Deregulatory Takings

and the

Regulatory Contract
Deregulatory Takings and the Regulatory Contract

The Competitive Transformation of Network Industries in the United States

J. Gregory Sidak
Daniel F. Spulber
To Our Families
Contents

Preface xiii

About the Authors xix

1 The Nature of the Controversy 1
   The Takings Landscape 2
   Regulation and Contract 4
   The Scope of Analysis 10

2 Deregulation and Network Pricing 19
   Natural Monopoly and Network Industries 20
   Sunk Costs, Barriers to Entry, and Stranded Costs 25
   Incumbent Burdens 30
   Open Access and Mandatory Unbundling 47
   Conclusion 53

3 Quarantines and Quagmires 55
   The Structure of the Quarantine Argument 60
   The Natural Monopoly Argument 64
   The Barriers to Entry Argument 77
   The Leverage Argument 85
   The Cross-Subsidization Argument 90
   Conclusion 96
## 4 The Regulatory Contract

Economic Foundations of the Regulatory Contract 101

The Principal Components of the Regulatory Contract 113

The Duration of the Regulatory Contract 129

The Contractual Foundations of Charles River Bridge and Munn v. Illinois 132

Explicit Contracting between Municipalities and Public Utilities 140

The Regulatory Contract in the Supreme Court 145

The Evolution from Municipal Franchises to State Public Utilities Commissions 160

Contracting with the Sovereign 163

The Regulatory Contract in Texas 168

Winstar and the Unmistakability of the Regulatory Contract 171

Conclusion 177

## 5 Remedies for Breach of the Regulatory Contract

The Public Utility's Right to Expectation Damages for the Regulator's Breach of the Regulatory Contract 180

Competition and Mitigation of Damages 181

Contract Modification: Replacing Rate-of-Return Regulation with Incentive Regulation 188

The Rule against Retroactive Ratemaking 190

Sovereign Immunity 191

Mistake and Impossibility 198

The Regulatory Contract and the Statute of Frauds 201

Promissory Estoppel 210

Conclusion 212

## 6 Takings and the Property of the Regulated Utility

Economic Rationales for Property Protections 214

The Judicial Rationale for the Takings Clause 216

Regulatory Takings and the Destruction of the Investment-Backed Expectations of the
Contents ix

Incumbent Regulated Firm 219
Physical Invasion of Network Facilities 226
Just Compensation and the Regulation of Public Utility Rates 240
Unconstitutional Conditions on the Lifting of Incumbent Burdens 255
The Inapplicability of Market Street Railway 256
Northern Pacific Railway and the Regulator’s Redefinition of the Intended Use of Dedicated Property 262
The Misinterpretation of Judge Starr’s Concurrence in Jersey Central 268
Conclusion 272

Just Compensation for Deregulatory Takings 273
Just Compensation and Voluntary Exchange 274
Investment-Backed Expectations, Opportunity Costs, and Deregulatory Takings 276
Deregulatory Givings and the Quid pro Quo Defense 278
Conclusion 281

The Efficient Component-Pricing Rule 283
Economic Analysis of the Efficient Component-Pricing Rule 286
The Basic Framework 289
A Benchmark Case 290
The Contestable-Market Case 292
Capacity Competition 295
Product Differentiation 300
Conclusion 304

The Market-Determined Efficient Component-Pricing Rule 307
Pricing Unbundled Network Elements 312
The FCC’s First Report and Order and Recovery of the Incumbent LEC’s Total Costs 338
Conclusion 342
Deregulatory Takings and the Regulatory Contract

10 Answering the Critics of Efficient Component Pricing

The FCC’s Denunciation of Efficient Component Pricing in Its 1996 Interconnection Rulemaking

Academic Proponents of Efficient Component Pricing

Government Proponents of the ECPR

Misdirected Criticisms of the ECPR from Which the M-ECPR Is Immune a Fortiori

Did the Creators of the ECPR Reject the M-ECPR?

Conclusion

11 The Equivalence Principle

Expectation Damages

Just Compensation

Investor Valuation

The Efficient Component-Pricing Rule

Conclusion

12 TSLRIC Pricing and the Fallacy of Forward-Looking Costs

Problems with TSLRIC Pricing of Mandatory Network Access

Regulated Network Pricing and the Fallacy of Forward-Looking Costs

Conclusion

13 Deregulatory Takings and Efficient Capital Markets

A Brief Review of the Theory of Efficient Capital Markets

Has the Utility Already Been Compensated for Bearing the Risk of Stranded Costs?

The Justiciability of Diminished Expectations

Is Competitor Opposition to Recovery of Stranded Costs Farsighted or Myopic?

