HARVARD UNIVERSITY

JOHN F. KENNEDY SCHOOL OF GOVERNMENT

Harvard Electricity Policy Group

Center for Business and Government
79 John F. Kennedy Street
Cambridge, Massachusetts 02138

HARVARD ELECTRICITY POLICY GROUP SEMINAR

Forum: The Courts and Emerging Electricity Policy -- How Do We Secure a Better Congruence Between Agency Action and Judicial Review?

Hyatt Regency Capitol Hill, Washington, D.C.
October 13th, 1994

MEETING SUMMARY

The Harvard Electricity Policy Group has held several special seminars which dealt with regulatory and legal issues which have arisen as a result of the move to greater competition in the electricity industry. To date, these issues have concentrated on the more theoretical: how regulators might deal with stranded costs, mechanisms for resolving jurisdictional conflicts between regulatory bodies; the role that regional transmission groups might play; and how the process of regulatory decisionmaking might be modified to deal with the realities of a changed industry.

This seminar turned to a more practical issue of implementation of the changes being made in the industry -- specifically, the role of the courts in molding electricity policy. As the electricity industry reinvents itself, the courts will inevitably become involved in the process of determining its ultimate structure and direction. In what ways will the decisions that will emerge from the courts affect the process of "re-regulation"? Where are the functions of policymaking and judicial review likely to yield conflicts? At the request of several key groups involved in these discussions, this HEPG seminar was organized to take a prospective look at the relationship between agency action and judicial review of those actions during a time of policy transition.

Session I: Two views of the relationship between the courts and agencies in times of policy change: 'What can we expect, based on past experience?

The past history of judicial review of policy change is riddled with decisions that highlight basic conflicts and disconnects between agency actions and judicial oversight. What lessons can be gleaned from the experience of regulatory change in other industries? Are the courts an impediment to enlightened policymaking, or are they a necessary check on agency incompetence?

First Speaker:

By far the most frequent basis on which the courts reverse the FERC is the concept of the "duty to engage in reasoned decisionmaking". This doctrine sounds very good in the abstract and works very poorly in practice. Would the FERC suddenly switch to *unreasoned* decisionmaking, if the courts were to stop second-guessing it?

Rulemaking involves a large number of very closely interrelated issues. There were 147 issues presented to the D.C. Circuit court in the *summary* of the appeal of Order 636. The Administrative Procedure Act directs agencies to incorporate a concise statement of 'basis and purpose" in each rule. Yet when the FERC includes a 550 page statement of basis and purpose, it is routinely determined to constitute inadequate reasoning. Because the statement of basis and purpose is written before all the briefs are in, it is very easy for lawyers to compare the statement to the issues that were raised after the fact and find places they can pick on -- this is done routinely, often by people who used to write statements of basis and purpose at the FERC. The courts are buried in these briefs, filed by hundreds of intervenors, which they must try to balance against a single brief from the FERC saying, "Hey gang, we did the best job we could".

In many of these cases, judicial review also comes too late to have any social benefit. For example, the most significant order remanding the **FERC's** rules for dealing with the

natural gas shortage was issued in late 1978 -- the same week that Secretary of Energy Schlesinger announced that the gas shortage had been over for two months. During the surplus period that followed, the FERC had to go back and devote resources to doing studies of what effects its rules used to have when there was a shortage. Sometime in 1995 the D.C. Circuit will decide whether Order 636 was lawful. In the meantime, every participant in the market has completely restructured its organization. You can't unscramble eggs like that.

The substantive area in which the duty to engage in reasoned decisionmaking has proven particularly difficult is with respect to the allocation of transition costs. This is an intractable problem, because there is no clear objective answer, and it invariably involves a great deal of money. There is a great deal of literature on the subject of transition costs, and it's clear that the best you can come up with is a rough justice compromise. The courts, which look for some objective measure of right and wrong, don't lend themselves well to negotiated dealmaking like this, and find it very tempting to say, "If only you were to discuss this for another 15 pages, maybe you could come up with the right answer."

There are some areas where there is cause for optimism. In Justice Rehnquist's opinion reversing the 5th circuit opinion in *Mobil Oil Exploration vs. United Distribution Co.* [1], there is a gentle message to the circuit courts that they should stop or back off significantly in the manner in which they have been applying the doctrine of reasoned decisionmaking. There is also a chance that this message will become even clearer in the

1 111 S. Ct. 615 (1991)

future. If you look at now Justice Breyer's writings[2] in this area, you will see that he views it as an extraordinarily destructive doctrine, and one that courts are institutionally incompetent to apply.

Another cause for optimism is the D.C. Circuit treatment of the FERC's efforts to implement the transition to a competitive gas market. If you read the opinions chronologically, the court began by asking fora clear, objective solution, but over the course of seven years of dealing with the same issues, they became a little more sympathetic to the difficulty of producing such a solution.[3]

Finally, the D.C. Circuit has adopted a policy of "remand without vacation" of rules it finds to be arbitrary and capricious. This changes the dynamics for the agency significantly, because the rule remains in effect even if the agency is required to go back and write another 15 or 20 pages of explanation.

All of these reasons for optimism should have been encouraging, as we prepare to go through another complicated industry transition. How then to explain the D.C. Circuit's decision in *Cajun Electric4?* Where did the tying doctrine and anti-trust violation come from? It has nothing to do with the case. We went through this for the last ten years with natural gas, and no one said, "Hey, this is a violation of anti-trust law". The observation that allowing firms to recover transition costs through a surcharge is likely to slow the movement to a competitive market is totally noncontroversial. Of course you'll get there faster without

---

2 see especially Breyer, Stephen "Judicial Review of Questions of Law and Policy", 38 Admin. L. Rev. 363 (1986)

3 see *Public Utilities Commission of the State of California v. FERC,* 988 F.2d 154 (1993)

4 *Cajun Electric Power Cooperative, Inc. v. FERC* _ F. 3d _ (1994)

transition charges. But everyone knows that those aren't the choices. If this decision is indicative, we have a long process of educating judges ahead of us.

