

ASBESTOS and BANKRUPTCY a troublesome chemistry



On August 26, 1982, the Manville Corporation filed for bankruptcy under Chapter 11 of the Bankruptcy Code. The corporation was not insolvent (it actually reported over \$60 million in profits in 1981), but was faced with thousands of present and potential lawsuits asking compensation for asbestos-related diseases. Manville determined that the total cost of these future lawsuits would be about \$1.2 billion. Two other major asbestos producers, UNR and Amatex, have also filed under the Bankruptcy Act in response to an overwhelming volume of asbestos litigation.

It is a difficult problem to set up an equitable program of compensation for injured individuals where one of the principally responsible corporations predicts that its assets will not cover its potential liabilities. From a more critical perspective, the problem is: should a corporation with over \$2 billion in assets and over \$1 billion in net worth, including 1981 profits of over \$60 million, be able to use bankruptcy to delay and possibly reduce its obligation to pay damages to asbestos plaintiffs?

Background

The Manville Corporation, formerly the Johns-Manville Corporation, is the largest producer of asbestos in the world. Asbestos is a mineral fiber used widely in industrial and construction projects because of its durability, its ability to insulate, and its resistance to fire.

Asbestos fibers, which can be easily inhaled, were first recognized as a cause of lung disease in 1927. Nevertheless, its use continued through the 1970's, partly because of its beneficial qualities and partly due to an alleged cover-up within the industry. Evidence has been introduced in cases for damages against Manville that the corporation knew of the dangers of asbestos 30-40 years ago, but that it did not publicize the results or warn employees. Manville still disclaims having such knowledge.

Three of the predominant asbestos-caused diseases are asbestosis, mesothelioma, and lung cancer, all of which have a long latency period. Between 1940 and 1979, more than 27 million Americans were exposed to the asbestos, many as a result of working in naval shipyards during World War II, where asbestos was widely used in construction. According to a 1964 study by Dr. Irving Selikoff of Mt. Sinai Hospital in New York, 235,000 deaths will occur between 1982 and 2027 as a result of asbestos exposure. Every year, between 8,500 and 10,000 cancer deaths are related to asbestos, according to the study.

To date, claimants have filed 16,500 asbestos-related lawsuits against Manville, with an estimated

500 new lawsuits being filed every month. Manville's estimated liability from suits already filed is \$660 million. Although Manville's average settlement cost in these suits is \$40,000, it has in some cases been found liable for punitive damages of as much as \$600,000.

In *Johns-Manville Corporation v. Superior Court*, 27 Cal.3d 465 (1980), the California Supreme Court held that although an employee's compensatory damages for asbestos related injuries are usually limited by Worker's Compensation law, Manville was liable for punitive damages because of the corporation's knowledge and concealment of the dangers of asbestos.

Manville files under the Bankruptcy Act

According to a recent study which Manville commissioned, there will be 32,000 lawsuits filed against the Corporation during the next 20 years, resulting in over \$1.2 billion in future liabilities for the company. This future liability is no doubt speculative and perhaps inflated. The study's estimates were based on an average cost per case of \$40,000, while many cases in 1982 have cost Manville only \$16,000. In addition, the total cost of the suits over the next 30 years has not been reduced to a present value figure. At a discount rate of 8%, for example, Manville's estimate of \$1.2 billion in liabilities over the next 30 years has a present value of about \$500 million. From an economic standpoint, this is the more relevant figure, but Manville's estimate was reached by multiplying the total number of estimated suits by a flat expected cost per suit. The estimate of total future liability does not account for a likely decrease in Manville's defense costs due to increased efficiency through repetition, or through the possible consolidation of suits by the bankruptcy courts. Yet Manville used this study in predicting future financial insolvency, despite its present \$1 billion in net worth. It should be noted, however, that the estimated future liability was not adjusted for inflation.

As a result of this prediction of insolvency, Manville filed for protection from creditors and claimants under Chapter 11 of the Bankruptcy Reform Act (11 U.S.C. § 301). While Chapter 11 usually concerns "reorganization" of a faltering and insolvent debtor's

assets, Manville achieved a net income in the third quarter of 1982 of \$25 million, after filing for bankruptcy earlier that year. Soon after filing for bankruptcy, the Manville Corporation launched an ad campaign proclaiming "Manville's new world is full of promise."

