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## AN ANSWER TO PROFESSOR PIERCE: HOW UTILITY REGULATION CAN BE REFORMED IN HARMONY WITH CONSTITUTIONAL PRINCIPLES

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### INTRODUCTION

A thoughtful essay by Professor Richard Pierce of Columbia University addresses the role the federal judiciary should play with respect to public utility regulation.<sup>1</sup> His essay identifies grave problems that have arisen in this field and suggests fresh approaches to these problems. Although the authors disagree in significant ways with Professor Pierce's reading of the present state of the law, his review of the shortcomings of the utility rate-regulation process as it now exists, and his suggestion that reform of this process is urgently required, is commendable.<sup>2</sup>

Professor Pierce visualizes a world where public utility regulation—with the deficiencies characteristic of the process—would be replaced by the discipline of a competitive market. This would indeed be a vast improvement. Moreover, in the field of telecommunications, federal and state regulators are beginning to understand that the reality of competition is making the cumbersome and costly burdens of regulation obsolete. For example, the Federal Communications Commission ("FCC") and the Public Utilities Commission of the State of California ("California commission") are each proceeding with innovative plans designed to minimize the shortcomings of conventional public utility regulation.<sup>3</sup>

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\* The authors represent the GTE telephone companies before federal and state regulatory agencies and courts.

1. Pierce, *Public Utility Regulatory Takings: Should the Judiciary Attempt to Police Political Institutions?*, 77 GEO. L.J. 2031 (1989). See *infra* Postscript for a brief synopsis of Professor Pierce's article and his response to the points raised in this Article.

2. Professor Pierce recommends a proposal for "a new system of reliance upon competitive bidding, combined with contracts resulting from bidding, as the basis for new capacity decisions and the rate consequences of those decisions." Pierce, *supra* note 1, at 2072. By this means, "[c]ompetitive markets and judicially enforceable contracts ultimately will replace politically opportunistic state regulation as the primary mechanism for ensuring 'just and reasonable' rates for electricity and efficient conduct by the firms of the industry." *Id.*

3. For the FCC plan, see *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, consisting of *Notice of Proposed Rule Making*, 2 F.C.C. Rcd. 5208 (1987); *Further Notice of Proposed Rulemaking*, 3 F.C.C. Rcd. 3195 (1988) ("*Further Notice*"); *Report and Order and Second Further Notice of Proposed Rulemaking*, 4 F.C.C. Rcd. 2873 (1989), with 4 F.C.C. Rcd. 3379 (1989) ("*Report & Order*"); *Supplemental Notice of Proposed Rulemaking*, No. 87-313 (F.C.C., adopted Mar. 8, 1990, as corrected Mar. 23, 1990, second correction Mar. 14, 1990) (LEXIS, Fedcom library, FCC file). The plan was adopted in *Second Report and Order*, No. 87-313 (F.C.C., adopted Sept. 19, 1990) (LEXIS, Fedcom library, FCC file).

The FCC and California commission plans are designed to operate in harmony with the constitutional principles articulated by the United States Supreme Court in landmark cases dealing with utility regulation.<sup>4</sup> This harmony contrasts with Professor Pierce's paradoxical approach, which stresses the reality of confiscatory regulation and its destructive effects, while at the same time insisting that utility investors should be denied effective constitutional protection.

As long as public utilities are rate-regulated, the Constitution requires fair and workable rules of the game to prevent the immensely destructive effects of confiscatory regulation described in Professor Pierce's article. This Article demonstrates that the constitutional doctrine reaffirmed by the Supreme Court in the 1989 *Duquesne Light* case, and recently applied by the District of Columbia Circuit,<sup>5</sup> is entirely consistent with a more innovative approach to regulation in the public interest.

Section I of this Article summarizes Professor Pierce's excellent description of the confiscation problem that is afflicting the electric power industry in connection with canceled nuclear power plants. In Sections II, III, and IV, this Article discusses how to prevent confiscation by timely and effective application of keystone utility regulation principles, and stresses the interrelationship between those principles and the influence of the capital markets. Finally, in Section V, this Article reviews the innovative plans being implemented by the FCC and the California commission, with emphasis on their respect for constitutional principles.

#### I. POLITICAL PRESSURES ON REGULATORS AND THE BREAKDOWN OF THE SYSTEM

Professor Pierce describes a very grave crisis involving the electric utilities in

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For the California commission plan, see Alternative Regulatory Frameworks for Local Exchange Carriers, Interim Opinion on Phase II of L87-11-033, 107 Pub. Util. Rep. 4th (PUR) 1 (1989) ("*California Interim Opinion*"), *reh'g denied*, Decision 90-04-031, Apr. 11, 1990, *appeal pending sub nom.* *Toward Utility Rate Normalization v. Public Utilities Comm'n*, No. S015626 (Cal. Sup. Ct. filed May 17, 1990). Innovative plans are being considered or implemented in nearly every state.

4. *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923) ("*Bluefield*"); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*"); *Duquesne Light Co. v. Barasch*, 109 S. Ct. 609 (1989) ("*Duquesne Light*").

The guiding principle since 1896, according to the *Duquesne Light* Court, has been that "the Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory." *Duquesne Light*, 109 S. Ct. at 615. The focus of judicial review is not on methodology but on the end result of regulatory actions. "The Constitution protects the utility from the net effect of the rate order on its property." *Id.* at 619. This protection, grounded in the Just Compensation Clause of the Fifth Amendment, is made applicable to state or local regulation by virtue of the Due Process Clause of the Fourteenth Amendment. "If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments." *Id.* at 616. *See also infra* note 51; McKenna, *The Special Constitutional Status of Public Utility Regulation: From Munn to Duquesne Light*, 21 U. WEST L.A. L. REV. 31 (1990).

5. *See Jersey Central Power & Light Co. v. Federal Energy Regulatory Comm'n*, 810 F.2d 1168 (D.C. Cir. 1987) (*en banc*) ("*Jersey Central*"); *American Tel. & Tel. Co. v. FCC*, 836 F.2d 1386 (D.C. Cir. 1988) (*per curiam*), *conditional application for review en banc denied*, No. 85-1778, slip op. (D.C. Cir. Nov. 2, 1988) ("*AT&T*").

the United States. Since 1984, state agencies have repeatedly denied these utilities the opportunity to recover tens of billions of dollars invested in nuclear generating plants. A number of commentators "see this unprecedented pattern of decisions as evidence of a severe political malfunction in the ratemaking process."<sup>6</sup> After relatively light regulation for many years starting in 1966, "[e]xogenous factors caused utilities' costs to increase."<sup>7</sup> Then regulators "responded to the resulting requests for rate increases by beginning to constrain utility rates of return."<sup>8</sup> As a result, "[e]arned and allowed rates of return declined during the period 1966-69, even though utilities' cost of capital increased during that period."<sup>9</sup> Finding this pattern "inconsistent with a legal or economic explanation of the regulatory process and consistent with a political explanation," Professor Pierce suggests that the electrics became "easy and safe targets for opportunistic behavior by the majority and for exploitation by politicians" because: "[a]nxiety and anger over rising utility rates made it easy for politicians and the media to communicate with the majority by using simple symbols, e.g., rising rates and greedy utilities. This activated the previously docile and uninformed majority."<sup>10</sup>

A breakdown of the system followed. "The major increases in utility costs that began in 1969 caused the process to break down completely, with utilities systematically earning rates of return below their cost of capital."<sup>11</sup>

Placing heavy reliance on a study by Paul Joskow,<sup>12</sup> Professor Pierce concludes that state commissions, in rejecting requested rate increases, have denied electrics recovery of tens of billions of dollars in costs.<sup>13</sup> This situation arose because politicians "seize[d] the opportunity to curry favor with the majority by using their raw political power over the ratemaking process to redistribute wealth from the discrete, insular, and immutable minority [investors] to the majority [ratepayers]."<sup>14</sup> Finding "inherently implausible" the "trends and relationships implied by the aggregate data available from the regulatory actions disallowing investments as imprudent," Professor Pierce consequently finds it "easy to conclude that utility regulation in the 1980s is afflicted by the political malfunction [James] Madison feared most—majoritarian bias based on unequal distributions of property."<sup>15</sup>

"In constitutional law terms," Professor Pierce states, "the inference seems

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6. Pierce, *supra* note 1, at 2046.

7. *Id.* at 2048.

8. *Id.*

9. *Id.*

10. *Id.* at 2048-49.

11. *Id.* at 2049.

