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Transition Losses in the Electric Power Market: A Challenge to the Premises Underlying the Arguments for Compensation

Lois R. Lupica

University of Maine School of Law, lupica@maine.edu

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TRANSITION LOSSES IN THE ELECTRIC POWER MARKET: A CHALLENGE TO THE PREMISES UNDERLYING THE ARGUMENTS FOR COMPENSATION

*Lois R. Lupica**

In this Article, Professor Lois R. Lupica examines whether the electric utility industry, currently in the midst of deregulation, ought to sustain the resulting transition losses. Due to the significant modification of legal rules affecting the electric power market and changes in regulatory policy, the utilities currently have expenditures and expectations that are unrecoverable in a competitive market. In recent years, momentum has moved in the direction of compensating the electric utilities and their investors for these losses. Professor Lupica challenges the arguments for transition loss recovery and ultimately concludes that the doctrinal premises in support of transition loss recovery are flawed.

The Article begins by examining the history of the electric power market and continues by addressing the central arguments in favor of transition loss recovery. Proponents of transition loss recovery argue that investors will suffer losses as a result of a change in market dynamics or legal rules, and because the changes were not foreseeable, investors should be insulated from these resulting losses. Advocates of transition loss recovery further perceive the regulatory environment as contract-based, and thus argue that the

* Associate Professor of Law, University of Maine School of Law. B.S. 1981, Cornell University; J.D. 1987, Boston University School of Law. Many thanks to Nancy Brockway, Edward S. Godfrey, Dean Colleen A. Khoury, Michael B. Lang, David Nowlin, Marc R. Poirier, Laura S. Underkuffler, Thomas M. Ward, Jennifer Wriggins, Donald N. Zillman, and the participants in the University of Maine School of Law Faculty Workshop, for detailed and helpful comments on earlier drafts of this Article. Thanks also to Amy Lambiase, class of 2000, for excellent research assistance. To Melissa M. Perry, class of 1999—with enormous gratitude.

modification of the market's legal rules constitutes a breach of contract. Finally, some advocates claim that changes in legal rules and the resulting transition losses is a taking of property under the Fifth Amendment. Professor Lupica addresses each of these arguments and contends that the premises underlying these arguments are faulty. She further argues that transition losses are not unique to this context, and that, in addition to acknowledging the doctrinal challenges to recovery advocates' arguments, policy makers must evaluate transition loss recovery as an issue of fundamental fairness to utility consumers.

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I. INTRODUCTION

The electric utility industry is currently in the midst of a dramatic transition.¹ This industry has been significantly affected over the past decades by technological advances in both electricity transmission and generation.² These advances in technology, coupled with shifting consumer demand and preferences, have resulted in a significant modification of the legal rules affecting the electric

1. See Richard J. Pierce, Jr., *The State of the Transition to Competitive Markets in Natural Gas and Electricity*, 15 ENERGY L.J. 323, 336 (1994).

2. See Richard F. Hirsh, *Regulation and Technology in the Electric Utility Industry: A Historical Analysis of Interdependence and Change*, in REGULATION: ECONOMIC THEORY AND HISTORY 147, 159-77 (Jack High ed., 1991) (describing the central role played by technological changes in electric power generation and transmission). Electricity is a unique commodity, even among the commodities and services offered by public utilities. See RICHARD SCHMALENSSEE, THE CONTROL OF NATURAL MONOPOLIES 19 (1979).

power market.³ The ensuing decades will see even further changes in the legal regime governing this market.⁴

One of the primary objectives of these rule changes is the introduction of competitive participants to the wholesale and retail markets for electricity. The introduction of competition to a market that was previously dominated by one supplier⁵ has had many intended and unintended consequences.⁶ One such consequence is the surfac-

3. Currently, California, Connecticut, Illinois, Maine, Massachusetts, Michigan, Montana, New Hampshire, Oklahoma, Pennsylvania, Rhode Island, Tennessee, Texas, and West Virginia have enacted legislation authorizing the restructuring of the regulatory regime governing their state's electric utility market. See CAL. PUB. UTIL. CODE § 330 (West 2000); CONN. GEN. STAT. ANN. § 16-244d (West 1999); 220 ILL. COMP. STAT. ANN. 5/16-111 (West 1999); ME. REV. STAT. ANN. tit. 35-A § 3200 (West 1999); MASS. GEN. LAWS ANN. ch. 164, § 1A (West 1999); MICH. COMP. LAWS § 460.6n (1999); MONT. CODE ANN. § 69-8-101 (1997); N.H. REV. STAT. ANN. § 374-F:1 (1997); OKLA. STAT. ANN. tit. 17, § 190.1 (West 1999); 66 PA. CONS. STAT. ANN. § 2801 (West 1996); R.I. GEN. LAWS § 39-1-1 (1956); TENN. CODE ANN. § 3-15-801 (1999); TEX. UTIL. CODE ANN. § 31.003 (West 1999); W. VA. CODE § 24-2-18 (1999). In addition, at least a dozen states have retail access legislation pending or under legislative discussion, and many more have initiated pilot programs to study the issue. See generally *Strategic Energy Ltd.* (visited July 27, 1999) <http://www.sel.com/SE_Frames.html>.

4. See Pierce, *supra* note 1, at 336.

5. Electric utility firms, in their respective markets, possess what is known in economic terms as natural monopolies. In such a situation, one large provider emerges as the sole provider of a good or service. In such markets, prices may be higher and output may be more restricted, as compared to a competitive environment. Because one firm dominates the market, the consumer is forced to settle for that firm's version of quality and service. Furthermore, because most consumers are small and most suppliers are relatively large, the costs of litigating any controversy, if the goods or services provided are inadequate or deficient in some way, are more likely to exceed the expected recovery. See ALAN STONE, REGULATION AND ITS ALTERNATIVES 68, 74 (1997). Because, in general, there is not a great deal of variation in types of energy the existence of a monopoly supplier may not appear, at first glance, to be a critical issue for relatively fungible goods such as electricity. *But see* Armond Cohen, Energy Project Director, Conservation Law Foundation, Remarks at the Electric Industry Restructuring in the Northeast: A Regional Perspective Proceedings (May 31-June 1, 1996) (discussing the issue of renewable energy sources); *see also* SCHMALENSEE, *supra* note 2, at 19; STONE, *supra*, at 69. In circumstances where conditions lead to natural monopolies, many legislatures believed that the creation of a regulatory agency, as representative of the public's interests, was necessary to ensure that monopolistic providers offered adequate quality of service at just and reasonable rates. See STONE, *supra*, at 68-69.

6. Electricity is of critical importance in our culture. Electricity is a necessity and there is no close substitute for most of the product provided. Furthermore, electricity cannot be economically stockpiled or stored by the consumer for use during times of low supply or increased prices, leading to what is known, in economic terms, as a market with low elasticity of demand. See STONE, *supra* note 5, at 69. The United States comprises five percent of the world's population, yet it produces twenty-six percent of the world's electric energy. See CHARLES F. PHILLIPS, JR., THE REGULATION OF PUBLIC UTILITIES 623 (3d ed. 1993). There are currently 3500 public

ing of transition losses.⁷ Transition losses in the context of the electric utility market restructuring, also referred to as “transition costs” or “stranded costs,”⁸ have been defined as investments made on the basis of one set of circumstances and assumptions that, because of changes in these circumstances (such as technology and market demand), are currently unrecoverable.⁹ Transition losses have also been descriptively defined as the “anticipated shortfall in net revenues under competition as a consequence of changes in regulatory policy.”¹⁰ The realization of these obligations is a consequence, or fall-out, of the transition from a monopolistic to a competitive market.¹¹

and private companies involved in the generation, transmission, and/or distribution of electricity in the United States but only 100 to 200 of these firms supply seventy-five to eighty percent of the power used. See PAUL L. JOSKOW & RICHARD SCHMALENSEE, *MARKETS FOR POWER, AN ANALYSIS OF ELECTRIC UTILITY DEREGULATION* 11 (1983) (citing Federal Regulatory Energy Commission (1981)); Comments of Nancy Brockway, N.H. Pub. Utilities Comm’r, July 9, 1999 (on file with author) [hereinafter Brockway Comments]. See generally ROBERT A. CARO, *THE YEARS OF LYNDON JOHNSON, THE PATH TO POWER* (1982) (describing the hardships of life in rural Texas without electricity).

7. The privatization movement in Europe and South America offers many illustrations of transition losses. For example, in privatizing countries, the capital investment in obsolescent manufacturing facilities and the unrealized pension benefits of redundant workers become immediately realizable liabilities upon the sale of an enterprise from the state to a private party. The realization of these obligations is a consequence, or fall-out, of the transition from the public to the private sector. The issue that emerges in the course of this transition, is which affected party—the state, the firm, or the public—ought to pay for these transition losses. See generally *THE POLITICAL ECONOMY OF PUBLIC SECTOR REFORM AND PRIVATIZATION* (Ezra N. Suleiman & John Waterbury eds., 1990); Ronald A. Cass, *Privatization: Politics, Law and Theory*, 71 *MARQ. L. REV.* 449, 457 (1988).

8. But see Christopher Garbacz, *Never, Never Use the “S” Word! Always Say “Losses,”* *PUB. UTIL. FORT.*, Dec. 1996, at 16-18 (describing the widespread and misleading usage of the term “stranded” as applied to costs, assets, etc.).

9. See *infra* Part III for a discussion of the type of losses included in the term “transition losses.”

10. J. Gregory Sidak & Daniel F. Spulber, *Deregulatory Takings and Breach of the Regulatory Contract*, 71 *N.Y.U. L. REV.* 851, 869 (1996) [hereinafter Sidak & Spulber, *Deregulatory Takings*].

11. See, e.g., Steve Coll, *Economic Change, Social Upheaval; Governments Cutting Welfare Benefits, Selling State-Run Firms*, *WASH. POST*, Aug. 7, 1994, at A1 (“[S]cores of state-owned businesses, once regarded as the crown jewels of European states, are being auctioned off, one after another, to private buyers. The effects on the jobs and lives of workers are profound and often painful. . . . As Europe’s state-owned behemoths slim down to compete in the private sector, they are likely to shed about 750,000 jobs by 1998. . . .”); see also Debbie Harrison, *Continental Europe, Time Bomb Still Ticking*, *FIN. TIMES* (London), May 14, 1998, at 4 (“The transition from state to private-funded pensions will be slow and will incur considerable costs. . . .”).

There is no universally understood definition of transition losses, nor is there consensus on the types of obligations included within the term. Indeed, the most commonly used reference for such losses, *stranded costs*, masks the fact that what is at issue are losses and obligations owed, not costs. The rhetoric surrounding this issue has the potential to mislead the parties engaged in the resolution of the allocation of responsibility for these losses and may have far reaching consequences: transition losses in the electric power industry have been estimated to be as high as \$200 billion.¹²

Much has been written about the deregulation of the electric utility industry, including a body of scholarship addressing the question of which party should bear the transition losses incurred (or identified) as the industry moves from a regulatory to a competitive environment.¹³ A careful and critical examination of the transi-

12. See Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 861; see also Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Notice of Proposed Rulemaking, 59 Fed. Reg. 35, 274, 35, 278 (1994).

13. See generally J. GREGORY SIDAK & DANIEL F. SPULBER, DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT 444-45 (1998) (noting the failure of the FCC and state public utilities to consider the use of transition bonds in securing recovery of "stranded" or transition losses); William J. Baumol & Thomas W. Merrill, *Deregulatory Takings, Breach of the Regulatory Contract, and the Telecommunications Act of 1996*, 72 N.Y.U. L. REV. 1037, 1037 (1997) (contending that the utilities must bear the loss of monopolistic prices); John Burritt McArthur, *Cost Responsibility or Regulatory Indulgence for Electricity's Stranded Costs?*, 47 AM. U. L. REV. 775, 783-85 (1998) (stating that utility companies should not be fully liable for stranded losses, but they also should not be completely compensated); Elizabeth A. Nowicki, *Denial of Regulatory Assistance in Stranded Cost Recovery in a Deregulated Electricity Industry*, 32 LOY. L.A. L. REV. 431, 431-32 (1999) (arguing that former monopolies should be denied recovery for their stranded costs); Sidak & Spulber, *Deregulatory Takings*, *supra* note 10 (asserting that governments should be liable for the effects of their regulatory measures); J. Gregory Sidak & Daniel F. Spulber, *Givings, Takings and the Fallacy of Forward-Looking Costs*, 72 N.Y.U. L. REV. 1068, 1071 (1997) [hereinafter Sidak & Spulber, *Givings, Takings and the Fallacy*] (maintaining that the government is obligated to reimburse utilities "just compensation" for losses due to the regulators' change in regulatory policy); Stephen F. Williams, *Deregulatory Takings and Breach of the Regulatory Contract: A Comment*, 71 N.Y.U. L. REV. 1000, 1000-05 (1996) (stating that the utilities do not need to be reimbursed to compete with new companies); Oliver E. Williamson, *Deregulatory Takings and Breach of the Regulatory Contract: Some Precautions*, 71 N.Y.U. L. REV. 1007, 1011 (1996) (maintaining that it "depends" whether or not utilities should be compensated for stranded costs); Leigh H. Martin, Note, *Deregulatory Takings: Stranded Investments and the Regulatory Compact in a Deregulated Electric Utility Industry*, 31 GA. L. REV. 1183, 1220 (1997) (arguing that utilities should be permitted to recover any investments that were made in reliance of the "regulatory compact"). *But see* Jim Chen, *The Second Coming of Smyth v. Ames*, 77 TEX. L. REV. 1535, 1548 (1999) (reviewing and critiquing Sidak & Spulber's DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT: NETWORK INDUSTRIES IN THE UNITED STATES); Jim Rossi, *The Irony of Deregulatory Takings*, 77 TEX. L. REV. 297, 298-99 (1998). Indeed, the

tion loss definition offered by those advocating for transition loss recovery reveals, at its baseline, an assumption about entitlement. The premise is that utilities have a continuing right to a certain set of economic conditions. These conditions include the benefits that flow from a regulated market. There is no harm in recognizing and acknowledging the expected changes that will result from a change in the legal climate. The claim that utilities ought to be fully compensated by others for each and every liability resulting from changed circumstances, however, should be viewed with suspicion.¹⁴

For the most part, the literature on the transition loss issue has failed to put in a broader context the compelling interests of the parties subject to the transition of this market. Every transition results in winners and losers and the question of which party should "win" implicates normative concerns. It is a choice that is informed by both efficiency and fairness considerations. This Article looks at the transition loss issue in the electric power market re-

argument that the state has a legal obligation to provide utilities with a reasonable opportunity to recover stranded costs from ratepayers and that if the state does not permit stranded cost recovery, it will be "taking" utility property, has been used by utilities advocating their position before state legislatures. See The Maine Legislature Committee on Utilities and Energy, Forum #2 Stranded Costs and Securitization, Topic of the Day, David T. Flanagan, Central Maine Power at 14 (on file with author). United States Supreme Court Justice Stephen Breyer has acknowledged that the "stranded assets" issue is a political problem with no "technical answer" and offered his solution to the stranded asset problem:

[I]t would be possible to produce a lot of electricity and lower the rates quite a bit [after deregulation], but for the fact that you have to pay something for the stranded assets. But my impression from the companies is that nobody expects to get 100%. Maybe they would like 100%. What they are worried about is that they are going to get nothing. If that is really so, put them in a negotiating forum and work out these technical problems. That way they could use their incredibly good negotiating skills and produce some kind of solution. If prices began to fall at little bit, I think the average person would think that was the miracle of the century—to actually see a price coming down. If in fact that began to happen, even a little bit, I suspect the public would have tremendous confidence in whatever form of institution brought that about.

Conference, *Harvard Electricity Policy Group: Regulatory Decisionmaking Reform*, 8 ADMIN. L.J. AM. U. 789, 837 (1995).

14. A comparison of the proposed treatment of transition losses in the electric utility industry to the treatment of such losses in the market for natural gas reveals an interesting contrast. In the deregulation of the natural gas industry, costs of gas supply contracts at above-market prices were at risk of being unrecoverable. As a result of political pressures, as well as pressure brought in the form of lawsuits, the losses were split between the interstate pipeline companies and local gas distribution companies. In some states, however, the local distribution companies were allowed to recover their share of these losses from the consumers. See Donald F. Santa, Jr. & Clifford S. Sikora, *Open Access and Transition Costs: Will the Electric Industry Transition Track the Natural Gas Industry Restructuring?*, 15 ENERGY L.J. 273, 303-04 (1994).

structuring context and questions the underlying premises of many of the arguments offered by advocates of transition loss recovery.

Part II of this Article describes the history of the market for electricity and examines some of the evolutionary changes in technologies and market forces that have resulted in regulation, re-regulation, and de-regulation. Part III addresses the transition loss issue in the electric power industry and outlines the primary arguments offered by transition loss recovery advocates. Part IV explores the electric utility industry's transition loss issue from a broader perspective, summarizing the current scholarship on transitions and retroactive effects in a wide variety of situations. Much of this scholarship explores the question of whether there ought to be a significant distinction made between transition losses that arise from changes in legal rules and transition losses that are the result of market forces. Part IV then looks at alternative policy choices and asks (and attempts to answer) the question of whether the common transition loss allocation determination advocated by most utilities is the most prudent and efficient policy choice. The analysis of transition loss allocation in Part IV takes both an *ex ante* and an *ex post* perspective. Part V examines the predicate assumption implicit in many of the arguments for transition loss recovery, which is that such recovery naturally flows from a breach of the so-called "regulatory contract." Part V argues that, under basic common law contract doctrine, there is no basis for treating the prior regulatory arrangement as contractual in nature. Part VI examines the relationship between the consumer market and the regulated utility from a property rights perspective, challenging the notion that a change in regulatory policy instigated by technological and market changes rises to the level of a taking under the United States Constitution. Finally, in Part VII, this Article concludes that the issue of transition loss allocation and the premises and assumptions underlying the arguments made in favor of recovery by the utility investors must be re-examined by policy analysts, economists, scholars, and politicians in light of the broader issues that are implicated.

This Article takes no position as to the merits of the restructuring of the electric power market. Moreover, an analysis of the pros and cons of the enacted and proposed changes to the federal and state regulatory schemes is beyond the scope of this Article. The allocation of transition losses in connection with the re-regulation of the electric power market, however, is fundamental to the issue of whether the benefits of the market's restructuring are confined to the industry, or whether the benefits of a competitive market will be more widespread.

II. THE ELECTRIC POWER MARKET IN TRANSITION—CHANGES IN TECHNOLOGY, MARKET DEMAND, AND THE LEGAL RULES

The electric power market, with its rich history of regulation¹⁵ is currently in the midst of a significant transition.¹⁶ This transition

15. Electricity is the quintessential public utility and has been subject to some form of regulation since before the beginning of the century. The Industrial Revolution sparked a surge in the demand for electricity. At that time, there were few, if any, controls on its delivery to the public. One view of the origin of the market's regulation credits its roots in the opportunism of a few electric plant owning "robber barons." For example, in 1905, a New York state legislative committee investigation revealed that New York Gas and Electric was charging its customers a per kilowatt-hour rate for electricity that was twice what it cost to produce. See PETER NAVARRO, *THE DIMMING OF AMERICA, THE REAL COSTS OF ELECTRIC UTILITY* 3-4 (1985). Accordingly, because of utility owners' overreaching and the growing necessity of this commodity, the populists and progressives began to take an interest in the industry, which resulted in the emergence of a new form of regulatory entity—state public utility commissions (often known as PUCs). See generally WILLIAM T. GORMLEY, *THE POLITICS OF PUBLIC UTILITY REGULATION* 6-7 (1983); NAVARRO, *supra*, at 3-5; PHILLIPS, *supra* note 6, at 661.

At the time of their inception, PUC control was perceived by many as the preferred alternative to corrupt, local governance of the public utility markets. Utility companies themselves supported PUCs as theoretically independent and impartial bodies, with many industry leaders finding them preferable to local municipal authority and the chaos of the unregulated market, which included the risk of economic losses. Public utility commissioners' responsibilities included the setting of policy with respect to many technologically, economically and politically complex issues. See NAVARRO, *supra*, at 4-6.

As the electric utility industry became more evolved and service areas crossed state lines, the federal government began to take a greater interest in the market and demonstrated this interest through the enactment of federal legislation. In 1935, Congress enacted the Public Utility Holding Company Act ("PUHCA" or the "Holding Company Act"). See PHILLIPS, *supra* note 6, at 239. The Holding Company Act authorized the reorganization of electric utility firm structures by limiting the operations of each company to a single integrated public-utility system—known as vertical integration. See *id.* at 632-35. This means that the same entity generated, transmitted, and distributed power to the retail customer. See *id.*

In the decades following the enactment of PUHCA, in large part due to a growing population and considerable technological advances, the demand for electricity in the U.S. increased exponentially. See *id.* at 9. Technological developments in energy generation and transmission as well as economies of scale, resulted in increasingly larger firms generating, transmitting, and distributing electric power. Accordingly, most markets for electricity were served by a single, dominant firm. In recent years, Congress has enacted the Public Utilities Regulatory Policy Act and the Energy Policy Act of 1992—both designed to address inefficiencies and irregularities in the regulated market. See *infra* notes 53-73 and accompanying text.

16. Historically, in the wholesale market, electric utilities have been engaged in three vertically integrated functions: generation, transmission, and distribution. One utility has commonly generated, transmitted, and ultimately distributed electric power to the customer. In contrast, under the current deregulatory initiatives, utilities will disaggregate these three functions. Many utilities will purchase wholesale electricity from generating facilities for distribution over their own transmission

has come about because of modifications (and proposed modifications) in the legal rules governing the market for electricity, which have tracked changes in technology and the economics of the market.¹⁷ Moreover, the public's relationship with the regulated market has changed over time. These transitions have been affecting the industry since the mid-1970s, when a long period of electricity demand shifts began.¹⁸

From the time of the Industrial Revolution up until the early 1970s,¹⁹ it was forecast that electricity demand would increase with every decade.²⁰ Indeed, the utility companies, working in concert with manufacturers of home appliances, actively promoted the in-

lines to the consumer. Power providers will enter new markets and compete for wholesale business in an unregulated environment. It is expected that transmission and distribution of power will remain regulated to ensure that all power providers will have access to existing transmission systems. See Asgar Zardkoohi, *Competition in the Production of Electricity*, in *ELECTRIC POWER: DEREGULATION AND THE PUBLIC INTEREST* 63-66 (John C. Moorhouse ed., 1986) [hereinafter *ELECTRIC POWER*]; see also *Electric Power Generation Components, in The Changing Structure of the Electric Power Industry: An Update*, (visited Nov. 12, 1998) <http://www.eia.doe.gov/cneaf/electricity/chg_str/chapter3.html>.