Under bankruptcy procedure, the Federal Bankruptcy Court is placed in control of all claims and suits against the debtor, no matter where a claim originates. Presently, the 1978 Bankruptcy Reform Act is being reconsidered by Congress due to the U.S. Supreme Court's decision that the Act delegates an unconstitutional amount of power to federal bankruptcy judges. (*Northern Pipeline*, 50 U.S.L.W. 4892 (1982).) Asbestos claimant's are an unsecured class of creditors within the bankruptcy priority system and are represented by a committee. Manville's reorganization plan will be required to provide for asbestos claimants as well as all other creditors. For example, companies which supply Manville with products who have outstanding unsecured claims now have the same creditor status as asbestos claimants. If Manville were to liquidate its assets instead of reorganizing them, most if not all of the present asbestos claims would be paid. But Manville contends that no money would ever reach future claimants unable to sue now. This is why alternative legislative solutions, to be discussed later in this article, are important considerations when thinking about compensation for all asbestos victims. The Chapter 11 filing may give certain advantages to these future claimants.

Manville's petition for reorganization may permit consolidation of the thousands of asbestos claims pending in different states. Consolidation of the claims should make it less costly for Manville to defend itself, ostensibly resulting in more money for all creditors. By halting the present asbestos suits, money can be saved and a plan devised so that all asbestos victims, present and future, will be compensated to some degree. It is also true, however, that numerous suits approaching settlement were suddenly stopped by the filing of bankruptcy. In one well publicized case, a dying man was deprived of his compensation checks which had already been promised him by Manville.

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Asbestos

(continued from front page)

Many of the attorneys representing plaintiffs in asbestos litigation contend that Manville in fact filed for reorganization to defraud plaintiffs. They claim that now that bankruptcy has been filed, present asbestos plaintiffs will receive less from Manville than they would have through individual litigation. The committee of asbestos claimants has filed a motion in bankruptcy court arguing that Manville's petition was filed in "bad faith", and should be dismissed. As of this writing, this motion has not been ruled upon. If this motion is unsuccessful, Manville can be expected to propose a long-term plan of restructuring for the corporation and its debt. How present and future asbestos claims will be accommodated in this plan is uncertain. Furthermore, it is unclear whether an economically healthy corporation like Manville needs to restructure at all. Manville (and the entire asbestos industry) along with Congress, has recognized the need to consider alternative solutions to the problem of equitably compensating asbestos victims.

Industry Solutions to Asbestos Litigation

Manville would like to see established a "no-fault" system of compensation in which industry members and the federal government would contribute to a general compensation fund. This fund would be used to pay claimants directly, instead of each claim being litigated separately as Manville has done in the past. The fund would provide the asbestos industry with a collective and finite compensation program through which asbestos damage claims could be paid. Manville president John A. McKinley stated, "[The adequacy of asbestos compensation] is not a financial failure. It is a failure of our court and legislative system to compensate victims of an unexpected occupational health catastrophe." This fund would compensate most, if not all, of the victims. Prior to bankruptcy, Manville won about half of the suits against it, usually because the claimants could not prove a causal link between asbestos and their illness. With the fund, this would not happen. However, the compensation from the fund might not equal what a jury award would have been after individual litigation. Manville views this as a desirable way to limit its liability.

The federal government claims there is no basis for requiring government participation in such a compensation program since its liability for workers' injuries has not been established. Because of the many victims who were exposed in the military shipyards during World War II, the government has been sued as a co-defendant in about 1,200 asbestos

cases involving almost 13,000 individual claims. The government has argued that there was adequate surveillance of the shipyards and that health standards were upheld. Officials also claim that the government is already helping to compensate asbestos victims through Social Security Disability, Medicare, contributions to state worker compensation funds, and through other programs such as veterans benefits and benefits given under the Federal Employment Compensation Act.

Legislative Alternatives

One piece of legislation introduced to aid asbestos victims does not require government contributions to a general fund. Representative George Miller (D-Calif.) sponsored a bill (HR 5735) in 1982 that would require only asbestos manufacturers and suppliers to set up a compensation fund. According to Miller, requiring the government to contribute to the compensation fund "would establish a dangerous precedent which could open the door of the Treasury to every manufacturer of a hazardous product or substance which finds itself confronted with admittedly large liabilities . . . which are of its own making." Miller claims the taxpayers are already spending over \$3 billion a year to compensate victims through other government programs, and he believes government contributions to an asbestos-compensation fund would be a bailout for the asbestos industry.

