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Summary of Comment: Utility Regulation Should not Be Characterized as a “Regulatory Compact”

The February 4, 2016 Stakeholder Briefing Memo on the QER’s Second Installment describes the regulation of investor-owned electric utilities (IOUs) by state public utility commissions (PUC) as a “regulatory compact.” On behalf of the Harvard Environmental Policy Initiative, I urge the Task Force not to use this term in QER documents.

The First Installment of the QER emphasizes that new technologies and services, particularly distributed energy resources, add significant value to the electricity system. Yet, the document also cautions that “the ‘natural monopoly’ characteristics of much TS&D infrastructure tend to perpetuate the role of incumbent providers [and] constrain innovation” (page S-3). Characterizing state regulation as a “compact” between regulators and IOUs reinforces incumbents’ advantages by erroneously suggesting that the industry must develop within the confines of an imaginary century-old agreement. This “regulatory compact” notion risks dampening the sector’s innovative potential.

As the First Installment acknowledges, growth of distributed energy resources “could challenge utilities’ financial health under current business models” (3-17). But the “compact” description favors the status quo over reform and obligates regulators to maintain a regulatory framework that puts utilities at odds with distributed resources. Rather than endorsing a static “regulatory compact” as the basis for regulation, QER reports should recognize that regulation is rooted in state law, which can be revised to meet society’s changing needs and ensure that regulation continues to prioritize the public interest.

Framing utility regulation as a “compact” is a rhetorical device that has been invoked by industry to argue against competition and in favor of rate increases and cost recovery for investments that did not benefit ratepayers.¹ While several PUCs have used the term “regulatory compact” as a shorthand description of regulation, no court or PUC has concluded that a utility is legally entitled to relief, such as cost recovery, under a “regulatory compact.” On the contrary, PUCs and courts have explicitly rejected such arguments.

At the April 15, 2016 QER stakeholder meeting in Boston, I outlined my objections to the term “regulatory compact” during the public comment session. In this document, I expand on the history of the term, explain why it is misleading and show that the explanation of the term in the Stakeholder Briefing Memo conflicts with PUC orders and the precedents of numerous state courts.

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I. Background: The Briefing Memo Asserts that a “Regulatory Compact” Forged in the Early 20th Century “Legally Binds” Regulators and “Guarantees” Utility Cost Recovery

Under the heading “Distribution,” page 13 of the February 4, 2016 Stakeholder Briefing Memo states:

Although electricity distribution utilities in the United States are organized under a mix of private and public ownership, all of them follow principles that evolved early in the industry’s history to ensure the public’s interest was served by monopoly utility companies. This *regulatory compact* legally binds IOUs and regulators into a partnership based on reciprocal obligations and provides a powerful voluntary contract between COUs (most of whom are not regulated by state authorities) and their customers. This utility/regulatory model is unlike other commercial relationships because it is able to incorporate the public’s interest in utility obligations while assuring utilities adequate compensation.

The primary benefit of this structure in the early years of the 20th century was to guarantee that utilities would be repaid for investment in expanding electricity service to customers without access and that electricity rates would be reasonable. In the last part of the century, this regulatory compact was used to provide enhanced public benefits including energy efficiency, clean energy, and facilitation of energy production by customers in the form of distributed generation.

II. Framing Utility Regulation as a “Compact” Favors Incumbents Over the Public Interest and May Stifle Innovative Regulatory Approaches

A recent report published by the Edison Electric Institute, the IOUs’ trade association, asserts that the “aim of regulation is to preserve the balance of the *original bargain* between [utility] investors and customers.”² Describing the regulatory framework as a bargain or compact prioritizes maintaining incumbents’ advantages over ensuring that regulation aligns with twenty-first century technologies, consumer needs, and societal priorities. QER reports should not endorse this self-serving view, or the metaphor that supports it. As regulators, utilities, and policymakers make decisions about the future direction of the industry, the compact metaphor looks to the past and insinuates that regulators must defend the status quo in order to protect utilities from competitive pressures. On the contrary, regulation serves the public interest, not regulated utilities.

Around the country, robust debates are underway about the future of the electricity system, and particularly about the roles that distributed energy resources and third-party service providers may play. As the First Installment recognizes, enabling these resources and providers to flourish may require new regulatory approaches. But IOUs are resisting reforms that diminish their control over the grid and captive ratepayers.³ The Task Force should avoid implicitly putting its thumb on the scale in these proceedings by endorsing the compact metaphor.

Instead, the QER reports should use a competitively neutral description of electricity distribution regulation. One starting point is the Supreme Court’s recognition that public utilities were “created for public purposes [and] perform a function of the state.”⁴ As instruments of the state, they have unique authorities, such as the power to exercise eminent domain. In turn, the government has a responsibility to “protect the people against unreasonable charges for services rendered.”

The PUC-administered rate-setting process is thus the core of government oversight. Ratemaking provides IOUs with reasonable assurances that they can earn a return by prudently meeting consumer demand for electricity. The ratemaking process is conducted pursuant to state law and within the confines of Supreme Court precedent. While ratemaking is a highly technical process, it ultimately requires regulators to balance various interests. Like all aspects of utility regulation, the ratemaking process can be modified by state legislatures and PUCs.

Regulation has been a substitute for competition^a because competition was considered inefficient. But regulation and the industry have evolved. In much of the country, and over the objections of many IOUs, federal and state regulators brought competition to the bulk power system by enabling the creation of markets for wholesale generation and retail supply. Decentralized technologies and services allow regulators to further open the once-closed utility distribution system. These resources offer new possibilities for energizing and balancing the grid. Regulation should foster innovative approaches that benefit society, as a competitive market should, rather than shield incumbents from competitive pressures.

^a ALFRED E. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS*, VOL. 1, 20 (1970) (“The essence of regulation is the explicit replacement of competition with governmental orders as the principal institutional device for assuring good performance.”).