17. See Testimony of Peter A. Bradford on Behalf of the Maryland Office of People's Counsel Before the Maryland Public Service Commission, Case Numbers 8794 & 8804 (December 1998) [hereinafter *Bradford Testimony*] (on file with author). There was a steadily increasing demand for electricity from the mid-1930s to the 1970s. See Hirsh, *supra* note 2, at 155. This increased demand resulted in burgeoning energy plant construction. See *id.* Based in part on this historical record, experts from both the private and public sectors forecasted that demand for electricity would double in the ten years from the early 1970s to the early 1980s and that nuclear power facilities would be less expensive to operate than traditional oil and gas fueled plants. See Richard J. Pierce, Jr., *The Regulatory Treatment of Mistakes in Retrospect: Canceled Plants and Excess Capacity*, 132 U. PA. L. REV. 497, 500-01 (1984). As a result, utilities began to construct a record number of nuclear-fueled generators. See *id.* at 502. These capital-intensive investments were based upon the prediction that there would be a steady increase in demand for electricity in the years to come. See *id.* at 500 (citing Energy Information Admin., U.S. Dep't of Energy, *Nuclear Plant Cancellations: Causes, Costs, and Consequences* at 7, 16 tbl.5).

18. See *Bradford Testimony*, *supra* note 17, at 34-37.

19. John C. Moorhouse said, in his introduction to the anthology *Electric Power*, that "the 1970s witnessed a series of events that disrupted domestic energy markets. Sharp increases in oil prices worldwide, price controls and contrived fuel shortages at home, comprehensive environmental regulation, accelerating inflation, and unusually high costs of raising capital each contributed to what become known as the 'energy crisis.'" John C. Moorhouse, *Introduction: The Uncertain Future of the Electric Power Industry*, in *ELECTRIC POWER*, *supra* note 16, 1, 1.

20. Electricity usage grew from 1900 to 1920 at a rate of 12% per year. See RICHARD F. HIRSH, *TECHNOLOGY AND TRANSFORMATION IN THE AMERICAN ELECTRIC UTILITY INDUSTRY* 82 (1989). From 1920 until 1973 (with a growth set-back during the Great Depression) electricity usage grew 7% annually. See *id.*

crease in electricity usage.²¹ These utility usage campaigns needed to be successful; they created an adequate demand for the electricity generated by the regularly improved technologies.²²

Moreover, as early as the beginning of the century there developed what has been referred to as the “dominant design” of the electric utility industry—known as the grow-and-build-strategy.²³ This strategy was based on the premise that the growth of efficient new technologies would result in lower per-unit costs of electricity only as the number of the utility’s customers, and their usage, was increasing.²⁴ Thus, utility management realized early on that they could take full advantage of new technological developments in scale economies only in the absence of competition.²⁵ This realization led to initiatives by the utilities themselves to encourage the perception that the electricity market was a natural monopoly. In that way, regulatory oversight could be exchanged for the exclusive rights to generate and transmit electricity to individual markets.²⁶

21. See Hirsh, *supra* note 2, at 155. Utilities used the “grow and build” program to encourage residential, commercial, and industrial customers to use electricity. See *id.* Utilities launched the “Live Better Electrically” campaign, and offered customers electric hot water heaters and other electric appliances at discounted electric rates. See *id.*; see also Bob Harris, *Not Just Selling Railroad Tickets*, in MOONLIGHT IN DUNELAND, THE ILLUSTRATED STORY OF THE CHICAGO SOUTH SHORE AND SOUTH BEND RAILROAD 21-26 (Ronald D. Cohen & Stephen G. McShane eds., 1998) (describing the poster-based marketing campaign initiated by Samuel Insull glorifying the destinations reachable by the Chicago South Shore and South Bend Railroad, in order to stimulate railroad usage).

22. See Hirsh, *supra* note 2, at 155.

23. See HIRSH, *supra* note 20, at 16-21.

24. See *id.*

25. See Hirsh, *supra* note 2, at 150-51. Economist George Stigler said in an influential article, “regulation is acquired by the industry and is designed and operated primarily for its benefit.” George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 3 (1971). See generally FOREST MCDONALD, INSULL (1962) (describing the life of Samuel Insull, the man considered the father of governmental regulation of the electric power industry).

26. Enterprises have been defined as natural monopolies when they “supply, directly or indirectly, continuous or repeated services through more or less permanent physical connections between suppliers’ plants and the premises of consumers.” STONE, *supra* note 5, at 69. Another way of saying this is that a natural monopoly is present when there are high or initially costly barriers to entry into the market, and where unit costs of the product or service decline as output increases. Alan Stone used the following example to illustrate this point: “If, for example, an electric generator costs \$1 million and constitutes a very large proportion of a firm’s total costs, average costs will clearly be lower if fixed costs are amortized over sales of 1 million units than over sales of 100,000 units.” *Id.* at 70. Furthermore, electric companies have to string (or bury) wires from the point of electricity generation to the point of consumption of every customer. “The lowest cost between two points is obtained with a single, high voltage transmission line.” *Id.* at 71; see also SCHMALENSEE, *supra* note 2, at 152. The conclusion that natural monopolies are flawed markets in need of

As described in the biography of Samuel Insull, an early leader in the electric utility industry and a proponent of public utility regulation, a legal monopoly could justify investments in large-scale generating technologies, resulting in both cost savings and increased profits for the utility investors.²⁷

This explanation for the regulation of an industry, known as the "capture theory," views regulation as a force that provides significant benefits to firms within the regulator's purview.²⁸ Implicit is the conclusion that regulation is a result of the more powerful and organized entity's influence and that regulated firms benefit by virtue of the regulatory framework. Accordingly, regulation is a commodity, available to be captured by constituencies with sufficiently cohesive interests and the resources to capitalize on these interests.²⁹ Regulators supply rent-creating regulation in return for political favors offered by the demanding firms,³⁰ thereby redistributing wealth from some consumers to the effective coalitions.³¹ The efforts of the leaders of the electric utility industry to encourage regulation were successful and an elaborate regulatory scheme was enacted at both the state and federal levels.³² During the years lead-

regulatory assistance has not been universally accepted, however. Harold Demsetz has put forth the argument that, in the absence of collusive behavior, there are enough potential rival market participants waiting in the wings to compete that the dominant provider will be influenced by these potential competitors to charge a competitive price. See Harold Demsetz, *Why Regulate Utilities*, 11 J.L. & ECON. 55, 55-60 (1968). As such, Demsetz concludes, even a natural monopoly market ought not be regulated. See *id.*

27. See MCDONALD, *supra* note 25, at 113-24. Commonwealth Edison Company, headed by Insull, was able to expand its reach into over one hundred suburban Chicago communities while having to yield only to the direction of one state utility commission, rather than to each municipality's individual brand of governance. See *id.* at 127-28.

28. Such benefits include the imposition of barriers to market entry, as well as price supports. Expenditures made by regulated firms on encouraging, maintaining, and manipulating the regulatory process are treated by such firms as the cost of doing business. See STONE, *supra* note 5, at 70-71; see also Thomas W. Merrill, *Capture Theory and the Courts: 1967-1983*, 72 CHI.-KENT L. REV. 1039, 1043 (1997).

29. See Stigler, *supra* note 25, at 3-21. Economist Peltzman expanded on Stigler's theory of capture by recognizing the potential for effective coalitions of consumer-voters. See generally Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1 (1998).

30. See Stigler, *supra* note 25, at 4-5.

31. See Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167, 169 (1990).

32. There are myriad alternative theories of regulation. The classic politically-based theory is known as the public interest theory of regulation. Proponents of this theory believe that regulation comes about because of the deliberate influences of interest groups. These interest groups may include the regulated industry, consumers in general, and those consumer sub-groups with a special interest in the regu-

lated market. *See* Croley, *supra* note 29, at 5. Moreover, proponents of the public interest theory of regulation identify two primary influences on regulatory outcomes: (1) the degree of political stability of the regulators, and (2) the extent to which the general citizenry can monitor regulators for effective decision making. *See id.* at 65-67. These theorists distinguish the respective interests of the regulated market participants and believe that the extent to which each interest group has influence on regulators' positions determines the degree and type of regulation. *See id.* This perspective on regulation recognizes that the more politically precarious position a regulator is in, the more susceptible he/she is to such political influence. *See id.* at 68-71.

The coalition building theory of regulation, a variation on the public interest theory, similarly rests on political influence to explain regulatory outcomes. Its proponents, however, view regulation as a tool for wealth redistribution; equity and fairness, rather than efficiency concerns, drive regulatory decision making. *See* Harry M. Trebing, *Equity, Efficiency, and the Viability of Public Utility Regulation*, in *APPLICATIONS OF ECONOMIC PRINCIPLES IN PUBLIC UTILITY INDUSTRIES* 25-26 (Werner Sichel & Thomas G. Gies eds., 1981). Disciples of this theory believe that regulators are less vulnerable to constituency pressure and are more likely to weigh and balance the concerns and relative merits expressed by each special interest group. *See id.* Accordingly, regulated markets achieve optimal equity and efficiency. *See id.* Furthermore, implicit in this view is the assumption of a market where consumers are vulnerable to the effects of market imperfections and where regulators are willing to make adjustments to equalize the effects of these imperfections. *See id.* This theory addresses the evil of economic inefficiency while recognizing that efficiency should not be the singular goal in a market for a good that is a necessity. *See id.* Political coalitions form when regulators use prices or rates to favor a particular constituency. *See id.* Correspondingly, groups whose favor is not sought must pay prices substantially in excess of costs. *See id.*

Shortcomings of the coalition building approach include: (1) it provides little basis for evaluating the overall societal effects of regulation; (2) the nature of the coalition formed will be a factor of the regulators in control at a given time—thus as tenures change, objectives shift; and (3) in the absence of regulation, a monopoly firm will have the incentive to build a coalition in support of its monopoly position. *See id.* at 27. Such a firm would charge lower rates to some customers and higher rates to others, thus engaging in a cross-subsidization. *See id.*

A variation of the coalition building theory is known as the equity stability theory. *See id.* at 28. Its advocates support regulation even in efficient markets and conclude that in certain circumstances, it is beneficial and appropriate for regulators to place a higher value on fairness, social values, and stability than on market efficiency. *See id.* at 28-29. Thus, regulation ought not be introduced solely because of the inefficiency of markets (market failure) but rather because the free markets do not place a premium on consumers' social welfare. *See id.* The equity-stability theory offers a justification for regulation and regulatory behavior that places the virtues of equity and fairness in a superior position, relative to efficiency concerns. *See id.* The equity-stability theory of regulation is implicit in Professor Theodore Lowi's conception of judicial democracy. Professor Lowi observed that modern law has become a series of instructions to administrators rather than a series of commands to citizens. *See* THEODORE J. LOWI, *THE END OF LIBERALISM* 287-314 (1969). *See generally* STEPHEN J. BREYER, *REGULATION AND ITS REFORM* 3 (1982) (criticizing the regulatory process as being undemocratic and illegitimate); MARTHA DERTHICK & PAUL J. QUIRK, *THE POLITICS OF DEREGULATION* 40-41 (1985) (describing how the government policed the regulatory agencies); IRA MAGAZINER & ROBERT B. REICH, *MINDING AMERICA'S BUSINESS* 6 (1982) (stating that politically powerful industries are in-

ing up to the late 1960s, the industry saw some significant technological advances. Electricity was transmitted at increasingly higher voltages.³³ In addition, metallurgy technology resulted in greatly improved thermodynamic efficiency, meaning that each metallurgical improvement led to more electricity production from a fixed amount of fuel.³⁴ These advances led to a declining capital and fuel investment per unit of output which in turn led to greater cost savings for the consumer³⁵—so long as demand was increasing.³⁶

Moreover, nuclear-related technological advances led, for the first time, to widespread development of nuclear power plants. Partially in response to the United States' dependence upon oil, as well as to meet the projected demand for electricity, construction began on scores of nuclear powered generation facilities in the late 1960s and early 1970s.³⁷ Striving to be competitive with fossil-fuel-powered plants and taking advantage of government subsidies and manufacturers' incentives, utilities developed nuclear plants on a large scale, in reliance on projections of continued increases in electricity demand and in hopes of benefiting from scale economies.³⁸

In the 1970s, however, significant world and market events led to the beginning of a series of changes in the public's demand for electricity and the beginning of a period of corresponding changes in the legal rules regulating the market. First, the Arab oil embargoes of the early 1970s resulted in a decrease in the supply of oil³⁹ and a

strumental in determining the extent of government intervention); STONE, *supra* note 5, at 13 (asserting that interest group liberalism corrupts and immobilizes democratic government); Michael A. Crew & Charles K. Rowley, *Feasibility of Deregulation: A Public Choice Analysis*, in DEREGULATION AND DIVERSIFICATION OF UTILITIES 6 (Michael A. Crew ed., 1989) (examining the political economy of regulation); Croley, *supra* note 29, at 4 (questioning whether administrative agencies effectively fill "statutory gaps"); Levine & Forrence, *supra* note 31, at 169 (asserting that rent-creating regulation obtained as a political favor redistributes wealth from consumers to effective coalitions of firms).

33. See Hirsh, *supra* note 2, at 153.

34. See *id.*

35. For example, in 1892, electricity consumers paid 316 cents per kilowatt-hour, and in 1967, they paid seven cents per kilowatt-hour (inflation adjusted to 1986 dollars). See *id.* at 156 (citing EDISON ELECTRIC INSTITUTE, POCKETBOOK (30th ed.) and 1988 Statistical Report, ELECTRIC WORLD 202 (1988)).

36. From 1899 to 1953, the electric utility industry's productivity growth rate was 5.5% annually. See *id.* This industry grew during this period at a rate that was more than three times greater than the rate of growth of the country's private economy in general. See *id.*

37. Over 100 nuclear-fueled generating plants have been canceled since the early 1970s. See Moorhouse, *supra* note 19, at 1-2.

38. See HIRSH, *supra* note 20, at 61-62.

39. Together with coal, oil was one of the primary fuel sources for electricity generation. See *id.* at 58.

corresponding increase in oil prices.⁴⁰ Second, developers of many of the in-process and recently completed nuclear plants found themselves in financial difficulties. These plants proved to be expensive to build and many of them came in way over budget. As a consequence, the cost per kilowatt hour of nuclear power-generated electricity was considerably higher than the cost for power generated with alternative fuels. Third, under the direction of state Public Utility Commissioners ("PUCs"), pursuant to the Public Utilities Regulatory Policies Act ("PURPA") requirements, utilities entered into contracts to purchase electricity at the same rate it cost them to generate it.⁴¹ Since many of these contracts were entered into at a time when oil was the lowest cost fuel (notwithstanding its relatively high cost compared to current-day oil prices), oil-powered generation became the benchmark for pricing purchased power. At the same time, industrial electricity customers, responding to the high cost of electricity, began to seek an alternative to the expensive power being offered by the utility monopoly holders. Many larger industrial customers threatened to build their own power generation plants.

In part as a result of increasing electricity prices, and contrary to forecasts, customer demand for electricity leveled off by the late 1970s.⁴² Moreover, the public's awareness of energy conservation opportunities was heightened, and its behavior began to reflect the emerging environmentally conscious values.⁴³ For the first time, it became clear to economists studying this market that the demand for electricity was responsive to price.⁴⁴ During this same period, the public's concerns about the safety and environmental effects of nuclear energy contributed to its disenchantment with nuclear power. This resulted in even greater financial troubles for investors in nuclear power plants. By the early 1980s, many nuclear facilities rep-

40. It was further thought that the United States' dependence on oil was a threat to our national security given our precarious relationship with the Organization of Petroleum Exporting Countries ("OPEC"). See *infra* note 57 for a discussion of OPEC; see also Pierce, *supra* note 17, at 501 (asserting that relying on oil exposes the United States to future embargos).

41. This pricing mechanism is known as the "avoided cost" method. See *infra* note 58 for a discussion of the avoided cost-pricing methodology.

42. Less than half of the increased demand for electricity materialized. This was due to demand sensitivity to increasing price, as well as to consumer enlightenment about the benefits and effects of energy conservation measures. See Comments of Stephen Ward, Public Advocate, State of Maine (Feb. 23, 1999) (notes on file with author).

43. See HIRSH, *supra* note 20, at 112 (describing the public's mounting environmental awareness).

44. See John T. Wenders, *Efficiency, Subsidy, and Cross-Subsidy in Electric Utility Pricing*, in *ELECTRIC POWER, DEREGULATION AND THE PUBLIC INTEREST*, *supra* note 16, at 307, 311-312.

resented excess generation capacity,⁴⁵ which led to further cancellations of a number of partially completed projects.⁴⁶

The economic effects of the cancellation of so many costly projects were significant.⁴⁷ It has been estimated that the construction costs of abandoned energy generating plants were as high as \$60 billion.⁴⁸ Utilities sought financial refuge from their heavy nuclear plant-related obligations in the form of utility rate increases. Utilities made the case to their PUCs that these investments had been made based upon projections, albeit in hindsight faulty ones, of demand for electricity.⁴⁹ Arguing that the shift in demand was not anticipated and that their investments were "stranded," the utilities sought compensation for these stranded losses.⁵⁰

In response to these arguments, PUCs convened what became known as a series of "prudence hearings" to address the questions of whether the utility management's investment decisions in such plants was sound and whether the utility should be responsible for these losses.⁵¹ PUCs failed to hold in all cases that the public ought to make the utilities whole and utilities came to realize that full reimbursement for all investments made by them was not a certainty.⁵²

45. The accident at the Three Mile Island nuclear plant in March 1979, had the effect of shattering the public's confidence in nuclear power. *See, e.g.,* Wayne King, *5 States' Voters Decide on Atomic Energy Issues*, N.Y. TIMES, Oct. 28, 1980, at A16 (noting that voters are signaling "concern about all phases of nuclear development"); *Not Three Mile Island, But . . .*, N.Y. TIMES, Oct. 31, 1980, at A26 (stating that a nuclear water accumulation at Indian Point nuclear power plant "only further undermine[d] public confidence in [nuclear energy] management").

46. *See* Pierce, *supra* note 17, at 504.

47. The following were cited as consequences of energy generation plant cancellations:

In 1984 the Washington Public Power Service System defaulted on \$2.5 billion in debt service payments, and Cleveland Electric Illuminating Company, Public Service of Indiana (PSI), and Consumer Power Company (Michigan) each abandoned costly plants in various stages of completion. (PSI's \$7 billion Marble Hill Plant was 50 percent built when scrapped). Other utilities such as Georgia Power and Duke Power (North Carolina) have found it prudent to sell existing generating capacity to improve their finances. At least one investor-owned utility, Long Island Lighting Company, considered bankruptcy.

Moorhouse, *supra* note 19, at 2.

48. *See* Moorhouse, *supra* note 19, at 2.

49. *See id.*

50. *See id.*

51. Utilities are typically required to demonstrate that plants are "used and useful" before the cost of the plant can be included in the rate base and passed on to the consumer. There is considerable variation among states, however, in their application of this standard. *See id.*

52. For example, Consolidated Edison, the utility serving the New York City metropolitan area, began construction on a nuclear power facility in 1955 (known as the Indian Point Plant). *See* HIRSH, *supra* note 20, at 152. The budget for this pro-

In 1978, Congress responded to this changing market⁵³ with the enactment of the PURPA.⁵⁴ Congress's ostensible purpose in enacting PURPA⁵⁵ was to promote energy conservation⁵⁶ and the development of new environmentally friendly energy generation technologies. Moreover, Congress wanted to decrease reliance on foreign fuel sources⁵⁷ and encourage non-utility competitors to the electricity generation market, in part to provide customers with fairer electricity rates.⁵⁸

ject was \$55 million. *See id.* When the project was ultimately completed in 1962, its development costs were \$127 million. *See id.* Its cost to produce electricity was \$450 per kilowatt (kW) of capacity, as compared with the comparable conventional cost of \$190 per kW. *See id.* At the prudence hearing convened to review the extent to which these costs could be recovered from utility consumers, the New York Public Service Commission withheld more than \$100 million from its rate base. *See id.* The testimony of a nuclear physicist at the prudence hearing referred to the investment decisions of the utility as "imprudent." *See id.*

53. Factors which Congress found influential in its decision to enact PURPA included (1) the country's dependence on foreign oil sources, (2) rising electricity prices, (3) decreasing efficiency in the use of their generating capacities, and (4) environmental concerns related to the development of nuclear power plants. *See PHILLIPS, supra* note 6, at 655-56.

54. The Department of Energy ("DOE") was created in 1977 and was granted jurisdiction and authority over all energy-related matters regulated by the federal government. *See id.* at 655.

55. The utilities challenged PURPA in two cases that were ultimately reviewed by the Supreme Court. *See American Paper Inst. v. American Elec. Power Serv. Corp.*, 461 U.S. 402, 417 (1983) (holding that PURPA's rule requiring utilities to purchase electricity from qualifying facilities at their "avoided cost" was not arbitrary, capricious, or an abuse of discretion); *Federal Energy Comm'n v. Mississippi*, 456 U.S. 742, 769-70 (1982) (holding that PURPA's directives to state legislatures and utility commissions do not violate the 10th Amendment).

56. PURPA addressed the issue of energy conservation through the structure of setting rates. *See Implementation of the Public Utility Regulatory Policies Act of 1978: Hearings Before the Subcomm. on Energy and Power of the House Comm. on Interstate and Foreign Commerce*, 96th Cong. 1 (1979) (statement of John Dingell, Subcommittee Chairman).