An alternative piece of legislation, S. 1643 sponsored by Senator Gary Hart (D-Colo.), does specify government participation. This bill calls for establishing a commission of government, health, labor, and industry representatives who would develop criteria for state worker compensation boards. The criteria would be used to determine payments to victims by assessing each participant's responsibility through a complicated arbitrator's formula. Since each party would be required to pay its respective share, Hart claims his legislation is not a bailout bill. The key issue, says Hart, "[i]s, and always has been, not what is good for the asbestos industry . . . but what is necessary to insure that workers disabled from asbestos-related diseases are fairly compensated by the parties responsible." According to Hart, this plan would force Manville to take responsibility for the alleged cover-up of the asbestos problem 30-40 years ago, and would provide for federal contributions because of the federal government's status as an employer controlling work projects where asbestos was used extensively.

One of the main policy reasons behind Hart's bill is what he perceives as the inadequacy of state worker compensation programs and the need for their reform. Those programs tend to contain artificial barriers to compensation such as impractical statutes of limitations

which prevent recovery for diseases with long latency periods such as those caused by asbestos. Furthermore, payments under these programs are often inadequate because compensation is based on 1940 wage scales. Hart's bill calls for a plan of reform to correct these inadequacies.

Conclusions

Neither a final compensation plan nor a Chapter 11 reorganization plan for the Manville Corporation has been agreed upon at this date. The asbestos industry wants government participation in a plan to compensate asbestos victims; the government opposes it. Unions oppose any limitations on liability suits which a general fund or a revised worker compensation program might create. Victims oppose limitations on compensatory damages, and it is unclear what causes of action a dead victim's surviving family members might have under the different alternatives in seeking compensation. Furthermore, none of the proposed bills has been reintroduced into the new Congress; a new push will be needed to continue discussion for a legislative solution to emerge.

Beyond the immediate dispute involving Manville lies a broader policy question of how to avoid similar situations in the future. The alternatives offered will allow claimants to escape the burden of long and expensive individual litigation in seeking compensation. Individual litigation of asbestos cases has had the beneficial effect of bringing to light the information concerning Manville's early knowledge of asbestos' dangers and in some cases has resulted in Manville being held accountable accordingly.

As more and more toxic substances enter the workplace and environment, there is an increasing danger that the industries involved will seek refuge in bankruptcy to delay and possibly avoid compensating their victims. The Manville Corporation's use of bankruptcy towards this end brings into question the proper use and purpose of the bankruptcy law. Changes in bankruptcy, tort, and workman's compensation laws may be required to make certain that victims receive prompt and fair compensation, without permitting wrongdoers to escape their responsibility through bankruptcy laws or otherwise.

Norine Marks,
Adam Rosen



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SELLING THE PUBLIC LANDS SELLING

On February 25, 1982, President Reagan signed Executive Order 12348 to create the Federal Asset Management Program. The program's purpose is to identify federally owned land that is "excess or surplus" to the needs of executive agencies so that this property can be put to its "most beneficial use." One such use is to sell these properties to raise revenue. The Reagan administration estimates that 5% of the 744 million acres of federally owned land, approximately 35 million acres, could be sold during the next five years to raise over \$18.3 billion.

The Property Review Board and Terms of Sale

Executive Order 12348 established a Property Review Board (PRB) chaired by Edwin L. Harper, Assistant to the President for Policy Development. Other Board members include presidential aides Edwin Meese III and James A. Baker III, and National Security Advisor William P. Clark. The Order requires the head of each executive agency to inventory all "property holdings which . . . are not utilized, are underutilized, or are not being put to good use." Each inventory is to be sent to the PRB, which will help agencies sell the identified holdings. Properties would be offered first to other federal agencies, then to state and local governments, and finally to private entities and citizens. State and local governments must pay market value for these lands unless they can demonstrate that a lower selling price is in the public interest. Private purchasers must also pay market value.

Land for Sale

To date, executive agencies have identified numerous parcels of surplus land. On May 18, 1982, the U.S. Forest Service announced that 54 tracts of surplus land totaling 42,730 acres would be offered for sale. These tracts include the San Gabriel Canyon in Azusa, California, and the White Deer Administration Site in Dunlap, California. Most of the identified surplus lands are administered by the Bureau of Land Management (BLM) and are located in the sixteen western states. On June 17, the Interior Department released its estimate that 4.3 million acres of

BLM lands could be sold for approximately \$2.5 billion. Overall, more than 307 parcels of what is deemed "unnecessary federal property", totalling over 60,000 acres, are included in a list recently published by PRB Chairman Harper. Land offered for sale includes 17 acres of Waikiki beach front owned by the U.S. Army and valued at \$221 million; the now vacant five-story New York Assay Office on Wall Street estimated to be worth \$8.3 million; and the 33 acre Point Sur Light Station in Big Sur, Cali-

of certain federal lands to be used for state and federal acquisition of land for parks, recreation areas, wildlife refuges or other public uses. Thus, existing laws may prevent the funds raised from land sales from going into the general fund to reduce budget deficits.

