

## The Scope of Regulatory Bargaining

Contracts and other bargains are fundamental to competitive markets. Deregulated electric power and telecommunications markets look to contract to define the relationships between private firms, as well as between private firms and customers. As Joseph Kearney and Thomas Merrill (1998) note in the leading legal treatment of the topic of deregulation: “The new paradigm seeks to subject to ordinary contractual relations all common carrier and public utility services that can be provided through multiple competing providers” (1363). With deregulation, contract will become the primary mechanism for ordering market transactions between private firms and their customers, largely displacing traditional regulatory doctrines that required firms to provide service to customers on predetermined terms and conditions.

Contract is also fundamental to theories of regulation and regulatory law.<sup>1</sup> As economists studying regulated industries with natural monopoly characteristics have long recognized, regulation bears structural similarity to a long-term bilateral contract (Goldberg, 1976; Joskow & Schmalensee, 1983). The actions of the regulator can be analogized to contracts and other bargains. More than for run-of-the-mill industries, the contractual understanding of regulation is fundamental to capital-intensive industries, such as electric power and

<sup>1</sup> Legal scholars are perhaps guilty of using the term “contract” in the regulatory context with less precision and caution than it deserves. The scholarly literature uses the notions of contract in regulation as a rough analogy to describe the nature of various relationships but not necessarily as a legal term of art. Like most legal scholars, I do not intend to imply that regulatory contracts necessarily entail legal duties, obligations, and remedies – an issue I return to in Chapter 5.

telecommunications.<sup>2</sup> For these infrastructure industries, capital investments comprise a large portion of the firm's costs. The firm is only able to pay for these investments over a sustained period of time, making contract a useful way of approaching the finance issue faced by firms and regulators (Gómez-Ibáñez, 2003). To the extent it encourages investment, commitment is fundamental to any account of economic regulation. Contract – a legal tool for establishing commitment – is thus an obvious mechanism for regulatory law to invoke in order to promote investment.

Although notions of the regulatory contract are not foreign to regulatory law, discussion of the regulatory contract is highly polarized. Only at the fringes of regulatory law do contractual and other bargaining concepts enter into serious discussion. This may be due to overreliance on courts as the final arbiter of contracts and a narrow understanding of the scope of contractual bargaining. A bargaining account of government relations can shed light on the history of regulation, as well as on its operation and any changes in regulatory approach. With deregulation and other legal transitions, contractual aspects of regulation have taken on renewed vigor. However, in the context of electric power and telecommunications deregulation, litigants and commentators have made a distinctively legalistic turn in discussion of the regulatory contract and its enforcement. Their approach to the regulatory contract is typically limited to discrete bargains between the firm and governmental bodies, ignoring the bargaining process and other transactional settings, such as bargaining between governing bodies. Many of the important public law questions in economic regulation that are implicated by contractual bargaining remain largely unexplored.

A good example of the polarized nature of the issue is “deregulatory takings” – a prominent theory first advanced a decade ago by scholars and utility advocates. Writing at the height of electric power and telecommunications deregulation in the 1990s, J. Gregory Sidak and Daniel F. Spulber invoked the regulatory contract (which they refer to interchangeably as both a “compact” and a “contract”) as a foundational concept for their account of the state's obligations in introducing competition to industries such as telecommunications and electric power. According to them, the regulatory contract between the firm and the regulator is comprised of reciprocal burdens and benefits:

<sup>2</sup> A growing literature addresses whether other regulated activities can benefit from analogies to contract (Freeman, 2000). Although this book is focused on economic regulation, its lessons may also be of relevance to regulation as contract in other settings.