57. The Organization of the Petroleum Exporting Countries ("OPEC") is a permanent, intergovernmental organization, created in 1960, by five oil-producing countries. It currently has eleven member countries. OPEC's objective is "to co-ordinate and unify petroleum policies among Member Countries, in order to secure fair and stable prices for petroleum producers; an efficient, economic and regular supply of petroleum to consuming nations; and a fair return on capital to those investing in the industry." Organization of Petroleum Exporting Countries, *A Brief History of OPEC* (visited Apr. 24, 1999) <<http://www.opec.org/history.htm>>.

58. PURPA required utilities to purchase electric power from qualifying generating facilities (known as "QFs"). If QFs sell power to utilities at what it would cost the utility to generate that electricity, they are not subject to rate regulation; all other independent power producers (i.e., non-qualifying generating facilities) are subject to rate regulation under the Federal Power Act. This pricing system is known as the "avoided cost." Avoided costs may include both energy and capacity costs. FERC explained this pricing system as follows:

PURPA also removed the disincentive for those industries with co-generation capabilities (industries that produce steam for industrial purposes and have the capability to produce electricity for both use and sale)⁵⁹ to sell their surplus electricity. The co-generators were not subject to state regulation of electricity rates and service and those smaller generating facilities capable of producing not more than eighty megawatts were allowed access to the utility-owned transmission grid.⁶⁰

Notwithstanding PURPA's allowance of limited competition to the market for electric power, transmission and distribution lines were still owned and controlled by monopoly holders; this served as a disincentive for further development of generation technologies by non-utility independent producers.⁶¹ Not until access to the transmission and distribution grids to all power producers was mandated could there be competition at the wholesale and retail level.

Congress responded to an increasing demand for such access, as well as to some of the criticisms of PURPA,⁶² with the enactment of the Energy Policy Act of 1992 ("Energy Policy Act").⁶³ The Energy Policy Act empowered the Federal Energy Regulatory Commission (FERC)⁶⁴ to order vertically integrated⁶⁵ electric utilities to deliver power generated by competitors across their transmission lines to wholesale customers.⁶⁶ As a result, all independent generators now

The essence of avoided cost pricing is that payments to the QF should reflect the payments that would have been made to the sources of power that were displaced by the QF, that is, the costs avoided by purchasing QF power. Avoided cost pricing encourages efficiency and innovation, because QFs get any difference between their own costs and the avoided cost rate. The utility's ratepayers are indifferent in the short run because the utility pays no more for the QF's power than it would pay for generating its own power or purchasing power from another source.

Administrative Determination of Full Avoided Costs, Sales of Power to Qualifying Facilities, and Interconnection Facilities, Fed. Energy Guidelines (FERC) ¶ 32,457, at 32,163 (proposed Mar. 22, 1998) [hereinafter Administrative Determination of Full Avoided Costs].

59. Cogeneration has been "[d]efined as the sequential use of steam for industrial purposes and for production of electricity." Hirsh, *supra* note 2, at 165.

60. *See id.*

61. *See id.* at 167.

62. One of the unintended consequences of PURPA was that as industrial customers generated electricity, rates increased for those residential and commercial customers who remained customers of the utility. *See id.*

63. 16 U.S.C. § 791-828c (1994).

64. FERC has responsibility for the control of interstate transmission rates and the wholesale sale of electricity. Retail electric power rates are subject to the jurisdiction of the individual states' PUCs. *See* PHILLIPS, *supra* note 6, at 648-49.

65. *See supra* note 15 for a discussion of the concept of vertical integration.

66. This is known as "wholesale wheeling." The requested transmission access, however, must be able to be provided without compromising reliability and must be

have the legal right to access the transmission network's poles and wires for the sale of power at the wholesale level.

Moreover, the Energy Policy Act created a new category of independent power producers, called "exempt wholesale generators" ("EWGs"), that could generate electricity and sell power at wholesale (but not at retail), free from the Holding Company Act⁶⁷ restrictions.⁶⁸ These EWGs quickly became direct competitors of the market's existing power suppliers, which further altered the former monopoly market's stability.⁶⁹

Large power customers advocating for direct access to these smaller, more efficient power generators have made progress in recent years toward gaining direct access to these independent non-utility power producers.⁷⁰ Many more states are considering legislation to encourage retail electricity generation competition.⁷¹ The legislation typically mandates access to transmission facilities by competitive independent generators so that they can deliver power directly to retail residential, commercial, and industrial customers.⁷² This federal and state intervention (or de-intervention) has sparked a very public debate about the wisdom of creating a competitive electricity industry and the process by which it should be achieved. A central strand of the debate has been the issue of the treatment of the incumbent utilities' transition losses.⁷³

in the public interest. See 16 U.S.C. § 824j(b); see also PHILLIPS, *supra* note 6, at 648-49.

67. See *supra* note 15 and accompanying text for a discussion of the Public Utility Holding Company Act.

68. See PHILLIPS, *supra* note 6, at 658.

69. Thus, the Energy Policy Act had the effect of removing legal barriers to the development of independent power projects free of wholesale rate regulation and of ensuring them access to transmission systems. An electric-generating facility may file an application with the FERC requesting an order for wholesale transmission access. The parties independently negotiate the terms of this access arrangement, which must be approved by FERC. FERC has the authority to issue a wholesale wheeling (meaning access) order if it is "just and reasonable . . . and in the public interest." Administrative Determination of Full Avoided Costs, *supra* note 58, ¶ 32,157.

70. See *supra* note 3 for an illustrative list of states with legislation ordering the study or enactment of deregulatory measures affecting the electric power industry.

71. While many state legislatures have referred to the impending changes in the electric power market as *deregulation*, a more accurate term is *re-regulation* or *re-structuring*; even if all the modifications to the regulatory structure being discussed are enacted in every state, the market is being opened to competition only at the energy generation level—transmission and delivery of electricity will still be provided by a market monopoly holder. See, e.g., *supra* note 3.

72. See PHILLIPS, *supra* note 6, at 685-86 n.164 (citing Lori A. Burkhart, *Congress Passes Wide-Ranging Energy Bill*, PUB. UTIL. FORT., Nov. 1, 1992, at 72).

73. See West/Southwest Regional Meeting, Comments of Ms. Simon, Department of Energy, Electricity Deregulation (Oct. 22, 1996) (on file with author).

III. TRANSITION LOSSES IN THE ELECTRIC POWER INDUSTRY

Transition losses in the context of the electric power market generally fall into three basic categories:⁷⁴ (1) obligations incurred to carry or abandon redundant or obsolete energy generation plants; (2) other expenditures not recoverable under competition, including deferred investments in energy generation plants, deferred taxes, and retiree benefit costs; and (3) contractual obligations to purchase electricity from third parties at above market prices.⁷⁵ More broadly, transition losses are anticipated shortfalls in net revenues as a result of the introduction of competition.⁷⁶ These losses have been estimated to be as high as \$200 billion.

The momentum is moving in the direction of transition loss recovery.⁷⁷ For example, in both California and Massachusetts, a line item labeled "transition costs" is included in each consumer's monthly electricity bill.⁷⁸ Dozens of other states have either enacted legislation providing for consumers to absorb the utilities' transition losses, or are in the process of studying the issue.⁷⁹

Transition loss recovery advocates have put forth a series of arguments and assertions that, on their face, appear compelling. Many of these arguments, however, are based upon faulty premises and flawed predicate assumptions. Moreover, the electric utility transition loss issue has not been debated in light of the broader societal context in which it belongs. The transition loss issue is not unique to the electric power industry—indeed, the phenomenon is

74. What can and should be included under the title of transition losses has been, and continues to be, subject to debate among industry participants. See Brockway Comments, *supra* note 6.

75. Among the obligations unrecoverable by utilities in a competitive market are the long term contracts to purchase power which were entered into during a period when the avoided cost pricing baseline was at a historical high. Because these obligations were not incurred at the initiation of the utilities, but mandated by PURPA, the arguments against recovery by the utilities are not applicable to this category of transition losses.

76. The effort on the part of utilities to gain recovery of these losses has been compared to the recent federal bailout of the Savings and Loan industry. See Paul Fenn, *Stranded Costs* (visited Apr. 25, 2000) <<http://www.local.org/stranded.html>>; see also Pierce, *supra* note 17, at 497; Pierce, *supra* note 1, at 336.

77. In March 1998, the Clinton Administration released a proposal encouraging states to provide recovery for transition losses. While this proposal was not successful, it was one of many position papers advocating that utilities be held harmless from the consequences of the transition from monopoly supplier to market competitor. See Federal Energy Regulatory Commission, 18 C.F.R. § 35.28 (1999) (omitting proposed recovery scheme).

78. The bill for a Massachusetts customer for one month's usage was \$50, which included transition loss compensation of \$11.30—22.6% of the total bill. See Boston Edison Invoice (Jan. 26, 1999) (on file with author).

79. See *supra* note 3.

quite common and there is much to be learned from how transition losses are addressed in other contexts and markets.

One of the central claims made by transition loss recovery advocates is that it is inefficient not to compensate investors who have incurred losses as a result of a transition or change in market forces or legal rules. These advocates argue that denial of transition loss recovery raises the cost of capital to the industry⁸⁰ and that this will chill investors' enthusiasm for investment in similarly situated firms in the future.⁸¹ Moreover, recovery advocates argue that failure to compensate former monopoly holders for their transition losses provides a competitive advantage to potentially less efficient electricity suppliers entering the market.⁸² Therefore, compensation is the only efficient solution to the quandary the incumbent utilities find themselves facing on the advent of the restructuring of the market.

A further argument in favor of transition loss recovery is based upon the twin notions of foreseeability and reliance upon the status quo. Recovery advocates claim that the current instability of the electric utility market was not anticipated or foreseen. Furthermore, they argue that utility investors relied upon the statutorily-provided guaranteed aggregate return in making their investments, and are therefore entitled to recover the full measure of their investment.⁸³

The argument that has gained the greatest favor among transition loss recovery advocates is based upon the idea that legislation authorizing the regulation of the electric utility market constitutes a contract. Accordingly, a modification of this legislation arguably constitutes a breach of such contract and the damages for breach are the losses resulting from the transition.⁸⁴ Proponents of this argument claim the existence of an affirmative agreement in which utilities agreed to provide service to a given market, in return for a competitive rate of return from their market's customers.⁸⁵

Moreover, it is argued, the breach of this "regulatory contract," in the absence of compensation for damages incurred, constitutes a taking of private property in violation of the Fifth Amendment of the Constitution.⁸⁶ The related "takings" argument that property of

80. See William J. Baumol & J. Gregory Sidak, *Stranded Costs*, 18 HARV. J.L. & PUB. POL'Y 835, 839 (1995).

81. See *id.* at 839-40.

82. See *id.* at 836.

83. See *id.* at 843-44.

84. See *id.* at 840-41.

85. See *id.* at 841.

86. See U.S. CONST. amend. V ("[N]or shall private property be taken for public use, without just compensation.").

the utility has been taken by virtue of the change in legal rules that has affected the utility's expected return on its investments has also been made.

Parts IV, V, and VI below will address each of these arguments in turn. Part IV will argue that the transition loss issue must be analyzed in a broader context to fully understand the implications of cost recovery. An *ex ante* examination of the electric utility market during the period of regulation reveals the utilities' inefficient decision making, which was premised in part upon the flawed assumption of an infinite entitlement to the benefits that flow from regulation. If the assumptions about transition loss recovery that were made by the electric utilities are internalized and adopted by other industries, inefficiencies will proliferate. A comparison of the electric power market to other environments in which transition losses or their equivalent (what are referred to as "retroactive effects") have surfaced reveals not only the ubiquity of this issue, but also alternative approaches to its efficient and fair resolution.⁸⁷

87. One form of transition loss recovery that utilities have been heavily promoting is known as securitization. There have been several recent articles touting securitization's merits in connection with utility transition loss recovery. See, e.g., Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595, 597 n.5 (1998). While securitization as a method of raising working capital is not without its risks to both investors and third party creditors of the originator, there are some unique risks associated with a utility using securitization to recoup transition losses. See generally *id.* The first issue goes to the nature of the property to be securitized.

Typically, the assets transferred by originators in connection with a securitization are enforceable contract rights to payment, commonly known as "receivables." See *id.* at 599-600. In contrast, utilities are considering (and in some cases are engaged in) securitizing a portion of future consumer utility payments. There are a number of problems and risks unique to securitization in the electric utility context. See The Regulatory Assistance Project, *Stranded Costs and Other Risks to Look Out For*, ISSUESLETTER (1995) (visited Jan. 30, 2000) <<http://www.rapmaine.org/stranded.html>>.

First, even if one were to accept the idea that transition losses ought to be paid for up front by a third party (meaning the state or the consumer) instead of being absorbed by the utility investors, such obligations, by their forward-looking nature, are difficult, if not impossible, to accurately estimate; they will fluctuate with changing market conditions. Unforeseeable future events could impact market prices for electricity as well as for the plant assets, and this would result in a sharp variation in the actual dollar value of these losses versus the up-front estimate. See *id.*

Arriving at an estimate determining an appropriate treatment of transition losses is a significant public policy decision because of the decisive economic and equitable impact variations in estimates will have upon consumers. The utility consumer's primary concern ought not be the "costs" that have become stranded, but the "costs" that are at risk of becoming stranded in the future. This issue has been dubbed one of recovery of "strandable costs," thus highlighting the difficulty in up-front, irrevocable recovery of these obligations. See *id.*

Part V will refute the argument that the regulation of the electric power industry constituted a contract. The underlying premises to the contract-based arguments are flawed: the basic doctrinal elements necessary for contract formation were not present.⁸⁸ Moreover, even assuming the existence of a validly created contractual arrangement, there is no explicit or implicit contractual term providing for transition loss recovery.

Part VI will address the claim that deregulation of the electric utility market is a taking under the Fifth Amendment of the United States Constitution. There can be no taking in the absence of a property right. What is being declared as property by transition loss

Inherent biases characterize the indicators of changing market prices. This is because long-term projections are susceptible to influences which come out of current market conditions. The recent surplus in capacity and relatively depressed market prices for electricity in part informed predictions about the current magnitude of transition losses. It is important to note that even a prediction of slightly-lower-than-actual market prices in the future could result in a significant overestimation of the total. *See id.*

The uncertainty associated with any estimation of transition losses is a significant issue because of the irrevocable nature of a securitization arrangement. When the expected consumer utility payments are sold, it is on a non-recourse basis; they are not merely used as collateral in connection with a loan. Once sold, they become the property of the Special Purpose Corporation and are used to support payments to asset-backed security investors. Such investors are guaranteed a rate of return for the life of the security. While there is most often a credit enhancement mechanism put in to place to make up for any shortfall in customer payments from the predicted amount, the principal amount of the asset-backed security is fixed. The irrevocable nature of securitized asset transfers limits the ability of the market to discipline or revisit the amount of losses seeking to be recovered through securitization. *See id.* What results is a significant risk shift from utilities to consumers. It is because of this risk shift that securitization is touted as beneficial to utilities and asset-backed security investors.

In the legislation enacted in California providing for a state-supported credit enhancement, the state is to provide the "opportunity" for recovery of these losses, whereas the securitization documentation made reference to a "guarantee" of recovery. *See* Walter R. Hall II, *Securitization and Stranded Cost Recovery*, 18 ENERGY L.J. 363, 371-72 (1997).

Michigan Attorney General Frank J. Kelley has stated, "Only two groups will benefit from issuance of rate reduction bonds: the utility, which will receive the billions in proceeds, and Wall Street, which will receive millions in fees." *IPALCO White Paper Critical of "Securitization" Swindle—High Cost Utilities Use Scheme to Charge Customers for Future Losses* (visited July 22, 1998) <<http://www.ipalco.com/COMPETITION/Swindle/swindlewp.html>> (citing Written Comments of Attorney General Frank J. Kelly in Response to Staff Report on Electric Industry Restructuring, *In the Matter, On the Commission's Own Motion, To Consider the Restructuring of the Electric Utility Industry*, Mich. Pub. Serv. Comm. Case No. U-11290, Jan. 21, 1997, at 14); *see also* Lupica, *supra*, at 606-09 (discussing the strengthening relationship between the public utilities sector and the financial industry).

88. *See* discussion *infra* Parts V & VI.

recovery advocates is nothing more than, at most, an expectation that a certain state of affairs will continue.⁸⁹ Moreover, even if a property right belonging to the utility is recognized, a change in the regulatory structure, to the degree contemplated, is within the province of the State's inherent police powers and does not rise to the level of an unconstitutional compensable taking. Accordingly, transition loss recovery either from the consumer, or the government, cannot be had.

IV. TRANSITIONS IN A BROADER CONTEXT

One of the claims being made by advocates of transition loss recovery is that competition may "jeopardize the financial solvency of the public utility"⁹⁰ unless such losses are either shared by all firms in the competitive market or "explicitly reimbursed by some third party."⁹¹ What many recovery advocates fail to recognize, either explicitly or implicitly, is that transition losses surface upon the happening of many different types of changes.⁹² Indeed, when any investment is made based upon one set of circumstances and assumptions, and subsequently there is an unexpected change in such circumstances or assumptions, a portion of the amount invested may become "stranded" as a result of the transition. Much scholarship has been devoted to the subject of transition and retroactivity effects of changes in market, legal rules, and circumstances in general.⁹³ The conceptual framework outlined in this literature offers a

89. See discussion *infra* Part VI.

90. Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 858.

91. *Id.*

92. See, e.g., Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129, 1129-32 (1996) (describing transition losses that occur upon a change in the tax law).

93. See generally Ronald A. Cass, *Judging: Norms and Incentives of Retrospective Decision-Making*, 75 B.U. L. REV. 941, 948-66 (1995) (discussing the differences between retrospective and prospective decisions by judges); Richard H. Fallon, Jr. & Daniel J. Meltzer, *New Law, Non-Retroactivity and Constitutional Remedies*, 104 HARV. L. REV. 1733, 1738-49 (1991) (addressing the consequences of retroactivity in criminal cases); Jill E. Fisch, *Retroactivity and Legal Change: An Equilibrium Approach*, 110 HARV. L. REV. 1055, 1058 (1997) (asserting that the equilibrium theory is the appropriate framework for analyzing retroactivity); Michael J. Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47, 48 (1977) [hereinafter Graetz, *The Case of Retroactivity*] (examining the difficulties in "setting effective dates for changes in the income tax laws"); Michael J. Graetz, *Retroactivity Revisited*, 98 HARV. L. REV. 1820, 1822 (1985) [hereinafter Graetz, *Retroactivity Revisited*] (arguing that prospective changes in law have a retrospective impact); Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 558 (1986) (arguing for the "implementation of a consistent predictable transition policy"); Saul Levmore, *The Case for Retroactive Taxation*, 22 J. LEGAL STUD. 265, 273-91 (1993) (discussing the benefits of retroactive application of tax laws); Logue, *supra* note 92, at 1129; Stephen R. Munzer, *A Theory of Retroactive*

useful point of departure for examining the transition loss allocation issue in the context of electric power industry's restructuring.

An example of the transition loss issue commonly noted by scholars involves the losses sustained by taxpayers upon a change in the federal income tax law.⁹⁴ The classic illustration involves the repeal of the tax exemption for interest on state and local bonds.⁹⁵ Since the effect of such repeal would be to deflate the value of these bonds, bondholders suffer transition losses to the extent the return on their investment is less than what they expected it to be at the time of the bond's purchase.⁹⁶ Notwithstanding the potential for substantial investor losses, the government does not provide compensation for their losses.⁹⁷ They are deemed to be part of the foreseeable risk borne by every investor.

Another context in which transition effects have been felt is in the field of international finance. In recent years United States banks, acting as investors, have sought, and the United States government has provided, compensation for investors who have incurred losses in connection with their investments in Mexico, South Korea, and Russia, releasing them from the effects of their decisions to invest in such markets.⁹⁸ The decision to compensate these investors has been severely criticized by those who believe that these same investors reaped the benefit of high interest rates attendant to these initially high-risk loans and thus should not be shielded from the risk inherent in their decision making.⁹⁹ If the investors knew that they would not have to bear the downside risk of their investment decisions, they would have had the incentive to engage in imprudent decision making with substantial up-side and very little downside potential.

In the electric power market, utilities invested in generation facilities and incurred myriad other obligations based upon circumstances in place at that time and forecasts of the future. As with all investments, the value was contingent upon events in the future. The extent to which external conditions diverged from investor predictions resulted in investment gain or loss. Therefore, almost any

Legislation, 61 TEX. L. REV. 425, 425 (1982) (defending the retroactivity in legislation); Warren J. Samuels, *Commentary: An Economic Perspective on the Compensation Problem*, 21 WAYNE L. REV. 113 (1974) (addressing the various issues concerned with the compensation problem).

94. See Logue, *supra* note 92, at 1130.

95. See *id.* at 1133.

96. See *id.*

97. See *id.* at 1136.

98. See Barry Eichengreen, *Bailing in the Private Sector: Burden Sharing in International Financial Crisis Management*, 23 SPG FLETCHER F. WORLD AFF. 57, 57-59 (1999).

99. See *id.* at 57.

unanticipated discovery, change in market conditions, or modification in governing law affects the value of the investor's assets. Such unanticipated changes will also affect the value of the investments of competitors or those enterprises seeking to compete with the investor.

The competitive market would respond to a utility's excess capacity by depressing prices and, correspondingly, investor return. It would not allow a financial return on such excess capacity and would not provide recovery for investments that do not result in productive assets. The market provides an incentive for prudent and unbiased decision making and an inducement to invest heavily in accurate and unbiased forecasting.¹⁰⁰ If the solution to the electricity industry's current transition loss problem were to mirror the expected course taken in a competitive market, then utility investors ought to bear these losses. This solution provides the appropriate incentives for utilities not to overinvest in capacity and to invest heavily in objective market trend forecasts.¹⁰¹

In an important article, Professor Louis Kaplow makes the fundamental observation that the transition loss issue is not confined to losses that are incurred as a result of changes in governmental policies or even confined to the context where a statute provides for specific retroactive application.¹⁰² In our dynamic economy, investors are subject to many types of risk that they have no ability to accurately forecast or control.¹⁰³ Kaplow refers to these as "market risks"¹⁰⁴ and posits that markets operate most efficiently when investors bear both the full measure of their losses and reap the full benefits of the risks taken.¹⁰⁵

As Kaplow initially observes, competitive markets are not known for their qualities of forgiveness.¹⁰⁶ In such markets, mistakes are not forgiven, compensation is not offered when premises upon which investment decisions are made turn out to be fallacious, and firms are required to live with their imperfect forecasts of future trends.¹⁰⁷ Conversely, rewards for wise decision making, correct and prudent forecasts, and valid premises are doled out by the market for the benefit of firm owners. If the investing firm underinvests in forecasting tools or simply guesses wrong, it has to live

100. See *Pierce, supra* note 17, at 525-26.

101. See *id.* at 526.

102. See *Kaplow, supra* note 93, at 515-16.

103. See *id.* at 525.

104. *Id.* at 533.

