What "Regulatory Compact"?

Scott Hempling
March 2015

I recently came across this quote:

> There is ... a long-standing, but unwritten, rule that governs cost recovery and lies at the heart of establishing regulated prices. This rule is known as the regulatory compact. Under the regulatory compact, the regulator grants the company a protected monopoly, essentially a franchise, for the sale and distribution of electricity or natural gas to customers in its defined service territory. In return, the company commits to supply the full quantities demanded by those customers at a price calculated to cover all operating costs plus a "reasonable" return on the capital invested in the enterprise.[1]

This is the formula fed to regulatory newcomers: smooth, sweet and easily digested. But it lacks the essential nutrients. As commonly misused, the phrase "regulatory compact" refers to the regulatory treatment of shareholder investment under the statutory "just and reasonable" standard and the Fifth Amendment's Takings Clause in the U.S. Constitution.[2] There is a legal relationship between utility and regulator, and between utility investment and regulator-set rates. But that legal relationship is not "long-standing," it is not "unwritten," and it is not a "rule." To call a "compact" what the Supreme Court has described as "essentially ... ad hoc and factual" is artificially narrow, incumbent-protective, and legally wrong.

Artificially Narrow

Those who cite the "regulatory compact" talk only of an exchange of service for money. The real relationship is richer. It requires the utility to satisfy the regulator's standards for performance at "lowest feasible cost,"[3] to use "all available cost savings opportunities"[4]; and to pursue its customers' legitimate interests free of conflicting business objectives. In return, the regulator must establish compensation that is commensurate with the utility's performance. But there is more. To set standards for performance and ensure compliance, the regulator must have the resources, expertise and political support that is at least the equal of the utility's. And for this relationship to work to each party's benefit, it must include a mutual commitment not to use the political process to undermine either the utility's or the regulator's ability to do their jobs. Those who talk of a "regulatory compact" leave most of these factors out.

Incumbent-Protective

Utilities often cite the "compact" self-referentially, as if it is their compact, created solely to support their specific revenue needs and their specific business success. (As in, "Utility of the Future" rather than "Customer Needs of the Future.") But the legal relationship just described

transcends any particular utility. Its foundation is a franchise, of which the incumbent utility is but a temporary grantee, one whose rights depend on performance. The utility has no lifetime lock on the franchise (see "Regulatory Capture I: Is It Real?"); nor is it like a New York City taxi medallion—bought from government, resold for profit. The franchise is a right to be earned, not demanded.

Legally Wrong

"Regulatory compact" misstates the constitutional relationship between investors and regulators, and between investment and rates. There is no "compact" for a simple legal fact: The constitutional protection of shareholder property is far from airtight. In the landmark case of *Duquesne Light Co. v. Barasch,* Pennsylvania utilities argued that the Takings Clause (as applied to the states through the Fourteenth Amendment's Due Process Clause) guarantees full rate recovery of all prudent investment. The Supreme Court slapped them down:

> We think that the adoption of any such rule would signal a retreat from 45 years of decisional law in this area which would be as unwarranted as it would be unsettling. *Hope* clearly held that "the Commission was not bound to the use of any single formula or combination of formulae in determining rates." ... The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors. The Constitution within broad limits leaves the States free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public.[5]

The case involved a nuclear plant whose construction Duquesne stopped midway. The Pennsylvania Commission had found that Duquesne's decisions both to begin and to stop constructing were prudent. But the Commission disallowed recovery of Duquesne's plant costs based on a statute that limited cost recovery to investment that was "used and useful." The Court rejected the utility's argument that the Constitution required recovery.

This result surprised no non-wishful thinker, because in 1944 the Supreme Court had held that all that matters is the "end result,"[6] and in 1945 declared:

> The due process clause 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]

Given this precedent, those who talk of "the regulatory compact" are putting lipstick on the unpredictable pig of Takings jurisprudence—jurisprudence which, unlike a real compact, is "essentially ... ad hoc and factual."[8]

These foundational cases—*Duquesne, Hope, Jersey Central, Kaiser Aetna and Market Street Railway*—do not create a "compact." They do not create what Lesser and Giacchino call a "long-standing, but unwritten rule that governs cost recovery." What is "longstanding" is not a

"rule" but a principle: Government must compensate shareholders consistently with the legitimate shareholder expectations government creates.[9] In creating those expectations, government is not bound by a "compact"; it is bound by the public interest. To promote the public interest, regulators set standards for performance, then compensate based on performance. And regulators can assign risk (including, as in *Duquesne*, the risk of lousy luck borne by all businesses), then compensate based on the risk thus assigned.

* * *

To define the "regulatory compact" as "Government gives us a franchise, we sell service, you pay for service" misses all these points. The bottom line? Repetition does not create truth. There is no "regulatory compact." As T.S. Eliot wrote:

Words strain,
Crack and sometimes, break, under the burden,
Under the tension, slip, slide, perish,
Decay with imprecision, will not stay in place,
Will not stay still. . . .[10]

---

[1] Lesser and Giacchino, *Fundamentals of Energy Regulation* (2007) at p.43 (footnote omitted).

[2] The Fifth Amendment provides, among other things, that "nor shall private property be taken for public use, without just compensation."

[3] *Potomac Electric Power Co. v. Public Service Commission*, 661 A.2d 131, 137 (D.C. 1995).

[4] *Midwestern Gas Transmission Co. v. East. Tenn. Natural Gas Co.*, 36 FPC 61, *28 (1966), aff'd sub nom. *Midwestern Gas Transmission Co. v. Federal Power Commission*, 388 F.2d 444 (7th Cir. 1968).

[5] *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 315-16 (1989) (citations, footnotes omitted) (referring to *Hope Natural Gas v. Fed. Power Comm'n*, 320 U.S. 591 (1944)).

[6] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

[7] *Market Street Railway Co. v. Railroad Commission of California*, 324 U.S. 548, 566 (1945).

[8] *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (Starr, J., concurring) (quoting *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979)). These

concepts are discussed in detail in my *Regulating Public Utility Performance: The Law of Market Structure, Pricing and Jurisdiction* (American Bar Association 2013) at Chapter 6.

[9] *Penn Central Transportation Company v. New York*, 438 U.S. 104, 124 (1978) (listing factors involved in the Court's Takings analysis, including the "economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations").

[10] T.S. Eliot, "Burnt Norton" from *Four Quartets* (1943).