Congress' response to the Asset Management Program has been mixed. Senator Charles H. Percy and Representative Larry Winn, Jr., have introduced bills (S.R. 231, H.R. 265) in support of the program. These resolutions

fornia, for which no value has been determined.

Federal Law and the Disposition of Federal Lands

Executive Order 12348 emphasizes that the PRB's role in the Asset Management Program is only to resolve conflicts over the alternative uses to which the lands could be put in accordance with the federal law. However, existing land management policies and laws clash sharply with the President's program. On February 9, 1982, more than two weeks before the President signed Executive Order 12348, the Cabinet Council on Economic Affairs issued a report warning the President that "current statutes and regulations . . . make commercial sales of federal lands difficult if not practically impossible." President Reagan wants to sell lands to help balance the federal budget, but the Reclamation Act of 1902 requires proceeds from the sale of any western lands to go to the reclamation fund for use in building irrigation projects. The Land and Water Conservation Act of 1964 directs funds from the sale

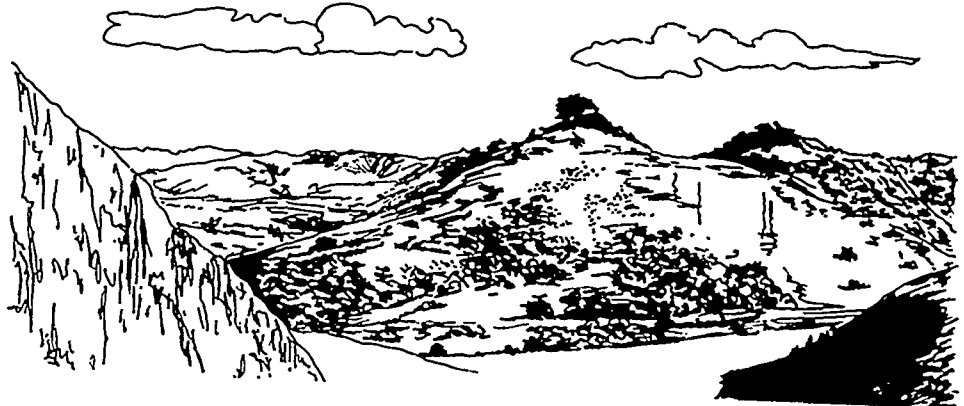
of certain federal lands to be used for state and federal acquisition of land for parks, recreation areas, wildlife refuges or other public uses. Thus, existing laws may prevent the funds raised from land sales from going into the general fund to reduce budget deficits.

Many Washington observers doubt that Congress will give the President the support needed to make asset management a success. Many Congressional representatives fear that lands will simply be sold to the highest bidder, with little consideration for the public interest. Governors of many western states fear that land sales could result in new absentee landlords, perhaps foreign ones.

Even if the administration succeeds in getting land sale proceeds funneled into the Treasury, the Federal Land Policy Management Act (FLPMA) of 1976 significantly restricts the sale of federal lands. FLPMA requires Congressional approval, for instance, before any parcel larger than 2500 acres is sold. FLPMA does not, however, totally prevent officials from selling excess or surplus lands.

The Implementation of the Asset Management Program

Some administration officials have expressed concern that the executive branch lacks the capacity to implement the President's program. A recent Congressional Budget Office (CBO) study estimates that the administration will fall \$4.75 billion short of its 1983-85 goal for land sales revenues of \$9.25 billion. The CBO predicts that in 1983 alone, the administration will fall \$900 million short of its \$1.25 goal. The CBO doubts that the General Services Administration (GSA), which is responsible for processing all federal land sales, will be able to handle large increases in its workload. In fiscal 1982 the GSA's 123 member staff coordinated the sale of almost \$135 million of federal property. The administration plans a nine-fold increase in land sales during fiscal 1983, but has not even doubled the GSA's real estate staff. Furthermore, in the past it has taken the



urge the President to submit legislation to stream-line current public land laws. The bills also specify that the proceeds from land sales go only to reduce the national debt. Congress has not acted on these proposals because the administration is expected to submit its own measure soon.

The President's Supporters

Despite widespread doubts that the Asset Management Program can significantly ease budgeting strains, the program does have the support of many high-level officials. Secretary of the Interior James Watt recently stated that he could think of no "better way to raise some of the revenues so badly needed than by selling some of the land and buildings no longer needed." Nevada Senator and presidential confidant Paul Laxalt would like to see the BLM's 155 million acres of grazing land sold to those who use these lands, i.e. large ranchers. Laxalt argues that "some form of privatization would benefit all of us."