The Anarchic Argument against Compensation

Restoring Credible Commitments through the Securitization of Stranded Costs

Conclusion
Contents

14 Limiting Principles for Stranded Cost Recovery 449
   Necessary and Sufficient Conditions for the Recovery of Stranded Costs 450
   Regulatory Contracts, Statutory Gratuities, and State-Managed Cartels 455
   The Deregulatory Experience in Other Network Industries 461
   Cable Television Franchises and Military Base Closings 483
   Retroactive Prudency Reviews as a Condition for Recovery of Stranded Costs 487
   Conclusion 493

15 Deregulation and Managed Competition in Network Industries 495
   The Economic Incentive Principle 497
   The Equal Opportunity Principle 503
   The Impartiality Principle 517
   Conclusion 533

16 The Tragedy of the Telecommons 535
   Four Epigrams for Protecting Private Property in Network Industries 535
   Ownership and Stranded Costs 540
   The Telecommons 545
   Regulatory Divestiture 551
   The Eighth Circuit's 1997 Decision in Iowa Utilities Board 557
   Conclusion 565

References 565
Case Index 591
Name Index 609
Subject Index 617
Preface

Significant deregulation efforts in the telecommunications and electric power industries are following on the heels of reduced regulation of natural gas, airlines, railroads, trucking, banking, and securities brokerage. The transformation of the network industries in the United States promises significant benefits. The removal of government controls over prices, products, and the entry of new firms, and their replacement by markets, should yield substantial productive efficiencies, allocative efficiencies, and innovation in technology and service offerings. Moreover, market allocation of goods and services obviates the costly administrative processes that inevitably accompany public regulation. The question, however, is whether the deregulatory process in network industries will fulfill its great promise.

Traditionally, the utility sector in the United States has been characterized by the combination of private ownership and management of companies with public control over prices, service obligations, and entry. Deregulation generally is interpreted to mean the relaxation of public controls. That type of deregulation is most likely to achieve the benefits of competition. Other types of public policies carried out in the name of deregulation, however, have the effect of encroaching on private ownership of property and increasing public control. Such policies cannot be expected to yield the full benefits of market competition. In this book, we address deregulatory policies that threaten to reduce or destroy the value of private property without any accompanying payment of just compensation, policies that we term “deregulatory takings.” We further consider the problem of renegotiation of the regulatory contract, which changes the terms and conditions of operation of utility companies. We
argue that constitutional protections of private property from takings, as well as efficient remedies for contractual breach, provide the proper foundation for the competitive transformation of the network industries.

By addressing the problems of deregulatory takings and breach of the regulatory contract, we are not advocating slowing the process of deregulation. Quite the contrary. Transforming the utility sector to allow competitive markets to form means that regulators should exercise forbearance. They should progressively remove regulation without trying to “manage” competition. That objective requires regulators to treat incumbents and entrants symmetrically: Regulators should remove “incumbent burdens” as well as artificial entry barriers. The benefits of competition do not stem from government regulations that redistribute income from utility investors to customers, nor do such benefits stem from regulatory policies for network access that promote entrants’ free riding on the incumbent’s facilities. Such actions represent a new version of increased regulation, not deregulation.

Investors in the network industries made investment in large-scale facilities in the expectation that they would receive from regulators the reasonable opportunity to recover those investments plus a competitive rate of return. Those investments built the U.S. telephone system and electrical systems, whose performance and reliability are self-evident. Such systems were well-suited to a regulated environment but are not likely to be optimal in a competitive market. Moreover, those systems reflect inefficiencies arising from regulatory performance incentives and pricing controls. Yet, such inefficiencies do not imply that we should today disregard the obligations that regulators incurred for past investments made by the firms they regulated. Rather, as in private contracts, the swiftest and surest path to terminating agreements is to compensate the parties for their expectation and allow the parties to pursue the most efficient alternative arrangements.

We present the main issues of the deregulation controversy. We show that there is a fundamental identity between the calculation of just compensation for deregulatory takings and the efficient remedy for breach of the regulatory contract. We further explore the pricing of access to network facilities upon deregulation. We show that “efficient component pricing” is closely related to the estimation of investment-backed expectations that underlie just compensation for takings and damage remedies for breach. Those equivalence principles provide a guide to public policymakers as they seek to open a network industry to competition.

We intend this book to be useful not only to public policymakers in all branches of government, but also to students and researchers in law,
economics, and political science. Our analysis is meant to contribute to legal research on property rights and contracts, with particular application to the relationships between the state and private enterprise. Our analysis also addresses issues in regulatory economics, which has tended to focus on mechanisms for implementing regulations rather than on the process of removing those regulations. We attempt to provide guidelines for the redesign and removal of regulatory controls. Finally, our analysis raises public choice questions about the deregulatory process, including income redistribution and jurisdictional issues.