The regulated utility submits to various regulatory restrictions including price regulations, quality-of-service requirements, and common carrier regulations. In return the regulated firm receives a protected franchise in its service territory, and its investors are allowed an opportunity to earn revenues subject to a rate-of-return constraint. Without the expectation of earning a competitive rate of return, investors would not be willing to commit funds for establishing and operating the utility. . . . Once the utility invests these funds, the long depreciation schedules typical in electricity and telecommunications regulation credibly commit the utility to performing its obligations under the regulatory contract by denying it the opportunity to recover its capital before the end of its useful life.<sup>3</sup>

This argument for deregulatory takings is a modern application of an implied regulatory contract in which the terms of the bargain are not necessarily express. Critics of this view, writing mostly from a legal perspective (Chen, 1999; Hovenkamp, 1999b; Rossi, 1998b), stake out an alternative view of the explicit regulatory contract that would allow regulators to change the terms and conditions of the regulatory contract with little or no attention to the costs this may impose on incumbent firms. In the 1990s, the debate represented by these two polar positions was among the most significant issues facing regulatory law.

Although this debate may have been the rage among regulatory lawyers during the 1990s, the issues faced today in industries such as electric power and telecommunications have little or nothing to do with deregulatory takings. As we near the end of more than a decade of legal transitions, dismantling old regulatory structures and replacing them with new ones, the short-lived theory of deregulatory takings might lead us to question whether the regulatory contract on which deregulatory takings is premised retains any relevance for these industries. That is, once old regulatory structures crumble, can the regulatory contract still be brought to bear on the conflicts infrastructure industries face, or is it a relic of an older economic and legal order with little modern application? In this book, I set out to advance government relations bargaining – a political process theory of the regulatory contract – as relevant to the deregulatory context and other legal transitions. Contract remains relevant, I argue, but bargaining accounts of regulation are challenged to tackle new issues in a changing regulatory environment. Bargaining accounts of government relations will bring important new insights to bear for public law in the context of economic regulation.

<sup>3</sup> Sidak & Spulber, 1997: 109.

## I. DISTINGUISHING POLITICAL FAILURE FROM MARKET FAILURE

In the summer of 2003, a massive blackout left 50 million customers in much of the Northeast and portions of the Midwest without electric power. The blackout affected an area extending from New York, Massachusetts, and New Jersey west to Michigan, and from Ohio north to Toronto and Ottawa, Ontario, Canada. The economic costs it imposed are staggering.<sup>4</sup> Media accounts were quick to blame the blackout on deregulatory policies the electric power industry adopted throughout the 1980s and 1990s.<sup>5</sup> Although intuitively appealing, efforts to blame deregulation for the problem fail to explain the mechanism by which deregulation might have contributed to the problem. There is, for example, little reason to expect traditional rate regulation would have fared better in avoiding the 2003 blackout.<sup>6</sup>

How, if at all, has deregulation failed? Has deregulation made industries such as electric power better (cheaper, more reliable, etc.) or worse for consumers, investors, and firms, and what role, if any, has the law played in this? Notions of the regulatory bargain can shed light on the issues faced by deregulated industries, such as electric power, and by other industries in transition. The conventional account of deregulation's weakness suggests that enhanced competition between firms will sometimes – perhaps even frequently – lead to predatory market conduct that harms consumers (Kuttner, 1999). This account might be applied to critique electric power deregulation, perhaps as much as in any other sector of the economy affected by deregulation. In California's newly deregulated electric power market in the late 1990s, energy supply firms were able to manipulate supply and prices, seeking short-term gain at a cost to

<sup>4</sup> Refer to <http://www.electricity.doe.gov/news/blackout.cfm?section=news&level2=blackout>. Some estimated the costs of the 2003 blackout to be as high as \$5 billion. Nancy Gibbs, *Lights Out*, TIME MAGAZINE, Aug. 5, 2003, at 30.

<sup>5</sup> On one account, “The current industry-centered deregulation of the national power grid has created market-driven chaos, with electric bills skyrocketing as high as 300 percent in California while power systems become less and less reliable – all at a time when the shrinking cost of renewable energy should be providing lower costs and a more reliable system.” Michael I. Niman, *Why the Lights Went Out*, THE HUMANIST, Nov. 1, 2003, at 4.

