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# THE ELECTRIC DEREGULATION FIASCO: LOOKING TO REGULATORY FEDERALISM TO PROMOTE A BALANCE BETWEEN MARKETS AND THE PROVISION OF PUBLIC GOODS

*Jim Rossi\**

MONOPOLIES IN AMERICA: EMPIRE BUILDERS AND THEIR ENEMIES FROM JAY GOULD TO BILL GATES. By *Charles R. Geisst*. New York: Oxford University Press. 2000. Pp. x, 355. \$30.

POWER LOSS: THE ORIGINS OF DEREGULATION AND RESTRUCTURING IN THE AMERICAN ELECTRIC UTILITY SYSTEM. By *Richard F. Hirsh*. Cambridge: MIT Press. 1999. Pp. x, 406. \$55.

THE NATURAL GAS MARKET: SIXTY YEARS OF REGULATION AND DEREGULATION. By *Paul W. MacAvoy*. New Haven: Yale University Press. 2000. Pp. xv, 140. \$35.

Over the last thirty years, regulators have deregulated just about every regulated industry. In no industry has deregulation raised as much fear and concern as in electric power markets. Even before the Enron debacle, a crisis that is more about the failures of corporate than regulatory law,<sup>1</sup> it was clear that something had gone seriously wrong in the turn towards deregulation of electric power.

Recent events in California are illustrative. In early 2000, consumers in California, the first state to deregulate retail power markets on a mass scale, saw repeated months of power interruptions. Many utility customers experienced a risk of service shut off — some even had their service interrupted — forcing changes in daily routines to find access to electric power.<sup>2</sup> Hospitals, nursing homes, and municipal utilities controlling sewage and water treatment facilities were forced

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1. See *infra* note 40.

2. Adam Bryant, *Lights Out*, NEWSWEEK, Jan. 29, 2001, at 44 (portraying public school district students huddled in dark, unheated classrooms as a result of electric power interruptions); Renee Sanchez, *California's Image Dims as Lights Go Out*, WASH. POST, Jan. 23, 2001, at A1 (presenting image of professors handing out flashlights in college classrooms).

to make choices affecting human safety when confronted with the prospect of power interruption.<sup>3</sup> Small businesses, families, and large corporations incurred large costs.<sup>4</sup> The consequences of California's regulatory system were not limited to utility consumers. One of the state's largest utilities, Pacific Gas & Electric ("PG&E"), declared bankruptcy on April 6, 2001, in part the result of the skyrocketing power procurement costs it has incurred in the deregulatory environment. Its reorganization is now before a federal bankruptcy court.<sup>5</sup>

Newspaper, television, and radio headlines overwhelmingly attributed the California power crisis to deregulation, or economic restructuring, of power markets to favor competitive markets over government regulation as a means for allocating power supply. Against the backdrop of such events, calls for a return to old-style regulation have abounded, often attributing the root cause of California's energy woes to deregulation itself.<sup>6</sup> Even regulators who are not inclined completely to abandon deregulation continue to struggle with refining the basic path of deregulatory policies, advocating deregulatory models that incorporate state participation in power procurement, price caps, or other regulatory safeguards in designing power markets.

The serious book on electric deregulation's failures has yet to be written — indeed, it will be several years before a comprehensive scholarly account is available — but this Essay uses three recent books on the history of regulated industries to address what went wrong in the turn toward deregulation of electric power.<sup>7</sup> The history of utility

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3. See Sanchez, *supra* note 2 (noting potential impact on hospitals); Joanne Wojcik, *Planning, Rapid Response Key to Keeping the Lights On*, BUS. INS., Apr. 30, 2001, at 97 (presenting problem hospitals face in planning for unreliable power).

4. See Bryant, *supra* note 2 (describing how businesses were affected by power interruptions); Laura M. Holson, *California Power Crisis Hurts Business and Idles Workers*, N.Y. TIMES, Jan. 20, 2001, at A1 (noting impact of power interruptions on California's economy); Sanchez, *supra* note 2 (mentioning that dairy farmers in California were unable to process milk).

5. *In re Pac. Gas & Elec.*, 263 B.R. 306 (Bankr. N.D. Cal. 2001); Tim Reiterman et al., *PG&E Declares Bankruptcy; State's Crisis Plans Collapse*, L.A. TIMES, Apr. 7, 2001, at A1.

6. In California, for example, Governor Gray Davis presented a plan designed to stabilize power supply and rates, including state negotiation of power supply contracts and state purchase of power. See *Energy Landscape is Forever Altered*, L.A. TIMES, July 29, 2001, at A1. California is not the only state in which deregulation policies are being abandoned. See Jeremy D. Oller & Donald A. Murry, *Cascading Caution: Cascading Crisis Delays Deregulation*, PUB. UTIL. FORT., Sept. 1, 2001, at 52.

7. Although no books have yet been published on the topic, a number of fine papers and reports discuss what went wrong in California. See, e.g., Severin Borenstein, *The Trouble with Electricity Markets: Understanding California's Restructuring Disaster*, 16 J. ECON. PERSP. 191 (Winter 2002); ERIC HIRST, THE CALIFORNIA ELECTRICITY CRISIS: LESSONS FOR OTHER STATES (Edison Elec. Inst. 2001), available at [http://www.eei.org/issues/comp\\_reg/CALessons\\_hirst.pdf](http://www.eei.org/issues/comp_reg/CALessons_hirst.pdf); PAUL L. JOSKOW, CALIFORNIA'S ELECTRICITY CRISIS (Nat'l Bureau of Econ. Research, Working Paper No. 8442, 2001), available at <http://www.nber.org/papers/w8442>; FED. TRADE COMM'N, STAFF REPORT: COMPETITION AND CONSUMER PROTECTION PERSP. ON ELEC. POWER REG. REFORM: FOCUS ON RETAIL COMPETITION (2001).

regulation, addressed in recent books, is a useful place to begin in assessing the problems regulators face today. If that history teaches us anything, it is that firm organization in capital-intensive industries is cyclical and evolutionary, and often influenced as much by technological change as by greed or politics.

The history of regulation also teaches us that regulatory policy — including deregulation — is not made in a jurisdictional vacuum. A statutory framework defined in Part II of the Federal Power Act, a New Deal-era statute enacted by Congress in 1935, gives federal regulators extensive powers but also places authority over many electric power policies in the hands of the states.<sup>8</sup> To the extent that state, rather than federal, policymakers are fashioning policies, different jurisdictional fora will produce many of the regulatory frameworks for electric power. If extreme or parochial factions, as may be more likely in state as opposed to national politics, successfully capture front-end market design of power markets, state politics is more likely to lead to dysfunctional markets than national approaches to restructuring.

I shall argue that, although wrong-headed deregulation policies contributed to California's crisis, the California deregulation fiasco illustrates the significance of the political process that produces the substance of economic regulation. Because it defines the jurisdictional scope for this process, the legal resolution of jurisdictional boundaries plays a significant role in the development of sound deregulatory policies. The law of regulatory federalism — defined broadly to include federal preemption doctrine, the dormant commerce clause, and state action immunity to antitrust enforcement — should find ways to encourage desirable participation and discourage undesirable interest group capture of the state political process. Regulatory federalism doctrines, central to current disputes involving electric power before the federal courts, are largely downplayed in the literature on the history of monopoly and regulation, including the three books reviewed in this Essay. The recent disputes in electric regulation challenge future authors to write the long overdue chapter on how jurisdictional boundaries have adversely affected economic regulation of the electric power sector, as well as other regulated industries.