Selling the Public Lands

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Some see the land sales as more of a philosophical than a budgetary issue. Economist Steven H. Hanke of John Hopkins University believes that "private property is always more productive than public property." Hanke disagrees with supporters of the "Sagebrush Rebellion", who advocate increased efficiency through the transfer of federal lands to state governments. Hanke argues that the only way to improve the productivity and efficiency of public lands is to privatize them. Curtis M. Miller, agricultural consultant to the California Agriculture and Water Resource Committee, complains that the lack of an incentive on the part of federal land managers to turn a profit causes federal agencies to "engage in some of the most wasteful and destructive practices imaginable."

Opponents of the President's Program

Many doubt the President's program can work even if legal and budgetary hurdles are overcome. Nevada Senator Dean A. Rhoades disagrees with Senator Laxalt and feels that ranchers don't want to buy land on which they would have to pay taxes. He says they would rather secure long-term grazing rights. Lonnie Williamson, Secretary of the Wilderness Institute in Washington, doubts that ranchers can afford to purchase federal lands. She says, "there are not two dozen livestock operations in the whole country that can afford to buy the land they graze on."

Historically, private management of what had been public domain has often resulted in despoilment rather than increased productivity. Such waste prompted Congress to pass the Taylor Grazing Act of 1934, the Wilderness Act of 1964, and the Federal Land Policy and Management Act of 1976. Federal land management policy has gradually evolved from a policy of disposal to one of conservation and preservation. Privatization ignores past policy and returns to an older system of management.

These considerations aside, many feel that "asset management" is not the proper way to reduce budget deficits. Nevada Representative James D. Santini says privatization misses the boat. He argues that the proceeds from federal land sales should be put in a trust fund to meet the environmental and recreational needs of the future. A recent *Los Angeles Times* editorial characterized the Asset Management Program as "a fire sale that will . . . burn Americans for generations to come." The Wilderness Society sees the program as nothing more than "an outright piracy of lands that belong to the American

people." It does in fact seem likely that if large amounts of land were suddenly to be put up for sale, the price received for the parcels would be far below their true values.

Conclusions

During the middle of this century, American policy makers reversed the country's policy of public land disposal after realizing that tremendous abuses of that policy were taking place, and that future generations' access to many public amenities and resources was being mortgaged away. Fifty years later, the Reagan Administration's Asset Management Program might seem like a reasonable method to help balance the budget. But since the program significantly changes federal land management policy, it raises important questions.



Congress must decide whether or not to initiate a policy of selling public lands to reduce the national debt. The Administration may have to ignore its budget cutting stance by increasing the GSA's budget to insure that that office, which must process land sales, is adequately staffed. Western state and local governments seem unwilling to support a program which transfers federal property from public to private ownership. Real estate purchasers may not respond enthusiastically to those lands the federal government offers for sale. The public must decide which lands to sell and when to sell them; prices will most certainly be lower in today's real estate market than they would be in a strong market. These issues need to be resolved before any program of asset management should be allowed to proceed.

Allen Ginsborg



small POWER DEVELOPMENT IN CALIFORNIA

In the last issue of *Environ*, Jim Laughlin described the potential for wind power development in California. Wind power, and other small power technologies, are increasingly attractive alternatives to central station power production from the standpoint of investors and electricity users.

In order to optimize small power development, state and federal policy makers have created rules governing the basic price and other contract provisions to be offered by regulated utilities to independent small power producers. California regulators have adopted various rules which seek to ensure the existence of a market for electricity produced by alternative energy technologies. In large part, the ability of developers to finance small power projects will determine the extent of such development in the state. This article presents a summary of public policy affecting the financing opportunities of potential developers.

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significant incentives for private investors to develop small power facilities. Before PURPA was enacted, most utilities paid small power producers meager sums, if anything at all, for power supplies. Furthermore, potential developers blamed the prospect of being regulated as public utilities as a major cause of the slow development of commercial alternative energy systems. To correct this roadblock, the provisions of PURPA exempt certain "qualifying facilities" (QFs) from utility status for the purpose of state and federal regulation. It requires regulated utilities to purchase QF power and to pay a price up to the utilities' "avoided costs," that is, the cost which the utility would otherwise incur to produce or acquire that power.

Notwithstanding such incentives, the difficulties of acquiring adequate financing impede private investment in small power facilities. A weak national economy and the financial risks associated with new energy technologies create an unfavorable climate for otherwise economically viable investments.

