

Book Reviews

The Takings Clause and Improvident Regulatory Bargains

Deregulatory Takings and the Regulatory Contract: The Competitive Transformation of Network Industries in the United States. By J. Gregory Sidak & Daniel F. Spulber. Cambridge: Cambridge University Press, 1997. Pp. 656. \$54.95.

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I. INTRODUCTION

Over the past twenty years, Americans have turned their backs on one of the New Deal's most important legacies by deregulating nearly every market to which regulation has been applied. At one time the markets for interstate trucking and air transport were subject to strict cost-of-service ratemaking and government controls on new entry. Now, however, both trucking¹ and air tickets² are priced by the market, the same way as potatoes or lumber, and anyone who can obtain access to the necessary facilities can enter. The telecommunications system was once a regulated monopoly from top to bottom, with price regulation applying to everything from long

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1. See Motor Carrier Act of 1980, 49 U.S.C. §§ 10706(b)(3)(B)-(D) (1994).

2. See Civil Aeronautics Board Sunset Act of 1984, Pub. L. No. 98-443, 98 Stat. 1703 (codified as amended in scattered sections of 49 U.S.C.); Airline Deregulation Act of 1978, Pub. L. No. 95-504, §§ 28, 30, 92 Stat. 1729, 1731 (codified as amended in scattered sections of 49 U.S.C.); MELVIN A. BRENNER ET AL., AIRLINE DEREGULATION (1985); STEPHEN BREYER, REGULATION AND ITS REFORM 197-204 (1982).

distance service to the mandatory rental rate of a telephone instrument.³ Now long distance rates are set through competition by numerous firms, the instruments are purchased off the shelf from any of a number of retailers, and significant competition for local telephone service appears imminent.⁴ Wholesale transfers of natural gas and electric power have also become substantially competitive, and the market for the delivery of retail electricity to residences may soon become competitive as well.⁵

This deregulation has produced tremendous gains for the United States economy. Prices for most deregulated services have dropped significantly. Following deregulation, the rate of innovation has increased substantially, with telecommunications providing only the most visible example. And, of course, we have saved many of the costs of operating the regulatory system itself—a set of pure transaction costs, or deadweight loss. Society is probably better off as a result.⁶

But while society as a whole may be better off, deregulation has undoubtedly diminished the welfare of the once-regulated firms. On the one hand, at least some of these firms have seen the removal of various regulatory restraints that prevented them from expanding into other markets. On the other hand, the rigors of competition have produced lower rates of return, greater risks, and occasionally the premature retirement of assets.

The main concern of Sidak and Spulber's provocative *Deregulatory Takings and the Regulatory Contract*⁷ is the state's duty to compensate regulated firms that encounter these losses. The authors give most of their attention to the problem of "stranded" costs: investments in specialized, durable assets that may have seemed necessary, or at least justifiable, when

3. On the history of telecommunications regulation, see MICHAEL K. KELLOGG ET AL., *FEDERAL TELECOMMUNICATIONS LAW* 23-39 (1992); and JOHN R. MEYER ET AL., *THE ECONOMICS OF COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY* 1-68 (1980).

4. The culminating deregulatory provision is the Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (codified as amended in scattered sections of 47 U.S.C.). See generally PETER W. HUBER ET AL., *THE TELECOMMUNICATIONS ACT OF 1996* (1996) (analyzing the effects of the Act on the telephone, broadcast television, and cable television industries).

5. See David S. Copeland, *Requiring Transmission Access by Electric Utilities: The Shifting Roles of Regulation and Antitrust*, 64 *ANTITRUST L.J.* 291 (1996); Lee A. Rau, *Open Access in the Power Industry: Competition, Cooperation and Policy Dilemmas*, 64 *ANTITRUST L.J.* 279 (1996); Michael O. Wise, *Overview: Deregulation and Antitrust in the Electric Power Industry*, 64 *ANTITRUST L.J.* 267 (1996).

6. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 396 (5th ed. 1998) (summarizing the costs of regulation). For helpful accounts of the opinions and the literature on this subject, see Thomas O. McGarity, *The Expanded Debate over the Future of the Regulatory State*, 63 *U. CHI. L. REV.* 1463 (1996); and William B. Tye & Frank C. Graves, *The Economics of Negative Barriers to Entry: How To Recover Stranded Costs and Achieve Competition on Equal Terms in the Electric Utility Industry*, 37 *NAT. RESOURCES J.* 175 (1997), which discusses the social gains resulting from the deregulation of the electric power industry.

7. J. GREGORY SIDAK & DANIEL F. SPULBER, *DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT: THE COMPETITIVE TRANSFORMATION OF NETWORK INDUSTRIES IN THE UNITED STATES* (1997).

constructed and placed into service under a regime of price and entry controls but that have become underutilized or even useless under deregulation.⁸ The superfluous electric generation plant is a paradigmatic example of this kind of asset.⁹ In the former regime of tight wholesale and retail regulation, utilities were typically regarded as being self-sufficient. To a significant extent, they produced their own power for their own customers. Furthermore, they needed to have a certain amount of excess capacity to protect their customers against unusually high demand or a temporary generation plant shutdown. But in the deregulated environment three things are happening.¹⁰ First, utilities can freely purchase wholesale electric power from elsewhere, thus giving an advantage to efficient producers who have lower costs; further, the high degree of interconnectivity necessitates fewer backup resources.¹¹ Second, many utilities have been required to purchase electricity from alternative low-cost sources, thus forcing their own higher-cost sources to lie idle. Third, certain “dedicated” equipment that was designed with a single producer and distributor of power in mind is unsuitable in the modern environment of free switching among numerous power sources.

The result is that, under deregulation, some of the plants and other equipment in which the utilities made significant investments either can no longer be operated profitably or cannot be operated at all. This problem is exacerbated by extreme specialization. An electric generation plant that has become unproductive as a result of mandatory power wheeling among utilities cannot profitably be converted into another use. In the extreme case of a completely useless plant, the owner may be able to obtain no more than the facility’s salvage value, which is typically only a tiny percentage of the unrecovered investment.¹²

To be sure, the nature and extent of the stranded cost phenomenon varies greatly from industry to industry. For example, deregulation in the airline industry has led to greatly increased demand for air travel.¹³ Not only did the deregulated airlines not have to retire significant numbers of

8. See, e.g., *id.* at 8-9, 28-30, 442-63.

9. See generally WILLIAM J. BAUMOL & J. GREGORY SIDAK, TRANSMISSION PRICING AND STRANDED COSTS IN THE ELECTRIC POWER INDUSTRY 98-114 (1995) (discussing stranded costs in the electric power industry); WILLIAM J. BAUMOL & J. GREGORY SIDAK, *Stranded Costs*, 18 HARV. J.L. & PUB. POL’Y 835 (1995) (same).

10. See generally sources cited *supra* note 9.

11. For example, a New England utility facing unusually high air conditioner demand during a summer heat wave may be able to purchase excess power from the Ohio Valley instead of relying on its own extra capacity.

12. See SIDAK & SPULBER, *supra* note 7, at 128 n.52.

13. See Elizabeth Brannen, *The Problem of Aging Aircraft: Is Mandatory Retirement the Answer?*, 57 J. AIR L. & COM. 425, 433-34 (1991) (explaining that deregulation has resulted in increased demand for air travel); cf. STEVEN MORRISON & CLIFFORD WINSTON, *THE ECONOMIC EFFECTS OF AIRLINE DEREGULATION* 1-2, 52 (1986) (finding that airline deregulation has resulted in lower prices and greatly increased productivity).

aircraft in response to deregulation, but the demand for aircraft has been so great that the carriers have tended to fly airplanes far longer than their manufacturers designed them to be flown.¹⁴ Further, mobile assets such as aircraft and trucks do not face the “stranded” cost problem to the same extent as, say, electric generation plants. If an airplane or a truck becomes superfluous in one market, it can readily be shifted to another.

The full costs of assets that are stranded by deregulation remains to be determined. As the case of airline deregulation suggests, one anticipated effect of deregulation is lower prices, which produce increased demand. To the extent that deregulation increases demand, fewer assets are “stranded,” and indeed, even older, less efficient plants may continue to find a use. So deregulation of telecommunications and electric power will shift a great deal of production toward more efficient producers, thus decreasing the demand on less efficient producers. At the same time, deregulation may increase total demand and leave a market even for higher cost producers. Indeed, some recent power plant sales made after Sidak and Spulber’s book was published suggest that the problem of stranded costs in the electricity industry is not nearly as great as was once thought. Power plants that had been written off as stranded by deregulation are in fact finding strong market demand.¹⁵

Part II of this Book Review examines the notion of the “regulatory contract,” that is, a unique bargain between the sovereign and the regulated firm. This presumed bargain provides the foundation for the Sidak/Spulber claim that a deregulated utility is entitled to compensation for its stranded costs. But the historical domain of the regulatory contract is not nearly as broad as Sidak and Spulber argue, and even when such a contract exists, it does not necessarily have the meaning that they assign to it. Further, while the argument for compensation based on a regulatory contract might make some sense when a regulated firm makes its investment in reliance on a government promise of regulated monopoly status, a great deal of regulation did not develop in that way. Rather, it was imposed ex post on

14. See Brannen, *supra* note 13, at 425, 433-34 (attributing the overuse of old aircraft to increased demand brought about by deregulation).

15. See *Power Plant Sales Raise Questions About Stranded Costs, Consumers’ Bills*, Antitrust & Trade Reg. Daily (BNA) (Feb. 6, 1998), available in LEXIS, BNA Library, BNAATD File (noting that there were numerous recent sales of power plants and that all were sold above book value, some significantly so); *Massachusetts Generating Plants Sold at Six Times Their Book Value*, Antitrust & Trade Reg. Daily (BNA) (May 28, 1998), available in LEXIS, BNA Library, BNAATD File. A related and problematic result, which Sidak and Spulber do not discuss, is that states that have enacted compensation regimes end up overcompensating because no actual stranded cost losses actually occur. This overcompensation, which goes only to utilities already in place that have facilities subject to stranding, operates to give incumbent utilities a significant cost advantage over new entrants, thus reducing market competitiveness. See *Report Warns New Market Power Could Kill Consumer Benefit of Electricity Reform*, Antitrust & Trade Reg. Daily (BNA) (June 25, 1998), available in LEXIS, BNA Library, BNAATD File.

firms that had already made their investments and thus could not have relied on any such governmental promise.¹⁶

Part III then continues this argument by explaining that the case for compensation is particularly weak when the private utility itself—often acting with only nominal governmental supervision—made its regulatory investments on its own initiative. This is indeed what occurred in a great majority of regulated industries.

In Part IV, I assess the notion that changes in regulatory policy rather than changes in technology are mainly responsible for the predicament in which some regulated firms find themselves. No one compensates a firm for technological obsolescence resulting from ordinary market forces. But an essential premise of the Sidak/Spulber argument is that deregulation policy rather than technological change has caused this obsolescence, and since the government, unlike markets, is responsible for the destruction in property values that it imposes, compensation must be paid.¹⁷

Finally, Part V challenges the Sidak/Spulber notion that compensation should be based on losses anticipated at the time competition is introduced, rather than on ex post measurements of losses that actually occurred. The method one chooses is of great importance, as anticipated losses have often failed to materialize. Sidak and Spulber's endorsement of the former method is inconsistent with the way damages are ordinarily measured in takings cases, and there are persuasive reasons for not deviating in these situations.