105. See *id.* at 529.

106. See *id.* at 531-33.

107. See *id.* at 533; see also *Pierce, supra* note 17, at 524-25 (describing the burden of investment costs as being born principally by the utility and not the consumers).

with its losses. There is no generalized mechanism for the bail-out of a firm's failure to anticipate changed circumstances.¹⁰⁸ Because market actors are on notice that they are subject to external risks, rational actors take steps to protect their investments against harm from such risks. For this reason, many market risks are specifically insured against, through traditional commercial insurance markets, investment diversification, and the use of more exotic financial hedging mechanisms.¹⁰⁹

Moreover, Kaplow notes the ubiquity of transition loss concerns.¹¹⁰ He observes that, in addition to "market risks" and the classic cases of retroactive legislation and judicial lawmaking, there are many rule changes to which investors are subject that have the effect of altering the "value of prior investments simply because the future value of such investments . . . depend[s] upon what rules [were] then in force."¹¹¹ Indeed, most investments are not entered into and concluded instantaneously and completely; in many instances, the closing of a transaction signals the beginning of a complex relationship that is subject to myriad variables over time. Among these variables are the legal rules in effect at the time the transaction was consummated as well as the rules that are going to be in effect throughout the duration of the legal relationship formed by the transaction.

Such investments include not only contracts which obligate parties over a period of time, but also transactions to purchase physical assets.¹¹² The value of a physical asset over time will depend upon a variety of factors. For example, in the case of an investment in a

108. See Graetz, *Retroactivity Revisited*, *supra* note 93, at 1823-24. This author makes a distinction between changes in governmental policies to effectuate an intentional wealth redistribution and those losses that come about as an unintended incident of action taken by the government. See *id.* at 1824-25. Whereas, for example, changes in the tax laws are intentional efforts on the part of the government to redistribute resources, any compensation offered by the government to offset losses would have the effect of nullifying the desired result regardless of whether a firm could anticipate and plan for the effect. See *id.* at 1826. In contrast, an incidental loss (such as the construction of a municipal facility on privately owned property) would require compensation because, presumably, the government's actions could not be accurately foreseen or predicted, and therefore, not planned for and compensation would not necessarily vitiate the statutory objective. Cf. *id.* (noting that the larger the loss from a change in the law, the greater the need for compensation in the interests of fairness); see also Samuels, *supra* note 93, at 116-17.

109. See Alan C. Shapiro & Sheridan Titman, *An Integrated Approach to Corporate Risk Management*, in *REVOLUTION IN CORPORATE FINANCE* 215, 215 (Joel M. Stern & Donald H. Chew eds., 1986) (evaluating various hedging mechanisms as an investment in a firm's stability).

110. See Kaplow, *supra* note 93, at 515.

111. *Id.*

112. See *id.* at 516.

commercial office building, the property's value will depend upon, *inter alia*, the state of the economy in general, the strength of the commercial rental market, interest rates, applicable tax rules, environmental circumstances, as well as the public's response to the amenities offered by the property.¹¹³ To the extent there is divergence between the condition of the forecasted variables and reality, unanticipated losses may be sustained. These losses are transition losses—losses incurred as a consequence of an unplanned for and unpredicted change in circumstances.

Kaplow concludes that from the perspective of the investor, such market risk is functionally similar to the risk that the government will modify the legal rules in effect.¹¹⁴ Each presents the risk that due to unforeseen changes, investments may not have the value initially predicted. In both cases, because investors are on notice that circumstances may change, their decision making to invest reflects an assumption of such risk.¹¹⁵ Furthermore, changes in legal rules are made on a less random basis than market changes and can be predicted and anticipated, especially by those most likely to be affected by the changes. When legal rules change in response to both demand and supply market shifts, there is even greater notice to the affected parties.¹¹⁶

A. *The Transitioning Electric Utility Market*

Much of Kaplow's argument is based on principles of efficiency. Efficiency analysis involves the calculation and evaluation of the costs and benefits of a given policy choice.¹¹⁷ Most economists and law-and-economics scholars agree that an efficient policy is one that results in the maximization of resources.

In the electric utility restructuring context, the threshold question to be addressed in evaluating the efficiency of a transition loss policy is which party—the government, the consumer, or the util-

113. See generally GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT, CASES AND MATERIALS (4th ed. 1992) (explaining real estate finance law using theoretical and practical underpinnings).

114. See Kaplow, *supra* note 93, at 512-13, 534-35.

115. But see Fisch, *supra* note 93, at 1056 (arguing that it is fairer for investors to bear the retroactive effects of a change of legal rules in contexts where legal rules are in flux).

116. To illustrate, in their consideration of the issue of the effect of a retroactive change in tax laws, scholars have argued that "absent any convincing empirical showing that the losses from political change are disproportionately distributed or more burdensome on productive output than market-reflected changes," efficiency criteria does not require compensating measures to firms affected by a change in legal rules. Kaplow, *supra* note 93, at 534.

117. Efficiency has been defined as the elicitation of the "maximum output from available inputs, including capital, labor, equipment, and raw materials." STONE, *supra* note 5, at 66.

ity—ought to bear the losses attendant to the transition from regulation to competition. The correlative question is which policy choice results in the maximization of economic and social resources. The analysis of who should bear the losses must be linked to larger concerns of social policy.

There are two perspectives from which to view and analyze this question: (1) an *ex ante* perspective, raising the question of which policy choice results in the utility's most efficient behavioral choices (a predictive perspective); and (2) an *ex post* focus on the positive and negative effects of each policy choice. This section will explore which policy choice (to compensate utilities or not to compensate utilities for transition losses), from both an *ex ante* and an *ex post* perspective, leads to the most efficient decision making.

1. The *Ex Ante* Perspective—Efficient Choices and Efficient Decision Making

The *ex ante* efficiency-based argument is premised on the notion that investors will behave differently if they know that they will be insulated from some of the market risks of their investments.¹¹⁸ When investors are not required to weather the full and real effects of their decisions, they are more likely to make riskier or imprudent investments.¹¹⁹ This phenomenon is referred to in economic literature as the problem of the "moral hazard"—meaning that there is a distorted incentive structure in place that motivates investors to make suboptimal choices because they do not bear the adverse consequences of these choices.¹²⁰

Moreover, investors, as reasonable economic actors, anticipate the possible risk of loss.¹²¹ Within the calculation of the fair market value of an investment is capitalized the risk of diminution of value due to changes. Therefore, compensating investors for changes in market value in the event of an adverse change in circumstances is tantamount to compensation for a loss that never occurred.¹²²

118. See Kaplow, *supra* note 93, at 526-27.

119. See *id.*

120. See generally ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW—A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES* 695-703 (1988) (discussing moral hazards in reference to insurance policies); see also Laurent L. Jacque, *The Asian Financial Crisis: Lesson from Thailand*, 23 SPG FLETCHER F. WORLD AFF. 87, 90 (1999) (describing the moral hazard problem as part of the incentive structure presented to banks who invested their money in Thailand, under the assumption that they would be held harmless).

121. See generally Thomas S. Ulen, Symposium, *Still Hazy After All These Years*, 22 L. & SOC. INQUIRY 1011 (1997) (reviewing WILLIAM A. FISCHER, *REGULATORY TAKINGS: LAW, ECONOMICS AND POLITICS* (1995)).

122. See *id.*

Conversely, the prospect that firms are subject to the consequences that flow from their decisions and forecasts—including their predictions regarding changes from the status quo and their expectations of the future—serves as an incentive to invest in forecasting tools and to consider the full array of risk-minimizing mechanisms available to it. It also forces careful and prudent decision making and a consideration of both the long term and short term risks. Thus, making investors bear the real costs and benefits of their decisions provides both positive and negative incentives for careful decision making.¹²³

As is the case in all other industries, profit-related incentives have had a profound effect upon decision making by electric utilities.¹²⁴ The pace and type of generation technology developed in response to the rate and profit structure that was defined by the regulatory framework.¹²⁵ To illustrate, throughout much of the century, regulation at the state level was concerned with the setting of prices for the public and establishing of a rate of return for investors. In order to establish these rates, regulators focused upon what is known as the utility's "rate base," which is the total value of all of the utility's capital expenditures.¹²⁶ Utilities were permitted to charge the public a "fair rate of return"¹²⁷ based upon their rate base, plus the public's share of current expenses for fuel and labor.¹²⁸ This regulatory formula provided the incentive to invest in capital intensive technology as a means to establish a greater rate base from which to calculate a "fair" rate of return.¹²⁹ Given that utilities were monopoly providers of electricity, capital intensive technologies developed on increasingly larger scales.¹³⁰ These investments, in many cases, resulted in greater profits for utility in-

123. The rule of avoidable consequences says that resources are scarce and rules should encourage people to conserve resources. See generally Amanda Kay Esquibel, *The Rule of Avoidable Consequences in Antitrust Cases: A Law and Economics Approach*, 26 HOFSTRA L. REV. 891, 894 (1998) (stating that the rule discourages wasting a party's resources).

124. See HIRSH, *supra* note 20, at 82-84.

125. See *id.*

126. See Hirsh, *supra* note 2, at 157.

127. See *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 690-92 (1923); *Smyth v. Ames*, 169 U.S. 466, 546-47 (1898). The Supreme Court defined "fair rate of return" as a return which allows the utility investor to recover its market cost of capital. See *Federal Power Comm'n v. Hope Natural Gas*, 320 U.S. 591, 602 (1944).

128. See Hirsh, *supra* note 2, at 157.

129. See Harvey Averch & Leland Johnson, *Behavior of the Firm Under Regulatory Constraint*, 52 AM. ECON. REV. 1052, 1052-69 (1962); see also Hirsh, *supra* note 2, at 157.

130. See *supra* notes 33-38 and accompanying text.

vestors than comparable investments in labor coupled with investments in smaller-scale technologies.¹³¹

Advocates of compensation for losses related to these capital investments claim that such investments were made to ensure adequacy of service to the public, and were therefore made in the public interest.¹³² Given the incentive structure inherent in the regulatory scheme and the utilities' reasonable response to it, this argument rings hollow. While utilities had an obligation to provide adequate service, they also had a wide range of choices as to how to provide such service. When choices were made in the interest of profit maximization and such profits were realized and maximized over time, the utility owners ought to bear the associated risks of these choices.

This conclusion is even more compelling if one accepts the notion that a regulated industry is more likely than a competitive one to overinvest in capital assets.¹³³ Professor Richard J. Pierce, Jr., referring to the concept of transition losses as "mistakes in retrospect,"¹³⁴ has argued that the regulatory process itself leads a regulated firm to overinvest.¹³⁵ Borrowing from economists and regulatory theorists Harvey Averch and Leland Johnson,¹³⁶ Pierce observes that regulated utilities have an incentive to overinvest in capital assets not just because the traditional rate-setting and rate-of-return formulae allow utilities to earn a "rate of return in excess of their actual cost of capital"¹³⁷ but also because of the problem of the moral hazard.¹³⁸ A firm faces a moral hazard when it makes reckless

131. See *supra* notes 33-38 and accompanying text. There are those who argue that the Averch and Johnson theory of the regulated firm is overstated. See Brockway Comments, *supra* note 6. Two examples support this position. Both Wisconsin Electric and New England Electric Systems diversified their investments, failed to invest in large scale nuclear generation technology, and showed significant profits. See HIRSH, *supra* note 20, at 157-58. An alternative explanation offered for the overinvestment in technology had to do with who the investment decision makers were at that time. Engineers, whose self-conception and worth were tied into engineering technology, saw further investment in increasingly larger plants as an affirmation of their importance. See Brockway Comments, *supra* note 6.

132. See Baumol & Sidak, *supra* note 80, at 842.

133. See Averch & Johnson, *supra* note 129, at 1059-60.

134. Professor Pierce's reference is to approximately 15 billion dollars of investments in nuclear power plants with excess capacity, including plants that have been entirely decommissioned. See Pierce, *supra* note 17, at 498.

135. See *id.* at 499.

136. See *id.* at 506 (citing Averch & Johnson, *supra* note 129, at 1055).

137. Averch & Johnson, *supra* note 129, at 1061, 1062. See generally ALFRED KAHN, 1 THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS (1970) (describing "the contribution economics can make to government regulation of business").

138. See *supra* notes 119-20 and accompanying text.

or imprudent decisions influenced by the fact that a third party will bear responsibility for the negative consequences of such imprudence.¹³⁹ If the regulatory environment protected utilities from losses, there was an incentive to make decisions without adequate consideration of the risk of loss.

Moreover, another theory posits that utilities invested insufficient resources in forecasting, largely due to their insulation from the consequences of inaccurate or biased forecasts.¹⁴⁰ Their decisions to invest in new generation capacity at a time when the market was unstable¹⁴¹ were predicated upon forecasts that were biased in favor of the need for new capacity.¹⁴² Alternatively, utilities erred on the side of investing when they were unsure about the reliability of these forecasts.¹⁴³

A further explanation for utilities' failure to make efficient investment choices is rooted in the idea of institutional inertia.¹⁴⁴ To the extent utilities' decision makers were insulated from the effects of market and technological changes due to regulatory protections, they did not have to be nimble and responsive to dynamic conditions. There was little motivation to stray from basing their decisions on intuition coupled with their experience, which at times resulted in forecasts and decisions grounded upon faulty premises.¹⁴⁵

2. Efficient Decision Making—*Ex Post*

An *ex post* perspective calls for the examination of a decision for the purpose of selecting the best policy for future actors. The ques-

139. Borrowed from the law of insurance, a moral hazard is a risk of insulating a person or firm from the consequences of their decision making. For example, the problem of moral hazard is present when an insured acts recklessly, knowing that it is the insurance company that will bear the risk of their imprudent behavior. In most insurance contexts, deductibles and co-pays are made part of insurance policies to provide insureds with an appropriate incentive to minimize their risky behavior. The moral hazard problem highlights the necessity of investors taking responsibility for their risky, or even foolish decisions. See generally KEETON & WIDISS, *supra* note 120.

140. See Pierce, *supra* note 17, at 506-07. The Averch and Johnson model used to explain utility investments is not without its critics. One such criticism observes that while investments in capital intensive equipment may increase the rate base, such investment may also yield greater efficiencies in electricity generation, thus lowering the cost to the public. See *id.* Given the lag that often results between the time costs are lowered and when customer rates respond, utilities benefited from the period of time when costs were lowered, but rates had not yet dropped. See *id.*

141. See *supra* note 37-50 and accompanying text.

142. See Pierce, *supra* note 17, at 505-07.

143. See *id.*

144. See Brockway Comments, *supra* note 6.

145. See Pierce, *supra* note 17, at 504, 524-26; see also KAHN, *supra* note 137, at 175-76; Averch & Johnson, *supra* note 129, at 1061.

tion in the present context is what policy choice (compensation or no compensation) results in firms' optimal behavior in the future.

Compensating utilities for their transition losses sends the message that the expenditures they made in forecasting future trends, including market trends, technology advances, and future changes in legal rules, were sufficient. Thus, compensation provides no incentive in the future for utilities to devote further resources to accurate predictive tools. Moreover, compensation signals others observing this market that significant capital investments in rapidly changing technology may be made without seriously considering the risk of obsolescence. Such a policy choice also broadcasts to other unstable, changing, regulated industries¹⁴⁶ that they may be protected from the adverse consequences of their inefficient or high-risk decisions and that such decisions may be made with impunity. The grant of compensation to utilities for their transition losses therefore encourages and rewards imprudent investments.

Moreover, compensation for transition losses may also be deemed by the market as an externality that interferes with the market's intuitive response to a change in its equilibrium.¹⁴⁷ This is especially true if the action or investment in retrospect was harmful or imprudent in the first instance.¹⁴⁸ Arguably, the decision to invest in large-scale nuclear-technologies during a period of instability in the market and at a time of the emergence of anti-nuclear sentiment and environmental consciousness is suggestive of imprudence.¹⁴⁹ The market can best deal with these flawed decisions in a way that will discourage future imprudence by letting the market react to the transition to competition without mandated compensation.

B. The Reliance Theory

Many of the arguments offered for compensation for transition losses are based on the theory of reliance.¹⁵⁰ The reliance theory in the context of market-based transitions is as follows: the firm relied

146. For a discussion of unstable markets and legal rules, see *infra* notes 147-61 and accompanying text.

147. See Kaplow, *supra* note 93, at 551 ("Transitional relief constitutes an externality that disrupts the market's response to the risk imposed by uncertainty concerning future government action.").

148. Kaplow uses the example of the regulatory prohibition of a harmful product. In this circumstance, a retroactive application of the prohibition (with its attendant transition losses) is more appropriate than if the rule change was completely unanticipated and not in response to a potential harm to society. See *id.* at 551-52.

149. See *supra* note 45.

150. The reliance argument has also been made under the contract-related rubric of promissory estoppel. See Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 931-33.

upon a set of assumptions and on the status quo in arriving at their profit prediction and because of unanticipated and unplanned for changes a positive return on investment was not realized. Therefore, the State (or some other third party) ought to make up the difference.

The question of the appropriateness of compensation based on the theory of reliance turns on a number of factors. Implicit in the reliance argument is the claim of a lack of notice or foreseeability of the risk of change. The strength of the argument also turns upon the degree of the market's stability. The question of whether a particular market is unstable depends upon when the market changes first occurred, as well as the degree and magnitude of those changes. Conspicuous changes over a long period of time strongly suggest foreseeability.

As noted above, the electric power market experienced a considerable upheaval as early as the 1970s.¹⁵¹ As the reliability of world fuel supplies became more precarious, electricity demand declined and social and environmental energy-related concerns became more compelling.¹⁵² Accordingly, the public's relationship with the regulated market shifted in response to these changes and the market became increasingly unstable.¹⁵³ Customers who could seek alternative energy sources did.¹⁵⁴ Once energy produced by the monopoly provider became expensive enough to encourage industrial consumers to enhance their co-generation capabilities,¹⁵⁵ those who would benefit began to make investments in smaller energy generation technologies. From that point forward, utilities were on notice that industrial customers were leaving the market, thus decreasing utilities' customer bases. The signal of market volatility was broadcast prior to many of the expenditures for which utilities are currently seeking recovery.¹⁵⁶ Changes in legal rules that further facilitated alternative energy generation followed.

151. See *supra* notes 42-44 and accompanying text.

152. See *supra* notes 42-44 and accompanying text.

153. In a recent article, Professor Jill Fisch addressed the issue of retroactivity and its effects. See Fisch, *supra* note 93, at 1058-63. In proposing a new framework for retroactivity analysis, she focuses upon the stability of the market in which change occurs in evaluating how the law should deal with the effects of such changes. See *id.* Dubbing her doctrinal analysis an "equilibrium approach," she argues that when rule changes disturb stable markets or structures, efficiency and fairness suggest that retroactive effects ought to be minimized. See *id.* Conversely, when a change in law impacts an unstable market, then retroactive effects do not have a significant impact, and thus should be borne by the affected parties. See *id.*

154. See *supra* note 42 and accompanying text.

155. See *supra* note 59 and accompanying text.

156. See Hirsh, *supra* note 2, at 156-61.

Not only can we infer notice from the circumstances surrounding the changes in the market, technology, and legal rules over a period of at least twenty years,¹⁵⁷ but there are also records of specific instances of utility investors' notification that they may not get a return on the full measure of their investments.¹⁵⁸ For example, Long Island Lighting Co. disclosed in its 1988 annual security holders' disclosure statement that investors might not be compensated for losses incurred in connection with the abandoned Shoreham nuclear power plant.¹⁵⁹ Thus, utilities were aware of the signals of change being broadcast to the market. They simply failed to respond to these signals.

Moreover, a simple claim of "reliance" as justification for compensation ignores the normative dimension of this issue—such as whether or not this reliance, and the assumptions underlying it, was reasonable under the circumstances. As stated previously, investment value changes in response to changes in legal rules and market conditions.¹⁶⁰ A nuanced perspective on the concept of reliance recognizes that investors will make decisions based upon their evaluation of the probability of change in legal rules as well as changes in relevant market forces.¹⁶¹ Accordingly, the reliance position is overly simplistic in that it implicitly assumes that the probability of any change is zero.

V. THE SO-CALLED "REGULATORY CONTRACT"—A CHALLENGE TO THE PREDICATE ASSUMPTIONS

A further argument advanced by advocates of transition loss recovery by utilities conceives of the relationship of the utility and the public as based in contract. Proponents of this conception see regulation as an agreement, or contract¹⁶² between the utility and the regulator-as-agent-of-the-legislature-as-representative-of-the-public. They argue that one of the central responsibilities of regula-

157. See *infra* notes 158-59 and accompanying text.

158. See Elizabeth A. Nowicki, *Denial of Regulatory Assistance in Stranded Cost Recovery in a Deregulated Electricity Industry*, 32 LOY. L.A. L. REV. 431, 449 (1999) (citing Long Island Lighting Co., 1988 Annual Report to Shareholders (1988)); see also Niagara Mohawk Power Corp., Form 10-K, 1, 6-7 (Mar. 29, 1996) (visited Mar. 12, 1999) <<http://www.sec.gov/Archives/edgar/data/71932/10000071932960000009.txt>>.

159. See Nowicki, *supra* note 158, at 449.

160. See *id.*

161. See Kaplow, *supra* note 93, at 517-18.

162. This is also sometimes alternatively referred to as a "regulatory compact" or "regulatory bargain." See generally Sidak & Spulber, *Deregulatory Takings*, *supra* note 10; see also *supra* notes 12-14 and accompanying text (describing the rhetoric and its influence in the industry and academic discussion of the transition loss issue).

tors is to define service territories and assign investor-owned utilities to such territories.¹⁶³ Utilities are correspondingly required to offer reliable, consistent electric power to all who work and reside in the service area. In exchange, utilities are granted exclusivity in the market and a "fair rate of return"¹⁶⁴ for capital invested. Accordingly, the argument concludes, a revision of the regulatory scheme that introduces competitive electricity providers to the service territory constitutes a breach of this agreement, which entitles the utility to damages.

