From Monopoly to Competition: Legal Sand in the Gears
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From Monopoly to Competition: Legal Sand in the Gears

Scott Hempling, Attorney at Law[1]

This presentation discusses three large legal questions that need clarifying for the industry transition to occur cost-effectively and constitutionally:

> **The incumbent utility franchise:** How must it change, to allow entry by new competitive providers of historically monopoly products?
>
> **Utility cost recovery:** What legal principles—statutory and constitutional—address customer responsibility for the incumbent's past and future costs?
>
> **State-federal jurisdiction:** How must we interpret—or change—a 1935 statute to accommodate today's facts?

I. The incumbent utility franchise: How must it change so that new competitive providers can penetrate historically monopoly products?

A. The exclusivity spectrum

For most of the last century, public utility service was provided by monopoly utilities under exclusive franchises granted by government. An exclusive retail franchise arises when the 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 (c) appoints a company to be the sole seller of services mandated by the state. Here are the two poles of exclusivity:

> South Dakota: "Each electric utility has the exclusive right to provide electric service at retail at each and every location where it is servicing a customer as of March 21, 1975, and to each and every present and future customer in its assigned service area." S.D. Codified Laws sec. 49-34A-42 (2015).

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Hawaii: Franchises (originally granted by the King) are expressly non-exclusive.

B. Departures from historic exclusivity: four types

1. Incumbent offers inadequate service, or fails to offer a service that non-incumbent is willing and able to provide

a. Saco River Communications proposed to offer Maine citizens discounted intrastate long-distance telephone service, purchased wholesale from other telephone companies. Saco's customers would have to dial extra numbers and sometimes wait for a scratchy line, but would pay less than they paid the incumbent. The incumbent utility opposed the request.

b. The Commission applied a three-part test: (1) Is there a "public need" for the proposed service? (2) Does the applicant have the necessary technical ability? (3) Does the applicant have adequate financial resources? Answering all questions affirmatively, the Commission granted the request. The Maine Supreme Judicial Court upheld the Commission.[2]

2. Some customers are able to serve themselves, alone or in groups, more economically and effectively than the incumbent

Because self-generation breaches the exclusive franchise wall, they are usually regulated by the state. The type of regulation reflects the regulator's judgment about self-generation's benefits and risks. California and Massachusetts offer contrasting examples.

a. Benefits

(1) Self-generation can give the customer (a) back-up power during utility outages, (b) peak-demand power for high demand periods when the utility lacks enough capacity to serve its remaining load, (c) economic power for when self-generator's cost is less than the utility's rate, (d) pollution reduction when the self-generator's emissions are less than the utility's, and (e) and power quality

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

enhancement where the customer's special equipment uninterrupted flow.

(2) Focusing on these benefits, California offers incentives for self-generation. Responding to capacity shortages in peak periods, the Legislature required the Commission to "adopt energy conservation, demand-side management and other initiatives in order to reduce demand for electricity and reduce load during peak demand periods."[3]

b. Risks

When self-generating customer reduces its purchases from the utility, it no longer pays for its pro rata share of fixed costs incurred historically by the utility to have sufficient capacity available. Those costs then are absorbed by the utility's shareholders, or its non-self-generating customers. As the Massachusetts Department of Public Utilities explained, "to a large extent," a utility's "common costs ... operate as a closed system.... [I]f self-generating customers consume fewer kilowatt-hours from the electric company, transition costs are shifted from self-generating customers to non-self-generating customers."[4]

3. Within the range of monopoly services historically provided by the incumbent, there is one service better provided by a specialty company

a. The incumbent utility might lack the necessary expertise for—or commitment to, the activity. The state commissions of Hawaii, Vermont, Oregon and Maine each have appointed non-utility entities to provide energy efficiency services formerly provided by the utility. And the Maine Commission is investigating whether to appoint a "smart grid coordinator." The coordinator's franchise would be exclusive: "[T]he commission may authorize no more than one smart grid coordinator within each transmission and

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[3] Cal. Pub. Util. Code Sec. 379.5(b) (2012).

[4] Letter from the Department to the Legislature at 2 (July 1, 2011), available at http://www.env.state.ma.us/dpu/docs/electric/11-11/91311dpuordb.pdf (last visited June 25, 2012).

distribution utility service territory." Me. Rev. Stat. tit. 35-A Sec. 3143(5) (2009) Sec. 3143(5).[5]

b. These situations anticipate multiple franchisees in the same service territory, each having an exclusive right and obligation to provide defined services.