II. THE REGULATORY CONTRACT

Sidak and Spulber argue that public utilities that face “stranded” costs as a consequence of the deregulation process generally should be compensated for their losses. They point out that deregulation is a government act, which in this case has “taken” the property of the deregulated utilities, thus giving them a constitutional right to compensation under the Fifth Amendment's Takings Clause.¹⁸

That deregulation is a government-initiated process is thus central to the Sidak/Spulber argument. The market itself frequently makes older facilities obsolete or unprofitable, yet one who invests in soon-to-be-outmoded technology is not entitled to compensation. For example, if I have the misfortune to invest in a slide rule production plant that opens just days before a breakthrough allows scientific calculators to be produced cheaply for the mass market, no one will compensate me for my

16. See *infra* Section II.B.

17. See SIDAK & SPULBER, *supra* note 7, at 213-272.

18. See *id.* at 216-55.

improvident investment. Indeed, the competitive market is filled with the abandoned facilities and other debris that rivals' innovations have made obsolete.¹⁹

Further, as a general matter, forcing firms to bear the costs of obsolescence is wise policy because doing so encourages efficient risk-taking. If an entrepreneur contemplating a new investment knew it was entitled to compensation from the government if the investment did not pay off, then it would make the investment with little regard to the prospects of market success. Indeed, if there were full compensation, then any prospect of success would justify the investment, for the investor's downside exposure would be zero. But if the investor must bear the full cost of its own losses, then it will collect all cost-justified information pertaining to the prospects for success and balance the risk and costs of failure against the prospects and anticipated magnitude of success. In sum, the market tends to reward prudent investments by refusing to provide compensation for the "stranded" costs of facilities that new technology or changes in consumer preferences have made obsolete. Compensation for improvident investments would yield overinvestment.

For this reason, Sidak and Spulber's argument for compensation cannot succeed unless they can show that the investment made by a regulated firm rests on a fundamentally different footing than the investment made by an ordinary enterprise. The main difference that Sidak and Spulber believe they have found is that a "regulatory contract" exists between the government and the regulated firm, but not between the government and the unregulated firm. In its simplest terms, this regulatory contract is an agreement with the state that requires the utility to invest its resources in some expansion of its enterprise, such as a new power generation plant. In return, the state guarantees a rate of return that is significantly lower than the higher end of returns encountered in competitive markets, but also promises to remove the risk of improvident investment. As a result, the risk-adjusted rate of return is presumably about the same.²⁰

If such a contract exists, deregulation and the resulting obsolescence of stranded facilities require compensation to the utilities, as the government would be renegeing on its side of the regulatory bargain. In that case, Sidak and Spulber believe that the Takings Clause of the Constitution requires the government to compensate the utility by putting it in the same position in

19. For example, see Michael T. Maloney et al., *On Stranded Cost Recovery in the Deregulation of the U.S. Electric Power Industry*, 37 NAT. RESOURCES J. 59-60 (1997), which notes the extent to which obsolete microwave towers had to be destroyed by long distance carriers when advances in fiberoptic technology rendered them obsolete. Maloney also notes that the firms did not seek compensation, even though they were regulated, at least to the extent that they were required to file tariffs with the FCC. See *id.*

20. See SIDAK & SPULBER, *supra* note 7, at 101-68.

which it would have been had the regulatory contract been performed.²¹ This explains the use of the term “deregulatory taking” in their title. Just like regulatory takings, “deregulatory” takings arise when the government acts for the benefit of nearly everyone but unfairly or inefficiently places the burden on a small group of property owners.

Thus, as Sidak and Spulber freely admit, the regulated firm’s entitlement to compensation for obsolescence hinges on the existence of this regulatory bargain with the government.²² That bargain provides the basis for the reasonable, investment-backed expectations of someone who decides to invest in regulated rather than competitive markets. These expectations in turn justify applying the Takings Clause when the bargain is broken.

A. *Historical Development and Domain*

Sidak and Spulber speak of the regulatory contract in these terms:

The regulated utility submits to various regulatory restrictions including price regulations, quality-of-service requirements, and common carrier regulations. In return, the regulated firm receives a protected franchise in its service territory, and its investors are allowed an opportunity to earn revenues subject to a rate-of-return constraint. Without the expectation of earning a competitive rate of return, investors would not be willing to commit funds for establishing and operating the utility. . . . Once the utility invests those funds, the long depreciation schedules typical in electricity and telecommunications regulation credibly commit the utility to performing its obligations under the regulatory contract by denying it the opportunity to recover its capital before the end of its useful life.²³

But Sidak and Spulber also admit that the files of the regulated firms and the government’s regulatory agencies contain no explicit “regulatory contracts” guaranteeing compensation for stranded investments in exchange for the utilities’ willingness to invest in the regulated enterprise. They concede that the regulatory contract, if it exists, is like the English Constitution.²⁴ It does not exist on any single piece of paper, but rather is “a bundle of public utility statutes, utility commission precedents, adjudicatory

21. *See id.* at 273-81.

22. *See id.* at 450.

23. *Id.* at 109.

24. *See id.*

decisions, rulemakings, hearings on the record, formal notices of proposed rulemaking, and public commentary.”²⁵

The existence of any such contract imposing an obligation of compensation upon governments is controversial. Some scholars make the important argument that no compensation is due because there is no regulatory contract at all—indeed, that the entire concept of a regulatory contract is a relatively recent invention, developed at the behest of the utilities themselves to justify compensation awards that a competitive firm could never expect for its own improvident investments.²⁶

Sidak and Spulber counter by arguing that the regulatory contract in the United States is in fact quite old and dates back to the very first Supreme Court decision involving a rate-regulated “natural monopoly” utility—the *Charles River Bridge* case of 1837.²⁷ Sidak and Spulber also note that Irston Barnes’ influential treatise on public utility regulation, which was published in 1942, cited an “implied-contract” theory, whose justification Barnes found in the utility’s franchise from the government.²⁸ Sidak and Spulber then argue that the importance of the *Charles River Bridge* decision lies in the “common understanding throughout it that the relationship between the state and the private [regulated] firm was contractual in nature.”²⁹

But Sidak and Spulber’s account of *Charles River Bridge* and subsequent regulatory decisions seriously misrepresents the nature of nineteenth-century public utility regulation and, in the process, creates a false analogy between regulation then and regulation now. Further, the authors ignore the most important principle established in *Charles River Bridge*, one that the Supreme Court has reiterated time and time again: When one bargains with the state, nothing passes by implication, and all promises are to be narrowly construed.³⁰ This principle dramatically

25. *Id.* at 109-10. For this argument, Sidak and Spulber rely upon *United States Trust Co. v. New Jersey*:

[A] statute is itself treated as a contract when the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State. In addition, statutes governing the interpretation and enforcement of contracts may be regarded as forming part of the obligation of contracts made under their aegis.” (citations omitted).

431 U.S. 1, 17 n.14 (1977); see SIDAK & SPULBER, *supra* note 7, at 110.

26. Suggesting that such contracts do not exist are 1 MICHAEL T. MALONEY & ROBERT E. MCCORMICK WITH RAYMOND D. SAUER, CUSTOMER CHOICE, CUSTOMER VALUE: AN ANALYSIS OF RETAIL COMPETITION IN AMERICA’S ELECTRIC INDUSTRY 6 (1996); Robert J. Michaels, *Stranded Investment Surcharges: Inequitable and Inefficient*, PUB. UTIL. FORT., May 15, 1995, at 21; and William Niskanen, *A Case Against Both Stranded Cost Recovery and Mandatory Access*, 1996 REGULATION 16.

27. See SIDAK & SPULBER, *supra* note 7, at 134 (discussing Proprietors of Charles River Bridge v. Proprietors of Warren Bridge, 36 U.S. (11 Pet.) 420 (1837)).

28. See *id.* at 133 (discussing IRSTON R. BARNES, THE ECONOMICS OF PUBLIC UTILITY REGULATION 14-15 (1942)).

29. *Id.* at 134.

30. See *infra* notes 41-65 and accompanying text.

undermines the claim that utilities generally enjoy the benefits of a regulatory contract protecting them from stranded costs.

The fact that the *Charles River Bridge* case involved a regulatory contract with the government is beyond dispute. Indeed, the relationship between the state and the regulated firm in that decision was contractual in nature because the regulatory scheme itself consisted of a contract between the state and the shareholders of the Charles River Bridge corporation. This approach to regulation was very common in the late eighteenth and early nineteenth centuries. The state would typically strike a highly individualized deal with the regulated firm and enshrine that deal in the firm's corporate charter.³¹ Previously, in the *Dartmouth College* case, the Supreme Court had established that a corporate charter was a contract between the chartering state and the chartered corporation, and thus it fell under the constitutional provision forbidding the state from impairing an obligation of contract.³²

This mechanism of regulation by contract contrasted sharply with the statutory regulation that developed after the Civil War and was upheld in *Munn v. Illinois*.³³ In *Munn*, price regulation was applied after the fact to a firm that was already in existence and doing business, and the Court's decision rested on the premise that the state had always been empowered to set such prices. In *Charles River Bridge*, however, there was no statute of general application that regulated bridge tolls. Rather, the regulatory provisions were spelled out in the bridge company's own corporate charter, or contract with the state.³⁴

31. See HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW 1836-1937*, at 125-30 (1991).

32. See *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819). Almost a decade earlier, the Supreme Court had decided in *Fletcher v. Peck*, 10 U.S. (6 Cranch) 87, 135-38 (1810), that a land grant from the state was also a "contract" for Contract Clause purposes.

33. 94 U.S. 113 (1876).

34. The Charles River Bridge corporate charter, which had been issued in 1785, made the following provision for rates:

Each foot passenger (or one person passing), two-thirds of a penny; one person and horse, two pence two-thirds of a penny; single horse cart or sled, or sley, four pence; wheelbarrows, hand-carts, and other vehicles capable of carrying like weight, one penny, one-third of a penny; single horse and chaise, or sulkey, eight pence; coaches, chariots, phaetons and curricles, one shilling each; all other wheel carriages or sleds drawn by more than one beast, six pence; meat cattle and horses passing the said bridge, exclusive of those rode or in carriages or teams, one penny, one-third of a penny; swine and sheep, four pence for each dozen, and at the same rate for a greater or less number; and in all cases the same toll shall be paid for all carriages and vehicles passing the said bridge, whether the same be loaded or not loaded; and to each team one man and no more shall be allowed as a driver to pass free from payment of toll, and in all cases double toll shall be paid on the Lord's day; and at all times when the toll gatherer shall not attend his duty the gate or gates shall be left open.

STANLEY KUTLER, *PRIVILEGE AND CREATIVE DESTRUCTION: THE CHARLES RIVER BRIDGE CASE 10* (1971) (quoting the language of the charter). For another general discussion of the case, see HOVENKAMP, *supra* note 31, at 110-14. For a discussion of the company's rights under the charter, see generally *Charles River Bridge v. Warren Bridge*, 24 Mass. (7 Pick.) 344 (1829).