III. Suggesting that Utility Regulation Is Based on a Compact Is Misleading and Historically Inaccurate

The term “regulatory compact” does not appear in any PUC order or court decision until 1982,^b seventy-five years after states first passed public utility laws to regulate investor-owned utilities (IOUs). PUC regulation did not emerge from a compact, but from a consensus among industry, politicians, financiers, and academics. This consensus was codified into state laws, which have since served as the legal basis for PUC regulation. The briefing memo incorrectly suggests otherwise. There is no separate compact that governs the relationships among IOUs, PUCs, and the public. The regulatory compact is a “myth”⁵ and a “misleading metaphor whose time has passed.”⁶

A. *PUC Regulation Is Premised on State Law*

At the turn of the twentieth century, monopoly IOUs emerged from a brief period of fierce competition. To provide electric service to the public, a company first obtained a franchise from a municipality, which permitted it to string wires across city streets and serve residents. It was common for cities to grant franchises to all electric companies that applied.⁷ Without restrictions on where they could provide service, electric companies often competed for the same densely packed, affluent downtown customers. Collectively, early entrepreneurs over-invested in these areas of high demand, building duplicative infrastructure.⁸

The inevitable consequence of this unregulated competition was consolidation. Some companies went out of business, while others purchased or merged with their competitors.⁹ Although competition is typically regarded as a vital component of the nation’s economic system, unfettered competition in this nascent industry proved futile, chaotic, and destructive.¹⁰

As the competitive process was playing out, industry, politicians, academics, and financiers reached a “consensus” that transferring regulatory authority from municipalities to the states would bring order to the industry.¹¹ Electric utilities advocated for state-sanctioned monopolies, regulated by a commission of technocrats, because they understood that the state’s endorsement of utility monopolies would eliminate investor concerns about competition. Investments in utility companies would be perceived as low-risk, which would enable the utilities themselves to borrow money at low-interest rates to finance expansion.¹² As Samuel Insull, a powerful utility executive and proponent of state regulation, explained in 1913, “there is one great advantage that must follow regulation, and that advantage is protection.”¹³

In 1907, Wisconsin and New York became the first two states to regulate electric utility rates under state law.¹⁴ Under the Wisconsin law, each utility was granted an “indeterminate” permit that provided the privilege of continuing business as long as the utility furnished adequate service at

^b Comprehensive searches using the commercial legal database Westlaw reveal that the term “regulatory compact” first appears in an order issued by the Massachusetts Department of Public Utilities, Re Boston Edison Company, 46 P.U.R.4th 431 (Apr. 30, 1982). The search also included the terms “regulatory bargain” and “regulatory contract.” See also Douglas N. Jones, National Regulatory Research Institute, “A Perspective on Social Contract and Telecommunications Regulation” (June 1987) (speculating that the regulatory compact notion can be traced to the “social contract” concept from political philosophy, finding that some textbooks on public utility economics referred to the regulatory construct as a “social contract,” “regulatory charter,” or “regulatory bargain,” and providing examples of industry’s use of these terms in the late 1980s).

reasonable rates.¹⁵ The state PUC was authorized to approve rates based on the valuation of property “actually used and useful for the convenience of the public” and was required to assure that rates were not “unjust, unreasonable, discriminatory, or preferential.”¹⁶ This model spread quickly—by 1922, thirty-seven states passed laws that charged similar regulatory commissions with overseeing electric utilities.¹⁷

For politicians and government officials, PUC oversight was “typical of other reforms of the Progressive era”¹⁸ of American politics. It was a mechanism for avoiding municipal corruption and restraining powerful but necessary corporations to ensure that they operated for the benefit of both shareholders and citizens.¹⁹ Staffed by supposedly “politically neutral experts who could administer the laws using rational and scientific approaches,” the PUC itself reflected “the true spirit of Progressive ideology.”²⁰

For ratepayers, a regulated monopoly was presumed to be less expensive than a competitive market.²¹ When PUC regulation was enacted in the early twentieth century, the costs per kilowatt-hour of electricity production were declining as total production increased.²² Competition would have split the market among multiple firms, with each firm producing a fraction of society’s total electricity demand. With lower output, no firm would have realized the economies of scale of a single, monopoly firm and would therefore have higher per-unit costs.²³ Firms and industries exhibiting these characteristics are often considered “natural monopolies.”

Some aspects of utility regulation, such as the utility’s eminent domain authority, may, in some states, have roots that are traceable to contract-like franchise agreements. Many utilities continue to hold franchises, granted by municipalities or states, but these have been largely superseded by PUC regulation. For example, whether a utility held *exclusive* service territory was initially governed by its franchise.²⁴ However, nearly all states eventually passed laws that established exclusive territories for IOUs, which had the effect of granting IOUs de facto monopolies, even if IOU franchises were technically non-exclusive.²⁵ Today, nearly every aspect of utility regulation, and particularly ratemaking, is governed by a body of law that emanates from state public utility laws. There is no separate compact, contract, or agreement.

B. The Term “Regulatory Compact” Was Popularized When IOUs Faced Financial Challenges

The first PUC order or court decision to include the phrase “regulatory compact” was published in 1982 by the Massachusetts Department of Public Utilities (DPU). That DPU order recounts the history of a cancelled nuclear plant and decides whether the IOU may recover the costs of the failed project from ratepayers. When regulators across the country debated such requests in the 1980s, and a decade later when they considered restructuring the industry, IOUs and some PUCs used the “compact” framing in debates about stranded-cost recovery and protections from competition. This metaphorical compact is rooted neither in history nor in law.

Historically, PUC regulation encouraged utility growth. The ratemaking formula was devised when expanding access to electricity and enabling more consumption were both in the public interest. Rates were designed to finance low-cost expansion. With per-unit costs of electricity declining, the ratemaking process allowed IOUs to capture the profits of expansion while consumers actually paid

less per kilowatt-hour of energy. So long as these two premises—need for expansion and declining costs—held, traditional ratemaking provided reliable and steady growth.