12. Joskow, *Inflation and Environmental Concern: Structural Change in the Process of Public Utility Price Regulation*, 17 J. LAW & ECON. 291 (1974).

13. Pierce, *supra* note 1, at 2048-50.

14. *Id.* at 2049.

15. *Id.* at 2051.

inescapable that, on an aggregate basis, state governments are 'taking' billions of dollars worth of property through the regulatory process.<sup>16</sup> Many analysts who have studied the effects of the electric utility rate decisions of the 1980s recognize the grave consequences of this confiscatory regulation. They have reached the alarming conclusion that this opportunistic behavior "has so distorted utility decisions to invest in new plants that the United States is virtually certain to face some combination of blackouts, brownouts, and unnecessarily high electricity rates sometime in the 1990s."<sup>17</sup> Consequently, electric utilities "with a demonstrated need for new capacity either will not make any investments in capacity or will invest in low regulatory risk, high operating cost capacity."<sup>18</sup>

Without judicial intervention or a major change in the method of regulating utilities, Professor Pierce maintains, "it appears the nation will suffer scores of billions of dollars in unnecessary future costs because of current state regulatory takings from utilities."<sup>19</sup> Viewing "the political process of ratemaking" as "afflicted with the severe political malfunction of majoritarian bias," Professor Pierce explains that "[t]his manifestation of factionalism has already resulted in redistribution of billions of dollars through the exercise of raw political power, and it places the nation's future supply of electricity in grave jeopardy."<sup>20</sup> "Yet the courts," he suggests, "appear institutionally incapable of correcting this political malfunction at tolerable cost."<sup>21</sup>

Furthermore, he views "the political process of ratemaking [as] a dismal picture of seemingly perpetual Hobbesian behavior" where state agencies "fluctuate from dominance by minoritarian factions to dominance by majoritarian factions, using their political power to redistribute wealth among factions in an opportunistic manner that creates a negative sum game for society."<sup>22</sup> He concludes that, at the state level, "intense majoritarian pressure on [the] political actors forces them to behave opportunistically."<sup>23</sup> And he suggests "that no effort by the Supreme Court to reenter the ratemaking process under the takings clause is likely to have any real effect on the political actors who control ratemaking on the state level unless the Court is willing to impose strong judicial constraints. . . ."<sup>24</sup> Notwithstanding this conclusion, Professor Pierce argues against such "strong judicial constraints" and for innovative approaches to regul-

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16. *Id.* at 2051-52.

17. *Id.* at 2052.

18. *Id.* at 2052-53.

19. *Id.* at 2053.

20. *Id.*

21. *Id.*

22. *Id.* Professor Pierce states that he does not mean to suggest that state regulators ignore entirely the merits of rate cases. "Rather, I believe that the political environment in which they operate imposes on them pressures and constraints so powerful that it is impossible for them to decide cases in a detached, objective manner." *Id.* at 2070 n.211.

23. *Id.* at 2071.

24. *Id.* at 2070.

ation unsupported by actively enforced constitutional doctrine.<sup>25</sup>

## II. PREVENTING CONFISCATORY REGULATION

Professor Pierce's description of a highly politicized regulatory environment is well taken. Anyone who has worked in the field of regulation is aware of how destructive this kind of environment can be. However, Professor Pierce's views must be considered in light of public utility regulation as a whole, taking into account both its successes and its failures.

*A. The entire picture of public utility regulation in the United States is not as dismal as suggested by Professor Pierce's discussion.*

Professor Pierce's article focuses on the problems associated with canceled nuclear power plants. As important as this is, regulation of nuclear power plants does not reflect the totality of public utility regulation. The fact is that a wide variety of public utilities appear to be operating on a stable basis. Furthermore, the electric industry *as a whole* seems to be financially healthy notwithstanding the effects of plant cancellations.<sup>26</sup> Moreover, there are encouraging signs, particularly in telecommunications, that enlightened federal and state regulators are willing to make rational adjustments to a rapidly changing environment.<sup>27</sup>

Central to all applications of utility regulation is the very real problem stressed by Professor Pierce: How to provide regulation which serves the public interest when surrounded by a politicized environment. Universalizing the power plant controversy and its grim consequences does not provide a complete and balanced picture.

*B. Even without active involvement of the federal judiciary, the Bluefield/Hope principles have been an important influence.*

Stressing the inactivity of the federal judiciary in applying the constitutional principles established by the *Bluefield* and *Hope* cases, Professor Pierce implies that these principles have had no real impact.<sup>28</sup> However, as Professor Drobak

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25. See *supra* notes 2 & 4.

26. See, e.g., Standard & Poor, CREDIT REV.: ELECTRIC & GAS UTIL. 4-18 (May 11, 1990); Standard & Poor, CREDIT REV.: TELECOM. 4-12 (June 4, 1990). But see Professor Pierce's Comments, *infra* p. 104.

27. For example, many important and difficult adjustments have been implemented to reflect technological changes and the entirely new environment that followed the breakup of the Bell System. See *NARUC v. FCC*, 737 F.2d 1095 (D.C. Cir. 1984), *cert. denied*, 469 U.S. 1227 (1985) (where the court approved in principle the FCC's access charge plan).

28. Pierce, *supra* note 1, at 2046. See also *Bluefield*, 262 U.S. 679; *Hope*, 320 U.S. 591.

points out,<sup>29</sup> thousands of rate decisions by state courts and by state or federal agencies since *Hope* have cited these cases and applied their principles. This does not minimize the gravity of the political failures highlighted by Professor Pierce; but to assume the universality of those failures paints too bleak a picture.

*C. The massive failure of regulation described by Professor Pierce logically justifies increased judicial scrutiny rather than the elimination of effective constitutional protection.*

Professor Pierce demonstrates that political pressures on state regulatory agencies have resulted in large scale confiscatory regulation, with immensely destructive consequences.<sup>30</sup> This suggests the need for more effective enforcement of the constitutional principles reaffirmed by *Duquesne Light*—in particular, the need for a more active role on the part of the federal judiciary. Professor Pierce, however, appears to be insisting that any enforcement effort would necessarily be unsuccessful.<sup>31</sup> His paradoxical position relies on a pattern of confiscatory action to justify abandonment of actively enforced constitutional safeguards.<sup>32</sup>

The authors maintain that Professor Pierce's conclusion—that an increased risk of confiscatory regulation justifies diminished constitutional protection—conflicts with the very experience upon which he places so much emphasis. As discussed below, this untenable conclusion arises from: (i) his refusal to accept the Supreme Court's clear and simple articulation of the relevant law, and (ii) his failure to recognize the key role played by the capital markets.

### III. THE CLEAR AND DEFINITE PRINCIPLES OF *BLUEFIELD*, *HOPE*, AND *DUQUESNE LIGHT*

Professor Pierce's article subordinates the Supreme Court's clear articulation of constitutional principles in *Hope* and *Bluefield* to an assumed, but unproven,

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29. Drobak, *From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation*, 65 B.U.L. REV. 65 (1985). Referring to the "stringent protection" generally understood to apply to utility ratemaking, Professor Drobak says: "Hundreds, probably thousands, of judicial and administrative decisions, both state and federal, rendered during the past forty years" explain the law since *Hope* as holding "that the Constitution requires rates to be set at levels high enough to generate moderate profits for investors." *Id.* at 65-66.

30. Pierce, *supra* note 1, at 2046-50.

31. *Id.* at 2070.

32. See Postscript, *infra* pp. 103-04, where Professor Pierce clarifies his views:

[As for] your characterization of my position . . . as "insisting" utility investors be denied constitutional protection . . . [this] characterization is not inaccurate, but I hoped to convey more a flavor of reluctant acquiescence in the extremely limited ability of the courts to perform this theoretically desirable function.

*sub rosa* doctrine that public utilities must be left at the mercy of regulation.<sup>33</sup> Thus, Professor Pierce refers to the *Hope* principles and their application in such recent decisions as *Jersey Central Power & Light Co. v. Federal Energy Regulatory Commission*<sup>34</sup> and *American Telephone & Telegraph Co. v. Federal Communications Commission*,<sup>35</sup> as if they were a new proposal rather than forty-five year old doctrine reaffirmed in 1989.<sup>36</sup>

Failure of the federal judiciary in the past to apply established constitutional doctrine in a consistent manner does not justify Professor Pierce's implication that the doctrine does not really exist. His article stresses the courts' finite capacity to deal with cases and controversies, and that choices must be made about where their resources should be invested to achieve the most beneficial results.<sup>37</sup> Regrettably, these factors have resulted in neglect of utility matters over the past several decades. As Professor Pierce's article demonstrates, the price of this neglect is now being paid.<sup>38</sup> However, the judiciary's past neglect does not justify the conclusion that the Supreme Court's careful articulation of constitutional doctrine can be disregarded. Any doubts as to where the Court stands were resolved in *Duquesne Light*, where the Court explicitly reaffirmed the *Bluefield/Hope* constitutional standard.