4. The state, dissatisfied with the incumbent's performance, wants to use competition to select a new monopoly

a. "[T]he public has an obvious interest in competition, 'even though that competition be an elimination bout.'"[6]

b. Franchise competition is competition for "the right to serve all of the customers in a given territory, usually for a specific period of time...."[7] Retail franchise competition provides consumers "with their most meaningful opportunity to compare alternate price, quality and service. Indeed, at the retail service level, it is this very potential that provides an incentive for [wholesale competitors] to control costs and improve their performance in the areas that they serve."[8]

c. Granting and revoking franchise is a legislative function, delegated by some legislators to the commission: "Implicit in the

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[5] For an excellent analysis of rationales for shifting grid coordination responsibility from the incumbent utility to an independent entity, see Johann Kranz and Arnold Picot, *Toward an End-to-End Smart Grid: Overcoming Bottlenecks to Facilitate Competition and Innovation in Smart Grids*, National Regulatory Research Institute, 2011. Available at http://www.energycollection.us/EnergyRegulators/TowardEndEnd.pdf. The authors identify three incumbent-controlled "bottleneck facilities": the "last mile," meter data, and interoperability protocols.

[6] *Hecht v. Pro-Football, Inc.*, 570 F.2d 982, 991 (D.C. Cir. 1977) quoting *Union Leader Corp. v. Newspapers of New England, Inc.*, 284 F.2d 582, 584 n.4 (1st Cir. 1960).

[7] *Groton v. Connecticut Light and Power Co.*, 662 F.2d 921, 930 (2d Cir. 1981).

[8] *Massena v. Niagara Mohawk Power Corp.*, No. 79-CV-163, 1980 U.S. Dist. LEXIS 9382, at *28 (N.D. N.Y. 1980).

[commission's] power to grant a franchise is the power to revoke it for breach of the franchise's conditions."[9]

d. Compensation for revocation: *Monongahela Nav. Co. v. U S*., 148 U.S. 312, 319 (1893) (holding a franchise thus granted is a "vested right, and if congress thereafter, by condemnation, takes such improvements, it is bound to make just compensation for the value of the franchise, as well as for the physical property taken").

C. Gradations in exclusivity give policymakers options

1. Answering each of the four questions involves tradeoffs: between stability and predictability on the one hand, and innovation and competitive pressure on the other. The purpose of regulation is performance. So regulators must ask: What combination of these approaches most likely assures the desired performance?

2. 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."[10]

D. When we authorize competition services formerly provided by the franchised monopoly, how we make competitive effective?

Authorizing competition does not ensure effective competition; it makes entry legal but it does not necessarily make entry feasible. For example:

1. Does the utility have unearned advantages that will discourage new competitors from entering the market?

2. Does the incumbent control physical facilities that are essential to the newcomer's entry?

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[9] *Valley Rd. Sewerage Co*., 712 A.2d 653, 659 (N.J. 1998) (quoting N.J. Stat. sec. 48:2-14 for the proposition that no franchise granted to a public utility by a political subdivision is valid until approved by the Board of Public Utilities); see also Vt. Stat. tit. 30, sec. 231(a) (granting to the Board both powers to grant and revoke).

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

3. Are there non-physical entry barriers, like customer loyalty, inertia and inexperience, that favor the incumbent and thus distort competition-on-the-merits?

II. Utility cost recovery: What legal principles—statutory and constitutional—address customer responsibility for the incumbent utility's past and future costs?

A. Fifth Amendment Takings Clause: Key concepts

1. The Fifth Amendment to the U.S. Constitution states, in part: "... [N]or shall private property be taken for public use, without just compensation." How does this language apply to utility shareholders?

2. Applying this language to 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."[11]

3. 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 received by utility when it charges the rates set by the regulator. The "just compensation" problem arises if the utility is unable to recover its investment.

4. Suppose a utility with an exclusive franchise prudently invests $90 million in an asset having a 30-year life. After ten years, the utility has recovered $30 million through rates, while earning a return on the unrecovered amount. If the government then frees customers to buy from others, is there a failure to provide "just compensation"? The answer depends, in part, on the market value of the asset. If the market value of the asset is only $45 million, while its book value (the unrecovered amount of the original cost) is $60 million, there is stranded cost of $15 million. Whether there is a constitutional right to recovery of that $15 million has

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

never been decided by a federal court. What follows is the case guidance we do have.