## I. THE HISTORY OF NATURAL MONOPOLY IN THE ELECTRIC UTILITY CONTEXT

*Monopolies in America: Empire Builders and Their Enemies from Jay Gould to Bill Gates* is another tour de force by Charles R. Geisst.<sup>9</sup>

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8. 16 U.S.C. §§ 824-824(m) (1994).

9. Geisst, a finance professor at Manhattan College, is also author of *WALL STREET: A HISTORY* (1997). He has written a dozen books on the history of capitalism, making him one of the leading popular audience authorities on the topic.

Geisst begins his account with reference to the motto of the popular board game Monopoly<sup>10</sup> — “Accumulate as much property as possible and win” (p. 1) — which he sees as strikingly consistent with the principles of monopolistic industries. Geisst admirably traces the evolution of monopolies and their control in the U.S., focusing on legal and political efforts to effectuate control over the monopolistic tendencies he sees as inherent in capitalist economies. A colorful illustration of some of the most influential industrial and financial titans in U.S. history — Cornelius “Commodore” Vanderbilt, Jay Gould, J.P. Morgan, John D. Rockefeller — as well as the effort of courts and legislators to curb their power, Geisst’s account spans more than a century, but it does not delve in depth into any period or specific legal doctrine. Much, if not most, of his effort focuses on antitrust enforcement.

Throughout the book, however, he also touches on regulated utilities, monopolies that are not targeted by antitrust enforcers but are instead granted and protected by law. His illustrations include traditional public utility industries, such as railroads, telecommunications, and the electric power industry. Geisst briefly explains, for example, that for most of the twentieth century, and to a degree even today, electric power was provided by the investor-owned “public utility.” Under this firm structure, which was reinforced by regulatory law, high degrees of vertical and horizontal integration were the norm. A private company offered consumers a bundle of services, including generation, distribution, and transmission, typically while operating as a monopolist serving a geographic service territory subject to heavy regulation by federal and state agencies. For most of the twentieth century, this regulatory regime was stable for both the investor and the consumer. Utility stocks were notoriously low-risk, reliable investments, thus explaining the cheapness of the public utility square on the Monopoly board. With few exceptions, electric utilities were well suited to providing consumers with reliable, dependable electrical service.<sup>11</sup>

Geisst weaves a fascinating story, describing through anecdotes the historical development of government regulation of monopolies such as electric power. His history is robust in scope, touching on dozens of industries, including not just traditional public utilities but also book publishing, computer, and food manufacturing industries. His general thesis is that “[m]onopoly is the logical outcome of free market economic organization” (p. 319). More specifically, he sees regulation as “the antidote if that power overextends itself and ceases to provide benefits” (p. 319). Since Geisst understands regulation as largely

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10. Hasbro, Inc., produces and holds registered trademarks to “Monopoly.”

11. See Jim Rossi, *The Common Law “Duty to Serve” and Protection of Consumers in an Age of Competitive Retail Public Utility Restructuring*, 51 VAND. L. REV. 1233 (1998) (discussing this history).

erving political goals, he is able to weave an intriguing story through many colorful historical and political anecdotes. His book provides an easily accessible and nicely pitched popular history or introduction for a lay audience.

The book charitably introduces monopoly's early critics. Geisst summarizes many of the arguments made by Charles Francis Adams, Jr., who wrote a series of essays illustrating the financial problems that monopolies, especially the railroads, posed during the Gilded Age (pp. 18-23). The origins of regulation, on Geisst's account, were predominantly ideological and political, rather than economic: "From the beginning of the battle, economics and ideology would be mixed in an acrimonious argument about who knew what was best for the country" (p. 23). But on Geisst's account, economics took a backseat to political ideology. Adams and others who pushed for state regulation<sup>12</sup> were, according to Geisst, reformers driven predominantly by their progressive political beliefs.<sup>13</sup>

With masterful attention to detail, Geisst provides an account of regulatory and antitrust law as mediating between tempered private competition, which is permissible, and the accumulation of power by industrial firms, which Geisst deems undesirable. In both its early accounts and later descriptions of the development of antitrust law and regulation, however, Geisst's book gives little attention to more rigorous methodological accounts of the goals of antitrust or regulatory law. Like many other historical accounts, it fails to present a coherent economic theory of monopoly or regulation.<sup>14</sup> Thus, while Geisst reminds us of many colorful anecdotes and examples, his book does not provide the background methodological account most students of policy or regulatory reformers will demand. For instance, beyond a few broad-brush descriptions of "schools" of economic thought, such as the Chicago School, Geisst does not take seriously economic methods as a way for explaining approaches to regulatory enforcement.

As Geisst explains it, for example, federal regulation of railroads and federal remedies for smashing monopolies under the antitrust

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12. Adams lobbied for Massachusetts' creation of a Board of Railroad Commissioners in 1869 and became one of its original members.

13. By contrast, other historical accounts focus on nascent neo-classical economic principles reflected in the writings of reformers such as Adams. See HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW, 1836-1937* (1991). Geisst is not unaware of these principles — he acknowledges that Adams' writings, for example, "provided the basis for what would become known as the Harvard school of antitrust economics," p. 46, but he probably downplays their significance as ideas in history as it was unfolding.

14. It is on similar grounds, for example, that Herbert Hovenkamp critiques the work of other historical accounts of the same period, such as those presented in LEE BENSON, *MERCHANTS, FARMERS AND RAILROADS: RAILROAD REGULATION AND NEW YORK POLITICS, 1850-1887* (1955); GABRIEL KOLKO, *RAILROADS AND REGULATION, 1877-1916* (1965); GEORGE H. MILLER, *RAILROADS AND THE GRANGER LAWS* (1971); see also HOVENKAMP, *supra* note 13, at 131-36.

laws arose in the late nineteenth century because “the tide had shifted against the states’ attempts to control the railroads as early as 1871” (p. 32). Supreme Court cases recognizing limits on state authority<sup>15</sup> thwarted the effectiveness of well-intentioned state regulators, effectuating a “clear acknowledgement that federal law, not just a patchwork of state law and court rulings, would be necessary to control the railroads” (p. 32). Geisst deserves credit for paying attention to regulatory federalism early in our history of regulating monopoly, but he is less interested in providing a synthetic methodological explanation of regulation than in telling the larger story of its politics.<sup>16</sup>

By focusing predominantly on politics, not economic method, Geisst downplays contemporary and historical evidence suggesting how technological change contributes to firm structure and to concentration in public utility industries such as electric power. Instead, Geisst places at the fore of his historical account conflicts between profits and populist politics. This theme runs throughout the twentieth century as Geisst surveys the Wilson era, the establishment the Tennessee Valley Authority, passage of the National Industry Recovery Act, the adoption of the Glass-Steagall Act and later developments such as Nader’s corporate raiders, the breakup of AT&T, and the Microsoft antitrust case. Geisst presents convincing evidence of the durability of the tension between profits and bigness, on the one hand, and the public interest and government regulation, on the other. He nicely illustrates how this tension survived a number of historical eras, presenting an account that will appeal to a broad popular audience.