Most significantly, however, the corporate charter did *not* contain a provision granting the proprietors of the Charles River Bridge a monopoly or specifying a distance upstream or downstream in which no competing bridge could be built. Nor did it contain a provision promising compensation if the bridge should become unprofitable. During the first half of the nineteenth century, numerous such charters were negotiated with various railroad, bridge, and turnpike companies, each with their own unique provisions.³⁵ Some of these charters stipulated that the right to take toll should last only until the shareholders had recovered their invested costs plus a specified return, typically nine to twelve percent per annum.³⁶ At that point the bridge, turnpike, or other public facility would revert to state ownership. The Charles River Bridge shareholders were particularly fortunate that their charter did not contain such a provision, and they had been able to continue collecting tolls even though the bridge had been paid for many times over.³⁷ Other bridge companies had received different deals. For example, while other charters may have been of more limited duration, they also may have contained explicit monopoly provisions that forbade the construction of competing bridges within a specified distance, or for a specified time period.³⁸

The *Charles River Bridge* dispute arose when, in response to popular pressure, the Commonwealth chartered the Warren Bridge to operate a short distance away and compete with the Charles River Bridge. The Warren Bridge charter, unlike the Charles River Bridge charter, contained a provision stating that once the investors had received a return of their investment plus a reasonable profit, the bridge would become public and free. Further, it would become free in six years whether or not the proprietors received a reasonable return.³⁹ The six-year limitation in the Warren Bridge charter suggests how good a deal the proprietors of the Charles River Bridge had been able to negotiate for themselves. Though the bridge was originally chartered in 1785, by the time of litigation its proprietors had been collecting tolls for nearly half a century.⁴⁰

35. These are recounted in HOVENKAMP, *supra* note 31, at 36-41, 125-30. See also MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1780-1860*, at 122-26, 135-38 (1978) (discussing litigation involving these state-chartered monopolies).

36. See HORWITZ, *supra* note 35, at 129-30; HOVENKAMP, *supra* note 31, at 111-12.

37. See HORWITZ, *supra* note 35, at 130; KUTLER, *supra* note 34, at 12-13.

38. See HOVENKAMP, *supra* note 31, at 112 n.13.

39. See *Proprietors of the Charles River Bridge v. Proprietors of the Warren Bridge*, 36 U.S. (11 Pet.) 420, 427 (1837) (noting that under the terms of its charter, Warren Bridge was to be "surrendered to the state, as soon as the expenses of the proprietors in building and supporting it should be reimbursed," and in no event after six years).

40. The Warren Bridge had been chartered in 1828. See *id.* Furthermore, prior to the construction of the Charles River Bridge the same proprietors had owned the franchise for a ferry that had carried passengers from Boston to Cambridge in about the same place. See *id.* at 429-31. On the extraordinary profitability of the Charles River Bridge before the Warren Bridge was chartered, see KUTLER, *supra* note 34, at 12-13.

The basis of the *Charles River Bridge* suit was that the charter given to the Warren Bridge violated the Charles River Bridge charter because the latter should have been interpreted to contain an *implied* monopoly provision giving the Charles River Bridge perpetual protection from new market entry. Thus, by granting the competing charter, the Commonwealth had violated the Contract Clause.

But Chief Justice Taney held that the Court did not need to reach the constitutional issue because the Contract Clause comes into play only when the contract in question covers the claimed right. In this case, nothing in the bridge contract gave the Charles River Bridge proprietors a monopoly right or an entitlement to perpetual profits. The Court's most significant regulatory conclusion can thus be summed up in Chief Justice Taney's statement that "in grants by the public, nothing passes by implication."⁴¹ The proprietors of the Charles River Bridge had bargained with the state and won many explicit and favorable contractual terms, including high tolls and a lengthy franchise, but not a monopoly provision.

Following *Charles River Bridge*, both the Supreme Court and state courts consistently enforced similar regulatory contracts according to their literal terms. If the corporate charter contained a monopoly provision, the courts recognized and enforced it.⁴² Further, if there was an express monopoly provision and the state wanted to take it, compensation was required.⁴³ If the charter contained no monopoly provision, however, none would be implied.⁴⁴

41. *Charles River Bridge*, 36 U.S. (11 Pet.) at 546.

42. *See, e.g., In re Binghamton Bridge*, 70 U.S. (3 Wall.) 51, 82 (1865) (enforcing an explicit monopoly provision in a corporate charter).

43. *See, e.g., West River Bridge Co. v. Dix*, 47 U.S. (6 How.) 507, 529-34 (1848) (holding that a state must pay compensation when it uses its eminent domain power to take a previously granted monopoly right from a bridge company). In *Boston & Lowell Railroad v. Salem & Lowell Railroad*, 68 Mass. (2 Gray) 1, 4 (1854), the railroad had been given a 30-year charter promising that "no other railroad than the one hereby granted shall, within thirty years from and after the passing of this act, be authorized to be made, leading from Boston . . . to Lowell." The Supreme Judicial Court of Massachusetts permitted the state to charter a second railroad between the same two points, but only if it compensated the plaintiff. *See id.* at 36. The Supreme Court also confronted the issue of monopoly grants contained in rate regulatory charters in the *Slaughter-House Cases*, 83 U.S. (16 Wall.) 36 (1872). The corporate charter given to the Crescent City Company created a price-regulated public slaughterhouse in New Orleans, with the rates once again stipulated in the charter itself. *See id.* at 42. Further, it gave the corporation a monopoly by forbidding the commercial slaughtering of animals anywhere else in the city. *See id.* at 38. The Supreme Court upheld the provision against a claim that the monopoly grant violated the Thirteenth and Fourteenth Amendment rights of butchers who lost their independent businesses under the monopoly provision. *See id.* at 81. For more detailed discussions of the case, see HOVENKAMP, *supra* note 31, at 116-24; and Mitchell Franklin, *The Foundations and Meaning of the Slaughterhouse Cases* (pts. 1 & 2), 18 TUL. L. REV. 1, 218 (1943). *See also* CHARLES FAIRMAN, RECONSTRUCTION AND REUNION: 1864-88, at 1321-27 (1971) (discussing the background and import of the *Slaughter-House Cases*). The detailed rate regulations, which included charges of ten cents per animal per day for pen storage, and slaughtering fees of one dollar per head for cattle, fifty cents for hogs, and thirty cents for sheep, goats, and lambs, are spelled out in the opinion. *See Slaughter-House Cases*, 83 U.S. (16 Wall.) at 39, 42 (quoting the

For Sidak and Spulber, the *Charles River Bridge* case is significant primarily because the regulation at issue involved a contract.⁴⁵ It unquestionably did, as did most regulation of that time. But while the *Charles River Bridge* decision undoubtedly involved a regulatory “contract,” that case hardly stands for the proposition that all utilities—including those subjected to statutory rather than charter-based regulation—have such contracts. And it *certainly* does not stand for the proposition that such a contract, including specific protections for stranded costs, can be implied in the absence of an explicit right. Indeed, the holding is precisely to the contrary.

Significantly, the *Charles River Bridge* case did not merely involve a price-regulated public utility. It was also the Court’s first “stranded cost” decision—at least if one ignores the fact that by the time of litigation the Charles River Bridge structure had probably been paid for many times. The effect of introducing a free bridge a half mile away was to make the Charles River Bridge superfluous, thereby giving the proprietors an almost useless asset.

Nevertheless, the variety of regulatory contracts contemporaneous with the one at issue in *Charles River Bridge* made the wisdom of that decision crystal clear. Like anyone else bargaining with the state, the proprietors of the Charles River Bridge Company made the best deal they could get. In this case they had succeeded in getting a long-term right to collect tolls that provided for no diminution after the bridge’s costs were fully amortized, but they had not succeeded in getting a monopoly provision. The Warren Bridge charter limiting tolls until payoff or for six years was much less attractive. The Supreme Court wisely refused to interpret the Contract Clause of the Constitution so as to give the Charles River Bridge’s owners more than they had obtained through their negotiations.

The next major decision that Sidak and Spulber consider is *Munn v. Illinois*.⁴⁶ The distinguishing feature of the price regulation at issue in *Munn* is that it was not individually negotiated but rather was created in a regulatory statute that applied to all firms operating in a designated market.⁴⁷ Furthermore, the firms had already been in operation before the

1869 charter of the Crescent City Live-Stock Landing and Slaughter-House, §§ 3, 7); *see also* HOVENKAMP, *supra* note 31, at 121 (observing that butchers in New Orleans had to pay prices set in the Crescent City Charter in order to use the facility).

44. *See, e.g.*, *Turnpike Co. v. Maryland*, 70 U.S. (3 Wall.) 210, 213 (1865) (refusing to imply a monopoly privilege in a turnpike charter that contained no explicit provision).

45. *See* SIDAK & SPULBER, *supra* note 7, at 134-38.

46. 94 U.S. 113 (1877). *See* SIDAK & SPULBER, *supra* note 7, at 138-40.

47. *Munn* described the statute at issue as

fix[ing] by law the maximum of charges for the storage of grain in warehouses at Chicago and other places in the State having not less than one hundred thousand inhabitants, in which grain is stored in bulk, and in which the grain of different owners

price regulation provision was passed and had historically operated under common law rules that placed no limit on their power to set their own prices.

Sidak and Spulber misread *Munn* as implying the existence of a regulatory contract—in this case by relying on Richard Epstein’s observation that Chief Justice Waite justified rate regulation in *Munn* by noting “that traditional common carrier obligations imposed upon a party receiving a legal monopoly the obligation to charge only reasonable fees for the services rendered, where the restriction on the power to charge what one sees fit is the quid pro quo for the monopoly in question.”⁴⁸ That interpretation might make some sense if *Munn & Scott* had been a common carrier with a statutory monopoly or if it had a monopoly provision in its corporate charter. But there was no such provision. The monopoly enjoyed by *Munn & Scott* was entirely de facto, arising from its strategic location at the intersection of railroad tracks that gave it a preferred position as unloader and loader of grain from its silo to the open railroad cars below. As a result, there was no quid pro quo at all.⁴⁹

Indeed, in *Munn*, not only was there no “regulatory contract” contained in a corporate charter, as in the *Charles River Bridge* case, but there was no charter at all. *Munn & Scott* was a common-law partnership, created in a market (grain elevators) where firms traditionally had not been incorporated. In fact, as the Supreme Court made clear a few years later, it selected *Munn* among the numerous price regulation cases before the Court that term⁵⁰ because *Munn & Scott*’s lack of corporate status exposed the

is mixed together, or in which grain is stored in such a manner that the identity of different lots or parcels cannot be accurately preserved.

Munn, 94 U.S. at 123.

48. SIDAK & SPULBER, *supra* note 7, at 139 n.90 (quoting RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN 168 n.15 (1985)).

49. See *Munn*, 94 U.S. at 128 (describing the elevator’s status as a “virtual monopoly”). In his dissent, Justice Field noted, “The compensation which the owners of property, not having any special rights or privileges from the government in connection with it, may demand for its use, or for their own services in union with it, forms no element of consideration in prescribing regulations for that purpose.” *Id.* at 146 (Field, J., dissenting); see also *id.* at 136-37 (Field, J., dissenting) (declaring property rights to be protected by the Constitution from legislative interference). Finally, Justice Field protested that in other cases involving rate regulation, the firm in question had a legal monopoly, which served as a quid pro quo for the regulation in question. See *id.* at 152 (Field, J., dissenting).