However, in many parts of the country, the industry shifted rapidly in the 1970s. Utility productivity growth disappeared, and key costs, particularly for fuel and interest, spiked.²⁶ In response and due to changing economic conditions, consumer demand growth declined. Many utilities were accustomed to consistent sales growth and were caught off guard by the slowdown.²⁷

Because the robust growth that they had anticipated dropped off, utilities' planned investments were no longer needed to meet demand. Compounding that miscalculation, many utilities had underestimated the costs of generation projects, and the nuclear accident at Three Mile Island in 1979 stymied nuclear projects around the country. Utilities cancelled numerous planned and even partially constructed nuclear plants. One analysis concluded that utilities spent a total of \$15 billion on more than 120 cancelled nuclear plants between 1972 and 1990.²⁸

In 1982, Boston Edison Company asked regulators to provide reimbursement from its ratepayers for expenses associated with one of these cancelled nuclear plants.²⁹ In its order, the state's DPU allowed for partial recovery, concluding that the utility should have cancelled the project in June 1980 and that any subsequent expenses were imprudent and not recoverable. To explain its decision, the DPU reasoned that there is a "bargain implicit in the public utility laws." The key elements of this three-party "regulatory compact" are the "[utility's] service obligation, regulatory price control, and the [ratepayers'] support obligation." In general, when the utility expends money in furtherance of its "service obligation," "regulatory price control" ensures that ratepayers uphold their "support obligation." Because regulators set rates that preclude a utility from earning "extraordinary profits," the DPU required that in this case ratepayers pay for part of the cancelled plant in order to prevent the utility from incurring an "extraordinary loss."

The term "regulatory compact" next appeared in a 1984 Washington commission order.³⁰ Like the Massachusetts DPU, Washington regulators concluded that expenditures on a cancelled nuclear plant incurred after the company should have known that the plant was no longer needed were imprudent and therefore could not be recovered from ratepayers. The Commission rooted its decision in the "social and economic compact of utility regulation" that confers a "social duty to serve" and "provide[s] for a utility to recover expenses it prudently undertakes to meet that obligation." By allowing the utility to recover most of the costs it incurred for the cancelled plant, the utility avoided an "extraordinary loss" and the Commission "upheld" the "regulatory compact." As discussed in Section IV.B, both Massachusetts and Washington regulators invoked the compact metaphor to explain how they balanced the relevant parties' interests in that particular case.

In 1987, the U.S. Court of Appeals for the D.C. Circuit also addressed cost recovery of a cancelled nuclear plant. The court remanded to the Federal Energy Regulatory Commission (FERC) an order that denied a utility cost recovery in federally regulated wholesale rates.³¹ In a concurring opinion, Judge Kenneth Starr wrote that the "utility business represents a compact of sorts" and observed that "[e]ach party to the compact gets something in the bargain."³² The "compact of sorts" was descriptive; it was not relevant for the court's or the concurring opinion's reasoning. The term

“regulatory compact” appears in only a few other federal court decisions. In each case, the court is quoting from a litigant’s brief or, in a single instance, a proposed FERC rulemaking.

That proposed FERC rulemaking was the precursor to the Commission’s landmark Order No. 888, which required utilities to file open access transmission tariffs and paved the way for the industry’s restructuring in the mid-1990s. FERC stated in the proposed rule that past utility “investments have been made under a ‘regulatory compact’^c whereby utilities—and their shareholders—expect to recover prudently incurred costs.”³³ It concluded that “reliance on past contractual and regulatory practices must be recognized and past investments protected.” In an order immediately following Order No. 888, FERC affirmed its decision to provide stranded cost recovery based on “equity.” The Commission stated that “to deny stranded cost recovery would violate the pre-existing regulatory compact.”³⁴ FERC then abandoned the term “regulatory compact,” and has not used it since Order 888-A, issued in 1997.^d

Meanwhile, gas, electric, and telephone utilities used the term extensively in the 1990s in PUC proceedings and before FERC,³⁵ often to argue against competitive entry and in favor of stranded cost recovery. For instance, a Michigan electric utility told state regulators that “retail wheeling is incompatible with [its] obligation to serve under the ‘regulatory compact;”³⁶ a New York telephone company argued that “introducing competition, has altered the historic regulatory compact;”³⁷ and Maryland utilities claimed that a regulatory compact “entitled” them to stranded cost recovery.³⁸

Approximately twenty PUCs used the term in the 1990s as well (not including instances where PUC orders summarize the arguments presented to it), and nearly thirty PUCs have ever used the term. Across all PUCs, the term is used sparingly; nearly all PUCs that have ever used the term have done so in fewer than five orders. Moreover, as discussed in the next section, the term is legally irrelevant. It is used as a shorthand description but is never a basis for reaching a legal conclusion. In fact, several PUCs and at least two state courts explicitly rejected the regulatory compact theory as a basis for providing utilities the legal relief they requested.

IV. The Briefing Memo’s Definition of the “Regulatory Compact” Is Legally Wrong

Shorthand descriptions and metaphors can bring clarity to complicated issues. The term “regulatory compact,” however, misses the mark. DOE’s Memo adds to the confusion by defining the so-called compact as a “legally binding” contract that “guarantees” cost recovery. This characterization of utility regulation is wrong as a matter of law.

A. The So-Called Regulatory Compact Is a Metaphor, not a “Legally Binding” Contract

As discussed in the previous section, PUC regulation of electric distribution utilities is based on state law, not an unwritten compact. No court has ever endorsed the proposition that there is a legally binding agreement between utilities and regulators. Even when PUCs have given the term

^c The quotation marks around regulatory compact are in the original.

^d The term does appear in a handful of Commission orders, but in each case the order is parroting arguments presented to the Commission.

regulatory compact very limited legal meaning, they have ascribed the term different meanings and recognized that they can unilaterally modify the “compact.”