But historical synthesis of such a range of events comes at a price. Although it brims with fascinating stories, Geisst’s wide-ranging history provides little, if any, serious method to mediate the conflicts that repeatedly play out in the events. The discerning reader is left grasping for some methodological account of regulation, or some explanation for why regulation exists independent of its politics. Geisst nicely positions the origins of railroad regulation in the context of federalism, but he does not address the federalism problems with regulation beyond the Gilded Age, including the many problems that have thwarted regulatory law from promoting its goals throughout the twentieth century.

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15. See, e.g., *Wabash, St. Louis & Pac. Ry. Co. v. Illinois*, 118 U.S. 557 (1886) (holding that a state does not have authority to regulate the intrastate portion of an interstate shipment).

16. Many other well-regarded histories of the period have been described as disappointing in this same respect. See HOVENKAMP, *supra* note 13, at 136 (“Failure to appreciate the complexity of Gilded Age regulatory policy in a federalist system has led historians to easy oversimplifications about the nature of regulation.”).

## II. THE MOVEMENT TO DEREGULATION AND THE PROBLEMS WITH PARTIAL DEREGULATION

A more complete historical account of regulation sees the development of the vertically integrated public utility as closely related to technological change, not primarily motivated by investor greed or politics. In the late nineteenth century, for example, the electric power industry began with high degrees of decentralization. Only with the development of the technologies of the central station and alternating current did concentration and vertical integration become economically practical. Concentration provided benefits not only to utility investors, but also to consumers, to the extent the technology of the central station allowed coordination between supply and use in ways that enhanced the availability and reliability of power supply and minimized costs.<sup>17</sup>

Academic historian Richard F. Hirsh's *Power Loss: The Origins of Deregulation and Restructuring in the American Electric Utility System* gives us an account of the origins of electric power deregulation.<sup>18</sup> Hirsh sets out to discern the historical origins of deregulation, but begins by addressing the origins of regulation. For him, regulation's origins can be traced to a "utility consensus" (p. 2) produced by a managerial elite that exerted power through "the manipulation of individuals and state institutions to obtain results that directly profit them."<sup>19</sup> Without explicitly invoking public choice theory, Hirsh illustrates how "shrewd power company executives realized that state oversight meant governmental acceptance of their companies as natural monopolies, which brought with it a host of benefits (p. 23). He does not see progressivism as irrelevant to the utility consensus, but he sees the utility consensus as drawing heavily on the progressive idea of delegation to a body of elites rather than implementing directly progressive political values (p. 30). With time, progressive objectives would become frustrated, as power company executives would "maintain . . . a cozy relationship with regulators" (p. 45) and close the power network (p. 51), leading regulators to play a "subordinate role to power company managers" (p. 41).

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17. For an excellent discussion of this history, see HAROLD L. PLATT, *THE ELECTRIC CITY: ENERGY AND THE GROWTH OF THE CHICAGO AREA, 1880-1930*, at 59-92 (1991).

18. His book is a nice companion — and largely complementary — to the classic modern economic assessment in PAUL JOSKOW & RICHARD SCHMALENSEE, *MARKETS FOR POWER* (1983).

19. P. 2. Hirsh clarifies that his notion of utility consensus is not to be confused with the "regulatory contract," which has been used by utility executives to argue that regulation has created a set of legally enforceable obligations. P. 4; see also J. GREGORY SIDAK & DAN F. SPULBER, *DEREGULATORY TAKINGS AND THE REGULATORY CONTRACT: THE COMPETITIVE TRANSFORMATION OF NETWORK INDUSTRIES IN THE UNITED STATES* (1997).



Hirsh properly sees the movement toward deregulation as a complex interaction of political, economic, and technological forces. State cost-of-service regulation of the public utility worked well so long as it resulted in lower-cost electricity for consumers. But by the 1970s, state-centered cost-of-service regulation was no longer seen as an effective way to keep electricity prices uniformly low. Politically, federal regulators saw early steps toward deregulation — taken in President Carter's 1977 Energy Plan and endorsed by Congress in the Public Utility Regulatory Policies Act of 1978 ("PURPA") (pp. 75, 101-05) — as a way to avoid the disasters of excess capacity wrought by overbuilding large plants, primarily nuclear, in the 1960s and 1970s, along with post-1968 inflation and higher prices of oil after the 1973 oil embargo. "After PURPA began to be implemented . . . it looked as if the utility system, like Humpty Dumpty after his fall, would never be the same again" (p. 131). Economically, deregulation was — and, to many, still is — seen as good industrial growth policy, as the largest beneficiaries of deregulation have been large industrial companies who, against the backdrop of liberalized supply options, were positioned to bargain for lower cost energy inputs (p. 248). Since, by the 1990s, retail rates varied widely from state to state, states themselves saw deregulation as a way to even out geographic differences in the cost of power.<sup>20</sup>

Moreover, technologically, deregulation provided an opportunity for more efficient electric supply options to flourish. Hirsh's history recognizes the importance of technological change in making possible and popularizing deregulation as a regulatory reform approach in the utility industry.<sup>21</sup> By the late 1970s, technological improvements made smaller scale generation projects more feasible, reducing the dependence on long-term capital commitments for purposes of securing financing in the industry (pp. 105-08). Since the late 1970s, most economists have recognized power generation as a structurally competitive sector of the industry, although power distribution and transmission remain natural monopolies even today in the eyes of most economists (pp. 101-17). Transmission line and coordination technology, as well as distribution and metering technology, have also advanced significantly in recent years, providing new alternatives to firms who concentrate their efforts in these sectors of the industry (pp. 262-63).

With technological improvements in electric generation and distribution, the gains from treating generation as competitive, whether political or economic, were far more significant than they might have

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20. In 1991, for example, Californians paid retail rates that were thirty to fifty percent above the national average. P. 253.

21. In fact, an earlier book by Hirsh focuses exclusively on this theme in the history of electric power regulation. See RICHARD F. HIRSH, *TECHNOLOGY AND TRANSFORMATION IN THE AMERICAN ELECTRIC UTILITY INDUSTRY* (1989).

been in previous eras. Thus, while deregulation of the industry may have benefited investors and some large companies, it is overly simplistic to describe the movement, as many might suggest, as predominantly driven by greed and politics. When technological advances created the prospect of efficiency gains, continuing to protect the monopoly of older technology imposed significant costs on consumers. The old structure to regulating utilities — based on approval of cost-of-service rates — placed all of the risk of poor investments on the ratepayer, not the investor. The prospect of deregulation shifted these risks away from the ratepayer and placed them where they belong — on utility investors.

Taking the movement to deregulation full circle, Hirsh ties the trend toward deregulation to the fate of utility managers. According to him, all of these developments — political, economic, technological — led to a transition, if not dissolution, of the utility consensus (pp. 267-69). “[P]ower company executives lost authority because not all of them sought to maintain the terms of the original consensus, with some openly seeking to dissolve the traditional structure of the system” (p. 264). New interest groups — such as independent power producers, public power, and conservation-minded interest groups — displaced utility executives as the predominant or elite groups in state and federal regulatory politics (p. 268).