A. *Claimed Historical Basis for the "Regulatory Contract"*

The conclusion that the regulatory scheme is contractual in nature is not supported by the industry's regulatory history. Some scholars have tried to trace the contractual conception of regulation to the nineteenth century's municipal franchise grants to utilities.¹⁶⁵ The franchise framework put in place then was supplanted by regulation. The franchise arrangement was repudiated in favor of regulation because of the arrangement's inflexibility and its inability to adapt to changing technological environments.¹⁶⁶ Indeed, it was the contract-like characteristics of municipal franchises, including the inherent difficulty of modifying rates and standards of service, that led to the current non-contractual regulatory relationship.¹⁶⁷ As Peter Bradford, former public utility commissioner and expert on the history of public utilities, observed in his testimony before the Maryland Public Service Commission, "[i]t makes little sense to argue that regulation embodies the very contractual attributes that it was intended to correct."¹⁶⁸

Notwithstanding some early courts' recognition of contractual arrangements when faced with an explicit contract between the State and the regulated industry,¹⁶⁹ the "regulatory contract"¹⁷⁰ label

163. See Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 879.

164. See *supra* note 127.

165. See Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 905-06.

166. See Bradford Testimony, *supra* note 17, at 20 (citing PHILIPS, *supra* note 6, at 130-132).

167. See *id.*

168. *Id.*

169. See *Charles River Bridge v. Warren Bridge*, 36 U.S. (11 Pet.) 420, 427 (1837) (discussing the regulatory scheme of an explicit contract provision contained in the corporate charter). In finding a contract-based arrangement, but not one including a term providing perpetual protection from market competitors, Chief Justice Taney stated, "in grants by the public, nothing passes by implication." *Id.* at 546. In his concurring opinion, Justice McLean stated that a charter granted to the operator of a bridge should be construed, by analogy by the "same rule that governs contracts between individuals." *Id.* at 558 (McLean, J., concurring); see also *In re Binghamton Bridge*, 70 U.S. (3 Wall.) 51, 82 (1865) (recognizing a provision in a corporate charter granting a monopoly as a contract). *But see* *Washington & Baltimore Turnpike Co. v.*

was first used to refer to the present-day regulatory framework in 1983.¹⁷¹ This characterization of regulation gained favor among advocates of transition loss recovery and today is very much a part of the lexicon.¹⁷² Disturbingly, such a notion has gained favor among those advocating for transition loss reimbursement and has been presented to PUCs and state legislatures in their deliberations on the transition loss issue. There is, however, no historical foundation for the award of contract damages for transition losses.

B. The Conceptual "Regulatory Contract"

The success or failure of a "regulatory contract" paradigm turns on a number of basic contract-related issues. The threshold issue is whether a contract was formed in the first instance. To conclude that a contract has been formed, one must first establish and identify the parties to the contract, and then the circumstances of negotiation, bargain, consent, and mutuality of obligation between such parties. Assuming *arguendo* a contract's proper formation, recovery for transition losses must be addressed and provided for in the contract's substantive terms.

Those advocates urging the existence of a "regulatory contract" do not, however, squarely address the critical issue of the identity of the contract parties. Moreover, even if the parties to this ostensible contract are identified, the fundamental doctrinal elements necessary for contract formation were not present.¹⁷³ There is little direct evidence of bargaining, consent, or mutuality of obligation between any of the possible parties. Further, even if the proper formation of a contract is assumed, there is no support for the conclusion that

Maryland, 70 U.S. (3 Wall.) 210, 213 (1865) (failing to enforce a contract in the absence of explicit contractual terms); see also David B. Toscano, Note, *Forbearance Agreements: Invalid Contracts for the Surrender of Sovereignty*, 92 COLUM. L. REV. 426, 452-53 (1992) (observing a connection between the unmistakability doctrine and the *Charles River Bridge* case).

170. See *supra* note 162 and accompanying text.

171. Peter Bradford observed in his testimony to the Maryland Public Utility Commission that the earliest use of the term "regulatory compact" was in a PUC record of a rate proceeding in Washington State. See Washington Util. & Transp. Comm'n v. Puget Sound Power & Light Co., 62 P.U.R. 4th 557, 581-83 (Wash. Util. & Transp. Comm'n 1984); Bradford Testimony, *supra* note 17, at 23.

172. See PHILIPS, *supra* note 6, at 21 (citing Irwin M. Stelzer, *The Utilities of the 1990s*, WALL ST. J., Jan. 7, 1987, at 20); see also Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 857-58; Sidak & Spulber, *Givings, Takings and the Fallacy*, *supra* note 13, at 1105.

173. In addition to the claim of a breach of a formal contract, parties may claim damages based upon the doctrine of quasi-contract or unjust enrichment. Such a claim is based, not on the notion of a promise, but on the idea that one who is unjustly enriched ought to repay to one who enriched, in the amount of the benefits conferred. See generally E. ALLAN FARNSWORTH, *CONTRACTS* § 2.20, at 99-100 (1982).

parties to this contract contemplated damages for compensation by consumers for losses incurred by investors.

1. Parties to the "Regulatory Contract"

Sidak and Spulber, in their argument favoring recognition of a "regulatory contract," gloss over the issue of who the parties to this contract are.¹⁷⁴ References are made to the electricity consumer as a contract party,¹⁷⁵ to "[b]argaining between consumers and firms under the auspices of the regulatory agency,"¹⁷⁶ and to contracts between the "sovereign power and private citizen[s]."¹⁷⁷ In what is perhaps the clearest articulation of the identity of the parties to the "regulatory contract," Sidak and Spulber state that "the regulatory contract is between the utility and the regulatory commission, as the agent of the legislature, which in turn represents the general public."¹⁷⁸ Moreover, notwithstanding the confusion surrounding the identity of the utilities' counterparty to the "regulatory contract," Sidak and Spulber clearly conclude that it is the public who must compensate the utilities for losses incurred in the transition from monopoly to competition.¹⁷⁹

The regulator-as-agent-of-the-legislature-as-representative-of-the-public as the identified contracting party strains the conclusion that because the legislature modified the legal rules affecting the market, the public ought to pay damages.¹⁸⁰ For instance, if the government, acting through its agents, breached a written, mutually-consented-to-contract, entered into with a private party, then costs

174. See Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 879-930.

175. See *id.* at 879.

176. *Id.* at 890.

177. *Id.* at 899.

178. *Id.* at 907.

179. See *id.* at 930 ("[C]onsumers compensated the utility under cost-of-service regulation for the value of service delivered. The services consumed cannot be returned, and reasonable payment has already been made. Thus, the remaining compensation that need be made by consumers in this case is the regulated firm's rate base plus a fair rate of return to capital investment.").

180. There is no evidence that legislatures acted as agents of the public in entering into a "regulatory contract." While agents may possess powers arising in three different ways, (1) expressly granted or impliedly authorized by the principal; (2) apparently authorized; and (3) inherently authorized, it is outside the law of agency to both imply authority based upon the ostensible cast of a principal's vote and then further imply that a regulatory enactment by an agent of the government was indeed a contract between the government as agent and the public and principal. See W. EDWARD SELL, *SELL ON AGENCY* 3 (1975); see also Thomas W. Merrill, Symposium, *Public Contracts, Private Contracts, and the Transformation of the Constitutional Order*, 37 CASE W. RES. L. REV. 597, 611 (1987) (distinguishing between explicit contracts entered into by the government and regulatory enactments, and arguing that the government may influence its contracts through regulation, but such regulation is not contractual in nature).

of the breach could not be passed on directly to the customers of the non-breaching private party.¹⁸¹ It is absurd to conclude that customers, because they represent the public who elect legislators, should be held liable for damages. Likewise, any argument that identifies the "regulatory contract" as between the regulator-as-agent-of-the-legislature-as-representative-of-the-public and the utility, and that concludes that losses incurred by the utility in its transition from monopoly holder to market competitor ought to be paid for by the public, is without doctrinal support.

Even if one accepts the premise that a "regulatory contract" was formed between the regulator-as-agent-of-the-legislature-as-representative-of-the-public and the utility, the public is not a party to the contract, but rather a third party beneficiary.¹⁸² The third party beneficiary doctrine states that third parties may enforce a contract made for their benefit,¹⁸³ but may not be held responsible for damages in the event of the contract's breach.¹⁸⁴ In the classic

181. It may, however, be passed on to the consumer in the form of increased tax liability, but that is not what is being contemplated by legislatures seeking to determine who ought to pay for transition losses. When the government seeks to redistribute losses through the imposition of a tax, the distribution of losses is greater than the compensation scheme that is being advocated by transition loss recovery proponents.

182. Courts have regularly addressed the issue of whether welfare and other benefit recipients have a private right of action to enforce their entitlement to the benefit at issue. See *Bowen v. Public Agencies Opposed to Soc. Sec. Entrapment*, 477 U.S. 41, 55 (1986) (noting that the "contractual right" at issue in this case bears little, if any, resemblance to rights held to constitute 'property' within the meaning of the Fifth Amendment. . . . the provision simply was part of a regulatory program over which Congress retained authority to amend in the exercise of its power to provide for the general welfare. . . . [it] did not rise to the level of 'property'"); see also *Bowen v. Gilliard*, 483 U.S. 587, 608 (1987); *Northern Cheyenne Tribe v. Hollowbreast*, 425 U.S. 649, 651 (1976); *United States v. Fuller*, 409 U.S. 488, 492 (1973). In such cases, plaintiffs are claiming a beneficial interest in benefits flowing from a statute, not a contract. Professor Waters makes the point that it is the status of an individual in relation to either a statute or a contract that leads to the cause of action. See Anthony Jon Waters, *The Property in the Promise: A Study of the Third Party Beneficiary Rule*, 98 HARV. L. REV. 1109, 1116 (1985).

183. See, e.g., *Cort v. Ash*, 422 U.S. 66, 78 (1975) (stating that non-party plaintiffs may sue on a contract theory if they are "one of the class for whose *especial* benefit the statute was enacted") (quoting *Texas & Pacific R.R. Co. v. Rigsby*, 241 U.S. 33, 39 (1916) (emphasis in original)).

184. Cases suggest that the third party contract beneficiaries have what rises to the level of a property interest in the contract benefits, and as such have a cause of action for breach. Cf. *Goldberg v. Kelly*, 397 U.S. 254, 264-65 (1970) (holding that the termination of welfare benefits rose to the level of a property interest due to individuals' reliance on these benefits); *Davis v. Ball Mem'l Hosp. Ass'n*, 640 F.2d 30, 43 (7th Cir. 1986) (holding that indigent people needing hospital care had a property interest in the hospitals complying with the Constitution and the Hill-Barton Act); *Euresti v. Stenner*, 458 F.2d 1115, 1118 (10th Cir. 1972) (permitting a cause of

third party beneficiary case, it is the beneficiary of one party's contract who is suing to redress some abrogation of benefit to which it claims an entitlement.¹⁸⁵

For example, tenants of a housing project sued, as third party beneficiaries, the project owners for assistance payments that were overdue as a result of the owner's negligence.¹⁸⁶ The project owners had entered into a contract with the Department of Housing and Urban Development ("HUD") under which the owners were obligated to comply with certain administrative requirements for HUD to remit funds for the benefit of the project's tenants.¹⁸⁷ The court said that because the contract for tenant assistance between the project owners and the federal government was made for the tenants' direct benefit, they were entitled to bring suit as third party beneficiaries.¹⁸⁸

The situation presented by the utilities seeking damages for breach of the "regulatory contract" is the reverse of this model. First, there is no actual contract between the government and the utility—merely a conceptual contractual model inferred from an amalgam of behavior, statutes, and proceedings.¹⁸⁹ Second, it is the utilities, not the public-as-third-party-beneficiary, that are claiming a breach of the "regulatory contract." Moreover, the utilities are

action against a hospital for denying care to indigent patients based on their entitlements under Title VI of the Public Health Service Act). The most common current-day application of this rule in the context of the government as a party to a contract, can be traced to Charles Reich's ground-breaking proposal that government benefits ought to be treated as recognizable property interests. See Charles A. Reich, *The New Property*, 73 YALE L.J. 733, 785 (1964) (arguing that because of people's increasing dependence upon governmental benefits for their basic needs, these benefits should be treated as "property interests"). *But see Bowen*, 477 U.S. at 51; *Atkins v. Parket*, 472 U.S. 115, 129 (1985) (stating that individuals have no property entitlement rights to governmental benefits); *Wyman v. James*, 400 U.S. 309, 326 (1971).

185. See, e.g., *Holbrook v. Pitt*, 643 F.2d 1261, 1270 (7th Cir. 1981); *Ayala v. Boston Hous. Auth.*, 536 N.E.2d 1082, 1088 (Mass. 1989). *But see Falzarano v. United States*, 607 F.2d 506, 512 (1st Cir. 1979); *Little v. Union Trust Co.*, 412 A.2d 1251, 1253 (Md. Ct. Spec. App. 1980) (holding that because there was no intention on the part of the promisee to bestow direct benefits upon tenants as third parties, there could be no recovery). Even if one could argue that consumers were a party to the "regulatory contract," consumers were never obligated to buy electricity from the utilities—and therefore any such contract would be illusory.

186. See *Holbrook*, 643 F.2d at 1264-65.

187. See *id.*

188. See *id.*

189. See *Sidak & Spulber, Deregulatory Takings*, *supra* note 10, at 887 (analogizing the regulatory contract to the English Constitution, and identifying it as comprised of a "bundle of public utility statutes, utility commission precedents, adjudicatory decisions, rulemakings, hearings on the record, formal notices of proposed rulemaking, and public commentary").

seeking recovery *from* these purported third party beneficiaries, a theory of recovery that is without support in the body of contract doctrine. The third party beneficiary doctrine has evolved to protect the interests of third parties who are the direct beneficiaries of contractual agreements between two other parties. Therefore, it is inequitable, as well as contrary to established contract doctrine, to require the public—the third party beneficiary—to pay for damages upon this ostensible contract's termination.

2. Offer, Acceptance, Consent, and Mutuality of Obligation

Even assuming away, for the moment, the regulator-as-agent-of-the-legislature-as-representative-of-the-public “identification of contract party” problem, the issue of contract formation remains. Basic contract doctrine tells us that in order to find the existence of a contract, there must be both an offer and acceptance of terms.¹⁹⁰ Moreover, to get to the point of acceptance, there must be negotiation, bargain, and consent on the part of the parties.¹⁹¹ In the party-shifting world of transition loss recovery advocates, however, it is not clear which party is deemed to have consented to the terms of this ostensible contract.

a. Assuming the Contract Parties are the Public and the Utility

Assuming, *arguendo*, that the parties to the “regulatory contract” are the public and the utility, then there was no formal, objective manifestation of consent on the part of the public.¹⁹² Contract doctrine tells us that consent to a contract must be manifested by both parties in some form;¹⁹³ the more explicit the consent, the less uncertainty surrounding its existence.¹⁹⁴ The regulated utilities'

190. See Arthur L. Corbin, *Offer and Acceptance, and Some of the Resulting Legal Relations*, 26 YALE L.J. 169, 169 (1917) (examining the factors that must be present to form the legal contractual relationship).

191. See generally JOHN G. CROSS, *THE ECONOMICS OF BARGAINING* 3-15 (1969); see also *supra* note 32 (discussing the various politically based theories of regulation and positing the regulation may arise because of the power and influence of various interests groups, and not necessarily, in all cases, come about because of the public interest).

192. See “Stop the Bailout” Coalition Statement, *Don't Charge Consumers for Utilities' Past Mistakes* (last modified Aug. 1997) <<http://www.local.org/stop-bail.html>>.

193. See FARNSWORTH, *supra* note 173, at 113-18.

194. The objective theory of contracts states that there must be a manifestation of mutual assent. As Judge Easterbrook stated:

Walters stoutly maintains that he subjectively intended to be bound and he wants to invite a jury to infer the same about Telstar.

... Yet ‘intent’ does not invite a tour through Walters’s cranium, with Walters as the guide. . . . ‘The intent of the parties [to be bound] must

monopoly was presented to the public, but its direct consent and approval was not sought.¹⁹⁵ The public's casting of votes for legislators who in turn vote for legislation that results in regulatory market oversight is not tantamount to consenting to be bound to a contract.¹⁹⁶

Moreover, as noted previously, the regulatory framework was created at the initiation of the utilities themselves, the party with the greater resources and cohesive interests, to serve their profit-related ends. It is questionable whether the regulation of this market was enacted with the full assent (taking into consideration resource and informational imbalances) of the public.¹⁹⁷ These differentials result in an inequality in bargaining power. It is therefore difficult to argue that the behavior of the public, as captive customers of utility monopoly holders, ought to be interpreted as consent to a contract. Consent to a form of regulation is not the same as consent to the substantive details of any rate base or structure approved by the utility and the regulatory authority. Notwithstanding some of the benefits received by the public by virtue of the regulators' involvement,¹⁹⁸ the parties did not reach an express contractual

necessarily be derived from a consideration of their words, written and oral, and their actions.' . . . Secret hopes and wishes count for nothing. The status of a document as a contract depends on what the parties express to each other and to the world, not on what they keep to themselves. . . .

The objective approach is an essential ingredient to allowing the parties jointly to control the effect of their document. If unilateral or secret intents could bind, parties would become wary, and the unwritten word would lose some of its power. The ability to fix the consequences with certainty is especially important in commercial transactions that are planned with care in advance.

Skycom Corp. v. Telstar Corp., 813 F.2d 810, 814-15 (7th Cir. 1987).

195. *But see supra* note 32, describing, in general, various theories of origin of the regulatory state. The social and historical origins of regulation, however, does not necessarily rise, for purposes of contract formation, to the level of consent.

196. *See supra* note 180.

197. *See supra* notes 28-32 and accompanying text.

198. Notwithstanding the sound historical basis for the capture theory's explanation for the genesis of the regulation of this industry and its corresponding benefits to the industry owners, the regulatory framework has offered consumers some beneficial effects as well. For example, many states require utilities to disclose to consumers the lowest available rate, provide discounted prices for low income or elderly customers, and limit disconnection of service to households that include the infirm, infants, or the elderly. As long as one firm provides service to all consumers in a given service area, the costs of these protections can be fairly and evenly distributed. With the advent of industry restructuring in many states, some of these consumer protective measures may be in jeopardy. *See* Jerrold Oppenheim, *Consumer Law Remedies for Failure to Disclose Electricity Service Discounts and Protections* 2-3 (Aug. 1998) (on file with author). Other consumer protections that may be lost when the industry is restructured include affirmative protection against redlining, requirements to disclose credit fees in connection with the extension of credit to cer-

agreement, and a "meeting of the minds" cannot be inferred from the behavior of the parties.¹⁹⁹

In a commercial context, evidence of parties' meeting of the minds is found in a contract's express terms, or in the absence of such express terms, in the course of the parties' dealings. Again, merely because there was assent to a regulatory arrangement does not mean that the arrangement rises to the level of a contractual relationship. If every statute resulting in a regulation was deemed to be a binding contract with an unlimited duration between the public and the party affected by the regulation, then upon every rule change, the party responsible for such change (presumably the public, who vote for legislators who change rules) would be liable for breach of contract damages.²⁰⁰ The public may have indirectly consented to being regulated,²⁰¹ but there was no expression of consent, viewed either objectively or subjectively, to a contractual relationship.²⁰² Moreover, there was no affirmative consent on the part of

tain customers, ancillary fee and charge disclosures, conservation education and assistance. *See id.* at 2-4.

199. Courts have referred to the identification of a "meeting of the minds" as a manifestation of assent to contract. Most cases, however, do not describe this as a subjective manifestation of intent—but an objective one in which there must be an apparent and provable "meeting of the minds." Indeed, under section 2-204 of the Uniform Commercial Code, case holdings are consistent with the objective theory of contract. *See generally* *Computer Network, Ltd. v. Purcell Tire & Rubber Co.*, 747 S.W.2d 669, 675 (Mo. Ct. App. 1988) (stating that to ascertain a true meeting of the minds the parties must have had an objective manifestation of intent); *see also* *Sidak & Spulber, Deregulatory Takings*, *supra* note 10, at 888 ("Even if there were no explicit documentation at all of the relationship between the regulator and the firm, the regulatory contract would still represent a meeting of the minds.").

200. *But see infra* Part V.B.4 (discussing the unmistakability doctrine). This doctrine states that "to deem a state legislative enactment a contract [between the state and the party affected by the legislation] for the purposes of the Contract Clause, there must be a clear indication that the legislature intends to bind itself in a contractual manner." *Parker v. Wakelin*, 123 F.3d 1, 5 (1st Cir. 1997).

201. *But see supra* note 32 and accompanying text describing and outlining the various theories of regulation and positing that the capture theory, whereby regulators' interests are "captured" by the regulated parties, is the theory best supported by the electric utility industries' history.

202. Restatement (Second) of Contracts section 20 speaks to the issue of the defective formation of agreements. It states:

(1) There is no manifestation of mutual assent to an exchange if the parties attach materially different meanings to their manifestations and (a) neither party knows or has reason to know the meaning attached by the other; or (b) each party knows or each party has reason to know the meaning attached by the other.

(2) The manifestations of the parties are operative in accordance with the meaning attached to them by one of the parties if (a) that party does not know of any different meaning attached by the other, and the other knows the meaning attached by the first party; or (b) that party has no reason to know of any different meaning attached by the other,

the public to an express contractual *term* providing that the public would compensate utility owners in the event of the introduction of market competition. No such term has been recognized or identified even by transition loss recovery advocates, or revealed in any of the composite of documents claimed to comprise the "regulatory contract."²⁰³

Because there was no consent, either to the conceptual contract or a specific term addressing loss recovery, there was no contract formation and no liability for damages for breach, as between these parties.²⁰⁴ This conclusion finds support in the work of Morris Cohen.²⁰⁵ More than half a century ago, Cohen observed that included in the realm of contract are arrangements between parties where there has been no affirmative bargaining or assent to the terms.²⁰⁶ As an illustration, he set forth an example of a public transportation passenger paying her fare and thereby being subject to the "terms of an agreement" between the passenger and the railway.²⁰⁷ Citing this as an "excess of contractualism,"²⁰⁸ Cohen concluded that the relationship between the customer and the service provider may be one governed by law, but it is "pure fiction" to say that it came about as a result of any "agreement of the wills of the parties."²⁰⁹ Notwithstanding the fact that the customer voluntarily engaged the services of the transportation provider,²¹⁰ the absence of

and the other has reason to know the meaning attached by the first party.