<sup>6</sup> Indeed, for many Americans older than 45 years of age, the blackouts of 2003 were reminiscent of the blackouts of 1965, which left millions in eight Northeast states without power for almost 24 hours, or the blackout of 1977, which plunged New York City into darkness and brought about violence in several communities. For comparison between the 1965 blackout and the 2003 blackout, see Sillin (2003). The analogy between the blackout of 1977 and the blackout of 2003 is discussed in Goodman (2003).

consumers and others (Weaver, 2004). Similarly, in deregulated wholesale power markets (structured primarily by federal as opposed to state regulators), private greed certainly contributed in part to a serious shortage in generation supply and transmission capacity, exacerbating the blackouts that left New York City and much of the northeastern United States in the dark in the summer of 2003.<sup>7</sup> On this account of deregulation's weakness, private greed is the core cause of failures in the transition to competitive markets.

This account of deregulation's weakness is controversial. It may or may not have merit, but it is not the full story. Deregulated markets face another challenge that is underexplored in the popular and academic press. Most economists believe that properly designed markets can curtail the negative impacts of greed in the competitive process. Changes to regulatory structure are not only relevant insofar as they influence how private firms compete with each other in the unregulated sphere of the marketplace. Regulatory change also affects how firms interact with and influence governmental bodies in the formulation and implementation of regulatory law. Government relations bargaining in this context have serious consequences for the regulatory process and for public law.

For example, the failure of electric power deregulation in California was as much a consequence of ill-conceived government competition policies, frequently framed by public law doctrines, as it was a consequence of private greed in deregulated markets. Like most deregulated markets, California's plan to deregulate retail electric power did not dismantle government regulation. Instead, it emphasized new types of regulation, such as a state-supervised power pool that prohibited certain types of transactions and sanctioned others. Wholesale power supply markets, largely deregulated by the federal government in the 1990s, before California's retail market opened, are subject to market-based supply decisions by private firms and large price swings. California retail power suppliers, however, were subject to a price cap imposed by state lawmakers and were also prohibited from using long-term contracts to serve retail customers. Due to the state-imposed price cap, California utilities were precluded from passing on their costs to customers, forcing them to absorb monumental losses in highly volatile short-term supply markets when wholesale

<sup>7</sup> Matthew L. Wald, *A Question Still Unanswered: How Did the Blackout Happen?*, NEW YORK TIMES, May 10, 2004 (online edition) (quoting Robert Blohm, an electricity consultant who questions whether deregulation impaired reliability and caused the blackout to spread).

power prices skyrocketed. Several electric power utilities in the state – previously considered risk-free investments – went bankrupt. Undoubtedly, state policy decisions in California to cap retail prices and prohibit long-term contracts were influenced by strategic lobbying and other regulatory maneuvers on the part of private stakeholders in the California law-making process. Private manipulation of government regulation is as significant as, and may even eclipse, private abuse of competitive markets.<sup>8</sup> To the extent public law invites such manipulation, it shares responsibility for failed market policies.

Most accounts of California's failed deregulatory policies focus on private greed in the marketplace. In contrast, a government relations bargaining story of California's failed deregulation plan highlights weak links in the political processes leading to the formation and implementation of competitive retail power markets in the state. Firm–government interactions had significant influence on the path of California's competition policies as it implemented its deregulation plan. So did government–government interactions, as utilities in the state were brought to the brink of financial disaster while federal and state regulatory bodies faced off in inaction – each attempting to pass the blame to the other for the failures in California's deregulated markets, with neither one stepping up to the plate to address the serious regulatory problems that had been created. Public law doctrines, such as the filed rate doctrine (see Chapter 6) and federal preemption (see Chapter 8), were central to this crisis.

A government relations bargaining account can also be used to explore the issues of transmission reliability – perhaps the greatest problem competitive markets in electric power will face in the coming decade. A massive blackout in the summer of 2003 left large portions of the Northeast and Midwest without power due to a cascading failure of the interstate transmission grid. The 2003 blackout may have been triggered by individual negligence (and perhaps even greed, although that is doubtful), but private market behavior was certainly not the immediate reason the blackout spread from Ohio, where it is widely reported the initial event leading to the blackout occurred, to New York and other states. Consequences were made far worse for areas like New York City due to both public

<sup>8</sup> Accounts of California's failed deregulatory scheme focus on tensions and gaps between state and federal deregulatory policies (Joskow, 2001; Rossi, 2002). Other accounts emphasize California's failure to allow long-term contracts to serve the retail market (Borenstein, 2002). These accounts share a focus on California's failed government policies, not an inherent failure in power markets.

and private failures to expand transmission facilities over several decades. These failures were influenced by private conduct in a regulatory process – both preceding and following deregulation – as much as by deregulation itself. As one author observes, “[e]lectricity consumption increased by 35 percent in the 1990s alone (and is twice the level of the early 1970s), with transmission carrying capacity increasing by only 10 percent” (Sillin, 2003: 34).