B. Case law Under the Takings Clause

The Supreme Court has held that Takings Clause analysis 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."[12] The line of cases applying the Clause to public utilities establishes this principle: Within some vaguely defined boundaries, utility investors are not guaranteed, constitutionally, recovery of stranded cost. Rather, government regulation can impose on investors the risk that that their leave prudent investments will go unrecovered. But the judicial guidance is imperfect, leading policy makers to make compromise calls that have survived judicial challenge.

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

There the parties fought over the best ways to cross the Charles River. First the facts, then the Court's reasoning.

a. *Ferry*: The Massachusetts Legislature allowed Harvard College to run a ferry service over the Charles River between Charlestown to Boston, and to keep the profits from the operation.

b. *Bridge #1 (Charles River Bridge)*: To make river crossing more convenient, the Legislature subsequently granted Thomas Russell a charter to build a bridge at the ferry's location. The 40-year charter allowed the new company, "The Proprietors of the Charles River Bridge," to charge tolls. During the 40 years, the bridge owner had to pay Harvard "reasonable annual compensation" for the income Harvard would have received from the ferry had the bridge not been built. After 40 years the bridge would belong to the Commonwealth of Massachusetts. The bridge opened in 1786; its charter was later extended to 70 years.

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[12] See *Penn Central Transportation Co. v. New York*, 438 U.S. 104, 124 (1978) (listing factors involved in the Court's fact-based, "ad hoc" 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").

c. *Bridge #2 (Warren Bridge)*: In 1828, midway through the Charles River Bridge's charter term, the Legislature chartered a second company, "The Proprietors of the Warren Bridge," to build a second bridge nearby ("about fifty rods apart"). This charter required the builders to turn the bridge over to the state after it recovered its costs, but no later than 6 years after beginning operation. Once the state received ownership it ended the tolls, making passage free.

d. *The Charles River Bridge owners sued*. Their charter was exclusive and perpetual, they argued. Chartering the second bridge destroyed the value of their bridge, and therefore "impaired the obligation of [their] contract" with the Commonwealth.

e. *The Court's reasoning:* The Supreme Court found that plaintiff Charles River Bridge could prevail only by showing that the State had breached a contract with the plaintiffs: "It is well settled, by the decisions of this court, that a state law may be retrospective in its character, and may divest vested rights, and yet not violate the constitution of the United States, unless it also impairs the obligation of a contract." Here, there was no breach because the Charles Bridge charter never surrendered the Legislature's continual power to do what is necessary to "promote the happiness and prosperity of the community by which it [*i.e.*, the government] is established...." Chartering a second bridge, even if doing so destroyed the value of the first one, was the government's way of promoting the public good:

> "[I]n a country like ours, free, active and enterprising, continually advancing in numbers and wealth, new channels of communication are daily found necessary, both for travel and trade, and are essential to the comfort, convenience and prosperity of the people.:

Absent an explicit statement, the government will not be deemed to have abandoned its powers to meet the public's needs. And if plaintiffs like Charles River Bridge could block legislative decisions like this one, public improvements would be impossible, with dire consequences:

> "[Y]ou will soon find the old turnpike corporations awakening from their sleep, and calling upon this

> court to put down the improvements which have taken their place. The millions of property which have been invested in railroads and canals, upon lines of travel which had been before occupied by turnpike corporations, will be put in jeopardy. We 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 avail themselves of the lights of modern science, and 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."

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

a. Market Street Railway operated streetcars and buses in and around San Francisco. Due to competition from municipal transportation companies and other transportation modes, the company was losing customers. The state commission lowered the rates, finding that the lower fare (6 cents) would stimulate traffic sufficiently to leave a 6 percent return on the rate base. The utility challenged the rate reduction as an unconstitutional denial of just compensation.

b. Upholding the rate, the Court explained that the Constitution has no sympathy for a company whose services are no longer needed:

> "[I]f there were no public regulation at all, this appellant would be a particularly ailing unit of a generally sick industry. The problem of reconciling the patrons needs and the investors rights in an enterprise that has passed its zenith of opportunity and usefulness, whose investment already is impaired by economic forces, and whose earning possibilities are already invaded by competition from other forms of transportation, is quite a different problem. . . . 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."