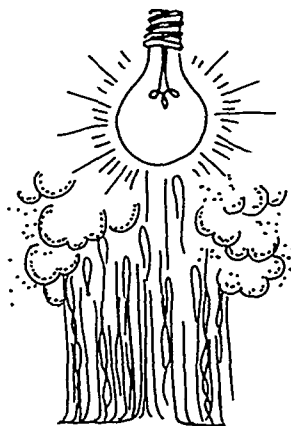
Under PURPA, federal law permits state authorities to implement policies which would help developers acquire financing. In California, the Public Utilities Commission (PUC) is responsible for establishing such policies by its implementation of contracting principles which apply to the state's utilities. This article discusses QF financing and how the PUC's adopted policies may affect small power development in the state.

Financing Small Power Development

The value of small power technologies has become more obvious as the cost of conventional power generation has increased. The California Energy Commission reports that by 1985, alternative technologies will have lower costs of supply than conventional options. (See California Energy Commission, *Service Corporations: Opportunities for California Utilities*, November 1980). This long-term advantage, however, may not be enough to convince lenders to back small power projects.

High interest rates discourage new investments. Small power production is especially expensive because lenders often require large equity contributions to cover the high initial costs associated with small power technologies. Small power developers, however, fre-

(See SMALL POWER, page 5)



Introduction

The Public Utilities Regulatory Policies Act (16 U.S.C. § 824a-3 et seq.) of 1978 created

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quently have little or no independent financial strength.

In addition, small power technologies such as wind and waste-to-energy are relatively new and are thus considered to be high risk ventures. Even technologies that have been tested and that are considered more reliable, such as cogeneration, may seem risky to investors because of regulatory uncertainty. Lenders will not absorb the risk that the avoided cost payments a QF receives from the utility will fall below debt service obligations. The effect of all these "market failures" is that developers may not be able to secure adequate financing if utilities' avoided cost payments are allowed to vary over the life of the project.

Unfortunately, avoided costs are certain to fluctuate over a project's life since they are based on the changing costs of a utility's fuel supplies and of projected additions to its capital plant. Numerous contract terms may be devised, however, to ease the effect of this condition on financing attractiveness. For example, "levelized" payments guarantee a price per kilowatt hour of energy delivered for some specified length of time, with early payments which exceed avoided costs being offset by later payments which are below avoided cost. In the long run, the sum of all the payments is equal to the total avoided costs or some percentage of them. Another option is loan guarantees that secure indebtedness in the event of project failure. Alternatively, price "floors" insure that the avoided cost payments will not slip below a negotiated level.

These provisions and others can encourage QF development because they reduce the investment uncertainties faced by lenders. They also, however, may redistribute financial risk from the project developers to the utilities' stockholders or ratepayers. This problem must be taken into account by state regulators who have the power to require utilities to offer contract terms which enhance financing opportunities, either through "standard offers" or through a process of negotiation between the utility and the developer. Standard offers are created through a process of rulemaking at the PUC, and must be offered to QFs by the utilities. Negotiated contracts deviate from standard offers, and may be tailored to the particular needs of the developer. If a QF seeks a negotiated contract, the utility must bargain in good faith. The following section contains a summary of the contracting policies adopted by the PUC.

Summary of California Policy

California policy makers have generally supported small power

development. Shortly before PURPA was enacted at the federal level, the PUC adopted similar policies to encourage development at the state level. In a 1978 decision, the Commission ordered the state's utilities to pay small power producers avoided costs for purchased power. The decision also discussed the benefits which occur as a result of the development of alternative power sources such as resource diversification, increased independence from foreign fuel sources, and the shorter lead time required for the construction of generating facilities.

More recently, the Commission went a step further and established guidelines for the development of a number of standardized contracts which the state's regulated utilities were then required to offer to QFs. That decision was the Commission's first step towards implementing the Order Instituting Rulemaking #2 (OIR 2), which was issued by the PUC in January of 1982.

OIR 2 established guidelines for four "standard offer contracts" and for policies regarding project-specific contracts which are individually negotiated between the utilities and developers. The provisions of the four standard offer contracts are:

1. Short Term As-Available Contract. Facilities providing utilities with "non-firm" power receive full avoided energy and capacity payments which vary by time of delivery. Non-firm means the QF is not bound to deliver power at any particular time of day or season, so the utility cannot rely on it for peak demand periods. However, if the QF does provide power during periods of high demand the utility must pay a higher price than that paid for power delivered during other periods.