Both Geisst and Hirsh provide historical accounts, and in doing so have something to say about the process of regulation and deregulation. But as historians they do not focus on the substantive goals of regulation, or on any method for evaluating its merits. Looking to deregulation in electric power’s sister industry, natural gas, Paul MacAvoy, a highly-regarded academic regulatory economist, makes the case for completely deregulating the natural gas industry in *The Natural Gas Market: Sixty Years of Regulation and Deregulation*.<sup>22</sup>

MacAvoy convincingly argues that partial deregulation has impeded consumers and other interest groups from realizing the full gains of natural gas deregulation. Unlike Geisst and Hirsh, who draw on historical methodologies to shed light on regulatory law, MacAvoy uses an econometric model to assess the effects of deregulation of natural gas on various stakeholders, including producers, pipelines, and consumers. Prior to natural gas deregulation, the natural gas market experienced widespread shortages, followed by a bubble period during the 1980s. MacAvoy believes that the industry began improving

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22. MacAvoy is a professor at the Yale School of Management and the author of a number of works on natural gas, railroad and telecommunications deregulation. He co-authored *ENERGY REGULATION BY THE FEDERAL POWER COMMISSION* (1974) with Justice (then Professor) Stephen Breyer. His other studies of the natural gas industry include *PRICE FORMATION IN NATURAL GAS FIELDS: A STUDY OF COMPETITION, MONOPSONY AND REGULATION* (1962); and *THE ECONOMICS OF THE NATURAL GAS SHORTAGE, 1960-1980* (1975) with Robert S. Pindyck.

its prior dismal performance once federal deregulation policies were implemented. As MacAvoy illustrates, the deregulatory policies initiated by the Federal Energy Regulatory Commission (“FERC”) in 1985 and culminating with Order No. 636 in 1992 have created high levels of economic performance in the industry and have led to an increased use of in-ground storage of gas, helping to ensure adequate supply (p. 17).

“Partial deregulation” policies, however, have impeded the degree of improvement in the natural gas industry. For example, MacAvoy observes that “gas reserves and gas production have not greatly expanded after Order 636” (p. 93). Without a doubt, the Order has contributed to high natural gas prices. According to MacAvoy, the reason for this limited growth is that FERC’s policies in Order No. 636 constrain markets for spot gas and transport capacity.<sup>23</sup> As MacAvoy’s econometric model illustrates, substantial gains could be realized by consumers, pipelines, and consumers if FERC further deregulated pipeline capacity (p. 98). MacAvoy believes that federal regulators should remove “tariff rates on released and firm capacity between major hubs” and set benchmark tariffs to limit the exercise of market power (p. 99).

Moreover, MacAvoy argues, the gains of deregulation have been thwarted by the actions of state regulators. The unbundling of markets for retail gas and distribution remains largely in the hands of state regulators and subject to state politics. Many states — twenty-three plus the District of Columbia at the time of MacAvoy’s study (p. 100) — have implemented programs that would allow small residential or commercial customers to “unbundle” retail service, separating the delivery of gas from transportation and storage (p. 105). Unbundling, as MacAvoy suggests, holds out the “promise of deregulation” to the extent that consumers could purchase services from sources that are not subject to rate regulation by states (p. 105).

But as MacAvoy reminds us, there is “no empirical foundation for the position that vertical separation of gas ownership, transport and billing reduces costs; indeed, there would be an increase in transaction costs with more transactions” (p. 105). In fact, MacAvoy suggests, with unbundling many state and local regulators have imposed requirements for “utility line access, system balancing, and load forecasting” (p. 111). To be sure, state regulators have imposed such requirements for the hope of continued reliability and consumer protection in their respective jurisdictions. But MacAvoy believes that unbundling to

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23. In Order No. 636, for example, FERC retained price regulation of both firm and release capacity, which has limited the expansion of pipeline transportation and adversely affected prices and quantities. Pp. 94-95. According to MacAvoy, “[t]hese limits act like rent control in a housing market, creating disincentives to provide more capacity, whether by the pipeline or by the shipper in release contracts.” P. 95.

create the benefits of competition has created a political need for further intervention in individual transactions by state regulatory agencies, thwarting the gains from natural gas competition (p. 111). In his final analysis, MacAvoy argues that natural gas markets could realize price gains of as much as twenty percent by eliminating federal and state regulation of transmission and distributor systems (p. 120).

### III. MARKET DESIGN OR TAXATION AS A MECHANISM FOR PROVIDING FOR PUBLIC GOODS?

Geist, Hirsh, and MacAvoy tell us a great deal about how the regulatory process and regulatory law have failed as we embarked upon the deregulatory path in California and other states. In the electric power sector, regulators and legislators have almost exclusively responded to political signals and short-sighted concerns with profitability in formulating state plans for electric power competition. While the popular press's anecdotes of deregulatory policies, especially in states like California, would nicely complement and continue a history that sees such events as the result of progressive politics or regulatory capture, these anecdotes give short shrift to the technological innovations that Hirsh correctly sees as a central motivation of the deregulation movement.

If, as MacAvoy argues, partial deregulation has impeded realization of the benefits of gas regulation, it is more likely to thwart the gains of competition in electric power. Thus, MacAvoy's study of partial deregulation of natural gas markets provides an important analog for understanding many of the specific failures in California and federal electric power deregulatory policies. For example, federal regulators completely deregulated wholesale electric power supply markets when FERC adopted Order No. 888 in 1996. That order implemented open access to transmission facilities in wholesale power supply markets. Against this backdrop, some states, like California, have deregulated markets subject to state control; others, like Florida, have steadfastly resisted any movement towards deregulation.

California's deregulation plan included a price cap on retail power, designed to protect retail consumers.<sup>24</sup> During the year 2000, however, price caps forced the state's utilities between a fiscal rock and a hard place when supply shortages sent wholesale prices skyrocketing. At the same time, California's utilities were allowed to recover billions of dollars in subsidies through stranded cost surcharges and access fees — dollars paid to utilities by consumers and competitors that often

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24. See A.B. 1890 § 854, 1996 Cal. Stat. 854, codified in relevant part at CAL. PUB. UTIL. CODE §§ 330-398.5 (West Supp. 2001).

lined the fisc of the electric utility's parent.<sup>25</sup> With deregulation, California also failed to reassess its state power plant siting laws for the competitive market, creating uncertainty for even those investors who wanted to build generation plants to serve California consumers.<sup>26</sup>

MacAvoy, however, warns policymakers against glorifying unbundling, or a single preferred firm structure, in a competitive market (pp. 105-06). The fetish for unbundling among reformers, while a nice counter-juxtaposition to the predominant organizational form, may prove dangerous if technological innovations coupled with economic incentives swing back toward a need for convergence of services in the industry. California regulators, for example, experimented with efforts to dictate firm structure in electric power. Their establishment of the Power Exchange led to a prohibition against suppliers offering long-term contracts, a regulation designed to keep suppliers from locking into a market and migrating toward a vertically integrated structure.<sup>27</sup> While a well-intentioned effort to bolster a growth in competitive spot markets for power supply, this prohibition eviscerated one of the most important financing tools for attracting power investors. It also potentially exposed consumers to price volatilities, otherwise softened through long-term contracts.<sup>28</sup> The prohibition on long-term contracts also worked to favor incumbent supply firms, providing them fertile opportunities for strategic manipulation of the market.<sup>29</sup>

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25. See Michael A. Yuffee, *California's Electricity Crisis: How Best to Respond to the "Perfect Storm,"* 22 ENERGY L.J. 65, 71 (2001); see also Susan Rose-Ackerman & Jim Rossi, *Disentangling Deregulatory Takings*, 86 VA. L. REV. 1435 (2000) (criticizing stranded cost recovery); Jim Rossi, *The Irony of Deregulatory Takings*, 77 TEXAS L. REV. 297 (1998) (same).