3. *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

a. Anticipating demand growth, Duquesne began constructing a nuclear plant. When demand growth slowed, the utility changed its plan and stopped construction. The Pennsylvania Commission found the utility prudent throughout: its forecast of demand, its decision to build, its decision to choose nuclear, its decision to stop and all costs incurred in between—all prudent. But the Pennsylvania Legislature had passed a statute requiring the costs of abandoned plant to be absorbed by shareholders, because it was not "used and useful" to customers.[13]

b. Duquesne argued that the Takings Clause required recovery. The U.S. Supreme Court disagreed, and upheld the statute. Pennsylvania was free to enact laws that put the risk of prudent-but-unlucky costs on shareholders. "[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.'" Further, applying the "end result" required by *Hope Natural Gas*, the Court found the economic effect of disallowance (0.4 percent of the utility's annual revenue requirement) non-confiscatory because it was so small.

c. An intervenor, the Pennsylvania Electric Association, separately argued that the Constitution necessarily requires recovery of prudent costs, regardless of their usefulness and regardless of the economic effect of a disallowance. That argument, if accepted by the Court, would have prohibited regulators from allocating to shareholders the risk of prudent but uneconomic outcomes. The Court rejected the argument as inconsistent with Hope:

> "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

[13] 66 Pa. Cons. Stat. sec. 1315.

> formula or combination of formulae in determining rates . . . ."[14]

d. The Court thus reaffirmed a line of cases holding that that the Constitution does not insulate a utility from uneconomic outcomes, whether in the form of market forces, obsolescence or bad luck, even when the utility has acted prudently. If an asset is not "used and useful," the Constitution does not make customers pay.

4. Exception: Explicit government promise

a. One Supreme Court decision did find a constitutional right to recovery of stranded cost. But it first found an explicit government promise that it deemed to a contract:

> "The permission given to [Rivers] by the city council to lay pipes in the streets for the purpose of conveying water to his hotel is plainly in derogation of the state's grant to [Waterworks], for, if that body can accord such a use of the public ways to [Rivers], it may grant a like use to all other citizens and to corporations of every kind; thereby materially diminishing, if not destroying, the value of [Waterworks's] contract, upon the faith of which it has expended large sums of money, and rendered services to the public which might otherwise have been performed by the state or the city at the public expense."

The City still could break Waterworks monopoly, but it would have to pay:

> "The rights and franchises which have become vested upon the faith of such contracts can be taken by the public, upon just compensation to the company, under the state's power of eminent domain . . . . In that way the plighted faith of the public will be kept with those who have made large

[14] *Id.* at 315 (citing *FPC v. Hope Natural Gas*, 320 U.S. at 602).

investments upon the assurance by the state that the contract with them will be performed."[15]

b. The U.S. Supreme Court thus viewed (a) a statutory promise of monopoly status as a contract, (b) the expectation created by the contract as a property right, and (c) the state constitutions breach of that monopoly as a breach of contract, requiring compensation because of the damage to the property right.

C. Application to a changing industry

1. When the government authorizes competition in a historically monopoly market, it disappoints utility shareholders. Their company's market position, and the associated profit expectations, are no longer secure. Has the government taken private property without "just compensation"?

2. A utility's obligation to serve includes the obligation to invest in the infrastructure necessary to serve: generation, transmission, pipelines, switching equipment, wires, poles and pumping stations. The investors expect that the utility's obligation to serve will be matched by the customers' obligation to pay. That obligation to pay—the necessary result of an exclusive franchise structure—assures the incumbent stable revenue flow that covers expenses, debt, recovery of the shareholders' investment and a return on that investment.

3. When government allows customers to try new suppliers, the utility's revenue flow is stable no longer. The incumbent then faces two possible disappointments: It might not recover its prior investment (what economists call "sunk costs), and it will no longer earn the relatively secure profit associated with the monopoly service. These two disappointments are often conflated into the single term "stranded investment." The conflation is inaccurate, because the concepts differ in their legal and practical treatment. The distinction is between **sunk costs and future profits.**

4. The **sunk cost problem** arises if (a) unrecovered book cost associated with assets built or acquired to serve obligatory captive load, exceeds (b) the market value of those assets. The sunk cost problem arises from five factors, acting in combination:

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[15] *New Orleans Waterworks Co. v. Rivers*, 111 115 U.S. 674, 682-83 (1885).

a. The production of electricity is capital intensive.

b. Load growth is incremental, while major infrastructure additions are lumpy.

c. Under traditional ratemaking, the investment cost of infrastructure capital additions is allocated to ratepayers over the plant's useful life.

d. The government introduces competition before all a facility's costs have been recovered.

e. The utility then will be able to recover its unrecovered book costs only if it can find buyers for the infrastructure (or its output) and only if the market prices paid by those buyers produce revenues that equal or exceed the unrecovered book value.