Private utilities – owning both transmission, a natural monopoly network, and generation, which is competitive – frequently resist the expansion of transmission when it is not in the interest of their profits. Their influence is magnified, perhaps even masked, by environmental interest groups, who are allied with powerful incumbent firms in favoring state and local regulation of the industry. As James Madison predicted long ago in Federalist No. 10, if left to its own devices the state regulatory process is particularly vulnerable to the influence of powerful private interest groups. Where federal regulators also lack plenary authority to solve transmission problems, both federal and state regulators can readily fall into a cycle of evading difficult network congestion problems.

For example, the state of Connecticut has strongly opposed the Cross-Sound Cable, a 23-mile merchant transmission line that would allow Long Island Power Authority to import power from New Haven, Connecticut. Some Connecticut officials cite environmental concerns in support of their opposition to the project, such as impacts on shellfish beds and dredging operations in the New Haven Harbor; however, the project complies with all state siting and environmental statutes. The cable, already in place, was authorized to operate under a temporary emergency order issued by the Secretary of Energy following the August 2003 blackout, which was lifted in early 2004. There is reason to believe that the issue is within the jurisdiction of the Federal Energy Regulatory Commission (FERC), but the scope of federal authority over the matter is not clear because the FERC does not site transmission lines. Connecticut’s Attorney General, backed by environmental interest groups and a major incumbent utility serving Connecticut customers (Northeast Utilities, which owns an older, parallel transmission line), threatened litigation if the Cross-Sound Cable was allowed to go live again.<sup>9</sup>

As electric power transmission illustrates, the behavior of private stakeholders is not only relevant in the market sphere, but also in the

<sup>9</sup> Bruce W. Radford, *Cross-Sound Cable Puts Feds on the Spot*, FORTNIGHTLY’S SPARK, June 2004, at 1.

regulatory process that implements the constitutive governance of deregulated markets and the public law doctrines that frame this process. Because states retain jurisdiction over the siting of power plants and transmission lines, public law defines the range of permissible regulatory responses in state politics and thus plays a central role in framing disputes over the location and expansion of transmission lines (see Chapter 7). As in the case of California's deregulation plan, prior to the 2003 blackout, interactions between governments were a major impediment to the expansion of transmission; long-standing jurisdictional conflicts and gaps under extant public law doctrines have left both state and federal regulators unable to take action to expand transmission (an issue addressed in Chapter 8).

Focus on private interactions with governmental bodies and interactions between governmental bodies – what I collectively refer to in this book as government relations bargaining – is not a new insight for regulatory lawyers and economists. A large literature explores private bargaining with the government. Since public choice theory came into its own in the 1960s, economists and political scientists have increasingly paid attention to how private firms interact with the government. Most applications, however, focus attention on a specific moment of change – for example, a regulator's decision to regulate or deregulate, the passage of a major piece of legislation, the repeal of previous regulatory approach. Public choice theory is downright cynical about the ability of regulation to enhance social welfare. Apart from condemning capture of the regulator, the literature rarely focuses attention on the continuing and recurring interactions between private firms and the government in a deregulatory environment. However, because deregulation seldom entails the complete dismantling of government – the general literature on regulation broadly defines deregulation as including restructuring initiatives that depend on government for some implementation and oversight (Borenstein & Bushnell, 2000; Cudahy, 2002a; Hirsh, 1999)<sup>10</sup> – such interactions regularly occur in the adoption and implementation of policies designed to enhance competition. A growing literature also explores interactions among governmental bodies, such as interactions between the

<sup>10</sup> Throughout, I follow this convention, using “deregulation” to refer to a variety of government competition policies regarding utility industries – for example, lifting restrictions on entry and exit, mandating open access to networks, and unbundling vertically integrated services – few of which require complete dismantling of regulation, although with deregulation prices are no longer determined under traditional cost-of-service standards and may be left entirely to the market.