Capacity payments are based on the utility's short run avoided cost reflecting the cost of a gas turbine plant. A capacity payment is offered, even though supplies are non-firm, because it is assumed that the aggregate reliability and value of the small power system exceeds the sum of individual units' production. Avoided cost payments are calculated at the time power is received by the utility, and will therefore vary over the life of the contract.

2. As-Available Contract with Escalated Energy Payment Option This contract provides payments for non-firm energy sup-

plies which are based on projected avoided energy costs at the time the obligation is incurred. These energy prices are based on forecasts and are guaranteed for up to five years.

3. Firm Capacity Contract. A QF providing the utility with firm capacity may receive a higher capacity payment than that offered under an as-available contract. To qualify, the QFs must meet certain power generation performance



standards. If the QF exceeds the utility industry's performance standards, it will qualify for higher capacity payments.

By choosing this option, the QF qualifies for a levelized capacity payment schedule. Levelized payments are calculated by estimating the total value of the QF's production over the contract period, and then spreading this total value based on full avoided costs out over that period through average payments. Under this option, capacity payments are based on the short run costs of the utility as defined above. The levelized payment period may extend for up to 30 years.

4. Long Term Contract for Energy and Capacity. QFs which enter into long term contracts for firm capacity may qualify for payments based on long run avoided costs of energy and capacity. Utility calculations are to be based on the costs of additional power generation projects in their resource plans, but the details of these contracts have yet to be worked out by the utilities.

The Commission also granted utilities the discretion to submit individually negotiated contracts for CPUC review as they are signed, although the Commission did discourage regular use of this option. The utility is more assured of recovering all contract costs through its rate base if the Commission has approved the contract. If the utility chooses not to acquire advance approval, it is at risk for contract costs which may be construed as unreasonable by the Commission in subsequent rate proceedings.

The Gospel According to OIR 2

In establishing contract terms for QFs, regulators have to balance many competing interests and evaluate numerous alternatives using a number of guidelines. The goals of the contracting process are to:

1. Encourage development of economical small power facilities. The intent of avoided cost pricing policy is to promote those facilities which would be viewed as attractive private investments under competitive market conditions. The newness of alternative energy technologies, the regulatory uncertainty, and other development barriers complicate the market for small power facilities. Regulation may be required to mitigate these problems.
2. Establish contract options which do not redistribute risk without adequate compensation. Policies which provide better financing opportunities simultaneously redistribute the risk of investment. For example, levelized payment schedules result in overpayments in the early years of a contract which are to be made up for in later years. Utilities are obviously taking on some additional risk in this case because of the possibility that the QF will stop producing power before the initial period of overpayments is made up for. Compensation for early risk could take the form of discounts from full avoided costs or some other offsetting contract term.
3. Avoid a situation where ratepayers or utility stockholders subsidize QF development. Over the term of a contract, total energy and capacity payments to QFs should not exceed the utilities' avoided costs. Subsidies to QFs would distort investment choices and could place unfair burdens on ratepayers or stockholders in the short term.
4. Encourage the utilities to use their expertise and financial strength to aid small power development. Utilities have engineering, managerial and financial expertise which are valuable assets for developing an efficient small power system. Most utilities also have access to relatively inexpensive credit. Regulators can induce the

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utilities to put these assets to work with 1) standards which tie utilities' regulated rates of return to evidence of good faith efforts to encourage small power development; 2) guarantees that contracted expenses will be passed through to ratepayers; and 3) rewards to the utilities implemented through the rate base or through some other regulatory mechanism. Generally, some type of inducement is needed since a utility has little incentive to promote the development of a system which complicates its own operations and with which it must compete.

5. Avoid unnecessary regulatory involvement. The more regulators are involved in the contracting process, the more expensive and time consuming the process becomes for developers. Requiring pre-approval of all negotiated contracts, for example, could add significantly to the cost of project development.

Given this list of policy criteria, and given regulators' inexperience with small power production in general, it is not surprising that the Public Utilities Commission's OIR 2 policies have turned out to be conservative from the standpoint of developers.

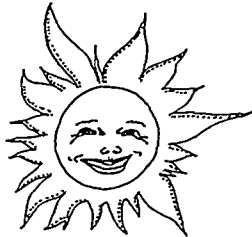
Assessment of PUC Policies from the Developers' Standpoint

The terms of the standard offer contracts have not received rave reviews from developers. Those contracts are unlikely to enhance financing opportunities of developers unless their projects use well-developed technologies so that investors can provide lenders with evidence of past success, unless the projects are capable of producing highly controllable output, or unless they are backed by other sources of income or large equity contributions. The levelized payment option is available only to projects which have predictably high performance standards. Furthermore, it is only the capacity payments that are levelized, and they represent only a small portion of total QF income. Escalation, although an option available to all QFs, is offered over a time period that may be too short to help developers match income streams to debt service obligations. Because of the shortcomings of the standard offer contracts, many developers will opt to negotiate individual contracts in order to secure financing.