Where the term regulatory compact does appear in court decisions, it has been qualified as a “compact of sorts,” a “theoretical agreement,” or a “theory.”³⁹ An Arizona state appeals court was explicit: “[t]he nature of [the utility’s] relationship with the State through the Commission is *not* contractual.”⁴⁰ The court found that the cases relied on by the utility “were speaking descriptively or metaphorically; none holds that there is an actual contract, for breach of which the law of contracts gives a remedy.” The court concluded that the utility had no contractual rights because it was unable to rebut the legal rule that regulation under state law does not create a contract.⁴¹

The court explained in more detail why state utility laws do not create a legal contract. As first-year law students are taught, an enforceable contract is formed through an offer, an acceptance, consideration, and sufficient specification of terms. A party asserting that there is a contract bears the burden of proving that each element is present. Not surprisingly, the court found that “[s]everal of the characteristics of an actual contract are missing here.” An article in a 1999 legal journal elaborates on the missing contract elements.⁴² It concludes that utilities’ contract theory as a basis for stranded cost recovery is “flawed” because “the parties to this ostensible contract have never been adequately identified, nor have the necessary elements for contract formation been shown.” Even if one assumed that a contract did exist, there are no explicit or implicit provisions that mandate stranded cost recovery.⁴³

Many PUCs reached similar conclusions in the 1990s about whether any “regulatory compact” dictates stranded cost recovery. Washington regulators determined that “[t]here is no agreement or compact, stated or unstated, that commits the Commission to ensure that [the utility’s] capital will be recovered fully regardless of any changes in the economic, technological, or regulatory environment.”⁴⁴ The Pennsylvania PUC concluded that it “is not required to grant a utility recovery of 100% of its claimed stranded costs upon either constitutional principles or a ‘regulatory compact’ theory.”⁴⁵ In Vermont, regulators found “no basis in law to support the existence of a regulatory compact that constitutes a binding and enforceable contract with the State.”^e And the Texas PUC rejected a utility’s arguments, stating that “[t]here is no written contract by which the State of Texas promised to pay a utility a reasonable return on and of its generation investment.”⁴⁶

State regulators also found that there is no “compact” that shields vertically integrated monopolies from competition. The New Mexico Commission explained in 1998:

PNM [Public Service Company of New Mexico] asserts a so-called ‘regulatory compact’ that would purport to grant PNM protection . . . Simply put, there is no

^e Although it rejected the idea that there is a “binding regulatory compact between the State and its electric utilities,” Vermont regulators concluded that the argument has “some equitable force” in the context of stranded cost recovery amidst industry restructuring. The PUC determined that it must “protect the financial viability of Vermont’s electric utilities without denying Vermont’s ratepayers the lower market prices that customer choice would offer.” Re: Restructuring of the Electric Utility Industry in Vermont, 174 P.U.R.4th 409 (VT P.S.B. 1996).

such ‘compact’ and there is no ‘grant of monopoly power.’ Instead, there are only the applicable laws of the United States, the State of New Mexico and the rules and regulations of the Commission. PNM’s suggestion that regulation of it as a utility is the result of its ‘submission to Commission control’ is without foundation in the law. Regulation of PNM as a utility is not something ‘bargained for’ between PNM and the Commission. Regulation is the mandate of the Public Utility Act, passed by the legislature and signed into law by the Governor. It is not subject to negotiation and is not premised on PNM’s consent to be regulated.

PUCs that have used the term “regulatory compact” as a metaphor have found that the “compact” can be modified when circumstances change.⁴⁷ The Ohio PUC concluded that new state and federal laws and technological advancements “made it possible to reconsider the regulatory compact [with telecommunications companies] and to determine to what extent, if any, this Commission can substitute competitive market forces in place of regulatory forces.” In the 1990s, as it set the stage for electric industry restructuring, the California PUC found that the “regulatory compact must . . . change if we expect the state’s consumers and [] economy to continue to benefit from this vital industry.”⁴⁸ In these two instances, the “compact” is a shorthand description of the then-effective regulatory model. The PUC orders are not referring to an actual agreement. That these PUCs asserted a unilateral right to change the arrangement based on developments in the industry underscores that regulators are not legally bound by any “compact.”

Regulators have also ascribed different meanings to the term “regulatory compact.” Idaho regulators described an order that assured a utility that its investment in a hydro facility could be included in its rate base as a “regulatory compact” between the utility and the PUC.⁴⁹ Wyoming regulators described a specific cost recovery mechanism as a “regulatory compact” between the utility and its ratepayers.⁵⁰ In these orders, the “regulatory compact” stands for the uncontroversial proposition that PUC orders create legally binding obligations, as specified in that order. They do not endorse the view that there is a sweeping contract that underlies regulation.

To summarize, there is no legally binding agreement between regulators and utilities, or between ratepayers and utilities, that governs utility regulation. Although some PUCs have used the “regulatory compact” metaphor, they do not use the term consistently and have recognized that they may modify the so-called compact as they see fit. Thus, the regulatory compact metaphor has no legal force.

B. *There Is No Blanket “Guarantee” that Utilities Will Be Repaid for Investments*

The Supreme Court’s 1944 decision in *Federal Power Commission v. Hope* set the Constitutional standard for utility ratemaking. The Court held that “fixing ‘just and reasonable’ rates involves a balancing of the investor and consumer interests. . . . [r]egulation does not insure that the business shall produce net revenues.”⁵¹ The Court also recognized that the “investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated.”

Courts and PUCs have understood that the Supreme Court’s holding guarantees only that utilities have *an opportunity* to recover investments from ratepayers.⁵² In addition, as the Michigan Supreme Court concluded in 1944, utility regulators have “discretionary power to exclude any and

all unnecessary elements of expense in determining a just and reasonable rate.”⁵³ In 1989, the Supreme Court likewise concluded that a “scheme of utility regulation does not ‘take’ property simply because it disallows recovery of capital investments that are not ‘used and useful in service to the public.’”⁵⁴ The nuclear cost recovery cases discussed in Part III.A illustrate this principle in action. In both Massachusetts and Washington, regulators relied on *Hope* as the legal basis for their decisions. The “compact” metaphor described regulators’ approaches to balancing consumer and investor interests in the unusual circumstances of a utility facing a one-time “extraordinary loss.”

State courts have likewise concluded that regulation provides utilities with an opportunity but not a guarantee that they will recover all incurred costs. The Wisconsin Supreme Court held that regulation by the Public Service Commission (PSC) “does not guarantee the amount of revenue a utility will generate nor the rate of return it will earn for its shareholders. Rather, the PSC sets rates which give the utility the opportunity to earn the authorized rate of return.”⁵⁵ The Pennsylvania Supreme Court rejected utilities’ arguments that under *Hope* they have “a constitutionally guaranteed right to rates which would preserve their financial integrity.”⁵⁶ Instead, *Hope* sets a balancing test “to be applied with the aim of protecting consumers against exploitation at the hands of utility companies while seeking to preserve [utilities’] financial integrity.”