26. See Yuffee, *supra* note 25, at 68 (describing state's "extremely complex" generation siting and permitting procedures).

27. California's restructuring policies included a buy-sell requirement, prohibiting utilities from acquiring power through forward-looking contracting, which was to remain effective until all utilities recovered their stranded costs. Pursuant to this requirement, all investor-owned utilities were required to bid all of their generation into a power exchange and were required to purchase all of their power from the power exchange. See *Preferred Policies Governing Restructuring California's Electric Service Industry and Reforming Regulation*, 166 Pub. Util. Reg. 24 (Dec. 20, 1995). The requirement and its rationales are discussed in Yuffee, *supra* note 25, at 69.

28. *California Power Exch. Corp. v. FERC*, 245 F.3d 1110, 1116 (9th Cir. 2001).

29. See Yuffee, *supra* note 25, at 70-71; see also *California Power Exchange*, 245 F.3d at 1116 (noting that FERC determined that over-reliance "on the spot market also exposed the . . . [utilities] to the possible exercise of market power" by wholesale suppliers). As a remedy, FERC eliminated the power exchange buy/sell requirement, inviting the use of forward-looking contracting. *Id.* FERC observed that "eliminating any mandated reliance on the spot market represents the single most important aspect of wholesale market reform and is one of the most critical components of all of the immediate market reforms necessary to correct the problems in California electric markets and provide long-term protection of customers." *Id.* (internal quotations omitted). The remedy, however, did not provide California utilities the relief they needed against the backdrop of the retail price cap.

As these examples illustrate, the problem in California was not necessarily deregulation. Instead, the problem was the way in which state regulators designed deregulated power markets to provide for public goods, such as consumer and environmental protection, particularly against the background of federal regulatory policies encouraging competition in the same industry. Misguided regulatory backlash in reaction to failed deregulatory policies may produce significant social costs, eerily echoing the same concerns that gave rise to the demand for deregulation in the first place. Consider, for example, the now widely known source of California's power woes: demand for power outstripping supply. The obviously simple solution of building more plants, especially if subsidized with tax benefits or by consumer rates, or if planned by state or federal regulators, places the risk of another overcapacity problem with the public or consumers — not with investors, where it belongs. Thus, the obviously simple policy solution here leads to costly and absurd results.

The California deregulation fiasco was created by state regulators' misguided efforts to provide for public goods in the face of deregulated energy markets, not necessarily by deregulation itself. The provision of public goods, such as consumer and environmental protection, is an important policy for state regulators. In California, however, the mechanisms for public good provision were misplaced and contributed to dysfunctional power markets — especially since California policy-makers failed to anticipate how their new power markets might actually operate in practice.

While California regulators attempted to provide for public goods in *ex ante* market design, this approach created at least two problems. First, a focus on front-end market design may itself be flawed if looked to as the primary mechanism for providing for public goods. Taxation mechanisms are the most efficient way to provide for public goods, because they create the fewest price distortions and avoid the strategic manipulation opportunities created by planned efforts at market design. Professors Louis Kaplow and Steven Shavell, for example, argue that the fairness of legal rules is best ensured through back-end taxation measures rather than in front-end architecture or design.<sup>30</sup> Legal rules, they observe, are designed to affect only small fractions of the population and, at best, accomplish only crude redistribution. As they state, “redistribution through legal rules entails both the inefficiency of redistribution generally (due to adverse effects on work incentives) and the additional cost involved in adopting less efficient legal rules.”<sup>31</sup>

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30. See Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961 (2001).

31. *Id.* at 994; see also Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEG. STUD. 821 (2000); Louis Kaplow & Steven Shavell, *Why the Legal System is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. LEG. STUD. 667 (1994).

On their analysis, the price distortions and other adverse effects of front-end redistributive policies imposed through rules of market design, including these effects on strategic behavior, can create serious inefficiencies. By contrast, the imposition of taxes to support redistributive policies minimizes both price distortions and strategic manipulation of the market. If Kaplow and Shavell are correct, taxation mechanisms are the best way for deregulated electric power markets to minimize price distortions while also enhancing social welfare. Federal regulators have adopted this approach, however imperfectly, in the context of telecommunications deregulation, where something akin to a tax, rather than a service mandate, finances universal service.

A second problem with California's approach to electric power deregulation was a practical result of the state political process in which it was adopted. More than deregulation in the contexts of telecommunications or natural gas deregulation, electric power deregulation is the result of state political processes. In California, for instance, the deregulation plan adopted in 1996 included many front-end market design mechanisms designed to appease consumer groups so that state legislators could assure their constituents that deregulation would lead to rate reductions. In retrospect, the California Assembly could not have been more wrong! California adopted one market model, mixing it with incompatible features. According to the distinguished economist Paul Joskow, "It was an accident waiting to happen from day one."<sup>32</sup>

Even where front-end market design might work, the political pathologies of the state political process are certain to make its success even less likely. At best, it will probably result in "partial deregulation," akin to the phenomenon critiqued by MacAvoy, by retaining patchwork regulation but for the wrong reasons and in the wrong form.

#### IV. REGULATORY FEDERALISM AND EFFICIENT ELECTRIC POWER (DE-)REGULATION

Ultimately, a major source of the problem with deregulation of electric power can be traced to the eighteenth-century origins of federal railroad regulation discussed in Geisst's book. As with railroad regulation, a jurisdictional divide in electric power regulation between federal and state regulators threatens the ability of even well-intentioned state regulators to implement efficient regulatory policies in the electric industry. This divide has been a longstanding issue of contention in electric power regulation. For instance, when Rhode Island attempted to regulate the rates charged by a Rhode Island plant

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32. Arthur O'Donnell, *Economists and the Golden State*, PUB. UTIL. FORT., Apr. 1, 2002, at 20.

selling electricity to a Massachusetts company, which then resold electricity to the city of Attleboro, Massachusetts, the U.S. Supreme Court invalidated the regulation because it imposed a “direct burden upon interstate commerce.”<sup>33</sup> This limitation on state regulation, which created the “Attleboro gap” (an area in which neither federal nor state regulators had jurisdiction), led Congress to adopt Part II of the Federal Power Act in 1935, giving federal authorities jurisdiction over interstate electricity transactions that are beyond the scope of state authority.

But leaving even residual authority over regulation to the states raises difficulties for regulatory law. The strongest interest groups may more readily capture the regulatory process in state politics than in national politics, thereby thwarting the goals of both federal and state regulatory policies. To the extent that state politics enhances the participation of stakeholders in the regulatory process — and the lower costs of participation in state and local politics holds particular promise in this regard — the state forum has many advantages over federal regulation for the development of economic regulatory policies. State governments, for example, are routinely touted as laboratories of democracy, encouraging policy experimentation that the federal government would find unwieldy because of the heterogeneity of interest groups at the federal level and the costs associated with national implementation of policies.