RESTATEMENT (SECOND) OF CONTRACTS § 20 (1981).

203. See *supra* note 189 describing the amalgam of documents that according to some theorists, comprise the "regulatory contract."

204. See *supra* note 189.

205. Cohen discusses both the social roots of contract law as well as the relationship between the state and contracting parties. See generally Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553 (1933). In his view, the law of contract is inexorably tied to the realm of public law in that the sovereign power of the state plays a central role in enforcing and filling in the terms of essentially voluntary agreements. See *id.* at 586. Most, if not all, contracts contain an element of public interest and the view that contracts are formed exclusively as a result of the expression of the will of the parties ignores the role the state plays not merely in contract enforcement, but in defining some of the terms of private agreements. See *id.* at 585-92.

206. See *id.* at 568.

207. See *id.* at 568-69.

208. See *id.*

209. *Id.* at 569. Cohen further cites the example of the worker and employer relationship and how the agreement between these two parties is referred to as a "labor contract." See *id.* Similarly, absent in this relationship are the power to negotiate on the part of the employee and the inability on the part of the worker to significantly alter the terms of the agreement between the parties. See *id.*

210. Even if the railway held a transportation monopoly along the passenger's desired route, the passenger could have opted to walk. Similarly, while electricity is

coercion on either party's part does not necessarily suggest consent²¹¹ or a contractual relationship.²¹²

Furthermore, consent can be expressed in a variety of contexts. One can consent to a wealth transfer with a gun to the head, or consent to onerous lease terms in a tight rental market. The validity of the former expression of consent would be subject to the contract defense of duress, but the validity of the latter would have to be evaluated in light of substantive and procedural fairness concerns. Normative choices have to be made about the validity of the consent given, and a recognition of the need for normative evaluation of consent must be central to the inquiry of whether, in a given context, a contract has been formed.²¹³

b. Assuming the Contract Parties Are the State-Acting-Through-the-Regulator and the Utility

Assuming, in the alternative, that the parties to the "regulatory contract" are the State-acting-through-the-regulators and the utility (notwithstanding the fact that it is the public from whom compensation is being sought), it is similarly difficult to identify objective and affirmative negotiation, bargaining, and consent. Sidak and Spulber look to the relational contract theory to support their conclusion that a contract was formed.²¹⁴ They characterize the "regulatory contract" as an arrangement that relies on "rough formulae or mutual agreement to adjust the contract to current situations," and use agency doctrine to explain how the regulator-as-agent-of-the-

commonly recognized as a necessity, most persons can live, albeit primitively, without it.

211. Cf. *Waters*, *supra* note 182, at 1113 (noting the third party beneficiary doctrine in which a party not involved in a contract may sue to enforce intended benefits from the contract through a private suit).

212. Cf. *id.*

213. Targeting the focus of the issue of contract formation on the issue of consent, disciples of an alternative contract theory, known as the Libertarian Consent Theory, view consent as the objective manifestation of an intention to transfer an entitlement. See generally Randy Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986). At the root of this theory, however, are certain assumptions about who holds entitlements. See *id.* According to this theory's proponents, entitlements serve to define the boundaries between the individual and the State. See *id.* Once entitlements are recognized and established, the way such entitlements are transferred is by consent. See *id.* This theory, however, assumes the existence of a prior distribution of entitlements and begs the question of the origin of entitlements. See *id.* If one accepts the conception that property rights are not static boundaries which define the limits of an individual's autonomy, but rather socially constructed rules that evolve out of shared values and experiences, then the Libertarian view of consent does not fully answer the question of whether a contract has been formed. See *id.* It simply offers a framework for determining, once entitlements have been established, how entitlements are transferred. See *id.*

214. See Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 887-90.

public acts to "negotiate the terms and administer the contract over time."²¹⁵ The application of this doctrine to the regulation of the electric power market does not support the conclusion that a contract has been formed. Indeed, a disciplined application of the relational contract theory leads to the opposite conclusion.

The relational contract theory conceives of contract as an arrangement whereby an exchange takes place, but the nature and terms of the exchange are defined with reference to the "power and normative positions" of the parties.²¹⁶ Accordingly, consent is viewed not as a rigid, one time, objective manifestation of a party's intention to contract, but as a process, which can be inferred from the relationship formed between the parties.²¹⁷ The substantive terms of the contract, to the extent not fully spelled out at the outset, gain content from the norms of cooperation, fairness, and response to changed circumstances.²¹⁸

The relationship that has evolved between the State-acting-through-the-regulators and the utilities is, in part, due to resource limitations of the regulators, reflective of an informational imbalance.²¹⁹ Utilities have historically had control over the flow of information available to regulatory bodies and, as a result, regulators have had to rely heavily on the utilities' version of the facts in setting their regulatory policies.²²⁰ This resource and informational distribution suggests a power imbalance. If one is looking at the process of electric power market policy making with reference to the "power and normative positions" of the parties, one may conclude that because of the regulators' (and the public's) lack of negotiation,

215. *Id.* (quoting Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426, 428-29 (1976)).

216. See Ian MacNeil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract*, 72 NW. U. L. REV. 854, 889 (1978). This theory can be contrasted with the "neoclassical theory" of contract, which has as its focus the terms and circumstances of the parties' original agreement. See *id.* at 890. See generally RESTATEMENT (SECOND) OF CONTRACTS 5 (1979) (defining contract as "a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty").

217. See MacNeil, *supra* note 216, at 889-90.

218. See *id.* at 895.

219. See McArthur, *supra* note 13, at 866 n.359 (citing JOSEPH KALT, ET AL. RE-ESTABLISHING THE REGULATORY BARGAIN IN THE ELECTRIC UTILITY INDUSTRY 48 (1987)); see also MURRAY EDELMAN, THE SYMBOLIC USE OF POLITICS 66 (1964); THEODORE LOWI, THE END OF LIBERALISM 94-97 (1979).

220. See GORMLEY, *supra* note 15, at 31-33. "[G]overnment institutions are highly responsive [to their constituencies], but only to the inputs they receive. Those inputs—in the form of legal briefs, statistical compilations, feasibility studies, and customer surveys—come primarily from regulated industries, which spend enormous amounts of money on formal presentations in regulatory agency proceedings." *Id.* at 31-32.

bargain, and consent to a contractual arrangement, no “regulatory contract” was ever formed.

Moreover, mutuality of obligation, another essential element to the finding of an enforceable contract, is absent.²²¹ There were no reciprocal promises made by the State-acting-through-the-regulators and the utilities with the intent that both parties be legally bound by such promises.²²² The state is free to change the legal rules at any time—and it often does.²²³ At no point did the state legally bind itself, for an infinite duration, to the regulatory arrangement that is in the midst of transition. Accordingly, the absence of mutuality of obligation leads to the conclusion that there is no contract.²²⁴

3. Terms of the “Regulatory Contract”

To discuss whether the terms of the “regulatory contract” provided for transition loss recovery, one must assume the proper formation, and therefore the existence, of a contract. Proceeding upon this assumption, if the parties to the agreement (either the State, the regulators, the State-acting-through-the-regulators, the regulator-as-agent-of-the-legislature-as-representative-of-the-public or the public and the utility) memorialized their positions with explicit and clear contractual terms outlining the consequences of a transition to a competitive market, then it would be hollow to argue that the utilities are not entitled to compensation for any such adverse consequences. In such a circumstance, the parties (no matter who they are deemed to be) would be required to honor all

221. In a case against the Public Utilities Commissioners of New Hampshire, the Commissioners argued against the existence of a regulatory contract in their opposition brief to plaintiff's motion for summary judgment, based in part on the lack of plain contractual language, no evidence of intent to contract inferred from circumstances and behavior of the parties, as well as lack of mutuality of obligation. See Defendants' Opposition to PSNH's Motion for Summary Judgment at 9-36, *Public Service Co. v. Patch*, 87 F. Supp. 2d 57 (D.N.H. 2000) (No. 97-97-JD (NH)) & (97-121 L (RI)) [hereinafter Defendants' Opposition]. The Commissioners argued with respect to the mutuality of obligation issue that, under the specific facts of their case, any performance obligation found in the documents framing their regulatory arrangement were “so discretionary and conditional that neither party can claim the other was legally bound to do anything.” *Id.* at 28-29.

222. See *Crellin Techs., Inc. v. Equipmentlease Corp.*, 18 F.3d 1, 7 (1st Cir. 1994) (“The law requires mutuality of obligation as a prerequisite to a binding bilateral contract.”).

223. For example, during the 105th Congress, there were 4874 bills introduced in the House of Representatives and 2655 bills introduced in the Senate. See [1997-1998 Transfer Binder] Cong. Index (CCH) at 14,294 & 28,445.

224. U.C.C. § 2-204, governing contracts for the sale of goods, offers an interesting analogy. This section provides that contracts must be definite enough to allow (1) a clear determination of breach and (2) the calculation of damages. See U.C.C. § 2-204 (1994).

they are deemed to be) would be required to honor all the terms of the contract and the breaching party would pay damages, if any, upon its breach. No transition loss recovery advocate, however, has been able to identify any such explicit term in any of the composite of documents, statutes, provisions, or hearing records claimed to comprise the "regulatory contract."²²⁵

In the absence of such an explicit contractual term providing for loss recovery, the next inquiry is whether such a term is *implicit* in the "regulatory contract."²²⁶ If terms implicitly providing for transition loss recovery are identified, then any missing feature or elements of such a term are inferred based upon common law contract principles.²²⁷ Alternatively, if consequences flowing from the market transition affecting the electric power industry are deemed to be totally contractually unspecified, then upon a challenge, courts may engage in an *ex ante* normative analysis to determine how the parties would have resolved the issue, had they anticipated it.²²⁸

a. Implicit Remedial Terms

The first issue that must be examined in order to determine whether a term specifying the remedy for the breach of the "regulatory contract" is implicit is the extent to which the current-day regulatory reform was foreseeable, considered, and assented to by the parties. Under common law, to imply contract terms not explicitly included in the contract by the parties, courts will look to the extent to which the parties directly or indirectly assented to what is sought to be implied.²²⁹ Such an expression of agreement to the claimed term can be found by reference to an "objective extrinsic event," but a court cannot "impos[e] its own conception of what the parties should or might have undertaken."²³⁰ Recovery advocates claim that full recovery of transition losses is an implied term of the "regulatory contract"; however, because full recovery is a material

225. See *supra* note 180 and accompanying text.

226. See Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 880-83.

227. Taking these inquiries a step further analytically, one policy analyst makes a distinction between what he refers to as complete and incomplete contracts. Complete contracts are those in which responsibilities of the parties are explicitly or implicitly defined in every foreseeable circumstance. See James Boyd, *The "Regulatory Compact" and Implicit Contracts: Should Stranded Costs be Recoverable?*, 19 ENERGY J. 69, 73 (1998). In contrast, an incomplete contract is one in which a circumstance occurs that was both contractually unspecified and unforeseeable. See *id.*

228. See *id.*

229. See, e.g., *Joseph Martin, Jr., Delicatessen, Inc. v. Schumacher*, 417 N.E.2d 541, 543 (1981) (stating that "before the power of law can be invoked to enforce a promise, it must be sufficiently certain and specific so that what was promised can be ascertained").

230. See *id.* at 543-44.

provision with far-reaching consequences, one would think that transition loss recovery advocates would be able to point to *some* extrinsic evidence of those parties' intention to include such a term.

Another approach under the common law is to apply the "default rule" whereby, in the event a court is faced with an incomplete or absent contract term, it either inserts a term that the parties would have wanted had they agreed, or a term most commercial parties would have agreed to in similar circumstances.²³¹ Clearly, the utilities would have wanted to include such a term, but it is difficult to imagine what circumstances would have induced the public—or even the regulator-as-agent-of-the-legislature-as-representative-of-the-public—to agree to cover the losses incurred by the utilities in the event of a transition, without some form of compensation, in the form of rate discounts to compensate them for bearing such risk. In considering which party is better able to bear and therefore insure against major risk—between the public and the utility or the regulator-as-agent-of-the-legislature-as-representative-of-the-public and the utility—it is clear that the utility, with its superior information and resources, is in the better position.²³² As noted previously, the industry itself is in the best position to predict and dictate technological advances and corresponding market changes.²³³ Moreover, the legal rules governing the market have been changing in response to these advances (which include case law as well as rate case proceedings) over the past twenty years. The norms of cooperation and fairness suggest that between utility investors and their ostensible counter-party, the utility is in the superior position to predict changes, as well as to insure and mitigate the consequences of such changes.²³⁴

231. *See id.*

232. As observed by policy analyst James Boyd, "[u]tilities are clearly more expert than regulators in the prediction of technological change in power generation and . . . are in the best position to adjust production choices and investment decisions to these changes." Boyd, *supra* note 227, at 79.

233. *See HIRSH, supra* note 20, at 145.

234. An alternative approach to the consideration of the incomplete contract term dilemma has been offered by Professors Ian Ayres and Richard Gertner in circumstances where terms are incomplete as a result of strategic bargaining by the parties. *See* Ian Ayres & Richard Gertner, *Filling Gaps in Incomplete Contract: A Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 93 (1989). In such circumstances, Ayres & Gertner argue that the terms should be determined according to what the parties would not have wanted, in order to provide an incentive to be more forthcoming in the bargaining process and therefore improve the bargain's efficiency. *See id.* Their challenge to the "what the parties would have wanted" approach to filling in incomplete contracts is on the basis of high transaction costs. *See id.* If one assumes that the absence of an explicit term in the "regulatory contract" providing with specificity exactly who should bear the transition losses was a strategic decision on the part of the utility, then pursuant to the Ayres/Gertner theory the common law

b. Remedial Terms Not Considered by the Parties

Alternatively, if the "regulatory contract" is viewed as an incomplete contract, meaning the parties never considered the issue of remedial terms in the event of a "breach," the inquiry then becomes, how would the parties have allocated the liabilities for the surfaced losses in the event of transition to competition.²³⁵ In answering this question, one can reasonably assume that the parties, in making such a decision, would try to maximize each of their respective interests. They would consider which party is better able to adapt to or insure against such occurrences at the least cost.²³⁶

As stated previously, adding a term to an incomplete contract providing for compensation to utilities for their transition losses communicates an approval of the type and degree of investment made in forecasting. The addition of a remedial term to an incomplete "regulatory contract" provides no incentive for utilities to invest their resources in more accurate predictive tools in the future.

Moreover, the "reading in" of such a remedial term provides an incentive to other similarly situated parties to make significant capital investments in rapidly changing technologies without considering the risk of obsolescence (or even to include the consequences of the risk of obsolescence in their contracts). Other regulated industries operating in unstable and changing markets could simply enter into contracts (or argue that their regulatory arrangement was contractual in nature) with impunity, but omit any mention of remedial term. This would lead to both flawed decision making as well as a greater number of parties bargaining around difficult terms.²³⁷ Parties who are protected from the adverse consequences of their decisions are far more likely to engage in inefficient or simply high-risk behavior.²³⁸

4. The Unmistakability Doctrine

The unmistakability doctrine states that "in order to deem a state legislative enactment a contract for the purposes of the Contract Clause, there must be a clear indication that the legislature intends to bind itself in a contractual manner."²³⁹ Legislation is pre-

remedy would be what the party engaging in strategic bargaining would not want. If this party is the utility, then it is the utility that ought to absorb the costs of transitioning from monopoly to regulation. See *id.*

235. See Boyd, *supra* note 227, at 78.

236. See *id.*

237. See *supra* notes 98-99 and accompanying text.

238. See *supra* notes 98-99 and accompanying text.

239. Parker v. Wakelin, 123 F.3d 1, 5 (1st Cir. 1997); see also Edward J. DeBar-
tolo Corp. v. Florida Gulf Coast Bldg. & Constr. Trades Council, 485 U.S. 568, 575
(1988) ("[W]here an otherwise acceptable construction of a statute would raise seri-

sumed to be policy oriented in nature and not intended to create private contractual or vested rights.²⁴⁰ Courts will not infer contractual rights from legislation that does not unambiguously express the power or intention to create a contract.²⁴¹

This point is well illustrated in the recent case of *United States v. Winstar Corp.*²⁴² To encourage the turn around of the ailing savings and loan industry, the Federal Home Loan Bank Board (and the FSLIC), through regulatory enactments, favorably treated thrifts with respect to the calculation of their capital reserve requirements.²⁴³ The "express arrangement" between the regulators and the thrifts was subsequently superceded by the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"),²⁴⁴ which disallowed such favorable treatment.²⁴⁵ The Supreme Court upheld the Federal Circuit Court's finding of an express contractual agreement between FSLIC and the thrifts, citing clear language in documents that were incorporated and integrated into the thrifts' merger agreements.²⁴⁶ Because FIRREA precluded the government from fulfilling its contractual promise, the United States was liable for breach of this express contract.²⁴⁷

The benefits conferred on the thrifts in *Winstar*, with respect to their capital reserve requirements, were neither generalized regulatory pronouncements nor the amalgam of ratemaking decisions, statutes, and regulations, as in the case at hand.²⁴⁸ The *Winstar* Court found it significant that not only did the parties affirmatively and explicitly agree to the capital reserve arrangement, but also that such contracts included a "risk shifting" term, allocating "losses [to the government] arising from future regulatory change."²⁴⁹

Again, transition loss recovery advocates have been unable to point to any legislation that specifically created private contractual rights. Moreover, because the "regulatory contract" identifies at best a compendium of documentation, including statutes, regula-

ous constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress." (citing *Murray v. The Charming Betsy*, 2 Cranch 64, 118 (1804)); *Bowen*, 477 U.S. at 52 .

240. See *Dodge v. Board of Educ.*, 302 U.S. 74, 79 (1937).

241. See *Parker*, 123 F.3d at 8.

242. 518 U.S. 839 (1996).

243. See *id.* at 853.

244. Pub. L. 101-73, 103 Stat. 183 (1989).

245. See *id.*

246. See *Winstar Corp. v. United States*, 64 F.3d 1531, 1540, 1542-43 (Fed. Cir. 1995).

247. See *Winstar*, 518 U.S. at 870.

248. See *supra* note 182.

249. *Winstar*, 518 U.S. at 881.

tions, and ratemaking decisions, and is at worst a conceptual contractual arrangement, under the presumptions of the unmistakability doctrine, an implied governmental contractual obligation is without support.²⁵⁰ As the New Hampshire Public Utility Commissioners stated:

In order to properly analyze [the utility's] contract clause claim, it is critical to appreciate the extraordinary character of the contract rights that [the utility] claims it secured from the State. According to [the utility], the State has accorded it an unfettered right to perpetuate its monopoly status to charge rates set as [sic] pre-determined levels for an indeterminate period of time and irrespective of a finding by the . . . Legislature that current electric rates are unreasonably high.²⁵¹

VI. DEREGULATION AS A TAKING

One of the central claims made by the advocates of transition loss recovery is that the introduction of competition to a market previously dominated by a single monopoly supplier has "taken" value from the incumbent supplier, and that such a taking constitutionally requires compensation. The Fifth Amendment to the Constitution reads, in pertinent part, "nor shall private property be taken for public use, without just compensation."²⁵² Colloquially referred to as the "Takings Clause," this constitutional provision has enabled courts to determine when governmental action affecting a property owner's interest requires compensation.²⁵³

250. See generally Defendants' Opposition, *supra* note 221, at 36-41. To illustrate, the Supreme Court recognized a contractual obligation on the part of the government in circumstances where the statutory language read, the "States covenant and agree with each other and with the holders of any affected bonds . . ." United States Trust Co. v. New Jersey, 431 U.S. 1, 18 (1977) (quoting from 1962 N.J. Laws, c.8, § 6; 1962 N.Y. Laws c.209, § 6)). The "sovereign act defense" doctrine similarly states that a "public and general" sovereign does not trigger contractual liability. See Horowitz v. United States, 267 U.S. 458, 461 (1925).

251. Defendants' Opposition, *supra* note 221, at 40-41.

252. U.S. CONST. amend. V.

253. Takings have been found in cases of the State's physical invasions of property as well as when government regulation has the effect of abrogating property interests. The leading physical invasion case is *Loretto v. Teleprompter Manhattan CATV Corp.*, where the Court found the intrusion of a cable television wire on a property owner's apartment building to be compensable. See *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 434-35 (1982). The court held that a "permanent physical invasion" of someone's property constituted a per se taking. See *id.* at 419. The Court, in justifying its per se rule stated, "the property owner entertains a historically rooted expectation of compensation, and the character of the invasion is qualitatively more intrusive than perhaps any other category of property regulation." *Id.* at 441. Sidak and Spulber make the argument that allowing competitors

A. Regulation as an Exercise of Police Power

The police powers of the states are inherent and these powers are protected from federal intrusion by the Constitution's Tenth Amendment.²⁵⁴ Pursuant to their police power, states have the right to enact regulations in the name of the physical, moral, social, and economic well being of the public.²⁵⁵

The United States Supreme Court first addressed the question of the constitutionality of the states' regulation of private businesses in the 1877 case of *Munn v. Illinois*.²⁵⁶ The Court said that certain industries, "affected with a public interest" could be properly regulated by governmental action.²⁵⁷ Businesses that "become a thing of public interest and use" and function as a "virtual monopoly" may be regulated pursuant to the State's police power.²⁵⁸

access to incumbent utilities' power grid (meaning the poles and wires) constitutes a taking. See *Sidak & Spulber, Deregulatory Takings*, *supra* note 10, at 952; see also *FCC v. Florida Power Corp.*, 480 U.S. 245, 252 (1987) (addressing the issue of whether the state could regulate rates charged under a voluntary attachment agreement, and by distinguishing *Loretto* on the facts, held that as long as the rates were not confiscatory, there was no taking).