5. The **future profits** problem is this: A utility that loses its exclusive franchise foregoes the profit flow that came with it. Even if the departing customers pay off the past, there is no profit future.

6. Question: Are disappointments over sunk cost recovery and future profit prevented by the Constitution? Should these disappointments be prevented by legislation?

III. State-federal jurisdiction: How must we interpret—or change—a 1935 statute to accommodate today's facts?

Crafted constitutionally in the 1780s and shaped statutorily in the 1930s, the state-federal regulatory relationship is going through tough times. Our infrastructural industries are multi-state, yet much utility regulation remains state-by-state. The resulting tensions take multiple forms: differences over cost allocation, market structure, fuel sources, regulatory techniques and even the very purposes of regulation. Can these differences give way to a relationship between the state and federal jurisdictions that makes best use of both?

A. No escape: When regulated industries are interstate industries, federal-state simultaneity is unavoidable.

Until the 1980s, most of the infrastructural assets, corporate boundaries, business activities, and relevant markets were primarily intrastate. As a result, state regulation coincided with effective regulation. No longer. Electric and gas

consumers depend on production from distant states, brought by multistate transmission lines and pipelines; their consumption pollutes the air and water in other states. Local water users benefit from (and pay for) national water quality standards. Local phone callers depend on a national market of providers who use an interstate telecommunications infrastructure. From single state and independent, our infrastructure has become interstate and interdependent.

B. Mystery: Given the inevitability of "interdependency," why is there so much federal-state irritability?

After three decades of advising, litigating, teaching and testifying, I see the tension coming from five sources.

1. When national and in-state interests clash

a. It is in the national interest for least-cost fuel sources to reach needy loads. The two things are rarely in the same place. So we need electric transmission and gas pipelines to cover long distances, across state lines.—That's a source of tension: between the national interest in least-cost, reliable service, and the state or local interests in preserving natural resources.

b. The tension is natural. It is hard for a state to weigh its wishes against the nation's needs objectively; it is equally hard for a distant federal regulator to value local passion fully.

2. When the federal vs. state issue is, at bottom, a state vs. state issue

a. There seems no end to state vs. state cost allocation battles, resolved finally at FERC, with the winner praising the "nobility of the federal neutral," and the loser attacking the "arrogant federal preemptor." It reminds me of my seventh grade math teacher, Mrs. Fitzpatrick, who once said: "I know how you kids talk about grades: If it's a 'B' or above, it's 'Look what I got!' But if it's 'C' or below, it's 'Look what she gave me.'"

b. Beneath the friendships and trust gained from residence in this state regulatory community, the subsurface has plenty of growling, teeth-baring and logic-suppression. Examples:

(1) Why do coal states insist on a right to low rates, when those low rates stimulate electricity consumption that causes pollution costs to other states?

(2) Why do the beneficiaries of hydro-electricity insist that the benefits are "theirs", when this power source's low cost owes more to nature, geographic serendipity, federal taxpayers and 1930s laborers than to any efforts and innovations from the residents of that states?

(3) Why do residents of nuclear power states complain of federal regulations requiring them to bear the cost of burying the nuclear waste they produce?

(4) Why do states who see wind power as in-state economic development work so hard to have other states fund the transmission investment?

(5) Why do states whose air quality benefits from wind power expect other states to incur the associated aesthetic and transmission costs?

(6) Why do so many urban power plants end up near low income neighborhoods?

c. Consider, contrast, these examples of states that offer their wealth to others:

(1) The states that cause their ratepayers to pay extra to attract renewable energy, or to increase energy efficiency, even though the benefits of supplier diversity, emissions reduction and demand reduction will produce lower costs and prices for non-residents.

(2) The states that subsidize education for the next generation of power engineers, linesman, pipehangers so that the nation's lights stay on, even though some of these students will take their skills to other states.