All of the above is with respect to the potential grounds for petition for review of the case. There is also the possibility of alleging violation of statute, but in cases where the legal standard is "just and reasonable", the possibility of providing objective content to prove whether the standard has been violated is limited. "Just and reasonable" are meaningless terms. Then Judge, now Justice Ginsburg described this statutory interpretation issue beautifully in her opinion in *National Cable Television Assoc. v. Copyright Royalty Tribunals,* where she said that, if a statute has some precise objectively determinant standards, the judges have an important role in making sure the agency stays within those boundaries. If, on the other hand, the statute does not have clear, unambiguous language, but rather has terms that are susceptible to almost any interpretation, then the role of the judge is necessarily less important. This is a very sensible distinction, and one which could carry the FERC over many alleged violations of law.

There are, of course, serious and difficult jurisdictional issues that can arise, there is definitely law to apply, and the courts have an important role to play in determining where the jurisdictional boundaries lie between the FERC and state commissions. The central issue of course is the jurisdictional authority of a state to order retail wheeling. In an article in the next issue of the Energy Law Journal, I have developed some analysis that convinces me that a state *can* order retail wheeling, but **it cannot determine the terms and conditions** for the use of transmission lines in those transactions -- it must leave that task solely to the FERC. This would produce a sensible legal regime, and I think the agencies

[5] 724 F.2d 176 (1983)

and courts can get there.

All the current jurisdictional problems are related to the vertical integration of the industry. Moving to a vertically de-integrated industry structure would now only have enormous social benefits, but would also resolve all the major jurisdictional issues. The distribution company is subject to the sole jurisdiction of the state. The transmission company is FERC jurisdictional, and generating companies are competitive. All other policy issues that have effects within the state are addressed by the state commissions.

One final point of optimism with respect to jurisdictional issues is the court's opinion in the *Chevron* case[6] , that a reviewing court must defer to an agency's reasonable interpretation of ambiguous language in a statute it is assigned to administer. But while the circuit courts are adhering to the *Chevron* doctrine, the Supreme Court is not. Over the past two terms, the Supreme Court has been taking a dramatically different approach to statutory interpretation. It has not been able to reach the deference step in *Chevron*, because it has been unwilling to admit that any statutory language is ambiguous. It is a cause for hope that this method of statutory interpretation is repugnant to Justice Breyer, and we will start seeing some very lively debates on these issues. I hope they occur before the circuit court judges begin to feel compelled to emulate the current practice, or it is going to spell bad news for the transition in electricity, and, frankly, for the administrative function in general.

Second Speaker:

The previous speaker's argument is that, in a perfect society, a perfect regulatory agency will make perfect decisions and therefore should not be harassed, slowed down, or

6 *Chevron v. Natural Resources Defense Council*, 467 U.S. S. Ct. 837 (1984)

confused by judicial review. But he is focussing on the wrong issue. In any regulated industry that is going through rapid change induced by economic rather than regulatory changes, there is a lot of money that changes hands. There is not going to be any way of making sure there are net winners all around. The question before the FERC and other agencies is going to be how to maximize the social benefits -- the effects this has on specific segments of the industry will have to be fought out later.

What is the legitimate function of an agency? Agencies take money from one set of stakeholders and give it to another with every decision they make. There is no way that can be avoided. Agencies are set up to provide a way of resolving complicated disputes -- some of them involving hundreds of parties. The combination of complexity and high stakes makes it necessary to have in place auxiliary precautions. The basic function of judicial review is to make sure that agencies have not been captured by a particular interest -- that they are able to articulate their reasons for resolving things in favor of one and not in favor of another. In the past, it is well known that a call from the White House or the Hill to the FERC has resulted in decisions being changed. This happens from time to time in the best of agencies. Fairness demands that both procedural and substantive appeal mechanisms be available.

Judicial review has impelled progress at least as often as it has stalled it. In the *Gulf States'* case, the D.C. court and the U.S. Supreme Court dragged a reluctant FERC into the twentieth century, saying, "You have to deal with anti-competitive problems -- you can't just leave it to the anti-trust division." They forced the agency to look at an industry which was rife with abuses, which led to a consideration of market imperfections in general, and thence

---

7 *Gulf States Utility Co. v. FPC 411 U.S. 747 (1973)*

to the idea that a market might to a better job of fulfilling some of the discipline functions previously assigned to the FERC. In the *Conway* case[8], the U.S. Supreme Court told the FERC it could not ignore differences between rates that were charged at the jurisdictional wholesale level and at the nonjurisdictional retail level (the so-called "price squeeze" theory). This in turn led to the theoretical basis for the comparability standard.

In cases where the regulatory body knows what the "right" thing to do is, but cannot do it for political reasons, the courts' greater independence from political pressure can be a valuable policymaking tool. The *Cajun*[9] case was a good decision in the respect that many people felt the FERC had left open the possibility of imposing a stranded cost charge at some future point as a concession to political pressure. The court rightly said that this was not the same thing as charging the same rate to your own customers as to everyone. This decision will give the FERC some political freedom that it might otherwise not have had.

The idea of deference to the agency on interpretation of statute has a tradeoff. If you are going to defer to the agency the authority to throw billions of dollars of assets at risk, there must be an obligation to articulate the reasons for doing so in a way that is acceptable to the public. There are clearly times when an agency like the FERC needs a way to let the world know that the agency is making a change in course. I agree that the review process ought to be capable of accepting this change, as long as the explanation for the change is rational and the change itself is within the authority of the agency.

Rulemaking is an efficient way of creating change in an industry. The FERC has

---

8 *Conway Corp. v. FPC,* 426 U.S. 271 (1976)

9 **Cajun, supra note** 4.

recently been trying a very innovative way of using rulemaking as a way of establishing ground rules for the gas industry. Working on a thematic approach to resolution of industry problems, they have been trying to set out some guidelines or rules that the rest of the industry will then fix on and begin to incorporate in their day to day transactions. By the time the original rule gets to the courts, the industry will have accepted it -- it will be a *fait accompli.* If this strategy is successful, it will cut down on the case load considerably.

First Speaker. comment:

I've accused the FERC of many things, but I don't ever remember accusing them of being perfect. I assume they will get things wrong a lot. They have an unbelievably complicated task, and they're only human, so I assume they'll screw up. I also assume that they are acting in good faith, and will correct screw ups as soon as they detect them. That's the way it works at every agency. I agree that the agency's job is the resolution of policy issues. They area much more appropriate institution to make policy decisions than the courts.