In 1996, a New York appeals court rejected arguments that the PUC violated the regulatory compact by deciding to evaluate stranded cost recovery on a case-by-case basis, rather than issue a blanket cost-recovery guarantee to all utilities.⁵⁷ The Court held that the regulatory compact arguments are contradicted by state law and “have repeatedly been rejected by the courts.” Consistent with *Hope*, the Court said that “[j]ust and reasonable’ rates do not necessarily guarantee utilities net revenues nor do they immunize utilities from the effects of competition.”

Arguably, Supreme Court precedent does not even guarantee a utility’s continued existence. In 1945, the Court held that a regulated street car company that had seen its ridership dwindle as automobiles gained market share was not entitled to rates that ensured its profitability. The Court held that the Constitution “has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.”⁵⁸ If electric utilities lose ratepayer revenue to distributed energy resources, microgrids, or other technologies and services, neither the Constitution nor a metaphorical regulatory compact guarantees them a right to rates that provide for their continued viability.

C. “Public Benefits” Are Unrelated to a Metaphorical Compact

The QER Briefing Memo incorrectly claims that the “regulatory compact was used to provide enhanced public benefits including energy efficiency, clean energy, and facilitation of energy production by customers in the form of distributed generation.” Utilities in many states are legally required to achieve energy efficiency targets and meet clean energy goals. Those obligations are typically enshrined into law by the state legislature, and wholly unrelated to a so-called compact.

The Supreme Court has long held that “regulation of utilities is one of the most important of the functions traditionally associated with the police power of the States.”⁵⁹ States, and not the federal government, authorize the construction of new power plants and can dictate which fuels may be used to generate electricity.⁶⁰

States have exercised their broad authority in a variety of ways. As of May 2016, twenty-nine states have legally binding renewable portfolio standards that require IOUs (and, in some cases, municipal and cooperative utilities) to procure a certain amount of renewable energy each year.⁶¹ These requirements are enshrined in statute in twenty-seven states; in Arizona and New York, the renewable requirements were set by the PUC. Approximately twenty states require IOUs to achieve certain energy efficiency savings.⁶² In nearly every such state, these requirements were passed by the legislature.

V. Conclusion

On behalf of the Harvard Environmental Policy Initiative, I urge the Task Force not to use the term “regulatory compact” in QER documents. The term is misleading and inaccurate, and the Briefing Memo’s explanation is legally wrong. More importantly, the QER reports should not constrain regulators by suggesting that they are beholden to incumbent providers or to the industry’s century-old technology and business model. Instead, the QER reports should recognize that regulation ought to foster innovative approaches that benefit society and serve the public interest.

ENDNOTES

¹ See notes 35 to 38 and accompanying text. *See also*:

- Pre-Filed Rebuttal Testimony of Gerard Ortiz on behalf of Public Service Company of New Mexico (No. 15-00261-UT) (N.M. Pub. Reg. Comm’n., Feb. 22, 2016) (Utility vice-president’s testimony stating that absent a cost-recovery mechanism, a state mandate that a utility offer energy efficiency programs “disturb[s] the regulatory compact”);
- Comments of Duke Energy (No. SP-100) (N.C. Utils. Comm’n., Oct. 30, 2015) (Utility’s comment asserting that allowing a non-utility entity to provide a solar lease/PPA would violate the “regulatory compact”);
- Pre-Filed Rebuttal Testimony of Edwin H. Overcast on behalf of Kansas City Power & Light Company (No. ER-2014-0370) (Mo. Pub. Serv. Comm’n., May 7, 2015) (Consultant’s testimony claiming that there are “regulatory compact provisions” that dictate terms of utility cost recovery and that under the compact a utility has a “right” to “protection from competition”);
- Public Service Company of New Mexico’s Post-Hearing Response Brief (No. 13-00390-UT) (N.M. Pub. Reg. Comm’n., Feb. 27, 2015) (Utility’s brief arguing that under a “regulatory compact” the company should be allowed to recover a portion of its un-depreciated investment in coal-fired units that it is retiring);
- Comments of Interstate Power and Light Company (No. NOI-2014-0001) (Ia. Utils. Bd., Feb. 25, 2014) (Utility’s comment about distributed generation that include an Edison Electric Institute document that asserts “social pricing is incompatible with the “regulatory compact”);
- Pre-Filed Testimony of Julie Cannell on behalf of Duke Energy Ohio (No. 12-2400-EL-UNC) (Oh. Pub. Util. Comm’n., Mar. 1, 2013) (Investor-advisor’s testimony stating that “investors understand that utilities have a regulatory compact with regulators,” claiming that investors value “consistency” in regulatory decisions, and presenting a ranking of utility commissions from an investor’s perspective);
- Pre-Filed Testimony of Paul J. Bonavia on behalf of Tucson Electric Power (No. E-01933A-12-0291) (Az. Corp. Comm’n., July 2, 2012) (CEO’s testimony framing a rate case as “aris[ing] from the regulatory compact” and arguing that regulators have “an opportunity . . . to fulfill [their] obligations under the regulatory compact” by granting the company’s rate requests);

- Opening Comments of Idaho Power Company (No. UM-1461) (Or. Pub. Utils. Comm’n., Aug. 27, 2010) (Utility’s comment arguing that permitting non-utility entities to sell electric vehicle charging services would “undermine the regulatory compact”);
- Hearing Testimony of Paul Elnitsky on behalf of Progress Energy (No. 100009-EI) (Fl. Pub. Serv. Comm’n., Aug. 25, 2010) (Utility vice-president’s testimony stating that there is a “regulatory compact” that assures ratepayers pay one hundred percent of the costs of a new nuclear plant); and
- Petition of Mississippi Power Company for a Certificate of Public Convenience and Necessity (No. 2009-UA-14) (Miss. Pub. Serv. Comm’n., Jan. 25, 2010) (Utility brief relating to cost recovery of proposed Kemper IGCC facility arguing that the “historic regulatory compact” may not be modified to “shift or reallocate the risk associated with the construction of such a large project”).

² KARL MCDERMOTT, EDISON ELECTRIC INST., COST OF SERVICE REGULATION IN THE INVESTOR-OWNED ELECTRIC UTILITY INDUSTRY: A HISTORY OF ADAPTATION 8 (2012),

http://www.eei.org/issuesandpolicy/stateregulation/documents/cosr_history_final.pdf.