50. Collectively, the companion cases to *Munn* are referred to as the “Granger Cases” because they originated in the Grange movement, which organized farmers in opposition to what they perceived as unduly high rates charged by railroads, grain elevators, and related firms providing transportation and storage services to midwestern grain growers. The other cases all involved railroads that had corporate charters. In each case, the Supreme Court upheld statutory price regulation, notwithstanding the fact that the railroads had pre-existing charters containing no provision entitling the state to regulate rates. The cases were *Chicago, Burlington, & Quincy Railroad v. Iowa*, 94 U.S. 155 (1876); *Peik v. Chicago & Northwestern Railway*, 94 U.S. 164 (1876); *Chicago, Milwaukee, & St. Paul Railroad v. Ackley*, 94 U.S. 179 (1876); *Winona & St. Peter Railroad v. Blake*, 94 U.S. 180 (1876); and *Stone v. Wisconsin*, 94 U.S. 181 (1876).

heart of the dispute: whether the state had the power to regulate *in the absence of a regulatory contract*:

[T]he case of *Munn v. Illinois* was selected by the court as the most appropriate one in which to give its opinion on [the state's power to "limit . . . tolls and charges"], because that case presented the question of a private citizen, or unincorporated partnership, engaged in the warehousing business in Chicago, free from any claim of right or contract under an act of incorporation of any State whatever.⁵¹

Thus, *Munn* in fact stands for the broad proposition that a firm that began as a common investor in a presumably competitive market could later be made subject to price regulation if it acquired a bottleneck, or monopoly, status.

Sidak and Spulber's history of the regulatory contract subsequent to *Munn* does no more than state the obvious. In this instance, the obvious was already implicit in the *Charles River Bridge* decision: Where there was an *explicit* contract between a franchised public utility and a government entity, the Supreme Court enforced the contract according to its terms. But this hardly establishes the existence of a regulatory contract in other cases where no such explicit obligation exists—and it does nothing to upset Chief Justice Taney's unambiguous pronouncement that "in grants by the public, nothing passes by implication."⁵²

The decisions that Sidak and Spulber cite for the proposition that a "regulatory contract" generally exists with regulated firms in fact stand for the quite different proposition that only particular regulated firms have such contracts. When they do have them, the courts have interpreted their explicit language literally but have not gone further. For example, the *Binghamton Bridge* case, from which Sidak and Spulber quote at some length, rests on the existence of "a contract, with mutual considerations," and "justice and good policy alike require that the protection of the law should be assured to it."⁵³

But the issue in *Binghamton Bridge* was hardly the existence of a general "regulatory compact" to be collected from numerous sources and

Indeed, in the *Stone* case, the railroad operated under a corporate charter that permitted the company to "demand and receive such sum or sums of money for passage and freight of persons and property as they shall from time to time think reasonable." *Stone*, 94 U.S. at 181-82. Notwithstanding what appeared to be an explicit contractual right allowing the railroad to set its own rates, the Court permitted the state of Wisconsin to impose rate regulation by statute after the fact. *See id.* at 182-83.

51. *Wabash, St. Louis, & Pac. Ry. v. Illinois*, 118 U.S. 557, 569 (1886).

52. *Proprietors of the Charles River Bridge v. Proprietors of the Warren Bridge*, 36 U.S. (11 Pet.) 420, 546 (1837); *see supra* text accompanying notes 27-45.

53. *In re Binghamton Bridge*, 70 U.S. (3 Wall.) 51, 74 (1865), *quoted in* SIDAK & SPULBER, *supra* note 7, at 144-45.

full of implied grants. Rather, it was an explicit provision in a corporate charter. The Court described the charter in great detail, noting that it stipulated where the bridge should be built, how it should be constructed, where the toll gates should be located, and “the amount of tolls to be taken”⁵⁴ Most importantly for the dispute at issue, the charter provided: “It shall not be lawful for any person or persons to erect any bridge, or establish any ferry across the said west and east branches of Delaware River, within two miles either above or below the bridges to be erected and maintained in pursuance of this act.”⁵⁵ The lawsuit then arose when, a half century later, the legislature of New York authorized the construction of a second bridge “within the prescribed limits” of the monopoly grant given to the plaintiffs.⁵⁶ The Court agreed that the authorization of this second bridge violated the first bridge’s charter, and thus that the charter given the second bridge violated the Contract Clause.

By the same token, the *New Orleans Water Works* decision,⁵⁷ which Sidak and Spulber also discuss at some length,⁵⁸ involved the express provisions of a franchise that gave the plaintiff the exclusive right for fifty years to lay its water pipes and mains under the streets of New Orleans and provide that city with water. The dispute arose when the city passed an ordinance permitting a second company to begin supplying water long before the plaintiff’s exclusive right had expired. The Court once again found impairment of an obligation of contract. Likewise, the *Walla Walla*⁵⁹ case involved a municipal grant to a waterworks company to place “all necessary water mains, pipes, connections, and fittings” under the city streets and operate the city’s water system, reserving to the city itself only the right to place fire hydrants where it might see fit.⁶⁰ The charter further provided that “the city of Walla Walla shall not erect, maintain or become interested in any water works except the ones herein referred to”⁶¹ The dispute arose when the city decided to go into the water business for itself in express contravention of the charter, thus reducing demand for the plaintiff’s water system.

Finally, *Russell v. Sebastian*⁶² involved a state provision that permitted a municipality to authorize a single gas company to provide the entire city with gas. Acting in reliance on this provision, the plaintiff built a plant

54. *In re Binghamton Bridge*, 70 U.S. (3 Wall) at 52-53.

55. *Id.* at 53.

56. *Id.* at 72.

57. *New Orleans Water Works Co. v. Rivers*, 115 U.S. 674 (1885).

58. See SIDAK & SPULBER, *supra* note 7, at 146-47.

59. *Walla Walla City v. Walla Walla Water Co.*, 172 U.S. 1 (1898), *discussed in* SIDAK & SPULBER, *supra* note 7, at 147-49.

60. *Walla Walla City*, 172 U.S. at 4.

61. *Id.* at 5.

62. 233 U.S. 195 (1914), *discussed in* SIDAK & SPULBER, *supra* note 7, at 149-53.

capable of serving the entire city, including the numerous new streets that were being constructed and annexed. However, Los Angeles later took the position that the exclusive grant referred only to the then-existing streets already served, and that it was free to charter one or more additional companies to provide gas to the expansion areas. Once again, the challenge came under the Contract Clause, and the Court held that the only reasonable interpretation of the charter provision under which the gas company had acted was that it would be entitled to serve the entire city, including expansion areas. The Court, however, also reiterated the *Charles River Bridge* conclusion that “public grants are to be construed strictly in favor of the public” and that “ambiguities are to be resolved against the grantee.”⁶³ In explaining the rationale for narrow construction, the Court noted:

It has often been stated, as one of the reasons for the rule, that statutes and ordinances embodying such grants are usually drawn by interested parties and that it serves to frustrate efforts through the skillful use of words to accomplish purposes which are not apparent upon the face of the enactment.⁶⁴

In this case, however, the Court found “no ambiguity” in the contract language authorizing the utility to supply the entire city, including expansion areas.⁶⁵

In sum, none of these decisions do not bear the weight that *Sidak* and *Pulber* attach to them. They hardly stand for the proposition that every public utility enjoys the benefit of an unwritten “regulatory contract” protecting its investment from subsequent government decisions making that investment unprofitable. Rather, they stand for a proposition that is much narrower (particularly when one considers the sophistication of public utility managers): that public utility investors get from the state precisely what they are able to bargain for, no more and no less.

Further, the idea that grants from the state must be explicit and narrowly construed is hardly idiosyncratic or well camouflaged in the law of regulated industries. To the contrary, it is so unmistakable that it must be regarded as a part of the rational expectations of any knowledgeable public utility investor. Literally dozens of times, throughout both the nineteenth and twentieth centuries,⁶⁶ the Supreme Court has reiterated and consistently adhered to the *Charles River Bridge* prescription that contracts with the

63. *Russell*, 233 U.S. at 205 (citing *Proprietors of the Charles River Bridge v. Proprietors of the Warren Bridge*, 36 U.S. (11 Pet.) 420, 546, 549 (1837)).

64. *Russell*, 233 U.S. at 205 (citing numerous decisions).

65. *Id.* at 206 (“There is no ambiguity as to the scope of the offer. It was not simply of a privilege to maintain pipes actually laid, but to lay pipes . . . so far as may be necessary for introducing into and supplying such city and its inhabitants either with gaslight, or other illuminating light, or with fresh water for domestic and all other purposes . . .”).

66. Most recently in *United States v. Winstar Corp.*, 518 U.S. 839, 874 (1996).

government are to be strictly construed against the grantee. In fact, the Court has often gone further, insisting that one cannot read “implications and presumptions” into the state’s promises,⁶⁷ that regulatory promises from the state are to be given the “narrowest rational reading,”⁶⁸ and that claimed provisions in agreements with the state be “clearly and unequivocally expressed.”⁶⁹ As the Supreme Court reiterated in a 1939 decision refusing to imply a monopoly:

The vice of the position is that neither their charters nor their local franchises involve the grant of a monopoly or render competition illegal. The franchise to exist as a corporation, and to function as a public utility, in the absence of a specific charter contract on the subject, creates no right to be free of competition, and affords the corporation no legal cause of complaint by reason of the state’s subsequently authorizing another to enter and operate in the same field. The local franchises, while having elements of property, confer no contractual or property right to be free of competition either from individuals, other public utility corporations, or the state or municipality granting the franchise. The grantor may preclude itself by contract from initiating or permitting such competition, but no such contractual obligation is here asserted.⁷⁰

The consistency, clarity, and frequency of these decisions completely undermine any argument that public utility investors have a “settled expectation” of compensation from injuries caused by the insertion of competition into markets that were previously regulated monopolies. Quite the contrary, the only expectation that can be regarded as “settled” is that utility investors are entitled to what the government has explicitly and unambiguously committed itself to and no more. In all probability, only a

67. *National R.R. Passenger Corp. v. Atchison, Topeka, & Santa Fe Ry.*, 470 U.S. 451, 466 (1985) (citing *Proprietors of the Charles River Bridge*, 36 U.S. (11 Pet.) at 548, for the proposition that one cannot construe an explicit regulatory contract broadly by using “implications and presumptions”).

68. *Atlantic Coast Line R.R. v. Phillips*, 332 U.S. 168, 173 (1947).

69. *Keefe v. Clark*, 322 U.S. 393, 396-97 (1944) (“Since the contract here relied upon is one between a political subdivision of a state and private individuals, settled principles of construction require that the obligation alleged to have been impaired be clearly and unequivocally expressed.”).

70. *Tennessee Elec. Power Co. v. TVA*, 306 U.S. 118, 139 (1939) (citing numerous decisions, including *Proprietors of the Charles River Bridge*, 36 U.S. at 548) (footnotes omitted); see also *United States v. Grand River Dam Auth.*, 363 U.S. 229, 235 (1960) (stating that “all federal grants are construed in favor of the Government lest they be enlarged to include more than was expressly included” in finding that no compensation was due when a federal flood control project rendered a state power plant worthless); *Barcellos & Wolfson, Inc. v. Westlands Water Dist.*, 899 F.2d 814, 824 (9th Cir. 1990) (“[A]ny ambiguity in the contract must operate against the adventurer and in favor of the public.”) (citation omitted); *Northwest Paper Co. v. Federal Power Comm’n*, 344 F.2d 47, 51 (8th Cir. 1965) (holding that ambiguities in federal grants should be “construed in favor of the government”).

tiny fraction of the firms facing deregulation today can claim to have a "regulatory contract" that unambiguously entitles them to compensation for the incursions of competition.