Finally, everyone knows there are occasional calls from the White House and the Hill. That is the way policy gets made in a democracy. We elected those guys -- this isn't despotism. It is not only lawful but appropriate to have communication between Capitol Hill, the White House, and the agencies with respect to policy issues.10

10 see *Sierra Club v. Costle, 657 F.2d 298 (D.C. Cir., 1978)*

View from the Agency: How to get policy changes through the courts

The two largest potential sources of policy change-related litigation as we go through the process of changing the regulation of electricity will arise over strategies devised by regulators for the allocation of stranded assets, and inter-commission conflicts arising from areas of overlapping jurisdiction, e.g. transmission pricing. As agencies try to develop options for dealing with changes in the industry, how will these policy changes be viewed by the courts? Do agencies drown in judicial review? Does it make them emphasize process at the expense of policy? When is judicial review timely? When can it be used as a policy tool by agencies?

First Speaker (state regulatory agency):

In Texas, the commission has even more heightened scrutiny than does the FERC, because it has three levels of judicial review: a local country district court which is specialized to hear agency appeals; a court of appeals; and the state's Supreme Court. Consequently, the pursuit of appellate certainty tends to be time-consuming. It is not unusual to have a case remanded back after five or six years. On the other hand, about 80% of all the commission's decisions are actually affirmed by the courts.

All judges in Texas are elected on a partisan basis, so they are sensitive to the blowing of political winds. There is a strong populist tradition in Texas, and many cases in the civil courts are characterized as "Big Company vs. the Little Guy" issues. This is not to say that we don't have good judges, but it is naive to conclude that the members of the bench are not sensitive to the political environment in which they make their decisions.

Until recently, most of the cases brought up on appeal have dealt with specific rate issues, and have not focussed on broad matters of policy. I agree with this morning's first speaker, that there is a tendency of some of the appellate courts to substitute their judgment for that of the Commission. This puts the courts in a bad position, because they tend to focus on statutory construction without the benefit of familiarity with the policy history that may underlie a particular Commission decision. They only have what's put before them by

the parties, and they only have the two minute version of what could be a multi-year regulatory history.

A good example of this is a recent telecommunications decision[11] where the court tried rather unsuccessfully to grapple with the statute in the face of the Commission's effort to manage in a rational way the process of promoting competition in the telecommunications industry. The rulemaking process had been very difficult, dealing with what is and is not still regulated as it constitutes local exchange service. Without the benefit of the history of the battle over who provides what service, when the court reversed the commission, it essentially reversed eighteen years of regulatory history in the process. If this decision is left to stand, it could conceivably create a procedural nightmare that would actually *increase* the level of regulation of these services. As we approach the same types of competitive questions in the electricity industry, we could face the same sorts of problems.

There was one instance where the resort to judicial sanctions actually resulted in better policy than the commission would have been able to make on its own. The commission concluded that "Caller I.D." service violated the state's Wire Tap and Trace laws, and would not stand up to an appeal. When the telephone company went to the legislature to get the statute changed, we were actually able to build into the amendment the requirement that they had to offer blocking of that service on an ongoing, rather than per-call, basis -- something that **I doubt** the Commission would have been able to do purely as a matter of administrative fiat. So in that case, the prospect of adverse judicial review actually helped the Commission make policy that was more consistent with the public

[11] *Southwestern Bell et al. v. PUC of Texas et al.* Opinion, Court of Appeals, Texas Third District, No. 3-93-552-CV. Sept. 21, 1994.

interest.

That was a very unique situation, however, and on the balance heightened judicial scrutiny will be an impediment to attempts to make changes to deal with a changing industry. Stranded investment issues will likely center, not simply on whether recovery should be allowed, but also on who picks up the cost. The courts are going to be inclined to step into these cost allocation issues, and, given their populist streak, to the extent that cost burdens are perceived as being shifted to residential customers, there could be a tendency to second-guess Commission decisions.

I am not convinced that our courts are well equipped to guide the Texas commission in an era of regulatory change. That is not why they were created. They were created as maintainers of the status quo, and they see themselves as a check on agency action. As a result, the Texas commission is more likely to rely on rulemaking rather than specific adjudications in order to develop policy. A rule is more likely to be perceived as having an overarching generic impact, whereas the court might find it easier to rationalize to itself that a specific case can be distinguished from other cases and therefore find it easier to justify lack of deference.

In Texas, we have statutory language that specifically states that there is no competition in the electricity industry. We've got to get that changed at least to the extent of recognizing that there is the potential that competition is emerging. At the same time, we could broaden the Commission's ability to form innovative mechanisms for dealing with competition as it emerges. Because of our inability to forecast where the industry will go, an overly prescriptive approach would not be the most useful, but there are others of course who will not agree. The utilities, for instance, would probably prefer rather strict marching

orders, because they are always distrustful of giving the agency too much discretion.

Second Speaker (natural go experience. federal regulatory agency}:

Federal regulators are not captured by utilities. We spend much more time talking about impacts of our actions on ratepayers than the impacts on specific companies. On the other hand, we do need to do a better job of setting forth our reasoning in our decisions -- making a clear argument for why we've reached a certain position, especially when we're changing what we've done in the past.

The courts have been very harsh on the FERC in the past, in telling us to look at alternatives, and look at experiences. In dealing with market-based rates we really *have* no experience, and have to make policy decisions that are leaps of faith. It is going to be very interesting to see what the courts will do with Order 636.

FCC decisions have been upheld almost unanimously by the D.C. circuit. They have a different statutory standard -- "in the public interest" -- which is a much broader standard. The 'Just and reasonable" standard, for gas and electricity, is much harder to meet, particularly when the commission needs to make regulatory changes. Telecommunications and the media are also much more visible, which means that it is easier in that industry to explain to judges how and why policy changes are being made.

Because of the eight or ten decisions that reversed some of the key points the FERC made in Orders 436 and 500, the current commission has been very careful to build a record in rulemaking proceedings. We've done NOI's, public hearings, rehearings, as-applied cases, etc. -- so even if the court reverses parts of 636, we will have all the specific cases, and it may be that they will stand.