³ See Ari Peskoe, *Unjust, Unreasonable, and Unduly Discriminatory: Electric Utility Rates and the Campaign against Rooftop Solar*, TEX. J. OIL GAS & ENERGY L. (2016).

⁴ *Smyth v. Ames*, 169 U.S. 466, 544 (1898).

⁵ Harvey L. Reiter, *Competition Between Public and Private Distributors in a Restructured Power Industry*, 19 ENERGY L.J. 333, 338 (1998) (stating that the regulatory compact is a “myth . . . [w]hen regulators take actions within their lawful authority to promote competition they are not contravening any regulatory compact; they are acting in furtherance of their historic obligations to treat regulation and competition as complementary forces”).

⁶ Jim Chen, *The Death of the Regulatory Compact: Adjusting Prices and Expectations in the Law of Regulated Industries*, 67 OHIO ST. L.J. 1265, 1315 (2006).

⁷ Gregg A. Jarrell, *The Demand for State Regulation of the Electric Utility Industry*, 21 J. L. & ECON. 269, 273 (1978) (quoting BURTON BEHLING, COMPETITION AND MONOPOLY IN PUBLIC UTILITY INDUSTRIES 18–22 (1938)); In Chicago, for example, the city granted forty-five “mostly overlapping franchises.” Robert L. Swartwout, *Current Utility Regulatory Practice from a Historical Perspective*, 32 NAT. RESOURCES J. 289, 299 (1992); see also William M. Emmons III, *Franklin D. Roosevelt, Electric Utilities, and the Power of Competition*, 53 J. OF ECON. HISTORY, 880, 881 (1993) (stating that many municipalities placed no territorial restrictions on franchisees).

⁸ Forrest McDonald, *Samuel Insull and the Movement for State Utility Regulatory Commissions*, 32 BUS. HIS. REV. 241, 244 (1958).

⁹ See, e.g., FORREST MCDONALD, LET THERE BE LIGHT: THE ELECTRIC UTILITY INDUSTRY IN WISCONSIN, 1881–1955 33–95 (summarizing efforts throughout Wisconsin in the late nineteenth century to provide electricity and concluding that “[a]s business ventures, the vast majority of the pioneer stations in Wisconsin were failures”).

¹⁰ Jarrell, *supra* note 7, at 274 (quoting BURTON BEHLING, COMPETITION AND MONOPOLY IN PUBLIC UTILITY INDUSTRIES, 54 (1938) (“Bankruptcies and consolidations left in their wake “torn-up streets, dead wires and useless poles and pipes, enormous overcapitalization, and paralyzed service.”). Utility Industry in Wisconsin, *supra* note 9 at 34 (“Growth was characterized by confusion, uncertainty, and almost yearly corporate change.”). Cf. *id.* at 47 (“More conservative capitalists, on the other hand, thought that the limits of direct current transmission made it more feasible to divide cities into numerous zones, each served by a separate company.”).

¹¹ RICHARD F. HIRSH, POWER LOSS: THE ORIGINS OF DEREGULATION AND RESTRUCTURING IN THE AMERICAN ELECTRIC UTILITY SYSTEM 18–34 (1999).

¹² *Id.* at 23 (1999); Utility Industry in Wisconsin, *supra* note 9, at 115 (noting that although the creation of a state regulatory commission in Wisconsin was a “one of the most significant achievements of progressivism in Wisconsin,” the movement for such regulation was led by the utilities).

¹³ Hirsh, *supra* note 11, at 31. *Id.* at 34 (1999) (quoting a bank executive saying that PUCs “recognizing the monopoly character of the business, are guarding it from useless and venal competition” and an industry executive saying that the PUC had “done in two years more to inspire the investor with confidence . . . than all gilt-edged promises of promoters in the years past.”).

¹⁴ See Ari Peskoe, *A Challenge for Federalism: Achieving National Goals in the Electricity Industry*, 18 MO. ENVTL. L. & POL’Y REV. 209, 212–16 (2011).

¹⁵ George B. Hudnall, *The Public Service Commission Law of Wisconsin*, PROC. AM. POL. SCI. ASS'N, Vol. 4, 316, 321–22 (1907); *see also* Utility Industry in Wisconsin, *supra* note 9, at 121–22 (noting that an indeterminate permit was critically important because municipalities had typically granted franchises for a limited term, which discouraged long-term investment and encouraged management to extract maximum profits before the franchise expired).

¹⁶ *Id.* at 319.

¹⁷ Hirsh, *supra* note 11, at 26 n.110; *see also* Harry M. Trebing, *Public Utility Regulation: A Case Study in the Debate Over Effective Economic Regulation*, J. OF ECON. ISSUES 223, 225 (1984) (finding that by 1913, twenty-seven additional states set up regulatory commissions with jurisdiction over electric utilities).

¹⁸ *Id.* at 30 (1999).

¹⁹ Hirsh, *supra* note 11, at 19, 23; McDonald, *supra* note 8, at 244 (“... but at the rate the electric business was growing it would not be long before barons and boodlers [aka Chicago’s aldermen] alike would turn their hungry gaze upon” the electric industry.); *see also* Jarrell, *supra* note 7, at 275 (1978) (municipal regulation “often became entangled in the confusion of local politics; the regulatory machinery was poorly adapted to the rapidly changing technical conditions... worst of all, untrained men struggled to fix rates and service standards—or were bribed.” (quoting EMERY TROXEL, *ECONOMICS OF PUBLIC UTILITIES* 49, 53 (1947)); Werner Troesken, *Regime Change and Corruption. A History of Public Utility Regulation*, NAT’L BUREAU OF ECON. RESEARCH 267–69, <http://www.nber.org/chapters/c9986> (chronicling examples of corruption of municipal regulators in Chicago, St. Louis, and Grand Rapids).

²⁰ Hirsh, *supra* note 11, at 30.

²¹ McDonald, *supra* note 8, at 243.