254. The Tenth Amendment to the Constitution provides that, "[t]he powers not delegated to the [federal government,] . . . nor prohibited . . . to the States, are reserved to the States . . ." U.S. CONST. amend. X.

255. See ERNST FREUND, *THE POLICE POWER, PUBLIC POLICY AND CONSTITUTIONAL RIGHTS* 7 (1976).

256. 94 U.S. 113, 124-25 (1877) (establishing the right of government to regulate and set rates for monopoly providers acting in the public interest). The regulatory state can trace its roots to Europe and the American colonies as far back as the 18th century, when mercantilism was the dominant system for the organization and control of commerce. See *Conference Addendum: Regulating in Pursuit of Efficient and Just Prices*, 8 ADMIN. L.J. AM. U. 913, 914 (1995).

257. See *Munn*, 94 U.S. at 130; see also *Smyth v. Ames*, 169 U.S. 466, 521-23 (1898) (upholding the right of the State to regulate prices charged to the public by a business "affected with a public interest"), *overruled by Federal Power Comm'n v. Natural Gas PipeLine Co. of Am.*, 315 U.S. 575, 602 (1942). Article I, Section 8 of the Constitution, the Commerce Clause, grants the federal government the power to regulate interstate businesses. See U.S. CONST. art I, § 8. The provision grants Congress the power "[t]o regulate Commerce . . . among the several States." U.S. CONST. art. I, § 8, cl. 3. Article I also grants Congress certain "implied powers" to "make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States." U.S. CONST. art. I, § 8, cl. 18.

258. *Munn*, 94 U.S. at 132 (internal quotations omitted). In 1924, the Court further clarified the contours of states' powers to regulate businesses in holding that "[w]hether competition between utilities shall be prohibited, regulated or forbidden is a matter of state policy." *Tennessee Elec. Power v. TVA*, 306 U.S. 118, 141 (1924). In 1934, the Supreme Court in *Nebbia v. New York*, upheld the state's authority to regulate the business on the basis of the state's police powers, coupled with the power of the legislature to regulate intrastate commerce. See *Nebbia v. New York*, 291 U.S. 502, 536 (1934) (concluding that while there was "no closed class or cate-

Public utilities have been among the prime candidates for state regulatory action.²⁵⁹ Because utilities provide a distinct and necessary service to the public,²⁶⁰ they have been held to what is colloquially known as the "public interest standard."²⁶¹ This standard recognizes that the continued operation of public utilities is in the public interest.²⁶² The controls and limits placed on the industry in the form of regulation are designed to balance the needs of the public with the constitutionally protected interests of the regulated industry owners.²⁶³

gory of businesses affected with a public interest," regulation affecting the pricing of milk was nonetheless a reasonable use of governmental authority). The doctrine originally announced in *Munn v. Illinois* has been regularly refined and affirmed by courts in their identification of features of businesses functioning in the interest of the public. See *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389, 411 (1914) (upholding the regulation of fire insurance premiums in the name of the public's interest); *Brass v. Stoeser*, 153 U.S. 391, 403-04 (1894) (upholding the state legislature's regulation of grain elevator and storage facility owners based on the concept of the industry operating in the public's interest).

259. Public utilities have been defined as a "diverse group of businesses that have been subjected over several decades to detailed local, state, and federal regulation of rates and service." PHILLIPS, *supra* note 6, at 4.

260. These services include transportation, telecommunications, natural gas, and electricity and have been broadly characterized as functions of the State. See PHILLIPS, *supra* note 6, at 4-5.

261. The standard has also been referred to as the "public interest, convenience and necessity" standard. Daniel J. Smith, Note, *Stay the Course: A History of the FEC's Response to Change in the Cable Industry*, 13 J.L. & POL. 715, 721 (1997) (citing Glen O. Robinson, *The Federal Communications Act: An Essay on Origins and Regulatory Purpose*, in A LEGISLATIVE HISTORY OF THE COMMUNICATIONS ACT OF 1934, 14-15 (1989)). Justice Brandeis said in his dissent in *New York State Ice Co. v. Liebman*, when a business is "so pervasive and varied as to require constant detailed supervision and a very high degree of regulation. . . it is common to speak of the business as being a 'public' one, . . . [and] [i]t is to such businesses that the designation 'public utility' is commonly applied; or they are spoken of as 'affected with a public interest.'" *New York State Ice Co. v. Liebman*, 285 U.S. 262, 301 (1932) (Brandeis, J., dissenting) (citing *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389, 408 (1914)).

262. Justice Frankfurter said in his dissent in *Federal Power Commission v. Hope Natural Gas Co.*:

For our society the needs that are met by public utilities are as truly public services as the traditional governmental functions of police and justice. They are not less so when these services are rendered by private enterprise under governmental regulation. Who ultimately determines the ways of regulation, is the decisive aspect in the public supervision of privately-owned utilities.

Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 625 (1944) (Frankfurter, J., dissenting).

263. Progressive leader Samuel O. Dunn explained his view of the role of regulatory agencies in 1914:

"The management of public utilities should be left in the hands of the owners or those that they choose to represent them. The regulating commissions should be strong enough in personnel and statutory

It is well-settled law that rate regulation (which directly affects investor rate of return on investments) is within the scope of the State's police power until the point at which it becomes confiscatory.²⁶⁴ The Supreme Court, in *Federal Power Commission v. Hope Natural Gas*,²⁶⁵ stated that so long as the statutory rate setting standard of "just and reasonable" was met (meaning that rates would be set at a level that enabled "the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for risks assumed"), a court will not second guess the rate order by deeming it a taking.²⁶⁶ State public utility commissions, in their rate setting capacity, have had to meet the challenge of striking a balance between meeting the reasonable needs of the public and providing utility investors with a fair rate of return.²⁶⁷

power to exercise corrective authority over the management when the acts of the management are unreasonable and unjust to the public."

THE ECONOMIC REGULATION OF BUSINESS AND INDUSTRY, A LEGISLATIVE HISTORY OF U.S. REGULATORY AGENCIES 9 (Bernard Schwartz ed., 1973).

Cases specifically addressing the permissible contours of public utility regulation have identified the scope of authority of public utility commissioners, as delegated by the legislature:

[PUC orders] are final unless [they are] (1) beyond the power which it could constitutionally exercise; or (2) beyond its statutory power; or (3) based upon a mistake of law. But question of fact may be involved in the determination of questions of law, so that an order, regular on its face, may be set aside if it appears that (4) the rate is so low as to be confiscatory and in violation of the constitutional prohibition against taking property without due process of law; or (5) if the Commission acted so arbitrarily and unjustly as to fix rates contrary to evidence, or without evidence to support it; or (6) if the authority therein involved has been exercised in such an unreasonable manner as to cause it to be within the elementary rule that the substance, and not the shadow, determines the validity of the exercise of the power. . . . In determining these mixed questions of law and fact, the court confines itself to the ultimate question as to whether the Commission acted within its power.

Interstate Commerce Comm'n v. Union Pac. R.R., 222 U.S. 541, 547 (1912); see also *Panhandle E. Pipe Line Co. v. Federal Energy Regulatory Comm'n*, 890 F.2d 435, 439 (D.C. Cir. 1989); *Southern Cal. Gas Co. v. California Pub. Utils. Comm'n*, 591 P.2d 34, 40 (Cal. 1979); *United Inter-Mountain Tel. Co. v. Tennessee Pub. Serv. Comm'n*, 19 P.U.R. 4th 589, 591 (Tenn. 1977).

264. See *Federal Power Comm'n*, 320 U.S. at 598. This holding was a restatement of the principle declared by the Court in 1923 in *Bluefield Water Works & Imp. Co. v. Public Serv. Comm'n*. In *Bluefield*, the court noted that an array of factors must be considered by courts in their evaluation of a fair rate of return, rather than the application of a rigid formula. See *Bluefield Water Works & Imp. Co. v. Public Serv. Comm'n*, 262 U.S. 679, 692-93 (1923). See generally A. Lawrence Kolbe & William B. Tye, *The Duquesne Opinion: How Much "Hope" is There for Investors in Regulated Firms?*, 8 YALE J. ON REG. 113, 127 (1991) (describing the risks of rate regulation).

265. 320 U.S. 591 (1944).

266. *Id.* at 602, 605.

267. See GORMLEY, *supra* note 15, at 24.

These principles were recently affirmed by the Supreme Court in *Duquesne Light Co. v. Barasch*,²⁶⁸ wherein the Court held that regulated public utility investors may not be allowed a return on *all* of their capital invested due to the proper exclusion of a portion of the investment from the rate base.²⁶⁹ What constitutes a "fair rate of return" to public utility investors has been assiduously studied by the courts²⁷⁰ and the resolution of the question turns on whether the utility's "rates are inadequate to compensate current equity holders for the risk associated with their investments under a modified prudent investment scheme."²⁷¹ It is within a state's police power—and not a taking—to affect a utility's earnings, as long as the earnings remained "just and reasonable."²⁷²

That is not to say, however, that a state's exercise of its police power can never rise to the level of a taking. Justice Scalia explicitly said in *Lucas v. South Carolina Coastal Commission*,²⁷³ that the act at issue was a lawful exercise of South Carolina's police power, but "the government's power to redefine the range of interests included in the ownership of property was necessarily constrained by constitutional limits."²⁷⁴ These limits, as defined by the *Lucas* Court, included permanent physical invasions and deprivations of all economically beneficial uses of property.²⁷⁵ The post-*Lucas* question

268. 488 U.S. 299 (1989). In this case, the Court addressed the question of the constitutionality of a state statute prohibiting the inclusion of the "cost of construction or expansion" of electric power facilities "until such time as the facility is used and useful in service to the public." *Id.* at 304 (quoting 66 Pa. Cons. Stat. § 1315 (Supp. 1988)). Absent a showing that a particular rate setting methodology results in unreasonable rates that jeopardize the utility's financial integrity or otherwise fail to compensate shareholders for their investment risks, no taking will be found.

269. *See id.* at 314.

270. *See, e.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299, 301-02 (1989) (deciding that a statute precluding inclusion in utilities' rate base plants that were not used and useful was not an unconstitutional taking); *Federal Power Comm'n v. Texaco Inc.*, 417 U.S. 380, 387-90 (1974) (ruling that FPC may indirectly fix rates charged by small gas producers so long as rates are just and reasonable); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585-86 (1942) (stating that ratemaking authority was not constrained by the Constitution against the making of pragmatic downward adjustments in gas rates unless such reductions were confiscatory); *Covington & Lexington Turnpike Rd. Co. v. Sanford*, 164 U.S. 578, 598 (1896) (holding that a statute reducing tolls able to be charged by a turnpike which were below those allowed by a general statute was Constitutional).

271. *Duquesne Light*, 488 U.S. at 312. This means that investor's rate of return must be evaluated in light of the relative investment risks incurred.

272. *See id.*

273. 505 U.S. 1003 (1992).

274. *Id.* at 1014 (quoting *Pennsylvania Coal v. Mahon*, 260 U.S. 393, 415 (1922)).

275. *See id.* at 1027. "[P]roperty owner[s] necessarily expect[] the use[] of [their] property to be restricted, from time to time, by various measures newly enacted by the State in legitimate exercises of its police powers." *Id.*

therefore, is whether a state, in its enactment of regulations, exceeds the scope of its police powers by engaging in acts that are "categorically compensable," or otherwise exceeds Constitutional limits.²⁷⁶

B. Regulation, Deregulation, and Police Power

Unless the regulation of public utilities under the rubric of the states' police powers is confiscatory, is of a "categorically compensable" nature, or goes "too far,"²⁷⁷ such state action is sanctioned when the property affected is "used in a manner to make it of public consequence."²⁷⁸ The utilities' operations become "clothed with a public interest" and thus are subject to state-imposed constraints.²⁷⁹ These circumstances result in some erosion of utility owners' absolutist property interest because of the devotion of a portion of the formerly "private property" to the interest of the public.²⁸⁰

Whether the deregulation of the electric power market results in a taking similarly turns on the objectives of and justification for the regulatory action. In essence, the changes being made to the regulatory scheme governing the electric power market constitute a re-regulation of this market.²⁸¹ Through the enactment of laws and regulations, the door is being opened to competition in hopes of improving the social and economic well being of the consuming public. In the same way that the incumbent firms' relationship with the regulatory framework was created pursuant to the states' police powers, the states are exercising their police powers to modify and recreate all of the competitors' relationships with the market. Accordingly, the regulation and re-regulation of the electric power market is accomplished through the exercise of the inherent police powers of the State. Since the State in this context is not engaging in either of the *Lucas*-identified categorically compensable actions, the next step is to determine whether the regulatory scheme has gone "too far" by balancing issues of state control with the interests of property protection.

276. *See id.*

277. Justice Holmes said in *Mahon*, 260 U.S. at 415, that when regulation goes "too far" it will be recognized as a taking. *See infra* note 281 and accompanying text.

278. *Munn v. Illinois*, 94 U.S. 113, 126 (1877).

279. *See id.*

280. *See* Gregory S. Alexander, *Takings and the Post-Modern Dialectic of Property*, 9 CONST. COMMENTARY 259, 267-68 (1992); Laura Underkuffler, *On Property: An Essay*, 100 YALE L.J. 127, 142-43 (1990).

281. It is important to note that the electricity transmission, distribution, and generation assets held by the former monopoly holder are not being seized by the state—nor are the utilities being foreclosed from their continued operation. The utilities will continue to have the opportunity, in a competitive market, to earn a fair rate of return. *See* Bradford Testimony, *supra* note 17, at 41.

C. The Court's Takings Tests

The starting point for the examination of whether deregulation of the electric power industry constitutes a taking is the Supreme Court's body of regulatory takings law. Regulatory takings cases arguably constitute one of the most confused bodies of jurisprudence and have provided much fodder for scholarly theorizing and criticism.²⁸² A few distinct, although not easily applied, tests have emerged from a line of cases evaluating the extent to which regulations have impinged upon a property owner's rights.

The seminal case originating the early regulatory takings rule is *Pennsylvania Coal v. Mahon*.²⁸³ Justice Holmes, writing for the majority, announced that "while property may be regulated to a certain extent, if regulation goes too far it will be recognized as a

282. For example, compare the court's analysis of *Keystone Bituminous Coal Association v. DeBenedictis*, 480 U.S. 470, 481-502 (1987) (rejecting a takings challenge to a Pennsylvania law limiting the right of a coal company's mining rights), with *Mahon*, 260 U.S. at 413-16 (finding a taking and striking down legislation limiting the rights of a coal company's mining rights). Justice Stevens observed in his dissenting opinion in *Nollan v. California Coastal Commission*, 483 U.S. 825 (1987) (Stevens, J., dissenting), "[e]ven the wisest lawyers would have to acknowledge great uncertainty about the scope of this Court's takings jurisprudence." *Id.* at 866. See generally Alexander, *supra* note 280; Robert Brauneis, "The Foundation of Our 'Regulatory Takings' Jurisprudence": The Myth and Meaning of Justice Holmes's Opinion in *Pennsylvania Coal v. Mahon*, 106 YALE L.J. 613, 619 (1996) (arguing that Holmes's opinion in *Mahon* is the foundation for Rehnquist era taking decision, "obscur[ing] its original meanings."); Robert Ellickson, *Takings Legislation: A Comment*, 20 HARV. J.L. & PUB. POL. 75 (1996); Richard Epstein, *Pennsylvania Coal v. Mahon: The Erratic Takings Jurisprudence of Justice Holmes*, 86 GEO. L.J. 875, 884-88 (1998) (discussing the features of recent state takings acts); Ronald J. Krotoszynski, *Fundamental Property Rights*, 85 GEO. L.J. 555, 560 (1997) (concluding that "the Supreme Court's current liberty-based substantive due process doctrine should be extended to fully protect fundamental property rights and to protect nonfundamental property interests from utterly arbitrary or irrational government action."); Molly S. McUsic, *The Ghost of Lochner: Modern Takings Doctrine and its Impact on Economic Legislation*, 76 B.U. L. REV. 605 (1996) (discussing the correlation between *Lochner v. New York* and the takings doctrine); Frank I. Michelman, *Property, Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation Law"*, 80 HARV. L. REV. 1165 (1967) (examining the line drawn between compensable and non-compensable takings); Andrea L. Peterson, *The Takings Clause: In Search of Underlying Principles Part I—A Critique of Current Takings Clause Doctrine*, 77 CAL. L. REV. 1299, 1304 (1989) (noting that while the Takings Clause doctrine cases appear to be chaotic, an underlying pattern exists that makes the results more predictable); Carol Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988) (discussing the evolution of property rules from clear rules, to muddled exceptions, to new clear rules); Carol Rose, *Mahon Reconstructed: Why the Takings Issue is Still a Muddle*, 57 S. CAL. L. REV. 561 (1983-84) (exploring *Pennsylvania Coal v. Mahon* and different views of property).

283. 260 U.S. 393, 415 (1922).

taking.²⁸⁴ What constituted a regulation going "too far" remained elusive until 1978 when the Court decided *Pennsylvania Central Transportation Co. v. New York City*.²⁸⁵

In *Pennsylvania Central*, the Court examined a claim by the owners of New York City's Grand Central Station that a landmark preservation ordinance that precluded the erection of an office tower above the rail station was a compensable taking. Justice Brennan, writing for the Court, set forth the test that has since been widely adopted in subsequent regulatory takings cases.²⁸⁶ Courts must examine three distinct issues: (1) the character of the governmental action,²⁸⁷ (2) the economic impact of the regulation,²⁸⁸ and (3) the extent to which the regulation interfered with the claimant's investment-backed expectations.²⁸⁹

The *Pennsylvania Central* Court offered this balancing test, however, without providing any guidance with respect to the relative weight one should put on each of the three factors. Not surprisingly, regulatory takings cases have at times been decided based upon an inconsistent application of these factors to a variety of regulatory enactments affecting a broad range of property interests.²⁹⁰

1. The Character of the Governmental Action

The first prong of the *Pennsylvania Central* test, the character of the governmental action, looks to whether the government in enacting the regulation is furthering an important public policy.²⁹¹ In the context at hand, the governmental action subject to challenge is the enactment of regulations allowing competitive electricity providers to enter heretofore monopoly markets.²⁹² The electric deregulation

284. *Id.*

285. 438 U.S. 104 (1978).

286. *See id.* at 124. Some courts, however, have adopted the test announced two years after *Pennsylvania Central* in *Agins v. City of Tiberon*, 447 U.S. 255, 260 (1980). The Court in this case said a regulation affects a taking if (1) "it does not substantially advance legitimate state interests," or (2) "denies an owner economically viable use[s] of his [property]." *Id.*

287. *See id.*

288. *See id.*

289. *See id.*

290. *But see* Molly S. McUsic, *Looking Inside Out: Institutional Analysis and the Problem of Takings*, 92 NW. U. L. REV. 591 (1998) (positing that judicial takings decisions can be reconciled and explained once politics, legislation, regulation, judicial appointments, and judicial precedents are taken into consideration).

291. *See, e.g., Atlas Corp. v. United States*, 895 F.2d 745, 757-58 (Fed. Cir. 1990) (finding a public purpose in a statute requiring the decommissioning and clean-up of a uranium mill).

292. The movement toward deregulation's early impetus came from industrial consumers concerned about high electric rates. Not surprisingly, states with the

lation movement grew out of a concern that stagnation in the industry, technological advances, and changed market conditions had made monopoly suppliers of electricity anachronistic.²⁹³ Therefore, for the social and economic benefit of the public, the states have begun to encourage competition in the market. The state action's ultimate objective is to lower electricity costs to the consumer—an objective clearly within the scope of an important public policy.

2. The Economic Impact of the Regulation and Interference with Investment-Backed Expectations

The second and third prongs of the *Pennsylvania Central* test are closely related in that both the economic impact of the regulation and the degree of the regulation's interference with the claimants' investment-backed expectations target their focus on the nature of the property interest at issue. Indeed, both tests can only be applied after it is determined that the party claiming a taking has a property interest worthy of constitutional protection.

In essence, the takings claim being made by transition loss recovery advocates is that the utility investors' property interests are being impaired as a result of the market's restructuring. What has not been clearly identified, in either the pleadings of cases in which this claim is being made,²⁹⁴ or in the academic writings advocating for the extension of the takings doctrine to a deregulating market,²⁹⁵ is exactly what the claimants' "property interest" is. The Supreme Court has clearly stated that a reasonable "investment-backed expectation" must be more than a "unilateral expectation or an abstract need."²⁹⁶ If "investment-backed expectation" is viewed as a more generalized interest in the benefits of the regulated market, the policy question implicated is to what extent should the law give force to such interest, thereby transforming it from a mere private interest to a legally enforceable entitlement.²⁹⁷ References to the

highest electric rates were at the forefront of the deregulation movement—presumably in their efforts to lower consumer rates. See Comments of Nancy Brockway, N.H. Public Util. Comm'r, Feb. 9, 1999 (on file with author).

293. See *supra* notes 39-46 and accompanying text.

294. See, e.g., Memorandum in Support of NHPUC's Opposition to Unitil Power Corp., Motion for Partial Summary Judgment at 26, Public Serv. Co. v. Connecticut Valley Elec. Co. (No. 97-97-JD (N.H.)) & (97-121 L (R.I.)).

295. See Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 945-46 ("The regulatory contract exists to create the institutional structure of incentives and credible assurances for the public utility to undertake the substantial capital costs required to perform its service obligations.").

296. *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 161 (1980).

297. See Madeline Morris, *The Structure of Entitlements*, 78 CORNELL L. REV. 822, 827-31 (1993) (discussing legal entitlements and the complexity of identifying what interests rise to the level of entitlements and the extent and type of legal force due such interests).

vague notion of "the institutional structure of incentives and credible assurances"²⁹⁸ appear to suggest a view that the property lies in the institutional structure of monopoly regulation, and all the benefits that flow therefrom.

a. Property's Evolutionary Definition

Property is popularly and comfortably conceived of as the embodiment of tangible and intangible things.²⁹⁹ Often, however, property is more apt to be viewed as more than just a thing and as something that extends beyond a derivative of a physical fact.³⁰⁰ A broader conception of property recognizes property as the *relations* between persons or other entities³⁰¹ with respect to *things*.³⁰² Taking this view of property even further, some scholars in Hohfeldian tradition,³⁰³ have noted that the traditional conception of property as related to things has disintegrated and been replaced by a frame-

298. Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 945.