(3) The states that are generous with low income assistance, according dignity to our poorer citizens, making the entire nation more civilized.

3. When the federal agency makes decisions that raise costs for state-jurisdictional service

EPA sets water quality standards, FERC approves transmission "adders," FCC approves a cost-increasing universal service modification: These decisions might benefit the nation in the long term, but they raise costs for local customers in the short term. The political distance of decisionmaker from affected people is the source of the tension, but may also be the strength of the solution (since political distance increases political insulation, enabling the decisionmaker to "do the right thing.").

4. When the federal and state agencies differ over the purpose of regulation

a. We see this most often in disputes over what is imprecisely called "deregulation." States often criticize FERC and FCC for these agencies view that competition is sufficient to support reduction in regulatory presence. This is not a dispute over the respective roles of state and federal regulators; it is a difference over regulatory outlook and technique, and for some, regulatory conscientiousness.

b. But when the anger is high enough, the disagreement over policy sours into one over trustworthiness and turf. Former FERC Chairman Pat Wood sought to introduce regional transmission policies and regional organized markets. His goals were to rationalize infrastructure investment, diversify customer choices, increase market accountability, and reduce long-run costs. Plenty of people, based on their economic positions, had predictable reasons to support or oppose him. That's politics. What devalued the debate was the hyperbole, as when one state commissioner, perhaps unaware of the tragic overtones, accused Chairman Wood of lining up states for a "forced march."

5. When states act like interest groups rather than regulators

a. Car drivers pursue their self-interests—dentist appointments, court appearances, soccer games. So do airlines—on-time departure reports, labor and fuel costs, bump avoidance. Because these self-interests often diverge from the public interest, we regulate—with speed limits and traffic lights for car drivers, air traffic controls for airlines.

b. Buyers and sellers of electricity also pursue their self-interests. Consumers want TVs working at low cost, stockholders want value growth, generation owners want maximum output at maximum price, no one wants blackouts. Individual, unregulated, self-interested decisions to inject and remove power would render the interconnected interstate transmission unstable. So we regulate. A national regulator, FERC, certifies a national reliability organization and multiple regional transmission organizations, approves transmission tariffs and then allocates generation and transmission costs among the states.

c. From FERC's perspective, allocating costs is simply a version of allocating responsibility. To have a successful church supper, someone assigns responsibilities for food groups. Otherwise, we'd have free-loaders. FERC allocates cost responsibilities, so we don't have free-riders. If we left it up to each state to determine its contribution to the whole, we'd risk insufficiency as each state tried to minimize its cost.

d. Not everyone buys into this economic and physical reality. So we see state commissions to convert from regulators of industry performance into stakeholders seeking to minimize their costs. If we can avoid that reflex—if we can focus on improving overall industry performance rather than minimizing our own state's costs, we likely can achieve both.

e. No one should disagree with this proposition: When unregulated, self-interested uses of an interconnected system would cause reliability problems for others, there is a need to regulate. answer. And if regulation of interstate adequacy is inevitable, then <u>who</u> should regulate? It cannot be a state commission because no state can be objective about the multistate whole. Just as airlines can't be air traffic controllers, transmission users can't be adequacy regulators. There is no "state prerogative" to make decisions that damage other states.

f. The compelling concern is not that a national regulatory entity prescribes results within the state, but that in prescribing results, the national regulatory entity will ignore local concerns. There cannot be "local control" of decisions that affect non-local interests; but the federal forum must take into account local facts and local values. Take into account does not mean "be bound by"

or "honor at all costs." It means "weigh along with other facts and values."

C. Solutions: Literacy, joint purposes and broader decisional contexts

With powers and performance in mind, consider now the difference between state-as-stakeholder (*i.e.*, when it advances its residents' interests over non-residents' interests) and state-as-regulator (*i.e.*, when it focuses on improving industry performance). If we focus less on stakes and more on performance, we focus less on loss and more on benefit.

1. Be constitutionally literate

   a. "A victory for the 10th Amendment," declared Arizona's Governor, about a Supreme Court opinion that never mentioned, and had nothing to do with, the 10th Amendment. At issue was the Supremacy Clause, not the 10th Amendment.[16]

   b. We should avoid rhetoric rooted in illiteracy. "States' rights," "Tenth Amendment," "sovereignty," "encroachment": These terms often carry dramatic emphasis disproportionate to their constitutional relevance.