Professor Pierce, who found *Hope* ambiguous, similarly finds *Duquesne Light* ambiguous.<sup>39</sup> The following discussion of the case law shows that there is not ambiguity, but rather a clear and consistent standard under which the essential benchmark for constitutional purposes is the utility firm's continuing ability to access the capital markets.

Judge Bork's opinion for the District of Columbia Circuit Court of Appeals sitting en banc in the *Jersey Central* case neatly summarized the case law. Courts reviewing rate orders "must determine whether or not the end result of that order constitutes a reasonable balancing, based on factual findings, of the investor interest in maintaining financial integrity and access to capital markets and the consumer interest in being charged non-exploitative rates."<sup>40</sup>

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33. "[T]he 'end result' test announced in *Hope* can be seen as a decision to allocate to the political institutions of government near total power. . . ." Pierce, *supra* note 1, at 2046.

34. *Jersey Central*, 810 F.2d 1168.

35. *AT&T*, 836 F.2d 1386.

36. Pierce, *supra* note 1, at 2036-39.

37. *Id.* at 2040-47.

38. See *supra* notes 16-25 and accompanying text.

39. Pierce, *supra* note 1, at 2036.

40. *Jersey Central*, 810 F.2d at 1177-78. For an authoritative review of the cases that, over a hundred year period, established and applied the constitutional standard, see Pond, *The Law Governing the Fixing of Public Utility Rates: A Response to Recent Judicial and Academic Misconceptions*, 41 ADMIN. L. REV. 1 (1989). Pond's article is in sharp disagreement on many points made by Drobak. See *supra* note 29.

Referring ominously to "constitutionally-based micromanagement of utility ratemaking," Pierce, *supra* note 1, at 2036, Professor Pierce's article recounts the rationale of the *Jersey Central* court not as settled doctrine, but as some alien concept being proposed for the first time. *Id.* at 2036-39. The fact is that *Jersey Central* simply applied the end result test and remanded the agency's decision on



Judge Bork's words indicate the critical focus for constitutional purposes is access to the capital markets. This was made clear in the 1923 *Bluefield* case, which stated that a public utility is entitled to charge rates that will permit the company "to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties. . . ."<sup>41</sup> This entitlement does not mean that government guarantees a return. It means that government action will not deny the regulated firm the *opportunity* to earn a return that is "reasonably sufficient to assure confidence in the financial soundness of the utility," and therefore "adequate, under efficient and economical management, to maintain and support [the firm's] credit and enable it to raise the money necessary for the proper discharge of its public duties."<sup>42</sup>

Similarly, the 1944 *Hope* case, which emphasized the "end result" character of the constitutional test, focused on ensuring that the firm could maintain its

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that basis. The careful review of constitutional principles by Judge Bork in his opinion for the en banc court, 810 F.2d at 1175-82, was not challenged by the dissent, *id.* at 1194-1215, which focused on important procedural aspects of the case.

The court's holding stressed the overarching character of the end result test. The test is concerned with the aggregate result of agency action, i.e., "whether the component decisions together produce just and reasonable consequences." *Id.* at 1179. An order "cannot be justified simply by a showing that each of the choices underlying it was reasonable; those choices must still add up to a reasonable result." *Id.* at 1178. In rejecting an agency argument that "because excluding the unamortized portion of a canceled plant investment from the rate base had previously been upheld as *permissible*, any rate order that rests on such a decision is unimpeachable," the D.C. Circuit reasoned that such a theory "would turn our focus from the end result to the methodology, and evade the question of whether the component decisions together produce just and reasonable consequences." *Id.* at 1179 (emphasis in original).

Each component element in a rate order may be perfectly valid, but the Constitution is violated if the total effect is confiscatory. "The fact that a particular ratemaking standard is generally permissible does not *per se* legitimate the end result of the rate order it produces." *Id.* at 1180 (referring to Permian Basin Area Rate Cases, 390 U.S. 747, *reh'g denied*, 392 U.S. 917 (1968)). "In examining the end result of the rate order, [*Permian Basin*] made clear, a court cannot affirm simply because each of the component decisions of that order, taken in isolation, was permissible; it must be the case 'that they do not *together* produce arbitrary or unreasonable consequences.'" *Jersey Central*, 810 F.2d at 1177 (emphasis added) (quoting *Permian Basin*, 390 U.S. at 800).

Similarly, while *AT&T* is an important decision, it propounds no new constitutional principles. In *AT&T* the D.C. Circuit struck down a refund plan developed by the FCC because the plan was internally inconsistent. The parameters and acknowledged effect of the plan itself would make it impossible for a carrier to earn the minimal rate of return prescribed by the agency. The basis for the *AT&T* court's ruling did not directly implicate constitutional questions. The court found the FCC's refund rule to be arbitrary and capricious and therefore in violation of the Administrative Procedure Act, 5 U.S.C. § 706(2)(A) (1982). *AT&T*, 836 F.2d at 1389. Then the court took the unusual step of providing the agency with "guidance" in case it should choose to reformulate its refund rule. Citing *Hope*, 320 U.S. at 602, the court said that the FCC "should explain how [a refund mechanism] that would result in pushing the carriers' total return below a reasonable level would be consistent with the constitutional doctrine that an agency rate order 'viewed in its entirety' must produce a just and reasonable 'total effect' on the regulated business." *AT&T*, 836 F.2d at 1391-92.

Although referred to by Professor Pierce as "revolutionary decisions", Pierce, *supra* note 1, at 2039, *Jersey Central* and *AT&T* are merely applications of long-standing doctrine.

41. *Bluefield*, 262 U.S. at 692.

42. *Id.* at 693.

credit and attract capital.<sup>43</sup> The *Hope* Court stated that the "return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks;" and such return "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. . . ."<sup>44</sup>

*Duquesne Light* explicitly reaffirms this doctrine. Nonetheless, Professor Pierce insists this 1989 decision of the Supreme Court is "ambiguous."<sup>45</sup> In fact, Chief Justice Rehnquist's Opinion for the Court<sup>46</sup> simply restates the constitutional rules underlying *Bluefield* and *Hope*. "The Constitution," according to the *Duquesne Light* Court, "protects the utility from the net effect of the rate order on its property."<sup>47</sup> The Court points out this principle dates back to *Covington & Lexington Turnpike Road Co. v. Sanford*, decided in 1896.<sup>48</sup> Since then, "[t]he guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory."<sup>49</sup> Implicitly sweeping away any claim that this doctrine is a matter of substantive due process,<sup>50</sup> the *Duquesne Light* Court explains the constitutional basis for the doctrine is the fourteenth amendment (Due Process Clause) and the fifth amendment (Just Compensation Clause).<sup>51</sup> "If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments."<sup>52</sup>

As stressed by *Duquesne Light*, the *Hope* case sets out clear and definite constitutional principles that must be respected by federal, state, and local government. Yet Professor Pierce finds *Hope* "at best" ambiguous.<sup>53</sup> He recognizes that the *Hope* Court "did not announce that utility ratemaking was

43. "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling." *Hope*, 320 U.S. at 602 (citations omitted). The statutory standard reflected in the phrase "just and reasonable" has been held to coincide with the constitutional standard. See *Permian Basin*, 390 U.S. at 770; *Federal Power Comm'n v. Natural Gas Pipeline Co. of America*, 315 U.S. 575, 586 (1942) ("*Natural Gas Pipeline*").

44. *Hope*, 320 U.S. at 603 (citations omitted).

45. Pierce, *supra* note 1, at 2036.

46. Only Justice Blackmun dissented, on procedural grounds.

47. *Duquesne Light*, 109 S. Ct. at 619.

48. *Covington & Lexington Turnpike Road Co. v. Sanford*, 164 U.S. 578 (1896).

49. *Duquesne Light*, 109 S. Ct. at 615.

50. See McKenna, *supra* note 4.

51. The Just Compensation Clause of the Fifth Amendment provides: "[N]or shall private property be taken for public use, without just compensation." In *Chicago, Burlington & Quincy Railroad Co. v. City of Chicago*, 166 U.S. 226, 241 (1897), the United States Supreme Court established that the Just Compensation Clause binds state and local government by virtue of the Due Process Clause of the Fourteenth Amendment, which provides: "[N]or shall any State deprive any person of life, liberty, or property, without due process of law. . . ."