299. Professor Thomas Grey criticized this idea:

Most people, including most specialists in their unprofessional moments, conceive of property as *things* that are *owned* by *persons*. To own property is to have exclusive control of something—to be able to use it as one wishes, to sell it, to give it away, leave it idle, or destroy it. Legal restraints on the free use of one's property are conceived as departures from an ideal conception of full ownership.

Thomas C. Grey, *The Disintegration of Property*, in *PROPERTY: NOMOS XXII* 69 (J. Roland Pennock & John W. Chapman eds., 1980); *see also* STEPHEN R. MUNZER, *A THEORY OF PROPERTY* 16 (1990).

300. Indeed, much property in our society is of an intangible nature. Consider the following: shares of stock, intellectual property, licenses, bank accounts, debt instruments, and goodwill. *See* Grey, *supra* note 299, at 69.

301. For example, corporations, partnerships, limited liability companies, and other legal entities. *See* ROBERT E. SWINDLE, *FUNDAMENTALS OF MODERN BUSINESS* 89-116 (1977).

302. The Supreme Court observed in *United States v. General Motors Corp.*, 323 U.S. 373 (1945):

It is conceivable that [the term "property" in the Takings Clause] was used in its vulgar and untechnical sense of the physical thing with respect to which the citizen exercises rights recognized by law. On the other hand, it may have been employed in a more accurate sense to denote the group of rights inhering in the citizen's relation to the physical thing, as the right to possess, use and dispose of it. In point of fact, the construction given the phrase has been the latter.

Id. at 377-78; *see also* MUNZER, *supra* note 299, at 16.

303. *See* Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 *YALE L.J.* 16, 21-23 (1919). Hohfeld, known as one of the founders of legal realism, observed that "a claim of property may implicate some combination of rights, liberties, powers, and immunities requiring action or forbearance on the part of others." Barbara Bennett Woodhouse, "Who Owns the Child?": Meyer and Pierce and the Child as Property, 33 *WM. & MARY L. REV.* 995, 1045 n.231 (1992) (summarizing Hohfeld's famous analysis).

work of legal entitlements.³⁰⁴ The potential for the fragmentation of rights with respect to things (i.e., one person can have usage while another, the right to profits) makes relationships among people with respect to things as constitutive of property interests.³⁰⁵ Therefore, property is a reflection of a collective choice of what kinds of interests are significant and compelling enough to rise to the level of a right worthy of legal protection.³⁰⁶

Few of even the most ardent advocates of property rights protection would argue that property is a creature of natural law.³⁰⁷

304. See Grey, *supra* note 299, at 72. One of the examples of a legal entitlement cited by Professor Grey is the limited liability held by corporations; see also Reich, *supra* note 184, at 733.

305. See James L. Oakes, "Property Rights" in *Constitutional Analysis Today*, 56 WASH. L. REV. 583, 587 (1981). The full list of elements of property rights (sometimes referred to as sticks in the bundle of property rights) are (1) the right to possess (meaning either actual physical possession or metaphorical possession in the case of intangibles); (2) the right to use (referring to personal enjoyment); (3) the right to manage and control; (4) the right to income and other benefits from the thing; (5) the right to the capital (meaning the power to alienate, consume, waste, modify or destroy); (6) the right to security (meaning protection from appropriation); (7) the power to devise or bequeath; (8) the absence of term (meaning the right to have an indeterminate length of tenure); (9) the prohibition of harmful use; (10) liability to having the "thing" appropriated for the payment of a debt; and (11) residuary character (meaning the existence of rules governing the reversion of lapsed ownership rights. See LAWRENCE BECKER, PROPERTY RIGHTS 19 (1977) (citing A.M. Honore, *Ownership*, in OXFORD ESSAYS ON JURISPRUDENCE 107-47 (A.G. Guest ed., 1961))).

306. See Laura S. Underkuffler-Freund, *Takings and the Nature of Property*, 9 CANADIAN J.L. & JURISPRUDENCE 161 (1996) (observing that the Supreme Court, in its takings jurisprudence, has failed to establish a coherent view of property); see also A. ALLAN SCHMID, PROPERTY, POWER AND PUBLIC CHOICE, AN INQUIRY INTO LAW AND ECONOMICS 25 (1978).

307. *But see infra* note 315. Traditional treatments of property ownership as a natural right were based upon the arguments from first occupancy and the Lockean-based labor theory. See generally BECKER, *supra* note 305, at 24-80. If one is seeking to determine the respective rights of parties in a heretofore "unowned" parcel of property, the argument from *first occupancy* has great intuitive appeal. See *id.* at 24-31. This justification comes with some significant restraints and is vulnerable to the central criticism that even if appropriation is in accord with a natural right or moral law, permanent possession may not be. See *id.* at 28-30. Similarly, the *labor theory* of property acquisition provides that efforts expended with respect to property entitles one to an interest in that property. This notion rewards those that have invested part of themselves in a thing. See *id.* The flaws in this theory are revealed when it is appropriately qualified. When the labor expended is

(1) beyond what is required morally, that one do for others; (2) produces something which would not have existed except for it; and (3) its product is something which others lose nothing by being excluded from, then (4) it is not wrong for producers to exclude others from the possession, use, etc. of the fruits of their labors.

Id. at 41. These qualifications are so limiting that all one can conclude when this theory is put into application is that the party who expended the efforts only has an

Property is often conceived of as a product of positive law, taking its meaning and definition from the social construct of the State.³⁰⁸ To the extent that property, in a sense, defines the boundaries of State power and control, it is the State that draws these boundaries in the first place.³⁰⁹ As such, even the term "private property" masks the authority the State has in its ability to allocate who holds a property right and wrongly suggests that snapshots of resource distribution are organic and not vulnerable to challenge or abrogation.³¹⁰

b. Property Being Taken

The issue that has been consistently fundamental to the finding of a regulatory taking, however, is the abrogation of a property interest. Accordingly, implicit in every regulatory taking claim is the presence of an antecedent "property" or "legal right" held by the party claiming a taking. Unfortunately, the issue of what the property at issue is or how it is defined is rarely explicit in regulatory takings cases.³¹¹ Moreover, the process courts have engaged in to

entitlement to the tangible results of his efforts if no one else is competing for the same goods. See generally *id.* at 24-80. Furthermore, it does not necessarily follow that because one expended efforts with respect to a thing, that one becomes entitled to such thing. Perhaps, in some cases, it is more appropriate to compensate the laborer with money rather than the object of his efforts. Because the fundamental concept behind the labor theory is that one should be rewarded for his labor, and not, in all cases, that one should receive the thing labored upon, it fails as a fundamental justification for property rights. We have the legal Realists to thank for the recognition that property rights are creations of the power of the state and that property is allocated to some at the expense of others. See CHARLES E. LINDBLOM, *POLITICS AND MARKETS: THE WORLD'S POLITICAL ECONOMIC SYSTEMS* 127 (1977); see also Morris R. Cohen, *Property & Sovereignty*, 13 *CORNELL L.Q.* 8, 8 (1927).

308. See *Board of Regents v. Roth*, 408 U.S. 564, 577 (1972) ("Property interests . . . are not created by the Constitution. Rather, they are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law . . ."); Cohen, *supra* note 307, at 12 (characterizing property rights as "sovereign power compelling service and obedience").

309. See JENNIFER NEDELSKY, *PRIVATE PROPERTY AND THE LIMITS OF AMERICAN CONSTITUTIONALISM* 252, 272-73 (1990).

310. See *id.*; see also Carol M. Rose, *Property as the Keystone Right?*, 71 *NOTRE DAME L. REV.* 329, 349 (1996) (discussing the importance of property as a symbol for all other rights.)

311. See Underkuffler-Freund, *supra* note 306, at 165 ("For a concept of such crucial significance, the sheer absence of articulation by the Court of [a property's] shape, contours, or other identifying characteristics is astonishing. In fact, in the mountains of Supreme Court takings jurisprudence in recent years, comparatively little attention has been devoted to this first, threshold question. The question of the 'property' involved generally receives superficial gloss, with the Court moving quickly to the issue of 'taking.'").

identify property is neither consistent nor revealing of a greater vision or understanding of the concept of property.³¹²

The Supreme Court has begun to identify a hierarchy of property-related interests worthy of protection by, for example, deeming "the right to exclude" and "all economically beneficial" uses of property to be important enough to be categorically compensable.³¹³ Regrettably, however, the Court has failed to articulate a principled justification for its announcement of such distinctions.

At a minimum, it is clear that the definition of property in the takings realm is not confined to tangible property.³¹⁴ It is also clear, that while failing to acknowledge it explicitly, the Court has implicitly infused normative judgments into its property definitions.³¹⁵ The Court appears, a number of times, to reject the legal realist notion that property rights are socially constructed and adopt what seems to be a natural law approach to property's definition.³¹⁶ In doing this, the Court skirts the necessity of acknowledging the value choices it is making each time it determines a particular interest to be a property interest. The dominant approach with respect to the identification of property interests in the Supreme Court's takings jurisprudence, however, is the recognition that property must be defined with reference to previously created state or federal rights.³¹⁷ The question in the context at hand is whether the utility investors have an entitlement to the regulatory state worthy of government protection.

312. See *Dolan v. City of Tigard*, 512 U.S. 374, 384, 388-96 (1994) (identifying the property rights at issue as both the "right to exclude," the "right to use" as well as referencing both the entire parcel of land owned by claimants as well as the smaller portion specifically affected by the regulatory action); *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1016 n.7 (1992) (where the court, in attempting to define property, posited both "the owner's reasonable expectations" as well as "the State's law of property").

313. *Lucas*, 505 U.S. at 1015-16.

314. See, e.g., *Ruckelshaus v. Monsanto*, 467 U.S. 986, 1001-04 (1984) (stating that trade secrets were property); *United States v. General Motors*, 323 U.S. 373, 377-78 (1945) (holding rights with respect to a lease was property).

315. See, e.g., *Miller v. Schoene*, 276 U.S. 272, 279 (1928) (ruling that investors' interests in apple trees were worthy of constitutional property rights protection, whereas investors' interests in red cedar trees were not); see also Joseph William Singer & Jack M. Beerman, *The Social Origins of Property*, 6 CAN. J.L. & JURIS. 217, 218-19 (1993) (arguing that land distribution in the United States is a result of government policy and not social evolution).

316. See *Nollan v. California Coastal Comm'n*, 483 U.S. 825, 834 n.2 (1987) (stating that "the right to build on one's own property. . . cannot remotely be described as a 'governmental benefit'").

317. See *Webb's Fabulous Pharmacies, Inc.*, 449 U.S. at 160-65 (recognizing the money deposited in an interpleader fund as "property").

c. Property Rights and the Regulatory State

Regulation's detractors have clearly and affirmatively characterized regulation as a form of interference with free enterprise.³¹⁸ The "market" is viewed as the natural order and any deviating limitations on its rhythmic movement are artificial interventions requiring specific and persuasive justification.³¹⁹ The property rights of free market participants are simply viewed as a given.³²⁰ What is often not recognized by free market proponents, however, is the fact that markets for commerce themselves are the essence of socially constructed institutions.³²¹ The State sanctions, enforces, and in some circumstances, create the property that trades "freely" in such markets.³²² For example, corporations, LLCs, and partnerships are all examples of property created by state law and constitute property that is engaged in trade.³²³ Moreover, the State effectuates the enforcement of contracts to buy, sell, and use property. Accordingly, neither the property, the market, nor its distributional outcomes are of natural or organic origin.³²⁴

Professors Sidak and Spulber, in advocating for deregulation's characterization as a taking, have implicitly adopted the free market proponents' conception of property.³²⁵ In their articles advocating for utilities' interests, they state that their "overriding concern is the protection of private property as the foundation of a competitive economy."³²⁶ Indeed, they describe their position as one of "defending property rights."³²⁷ These seemingly noncontroversial statements, presuppose, however, the existence of a property interest in the party claiming deregulation's adverse effects—the utility investors. They are viewing property as an absolute and natural right, one held exclusively by the utility investors and worthy of protection without question.³²⁸

318. See generally MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* (1962); RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* (1977).

319. See *id.* See generally Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 873.

320. See *supra* note 316 and accompanying text.

321. See NEDELSKY, *supra* note 309, at 258-59 (noting the socially-constructed nature of so-called free markets).

322. See generally SWINDLE, *supra* note 301, at 10-19.

323. See *id.*

324. See NEDELSKY, *supra* note 309, at 257-59.

325. See Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 933-34; see also Sidak & Spulber, *Givings, Takings and the Fallacy*, *supra* note 13, at 1074.

326. Sidak & Spulber, *Givings, Takings and the Fallacy*, *supra* note 13, at 1074.

327. *Id.*

328. See NEDELSKY, *supra* note 309, at 259 ("[I]t is surprising how many sophisticated commentators (academic and other) adopt the language of 'interference' with a presumptively natural market.").

Sidak and Spulber further claim, on behalf of utilities, an entitlement to the regulatory state.³²⁹ They argue that because the deregulatory schemes proposed by federal and state legislatures are *taking away the state of regulation* and all the benefits flowing from the regulatory environment, the expectations held by the utilities are being interfered with, and thus there has been a "taking" under the Fifth Amendment.³³⁰ This position seemingly adopts what has been observed as an "absolut[ist] approach to property . . . combined with [a] seemingly absolute constitutional guarantee[.]"³³¹ This approach both ignores the market's history of the State's exercise of its police power and the nature of the exercise of power and corresponding changes being contemplated.

Moreover, what is being claimed to be a transition loss worthy of compensation, an "anticipated shortfall in revenue," is not a property interest, but merely an expectation held by utility investors that they would receive a certain rate of return. Since "unilateral expectations" are not protected property rights under takings jurisprudence,³³² any regulation that affects such an expectation cannot be deemed to be a taking.

d. Investment-Backed Expectations as Property

The case for unilateral expectations as property is less substantiated in circumstances where there is the foreseeable potential for regulation in the future.³³³ In examining cases where regulated industries claim takings upon re-regulation, courts have regularly found that if such industries are operating in a regulatory environment, they cannot reasonably claim reliance on the status quo and a compensable property interest in the current regulatory state. For example, in *Concrete Pipe & Products of California, Inc. v. Construction Laborers Pension Trust*,³³⁴ the claimants asked the Court to recognize a taking upon the regulatory imposition of a liability on

329. See Sidak & Spulber, *Deregulatory Takings*, *supra* note 10, at 863-64.

330. See *id.* at 865.

331. Underkuffler, *supra* note 280, at 133.

332. See *Webb's Fabulous Pharmacies*, 449 U.S. at 161 (finding that "a mere unilateral expectation or an abstract need is not a property interest entitled to [Constitutional] protection"); *Board of Regents v. Roth*, 408 U.S. 564, 577-78 (1972) (deciding, on due process grounds, that a unilateral expectation of tenure did not give rise to a property right); *United States v. Petty Motor Co.*, 327 U.S. 372, 377 (1946) (ruling that tenants' interests in a lease is not measured on a subjective special use basis, taking into account tenants' expectations with respect to the property, but at market value).

333. See generally Marc R. Poirier, *Regulatory Takings*, § 10.05 (Matthew Bender ed., 1999).

334. 508 U.S. 602 (1993).

a pension plan sponsor.³³⁵ The Court examined the claimants' position in light of "three factors with particular significance" for takings claims.³³⁶ First, there was no physical invasion or permanent appropriation of the claimant's assets.³³⁷ Second, the economic impact of the imposition of liability was not determinative. "[D]iminution in the value of property, however serious, is insufficient to demonstrate a taking."³³⁸ Finally, the Court noted that at the time the liability was imposed on the plan sponsors, "pension plans had long been subject to federal regulation."³³⁹ Accordingly, "Concrete Pipe's reliance on [the regulation's] original limitation of . . . liability . . . is misplaced, there being no reasonable basis to expect that the legislative ceiling would never be lifted."³⁴⁰ Under similar facts, the Court in *Connolly v. Pension Benefit Guaranty Corp.*³⁴¹ stated "[t]hose who do business in [a] regulated field cannot object if the legislative scheme is buttressed by subsequent amendments to achieve the legislative end."³⁴²

In a different but analogous context, owners of state created leases for water-bottom lands used to cultivate oysters, in *Avenal v. United States*,³⁴³ claimed a compensable taking when subsequent regulation foreclosed the opportunity to continue oyster propagation.³⁴⁴ In its application of the three-factor *Pennsylvania Central* takings test, the court observed that the plaintiffs' property right came about as a result of their taking "advantage of the existing conditions for their own economic benefit."³⁴⁵ "It is hard for them to claim surprise, however, that the pre-existing salinity conditions, created at least in part by earlier government activity, were not left alone, but were again tampered with to their (this time) disadvantage."³⁴⁶

335. See *id.* at 605.

336. *Id.* at 643.

337. See *id.* at 643-45.

338. *Id.* at 645.

339. *Id.*

340. *Id.* at 646.

341. 475 U.S. 211 (1986).

342. *Id.* at 227 (quoting *FHA v. Darlington, Inc.*, 358 U.S. 84, 91 (1958)); see also *California Hous. Sec. Inc. v. United States*, 959 F.2d 955, 958 (Fed. Cir. 1992) (holding that the regulated environment in which the association operated abrogated any historically rooted expectation of compensation for regulatory action); *Lakeview Dev. Corp. v. City of S. Lake Tahoe*, 915 F.2d 1290, 1295 (9th Cir. 1990) (noting that in a heavily regulated situation, the parties were on notice that the investment was subject to further legislative action).

343. 100 F.3d 933 (Fed. Cir. 1996).

344. See *id.* at 935-36.

345. *Id.* at 937.

346. *Id.*

Recently, in *Eastern Enterprises v. Apfel*,³⁴⁷ coal operators challenged the Coal Industry Retiree Health Benefit Act, funded by premiums assessed against them, as an unconstitutional taking.³⁴⁸ Justice O'Connor (with three justices concurring and one justice concurring in the judgment), found a taking and held that the government action at issue imposed "severe retroactive liability on a limited class of parties that could not have anticipated the liability."³⁴⁹ In this case, the coal operators' lack of foreseeability of regulatory change was dispositive.

In *Ruckelshaus v. Monsanto Co.*,³⁵⁰ the holder of a trade secret claimed that a government regulation requiring disclosure of certain data, which included the trade secret, constituted a taking.³⁵¹ The Court, in recognizing Monsanto's trade secret as a property right,³⁵² decided nevertheless that absent an *express promise* made by the government (acting through the Environmental Protection Agency as regulator), Monsanto had no reasonable investment-backed expectation that its information would remain a secret.³⁵³ Because Monsanto gained "economic advantages" in exchange for its submission of information for disclosure, it could not later complain that the government's required disclosure of its trade secrets was beyond the scope of the police power.³⁵⁴ The Court stated:

In an industry that long has been the focus of great public concern and significant government regulation, the possibility was substantial that the Federal Government, which had thus far taken no position on disclosure of health, safety, and environmental data concerning pesticides, upon focusing on the issue, would find disclosure to be in the public interest.³⁵⁵

The application of the holdings of these cases to the transitioning electric utility market leads to the observation that, pursuant to

347. 524 U.S. 498 (1998).

348. *See id.* at 517.

349. *Id.* at 528-29.

350. 467 U.S. 986 (1984).

351. *See id.* at 998-99.

352. *See id.* at 1001-04 (citing *United States v. General Motors Corp.*, 323 U.S. 373, 377-78 (1945)) ("It is conceivable that [the term "property" in the Takings Clause] was used in its vulgar and untechnical sense of the physical thing with respect to which the citizen exercises rights recognized by law. On the other hand, it may have been employed in a more accurate sense to denote the group of rights inhering in the citizen's relation to the physical thing, as the right to possess, use and dispose of it. In point of fact, the construction given the phrase has been the latter.").

353. *See id.* at 1008.

354. *See id.* at 1007-08.

355. *Id.* at 1008-09.

its police power, what the government giveth, the government can taketh away. Benefits were gleaned by these regulated industries (oyster propagators, pesticide manufacturers and electric utilities) for many years, and the parties were on notice of the possibility of prospective changes in the regulatory schemes. Accordingly, there are no reasonable investment-backed expectations held by the regulated industries taken by the State upon a modification of the regulatory landscape—and thus no compensable taking.

VII. CONCLUSION

The movement toward nationwide deregulation of the electric power market has gained momentum. Assuming a competitive market will result in lower electricity prices, it may well be a good idea. The good in this idea, however, may be lost if the transition loss issue is not adequately resolved. Legislatures must make some difficult policy choices with respect to whether utilities ought to be held harmless from the consequences of their choices during the period of monopoly markets. Those in a position to make decisions with respect to the allocation of these obligations must critically examine the nature of the arguments being put before them—as well as these arguments' underlying factual and doctrinal premises.

The doctrinal premises underlying both the contract-based and property-based arguments are flawed.³⁵⁶ The parties to this ostensible contract have never been adequately identified, nor have the necessary elements for contract formation been shown. Moreover, even assuming the existence of a validly created contractual arrangement, due to the absence of explicit or implicit provisions allowing for recovery of losses by utilities, there is no basis for identifying or implying such a recovery for transition losses from the consumer. Yet this is exactly what a number of state legislatures have decided.

Furthermore, there can be no taking in the absence of a property right created by state law. What is being declared as property by transition loss recovery advocates is nothing more than, at most, a unilateral expectation. Accordingly, this argument fails because takings jurisprudence's first foundational principle—a property right—cannot be found. Even assuming a property right in the utility is recognized, changes made to a regulatory structure initially created by the State pursuant to its inherent police powers under current takings jurisprudence, are also within the province of the State's police powers. It is incumbent upon policy makers to challenge these arguments and critically examine their embedded assumptions.

356. See discussion *infra* Parts V & VI.

Moreover, it is important for legislators to recognize that the transition loss issue is not unique to this time and to this industry. Rule changes happen on a regular basis, as do market-based changes. Risk of change is an element of every investment—and as such, it is (or should be) internalized in every investment decision. The transition loss issue facing the electric power industry must be analyzed in a broader context to fully understand the economic implications of loss recovery. In light of the history of this industry and the market it has operated in, policy makers should also consider issues of fundamental fairness.