At the same time, however, states allow more extreme interest groups to influence the content of policies, since those interest groups are not required to build coalitions with others in the more diverse national forum, where extreme factions are less likely to influence policy. For reasons Madison articulated in *The Federalist* No. 10 — well-chronicled in modern public choice literature — constituent groups, including industrial consumers, environmental groups, and consumer interests, are more likely to organize into dysfunctional factions at the state level, as opposed to in national politics.<sup>34</sup> Such factions can adversely influence the content of economic regulation. Moreover, the state political process is more prone to favor interest groups with parochial concerns, rather than those that are likely to favor concerns affecting matters outside of a given state. As Hirsh’s study of deregulation indicates, in electric power restructuring many of the interest groups favoring competitive markets are out-of-state stakeholders, prone to clash with the interests of in-state rivals who have held monopolies for more than a half century.<sup>35</sup>

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33. See *Pub. Util. Comm’n of Rhode Island v. Attleboro Steam & Electric Co.*, 273 U.S. 83, 89 (1927).

34. THE FEDERALIST NO. 10 (James Madison).

35. For one commentator’s view of how state and local political processes may not be as effective as federal processes in reflecting the values of constituents, see Clayton P. Gillette,



Against the backdrop of the state political process and its production of laws and policies conflicting with federally created wholesale power markets, regulatory federalism issues define a number of legal disputes facing the industry today. For example, a recent U.S. Supreme Court case addresses the jurisdictional issues in FERC's 1996 restructuring order, known as Order No. 888. In Order No. 888, FERC took a major step toward implementing wholesale power competition by requiring utilities subject to its jurisdiction to adopt a standard tariff offering transmission service to customers other than retail customers on a nondiscriminatory basis. FERC's order asserted preemptive authority to prescribe such requirements notwithstanding the existence of state rules to the contrary. FERC, however, declined to assert jurisdiction over the transmission component embedded in traditional retail sales service to native load customers. On appeal, the U.S. Court of Appeals for the D.C. Circuit affirmed the open access requirements as well as the jurisdictional rulings FERC made in Order No. 888.<sup>36</sup> The Court affirmed that FERC's jurisdiction extended to transmission even where the generating plant and consumer were located in the same state.<sup>37</sup> While FERC's Order No. 888 did not require all jurisdictional utilities to unbundle the transmission component of service from retail sale services, the D.C. Circuit concluded that FERC's more restrictive reading of the statute, which deferred to state jurisdiction over bundled service, was permissible and subject to deference by the court.<sup>38</sup>

In 2001, the U.S. Supreme Court granted two petitions for certiorari to review the D.C. Circuit's jurisdictional rulings.<sup>39</sup> State regulatory officials brought the first appeal, which maintained that FERC's assertion of authority over intrastate transmission reached too far by including unbundled retail transmissions of electricity widening the scope of its open access requirements. The other appeal, brought by Enron,<sup>40</sup> the now infamous power marketer, maintained that FERC's

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Comment, *Interest Groups in the 21st Century City*, 32 URB. LAW. 423 (2000); see also Clayton P. Gillette, *In Partial Praise of Dillon's Rule, or Can Public Choice Theory Justify Local Government Law*, 67 CHI. KENT L. REV. 959 (1991).

36. See *Transmission Access Policy Study Group v. FERC*, 225 F.3d 667 (D.C. Cir. 2000).

37. *Id.* at 693-95.

38. *Id.* at 694-95.

39. See *New York v. FERC*, 69 U.S.L.W. 3574 (Feb. 26, 2001) (Nos. 00-568 and 00-809).

40. Of course, by Spring 2002, Enron had announced the largest bankruptcy in United States history. Enron's collapse and the subsequent scandal over Enron's corporate financial reporting seem to be driven primarily by internal management decisions, not the external deregulatory policies under which Enron often operated. To the extent regulatory policies played a direct role in Enron's financial failure, these were corporate disclosure policies, not policies related to competition in electric power. However, failure of regulators to effectively monitor power marketers' claims of supply and demand did allow Enron and others to manipulate markets for financial gain. See Richard Behr, *Papers Show that Enron Manipulated*

assertion of jurisdiction did not go far enough and that FERC is required to extend its open access remedy to bundled retail transmissions.

The Supreme Court consolidated the two appeals and issued a single opinion upholding the D.C. Circuit's approval of FERC's Order No. 888 — the most significant opinion in decades to define the scope of federal power to implement competition in electric power markets.<sup>41</sup> The Court observed that the Federal Power Act did not, in its express language, evidence a congressional intent to safeguard preexisting state regulation of the delivery of electricity to retail customers,<sup>42</sup> and that FERC was careful not to attempt to exercise control over local distribution facilities.<sup>43</sup> Thus, the Court concluded, the Federal Power Act “unquestionably supports” FERC's assertion of jurisdiction “to regulate the unbundled transmissions of electricity retailers.”<sup>44</sup> Effectively, the Court held that the Federal Power Act was not limited in its jurisdiction to closing the “Attleboro gap,” but also extend federal jurisdiction to the regulation of wholesale sales that had previously been subject to state jurisdiction.

As if this holding was not enough to empower federal regulators, the Enron argument invited the Court to further clarify the expansive scope of federal power over competition in electric power. In rejecting Enron's argument that FERC had held itself powerless to assert jurisdiction to remedy undue discrimination in bundled retail transmissions of electricity, the Court made it very clear that FERC had this authority.<sup>45</sup> Although FERC did not error in failing to exercise it in Order No. 888, which concerned discrimination in the wholesale market, the Court observed that if “FERC were to investigate this alleged [retail] discrimination and make findings concerning undue discrimination in the retail electricity market,” the Federal Power Act “would require FERC to provide a remedy for that discrimination.”<sup>46</sup>

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*California Crisis*, WASH. POST, May 7, 2002, at A1; Kathryn Kranhold and Rebecca Sedth, *Two Other Firms in Enron Scheme*, WALL ST. J., May 9, 2002, at A1; Richard A. Oppel, Jr., *How Enron Got California to Buy Power It Didn't Need*, N. Y. TIMES, May 8, 2002, at C1.

41. *New York v. Fed. Energy Regulatory Comm'n*, 122 S. Ct. 1012 (2002).

42. *Id.* at 1024. The language of the Federal Power Act gives FERC jurisdiction over the “transmission of electric energy in interstate commerce and . . . the sale of such energy at wholesale in interstate commerce.” 16 U.S.C. § 824(b). According to the Court, this language limits FERC's jurisdiction over the sale of power to the wholesale market, but authorizes FERC's jurisdiction over transmission, without regard to whether transmissions are sold to a reseller or directly to a retail customer. *New York v. FERC*, 122 S. Ct. at 1024.

43. *Id.* at 1026. This was important because 16 U.S.C. § 824(b) precludes FERC from asserting jurisdiction “over facilities used for the generation of electric energy or over facilities used in local distribution . . . .”

44. *New York v. FERC*, 122 S. Ct. at 1026.

45. *Id.* at 1028.