Because no work of this scope can blossom without some prior care and feeding, we thank the editors and staff of several law reviews for their patience in allowing us to shape and refine our ideas through the publication in their respective journals of the articles that formed the building blocks of this book. Specifically, we acknowledge the New York University Law Review, the Columbia Law Review, and the Yale Journal on Regulation. 1 Smaller portions of this book draw upon articles published in the Harvard Journal of Law and Public Policy and the Southern California Law Review, whose editors and staff we also thank. 2

In writing this book, we have benefitted from conversations with, and suggestions from, many colleagues. We gratefully acknowledge the feedback from the participants at a conference on takings held at the American Enterprise Institute in March 1996. Most notably in this regard, we appreciate the written comments by Oliver E. Williamson and by Judge Stephen F. Williams in response to our original working paper in this area. For their comments on other earlier papers, we also thank participants at a conference on telecommunications law at Columbia Law School in November 1996 and participants in the March 1997 industrial organization seminar at the Haas School of Business at the University of California, Berkeley. We also thank our students in courses on manage-


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Some of the insights in this book occurred to us in the course of presenting expert testimony in regulatory proceedings on behalf of Ameritech, Central & South West Corp., the Energy Association of New York State, GTE, Hong Kong Telecommunications Limited, Pacific Bell, PECO Energy Company, and the United States Telephone Association. The opposing testimony of the eminent scholars retained as expert witnesses in those regulatory proceedings, as well as the experience of answering live cross-examination, helped us sharpen the legal and economic reasoning contained in this book. In particular, we wish to recognize the scholars who have expressed their respectful disagreement with portions of our analysis: William J. Baumol, Nicholas Economides, David L. Kaserman, John W. Mayo, Thomas W. Merrill, Janusz A. Ordover, Frederick Warren-Boulton, and Robert D. Willig. We hope that our responses to their criticisms exhibit the same professional respect that we received from them. We are grateful to have had the
opportunity to have our theories so immediately applied to real-world problems and so thoroughly vetted by distinguished colleagues. It is our hope that such firsthand exposure to regulatory institutions has helped us to present our theoretical work as more than detached “blackboard economics” and that our analysis and conclusions will therefore be all the more useful and accessible to regulators, legislators, and jurists.

Finally, we are grateful to Dean Donald P. Jacobs of the J. L. Kellogg Graduate School of Management for his encouragement. We give special thanks to Christopher C. DeMuth, president of the American Enterprise Institute, for his steadfast support of our research, particularly in light of its controversial nature, and to Scott Parris of the Cambridge University Press for his supportive editing of the book and his help in bringing the project to fruition. Most of all, we thank our wives and children for their patience and understanding for the time that we denied them while completing this book.

J. GREGORY SIDAK
DANIEL F. SPULBER
About the Authors

J. GREGORY SIDAK is the F. K. Weyerhaeuser Fellow in Law and Economics at the American Enterprise Institute for Public Policy Research and senior lecturer at the Yale School of Management. He directs AEI’s Studies in Telecommunications Deregulation and its Studies in Postal Regulation.

Mr. Sidak served as deputy general counsel of the Federal Communications Commission from 1987 to 1989, and as senior counsel and economist to the Council of Economic Advisers in the Executive Office of the President from 1986 to 1987. As an attorney in private practice, he worked on numerous antitrust cases and federal administrative, legislative, and appellate matters concerning regulated industries.

before committees of the U.S. Senate and House of Representatives on regulatory and constitutional law matters, and his writings have been cited by the Supreme Court, the lower federal courts, state and federal regulatory commissions, and the Judicial Committee of the Privy Council of the House of Lords.

Mr. Sidak received A.B. and A.M. degrees in economics and a J.D. from Stanford University, where he was a member of the Stanford Law Review, and served as law clerk to Judge Richard A. Posner during his first term on the U.S. Court of Appeals for the Seventh Circuit.

DANIEL F. SPULBER is the Thomas G. Ayers Professor of Energy Resource Management and Professor of Management Strategy at the J. L. Kellogg Graduate School of Management, Northwestern University, where he has taught since 1990. He was previously professor of economics and professor of economics and law at the University of Southern California. He has also taught economics at Brown University and the California Institute of Technology.

He has conducted extensive research in the areas of regulation, industrial organization, microeconomic theory, law and economics, energy economics, and management strategy. In a ranking of economists published in the April 1996 issue of Economic Inquiry, he was ranked as the sixth most productive economist in the United States on the basis of publications in the top economics journals. He is the founding editor of the Journal of Economics & Management Strategy, published by the MIT Press.

Professor Spulber is the author of the textbook Regulation and Markets (MIT Press 1989). He is the coauthor with J. Gregory Sidak of Protecting Competition from the Postal Monopoly (AEI Press 1996), and coeditor with Leonard Mirman of Essays in the Economics of Renewable Resource Management (North Holland 1982).

Professor Spulber has published articles on regulation, pricing, microeconomic theory, competitive strategy, and related topics in numerous academic journals, including the American Economic Review, the Journal of Economic Perspectives, the Journal of Economic Theory, the Review of Economic Studies, the Quarterly Journal of Economics, the RAND Journal of Economics, the International Economic Review, the Columbia Law Review, the Journal of Law and Economics, the New York University Law Review, and the Yale Journal on Regulation.

Professor Spulber received his B.A. in economics from the University of Michigan in 1974 and his M.A. in 1976 and Ph.D. in 1979 in economics from Northwestern University.
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