federal government and states (see Chapter 3). Focusing on bargaining in the regulatory process shines light on a different kind of greed than popular critics of market transitions condemn. Rather than focus on private market greed, government relations bargaining focuses on private behavior and incentives in public ordering. Even in times of regulatory system stability, greed in politics may pose as a much of a challenge to market transactions as greed in private transactions. With deregulation and other legal transitions, however, focus on government relations bargaining brings to the fore important issues that other contractual accounts of regulation largely obfuscate.

## II. LIMITS OF THE LEGALISTIC TURN FOR BARGAINING ACCOUNTS OF REGULATION

Predominant accounts of utility regulation focus on three interrelated projects. Traditional progressive accounts view regulation as ensuring private markets do not ignore the public interest (Mitnick, 1980; Posner, 1974). Neoclassical economic approaches view regulation primarily as correcting for market failure in the interest of promoting economic efficiency or enhancing social welfare (Posner, 1974). Public choice theory focuses on the incentives and consequences of regulation (Farber & Frickey, 1991; Mashaw, 1997; Quirk, 1981). The more cynical strand of public choice embraces a “capture” thesis that sees regulators as beholden to the powerful firms they are charged with regulating (Stigler, 1971). These approaches first emphasize the ends of regulation (intentional and otherwise), and then pay attention to process only insofar as it is useful to achieving these ends.

More than 10 years ago, George Priest argued that the project of two of the predominant accounts of the origins of regulation – “public interest” theory, which sees regulation as a solution to market failure, and “public choice” theory, a strand of which views agency regulators as operating under the dominant influence of (or “captured” by) the private firms subject to regulation – are misplaced. Rather than attempt to identify a singular theory of the origins of regulation or of exogenous substantive ends, Priest (1992) imagined a research agenda in which scholars make an effort “to understand the mechanics of a change in regulatory regime before deriving a theory of it” (323). Implicit to this project is the recognition that theories of regulation place inordinate attention on the substantive content of regulation. In contrast, a research agenda that focuses on mechanism of evolution and change in regulated industries

poses a fundamentally different series of questions than conventional accounts.

An account of government relations bargaining places more emphasis on such questions than conventional accounts of economic regulation, such as public interest or public choice theories. Focus on government relations bargaining is not dismissive of ends – of course they are important – but recognizes that ends are not necessarily prior (or exogenous) to the theory of regulation. Process can matter as much as ends. Rather than begin with externally generated ends, analysis of economic regulation might take on different emphasis and realize fresh insights from paying attention to process first.

The goals of regulation are numerous; however, public interest, efficiency, and pluralist preference aggregation are most prominent. Public interest theories of regulation have intuitive appeal as a starting point for understanding the goals of regulation, although at best they are ambiguous. They focus almost exclusively on the substance of regulation rather than how it evolves and or promotes stable solutions to regulatory problems. As Bruce Mitnick's (1980) extensive study of regulation puts it, "there remains no accepted definition of the phrase ['public interest'], much less an accepted operational definition offering indicators that we may use to determine empirically whether something is in the public interest" (259). Approaching regulation as a bargain challenges us to focus not only on the substance of the public interest, but also on its evolution and, in particular, its ability to promote coordinated voluntary solutions to conflicts (its "equilibria" characteristics).

In addition, a government relations bargaining approach to regulation diverges from neoclassical economic theory in that it views natural monopoly regulation not merely as an efficiency-promoting solution to market failure, but also as a negotiated equilibrium that is the product of bargaining conditions and incentives. Such an approach also departs from many public choice accounts in that it does not embrace a strong capture thesis or condemn all rent seeking; instead, it acknowledges the reality of continuing interactions between firms and the government, and the incentives faced by private firms, as strategies used by stakeholders to sustain the commitments of the incomplete contracts surrounding the firm and its institutional arrangements in an industry.

It is certainly not a new insight for regulatory law to focus on bargaining. However, discussion of regulatory contracts generally assumes that the terms of the contract are complete, or downplays the incentive