Third speaker (federal regulatory agency):

The persistent question I ask myself as a regulator is, "How do we communicate effectively with the judiciary -- when we write our decisions, when we go through rulemaking or adjudicative processes? We and the courts have very different things that are required of us. More so than the courts, federal regulatory agencies are in a political crucible that requires an understanding of the conflicting interests among industries and in the economy as a whole, and we have to balance all these factors in arriving at our decisions. We're supposed to be the experts. And to the extent that we *are* the designated experts, the *Chevron* approach is certainly appropriate. When John Marshall, in *Marbury v. Madison,* said that it is the province of the judicial branch to say what the law is, he didn't have to deal with the NGPA and **CERCLA and RCRA and** the Energy Policy Act of 1992. In light of the proliferation of complex regulatory legislation, and the increasingly complicated industries that we regulate, certainly we are at least as capable as the courts. *Chevron,* in that sense, is what Cass Sunstein calls "counter-Marbury".

I believe in rulemaking -- it is a more efficient process, it provides better notice of change during times of industry transition, and it allows for wider input. Case-by-case policy creep tends frequently to have the effect of regulation by ambush. The quality of the facts that come out of the two processes is usually quite different. When you're done with a rulemaking, you've looked at a range of opinion, but none of it has been tested by cross-examination. This is the old dichotomy between legislative facts and adjudicative facts, and sometimes, when these rulemakings end up in court, the courts expect more of the process than it is capable of yielding.

The nature and timing of judicial review certainly affects regulators and how they do

their jobs. The chance of being reversed affects our risk analysis. Certainly we look at previous decisions and think about what we need to put in the record, and all those traditional things. But if we know that it will be three or four years before the court reviews a generic proceeding, regulators, being mere mortals, are probably going to be more inclined during a time of policy change to step a little closer policy-wise to the edge of what might be a settled doctrine of law. Maybe there are times when we don't care if we get reversed - - after all, there are short-term objectives in terms of achieving economic change that can be very enticing. Although this may be an unfortunate and unacceptable approach, historically the delay before judicial review has been treated by agencies as an open invitation to push the envelope when needed.

The nature and timing of judicial review affects our procedural choices. Case-by-case policymaking is certainly safer in terms of limiting the impact of reversal, and involves less angst for regulators. Court cases have a great deal of influence over how we pitch our policy choices. In the review of Order 436, we were very fortunate to have judges on the D.C. Circuit who were willing to support a pro-competitive change in the industry, and that gave us some room in the proceeding.

But sympathy with policy goals is not necessarily something that the courts should be influenced by. It has implications for our role at the agency level. We are the supposedly the ones with the expertise -- deference is more important than sympathy.

Are we experts? Our expertise is a function of the quality of the record we develop. However imperfect reasoned decisionmaking may be, a forthright record is the best cure for those imperfections when it is considered by the courts.

Fourth Speaker (federal regulatory agency):

When I was a law clerk, I felt that we did a very good job of reviewing agency decisions. We deferred to the agency where appropriate, but there were times when we felt the agency had overstepped its authority. When we reversed these decisions, I felt that we were acting in the public interest.

You may also remember the Bumpers Amendment that passed the Senate several times during the Reagan era -- it provided for *de novo* review in federal courts of all agency actions. In those days the Senate was of two minds about the federal courts. It wanted to give them more authority over the agencies, but on some issues like school prayer and busing it also liked to try to strip the *courts* of jurisdiction. You could say that they didn't trust the courts very much, but they trusted them more than the federal agencies. Then in about 1985 or '86, the Reagan Administration realized that their regulators, subjected to intense judicial review, were not being very aggressive about things that lifted the burden of regulation, so the pressure for applying the Bumpers Amendment to legislation subsided somewhat.

The changes in the electricity industry are being driven by economics, not by regulators, and we are simply trying to rationalize the policy changes that are necessary to keep up. What looks like a bold move, to say "redefine comparability", is really just barely staying ahead of the undertaker. But do we have the authority to redefine it? The Federal Power Act prohibits us from allowing terms and conditions that are unduly discriminatory. In the light of the sea change in the industry, you could argue that we don't have the authority *not* to impose comparability. If redefining it means that in order to do it logically you have to take on other issues as well (as we found to be true with the natural gas

industry), can we do that?

What does the Federal Power Act, to which the courts must turn to interpret our actions, have to offer in terms of guidance for these questions? It says we must be just and reasonable. Do I think we are in a better position than the courts to set policy? Yes. Do we have words that adequately describe what the standard of review is? No. We also find it very difficult, in the daily grind of regulatory work, to focus adequately on these big picture issues. So we need judicial review -- because we make mistakes, because we sometimes need a further opportunity to focus on the important decisions.

Fifth Speaker (federal regulatory agency):

It is very important to regulatory agencies that their policy choices stick, because otherwise it can be incredibly disruptive for the regulated industry and its customers. In the 1980's, we had a complete redirection of the natural gas industry every two years as a result of one or more judicial decisions. This made it very difficult for the industry to develop in the way that we all wanted it to develop -- to become more competitive and more efficient. So from the point of view of both the regulators and the regulated, this issue of how agencies can make their policy choices stick is quite important.

One of the periods where the FERC was very successful with the courts was in the immediate aftermath of the enactment of the **NGPA** and PURPA. There were a couple of key factors that made it easier for the agency to get the courts to accept its policy choices, the most important being clear and contemporaneous direction from Congress. Another factor which was very important was that the agency had given a lot of thought to what it wanted to do and had as a result a relatively coherent policy, and well-articulated policies

are much easier to defend in court. When an agency sets out to push the envelope in the absence of explicit Congressional directive, it is more at risk in the courts, which puts a special premium on being able to formulate its policy in a way that the courts can understand. In spite of occasional bumps in the road like the *Cajun* case, I think the current FERC is well on its way to doing this.

Discussion:

: One of the advantages of having federal institutions mirrored at the state level is the opportunity it gives us to observe governments that operate under a variety of different schemes for interaction between regulatory agencies and judicial bodies. We heard earlier that the system in Texas features three levels of judicial review. The decisions of the California commission are only appealable to the state's Supreme Court, and only on the specific predicate, "Did the commission pursue its authority regularly according to law?" That is a very broad statement, but in the early part of this century, a series of court cases established a very deferential character for that phrase, which set the tone for the relationship between the Supreme Court and the commission for the ensuing 90 years. The court has been very faithful to a doctrine it established for itself which declares that its job is not under any circumstances to attempt to second-guess the agency with regard to policy formulation, and uses this doctrine to discipline its interaction with the agency. It would be interesting to do a comparative study of these different systems, to see whether a noninterventionist standard of judicial review leads to despotic or capricious decisionmaking on the part of agencies.

