RESPONSES

DEREGULATORY TAKINGS AND BREACH OF THE REGULATORY CONTRACT: A COMMENT

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Gregory Sidak and Daniel Spulber[1] develop a comprehensive argument both justifying compensation of utilities for the adverse effects of various deregulatory developments and explaining how to do so. They read the Takings Clause as expressing a fundamental principle of political economy requiring compensation in order to prevent—or at least reduce the risks of—government action destructive of wealth. Compensation thus should be required in most instances where the action cannot be justified as preventing harm or where the "settlement costs" of providing compensation are not excessive. The last qualification rules out compensation, for example, for losses resulting from changes in monetary policy.

The authors' central image of deregulation takes the form of unbundling a once integrated system, allowing competition to flourish in segments that do not exhibit natural monopoly characteristics, while assuring all competitors fair passage through the bottlenecks for those that do. Thus the integrated electric utility must open its transmission lines to power produced by others and be exposed to their competition, and the natural gas pipeline must carry anyone's gas and be exposed to competition from any producer or marketer. Regulation is leaner—limited to the area where it is justified—but also, as Sidak and Spulber show, at least as a transitional matter it may be meaner.

My central concern about the authors' argument is the question of why the old utility may not be in a good position to compete with new entrants. The authors point to several problems induced by regulation. The first is redistributive pricing.[2] In natural gas, for example, if a local distributor has been forced by regulation to overprice gas to its industrial customers in order to subsidize residential ones, and reg-

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[1] J. Gregory Sidak & Daniel F. Spulber, Deregulatory Takings and Breach of the Regulatory Contract, 71 N.Y.U. L. Rev. 851 (1996).

[2] See id. at 873-74.

ulatory shifts suddenly enable others to serve the industrials with competitively priced gas, the distributor will have useless contract commitments from which it may be able to extract itself only at great cost. If it preserves the sales by cutting prices, it will cut into the revenue surplus that was needed to subsidize the residential customers. What Sidak and Spulber call "incumbent burdens"—such as a duty to serve even where service is unprofitable—seem to me the same problem under another name.[3] If the firm is required to extend lines unprofitably, yet the regulators have been sticking to their end of the regulatory bargain by assuring adequate revenues overall (at least up to the moment of deregulation), we simply have an extreme case of unbalanced, redistributive pricing.

In any event, if we focus on these examples, Sidak and Spulber are surely right, at least as a first approximation, in saying that compensation is economically sound.[4] When "deregulation" exposes the regulated firm to what is called cream-skimming, i.e., to market prices in the markets where it has been collecting rents that the regulator has doled out to someone else, the authors' case for compensation is powerful. And a duty to provide compensation will create pressure on the regulators to protect the utility by *rebalancing* the pricing, i.e., by using rebalancing to satisfy the compensation requirement (in whole or in part).

But there are other sources of loss from deregulatory unbundling. It is a commonplace of regulatory literature that the price-regulated natural monopoly is likely to be run inefficiently and with a degree of gold-plating—lavish executive offices, corporate jets, etc.[5] The price-regulated natural monopolist has relatively weak incentives to be efficient, as any saving in costs will soon be met by a reduction in the ceiling price, and an increase in costs will result in higher ceilings—yet ceilings calculated so as to still allow full recovery of costs even if the price increase reduces sales. The qualifier here, of course, is regulatory lag, which enables the firm to profit temporarily (i.e., between rate cases) from an efficient innovation and forces it to suffer temporarily from any new inefficiency. Price caps are an effort to reduce the perverse incentives; indeed, they can be seen as in part a de facto expansion of regulatory lag.

With this in mind, take the case of the electric utility that is suddenly required to wheel electricity for other entrants and finds its own

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3 Id. at 869.

4 Id. at 881-82.

5 See, e.g., Bernard S. Black & Richard J. Pierce, Jr., The Choice Between Markets and Central Planning in Regulating the U.S. Electric Industry, 93 Colum. L. Rev. 1339, 1345 (1993) (characterizing electric utilities as inefficient and "bloated").

power uncompetitively expensive. Part of its plight may well be due to obligations to sell to privileged customers at inadequate prices, but part of it may be due to inefficiencies generally associated with price-regulated natural monopolies. Can one clearly say that there is a compelling principle of political economy requiring compensation for one hundred percent of the losses attributable to inefficiency?

As I read the article, the efficient component-pricing rule allows the utility to amortize the cost of its capital plant at the moment of deregulation, as part of the unit access charge.[6] Thus, so long as this amortization proceeds, a new entrant with a more efficient plant gets no competitive benefit from that efficiency, although of course it does enjoy increased profits on each unit that it does sell. As a result final prices are higher, and quantity sold lower, than if the access charge did not include this embedded inefficiency. Of course we know that sunk costs cannot be *recouped*; the question is how much inefficiency may be caused by the way in which deregulation *distributes* them. Sidak and Spulber say that under their rule no new entrants' sales will occur except efficient ones. Yes. But it would seem to me that many new entrants' sales that are efficient will not be made. Is it necessary to have a rule of compensation that thwarts those efficient sales?