52. *Duquesne Light*, 109 S. Ct. at 616. Compliance with the *Bluefield/Hope* standard was not an issue before the *Duquesne Light* Court. See *id.* at 618. Absent a constitutional dimension, the Court would not be drawn into the merits of the "used and useful" issue that was before the Court.

53. Pierce, *supra* note 1, at 2031.

unconstrained by the takings [Just Compensation] clause" but "purported merely to substitute one constitutional test for another."<sup>54</sup> Nonetheless, Professor Pierce's article maintains that *Hope's* end result test "can be seen as a decision to allocate to the political institutions of government near total power to protect the constitutional values underlying the takings clause in the ratemaking context."<sup>55</sup>

The *Hope* case does not speak of "near total power" and it has not been viewed this way by the Supreme Court. For example, Justice Douglas, the author of the *Hope* opinion, wrote an Opinion for the Court in the 1945 *Colorado Interstate*<sup>56</sup> case that insisted the *Hope* test "is not a standard so vague and devoid of meaning as to render judicial review a perfunctory process [but is] a standard of finance resting on stubborn facts."<sup>57</sup>

There is special significance in the above-quoted words of Justice Douglas because of the key role he played in establishing the ground rules under which agencies and courts have operated since 1944. The *Hope* decision emerged after several years of controversy among the Justices as to the impact on rate regulation of the Court's post-1937 philosophy.<sup>58</sup> Justices Black, Murphy, and Douglas argued unsuccessfully in the 1942 *Natural Gas Pipeline*<sup>59</sup> case that rate regulation of public utilities should be subject to the same judicial deference as other forms of regulation.<sup>60</sup> The outcome in 1944 was two decisions written by Justice Douglas: *Hope*, decided January 3, 1944; and, a few weeks later, *Bowles v. Willingham*,<sup>61</sup> which made non-utility rate regulation, i.e. rent control, a subject of virtually complete judicial deference.<sup>62</sup> Citing *Hope*, the *Bowles* Court carefully distinguished non-utility regulation from "other price-fixing statutes [where] Congress has provided for the fixing of rates which are just and reasonable in their application to particular persons or companies."<sup>63</sup> *Bowles* stressed (i) the issue involved federal government action under the War Power, and (ii) the operative federal statute did not implicate a taking issue under the Just Compensation Clause because that statute did not impose a "requirement that the apartments in question be used for purposes which bring them under

54. *Id.*

55. *Id.* at 2046.

56. *Colorado Interstate Gas Co. v. Federal Power Comm'n*, 324 U.S. 581 (1945) ("*Colorado Interstate*"). See also *Pennian Basin*, 390 U.S. at 829-45 (Douglas, J., dissenting); *Jersey Central*, 810 F.2d at 1179 (rejecting an agency claim that the *Hope* standard is merely a limitation on judicial review).

57. *Colorado Interstate*, 324 U.S. at 605 (footnote omitted).

58. See *United States v. Carolene Products Co.*, 304 U.S. 144, 152 & n.4 (1938) ("*Carolene Products*"); Oakes, "Property Rights" in *Constitutional Analysis Today*, 56 WASH. L. REV. 583 (1981); H. ABRAHAM, *FREEDOM AND THE COURT: CIVIL RIGHTS AND LIBERTIES IN THE UNITED STATES* 8-27 (4th ed. 1982).

59. See *supra* note 43.

60. See *Natural Gas Pipeline*, 315 U.S. at 599-608 (Black, Douglas, Murphy, JJ., concurring).

61. *Bowles v. Willingham*, 321 U.S. 503 (1944) (argued within a week of the *Hope* decision and decided at the end of March 1944) ("*Bowles*").

62. *Id.* at 516-18.

63. *Id.* at 517.

the Act.<sup>64</sup> In contrast, the *Hope* Court (i) put aside the 1942 argument of Justices Black, Douglas, and Murphy that public utility regulation should be subject to the same judicial deference as other forms of rate regulation, and (ii) set out a coterminous statutory and constitutional standard that has been interpreted as such, and applied by innumerable agency and court decisions since then.<sup>65</sup>

Professor Pierce erroneously speaks of *Hope* as if it were *Bowles*—an allocation "to the political institutions of government [of] near total power. . . ."<sup>66</sup> Further, he insists the Court "implicitly reaffirmed its decision to allocate near total control over ratemaking to political institutions by refusing to hear any state ratemaking case under the takings clause from 1944 until 1986."<sup>67</sup>

As to the relative inactivity of the federal judiciary in the decades following *Hope*, Professor Pierce's own article provides a plausible explanation that does not require us to reach for a speculative *sub rosa* doctrine. It "is fair to draw the inference that the Court saw no political malfunction in the ratemaking process so severe that it justified the significant commitment of judicial resources that its experience from 1898 to 1944 had shown was necessary to constrain the process."<sup>68</sup>

Indeed, the Supreme Court over the past several decades may have simply preferred to expend its resources elsewhere. The Court may have believed that the system of public utility regulation was operating reasonably well and did not need closer scrutiny. Today, given the massive political failure described by Professor Pierce, the Court is willing to take a closer look. This does not indicate a change in doctrine, but rather a response by a different set of Justices to a different environment. Nothing in *Duquesne Light* suggests that any of the Justices believe a new doctrine has been articulated. Furthermore, Chief Justice Rehnquist's opinion stresses the consistency of the doctrine since 1896.<sup>69</sup>

64. *Id.* at 513, 517. The statute specified that "nothing in this Act shall be construed to require any person to sell any commodity or to offer any accommodations for rent." *Id.* at 517. In contrast, public utilities are not entitled simply to abandon an unprofitable service. See Drobak, *Constitutional Limits on Price and Rent Control: The Lessons of Utility Regulation*, 64 WASH. U.L.Q. 107, 110-11, 120 (1986).

65. See *supra* notes 29 & 43.

66. Pierce, *supra* note 1, at 2046.

67. *Id.*

68. *Id.*

69. In addition to *Covington* and *Hope*, the Court cites *Federal Power Comm'n v. Texaco Inc.*, 417 U.S. 380, 391-92 (1974). *Duquesne Light*, 109 S. Ct. at 615-16.

The dramatic contrast between treatment, in constitutional terms, of public utility regulation and non-utility regulation is clearly shown in two recent Opinions for the Court by Chief Justice Rehnquist: (1) *Duquesne Light* and (2) *Pennell v. City of San Jose*, 485 U.S. 1 (1988) (rent control). Professor Drobak suggests the Court should decide that utility-type safeguards will apply to rent control. See Drobak, *supra* note 64, at 138-39. A similar recommendation has been made by the co-author of this Article. See McKenna, *Paradox, Asymmetry, and Switcheroos: Approaching Constitutional Law from an Unexpected Angle*, 23 MARSHALL L. REV. 333, 348-49 (1990).

Professor Drobak's article reviews at length the difference in treatment between *Hope/Duquesne Light* and *Bowles/Pennell*, observing: "The *Hope* standards assure that adequate compensation . . . is

Nonetheless, arguing for a less active role of the federal judiciary, Professor Pierce describes both *Duquesne Light* and *Hope* as ambiguous; and he counts himself among "those who continue to interpret *Hope* as a signal of de facto judicial retreat from constitutional review of ratemaking" rather than among "those who find in *Hope* the seeds of a constitutional law doctrine that imposes significant judicial constraints on the political institutions controlling utility ratemaking."<sup>70</sup>

Far from being ambiguous, *Duquesne Light's* simple declarative sentences set forth constitutional doctrine with admirable clarity. In explicit terms, the *Duquesne Light* Court presents the *Hope* principle as "a constitutional law doctrine that imposes significant judicial constraints on the political institutions controlling utility ratemaking." Surprisingly, Professor Pierce does not even find "the seeds" of such a doctrine in *Hope*.<sup>71</sup>

Surely, when the Supreme Court sets forth principles specifically identified in constitutional terms, the Justices intend courts, agencies, and practitioners to rely on them. The *Duquesne Light* Court's language must be read for what it purports to be: an explicit statement of essential principles grounded in the Constitution—principles that must be respected by federal, state, and local government.