46. *Id.*

Even where federal policymakers have not expressly asserted jurisdiction, legal doctrines play an important role in minimizing market distortions created by the state regulatory process. Because interest groups are more readily able to capture the state regulatory process, as well as states' deregulation policies, state laws could potentially thwart full evolution of markets in electric power. If markets in electric power are to flourish, courts will be asked to clarify the role of additional doctrines, such as federal preemption doctrine, the dormant commerce clause, and state action doctrine in limiting state regulators. In fashioning limits on state regulatory power, courts must balance the advantages of state power, including its promotion of experimentation and the lower cost political participation it offers home-turf stakeholders, with its costs, many of which are related to the non-democratic implications of adverse interest group behavior in the regulatory process.

Approaches of regulators in California and Florida, for example, illustrate how, in the state regulatory process, front-end market design can serve as a forum for interest group capture of the regulatory process. In California, regulators protected in-state consumers by coupling the state's deregulation plan with retail price caps, even though wholesale power markets were not subject to price caps. When wholesale power prices increased by more than 500% in the second half of 1999 and the second half of 2000, retail prices were fixed, limiting the revenue recovery for California utilities and forcing them into insolvency.<sup>47</sup> In Florida, the state supreme court has interpreted a state power plant siting statute to limit plant siting to only those suppliers who are Florida utilities or who have contracts with Florida residents.<sup>48</sup> The result is to close Florida's wholesale power market to merchant power plants, plants intended to compete in federally deregulated wholesale power markets. For two consecutive terms, Florida's Legislature has failed to amend its statute to override the supreme court interpretation, ignoring the interpretation of the state regulatory agency charged with enforcing it and an independent commission's recommendations.<sup>49</sup> Taking their cue from Florida's success in blocking the development of wholesale power supply, other state and local governments, particularly in the South, have imposed moratoria on merchant power plants.<sup>50</sup>

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47. See JOSKOW, *supra* note 7, at 1.

48. *Tampa Elec. Co. v. Garcia*, 767 So. 2d 428, 435 (Fla. 2000) (holding that state's power plant siting statute "was not intended to authorize the determination of need for a proposed power plant output that is not fully committed to use by Florida customers who purchase electrical power at retail rates").

49. See Steve Huettel, *Panel Okays Energy Plan*, ST. PETERSBURG TIMES, Nov. 16, 2001, at 1E.

50. See Chris Deisinger, *The Backlash Against Merchant Plants and the Need for a New Regulatory Model*, 13 ELECTRICITY J. 51 (Dec. 2000); *Nervous of NOx, Southern Govs. Put*

If invoked by courts with the idea of limiting states' ability to thwart the goals of federal policies, doctrines such as federal preemption and the dormant commerce clause hold promise to limit, or at least temper, the use of state political processes to thwart operation of competitive markets in electric power. For instance, pursuant to federal law, state regulatory commissions are required to allow the retail utilities to recover the costs of FERC-mandated wholesale transactions and cannot disallow, or "trap," these costs by refusing to allow the utility to recover them in retail rates, unless they are imprudently incurred.<sup>51</sup> According to one set of authors, "the case law points strongly to the conclusion that California acted in violation of the Supremacy Clause when it refused to allow Edison and PG&E to pass through in retail rates the costs the two utilities incurred in purchasing wholesale power from the California Power Exchange."<sup>52</sup> Although federal law does not have a definitive preemptive effect on rate caps, California's policies raise the prospect for such challenges.<sup>53</sup> Similarly, Florida's restriction on siting out-of-state merchant plants raised federal preemption issues against the backdrop of FERC's Order No. 888, which adopted a federal policy of competition in wholesale power. Although FERC's rule did not preempt state regulators' authority to regulate the legitimate environmental impacts of power plant siting, FERC expressed a clear preference for relying on the market, not state regulators, to determine the need for wholesale power supply.

In addition to the argument that FERC's policies potentially preempted Florida's need restrictions on siting power plants, Florida's restrictive siting statute raises the potential for dormant commerce clause challenges to state regulations that impair competition, or impermissibly discriminate against out-of-state commerce by favoring in-state over out-of-state suppliers. Such arguments were raised before

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*Plants on Hold*, ELECTRICITY DAILY, Aug. 28, 2001; *State Limits on Merchant Plants a Growing Worry*, GENERATION WK., Aug. 22, 2001.

51. This is the federal preemptive effect of the "filed rate" doctrine. See generally *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354 (1988); *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953 (1986). In the natural gas context, the Supreme Court held that Congress's decision to substitute market-based prices for cost-of-service regulation does not alter the preemptive effect of the filed rate doctrine on the states. See *Transcon. Gas Pipeline Corp. v. State Oil & Gas Bd. of Miss.*, 474 U.S. 409, 417-23 (1986). A limited exception to the doctrine, known as the *Pike County* exception, is recognized where a state commission declares a particular quantity of power unreasonably excessive and lower-cost power is available elsewhere. *Nantahala*, 476 U.S. at 972. California's utilities, however, were barred from purchasing power outside of the state's Power Exchange.

52. Nicholas W. Fels & Frank R. Lindh, *Lessons from the California "Apocalypse:" Jurisdiction Over Electric Utilities*, 22 ENERGY L.J. 1, 19 (2001).

53. Oddly, and to no avail, California regulators tried to turn the argument around, suing FERC for its failure to cap wholesale rates. *The State Legislators Set to Sue Federal Energy Agency Power*, L.A. TIMES, May 22, 2001, at B8.

and rejected by the Florida Supreme Court,<sup>54</sup> but the inadequacy of a record establishing discrimination against out-of-state suppliers may impede their acceptance by the court. As other states impose moratoria on out-of-state merchant power plants that do not apply to in-state utilities, we can expect constitutional challenges to the state protectionist policies to mount. Such constitutional challenges have already been posed to state environmental regulations, many of which potentially favor in-state suppliers.<sup>55</sup>

A final, and increasingly important, regulatory federalism doctrine that will increasingly affect competition in electric power is state action immunity from federal antitrust enforcement. Unlike federal preemption and dormant commerce clause doctrines, which limit public actors, state action immunity relates to limits on the exercise of private decisionmakers in violation of antitrust laws. In *Parker v. Brown*, the U.S. Supreme Court enunciated the rule that principles of federalism immunize anticompetitive conduct pursuant to state laws restricting competition from federal antitrust scrutiny because “[i]n a dual system of government . . . an unexpressed purpose to nullify a state’s control over its officers and agents is not lightly to be attributed to Congress.”<sup>56</sup> Even before deregulation, state action immunity did not insulate utilities from all antitrust suits.<sup>57</sup> With federal deregulation and uneven and partial state deregulation, the extent to which state action immunity will immunize anticompetitive conduct from the reach of federal antitrust law in a deregulated electric power market remains unclear, particularly given the traditional extent to which states have regulated electric utilities.

Early cases have affirmed, based on analysis of state regulations, that a state regulatory policy prohibiting retail competition insulates a state’s utilities from antitrust suits by competing suppliers seeking access to retail transmission.<sup>58</sup> But, with evolving state regulatory poli-

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54. *Tampa Elec. Co. v. Garcia*, 767 So. 2d 428, 436 (Fla. 2000).

55. See Kirsten H. Engel, *The Dormant Commerce Clause Threat to Market-Based Regulation: The Case of Electricity Deregulation*, 26 *ECOLOGY L.Q.* 243 (1999); Steven Ferrey, *Renewable Subsidies in the Age of Deregulation: State-Imposed Preferences May Have Come to the Wrong Place at the Wrong Time*, *FORTNIGHTLY.*, Dec. 1997.