The Takings Clause jurisprudence on this issue is just as clear as the Contract Clause jurisprudence. Even Justice Scalia, whose strong position on takings makes him something of a hero in Sidak and Spulber's book,⁷¹ conceded in *Lucas* that a regulatory statute presumed to reduce the value of the plaintiff's property to zero was nevertheless justified if the state's historical legal traditions established that such an event could be said to be a part of the landowner's reasonable expectations.⁷²

B. *Regulation Applied to Assets Already in Place*

If the basis for statutory regulation were contractual, then regulation would have to be applied in such a way as to create the appropriate incentives for private investors. Ex ante, the state would induce the electric utility to build a new power plant by promising monopoly status,⁷³ a

71. See SIDAK & SPULBER, *supra* note 7, at 172-73, 175-77, 198, 244-45, 456.

72. In *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1030 (1992), the Court found that "this recognition that the Takings Clause does not require compensation when an owner is barred from putting land to a use that is proscribed by those 'existing rules or understandings' is surely unexceptional." But when property is denied "all economically productive or beneficial uses" that go "beyond what the relevant background principles would dictate," then compensation must be paid. *Id.* The Court remanded for inquiry into whether state nuisance law or other legal principles created a situation in which the land owner could reasonably have anticipated the regulation in question. *Id.* at 1031-32; *see also id.* at 1016 n.7 ("The answer to this difficult question may lie in how the owner's reasonable expectations have been shaped by the State's law of property—i.e., whether and to what degree the State's law has accorded legal recognition and protection to the particular interest in land with respect to which the takings claimant alleges a diminution in (or elimination of) value.").

In *Stevens v. City of Cannon Beach*, 854 P.2d 449 (Or. 1993), the Oregon Supreme Court concluded that the ancient common-law doctrine of "custom" was part of the law of Oregon, *id.* at 456, and that dry-sand beachfront property "has been enjoyed by the general public as a recreational adjunct of the wet-sand or foreshore area since 'the beginning of the state's political history.'" *Id.* at 453 (quoting *State ex rel. Thornton v. Hay*, 462 P.2d 671, 673 (Or. 1969)). As a result, a state law rule giving the public the right to enter privately owned beaches and providing no compensation to the owners met the *Lucas* test because it was part of the settled expectations of Oregon owners of beachfront property:

When plaintiffs took title to their land, they were on notice that exclusive use of the dry sand areas was not a part of the "bundle of rights" that they acquired, because public use of dry sand areas "is so notorious that notice of the custom on the part of persons buying land along the shore must be presumed."

Id. at 456. Justice Scalia wrote a vigorous dissent from the denial of certiorari, concluding that the federal courts, not the state courts, should have the right to determine whether a particular regulatory intervention was well enough established in a state's legal tradition so as make its assertion reasonably foreseeable. *See Stevens*, 510 U.S. at 1207-14 (Scalia, J., dissenting from the denial of certiorari).

73. In natural monopoly regulation a promise of legal monopoly status may be necessary to prevent alternative firms from "cream-skimming," or entering the market only to serve a subset of low-cost or high-profit customers. *See* 2 ALFRED E. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* 221-46 (1971).

guaranteed rate of return, or other mandated market conditions that would operate to guarantee the investors a competitive return in exchange for their willingness to give up the higher returns (and higher risks) that attend investment in a competitively structured market. The tradeoff would thus be reduced risk for the investor in exchange for reduced upside potential.

But beginning with *Munn v. Illinois*,⁷⁴ the Supreme Court has generally upheld rate regulation as applied to productive assets that were already in place at the time the regulatory statute was passed and that had been built on the assumption that they were being placed in unregulated markets.⁷⁵ Both *Munn* and the Supreme Court's later decision in *Budd v. New York*⁷⁶ concluded that the government could take an ordinary competitive business and subject it to price regulation, at least in circumstances where the businesses had acquired a de facto monopoly status.⁷⁷ Indeed, in the *Railroad Commission Cases*, the Supreme Court even permitted price regulation to be applied to previously unregulated railroads without requiring any showing of monopoly status.⁷⁸

More recently, in *Pennell v. City of San Jose*,⁷⁹ the Supreme Court went even further. There, the Court set aside a takings challenge to a municipal rent control ordinance that used some cost-based criteria for determining maximum rents but also permitted the administrative decisionmaker to consider "hardship to the tenant" as a factor justifying a further reduction of rents.⁸⁰ The reason for rejecting a takings challenge was that the hardship factor had never been applied in a way that had forced a landlord's rent

74. 94 U.S. 113 (1876).

75. The principal exception to the rule permitting after-the-fact regulation of assets already in place is when the regulation forces private investors to accept rates so low that they are unable to recoup historical costs plus a reasonable return on them. *See, e.g.*, *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) (finding a reasonable return on historical investment to be constitutionally adequate); *Smyth v. Ames*, 169 U.S. 466 (1898) (finding that investors are entitled to a reasonable return on the value of their property employed for the convenience of the public).

76. 143 U.S. 517 (1892) (adhering to *Munn* and discussing numerous intervening decisions).

77. As the Supreme Court explained in *Budd*:

It is contended . . . that the business of the relators in handling grain was wholly private, and not subject to regulation by law; and that they had received from the State no charter, no privileges and no immunity, and stood before the law on a footing with the laborers they employed to shovel grain, and were no more subject to regulation than any other individual in the community. But these same facts existed in *Munn v. Illinois*. In that case, the parties offending were private individuals, doing a private business, without any privilege or monopoly granted to them by the state.

Id. at 545.

78. The leading *Railroad Commission* case, and the only one producing a full opinion, was *Stone v. Farmers' Loan & Trust Co.*, 116 U.S. 307 (1886). The regulatory statute at issue was passed in 1884 and applied to a railroad that had been incorporated in 1848 under a charter permitting it to set its own rates. *See id.* at 308, 314, 316. Companion cases raising the same basic issue were *Stone v. Illinois Central Railroad*, 116 U.S. 347 (1886), and *Stone v. New Orleans & Northeastern Railroad*, 116 U.S. 352 (1886).

79. 485 U.S. 1 (1988).

80. *See id.* at 4-6, 13-14.

below the constitutional minimum level of reasonable return on historical investment.⁸¹

In any event, *Pennell* is particularly relevant for two reasons. First, residential rental property in San Jose was hardly a monopoly. There were many competing landlords, although there were also regulatory constraints on new construction that had created an imbalance between the supply and the demand, thus permitting landlords to charge rents above their costs. Furthermore, as the development of the case law from *Munn* to *Budd* to *Pennell* makes clear, monopoly status is not essential to the government's power to regulate without providing compensation for business losses. In *Munn* and *Budd*, the apparent premise was that the prices of the monopolist firms in question would not be constrained by competition. In *Pennell*, rent control was presumably thought to be justified by temporary imbalances between the demand for housing in San Jose and the rate of construction, but the Supreme Court never required any showing at all that the market was failing to drive prices to the competitive level.

Second, the rent control ordinance in question in *Pennell*, as is frequently the case, applied to property that had been placed on the market before the ordinance was passed and that presumably had been constructed on the premise that the market would determine rental rates. Further, nothing in the rent control ordinance created a quid pro quo—for example, a guarantee that landlords would be entitled to compensation if their apartments became obsolete or unprofitable for reasons unrelated to the size of the legal maximum rent.

Writing for the majority, Chief Justice Rehnquist assumed that “objectively reasonable” rent regulations would be permissible under the Takings Clause, notwithstanding the lack of any regulatory contract protecting the landlord's original investment from injuries caused by competition. He noted that the ordinance permitted allowable rents to be computed on the basis of a number of factors, six of which were objective and related to the cost of services and a reasonable rate of return.⁸² The factor that was being challenged, by contrast, related to the tenant's “hardship” and theoretically might have permitted a regulator to award a tenant a rental rate so low that the landlord would not receive a reasonable rate of return. However, as Rehnquist explained, “there simply [was] no evidence that the ‘tenant hardship clause’ [had] in fact ever been relied upon by a hearing officer to reduce a rent below the figure it would have been set at on the basis of the other factors set forth in the Ordinance.”⁸³ Beyond this, Rehnquist noted, there was no basis for a per se taking, for the

81. *See id.* at 8-11.

82. *See id.* at 9 (“The first six of these factors are all objective, and are related either to the landlord's costs of providing an adequate rental unit, or to the condition of the rental market.”).

83. *Id.* at 9-10.

Supreme Court had “consistently affirmed that States have broad power to regulate housing conditions in general and the landlord-tenant relationship in particular without paying compensation for all economic injuries that such regulation entails.”⁸⁴

In sum, if price regulation were a contract, we would expect the Supreme Court to strike down cases in which the regulator imposes limits on prices without giving the regulated firm anything in return, as in *Munn*, the *Railroad Commission Cases*, and *Pennell*. But the Court has done no such thing.

III. ASSIGNING RESPONSIBILITY FOR ULTIMATELY IMPROVIDENT REGULATORY INVESTMENTS

Compensation for stranded costs would therefore appear to be constitutionally compelled in a much narrower range of circumstances than *Sidak* and *Spulber* argue. The first compelling case arises when a regulatory contract exists. But as just discussed, the case law makes clear that neither the existence nor the coverage of such a contract can be implied from ambiguous circumstances.⁸⁵ Such a contract requires clear, unmistakable language from the sovereign promising to protect the utility’s investment, its monopoly status, its continued right to receive revenue from a specific plant, or any other right that might be in dispute. Breach of the regulatory contract justifies compensation only when the government has reneged on an express and unambiguous contractual promise. This is the meaning of the *Charles River Bridge* decision⁸⁶ and the numerous cases that have followed it.⁸⁷ Because the law on this issue is clear, it must be considered to be part of the investment-backed expectations of any utility investor.

Second, the case for compensation is strong even when no regulatory contract exists but the government actually initiates an action compelling the utility to construct a new facility and later changes regulatory policy in such a way as to render the facility useless or unprofitable. Such an act involves no calculated risk-taking at all by the utility, but rather merely involves compliance with a government order. As such, it is equivalent to the forcible transfer of valuable property from a private party to the state—as when the state takes title or forces a price-regulated firm to accept rates below its costs.

84. *Id.* at 12 n.6 (quoting *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982)). The Court also noted that “statutes regulating the economic relations of landlords and tenants are not *per se* takings.” *Id.* at 12 n.6 (quoting *FCC v. Florida Power Corp.*, 480 U.S. 245, 252 (1987)).

85. *See supra* Part II.

86. *See supra* notes 33-45 and accompanying text.

87. *See supra* notes 46-65 and accompanying text.

However, such situations must be regarded as the exception rather than the rule, and they must be proven. In most cases, the instigator of expansion is the regulated firm itself. The Sidak and Spulber theory of regulation and stranded costs seems to assume a world in which government agencies order public utilities to invest in new facilities “in the public interest,” and the utilities are then obliged to do so, accepting in return a governmental guarantee of a reasonable profit for the useful life of their investment. In this imagined enterprise, the government is the policy leader and the utility a mere follower. Furthermore, the follower appears to have no choice but to do what the government compels—always subject to the limitation that the utility is entitled to the competitive rate of return on its overall investment. Alternatively, they may contemplate a situation in which both regulators and utilities are equally well-informed, and the two engage in a joint enterprise determining the optimal regulatory investment.

The truth is most often to the contrary.⁸⁸ Much more commonly, public utility investments are made at the behest of the utilities themselves, with agencies advocating limitation rather than expansion. Alternatively, they are made under circumstances in which the utilities have access to better information than the agencies and disclose this information selectively to maximize their own profits.⁸⁹ In such cases, one can hardly conclude that the investment was compelled by the state.

