Regulatory Law: Why So Unclear on Matters So Important?

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Utility law defines the powers, rights and responsibilities of the participants: utilities, competitors, customers, landowners, regulators and legislators. When technological change brings market structure change, we look to law for stability: for clear and consistent descriptions of those powers, rights and responsibilities.

In today's electric industry, the epicenter of technological and market structure change is the space called "distributed energy resources": rooftop solar, community solar, microgrids, demand response, energy efficiency and storage—all ways to diversify and democratize how we produce and consume electric power. DER is the eighth chapter in a book begun 40 years ago, the other chapters being long distance phone service, local wireline service, gas pipeline transportation, wholesale gas, wholesale electricity, retail gas and retail electricity.[1]

In these efforts to bring competition into formerly monopolistic markets, in making powers, rights and responsibilities clear and consistent, how helpful is regulatory law? On two crucial sub-questions, the answer is "Not very."

Is the incumbent's franchise "exclusive"?

For most of the last century, public utility service was provided by monopoly utilities under exclusive franchises granted by state or local government. An exclusive retail franchise arises when a state (a) defines a geographic area and a specific set of services, (b) prohibits retail competition within that area for customers of those services, and then (c) appoints a company to be the sole seller of those services.

Exclusivity is familiar but it is not universal. And exclusivity in fact is not exclusivity in law. Hawaii's electricity franchises—granted by the King—are explicitly non-exclusive. Well before so-called "deregulation," the Maine Commission allowed a new long distance phone company to invade the incumbent's historically exclusive territory. The upstart offered lousy phone service at a discount. The Commission, upheld on appeal, said that if people wanted a service the incumbent had failed to provide it, then ending exclusivity promotes the public interest.[2]

How about when the incumbent lacks the expertise, or enthusiasm, to provide a service the regulator deems desirable? When a commission orders an electric utility to buy power rather than build, there's no invasion technically; but it is an invasion practically because the utility, previously a monopoly over generation and "wires," no longer has a monopoly over generation. In Hawaii, Vermont, Oregon and Maine, the commissions have awarded non-utility entities exclusive contracts to provide energy efficiency services formerly provided by the utility. The Maine and New York Commissions are asking who should perform the role of "smart grid

coordinator" or "distribution system platform provider." Industry players are debating whether third-party solar leasing companies are selling electricity in violation of the incumbents' exclusive franchises. States are studying whether to award exclusive franchises to construct and own electric vehicle charging stations.

These market structure questions affect millions of consumers and billions of investor dollars. You'd think the legal paths would be clear, so we could focus on economics, finance, service quality and customer education. Instead, lawyers are poring over the yellowed pages of utility franchises, and over legislative history made a century ago. Alfred Kahn famously wrote that the "central, continuing responsibility of legislatures and regulatory commissions [is] finding the best possible mix of inevitably imperfect regulation and inevitably imperfect competition."[3] To achieve that goal, we need legal clarity.

Who bears the utility's sunk costs?

"... [N]or shall private property be taken for public use, without just compensation." U.S. Constitution, Amendment V. Addressing the public utility context, Justice Brandeis described what property is "taken," for which "just compensation" is due: "The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return."[4]

So the private property "taken" is the shareholder investment prudently incurred by the utility to fulfill its public service obligations. The "just compensation" is the dollar amount awarded by the regulator. When we introduce competition into the historically exclusive distribution space, how do these principles apply? Specifically, when must customers hoping to "go off the grid"—or their new suppliers—pay off the utility's infrastructure costs incurred to carry out its pre-existing obligation to serve?

On this question, the law tells us little. Fifth Amendment analysis, said the Supreme Court, is "ad hoc." We must consider the "economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations."[5] What if there is no legitimate, "distinct" expectation of cost recovery? In the key cases reaching the U.S. Supreme Court, there was none. And so the franchise invaders owed the utility nothing.

An 18th-century bridge-builder with a 70-year, state-granted charter complained of lost profits when the Massachusetts Legislature chartered a second bridge only "fifty rods apart." The Court responded with ridicule. If the state had to pay the plaintiff's claim, "[w]e shall be thrown back to the improvements of the last century, and obliged to stand still, until the claims of the old turnpike corporations shall be satisfied; and they shall consent to permit these states ... to partake of the benefit of those improvements which are now adding to the wealth and prosperity, and the convenience and comfort, of every other part of the civilized world."[6]

An operator of streetcars and buses in San Francisco was losing customers to municipal transportation companies and other transportation modes. Hoping to stimulate traffic, the California Commission lowered the rates. The company sued, claiming denial of "just compensation." No luck: The Constitution "has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces."[7]

A utility planned a nuclear plant, and began construction; then when load dropped, stopped construction. The Pennsylvania Commission found that each action was prudent. But the state statute forbade recovery of the dollars because the investment was useless for consumers. The utilities argued that disallowance of prudent costs was necessarily denial of just compensation. No again, said the Supreme Court: "[A] state scheme of utility regulation does not 'take' property simply because it disallows recovery of capital investments that are not 'used and useful in service to the public.'" A constitutional rule requiring recovery of prudent cost "would signal a retreat from 45 years of decisional law in this area which would be as unwarranted as it would be unsettling."[8]

There must be some level of investor disappointment that presses the unconstitutionality buzzer. But the courts have not given us a clear example. (Unless one goes back to New Orleans in 1885. When the City granted an exclusive franchise via contract, the utility's contract right became a property right protected by the Constitution—a right that not even a subsequent state constitutional amendment banning monopolies could diminish.[9])

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These are two examples of regulatory policy crying out for legal clarity. Another is the federal-state relationship in the electric industry, in terms of the boundaries between intrastate commerce and interstate commerce, between transmission and distribution, and between wholesale and retail supply. I'll turn to that topic in a future essay.

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[1] And now there an ninth: competition to provide unbundled transmission service, thanks to FERC Order 1000's elimination (subject to *Mobile-Sierra* review) of incumbents' "right of first refusal".

[2] Standish *Tel. Co. v. Pub. Util. Comm'n*, 499 A.2d 458, 459 64 (Me. 1985).

[3] A. Kahn, *The Economics of Regulation: Principles and Institutions*, Vol. I, Introduction at xxxvii; Volume II at 114 (1970; 1988 edition).

[4] *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 290 (1923) (Brandeis, J., concurring).

[5] Penn *Central Transportation Co. v. New York*, 438 U.S. 104, 124 (1978).

[6] Proprietors *of Charles River Bridge v. Proprietors of Warren Bridge*, 36 U.S. 420 (1837).

[7] Market *Street Railway Co. v. Railroad Commission of California*, 324 U.S. 548 (1945).

[8] Duquesne *Light Co. v. Barasch*, 488 U.S. 299 (1989).

[9] New *Orleans Waterworks Co. v. Rivers*, 115 U.S. 674, 682-83 (1885). For more on this topic, see my essay "What Regulatory Compact?" See also Chapter 6 of my book, *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* (American Bar Association 2013).