56. 317 U.S. 341, 351 (1943). State action immunity has developed into a two-part test, today known as the “*Midcal* test.” “First, the challenged restraint must be one ‘clearly articulated and affirmatively expressed as state policy’; [and] second, the policy must be ‘actively supervised’ by the State itself.” *California Retail Liquor Dealers Ass’n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980).

57. See, e.g., *Cantor v. Detroit Edison Co.*, 428 U.S. 579, 596 n.35 (1976) (finding utility liable for illegal tying in connection with its program for distributing free light bulbs to residential customers, even though the light bulb exchange program was part of the utility’s approved tariff); *Gainesville Util. Dep’t v. Florida Power & Light Co.*, 573 F.2d 292 (5th Cir. 1978) (competing electric power companies conspired to divide the Florida wholesale power market in violation of section 1 of the Sherman Act).

58. See *North Star Steel v. Mid-Am. Energy*, 184 F.3d 732 (8th Cir. 1999) (holding that electric utility is protected by state action immunity from customer’s antitrust suit based on

cies, along with changes in both the industry and federal competition policy, the regulatory basis for state action immunity is shifting and in need of careful analysis. The federal government has declared a policy of wholesale competition in power supply and, even following the California fiasco, many states continue to express policies favoring retail competition. It is incumbent on federal courts to interpret the scope and degree of continued regulation posed by state policies, but state action immunity does not stand for automatic deference to the states. As an illustration, consider the conflict between the U.S. Courts of Appeals for the Tenth and Ninth Circuits. Notwithstanding claims of dysfunctional interest group involvement in a state regulatory scheme, evidence that is not directly relevant to the state action immunity legal inquiry, the Tenth Circuit held that state action immunity extends in a blanket manner to all utility sales regulated by the Oklahoma Corporate Commission, precluding an antitrust suit by a competitor who lost customers to a regulated utility.<sup>59</sup> By contrast, the Ninth Circuit held that an electrical cooperative's suit alleging that a utility violated antitrust laws by refusing to allow the cooperative to "wheel" (or provide access to its transmission facilities) to supply power to the utility's customers was not subject to state action immunity in Idaho.<sup>60</sup>

The primary purpose of the state action doctrine is to respect federalism concerns. But in a deregulatory era, courts should be wary of blanket deference to state regulatory programs and instead should look carefully to the scope and extent of specific regulatory provisions. Although evidence of adverse interest group behavior in states is not directly relevant to doctrinal application of the state action doctrine, the potential of such behavior behooves careful judicial construction of the specific scope and extent of state regulation in deciding to suspend application of antitrust law to private behaviors.<sup>61</sup>

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refusal to allow customer access over transmission lines to alternate sources of electricity, given Iowa's establishment of exclusive service territories for electric generation); *TEC Cogeneration v. Florida Power & Light Co.*, 184 F.3d 732 (11th Cir. 1996) (applying state action immunity to a utility's refusal to wheel power for cogenerators in its service territory, given Florida's specific regulatory prohibition on such wheeling).

59. *Trigen-Okla. City Energy Corp. v. Oklahoma Gas & Elec.*, 244 F.3d 1220 (10th Cir. 2001) (holding that all of Oklahoma Gas & Electric's sales of electricity are regulated by the state, and thus lawsuit by competitor who lost a customer to utility was subject to state action immunity).

60. *Snake River Valley Elec. Ass'n v. PacifiCorp*, 238 F.3d 1189 (9th Cir. 2001) (finding no active supervision of private agreements to divide customers, so state action immunity does not apply). Another case refusing to extend state action to a dispute in emerging competition power markets is *United States v. Rochester Gas & Elec. Corp.*, 4 F. Supp. 2d 172, 176 (W.D.N.Y. 1998) (holding that contract provisions, required by the utility, that prohibited a customer from entering the electricity market as a competitor in the future in exchange for a discounted electric rate, were not protected by the state action doctrine).

61. John Wiley has argued that courts should pay attention to interest group behavior in resolving the application of state action immunity. See John Shepard Wiley, Jr., *A Capture*

Together, these regulatory federalism doctrines will help determine the success of competition in electric power. The legal doctrines have distinct purposes and are invoked in distinct regulatory conflicts, but in the context of each of these doctrines courts must recognize that federal competition policy, even if limited to wholesale supply markets, cannot peacefully coexist with balkanized, protectionist regulation by individual states. Courts have developed longstanding doctrines of regulatory law to guard against such conflicts. The potential for interest group regulation gives rise to a need for narrow construction of state authority, along with an expectation of clear articulation of policies prohibiting competition by state regulators, in such contexts. Federal courts might inform application of regulatory federalism doctrines with awareness of the most egregious instances of interest group capture of the state regulatory process. While this alone would not guarantee the success of state regulation in the deregulatory environment — state politicians also must make the right choices about substantive regulation — regulatory federalism holds promise for promoting more successful state regulation in implementing competition policy.

#### CONCLUSION

New regulation of the electric power industry and the operation of its workers will be necessary, but regulators would be wise to acknowledge that a return to partial or full re-regulation of the industry is unlikely to create more efficient markets in states like California. Moreover, regulatory backlash in reaction to failed deregulatory policies may risk recreating some of the very same problems that gave rise to regulatory reform, coopted by deregulation advocates over the last thirty years.<sup>62</sup> The exercise of sound policy judgment is contingent on the political process and the incentives it creates for both participants and decisionmakers. Without the appropriate incentives, the state and local political process for formulating economic regulations can easily respond to the wrong signals. To be sure, as MacAvoy suggests, even federal regulators sometimes make the wrong decisions. But because

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*Theory of Antitrust Federalism*, 99 HARV. L. REV. 713, 743 (1986). For criticism of this capture theory approach, see Merrick B. Garland, *Antitrust and State Action: Economic Efficiency and the Political Process*, 96 YALE L.J. 486, 508-18 (1987). A more workable approach, using a political process argument to incorporate dormant commerce clause analysis into state action immunity doctrine, is presented in Daniel J. Gifford, *Federalism, Efficiency, the Commerce Clause, and the Sherman Act: Why We Should Follow Consistent Free Market Policy*, 44 EMORY L.J. 1227, 1276 (1995) (arguing “not only do the political processes as presently established fail to protect consumers from municipally established monopolies, but these political processes also foster the creation of monopolies as ways of obscuring from the voting public the extent to which society’s assets are being misallocated”).

62. For criticism of California’s re-regulation response, see *How to Keep the Fans Turning*, ECONOMIST, July 21, 2001, at 26.

so many of the details of electric power market operations remain in state regulators' hands, the propensity for poor decisions is subject to a different sort of interest group pressure and varied geographic solutions, especially given the emerging new interest groups Hirsh identifies, many of which are national rather than parochial in scope.

In light of recent events in the electric power industry, courts have the opportunity to curb state power to respond to extreme interest group politics. These recent events, particularly those in California, will challenge future accounts of regulation and deregulation to struggle further with the theme of jurisdictional boundaries and, specifically, how these boundaries influence interest group behavior in the formulation of regulatory law. Regulatory law will remain important, as deregulation of one aspect of this industry gives rise to a need to regulate elsewhere, but jurisdictional clarity can only help policymakers in discerning where that need is legitimate and where it is not.