Question: It is the nature of judicial decisionmaking to focus on the very narrow set of facts that they are presented with. When we're trying to deal with an industry that is going through fundamental and sweeping change, is this approach at all helpful? Or should the courts take on a broader role? This is a particularly important question with regard to resolving jurisdictional problems, because they are definitely a question of law, rather than policy.

: In the case of jurisdiction, the jurisdictional laws are probably going to be redrawn by the FERC and then the courts will either ratify it or reject it. The FERC may have already started down this road with the comparability standard. But we are not dealing with facts here, we are designing an appropriate set of fictions to create a defensible allocation of labor between state and federal regulators.

[Another participant noted that, when the FERC has asserted that kind of broader authority, it has often done so in uncontestable ways, so that the courts were never called upon to examine it.]

Question: We have been talking a great deal about the expertise of regulatory bodies. But regulators have very short tenures, and they work under a set of rules that restricts the exploitation of what expertise they possess, in that they are denied access to people who *do* have expertise. On the other hand, judges have a long tenure, they are free to consult one another, and they hear cases from a diverse set of regulatory agencies. So the question is,

where does the expertise really lie?

: It lies with the agency. Notwithstanding all the institutional limitations on the FERC's ability to bring its combined expertise to bear on any given issue, there is no doubt that the FERC knows more about electricity than the **D.C.** Circuit or any other circuit. It is impossible for anyone to divide up his job between thirty or forty tasks, each of which is complicated in itself, and have expertise in each of those areas.

: **I** would go a step beyond that. The courts deal in expertise in the known world -- in the accepted state of affairs. What is needed for this purpose, for this industry, is the expertise, if it can be had, in where things are moving or can be moved.

: **I** wonder if this issue is not too important to be left solely to *any* of these bodies. There is a certain amount of self-help required by the market participants themselves -- inside and outside of these fora. There is no substitute for good ideas, intelligently pursued, at the business level, and hopefully the results will be acceptable. The industry itself has to take the initiative to create good ideas, rather than waiting for regulators or judges to tell them how it's going to be.

: When these issues reach the courts, frequently the emphasis will be on how the money is going to be split up. It is very easy to lose sight of the fact that the ultimate goal is to get a better electricity industry. It is vital that we decide on stranded assets in the context of where we want to end up. We can't just say, "We'll deal with stranded assets and then we'll see where we are." Which forum is more likely to be able to make that vital connection? **I** think it will be the regulatory body, because it is a forum which combines the *political*

sensitivity needed to carry out the negotiation over cost allocation with *the policy* sensitivity needed to get us all to a better industry. When everyone's in court, talking about who gets how much money, is anyone going to be saying, "Well, there's this competition thing, so that's why this policy was important." I think the *Cajun* decision showed that there is no such connection made in a judicial situation.

—: I agree. If you don't have some economic theory guiding the direction of your policy, you're not going to make any sense at all out of the wealth transfer issues. There's a sense in which the role of economic theory in these debates is similar to the description of the role of the cavalry in 19th century warfare -- it puts a touch of class into what would otherwise be an unseemly brawl. It is the obligation of regulators to bring this purpose out in front and defend it. It is these ultimate objectives that justify all the trouble.

Regulators definitely need to do a better job of persuading the courts that we know what we're doing -- that we have some expertise and have made rational choices. The courts aren't as a rule gunning fora fight. They don't want to reverse agencies as a matter of course. They want to be persuaded, and we can do a better job of that.

View from the interests and the practitioners: How will the particular outlook that the courts bring to these issues affect the outcome for the electricity industry?

What is the impact of the uncertainty associated with judicial review on the litigants? How does *it affect the development of* ***corporate strategy?***

First Speaker (utility general counsel):

A long time ago I tried an anti-trust case, and won, and I thought we had achieved a remarkable result, except that now I find, 15 years later, that the customers we tried the case against have a choice of electricity supplier and long memories. I would ask you to stop for a moment and think **about** the process of appellate review from a customer relations perspective. The process of review, regardless of the outcome, adds several years of uncertainty to a series of transactions where consistency and predictability are very important. In dealing with commercial matters, it is much more important to know *where* the legal line is than to draw it, because if you know where it is you can structure your strategy to be on the right side of it, and be confident that your relationship with your customer will proceed as you intended.

If you do *not* know where that line is, it becomes impossible to arrange your affairs in a commercially reasonable manner. Earlier this year, a new energy supplier came into our marketplace and offered one of our customers an energy package. We went to that customer to put in a competing bid, which the customer agreed was at least as good and perhaps better than their other offer. But our bid required regulatory approval, and the customer said, "Even though the commission says it can approve this in 30 days, we don't know if it will stand up in court, and we can't wait around to find out." There is an enormous amount of effort that goes into regulatory decisions designed to send customers the right price signals, but our experience has been that the rates go into effect, then they

go into effect subject to refund, and then the refund goes into effect subject to appeals being resolved. When you get done with this process, the customer may be paying a rate which has no relationship whatever to the price signal you were trying to send.

The same thing is true for resource or asset planning. This process may have worked at a time when the technology and economics of the industry were stable. But when things are changing rapidly in every part of the industry, the uncertainties created by the appellate process far outweigh the advantages of review. This is not to say, of course, that we should do away with appellate review. But we should ask, "Why does appellate review interject the level of uncertainty that it does?" It is terribly difficult to make policy in individual case adjudications, where someone is winning and someone is losing. Part of the answer to this is for the agencies to concentrate on acting in a way that promotes judicial confidence in their processes. That means writing decisions that are sensitive to the courts' concerns and gaps in their information.

Someone mentioned earlier the difference between courts' perceptions of what the FERC and the FCC are doing. Everyone knows that there has been a revolution in telecommunications, and therefore instinctively understands that the rules of the game have to be changed. We may *think* that everyone out there knows that there's been a revolution in the energy business, but they don't. If we want to remove some of the uncertainty that comes from appellate review, we have to make sure that the public in general and the courts in particular know what's going on.