Of course, if a regulatory contract existed promising that the state would protect every “reasonable” utility investment, then a duty to compensate could be derived from the contract itself. But as implied above, such contracts must be regarded as exceptional, and even when they do exist they obligate the sovereign to do only what was explicitly promised. In the absence of such a contract, a utility must either be taking its own risks or else it must be following the orders of the sovereign. The duty to compensate in the latter case then derives from the fact that the state has taken from the private firm the ability to make its own assessment of reasonable risk. When no regulatory contract promising protection of investment exists, and when the utility effectively makes its own investment decisions (whether or not they were “prudent” when made),

88. A few examples of exceptional cases are *Ex rel. New York & Queens Gas Co. v. McCall*, 245 U.S. 345, 351 (1917), which upheld a state order that required a utility to extend its facilities over the utility’s objection that the incremental revenues would not be sufficient to cover the incremental costs of extension provided that the utility’s overall return continued to meet the constitutional minimum; *Puget Sound Traction, Light & Power Co. v. Reynolds*, 244 U.S. 574, 582 (1917), which upheld a state commission order requiring a street railroad to extend its current route; *Missouri Pacific Railway Co. v. Kansas ex rel. Railroad Commissioners*, 216 U.S. 262, 284 (1910), which mandated that a railroad operate an additional route; and *Atlantic Coastline Railroad Co. v. North Carolina Corp. Commission*, 206 U.S. 1, 21-27 (1907), which upheld a state agency order requiring a railroad to add a route to a town that it had previously abandoned.

89. On this point, see Oliver E. Williamson, *Deregulatory Takings and Breach of the Regulatory Contract: Some Precautions*, 71 N.Y.U. L. REV. 1007, 1013 (1996).

then a compensation requirement would overcompensate, by paying off risks that were already incorporated into the regulated returns.

Cost-of-service ratemaking can give regulated firms perverse incentives to make inefficient capital investments. A competitive firm decides to invest by comparing costs with overall impact on revenues. For example, if GM is deciding whether to build a new production facility, it must consider whether the market is ready to accept increased output at a profitable price, or whether there will be offsetting output reductions from existing facilities. If it miscalculates and the extra production drives prices below incremental costs, then the plant will be unprofitable. No one would compensate GM for the bad investment.

By contrast, the public utility is guaranteed a positive rate of return on its investment that quite typically exceeds the cost of capital. If the investment is excessive and produces excess capacity, the utility still will be entitled to receive an overall rate of return that is positive, provided that the investment was prudently incurred. Further, the regulated firm typically is allowed a positive rate of return on its capital assets, while it obtains only a pass through of expenses. As a result, the regulated firm will typically prefer more capital-intensive alternatives than an unregulated firm. The literature on this proposition is large, well-documented, and reasonably free of controversy.⁹⁰

90. The basic thesis was developed in Harvey Averch & Leland L. Johnson, *Behavior of the Firm Under Regulatory Constraint*, 52 AM. ECON. REV. 1052 (1962). They noted:

[I]f the rate of return allowed by the regulatory agency is greater than the cost of capital but is less than the rate of return that would be enjoyed by the firm were it free to maximize profit without regulatory constraint, then the firm will substitute capital for the other factor of production and operate at an output where cost is not minimized.

Id. at 1053. Justice Breyer once gave this example:

Michigan Electric Company would be delighted to borrow \$10 million at 7 percent to build Egyptian pyramids if the fair rate of return is 8 percent. If the regulator approves [the utility's request], it will collect an additional \$800,000 from its Michigan customers, pay \$700,000 to its bondholders, and keep the difference.

BREYER, *supra* note 2, at 49; see also KENNETH E. TRAIN, *OPTIMAL REGULATION: THE ECONOMIC THEORY OF NATURAL MONOPOLY* 19-22 (1991) (summarizing the Averch-Johnson effect); H. Craig Petersen, *An Empirical Test of Regulatory Effects*, 6 BELL J. ECON. 111, 124 (1975) (finding empirical support for the Averch-Johnson hypotheses). For a survey of the subsequent literature, see Roger Sherman, *The Averch and Johnson Analysis of Public Utility Regulation Twenty Years Later*, 2 REV. INDUS. ORG. 178 (1985); and for a summary, see 2 KAHN, *supra* note 73, at 47-94, especially at 49. Related recent literature includes Bernard S. Black & Richard J. Pierce, Jr., *The Choice Between Markets and Central Planning in Regulating the U.S. Electricity Industry*, 93 COLUM. L. REV. 1339, 1344-46 (1993), which explains how flaws in rate regulation were exposed; Jim Chen, *The Legal Process and Political Economy of Telecommunications Reform*, 97 COLUM. L. REV. 835, 872 (1997), which applies Averch-Johnson to account for "gold plating" and slowness of innovation in pre-divestiture telecommunications industry; and Peter Navarro, *The Simple Analytics of Performance-Based Ratemaking: A Guide for the PBR Regulator*, 13 YALE J. ON REG. 105, 119-23 (1996), which discusses the merits and disadvantages of performance-based ratemaking versus traditional rate-based regulation.

While Sidak and Spulber do not discuss Averch-Johnson in *Deregulatory Takings*, Spulber has discussed it elsewhere:

If regulatory agencies initiated all orders to construct additional facilities, then the state, rather than the private utility, would be responsible for excessive capital investments. But in most regulatory regimes a utility basically decides for itself whether to build extra facilities. The utility typically operates under an obligation to provide adequate service to its customer base, including sufficient capacity to handle reasonably anticipated breakdowns or temporary surges in demand. Yet the question of specific compliance is usually up to the utility itself. State regulatory regimes vary widely. Some states require that a utility, such as an electric power company, obtain regulatory approval before constructing an additional facility.⁹¹ In such regimes, however, it is typically contemplated that the utility requests the additional facility, and the regulatory commission then decides whether to approve. That is, ordinarily the process does not work the other way around—with the commission ordering the utility to build the facility whether it wishes to or not.⁹² Indeed, one of the stated reasons for requiring government agency approval is to offset the Averch-Johnson effect⁹³ by ensuring that the utility does not make a greater capital investment than necessary. In other states, the legislation simply requires the utility to serve its customers adequately and leaves it largely up to the utility to determine whether construction of additional facilities is warranted.⁹⁴ Even when regulatory approval of new investment is required, the utility, which generally controls the necessary information, may be in a position to present it selectively so as to make a stronger case for new investment.

The classic analysis of Averch and Johnson and voluminous subsequent literature shows that the imposition of a maximum allowed rate of return constraint causes distortions in the capital-labor ratio of regulated firms. Under some conditions, the profit-maximizing regulated firm employs more capital than the competitive firms as it tries to increase its rate base and correspondingly lower its rate of return to meet the constraint.

Daniel F. Spulber, *Pricing and the Incentive To Invest in Pipelines After Great Lakes*, 15 ENERGY L.J. 377, 390 n.56 (1994); see also DANIEL F. SPULBER, REGULATION AND MARKETS 617-24 (1989) (discussing capital biases in the regulation of new entrants and incumbents); Daniel F. Spulber & Robert A. Becker, *Regulatory Lag and Deregulation with Imperfectly Adjustable Capital*, 6 J. ECON. DYNAMICS & CONTROL 137 (1983) (confirming the existence of Averch-Johnson effects in advance of regulation, but not necessarily afterward, and indicating either capital or labor biases in anticipation of deregulation).

91. See Richard J. Pierce, Jr., *The Regulatory Treatment of Mistakes in Retrospect: Canceled Plants and Excess Capacity*, 132 U. PA. L. REV. 497, 532 n.191 (1984) (listing states in which regulatory approval is required in advance of construction).

92. See *id.* at 532.

93. See Pierce, *supra* note 91, at 533; *supra* note 90.

94. See, e.g., *Kelley v. Michigan Pub. Serv. Comm'n*, 316 N.W.2d 187, 190-92 (Mich. 1982) (holding that a Michigan regulatory agency had no power to approve or disapprove a utility's decision to build an additional facility); *Public Serv. Co. v. State*, 645 P.2d 465 (Okla. 1982) (holding that the state regulatory commission could not base a refusal of a utility's request to issue securities on a requirement that the utility demonstrate the necessity of the proposed construction of an electric plant).

Further, the regulated firm will have strong incentives to link adjacent markets, particularly if it faces different demand elasticities in them. For example, prior to the divestiture decree, AT&T had virtually no competitors in owning local telephone monopolies and faced low demand elasticities. By contrast, emergent competition in long distance gave it higher elasticities there. The optimal strategy in such a case would be for AT&T to cross-subsidize, charging higher rates in local markets where the decline in customer demand would be low, in order to support lower rates in long-distance markets. This would have increased the demand for capital investment in the long-distance market while making it difficult for competitive long-distance carriers who had no local monopoly to compete.⁹⁵ Thus, the Averch-Johnson effect may explain such phenomena as the refusal of Otter Tail Power Company to “wheel” power for adjacent small utilities, leading to an antitrust decree against it.⁹⁶ Even under price regulation, it would be far more profitable for Otter Tail Power to build and operate its own generation capacity to provide electricity to the smaller utilities, thereby earning its rate of return on the new capital investment.

The first point, then, is that rate of return regulation gives firms incentives to overinvest in capital with inefficient results. The second point is that regulatory overseers are not always able to control this tendency to overinvest, and sometimes they are not even committed to controlling it. In addition to the expansive literature on regulatory capture, the antitrust case law is filled with instances of decisions in which regulated firms faced grossly ineffective oversight by their regulators, who often did little more than rubber-stamp their requests.⁹⁷

To be sure, a regulatory agency or the courts may make a subsequent decision that a particular utility investment was prudent. For example, if an electric utility decides to build a nuclear power plant that is never brought into production as a result of changes in politics, demand, or the availability of alternative energy sources, the utility may be able to pass development costs on to consumers if these costs were “prudently incurred.”⁹⁸

95. See Roger G. Noll & Bruce M. Owen, *The Anticompetitive Uses of Regulation: United States v. AT&T*, in *THE ANTITRUST REVOLUTION* 290 (John E. Kwoka & Lawrence J. White eds., 2d. ed. 1994).

96. See *Otter Tail Power Co. v. United States*, 410 U.S. 366, 368-69 (1973). The Averch-Johnson effect may explain anticompetitive refusals to deal, in that the utility naturally prefers to apply its own capital to a market, receiving a positive rate of return, rather than cooperate with another firm in using the latter's capital. For example, by refusing to “wheel” power at wholesale, the utility may be able to take over a small adjacent utility and include that utility's delivery network into its own rate base. See 3A AREEDA & HOVENKAMP, *ANTITRUST LAW* ¶¶ 772b, 787c (rev. ed. 1996).

97. See, e.g., 2 AREEDA & HOVENKAMP, *supra* note 96, ¶ 226 (noting a lack of oversight by state and local regulatory agencies); 2A *id.* ¶¶ 242-43 (noting a lack of oversight by federal agencies).

98. Consider the Court's statement in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989):

Importantly, however, to say that an investment was prudent when made is to say that it was risk-*justified*, not that it was risk-*free*, and if the risk for a certain class of investments is positive, at least some investments in that class will likely fail.