#### IV. THE MUTUALLY REINFORCING EFFECTS OF THE CAPITAL MARKETS AND CONSTITUTIONAL PRINCIPLES

Professor Pierce discusses at length the difficulties that would arise if the federal courts actively applied the *Bluefield/Hope* standard.<sup>72</sup> However, he gives little or no weight to the critical role played by the operation of the capital markets.<sup>73</sup> He implies the judicial process must carry the entire burden of preventing confiscatory regulation. But experience indicates the constructive influence of the capital markets can make the task of regulators and jurists more manageable.

The dismal history of confiscatory action in matters involving nuclear power plants recounted by Professor Pierce shows that a rational process of regulation may be virtually precluded by an explosive political environment. This experience has taught that the influence of the capital markets by itself cannot

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provided through utility rates. On the other hand, . . . there is no requirement that price control schemes satisfy the *Hope* standards or generate profits at all." Drobak, *supra* note 64, at 109-10. Nonetheless, contrary arguments persist. See Darr, *The Constitutional Limits on Ratemaking: A Response to William [Walter] Pond*, 11 ENERGY L.J. 53 (1990).

70. Pierce, *supra* note 1, at 2033.

71. *Id.* Cf. cases cited *supra* note 4.

72. Pierce, *supra* note 1, at 2053-70.

73. See, e.g., Pierce, *supra* note 1, at 2062-63 & n.169. The passing references to the capital markets in Professor Pierce's article do not recognize their constructive influence. A variety of firms issue credit ratings for public utilities and also rate the impact of regulation in each jurisdiction. These ratings, which are the stuff of day-to-day reporting in the news media, both reflect and influence capital market reactions.

be expected to withstand a popular tantrum that respects no rules.<sup>74</sup> But it would be wrong to say this influence is not a factor at all. After all, our government has close to a hundred years of experience with utility regulation. This history shows that confiscatory action by government can be constrained by a combination of two mutually-reinforcing elements: (i) timely and effective constitutional enforcement, and (ii) the operation of the capital markets.

Indeed, the functioning of the capital markets is integral to the constitutional standard. Just as the capital markets give weight to constitutional protection in assessing risk, the constitutional standard focuses on ensuring that the public utility firm will be able to meet its financing needs. As stressed in Section III above, the standard mandates that government action not deny the regulated firm the opportunity to earn a return that is "reasonably sufficient to assure confidence in the financial soundness of the utility," and is "adequate, under efficient and economical management, to maintain and support [the firm's] credit and enable it to raise the money necessary for the proper discharge of its public duties."<sup>75</sup> The allowed return "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. . . ."<sup>76</sup>

Putting it simply, if the risk and return associated with a utility investment is not competitive with other options available to the capital markets, the flow of investment funds stops. In order to restart that flow, the risk associated with the investment and/or its return must be adjusted to make the investment more competitive. This simple reality compels regulators to recognize that agency actions such as holding rates below the level of cost (ostensibly to benefit the public) will quickly prove self-defeating because, as the firm's cost of capital increases, there will be upward pressure on rates.

For example, assume the capital markets perceive an increase in risk as a result of the kind of regulatory action just described. This increased risk makes investment in either the regulated firm's equity or its debt less attractive to the investor. If the alternative investment options available to the investor continue to be (at least) as attractive as they were, then this increase in risk should cause the capital markets to decline investment in the firm without (i) a reduction in

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74. For court action curbing confiscatory tantrums, see *Seawall Associates v. City of New York*, 74 N.Y.2d 92, 542 N.E.2d 1059, 544 N.Y.S.2d 542, *cert. denied*, 110 S. Ct. 500 (1989) (hotel property); *Calfarm Insurance Co. v. Deukmejian*, 48 Cal. 3d 805, 258 Cal. Rptr. 161, 771 P.2d 1247 (1989) (California's Proposition 103). See also McKenna, *supra* note 69, at 343 (rent control):

[I]n New York City . . . a very unamusing paradox was policy ostensibly adopted for the benefit of the poor that eliminated housing that could accommodate the poor. The consequences of confiscatory regulation are visible in dramatic form in the Bronx Ruin—mile after mile of burned-out hulks and rubble where there once stood a thriving city.

*Id.* (footnotes omitted).

75. *Bluefield*, 262 U.S. at 693.

76. *Hope*, 320 U.S. at 603 (citations omitted).

risk and/or (ii) an improvement in the interest to be paid on debt or the anticipated return on equity shares. As the resulting increase in the firm's real capital costs affects rates, it will defeat the supposed benefit of setting rate levels below costs. If this real cost increase is not permitted to affect rates in the first instance, the cycle renews itself, with the capital markets reacting to still another regulatory action restricting the return and increasing risk.

Knowledgeable and responsible regulators are fully aware of these realities. When regulators are permitted to function, public utility regulation limits the investor to an appropriate return without producing the destructive effects of confiscatory regulation. Thus, the inherent dynamics of the public utility system operating as part of a capitalistic society exert, over time, heavy pressure in the direction of responsible decisionmaking. For this reason, judicial action requiring compensatory rates follows the logical flow of events. The typical effect of judicial action when it does come into play is that sensible regulators are compelled to do what they know is necessary in the public interest.

However, the political process may impede responsible decisionmaking. As stressed by Professor Pierce, the mass of voters, who know little about the sophisticated system of public utility regulation, may be manipulated by symbols designed to stimulate hostility toward the companies. Public utilities can then become "easy and safe targets for opportunistic behavior by the majority and for exploitation by politicians."<sup>77</sup> This kind of manipulation has led to breakdowns in the system. It is also true that the system has withstood these pressures in countless cases.

As long as there is a perceived likelihood that the courts in enforcing the Constitution will take timely and effective action to counteract confiscatory decisions, the arguments of responsible participants in the political debate will be reinforced. Then, irresponsible participants arguing for confiscatory regulation will be faced with two mutually supporting obstacles: the threat of constitutional enforcement and the influence of the capital markets. For nearly a hundred years, this combination has been successful in a wide range of situations—through prosperity, inflation, and depression. On the other hand, where timely and effective constitutional enforcement disappeared as a practical matter, the outcome has been disastrous.<sup>78</sup> Professor Pierce's own paper substantiates this conclusion.<sup>79</sup>

The interrelated nature of constitutional principles and capital market reaction means that effective enforcement of these principles would not create the immense burdens and complications outlined by Professor Pierce. Long experience with utility regulation indicates that, if the courts act in a firm and timely way, respect for the Constitution and protection of the public interest can

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77. Pierce, *supra* note 1, at 2048.

78. Timeliness of judicial action against confiscation is central to its effectiveness. As indicated by the bitter dispute among the judges about "mere" procedure reflected in *Jersey Central*, if a reviewing court postpones action until every possible procedural nicety is taken care of, this may be tantamount to denying protection.

79. See *supra* Section I.

be maintained with a relatively modest dedication of judicial resources. Again, Professor Pierce's own essay confirms this point. He recounts the relative inactivity of the federal judiciary over the last forty years—a period during which public utility regulation escaped the kind of public policy catastrophe reflected in the Bronx Ruin.<sup>80</sup> Nonetheless, Professor Pierce would prefer the federal judiciary to return to its prior inactivity with respect to claims of confiscatory regulation. This Article responds by pointing out that his own statement of recent history indicates the need for effective and timely enforcement of long-established constitutional standards.

When reconciling these contrasting points of view, a key consideration is how any alternative would affect the Supreme Court's mission. Sound jurisprudence recognizes that the federal judiciary, and most of all the Supreme Court, should not be swamped by trivial cases.<sup>81</sup> The Court today has virtually complete discretion in controlling its agenda.<sup>82</sup> Its challenge is to employ this discretion by focusing its resources to ensure that the most critical and urgent matters receive due attention.

For these reasons, the Supreme Court applies various levels of scrutiny.<sup>83</sup> As discussed above, the federal courts afford immense deference to non-judicial government in the case of economic regulation of non-utilities. On the other hand, since public utilities are so vulnerable to arbitrary action of government, and the services that utilities provide are so critical to the functioning of society as a whole, a higher level of scrutiny is applied—as confirmed by *Duquesne Light*.

If one assumes, as implied by Professor Pierce's essay, that every case of alleged confiscatory regulation of a public utility would have to be exhaustively litigated, the burden on the courts would be formidable. But the great majority of issues in cases involving state regulation are resolved at the state level. An important factor leading to this result is the Johnson Act of 1934, which closed off the lower federal courts to utilities claiming confiscatory state action.<sup>84</sup>

Furthermore, agency, utility, and reviewing courts are united by a common interest in maintaining a favorable position of the enterprise vis-à-vis the capital markets, for all the reasons discussed above. It is this felicitous combination of interests that has permitted the system of utility regulation to function reasonably well in preventing confiscation, with one critical proviso: *provided the judiciary requires government to comprehend and respect the dynamics of the system*. The last forty years demonstrate that this can be accomplished with a fairly light commitment of Supreme Court resources, so long as there is timely action by lower courts applying the keystone principles to living enterprises functioning as

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80. See *supra* note 74.