Second Speaker (utility regulatory affairs):

Companies should not be passive players during this transition. The impact of uncertainty can be mitigated significantly if companies will reevaluate their planning process, move to real-time strategic planning, and reduce our bureaucratic tendencies to adopt a more flexible, adaptive approach to decisionmaking. Our strategic planning has to be rapid, anticipatory, and totally divorced from traditional planning cycles.

It's difficult to find predictability while the industry is changing so rapidly. The market is driving us to take risks. So the more unstable agency policies appear because the courts seem to be more aggressive, the less likely industry is to take business risks and the less likely financial markets are to invest in them. So if the uncertainties reach a certain point, the very policy of encouraging competition is defeated. It is important to balance the need for the development of a comprehensive record for judicial review with the need for rapid resolution. I do not believe that the FERC is moving too slowly in dealing with these issues.

Businesses should be reevaluating whether or not they want to challenge every agency decision that doesn't give us everything we want. This is a strategy fora bygone day. It may have become cheaper to adapt rather than to fight.

Overlapping or conflicting jurisdictions of different agencies is another area that is causing trouble during this transition. Voluntary coordination ("lead agency" positions) among agencies can reduce this problem, but a better resolution is legislative reform -- one place to find out what changes we need to make.

Judge Patricia Wald of the D.C. Circuit wrote an opinion a few years ago in a natural gas case. She stated that, in a time when the industry is going through a sea change, the

FERC must be granted considerable discretion, to assure that the transition period is handled in a manner than minimizes the disruption to the industry. The electricity industry is now going through such a change, and we hope that the courts will not differ from the agencies' attempts to deal with these changes without good reason.

Third Speaker (legal economist):

My observations, as an economist, are based on a view of judicial review from the perspective of inefficient markets. Judicial review historically has not had a disproportional impact on the development of corporate strategy in the electric power industry, and to a large degree its impacts have already been discounted and internalized in capital market assessments of participants in the industry. Ina relatively stable market, the consequences of the uncertainties associated with judicial review can be accommodated to some degree, and may not have the same effect as they would in the context of a market that's undergoing substantial change, where the consequences of the reallocation of economic rents that go along with these uncertainties can have a major impact on the evolution of the market. Existing market participants can be substantially disadvantaged relative to new participants, and these disadvantages can be compounded by the uncertainties associated with judicial review.

In the context of the strategic planning process, the uncertainties that come from judicial review are not substantially different from the whole issue of risk associated with regulatory uncertainty -- the business develops a set of strategic actions to achieve some objectives under conditions of uncertainty. Utilities have always planned under conditions of uncertainty. Regulatory risk was always one of the parameters of the company's total

risk. Those parameters are changing, and the consequences of guessing wrong are also changing, both in terms of the magnitude of the economic rents that flow from these changes, and how those rents are reallocated.

In planning, one works on the assumption that risk should be allocated relative to the market participant's ability to control the risk. Entities in a market are compensated for bearing risks. This does not necessarily work very well in the context of risks in the regulatory or judicial process. We have a strong indication that capital markets believe that as the industry evolves it will not provide adequate compensation for risk-bearing for these issues. Regardless of how regulators and the courts decide in terms of stranded asset allocation, capital markets have already discounted a substantial amount of these assets.

Judicial review can have an affirmative role, as a tool for allocating risks. In jurisdictions where judicial review can be used to delay decisionmaking, the delay can be used to buy enough time to allow normal ratemaking processes to deal with the issue. I suspect judicial review will serve this function, especially in states where there is no appellate body with some provision for expedited process.

The commercial and regulatory structure of the electric industry differs substantially from that of natural gas. The electric industry is vertically integrated to a much greater extent, and regulatory jurisdiction is allocated very differently between federal and state agencies. The judicial review process in the electric industry may end up being much more focussed at the state level.

The FERC has exhibited a very different rulemaking pattern in recent years. It has developed policy case by case, until it has an understanding of how the market is changing and reacting, and then after a certain period has taken the opportunity to articulate new

policies based on this experience. We have many decisions now on market-based pricing and the commission has yet to be challenged on its decisions in this area, which clearly points to a learning and reasoning process taking place. This process will also make its way to the state level as states begin to work through these cases.

The bottom line is that corporate strategic decisionmaking is ongoing. Strategic plans have to be robust enough to deal with a number of (possibly widely varying) alternative futures. Perhaps we have the same burden on the corporate side, to demand of ourselves the same kind of reasoned decisionmaking that we expect from the agencies and the courts. Those of us who are relying on the intervention of the courts, for instance, to sustain our ability to sell ten cent power into a five cent market, might question over the long term the degree to which we're being consistent with our own arguments.

Fourth Speaker (consumer advocate):

I think judicial review is critical, because it is fundamental to preserving the process -- both for utility customers and for the utilities themselves. This is not a question of the fear of incompetence on the part of the regulatory commission, nor is it a belief that the courts are in a better position to make policy -- it is simply important to have a system that offers checks and balances to any executive function.

In Pennsylvania, the vast number of commission decisions are not appealed. A good number of those that are appealed are upheld -- it is clear that the commission is the final arbiter in most cases. But the existence of judicial review serves a purpose in enhancing the quality of the commission's decisions. It forces the commission to justify its work in the context of statute, and to keep within its statutory authority, whether it is seeking to *exceed*

that authority on behalf of the utility or on behalf of the customer. As long as the courts recognize that it is not their job to re-weigh the evidence, or substitute their judgment for that of the commission, then judicial review will be a fundamental and beneficial protection of the public interest.

I agree that the agency is in a better position than the courts to set policy. The legislature is a forum that is preferable to both. If the commission tries to push the envelope of the direction that the legislature establishes, it is up to the courts to make sure they stay inside the envelope -- each entity plays an important and distinct role.

In the *Duquesne v. Barasch* [12] case, the commission was challenged for allowing recovery for canceled plant costs under the state's "used and useful" principle. When the case got to the Supreme Court, the utility sought very strict judicial restrictions on the ability of state legislatures to establish ratemaking principles. At the very end of his decision, Justice Rehnquist said that "The designation of a single theory of rate making as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors." Ina footnote, he went further than merely leaving discretion with the states, by saying, "...[particularly in light of] the emergent market for wholesale electric energy, [which] could provide a readily available objective basis for determining the value of utility assets." This opened up a variety of ideas that we are only developing now.