Participants in competitive markets do not enjoy a “prudent investor” rule providing compensation for failure. If Ford gathers all cost-justified information and makes an ex ante calculation that an additional production plant for its Taurus line is warranted, then it has acted prudently. But the automobile market or the economy may still take an unforeseen turn, rendering the investment unprofitable, and no one will be required to compensate Ford for its bad luck. Thus, in the absence of an explicit regulatory contract promising compensation, the mere fact that a regulatory investment is “prudent” at the time it was made is not sufficient to justify a subsequent compensation award when the investment decision was initiated by the utility itself.⁹⁹

Another possible rationale for requiring compensation for utilities’ own improvident investments is that, while utilities initiate most investment decisions themselves, the government is responsible for the cost-of-service ratemaking regime that creates the incentive to overinvest in the first place. Indeed, the state’s adoption of a particular regulatory approach is ultimately responsible not only for the incentives that the approach creates but also for the lack of effective regulatory review. So suppose a public utility operates in an environment in which its managers know that they can earn more for their shareholders by making excessive investments in specialized and durable productive assets.¹⁰⁰ Suppose further that it has been the utility managers’ experience that the agency will not adequately scrutinize the need for new facilities as carefully as it should and will probably grant the utility what it wishes.

Under the prudent investment rule, the utility is compensated for all prudent investments at their actual cost when made (their “historical” cost), irrespective of whether individual investments are deemed necessary or beneficial in hindsight. The utilities incur fewer risks, but are limited to a standard rate of return on the actual amount of money reasonably invested.

Id. at 309; see also *Pennsylvania Pub. Util. Comm’n v. Metropolitan Edison Co.*, 55 Pa. P.U.C. 478, 486 (1982) (permitting cost recovery, but not return, on the development of the subsequently abandoned Three Mile Island nuclear plant); Federal Energy Regulatory Commission, Order No. 888, 61 Fed. Reg. 21,540, 21,628-630 (1996) (ruling that stranded costs may be recovered only if “legitimate, prudent and verifiable”). See generally A. Lawrence Kolbe & William B. Tye, *It Ain’t in There: The Cost of Capital Does Not Compensate for Stranded-Cost Risk*, PUB. UTIL. FORT., May 15, 1995, at 26; Stephen F. Williams, *Deregulatory Takings and Breach of the Regulatory Contract: A Comment*, 71 N.Y.U. L. REV. 1000, 1003-04 (1996) (noting the difficulties of measuring product costs).

99. Cf. *Duquesne Light Co.*, 488 U.S. at 301-02 (holding that the Fifth Amendment does not require compensation for all prudently incurred public utility investments).

100. See sources cited *supra* note 90.

Sidak and Spulber's apparent answer is that the fact that the investment was initially approved already establishes that it was prudent.¹⁰¹ But, as noted previously, the unregulated market does not compensate even for "prudent" investments that subsequently become worthless. To make the argument for compensation, one must show not merely that the investment was "prudent" but also that it was not part of the investor's reasonable, investment-backed expectations that the government would later open the regulated market to increased competition. Significantly, the normal consequence of deregulation is not that the sovereign forcibly closes down a plant or forces the uncompensated transfer of title. Rather, the government typically opens the market to more entry or permits service providers from a wider geographic range to compete for a particular area's business.

In such a setting, where the utility itself is the real initiator of new investment; where the many defects of cost-of-service ratemaking have been a standard if not completely uncontroversial part of the literature for well over three decades;¹⁰² where a great deal of other literature has emphasized the great efficiency gains that can flow from regimes that emphasize competition for the market as an alternative to regulated monopoly;¹⁰³ where "deregulation" has been part of the general government agenda for two decades;¹⁰⁴ and where many technological changes have rendered increased competition both feasible and economically preferable, the utility can hardly claim a reasonable expectation that increased competition would not be encouraged in the future.

Further, given the strong element of utility initiative in new investment, a regime that provides compensation for investments subsequently rendered unprofitable by increased competition has precisely the same perverse effect here as it does in the general case of unregulated industries. It exacerbates the incentives that regulated firms already have to overinvest

101. See SIDAK & SPULBER, *supra* note 7, at 487 ("The regulator already passed on the prudence of those investments before the utility made them and was allowed to include them in its regulated capital account.").

102. The original Averch & Johnson article was published in 1962. See *supra* note 90.

103. See, e.g., WILLIAM J. BAUMOL ET AL., *CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE* (1982); Elizabeth E. Bailey & John C. Panzar, *The Contestability of Airline Markets During the Transition to Deregulation*, 44 *LAW & CONTEMP. PROBS.* 125 (1981); Richard Beilock & James Freeman, *The Effect on Rate Levels and Structures of Removing Entry and Rate Controls on Motor Carriers*, 21 *J. TRANSPORT ECON. & POL'Y* 167 (1987); Joseph F. Brodley, *Antitrust Policy Under Deregulation: Airline Mergers and the Theory of Contestable Markets*, 61 *B.U. L. REV.* 823 (1981); Harold Demsetz, *Why Regulate Utilities?*, 11 *J.L. & ECON.* 55 (1968); David R. Graham et al., *Efficiency and Competition in the Airline Industry*, 14 *BELL J. ECON.* 118 (1983); John S. Ying, *The Inefficiency of Regulating a Competitive Industry: Productivity Gains in Trucking Following Reform*, 72 *REV. ECON. & STAT.* 191 (1990).

104. For example, the initial trucking and airline deregulation occurred in the late 1970s and early 1980s. See *supra* notes 1-2 and accompanying text.

by guaranteeing them a profitable exit if the environment later becomes more competitive.

IV. CHANGES IN TECHNOLOGY VS. CHANGES IN REGULATORY POLICY

In competitive markets, productive assets often become worthless because consumer tastes change or new technology makes old investments obsolete. No one is entitled to compensation for such losses. According to Sidak and Spulber, the thing that distinguishes the regulatory relationship from ordinary business investments is that when obsolescence occurs, it is often the result of a government policy change rather than a change in consumer preference or technology.¹⁰⁵ Thus, Sidak and Spulber would limit compensation to changes that are brought about by shifts in government regulatory policy. They would not provide compensation for stranded costs brought about simply by changes in technology.¹⁰⁶

Discussions of obsolescence in competitive markets generally involve examinations of the relative benefits and costs associated with switching. At any given time, the market is full of “obsolete” technology. Airlines fly ancient aircraft; trucking companies continue to use trucks that do not incorporate all of the economy, convenience, or safety features of the latest models; farmers continue to use old tractors; businesses continue to use computers with pre-Pentium chips or old versions of Microsoft Windows. Firms do this not because of regulatory constraints or ideological opposition to innovation, but simply because switching costs are too high in relation to the gains to be obtained. For example, trucks are ordinarily driven until they wear out—perhaps at 200,000 miles—even though they may be technically “obsolete” after the first year because they no longer incorporate all the latest features. In some cases, firms buy assets and use them until they wear out, notwithstanding that they are no longer state-of-the-art. In other cases, where obsolescence has a more substantial impact on performance or other determinants of profitability, the firm abandons obsolete assets earlier. Unfortunately, regulated firms operate under more complex incentives because they ordinarily get their rate of return on both the obsolete assets and the new ones. As a result they may continue to use outdated facilities long after a “similarly situated” competitive firm would have abandoned them.

Sidak and Spulber’s conclusion that compensation is due for changes in government policy but not for changes in technology assumes considerably more discreteness about these two causes of obsolescence than reality

105. See SIDAK & SPULBER, *supra* note 7, at 19-25.

106. See, e.g., SIDAK & SPULBER, *supra* note 7, at 462-63 (noting that there is properly no compensation for a decrease in demand resulting from exogenous market factors not caused by changes in government policy).

warrants.¹⁰⁷ Granted, much of the deregulation movement has resulted from developments in economic and regulatory theory that emphasize the robustness of markets and the many costs and inefficiencies of agency regulation. But to a very large extent, deregulation has also been facilitated by developments in technology itself. That is, the government has merely responded to changes in available technology by changing the regulatory environment.

One case in point is the rise of competition in long-distance communications.¹⁰⁸ The pre-1970s regime, in which AT&T had a top-to-bottom monopoly on the telecommunications system, developed at a time when AT&T's long lines divisions really were made up of "long lines"—that is, long-distance connections were made along hard-wired circuits that traveled among local systems, making the national (and world) telephone systems a kind of macro-image of the local system. Long-distance competition with firms such as MCI or Sprint would have required the construction of additional sets of lines and switching devices that very likely exceeded the capabilities of the technology. What made long-distance competition feasible was the development of wireless communications systems, as well as switching and access technologies that enabled multiple providers to access local systems and calls to be recorded and billed accordingly.

The same is largely true of the interconnection requirements mandated by the 1996 Telecommunications Act,¹⁰⁹ for which Sidak and Spulber would apparently require compensation.¹¹⁰ In large part, interconnection to the local loop is designed simply to permit firms to take advantage of switching (and, in some cases, wireless technologies) that became available long after the original telephone monopoly was created. Likewise, in the electric power industry many plants have been rendered obsolete not by changes in government policy, but by the development of lower-cost

107. Cf. SIDAK & SPULBER, *supra* note 7, at 258-59, 423 (contrasting the technological obsolescence of the streetcar industry with the regulation enforced on electric utilities and local exchange telecommunications).

108. For a more complete account of this history, see KELLOGG ET AL., *supra* note 3, at 23-39; MEYER ET AL., *supra* note 3, at 1-68, 111-201; and RICHARD H.K. VIETOR, *CONTRIVED COMPETITION: REGULATION AND DEREGULATION IN AMERICA* 166-233 (1994).

109. These provisions impose broad duties on incumbent telecommunications providers to share their facilities by providing interconnection. The first provides, "Each telecommunications carrier has the duty (1) to interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers; and (2) not to install network features, functions, or capabilities that do not comply with the guidelines and standards established . . ." 47 U.S.C.A. § 251(a) (West Supp. 1998). The second provision creates a "duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms and conditions that are just, reasonable, and nondiscriminatory . . ." 47 U.S.C.A. § 251(c)(3) (West Supp. 1998). See generally 3A AREEDA & HOVENKAMP, *supra* note 96, ¶ 785 (describing the statutory duties of local exchange carriers); HUBER ET AL., *supra* note 4, at § 1.1.2b (same).

110. See SIDAK & SPULBER, *supra* note 7, at 307-42.

alternatives for constructing generation plants that make them cheaper to build and operate. Wheeling of power then becomes harmful to an incumbent with older, higher-cost units because it permits entry into the market by lower-cost production facilities.¹¹¹

One way to determine whether changes in technology or changes in policy "caused" the obsolescence of certain hardware is to consider what a business firm that owned the entire system would have done. Suppose that General Motors (GM) owns many discrete electric generation facilities servicing its numerous manufacturing plants around the world. Some of these generation facilities are efficient, others obsolete and high-cost. Then suppose technology develops that permits GM to transmit power over long distances at low cost, thus enabling it to utilize its least costly generation facilities. If GM would make the switch under such circumstances, it would be because of a recognition that the new technology is so far superior to the old one that premature retirement is justified. In that case, a government decision mandating the switch would do no more than recognize what technology has already determined, and no compensation would be due. This is essentially what has happened in the market for electric power during the last generation.¹¹² Yet the rule advocated by Sidak and Spulber would require compensation in such circumstances.¹¹³

In sum, one would expect a competitive firm to replace obsolete technology when it becomes cost-effective to do so. This often occurs before such technology has worn out, but no one compensates the firm for the unamortized costs of useful but obsolete machinery that must be retired. A rational firm might even invest in a technology (such as computers) that it foresees will become obsolete before it wears out if the firm anticipates that the gains from doing so will exceed the costs. Significantly, one would expect the regulatory agency overseeing such firms to do essentially the same thing. Agencies and the firms that they regulate presumably read the same trade literature and anticipate roughly the same developments.