²² Emmons, *supra* note 7, at 888 (showing declining residential prices for residential customers from 1890 to 1930); Ari Peskoe, *A Challenge for Federalism: Achieving National Goals in the Electricity Industry*, 18 MO. ENVTL. L. & POL’Y REV. 209, 217 (2011) (stating that from 1901 to 1932, electric generation increased by 12% per year and citing a U.S. Energy Information Administration publication); Hirsh, *supra* note 11, at 57, 69 (showing increasing efficiency of fossil-fueled steam turbines and increasing maximum total capacity of individual turbines).

²³ JAMES C. BONBRIGHT, ALBERT L. DANIELSEN & DAVID R. KAMERSCHEM, *PRINCIPLES OF PUBLIC UTILITIES* 8 (2d ed. 1988); STEPHEN BREYER, *REGULATION AND ITS REFORMS* 15 (1982) (noting that the “most traditional and persistent rationale for government regulation of a firm’s prices and profits is the existence of a natural monopoly.”).

²⁴ *See City of Walla Walla v. Walla Walla Water Co.*, 172 U.S. 1, 6 (1898) (upholding a contract between a city and a water company that prohibited the city from constructing competing facilities but did not restrict other commercial entrants, despite the city’s attempt to abrogate the contract, in part because it claimed that the contract created an illegal monopoly). *See also* Paul L. Joskow, *Mixing Regulatory and Antitrust Policies in the Electric Power Industry: The Price Squeeze and Retail Market Competition*, ANTITRUST AND REGULATION: ESSAYS IN MEMORY OF JOHN J. MCGOWAN 178–79 (1985) (summarizing that in some states franchises are exclusive and of indefinite duration while in most states they are technically non-exclusive, but in practice there is no competition).

²⁵ David C. Hjelmfelt, *Exclusive Service Territories, Power Pooling and Electric Utility Regulations*, 38 FED. B.J. 21 n.1 (1979) (stating that forty states had passed laws establishing exclusive utility territories). For example, although they had been regulated by a state commission since the early twentieth century, utilities in Georgia and Alabama did not have exclusive service territories until their state legislatures passed laws requiring states regulators to establish boundaries in 1974 and 1984, respectively. *See* Code of Alabama Adopted by Act of the Legislature of Alabama; Approved August 17, 1923, § 9631 (defining the Public Service Commission’s jurisdiction as including “electric companies”); Service Territories for Electric Suppliers Act, ALA. CODE §§ 37-14-1–17 (establishing exclusive service territories); The Code of Georgia of 1933, Adopted March 24, 1933 § 93–307 (defining the Public Service Commission’s jurisdiction as including “electric light and power companies” and noting that this provision was amended in 1922); Georgia Territorial Electric Service Act, GA. CODE ANN. §§ 46-3-1–15 (establishing exclusive service territories). Litigated cases from the 1930s highlight that IOUs in the following states had non-exclusive franchises: Alabama, Kansas, Kentucky, Mississippi, Missouri, South Carolina, Tennessee, Texas. This list is not exhaustive. *See* Tenn. Electric Power

Co. et al. v. Tenn. Valley Auth. et al., 306 U.S. 118, 138 (1939) (Alabama, Kentucky, Mississippi, and Tennessee); Kan. Gas and Electric Co. v. City of Independence, Kan., et al., 79 F.2d 32, 33 (10th Cir. 1935) (Kansas); Mo. Util. Co. v. City of Cal. et al., 8 F. Supp. 454 (W.D. Mo. 1934) (Missouri); Greenwood Cty., S.C. et al. v. Duke Power Co. et al., 81 F.2d 986, 997 (4th Cir. 1936) (South Carolina); S.W. Gas & Electric Co. v. City of Texarkana, Tex. et al., 104 F.2d 847, 848 (5th Cir. 1939) (Texas); *see also* Roger D. Colton and Michael F. Sheehan, *Raising Local Government Revenue Through Utility Franchise Charges: If the Fee Fits, Foot It*, 21 URB. LAW. 55, 59 (Winter 1989) (stating that the granting of exclusive franchises was either unconstitutional or at least contrary to statute).

²⁶ Paul L. Joskow, *Regulatory Failure, Regulatory Reform, and Structural Change in the Electrical Power Industry*, BROOKINGS PAPERS ON ECON. ACTIVITY 125, 126 (1989); Richard J. Pierce Jr., *The Regulatory Treatment of Mistakes in Retrospect: Cancelled Plants and Excess Capacity*, 132 U. PA. L. REV. 497, 502–05 (1984).

²⁷ During the prior two decades, sales increased by an average rate of nine percent per year and quintupled overall. *February 2015 Monthly Energy Review*, U.S. ENERGY INFO. ADMIN., Tbl. 7.6 (2015) (showing annual retail sales from 1949 through 2013).

²⁸ Douglas Hearth et al., *Nuclear power plant cancellations: sunk costs and utility stock returns*, 29 Q. J. BUS. & ECON. 102, 103 (1990).

²⁹ *Re Boston Edison Co.*, 46 P.U.R.4th 431 (Mass. D.P.U. 1982).

³⁰ *Washington Utilities and Transportation Commission v Puget Sound Power and Light Company*, 62 P.U.R.4th 557 (Wa. U.T.C., Sep. 28, 1984).

³¹ *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987).

³² *Id.* at 1189.

³³ Proposed Rulemaking: Promoting Wholesale Competition Through Open-Access Non-Discriminatory Transmission Services by Public Utilities, 60 Fed. Reg. 17662, 17663 (Apr. 7, 1995).

³⁴ FERC Order No. 888-A, 62 Fed. Reg. 12,274, 12,426 (Mar. 14, 1997).

³⁵ *See* John Burritt McArthur, *Cost Responsibility or Regulatory Indulgence for Electricity's Stranded Costs?*, 47 AM U. L. REV. 775, 851–53 (1998) for examples of utilities arguing to FERC that they are entitled to stranded cost recovery under a regulatory compact.

³⁶ *Re Association of Businesses Advocating Tariff Equity*, 145 P.U.R.4th 321 (Mich.P.S.C. 1993).

³⁷ *Re New York Telephone Company*, 151 P.U.R.4th 258 (N.Y.P.S.C. 1994).

³⁸ *In the Matter of the Commission's Inquiry Into the Provision and Regulation of Electric Service*, 1997 WL 35028190 (Md. P.S.C. 1997).