Fifth Speaker (utility external counsel):

There is little debate here that the agency is in the best position to forge the policies that will get us through this transition. There is also a fair amount of agreement that it is

12 *Duquesne Light Co. v. Barasch, 488 U.S. 299, 316 (1989)*

the court's job to observe the boundaries. But the existence of judicial review is not useful unless it is functional, and it is not functional if decisions are delayed for years. Commissions have many ways of delaying judicial review. The result is, that many times utilities are put in the position of acceding to a commission's (or the commission staff s) policies, even when they conflict with well-established precedent.

Discussion:

: Of course it is our job as corporate strategists to develop a strategy that is robust enough to deal with regulatory risks. The issue here is not our obligation to deal with them, but rather how does our government avoid creating a situation where some players are subject to these risks and others are not? Clearly that is a question that belongs in the courts. Jurisdiction over different aspects of transmission is also clearly a matter that is appropriate for the courts to decide. Having decided who has authority over these issues, the establishment of policy should then be left to that agency.

: There appears to be an assumption that all of the expertise in an agency sort of wells up and comes out as the best possible policy that expertise can formulate. I used to work in the government, and I know that's not always the way it happens. Sometimes the expertise takes you to a certain level, and then the constituent interests kick in, the political concerns of the administration kick in, and you get a decision that is a combination of expertise and other things. It's not *wrong* -- it's just the nature of the beast. In the '80's,

sometimes policies would get made, and they'd go to the Council on Competitiveness where there were other priorities, and sometimes they'd get sent back. Sometimes the agency had its heads knocked together so severely in this process that there was no attempt to provide a rationalization for a change it made. It was clear what had happened to them, and the court sent it back. The court has a role to play here in asking, "Did the agency come to its conclusion based on its expertise, based on the statute, and based on relevant concerns, or did the envelope fall off the table?"

: Vertical deaggregation, fora variety of reasons, is evolving much more quickly than people think, and while we are debating whether we should "636" the industry, the market is effectively doing much of the work for us. More and more companies are functionally breaking out their generating assets as separate business units within the corporate entity. Under the comparability standard, the power marketing function and the transmission function will be restricted in their ability to communicate with each other. Mergers, power pools, utilities pooling their transmission assets -- all of these are evolving, and within a finite time period we will have achieved, albeit incrementally and through individual business decisions, the kind of model that we are debating right now.

—: I agree, but there are some things that are not possible without approval of the state's regulatory system. If the utility has moved everything around, and three years later the court says [it] couldn't have done that, what happens?

: *Ohio Power"* is a classic example of that -- the court stepped in and said, "What's all

---

13 *Ohio Power Co. v. FERC 954* F.2d *779 (D.C. Cir. 1992)*

this competition stuff? We're going to enforce market power and we're going to make it stick. You missed a part of the statute when you thought this stuff applied to registered holding companies." What do you do with that?

: Some courts use a "remand without vacation" policy, where the error is simply one of inadequacy of reasoning with respect to one or two issues, and the change is allowed to stand in the meantime. With remand you can get the best of agency expertise with the guidance of the court as to compliance with the statute. Or the courts can invite the agency to come up with an interim rule that does as well as it can in the interim.

: ...And the courts do use remand quite a bit -- reversing an agency is rare. But there are some cases where, if the courts are *too* deferential, they are abrogating their function. Sometimes it's not a matter of inadequate justification -- the agency simply never had the authority to make the rule in the first place. Sometimes, admittedly, this is a judgment call, but judgment is their job, and you'll have to fix it some other way -- in the *case* of *Ohio Power*, perhaps by amending the statute.

: We should be careful about trying to impose a single national solution on what is actually a very heterogeneous industry with very heterogeneous problems. The New England companies think in terms of power pools, and their industry structure and operations reflect that. The western companies have large transmission systems that were build to move large amounts of power long distances, and not so much to exchange power. Texas is on its own. Some of the questions are the same, but some of the answers will be different.

: No company should be relying on the regulatory process to insulate them at this point. In every other industry where market prices and contract relationships have gotten way out of whack, ultimately the political process, if not the regulatory process, will step in and impose some equalization.

: As long as the regulated firm had a strong monopoly that was very tolerant of gross pricing errors and misjudgments, I didn't hear much call for predictability. Now that monopoly power is diminished, people have realized that there's not a lot of room for these errors before the regulated firm will feel it. There remains substantial room for error in the pricing of distribution services and transmission services, since they are still very strong natural monopolies. It is the pricing of power services where trying to sell ten cent power into a five cent market doesn't work awfully well if the monopoly's gone. While some would like to recreate that monopoly, it's a foolish quest to expect regulators to provide predictability in power sales.

: But those of us who are competing should have at least the assurance that a FERC decision for us is also going to apply to our competitors.

: We need to recognize the difference between the problems relating to the transition period and objectives we have for the post-transition world, but we need to deal with both.

I don't think putting it off solves anything -- that will simply add further risk to utilities that are already struggling with uneconomic assets. But neither should we embark on the transition without knowing where we're going. Utilities themselves are responsible for some of this uncertainty -- it is not all created by regulators. So the utilities must also be part of the process of deciding where it is going.

View from the bench: How do judges view their role in regulatory change?

What is the relevance of judicial review to quasi-legislative action by the agencies? How do you evaluate policy in the cocoon of judicial process?

First Judge (federal courts):

It is Congress that initially mandates judicial review, and it is Congress that incants the magic phrases, "arbitrary and capricious", "substantial evidence", "in the public interest", etc. Why do they do it? Because the courts area kind of surrogate for Congress to ensure fidelity to its statutes -- to ensure that the agencies do what Congress says (or more accurately, given the vagueness of most Congressional acts, to ensure that the agency does *not* do what the Congress says not to do). There are about a half dozen cases a year where, in the view of the courts, the agencies really do something which Congress did not mean for them to do. The courts mostly uphold agencies. That may not be good news to everyone, but it is a fact. There are exceptions, but the courts generally are reasonably quick. Most of these rules stay in effect during the appeal process -- they're not stayed.