The answer would seem to depend on the effects of alternative ways of cost distribution. One way would be direct compensation out of tax revenue, the collection of which generates its own inefficiencies. Another way would be to leave these costs where they land, i.e., on shareholders. I grant Sidak and Spulber's point that to do so causes some distortion of incentives, e.g., in increasing regulated utilities' resistance to deregulation.[7] But it also may have some positive incentive effects—at least firms that are now under conventional regulation but face a prospect of unbundling are given an incentive to avoid inefficient investment.

Now it is quite true that the *stockholders* will have gained nothing from the inefficiencies (though gold-plating will have benefited management). So, lapsing from efficiency to equity, I can see some equitable claim. But by the same token, it is not clear that customers necessarily bear any more responsibility for this perversity. One might say that regulation had been embarked upon in their name, so they should bear the costs of transition. But even this equitable argument is undercut if you accept commonly held stories of regulation as a benefit for the regulated firms, deliberately secured by them in the political market. If the equities are uncertain, there surely is ground

6 Sidak & Spulber, supra note 1, at 971-75.

7 Id. at 958-59.

to resist a compensation rule that projects the ill effects of regulation-induced inefficiencies into the future.

The problem is further complicated by the very source of these inefficiencies. If regulators were thoroughly adept at spotting inefficiencies, they wouldn't have existed in the first place—the regulators would have screened them out as impermissible costs. In fact, one of the arguments for deregulatory unbundling is precisely the tendency of regulation to cause inefficiencies. So there may be considerable difficulty separating the portion of the firm's losses due to embedded inefficiencies and the portion due to pricing imbalance.

Sidak and Spulber address an aspect of this issue rather briefly, observing that while the utility's inferior competitive position may be due to inefficiencies, these are costs that the regulators themselves have deemed "prudently incurred."[8] First, this may be empirically wrong in many cases—that is to say, costs are commonly not evaluated by the regulatory agency at all unless an issue has been made of them in a rate case. But more generally, if one of the defects of regulation is that we doubt the ability of the regulators to identify inefficiency, the fact of their failure to do so proves little.

It is not altogether clear to me whether Sidak and Spulber would include within their rule operating costs that the utility incurs in the *competitive* component of the process but which, for some reason, are not obviated when its sales decline.[9] A dramatic example is the natural gas industry, where "open access" transportation exposed the interstate pipelines to competition from sources that, unlike them, were not encumbered with long-term contracts to buy gas at prices well above then-current market levels.[10] If Sidak and Spulber mean to include such costs, further problems arise. While capital costs are sunk, so that the rules of the unbundling process cannot affect them (though it will affect their *impact*), operating costs are ongoing and may very well be affected. For example, a pipeline faced with bearing some of the losses from overpriced contracts is likely to bargain more aggres-

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8 Id. at 925; cf. William J. Baumol & J. Gregory Sidak, Transmission Pricing and Stranded Costs in the Electric Power Industry 117 (1995) (stating that opportunity costs to be recovered "*must exclude any monopoly profits or excessive costs attributable to inefficiency*" (emphasis in original)).

9 The proposal that the access charge equal the incremental unit costs of access "plus the change in the incumbent's net revenue per unit of access sold," Sidak & Spulber, supra note 1, at 974, suggests that Sidak and Spulber would include such costs. But the identification of the correct access charge as "the unit cost of access plus capital costs divided by the combined output of the entrants," id. at 975, points the other way (or may mean only that Sidak and Spulber have assumed that operating costs will decline in exact proportion to final sales).

10 See Associated Gas Distribs. v. FERC, 824 F.2d 981, 995, 1021 (D.C. Cir. 1987).

sively with suppliers for reductions in quantity and price, and they in turn may reduce investments in drilling wells. Of course if the compensation rates are fixed at the moment of deregulation, the incumbent utility will have normal profit incentives to cut the ongoing costs, as doing so will save money yet not change its permissible access charge or its competitive position. But it is unclear why customers should have to pay the excess of the cost recovered over the cost incurred. If they do, consumption will be lower than what would have prevailed at competitive rates, partially defeating a purpose of deregulation. And why should the new entrants' ability to displace the utility's sales be hobbled in this way?

Assuming Sidak and Spulber include such costs at all, perhaps they intend that the regulators will continue to adjust the utility's unit-revenue entitlement downward to reflect new savings, so that I have erred in depicting the access charge as embedding the old operating costs. But if so, then we are back to the standard perversities of regulation—the utility has a muted incentive to be efficient, and the incurring of excess costs will continue. Indeed, if compensation for these wasted operating costs is seen as an independent entitlement (independent, that is, of the full amortization of the utility's preder-egulation capital plant), and if because of economies of scale in operating costs an incumbent's loss of sales will cut into its profits (apart from the effect of underused capital plant), this perverse incentive may go on indefinitely.