81. See generally Komesar, *A Job for the Judges: The Judiciary and the Constitution in a Massive and Complex Society*, 86 MICH. L. REV. 657 (1988).

82. See 28 U.S.C. §§ 1254, 1257 (1988).

83. See *supra* note 58.

84. Johnson Act of 1934, 28 U.S.C. § 1342 (1988).



part of a dynamic system. However, where the judiciary fails to carry out its role, the system fails, and society suffers grave consequences. This is precisely what Professor Pierce illustrates through his grim history of confiscatory decisions.<sup>85</sup>

#### V. REFORMS INITIATED BY THE FCC AND THE CALIFORNIA COMMISSION

Professor Pierce's position is comprised of a number of self-contradictory elements. Finding ambiguity in *Duquesne Light* as well as *Hope*, he claims the Supreme Court's explicit statements of constitutional doctrine should not be taken at face value; rather, he assumes a *sub rosa* doctrine of near-absolute deference. He presents a persuasive case showing confiscatory action on a massive scale with grave consequences, and argues that this danger is an

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85. Why did the nuclear power plant fiasco described by Professor Pierce occur? This is a complex question beyond the scope of this Article and the expertise of its authors. We can only suggest that public utility regulation is designed to function in a reasonably predictable world of modest incremental changes and relatively low risk. It is this low risk that justifies a reasonably limited return. See, e.g., Justice Brandeis' seminal concurring opinion in the *Southwestern Bell* case, *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Comm'n of Missouri*, 262 U.S. 276, 289 (1923) (Brandeis, J., concurring, joined by Holmes, J.):

To give to capital embarked in public utilities the protection guaranteed by the Constitution, and to secure for the public reasonable rates, it is essential that the rate base be definite, stable, and readily ascertainable. . . .

....

In speculative enterprises the capital cost of money is always high. . . . It is to the interest both of the utility and of the community that the capital be obtained at as low a cost as possible.

*Id.* at 292, 307.

The decades-long controversy over the desirability of nuclear power plants has introduced dramatic increases in investor risk because:

(1) The construction of nuclear power plants involved vast undertakings making use of advanced technology and implemented over long periods of time; and, during construction, government safety standards and policies kept changing, thereby further extending construction and increasing cost. Inevitably, under these circumstances, a hostile review of management performance produced arguable failures that could form a basis for penalties.

(2) Federal/state policy conflict led to state and local government action denying the cooperation which is indispensable to obtaining a federal operating license; and then, regulatory action under intense political pressure denied recovery of invested capital based on the fact that a federal operating license had not been obtained.

(3) Judicial intervention was postponed to a stage far too late to exercise any constructive influence. See *Jersey Central*, 810 F.2d 1168; *Long Island Lighting Co. v. Cuomo*, 666 F. Supp. 370 (N.D.N.Y. 1987); *County of Suffolk v. Long Island Lighting Co.*, 710 F. Supp. 1387 (E.D.N.Y. 1989), *aff'd*, 907 F.2d 1295 (2d Cir. 1990).

The regulated enterprise is able to present to the capital markets an investment option that is competitive with other available options so long as the relatively low risk associated with that enterprise offsets the regulatory limits that restrict its return. Conservative investors will accept reasonably limited returns where risk is perceived to be low. Adventurous investors will accept higher risk for the sake of a generous return. But an investment option that—in comparison with other available options—is perceived to combine high risk and low return is not competitive, and the capital markets will not pursue that option unless it is improved by some combination of better return or lower risk.

The pattern of confiscatory regulation discussed in Professor Pierce's essay simultaneously limited the utility's return while dramatically increasing risk. He correctly concludes future ratepayers will bear higher capital costs because of the increased risk associated with this type of investment.

important risk necessarily associated with utility regulation. He then insists that the public interest requires the federal judiciary to return to a generally inactive role. Finally, his article overstates the difficulties of applying the Constitution by not recognizing the mutual reinforcement of constitutional doctrine and capital market influence.

The political malfunction he describes should lead to a different recommendation. The solution is reform of the regulatory process to correct its deficiencies—but reform that operates in harmony with constitutional principles. This subject will be addressed below in the context of regulatory initiatives in the field of telecommunications.

The FCC and California commission are pursuing innovative approaches to regulation that respect constitutional principles. Enlightened federal and state regulators are now addressing regulatory reform. Illustrations are available which demonstrate how the drawbacks of utility regulation can be dealt with through reforms that recognize constitutional principles. Plans developed by the FCC and by the California commission are designed to attain this result.

While public utility regulation, properly applied, has served the purpose of preventing both confiscatory regulation and excessive returns, the system suffers from a number of recognized deficiencies. Professor Pierce, the FCC, and the California commission have discussed the same essential drawbacks of conventional public utility regulation.<sup>86</sup> Conventional regulation suppresses the dynamic process that produces socially beneficial results in a competitive environment, and actually discourages the regulated firm from behaving in a socially beneficial way. Conventional regulation creates distorted incentives that reward inefficient operation. For example, it provides short term incentives to increase plant investment, rather than promoting efficient use of existing company facilities. Where the firm provides a variety of services, and some of those services are more competitive than others, conventional regulation raises intractable problems of cost allocation and cross-subsidy. Finally, such regulation may produce perverse incentives that discourage innovation.<sup>87</sup>

The plans developed by the FCC<sup>88</sup> and the California commission are each

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86. See Pierce, *supra* note 1, at 2058-61; *Report & Order*, 4 F.C.C. Rcd. at 2889-2913; *California Interim Opinion*, 107 Pub. Util. Rep. 4th (PUR) at 46-69.

87. See *Report and Order*, 4 F.C.C. Rcd. at 2889-92.

88. In principle, the FCC's price caps plan for Local Exchange Carriers ("LECs"), see *Report & Order*, 4 F.C.C. Rcd. at 2893-96, works this way:

(1) A carrier's services are grouped together in accordance with common characteristics.

(2) Certain limits ("price caps") are established at the outset on the firm's pricing for appropriate groupings of services.

(3) The weighted prices in each grouping are adjusted annually pursuant to formulas designed to reflect changes in the carrier's input costs, with changes measured with reference to the Gross National Product Price Index ("GNP-PI") because this "recognized, government-administered index . . . reflects broad-based input cost changes experienced by dominant carriers more accurately than the more commonly known Consumer Price Index." *Id.* at 2893-94.

(4) Based on industry experience, included in the formula is a productivity factor, so that the formula will exert constant downward pressure on rates.

(5) Provision is made for adjusting rates to reflect specified kinds of costs that are beyond a

designed to avoid these unfortunate effects.<sup>89</sup> In each case, a carrier's rates as they exist at the outset of the plan may be adjusted annually by a mechanism keyed to the Gross National Product Price Index ("GNP-PI")<sup>90</sup> and historic annual productivity improvement in the exchange carrier industry. Furthermore, there is a provision for sharing these consequences among ratepayers and investors in the event that actual results prove to be more or less favorable than intended. Also, should exogenous changes develop,<sup>91</sup> there are provisions enabling the commission to reflect the impact of these changes in the carrier's rates. These plans are designed to (i) facilitate rate reductions year by year, and (ii) replace the perverse incentives of conventional regulation with a set of constructive incentives that will reward rather than punish the regulated firm for conduct that better serves the public interest.

It is important to note how the FCC and the California commission plans—in contrast with Professor Pierce's approach—make explicit provision for compliance with constitutional standards. The FCC declares that its incentive plan is designed to operate in harmony with the coterminous statutory and constitutional standard reflected in the Communications Act.<sup>92</sup> Emphasizing the broad

carrier's direct control.

In a nutshell, the price caps plan the FCC has implemented for AT&T, and is moving to implement for LECs starting in 1991, not only holds the line on prices, it pressures the firm to reduce prices over time in accordance with historic industry improvements in productivity.

After the preparation of this Article, the FCC adopted a plan for LECs comporting with the foregoing description, with an added feature that contemplates a sharing with the ratepayer of LEC profitability beyond a specified level. See Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, No. 87-313 (F.C.C., adopted Sept. 19, 1990) (LEXIS, Fedcom library, FCC file).