That's the backdrop. Against this, you have members of the bench who are generalists, and haven't necessarily had much experience in administrative law when they come on the court. They're also very busy -- on the same day they'll hear four cases, and have to move from substantive issue to substantive issue. The D.C. Circuit handles about a third of all of the direct agency appeals in the U.S., so in a sense it does get a cumulative familiarity with the policy backdrop of particular cases.

Given the fact that the courts deal with so many different issues, it is terribly important for the agency to educate them as to how this particular case fits into the bigger picture. I remember one FERC case where we were fussing and fussing about a particular

rule, and it wasn't until one of the intervenors got up and said, "Let me explain to you how the spot market works", that it was finally made clear to us that the whole issue took place around the economics of the spot market that had grown up around the rule -- we were absolutely transfixed. The more complicated the case, the more important a background context becomes.

The greatest problem at agencies is not developing the underlying policies but communicating them to the court. The worst example of this, for all agencies, is inadequate explanations in the Statement of Basis and Purpose. The court does not allow post hoc rationalizations -- counsel can't come up with reasons in court that the agency didn't think of at the time -- so it's best to concentrate on making sense from the very beginning. We overturned one rule because there was -- honestly -- only one sentence of explanation in the agency rationale, and we couldn't even understand that. The agency should spend less time preparing background studies and more time formulating its rationale based on a few studies. We recently had a case where the agency said, 'These two volumes fully document our position", and the other side said, "Well, we have ***three*** **studies that say the opposite."** The judges simply do not have time to go back in their chambers and read all five studies.

A few more minor suggestions: It is important to cross-read. The court may be in the middle of formulating general principles in the same area for another agency, and no one but the judges are aware of it. It would also be very helpful, if an industry is going through a period of change which will involve policy changes, to find some way to provide general education to the bench on the relevant issues -- I'm not sure how that could be done, but it is very difficult to educate oneself within the constraints of a 15-minute oral argument structure.

Second Judge (federal courts):

We are currently in a deregulatory phase in our history, and there seems to be some feeling here that the courts have stood in the way of many of the deregulatory efforts of various agencies. But there have been cases where the courts have gone considerably beyond what the agency was required to do or had intended to do. An example is the D.C. Circuit decision some years ago which opened the AT&T switching network to MCI -- it was one of the most significant steps in opening communications to competition, and it went a good deal beyond what the FCC had in mind at the time.

We are also currently in search of economic efficiency in the industry, and economists have given us a variety of models for achieving this objective. But economists are also the first to say that efficiency is the only objective they can address -- fairness is not something to which their science is directed. Regulators try to balance all of it -- efficiency, fairness, and other objectives -- and at the other end, the principal task of the courts is to do justice. Just as with the single-minded pursuit of efficiency, this may get in the way of broader policy considerations. The appellate courts are not unaware that their decisions have a broader impact, and they are not the economic ignoramuses they once may have been, but their job remains essentially the weighing of fairness.

Finally, there has been some discussion about the relative merits of generalist versus specialist approaches to problems -- do we need more specialized courts? Certainly the agencies have to be specialists, but I think there are some basic advantages to having generalists involved in the process on occasion. In the early '80's, the Social Security Administration adopted a policy that essentially removed people from the disability list and made them re-prove their disability in order to retain their benefits. Perhaps that was a

justifiable policy from the fiscal and administrative point of view, but there were quite a few federal judges who took a broader view and did not think it was a good policy from the point of view of recipients of social security disability. So sometimes generalist's look at subjects from a broader point of view than those who deal with them on a daily basis.

Third Judge (state courts):,

What struck me throughout this session was the thought that we're replaying a debate that's been going on for years. Agencies and academics want judges out -- they don't think they should have anything to do with the administrative process, and they write books and articles about this. The practicing bar on both sides wants the whole system judicialized -- the more the better. I have to say that state judges feel that federal judges go a little overboard. Federal and state judges use the same standard -- reasoned decisionmaking, just and reasonable, etc. -- but I don't think it's the *standard* that everyone's objecting to here. I think they're objecting to the lack of reticence federal judges show when *applying* the standard. They get into these little arcane things that no one should be involved in. We had a case recently, where the issue was whether the customer should pay more than the avoided cost. That's not a hard issue -- we looked at the PURPA regulations and figured it out. We did *not* try to figure out whether the avoided cost should be 8.42 cents a kilowatthour or 8.35 cents.

We don't get into these big agency battles at the state level. It's like watching a gun battle --- you see the flashes in the distance, and you know that it is going to affect you sooner or later, but it really doesn't matter who wins, because whoever wins, they're going to come out of the hills and hurt you anyway. We know that there are changes happening

in the industry, and that these ten cent contracts are going to be stuck in the system for thirty years, which is going to be a big drag, but we can't say that in our opinion. We have to enforce federal law. That saves a lot of time.

Handouts for 10/13/94 Harvard Electricity Policy Group Special Seminar

Forum: The Courts and Emerging Electricity Policy -- How Do We Secure a Better Congruence Between Agency Action and Judicial Review?

Some of the materials listed below were prepared specifically for the seminar. Please do not cite any materials marked 'Draft"

- Cajun Electric Power Cooperative v. FERC. Opinion, U.S. Court of Appeals, D.C. Circuit, No. 92-1461. July 12, 1994.

  Duquesne Light Co. v. Barasch, 488 U.S. 299, 316. January 11, 1989 (excerpt).

  McDiarmid, Robert C. *The Role of the Courts in Emerging Electricity Policy.* Draft, October 13, 1994.

  Pierce, Richard J. *The State of the Transition to Competitive Markets in Natural Gas and Electricity.* Draft, April 1994.

  Pierce, Richard J. *The Unintended Effects of Judicial Review of Agency Rules. How Federal Courts Have Contributed to the Electricity Crisis of the 1990s.* Administrative Law Review 43(7), Winter 1991, pp. 7-29.

  PUC of California v. FERC/Southern California Gas Co. v. FERC. Opinion, 988 F.2d 154, 300 U.S.App.D.C. 206. March 19, 1993.

  Southwestern Bell et al. v. PUC of Texas et al. Opinion, Court of Appeals, Texas Third District, No. 3-93-552-CV. Sept. 21, 1994.