoing constitutional debate about utility valuation. While the prudence method did not achieve the status of the only constitutionally correct valuation method, it became a judicially developed concept useful for determining what facility costs should be allowed in rate base. Federal and state legislation rarely apply the concept of prudence explicitly to public utilities. A notable exception is the recent Congressional consideration of prudence as a regulatory standard governing the natural gas acquisition practices of interstate pipelines. However, the concept of a prudent utility decision has been abstractly articulated by the courts, leaving broad discretion for the application of the prudent investment standard by state commissions.

Review of the many recent state commission applications of the standard suggests four guidelines for successful use of the prudent investment test. These are, first, that there should exist a presumption that the investment decisions of utilities are prudent. The presumption of prudence can be overcome, however, by an allegation of imprudence that is backed up by substantive evidence creating a serious doubt about the prudence of the investment decision. Once the presumption of prudence is overcome, a commission needs to decide on the legal standard for judging prudence. The second guideline is to use the standard of reasonableness under the circumstances. That is, to be prudent, a utility decision must have been reasonable under the circumstances that were known or could have been known at the time the decision was made. A corollary to the standard of reasonableness under the circumstance is a proscription against the use of hindsight in determining prudence. Observing this proscription is the third guideline. The proscription against hindsight makes it unwise for a commission to supplement the reasonableness standard for prudence with other standards that look at the final outcome of a utility's decision, though consideration of outcome may legitimately have been used to overcome the presumption of prudence. The fourth guideline is to determine prudence in a retrospective, factual inquiry. The evidence needs to be retrospective in that it must be concerned with the time at which the decision was made. Testimony must present facts, not merely opinion, about the elements that did or could have entered into the decision at the time. Often the evidence for a state commission's retrospective, factual inquiry is developed through a staff investigation. Such a staff investigation can look at the past in great detail and therefore can be time consuming and expensive.

Following these guidelines is likely to be useful, perhaps necessary, for having a court sustain a commission decision regarding prudence.

However, because the prudence test is an emerging area of regulatory law, following these guidelines may not be sufficient to guarantee that a commission's decision based on prudence will be upheld.

Review of recent state commission prudence inquiries involving electric and gas utilities reveals that in only a few cases do commissions rely clearly and solely on the concept of prudence for reaching a judgment. Rather, in most cases commissions also reference the used-and-useful test or some other test when deciding if questionable costs should be included in rates. The review also shows that there have been many electric utility applications but few gas ones. The two principal areas of electric utility application have been construction cost overruns and plant abandonments, with capacity additions running a distant third.

Prudence inquiries involving construction cost overruns often depend on the results of a detailed staff investigation. Also, in cost overruns cases, use of the prudent investment test tends to work against utility interests in that the used-and-useful test alone, depending on how it is interpreted, is more likely to result in full cost recovery for an operational generating station.

The opposite is usually the case when the prudence test is applied to abandoned plant. Here, utilities introduce the prudent investment test in defense of their construction and abandonment decisions. In fact, the most frequent area of application of prudence in recent years has been where a utility plant has been abandoned or cancelled. Unlike construction cost inquiries, these prudence inquiries are usually not preceded by extensive staff investigations. In most cases, the presumption of prudence operates to allow recovery of most or all of the costs. However, a few cases have gone the other way.

Most state commissions have been reluctant to use the prudence test against decisions to add capacity. For many commissions, the mere existence of excess capacity is not necessarily indicative of an imprudent capacity planning decision, and, as long as state-of-the-art demand forecasting methods are used, there would be no finding of imprudence. Many commissions have dealt with cases where utilities defended excess capacity as resulting from prudent decision making. But several state commissions have held that the question of prudence applies not only to the initial investment decision but also to decisions made (or not made) during construction about the ongoing need for additional power. Thus, a failure to cancel a project that was prudently initiated, after it is no longer prudent to continue the project, can result in a finding of imprudence.