One must expect that in any case the plan will be appealed to the courts. For the view that the FCC's plan is likely to be upheld on appeal, see Ghosh, *The Future of FCC Dominant Carrier Rate Regulation: The Price Cap Scheme*, 41 FED. COMM. L.J. 401, 430 (1989).

89. The California plan only applies to the two largest LECs in California, Pacific Bell and GTE California Incorporated. The plan, which went into effect in January 1990, is a modified "price caps" approach that constrains the LECs' profits through annual rate updates coupled with a sharing mechanism. *California Interim Opinion*, 107 Pub. Util. Rep. 4th (PUR) at 13-15.

The regulatory framework of the plan is centered around a price cap indexing mechanism with sharing of excess earnings above a benchmark rate of return level. For pricing purposes, the LECs' services are divided into three categories: Category I embraces "basic monopoly" services, and their rates can be changed only with commission approval; Category II embraces services that are either discretionary or partially competitive, and the plan provides the LEC with downward pricing flexibility as to these services; Category III services—consisting of computer-enhanced services, Yellow Page directory advertising services, inside wiring services, and other services found to be fully competitive—enjoy the maximum pricing flexibility allowed by law. *Id.*

90. The GNP-PI is one of a number of GNP-based price indices published by the United States Department of Commerce. It "utilizes an historical base period (currently 1982), and summarizes price changes in all sectors of the economy. . . ." *Further Notice*, 3 F.C.C. Rcd. at 3390.

91. Such exogenous changes, i.e., beyond a carrier's direct control, could include government action altering the Uniform System of Accounts or altering the Separations Manual (separating costs related to intrastate service, regulated by the states, from those related to interstate service, regulated by the FCC). See *Report & Order*, 4 F.C.C. Rcd. at 3188-90. See also *California Interim Opinion*, 107 Pub. Util. Rep. 4th (PUR) at 14.

92. The Communications Act of 1934, 47 U.S.C. §§ 151-613 (1988). See *id.* §§ 201(b), 202(a). See generally *Further Notice*, 3 F.C.C. Rcd. at 3294-3306 (the FCC's discussion of legal authority). Addressing the coterminous "just and reasonable" standard, see *supra* note 43, the FCC states: "courts evaluate whether the end results of particular regulatory schemes produce rates that fall within a 'zone

discretion granted to a rate-regulating agency under *Hope's* end result test,<sup>93</sup> the FCC describes its plan as "moored to the statutory scheme."<sup>94</sup> The FCC maintains it is not departing from the statutory mandate, but merely seeking a better way to execute that mandate.

There is similar respect for constitutional principles reflected in the California plan, which is designed to comply with the requirements of state and federal statutes and constitutions.<sup>95</sup> "[T]he adopted regulatory framework allows [the LECs] a reasonable opportunity to earn a reasonable rate of return on their investments and thus is not confiscatory."<sup>96</sup> This opportunity is provided inasmuch as the plan "indexes rates for basic monopoly services and rate caps for flexibly priced services by the GNP-PI offset by a productivity target."<sup>97</sup> "With the protection of additional adjustments for exogenous factors," the California commission concludes, "this indexing approach will provide a reasonable estimate of revenues needed to compensate the utilities for their costs of providing these services."<sup>98</sup> Moreover, recognizing that the plan might result in "greater variability in earnings than under the traditional rate-of-return approach," the commission has "determined that the market-based rate of return is somewhat above that which would have been reasonable under traditional ratemaking."<sup>99</sup> Taking this point one step further, the California commission—observing "that the adopted productivity adjustment is a 'stretch' target"—has said it will prescribe "a benchmark rate of return somewhat above the market-based rate of return."<sup>100</sup> Accordingly, the California commission decided that:

[T]he utilities may keep all earnings from basic monopoly, flexibly priced, directory advertising, and inside wiring services up to that level if they meet and exceed the productivity target, and may further retain half of any earnings above the benchmark rate of return up to a cap.<sup>101</sup>

"This balanced regulatory package," the California commission maintains,

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of reasonableness.'" *Id.* at 3297 & n.351 (citing *Pennzoil*, 439 U.S. at 517; *Jersey Central*, 810 F.2d at 1168; *AT&T*, 836 F.2d at 1386). "For rates to fall within the zone of reasonableness," the FCC continues, "the agency rate order must constitute a 'reasonable balancing' of the 'investor interest in maintaining financial integrity and access to capital markets and the consumer interest in being charged non-exploitative rates.'" *Id.* at 3297 & n.352 (citing *Jersey Central*, 810 F.2d at 1177-78; *Pennzoil*, 439 U.S. at 517).

93. *See supra* note 43.

94. *Further Notice*, 3 F.C.C. Rcd. at 3300.

95. *See California Interim Opinion*, 107 Pub. Util. Rep. 4th (PUR) at 164-68.

96. *Id.* at 167.

97. *Id.* at 166.

98. *Id.*

99. *Id.*

100. *Id.* at 166-67.

101. *Id.* at 167.

provides the LECs "not only with a reasonable opportunity to earn a reasonable rate of return on these services but also with an opportunity to earn returns *above* market levels if they cut costs and otherwise respond to efficiency incentives in the new framework."<sup>102</sup> With periodic reviews to allow reflection in rates of productivity trends in a timely fashion, the agency concludes that its plan "is likely to be more effective than the current general rate case approach in maintaining reasonable and stable rates for basic telecommunications services."<sup>103</sup>

As the forgoing discussion shows, the plans adopted by the FCC and California commission are designed to work in harmony with coterminous statutory requirements and constitutional principles.

#### CONCLUSION

This Article challenges Professor Pierce's treatment of constitutional principles governing public utility regulation. As recently as the 1989 *Duquesne Light* case, the United States Supreme Court has carefully articulated these principles. "The Constitution protects the utility from the net effect of the rate order on its property."<sup>104</sup> The guiding principle is that "the Constitution protects utilities from being limited to a charge for their property serving the public which is so 'unjust' as to be confiscatory."<sup>105</sup> Thus, where state action is involved, "[i]f the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments."<sup>106</sup> These explicit statements of constitutional doctrine negate Professor Pierce's suggestion that the Court's intent is to allocate to political institutions "near total power" regarding ratesetting.<sup>107</sup>

Furthermore, the pattern of confiscatory regulation recounted by Professor Pierce underscores the need for this doctrine, and for its timely and effective application. He is quite correct in stressing the risk that a politicized environment may cause confiscation, and in highlighting the destructive consequences of confiscatory regulation. However, his article fails to recognize that many decades of experience show how the successful interplay of capital market influence and timely judicial action can prevent confiscation. These considerations should lead not to judicial abdication, but to greater emphasis on assuring compliance with the Constitution.

Finally, the regulatory reforms being implemented in the telecommunications industry by the FCC and the California commission show that the recognized shortcomings of public utility regulation can be dealt with effectively through

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102. *Id.* (emphasis in original).

103. *Id.*

104. *Duquesne Light*, 109 S. Ct. at 619.

105. *Id.* at 615.

106. *Id.* at 616.

107. Pierce, *supra* note 1, at 2046.

**policies operating in harmony with the constitutional principles established and consistently interpreted by the United States Supreme Court.**

## POSTSCRIPT

*A. Synopsis of Professor Pierce's Article\**

In *Public Utility Regulatory Takings: Should the Judiciary Attempt to Police Political Institutions?*,\*\* Professor Pierce argues that reinvigorated judicial review of the constitutionality of utility rate decisions offers little promise of improved performance of regulated industries. Professor Pierce begins by surveying the applicable precedents. He characterizes the Supreme Court's 1944 opinion in *Federal Power Commission v. Hope Natural Gas*\*\*\* as establishing a vague and ambiguous standard of constitutionality that is difficult to apply. From the Court's refusal to grant certiorari in state utility rate cases in the forty years following its opinion in *Hope*, Professor Pierce draws the inference that *Hope* represented a *de facto* withdrawal from the judiciary's prior attempts to enforce the Just Compensation Clause in the utility regulatory context. Professor Pierce notes several recent developments, however, that suggest the Court is now considering reentry into the business of constraining state utility regulation through meaningful judicial application of the Just Compensation Clause. He devotes the rest of the article in an attempt to answer the question whether renewed judicial involvement is justified by recent trends in state utility ratemaking.