This variation in the strength of different types of costs' claims for compensation leads to a broader question about the scope of the authors' rule. They set forth the existence of a franchise as a limit to their proposal,[11] but also seem ready to embrace franchises generally, i.e., to see franchises as manifesting the sort of regulatory bargain that calls for their solution. What of taxi franchises, held now *not* by the original rent-seekers but by people who have bought their franchises at market rates, i.e., rates that capitalized the value of the artificially created scarcity? Those purchases were transfer payments induced by regulation. Must the state provide compensation for losses in franchise value that will flow from any increase in the number of taxi franchises? Perhaps compensation should be excluded here because the medallion owners' payments have been made *outside* the system, somewhat like the payments by which particular investors in a utility become stockholders, as opposed to the investments of the utility itself (just as, today, a firm purchasing a regulated utility does not get a stepped-up "rate base" merely by paying more than book value for

[11] Sidak & Spulber, supra note 1, at 997.

the firm's assets). Or perhaps compensation should be denied on the ground that such purchasers were obviously buying the capitalized value of prior rent-seeking, and thus, the argument would run, an asset that is not only self-evidently hazardous but one of questionable social utility. I don't claim to have the right answer here, but Sidak and Spulber may want to spell out the limits of their proposal more clearly, so that potential followers can understand the implications.

To close this aspect of my Comment, let me return to my original point—the failure to sift out and deny compensation for sunk but inefficient capital costs. The failure to do so results in prices for the final product that are higher than if one took full advantage of new entrants' efficiency, and thus lower in sales volume. Until Sidak and Spulber canvass the full range of alternatives for distributing these costs, and compare the incentive effects of each, I think they have not made a complete economic case for their solution.

That is my central difficulty with what is, overall, a powerful and incisive analysis. I have a few more, less central comments. First, I seriously question the idea that one who purchases property *after* a restraint has been imposed should be barred from recovery.[12] The equity of the suggestion seems obvious, but turns out not to be. If we assume that the buyer gets a discounted price by virtue of the restriction, it looks like double recovery to allow him compensation. But why make that assumption? Why may we not suppose that the transfer included the prior owner's claims? Of course, in the absence of some specific grant (which might be regarded as a champertous sale of a legal claim), we don't know. But observe the real-world consequence of any rule barring the purchaser from recovery: it forces the owner at the time the restriction is imposed to bring the suit for compensation. Otherwise he loses it forever by the sale, and the entitlement to compensation goes forever unenforced—unless, of course, we say that the original owner may sue the state for compensation *after* he has sold. Surely the least troublesome solution is to treat the new owner as stepping into exactly the shoes of the old. This would not, of course, entitle any owner to recover for any new construction, or other investment of real resources, undertaken with clear notice of the government's intent to take. Such investment is a self-inflicted wound, and takings law clearly should not encourage it.

There is a second context in which Sidak and Spulber seem to overlook the potential circularity between compensation rules and market conduct. They appear to suggest that stock market price fluc-

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12 Id. at 943-45.

tuations can be used to measure deregulatory losses.[13] But if the rules are clear, and entitle the firm to full compensation, why should the stock fluctuate at all? All that will have happened is that entitlement to income in one form will have been replaced by entitlement to income in another.

Third, I'm not completely convinced that the measure of damages in *Loretto* should be, as the article appears to assume, the five-percent royalty that Teleprompter was routinely paying.[14] That price reflected the presence of a bilateral monopoly. Although the case is certainly not so compelling as the case for allowing the thirsty man in a desert to avoid his promise to give all his worldly goods in exchange for a glass of water, I'm puzzled at the thought of treating such a price as constitutionally sacrosanct.

Fourth, in a variety of ways that I will not try to enumerate, the article's sketch of takings law strikes me as somewhat more protective than the present reality. For example, the authors observe that physical invasions generate an automatic entitlement to compensation, and in a way that is true. The article notes that sending a train down someone else's tracks is a physical invasion,[15] and that invading a wire with particles is similar.[16] But some regulations that look to me very much like government licenses for physical invasions by third parties, such as rent-control laws, are not treated as such, but rather as regulations of land *use*.[17] I am not saying anything about the merits of the authors' position, only that it may not map perfectly onto the Supreme Court's previous analyses.

I want to close simply by saying that regardless of these comments, the authors' proposal seems to me likely to frame debate over these issues for at least the remainder of the current wave of unbundlings.

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13 Id. at 989.

14 Id. at 948-49 (discussing Loretto v. Teleprompter Manhattan Cable CATV Corp., 458 U.S. 419 (1982)).

15 Id. at 952.

16 Id.

17 See Block v. Hirsch, 256 U.S. 135, 156-57 (1921) (upholding rent-control law entitling tenant to remain in possession two years after termination of leases); see also *Loretto*, 458 U.S. at 450-52 (Blackmun, J., dissenting) (disputing majority's characterization of cable-laying easement as licensing a continuous occupation).