111. See, e.g., Samir F. Barakat & Gregory B. Enholm, *Key Considerations for Reinventing Electric Utility Regulation*, in REINVENTING ELECTRIC UTILITY REGULATION 7, 7 (Gregory B. Enholm & J. Robert Malko eds., 1995) (noting the availability of lower-cost electric power from smaller power plants); Wise, *supra* note 5, at 267-68 (same).

112. See, e.g., Michael Evan Stern & Margaret M. Mlynczak Stern, *A Critical Overview of the Economic and Environmental Consequences of the Deregulation of the U.S. Electric Power Industry*, 4 ENVTL. L. 79, 88-90 (1997) (describing how investor-backed entrepreneurs formed independent power producers that had the capability to send their product over the nationwide transmission system owned by traditional utilities).

113. See SIDAK & SPULBER, *supra* note 7, at 257-62 (requiring recovery of the portion of costs attributable to the regulatory action).

V. COMPENSATION FOR DIMINISHED EXPECTATIONS: FROM WHAT POINT SHOULD COMPENSATION BE MEASURED?

As noted previously, the debate over compensation for stranded costs in some industries, such as electric power, has been significantly muted by the fact that presumably “stranded” facilities have ended up fetching a significantly higher price than initially predicted. Indeed, to the extent the appropriate compensation measure is the book value of the stranded facilities, compensation may be zero because virtually all of the sales have taken place at prices in excess of book value.¹¹⁴

Nonetheless, Sidak and Spulber point out that when deregulatory regimes were put into place, the stock of many electric utilities declined precipitously almost immediately, reflecting shareholder expectations about declining value.¹¹⁵ They argue that this anticipatory measure, not the measure produced by the impact on profits measured *ex post* or as affected by subsequent events, ought to determine the amount of compensation.¹¹⁶ As they note, in an efficient market the loss of value imposed by deregulation is reflected immediately in the stock price and this immediate loss of value, not some subsequently determined measure of net value, is the true loss.¹¹⁷ To the extent that the values of higher-than-anticipated sale prices are not discounted in the market already, they do not reflect the value of the taking at the time it occurs, but only of developments that occur thereafter.

The other side of the coin, however, is that the Supreme Court has always applied after-the-fact, or backward-looking, measures of compensation in takings cases. Such measures therefore must be regarded as part of anyone’s investment-backed expectations in areas of enterprise that are subject to subsequent assertions of the eminent domain power. To give the classic example, suppose that the city of Detroit uses its eminent

114. See *Power Plant Sales Raise Questions About Stranded Costs, Consumers’ Bills*, *supra* note 15.

115. See SIDAK & SPULBER, *supra* note 7, at 439 (giving examples).

116. See *id.* The authors criticize the Supreme Court’s holding in *Pennell v. City of San Jose*, 485 U.S. 1 (1988), as creating a “ripeness” rule that would refuse to grant compensation merely on the passage of a rent control statute. SIDAK & SPULBER, *supra* note 7, at 439. The Court noted that at the time of the challenge the city actually had not yet applied the statute so as to reduce a tenant’s rent. But the *Pennell* case is not relevant to Sidak and Spulber’s analysis. Proper application of the ordinance in *Pennell* should lead to the result that no taking would ever occur; that is, if the federal constitutional minimum for rent control is a reasonable rate of return on historical cost, and rent control board administrative judges are so instructed, they could apply the San Jose ordinance in such a fashion that no unconstitutional taking ever occurred. The point of the Supreme Court’s analysis was that the mere fact that a rent control ordinance made a taking in a particular case conceivable (by considering tenant hardship and possibly assessing a rent lower than the constitutional minimum) did not make the ordinance ripe for a facial challenge; rather, landlords would have to make “as applied” challenges to particular instances in which the official actually awarded a rental rate below the constitutional minimum.

117. See SIDAK & SPULBER, *supra* note 7, at 15.

domain power to take a residential subdivision for subsequent resale to GM for a new production facility.¹¹⁸ The reason for using the eminent domain power in the first place is to obtain the property at its “residential value,” which equals its market value in a world in which GM had not intended to make the acquisition. Once GM has announced that it wishes to purchase the property by voluntary transactions, the price will rise, perhaps dramatically, and talented holdouts will be able to demand exorbitantly high prices. But in the eminent domain proceeding, compensation will be based on the testimony of appraisers and real estate brokers who will testify about *past* transactions that, of course, were made when GM’s entry into the market was not contemplated.¹¹⁹ In sum, the city of Detroit is able to facilitate GM’s entry into the Detroit economy by forcing the property owners to accept as compensation the amount of money they would receive in a world in which GM was not entering the market, rather than the actual world in which its entry is contemplated. As a result, the property owners will be seriously undercompensated. But “just compensation” is almost always measured by backward-looking measures of this type. Indeed, an important rationale for eminent domain as an alternative to voluntary exchange is to prevent landowners from insisting that the government pay all that it is willing to pay; rather, the government must pay only what some alternative purchaser would have paid in a market in which the eminent domain power was not being asserted.

Thus, although Sidak and Spulber may be right that utilities are receiving less compensation than an efficient market might provide them, in reality, after-the-fact measures provide them with all the compensation to which they are constitutionally entitled, and the rule is clear enough that an investor could not reasonably expect more.

Further, to the extent that the Sidak and Spulber duty to compensate utilities for stranded costs is based on contract, there is a duty to mitigate, and mitigation is—whether correctly or not—measured after the fact. That is, if I improperly vacate my apartment today and my landlord has a duty to mitigate, compensation for breach of the lease agreement will be based on the difference between the amount of rent I was paying and the amount that the new tenant *actually* ends up paying, plus other costs and expenses. The Sidak and Spulber approach would provide compensation based on the amount of rent that the landlord reasonably could have expected for the property at the time the breach occurred. Once again, if the duty to compensate is driven by the investor’s reasonable expectations, and these are determined by the state of the law, then any reduction in injury caused

118. See *Poletown Neighborhood Council v. City of Detroit*, 304 N.W.2d 455 (Mich. 1981) (analyzing precisely this case).

119. See POSNER, *supra* note 6, at 62 (noting that one justification for eminent domain is the holdout problem).

by *actual* sales of stranded facilities must be considered in calculating compensation.

Finally, the Sidak and Spulber argument for compensation based on immediately experienced lost shareholder value seems to undermine their case for compensation altogether. If shareholders had a reasonable investment-backed expectation that compensation for stranded costs would be paid, then why would shareholder value decline at all? For example, Sidak and Spulber note that when the California Public Utilities Commission announced that it would begin proceedings that would lead to the introduction of retail wheeling in that state, three major utilities experienced twenty percent declines in share prices almost overnight.¹²⁰ The anticipation that led to the decline was that importing power from remote sources would reduce the demand for local power, thus leaving local producers with excess capacity and stranding superfluous facilities.

If the shareholders' reasonable expectation was that they would be perfectly compensated for these losses, however, then shareholder price should not have declined at all. If the existence of the regulatory contract and the correlative duty to compensate is clear, an informed investor would have known that the cost of deregulation must be borne by the government. The decline in shareholder value that actually occurred indicates that shareholders were quite well-informed about the extent of the government's obligation to compensate. There was none.

VI. CONCLUSION

Sidak and Spulber make a prolonged and ingenious argument for transferring more of the costs of deregulation away from investors and toward utility customers or taxpayers. However, their central contention falls short. Their case for compensation rests mainly on the premise of a regulatory "contract" with the government that promises compensation for stranded costs. But such contracts are far less common in the twentieth century than they were before the Civil War, when much of regulation took the form of price or output controls stipulated in corporate charters. Under modern statutory forms of regulation, which are often applied to assets already in place at the time regulation is imposed, the argument for a regulatory contract is much more difficult to sustain—particularly when most investment decisions are at the regulated firm's own initiative.

The legal rules specifying when such contracts exist are so well-established and clear that the assumption of such a contract cannot typically be said to be a part of the investor's reasonable, investment-backed expectations. In that case, compensating utilities for investments made at

120. See SIDAK & SPULBER, *supra* note 7, at 439.

their own initiative—even if they were “prudent” when made—is counterproductive and has perverse results. It exacerbates even further the problem of chronic overinvestment by rate-regulated firms. To the extent that utilities are overcompensated in light of the risk that they actually assumed, the result may also be to give entrenched firms a significant advantage over new entrants, who cannot look forward to such largesse from the state.

In most circumstances, the utility investor’s investment-backed expectations are not all that different from the expectations of the investor in an ordinary enterprise, who can almost never expect compensation for obsolescence and only rarely for changes in government policy. In this case the change in policy is most typically the replacement of monopoly with some kind of competitive regime. Given that society has been debating the large costs and relatively small benefits of regulation for more than twenty-five years, one can hardly argue that perpetual freedom from competition must be a part of the investment-backed expectations of the utility shareholder.

Conduct Unbecoming

Closed Chambers: The First Eyewitness Account of the Epic Struggles Inside the Supreme Court. By Edward P. Lazarus. New York: Times Books, 1998. Pp. 576. \$27.50.

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Every July and August, three dozen of the nation's most promising young lawyers begin service as law clerks to the Justices of the United States Supreme Court. Being a Supreme Court clerk is the most prestigious job to which a law school graduate can aspire. Those selected spend a year observing and participating in the decisionmaking processes of our nation's highest court, an experience most lawyers can only dream of. A Supreme Court clerkship is a ticket to the best jobs in the legal profession and in academia. It is a source of pride for the rest of the lawyer's career.

Until the publication of *Closed Chambers*¹ last year, it was well understood that whatever a clerk learned about case deliberations during his term of service would never be disclosed outside the Court. This was made clear to the new clerks during conversations with the Justices, and it was part of the institutional ethos—the bedrock of assumptions shared by those working within the Court. During the 1988 Term, it was embodied in a written Code of Conduct for Supreme Court Law Clerks which provides: “A law clerk should never disclose to any person any confidential

[†] Judge, United States Court of Appeals for the Ninth Circuit. Chock-full of disclosures: I know many of the people described in this book, including the author, who clerked for one of my colleagues a decade ago. I clerked for Justice (then Judge) Kennedy, who is ill-treated in the book, and one of Justice Kennedy's clerks, who is portrayed as a cross between Don Corleone and Freddie Krueger, clerked for me prior to his tenure at the Supreme Court. I also clerked for Chief Justice Burger, who is briefly though brutally savaged, and I know and respect Chief Justice Rehnquist, several of the Associate Justices, and a number of their former clerks who are mentioned unfavorably.

I am grateful for the valuable comments of a number of people, particularly Professor Gerard Lynch of Columbia Law School; Professor Lynch and I clerked together at the Court, he for Justice Brennan. And a special thanks to my law clerk Bill Burck, who has spent countless hours on this project and has made a substantial number of useful comments and edits.

1. EDWARD P. LAZARUS, *CLOSED CHAMBERS: THE FIRST EYEWITNESS ACCOUNT OF THE EPIC STRUGGLES INSIDE THE SUPREME COURT* (1998).