Professor Pierce suggests a test to determine whether aggressive judicial enforcement of a constitutional constraint on politically accountable institutions is justified, given the limited institutional competence and resources of the Judicial Branch. According to Professor Pierce, the judiciary should become actively involved in constraining government conduct when: (i) there is evidence of a serious political malfunction in some important area of government action; and (ii) there is reason to believe that the judiciary can correct or curb that malfunction at tolerable costs with scarce judicial resources and with a tolerably low risk of judicial errors. Based on an empirical analysis of state electric utility rate decisions from 1984 through 1989, Professor Pierce concludes that this important area of government decisionmaking has been afflicted by the serious political malfunction of majoritarian bias. State regulators have engaged in massive opportunistic "takings" of utility capital investments in response to populist antipathy toward proposed rate increases. Moreover, this systematic pattern of behavior has created an environment in which utilities are unwilling to make the capital investments necessary to assure that the nation will have an adequate supply of electricity in the future.

Turning to the second part of his proposed test, however, Professor Pierce

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\* Professor Pierce authored the Synopsis of his Article.

\*\* Pierce, *Public Utility Regulatory Takings: Should the Judiciary Attempt to Police Political Institutions?*, 77 GEO. L.J. 2031 (1989).

\*\*\* Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944).

reluctantly concludes that the judiciary is ill-equipped to constrain state regulators from "taking" utility property through the ratemaking process. He notes that regulators have employed three different doctrines in the process of "taking" scores of billions of dollars from utilities. He argues that these three doctrines have a high degree of functional interchangeability. Thus, the courts cannot expect to limit state regulatory discretion to "take" utility property unless they are able to enforce effective limits on the power of state agencies to apply all three doctrines. Given the technical complexity of utility ratemaking and the critical role played by agency findings of unverifiable and elusive "facts," Professor Pierce expresses great doubt that the federal judiciary is capable of such a daunting task. Moreover, he expresses concern that judges are likely to introduce new sources of distortion into the regulatory system because of their limited ability to understand the complicated ways in which utility ratemaking doctrines interact.

Professor Pierce tempers the pessimism evident in the text of his article by adding an optimistic concluding hypothesis. He notes that electric utility ratemaking was afflicted with the political malfunction of minoritarian bias during the 1950s and 1960s. Utilities were able to use the complicated state regulatory process to "take" property from consumers by exploiting their power as ineffectively regulated monopolies. Pierce links that systematic utility success in the state regulatory process with electric utilities' traditional adamant opposition to all legislative and regulatory efforts to permit competition in the electricity market. The recent pattern of state victimization of electric utilities has caused many firms to reevaluate their position on the merits of competition versus regulation. Many utilities have become more willing to accept competition in the wholesale electricity market in return for some degree of insulation from the threat of opportunistic regulatory takings by state agencies. This change in attitude by electric utilities has had the salutary effect of increasing the political viability of the Federal Energy Regulatory Commission's proposals to restructure regulation of the industry to allow market forces to displace regulation as the primary determinant of the price of electricity.

### *B. Professor Pierce's Comments*

The authors of this Article sent a draft to Professor Pierce asking for his comments. He responded with a very courteous letter, which in relevant part is quoted below:

Thank you for favoring me with a copy of your manuscript. I am flattered that you considered my article worthy of response, and I think your response will be a worthy contribution to the dialogue in this important area. I found nothing "unfair" or "inaccurate" in your response, but I will accept your invitation to make a few comments.

...

I was a bit surprised at your characterization of my position [at



page 86] as "insisting" utility investors be denied constitutional protection. The characterization is not inaccurate, but I hoped to convey more a flavor of reluctant acquiescence in the extremely limited ability of the courts to perform this theoretically desirable function.

[Y]ou note accurately [at page 85] that the electric utility industry is financially healthy as a whole. Unfortunately, this is true only because electric utilities have ceased making any significant investments in assets that are subject to state regulation. That is not a very socially desirable route to financial health.

[Y]ou note [at page 86] that hundreds of state courts have cited and applied *Hope* and *Bluefield*. Your reference to state court review fills an unfortunate gap in my article. I left the gap, however, largely because I do not share your faith in state courts *when exogenous factors threaten very large rate increases*. I have encountered only a couple of cases in which state courts have reversed or remanded state agency decisions disallowing investments in new generating plants. State courts have *contributed* to the problem of regulatory takings from investors to a greater extent than they have protected investors from regulators. Consider, for instance, the decisions of the Supreme Courts of Pennsylvania, Mississippi, and Ohio that required state PUCs to disallow investments the PUCs had attempted to allow.<sup>\*\*\*\*</sup> The troublesome phenomenon I describe arises only when exogenous forces create large cost increases. When that happens, however, as it can in any regulated industry, most state courts are unlikely to provide investor protection from populist wrath.

[Y]ou attach considerable significance to [*Duquesne Light*]. . . . Why should we take [*Duquesne Light*] seriously when the court denies cert. in all of the large dollar cases, e.g., *Public Service of New Hampshire* and the two big Ohio cases?<sup>\*\*\*\*\*</sup> Once Lewis Powell left, I think the Court lost its enthusiasm to enter this area. Powell was the only Justice pushing hard to get the Court back in the fray. Also, what can the courts do about the scores of cases in which state PUCs disallow investments based on disingenuous findings of imprudence? [*Duquesne Light*] does not address that part of the problem at all.

[Y]ou discuss *Jersey Central* and *AT&T* [at page 87] We simply

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\*\*\*\* The cases Professor Pierce had in mind were: (i) *Barasch v. Pennsylvania Pub. Util. Comm'n*, 516 Pa. 142, 532 A.2d 325 (1987); (ii) *Mississippi ex rel. Pittman v. Mississippi Pub. Serv. Comm'n*, 506 So. 2d 978 (Miss. 1987); (iii) *Office of Consumer Counsel v. Public Util. Comm'n*, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981), *appeal dismissed*, 455 U.S. 914 (1983).

\*\*\*\*\* The cases Professor Pierce had in mind were: (i) *In re Public Service Co. of New Hampshire*, 130 N.H. 265, 539 A.2d 263 (1988), *appeal dismissed*, 109 S. Ct. 858 (1989); (ii) *Cleveland Elec. Illuminating Co. v. Ohio Pub. Util. Comm'n*, 4 Ohio St. 3d 107, 447 N.E.2d 746, *appeal dismissed*, 464 U.S. 802 (1983); and (iii) *Office of Consumer Counsel v. Public Util. Comm'n*, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981), *appeal dismissed*, 455 U.S. 914 (1982).

disagree on the proper characterization of those opinions. I agree completely with your discussion of capital markets [at pages 92-95].

Finally, [at pages 96-100] you discuss price caps. You probably will not like my skeptical treatment of price caps in the enclosed article. It will be published soon in *Northwestern Law Review*, along with a response by Hillman and Braeutigam.

Thanks again for giving me the opportunity to comment on your manuscript.

### C. Response to Professor Pierce's Comments

The questions about the risks and uncertainties of price caps regulation Professor Pierce raises in his letter and his article, *Price Level Regulation Based on Inflation is not an Attractive Alternative to Profit Level Regulation*,<sup>\*\*\*\*\*</sup> are well taken. By no means was it the intent of this Article to present the price caps concept as a panacea. Only time will tell whether alternative approaches to regulation such as price caps will prove to be effective in controlling rates while assuring the utility a reasonable opportunity to recover its costs, including the cost of capital.

For all of its faults, the current system of regulation has provided telephone companies with a considerable degree of protection from confiscation. The essential point of this Article is that any alternative system should be crafted to continue and improve this protection. The authors believe that this can be accomplished. The FCC and California plans illustrate how this might be approached.

No doubt the authors are influenced by their experience representing telephone companies. The telephone industry has not had to face the massive confiscation of investment that has afflicted power companies in connection with nuclear plants. In view of this relatively good experience with conventional regulation over a long period of time, it is very significant that the telephone industry has been, by and large, more than willing to support the FCC's price caps proposal and similar initiatives at the state level. The recognized deficiencies of the current system of regulating rates make alternative regulation attractive. Not only does the current system tolerate economic inefficiencies, its built-in perverse incentives stimulate inefficiencies. Facing ever-increasing competition, telephone company management is trying to escape from this kind of regulation. Consequently, telephone companies are willing to face the uncertainties of "incentive regulation." In the months and years to come, the outcome of this virtually nationwide experiment will emerge from the fire of actual experience.

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\*\*\*\*\*Pierce, *Price Level Regulation Based on Inflation is not an Attractive Alternative to Profit Level Regulation*, 84 NW. U.L. REV. 665 (1990). See also Hillman & Braeutigam, *The Potential Benefits and Problems of Price Level Regulation: A More Hopeful Perspective*, 84 NW. U.L. REV. 695 (1990).