      (1) Has Congress exceeded its interstate commerce powers?

      (2) Does the federal statute interfere with reserved state powers?

      (3) Does the state regulatory program violate discriminate against, or unduly burden, interstate commerce?

      (4) Did Congress intend to preempt state law?

   c. Consider, in particular, the phrase "states' rights." There is no such thing as "states' rights." Individuals have rights; states have powers. (See the U.S. Constitution, Tenth Amendment: "The <u>powers</u> not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.") A focus on "rights" creates a mindset of entitlement, leading to worry about winning. In

[16] *Arizona v. United States*, No. 11-182 (June 25, 2012).

regulation, the relevant powers are the powers to regulate industry performance.—

2. Articulate joint purpose: industry performance

   a. In this interstate context, "effective regulation" is, necessarily, coordinated state-state and state-federal regulation. The mission is not jurisdictional preservation, but jurisdictional effectiveness. Jurisdictional effectiveness requires us to define roles rationally, with a single purpose: to induce regulated industries to perform at their best.

   b. Have defined the joint purpose, decide who does what best. Consider the hospital operating room, the Habitat for Humanity construction site. The focus is on purpose and performance, the roles determined by expertise. No one argues about jurisdiction.

3. Defer gratification

An article in *The New Yorker*[17] described longitudinal studies of 4-year-olds in the 1960s. Researchers gave the children a choice: one marshmallow immediately vs. two marshmallows fifteen minutes from now. The children who managed to defer gratification for fifteen minutes had, in high school, better grades and SAT scores; and, decades later, better body mass indices, better careers, better lives. While attributing the inter-child differences in part to "wiring," the researchers have not given up on the immediate gratifiers. There are ways to "re-wire" children—to teach techniques that strengthen the will-muscles. (You had a better chance of surviving the fifteen minute wait if you simply turned away from the marshmallows or covered your eyes. Other techniques included "kicking the desk, or tug[ging] on their pigtails, or strok[ing] the marshmallow as if it were a tiny stuffed animal.")

Similarly, constituencies that learn to defer gratification live better lives—as do their successors. What has this to do with regulators? Regulators can teach "re-wiring." Regulators are the issue-experts. While regulation is political (its decisions assign obligations, benefits and costs), it is one step removed from politics. Its practices and procedures emphasize fact-finding, principles and consistency, over grab-bags, power struggles and happenstance. (Not to mention desk-kicking, pigtail-tugging

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[17] J. Lehrer, "DON'T! The Secret of Self Control," May 18, 2009; http://www.newyorker.com/reporting/2009/05/18/090518fa_fact_lehrer.

and marshmallow-stroking.) Regulators have the institutional credibility to help citizens grasp the need for deferred gratification.

4. Calm down

The tension is unavoidable; so our politicians ought to drop the exaggerated expressions of shock, dismay and disapproval. Over 200 years ago the people approved a Constitution, to create a nation of laws. At the economic core of that Constitution was the Commerce Clause—designed to convert our great continent from 13 colonial economies into one nation of commerce. Subsequent Supreme Court decisions, more numerous than should have been necessary, have reminded state legislatures that the Commerce Clause prohibits a state-as-regulator from hoarding its resources (including its land, scenic and environmental resources) to the detriment of other states.[18]

D. Conclusions

Our regulated industries perform many services, some near the customer, some distant; some local, some multistate. Regulation's purpose is to induce high-quality performance. The allocation of regulatory roles requires us to ask: What performance we do want from our regulated industries? What regulatory agencies are best positioned to produce that performance? Effectiveness over turf, substance over emotion: Those are the emphases most likely to ensure success.

States want deference from federal agencies. Which group of states more deserves deference: the cost-shifters and baby-splitters, who emphasize the internal and short-term; or the planners and pie-expanders, who emphasize the external and long-term? Would States deserve—and gain—more credibility with federal regulators if they were seen—and acted—less like states protecting their consumers and more as co-regulators seeking to solve a national problem?

There are not two interests, national and state. There is a single goal: high-quality industry performance. To produce that performance, there may be a national role and a state role, but there is not a national interest and a state interest.

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[18] *See*, *e.g.*, *Philadelphia v. New Jersey*, 437 U.S. 617, 624 (invalidating New Jersey's ban on imports of out-of-state garbage; "where simple economic protectionism is effected by state legislation, a virtually per se rule of invalidity has been erected").