The recent emergence of the prudent investment test is mainly due to the higher risks and higher stakes faced by energy utilities, particularly by electric utilities, over the last 10 to 15 years. The higher risks relate primarily to uncertainties about costs, demand growth rates, and the supply of generation capacity needed for the future. Because the environment is riskier, the chance of error in utility planning is greater, and the opportunity for making an imprudent decision is greater than in the

past. The consequences of an imprudent decision are also greater--both in absolute and relative terms. Today's direct costs of construction and costs of capital are much higher than in the past. Further, electric construction work in progress for privately owned utilities in the United States as a percentage of net electric plant has increased continuously from 1967 through 1983, from 8 percent to 36 percent, so that the effect on the average company of excluding a large construction project from rates is much greater today than in the past.

Who suffers the consequences of an error--utility customers or utility investors--has become an increasingly important question for commissions as the stakes involved in utility investment decision making grow. State commissioners today are pulled between the obligation to keep utilities financially sound and able to provide reliable service to customers and the obligation to set rates at a level reasonably related to the costs of providing service. They have been forced to choose between these two obligations where large investment values are at stake and where commission action exposes either stockholders or ratepayers to severe financial losses.

The concept of prudence provides commissions with a principle that does not necessarily require an "all or nothing" decision in favor of one side, but can allow some sharing of the risks between investors and ratepayers. The prudent investment test is a tool that regulators are using to provide an answer to the question of who should bear which risks and associated costs. In practice, it seems that many regulators choose not to hold utilities responsible for risks affecting the electric industry as a whole. Instead, state commissions often apply the prudent investment test so as to hold utilities harmless, except for the consequences of decisions that were unreasonable at the time they were made. The test is used principally to hold utilities responsible for the risks over which management has substantial control.

Regular and strict use of the prudence test by state commissions to disallow major portions of large expenditures by utilities is intended to protect utility customers and to compel responsible and efficient utility decision making, but such regular and strict use may have other, unintended consequences. One consequence could be a utility policy of minimal future investment in service capacity. This seems likely to occur unless commissions also provide positive investment incentives or underinvestment penalties. Another possible consequence of strict prudence application is utility bankruptcy. Recent studies suggest that a likely effect of utility debt reorganization would be to increase capital costs and utility rates above the levels that would exist with a limited prudence penalty that did not cause bankruptcy. However, this finding depends heavily on several factors, including the overlapping authorities of the bankruptcy court and the state commission and the extent to which the commission is allowed to participate in the bankruptcy proceedings.

Between the extremes of utility underinvestment and utility bankruptcy are other possible consequences of strict prudence application that

represent permanent alterations of the relationships among the parties to a major utility construction project: utility management, the financial community, equipment vendors, architect-engineers, and construction firms. Altering these relationships could raise the costs of utility service because of increased capital costs, more formal "arm's length" dealings, higher construction contract bids, increased litigation among the parties, more detailed record keeping, and less technical innovation. But it is not possible to generalize about the net effect on utility rates of protecting customers from imprudently incurred costs in the short run, compelling utility managers and contractors to be more efficient in the long run, and altering relationships so as to increase long run costs.

Numerous issues about prudence need to be resolved as this area of regulatory law continues to emerge. One set of issues concerns articulating more fully in the hearing room both the nature of a prudent investment decision in the utility business and the regulatory procedures for judging the prudence of a utility decision. In particular, the relationship of the prudence standard to the used-and-useful standard must be clarified. Concerns about the decision-making process for major utility investments have led some utility representatives and some regulators to call for greater commission involvement in this process. A second set of issues concerns the appropriateness of such involvement. Still another group of issues relates to the consequences of regular and strict prudence application and what limitations, if any, ought to be imposed on such application. Of particular concern is the issue of when regulatory disallowance of cost recovery becomes confiscation.

Despite these uncertainties, the extensive contemporary use of the judicially developed prudent investment concept by state commissions demonstrates the vitality and usefulness of the concept. It is not confined to the capital cost component of ratemaking, but has been used to assess the reasonableness of decisions involving operating expenses as well. Under the existing regulatory framework, a utility's rate case is the only occasion for providing accountability to the consuming public and the investing public. Within this framework, the prudent investment test is emerging as a necessary and flexible regulatory tool for identifying types of risk and for placing the risk of utility mismanagement on utility owners.