The PUC's policy on negotiated contracts is also a disappointment to developers, for they had hoped that the PUC would

automatically guarantee that the utilities' contract costs would be passed through to rates. The success of the pre-approval policy that was adopted will depend largely on the willingness of the utilities to negotiate and to accurately and fairly assess the technological and financial risks of QFs. Ultimately, its success may depend on whether the utilities are willing to sign a contract before the PUC approves it. If utilities require Commission approval beforehand, the ensuing long and expensive regulatory process may discourage otherwise attractive projects.

In spite of these disappointments, developers are likely to view



California's policies favorably when they are compared to those adopted by the regulatory agencies of other states. No other state has devoted so much attention to the details of utility contracts on behalf of developers. In fact, many states do not require utilities' contracts with small power facilities to conform to any adopted rules or guidelines. Many leave it to the utilities to estimate avoided costs rather than using the California approach of developing assumptions under which avoided cost calculations are made. Because of the PUC's attention to these matters, developers are likely to choose California sites over those in other states, when they have that choice.

The State of the World Since OIR 2

Since the Commission issued the first OIR 2 decision in January of 1982, the prospects for small power developers appear somewhat brighter. The PUC approved a 30 year negotiated contract between U.S. Windpower and PGandE in April of 1982. Briefly, the contract provides that payments to U.S. Windpower will not fall below a negotiated price per kilowatt hour of energy supplied to PGandE. PGandE's ratepayers are compensated for promising a guaranteed price floor with a discount from actual avoided costs. Overpayments to U.S. Windpower which accrue in the "bad" years are repaid to PGandE with interest in the "good" years, when avoided costs are high. Unfortunately, it took five months for PGandE and U.S. Windpower to obtain regulatory approval of the contract.

More recently, there are signs that some utilities will not choose to seek approval by the PUC before allowing contracts with QFs to take effect. Southern California Edison

signed a number of negotiated contracts in 1982 without Commission approval, thus expediting the process. Under such circumstances, a remaining concern is that utilities bargain in good faith with QFs. It appears that the PUC will be watching the utilities for signs of unfair bargaining, and that it will respond accordingly. The PUC docked Southern California Edison's return on equity 25 basis points in December of 1982 because the PUC concluded that the utility lacked vigor in its promotion of small power development.

On the other hand, avoided cost calculations for California utilities decreased significantly during 1982, frustrating small power developers. The oil glut, correspondingly lower oil and gas prices, and a good hydro year lowered the utilities' avoided energy costs. Erratic world fuel oil prices moved Southern California Edison to announce that it would not enter into negotiated contract obligations which include levelized payments or floor prices because of the difficulty of estimating future avoided costs.

During 1982, the PUC continued to investigate methodologies for calculating avoided costs and the contract terms included in the utilities' proposed standard offers. More hearings are planned for 1983 to establish the terms of the utilities' long term contracts. The resolution of these matters should provide more certainty for developers and lenders.

Conclusion

PURPA and OIR 2 signal a change in how and by whom energy will be produced. State and federal policy makers have taken steps to induce the development of an energy system which will include unregulated production by relatively new technologies. The risks of creating such a system are significant, but appear reasonable compared to conventional alternatives.

Although recently-adopted policies may give developers new incentives, institutional and economic uncertainty remains. The political preferences of state and federal administrations could threaten guarantees provided by current policies, a possibility which will be of foremost concern to investors. The PUC's pricing policies, however, appear secure for the time being. They were adopted by Brown Administration appointees to the PUC who favor alternative power development. Over the next few years, however, these policies could be jeopardized by the legislative preferences and political appointments of the Deukmejian Administration, which has already promised to reduce funding for the development of alternatives to central system power generation.

The cost of financing small power projects is still high, and the level of future avoided costs seems increasingly unpredictable because of the volatility of the world energy market.

Hopefully, the prospects for small power project development will be enhanced as the economy recovers, and as the success of a few early ventures instills confidence in the investment community. In the meantime, state policy makers will need to continue to pursue policies which can lead to optimal small power development, which will provide investors with the confidence that the market does not yet provide, and which will at the same time balance their interests with those of the state's energy consumers.

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