³⁹ *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1189 (D.C. Cir. 1987) (J. Starr, concurring); *PacifiCorp v. Pub. Serv. Comm'n*, 103 P.3d 862, 871 (Wyo. 2004); *Central Illinois Pub. Serv. Co. v. FERC*, 941 F.2d 622 (7th Cir. 1991); *see also* *United States Gypsum Co., v. Indiana Gas Co.*, 735 N.E.2d 790, 797 (Ind. 2000) (referring to the compact as a the “so-called ‘regulatory compact’”).

⁴⁰ *U S West Communications, Inc. v. Arizona Corp. Comm'n et al.*, 3 P.3d 936, 942 (Ariz. Ct. App. 1999).

⁴¹ *Id.* (citing *National R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry. Co.*, 470 U.S. 451, 465–66 (1985)).

⁴² Lois R. Lupica, *Transition Losses in the Electric Power Market: A Challenge to the Premises Underlying the Arguments for Compensation*, 52 RUTGERS L. REV. 649, 683–699 (Spring 2000).

⁴³ *Id.* at 717.

⁴⁴ *In the Matter of the Petition of GTE Northwest Inc., For Depreciation Accounting Changes*, 1997 WL 35263563 (Wash.U.T.C. 1997).

⁴⁵ *Application of Pennsylvania Power & Light Company for Approval of Restructuring Plan Under Section 2806 of the Public Utility Code*, 89 Pa.P.U.C. 587 (Pa. P.U.C. 1998).

⁴⁶ *Application Of Texas-New Mexico Power Company For Approval Of Transition Plan And Statement Of Intent To Decrease Rates*, 1998 WL 35860737 (Tex.P.U.C. 1998).

⁴⁷ *See, e.g.*, *Re Electric Utility Industry Restructuring*, 1996 WL 467779 (Me. P.U.C. 1996) and *Re Recovery of Stranded Costs Rulemaking*, 159 P.U.R.4th 279 (Me. P.U.C. 1995) (determining that electric industry restructuring “would, in effect, modify th[e] compact,” and that changes in federal law initiated this modification).

⁴⁸ *Re Proposed Policies Governing Restructuring of California's Electric Services Industry and Reforming Regulation*, 151 P.U.R.4th 73 (Cal. P.U.C. 1994). *See also*, *Re Regulation of Gas Utilities to Promote Efficient Use of Existing Utility Infrastructure and to Avoid Uneconomic Bypass*, 139 P.U.R.4th 140 (Cal. P.U.C. 1992);

Re Compliance with the Energy Policy Act of 1992, 1993 WL 777228 (Cal. P.U.C. 1993); Re Proposed Policies Governing Restructuring, 166 P.U.R.4th 1 (Cal. P.U.C. 1995).

⁴⁹ In the Matter of the Application of Idaho Power Co., 1993 WL 13805754 (Id. P.U.C. 1993).

⁵⁰ Re Pacificorp, 224 P.U.R.4th 1 (Wy. P.U.C. 2003); Re Pacificorp, 227 P.U.R.4th 517 (Wy. P.U.C. 2003).

⁵¹ FPC v. Hope Nat. Gas Co., 320 U.S. 591, 603 (1944).

⁵² Re Atlanta Gas Light Co., 1999 WL 1076303 (Ga. P.S.C. 1999) (stating that “[u]nder the regulatory compact, utilities are entitled to the opportunity to earn a reasonable return on their investment. . . . An opportunity to earn a reasonable return under the regulatory compact not the same as a guarantee to earn a reasonable return.”); Re Citizens Utilities Company, Kauai Electric Division, 1996 WL 497174 (Hi. P.U.C. 1996) (stating that under the “regulatory compact . . . utilities are assured a fair opportunity to earn a reasonable return on the capital prudently committed to the business.”). The Hawaii PUC has repeated this summary of the regulatory compact in several subsequent orders.

⁵³ City of Detroit v. Mich. Pub. Serv. Comm’n., 14 N.W.2d 784, 785 (Mich. 1944).

⁵⁴ Duquesne Light Co. v. Barasch, 488 U.S. 299, 301 (1989).

⁵⁵ Wis. Pub. Serv. Corp. v. Pub. Serv. Comm’n. of Wis., 325 N.W.2d 867, n. 2 (Wis. 1982).

⁵⁶ Penn. Electric Co. v. Penn. Pub. Util. Comm’n., 502 A.2d 130, 135 (Pa. 1985).

⁵⁷ Matter of Energy Assn. of N.Y. State v. Public Serv. Comm’n of State of N.Y., 169 Misc.2d 924, 938 (N.Y.Sup.Ct. 1996).

⁵⁸ Market St. Ry. Co. v. Railroad Comm’n, 324 U.S. 548, 567 (1945); Pub. Serv. Comm’n. of Mont. v. Great Northern Utils. Co., 289 U.S. 130, 135 (1933) (the Constitution “does not assure to public utilities the right under all circumstances to have a return upon the value of the property so used. The loss of, or the failure to obtain, patronage due to competition does not justify the imposition of charges that are exorbitant and unjust to the public. The . . . Constitution . . . does not protect public utilities against such business hazards.”).

⁵⁹ Ark. Electric Coop. v. Ark. Pub. Serv. Comm’n., 461 U.S. 375, 377 (1983).

⁶⁰ In 1992, Congress recognized states’ broad authority over the electric sector when it encouraged (but did not require) states to adopt an “integrated resource planning” planning process that evaluates the full range of options to meet consumer demand, including renewable energy resources and energy efficiency. Energy Policy Act of 1992 §111(d)(19) (codified at 16 USC § 2602).

⁶¹ Database of State Incentives for Renewable Energy (DSIRE), Renewable Portfolio Standards, <http://ncsolarcen-prod.s3.amazonaws.com/wp-content/uploads/2015/11/Renewable-Portfolio-Standards.pdf>.

⁶² Database of State Incentives for Renewable Energy (DSIRE), Energy Efficiency Resources Standards, <http://ncsolarcen-prod.s3.amazonaws.com/wp-content/uploads/2015/03/Energy-Efficiency-Resource-Standards.pdf>.