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Full Circle in the Formerly Regulated Industries?

*Hon. Richard D. Cudahy**

I. INTRODUCTION

The purpose of this short Article is to trace some of the recent history of industries, traditionally subject to pervasive economic regulation, which have been deregulated and now perform in a competitive environment. I have selected two industries for comment—electric power and the airlines. Electric power is of interest because of the power shortage that developed in the first state to deregulate electricity—California—and the extreme stresses produced by the shortage. Not long after, Enron—peerless leader of energy deregulation—collapsed ignominiously into bankruptcy.¹ I have also included a few comments on the airlines—the first industry to be subjected to complete deregulation. The airlines, faced with declining revenues even before the terrorist attacks of September 11, have been thrust into an apparent position of continuing loss. How to keep the airlines flying is an issue to which very serious attention may have to be paid. And what the future of deregulation itself may hold is suddenly a looming question.

II. THE MEANING OF CALIFORNIA

What does the recent unpleasantness in the electric power industry in California portend for the development of deregulation of that industry in the rest of the country?² Free market-oriented economist Irwin Stelzer has written, “[a]t minimum, deregulation is no longer clearly the

* Senior Circuit Judge, United States Court of Appeals for the Seventh Circuit. I am grateful to my law clerk, Bill Henderson, for his assistance in preparing this Article.

1. See Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES, Dec. 3, 2001, at A1, available at 2001 WL 32002298 (reporting on Enron’s once dominant and innovative role in the trading of natural gas and electricity and the events leading to its rapid and unprecedented collapse).

2. See Richard D. Cudahy, *Electric Deregulation After California: Down But Not Out*, 54 ADMIN. L. REV. 333 (2002) (providing a summary and overview of the events relevant to electricity deregulation in California and what they might portend for utility deregulation generally).

wave of the future.”³ On the other hand, Exelon’s CEO, John Rowe, in declaring that there can be no turning back, stated, “[t]here isn’t much choice. . . . We discredited the utility monopoly a long time ago.”⁴

The need in California to resort to regulatory measures to avert the consequences of deregulation run amok has, not surprisingly, slowed the movement toward deregulation of electric power in a number of states.⁵ However, any move to undo deregulation where it has already been adopted must contend with vested interests in the restructured system. This involves, for example, power plants transferred to new owners for competitive reasons⁶ as well as an army of experts with reputations heavily invested in a restructured industry. What is likely is that regulatory interventions in competitive arrangements that have at least temporarily gone astray will be much more likely than might otherwise have been the case.

First of all, what happened in California? Beginning in the year 2000, power shortages began to develop there,⁷ and rolling blackouts

3. Irwin Stelzer, *Long Hot Summer for Advocates of the Free Market*, SUNDAY TIMES (London), Sept. 3, 2000, at 4, available at 2000 WL 25262955 (discussing how high prices and consumer ousries have caused state authorities to intervene in the deregulation process).

4. Melita Marie Garza, *No Turning Back, Exelon Chief Says*, CHI. TRIB., Aug. 7, 2001, § 3, at 3, available at 2001 WL 4101672 (quoting John Rowe, commenting at roundtable discussion at the American Bar Association’s annual meeting).

5. See *Annual Report*, 2001 A.B.A. SEC. PUB. UTIL., COMMUNICATIONS, & TRANSP. L. 171 [hereinafter *ABA Public Utility Section*] (reporting that after the crisis in California, “many states took the more traditional cost-based market approach, many delayed their movement toward unregulated generation and customer choice, while a few proceeded cautiously to open selected areas to retail competition”); Neela Banerjee, *States’ Plans to Deregulate Get 2nd Look*, N.Y. TIMES, May 2, 2001, at A14, available at 2001 WL 20057955 (reporting that “nearly 75 percent of the state utility commissioners interviewed expect the California situation will either stop or decelerate restructuring in their states”).

6. In California, at the behest of the legislature, the utilities had sold off a major part of their generating plants to unregulated generators (frequently affiliated with other utilities). Joseph Perkins, *California Power Crisis*, SAN DIEGO UNION-TRIB., Jan. 26, 2001, at B7, available at 2001 WL 6439470 (noting that in 1996, the California legislature “required the state’s utilities to divest themselves of many of their electricity-generating plants” as part of the deregulation process). The California companies were then prohibited from taking back contracts for the output of the divested plants. See James Dukart, *The Aftermath: Where to Now?*, UTIL. BUS., Mar. 1, 2001, at 51, available at 2001 WL 11848905 (quoting think tank official who believed that the state erred when it “prohibit[ed] bilateral forward (long-term) contracts between utilities and power generators”); Laurence D. Kirsch & Rajesh Rajaraman, *Assuring Enough Generation: Whose Job and How to Do It*, PUB. UTIL. FORT., Apr. 15, 2001, available at 2001 WL 10544658 (commenting that the “restructured market design [in California] virtually prohibited the regulated utilities from entering into longterm contracts”).

7. See Paul Joskow, *California’s Electricity Crisis* (Harv. Elec. Pol’y Group), Sept. 28, 2001, at 30-33 (reporting that during early to mid-2000, five interdependent factors converged to cause the dramatic increase in wholesale electricity prices in California: (1) rising natural gas prices; (2)

had to be resorted to by the independent system operator (ISO) that controlled the transmission system and dispatched the generating plants.⁸ In an unregulated environment, shortages, of course, mean higher prices, and the price of wholesale electricity skyrocketed, especially during the periods of system peak load.⁹ For the most part, these high prices did not impact on California consumers because, under the deregulation law, the utilities were required to keep retail rates frozen until they had recovered their “stranded costs” (transition costs related to uneconomic investments and power supply contracts).¹⁰ The expectation underlying this arrangement was that, after deregulation, wholesale prices would fall, thereby increasing the margin between wholesale prices and the frozen retail rates.¹¹ The utilities were permitted to apply the expected margin in part toward recovery of their stranded costs.¹² San Diego Gas and Electric was the first utility to recover its stranded costs in this fashion, and therefore, the first permitted to adjust its retail rates to conform to wholesale cost. The anticipation of the architects of the California system was that, when the frozen local rates were allowed to float, they would decline in step with

large increase in demand; (3) reduced imports from other states; (4) rising prices for environmental emission permits for NOx; (5) market power problems).

8. See James Sterngold, *California Endures a 2nd Straight Day of Power Blackouts*, N.Y. TIMES, Jan. 19, 2001, at A1, available at 2001 WL 2012974; James Sterngold, *California in State of Emergency Over Power*, N.Y. TIMES, Jan. 18, 2001, at A1, available at 2001 WL 2012758 (reporting rolling blackouts from Oregon to Bakersfield).

9. See Alex Berenson, *A Spike in Electricity Prices Sets Off Debate in California*, N.Y. TIMES, July 29, 2000, at A7, available at 2000 WL 25027088 (reporting unanticipated price spikes in wholesale electricity prices, which was contrary to the expectation of lower, stable prices that would be brought about through deregulation, and discussing possible factors contributed to price increases, including market power by generators and traders).

10. See Joskow, *supra* note 7, at 11 (discussing features of the California deregulation plan, including an immediate ten percent price decrease from the then prevailing price, which would be financed in part from securitization of stranded costs, thus effectively freezing prices for up to four years after the commencement of deregulation).

11. *Id.* at 10 (“Nobody [involved in the drafting of the A.B. 1890, the California deregulation plan] broached the possibility that wholesale prices could possibly be higher than the regulated price of generation service reflected in prevailing retail prices.”); see also David Frum, Editorial, *Calif. Democrats Suffer a Shortage of Brain Power*, CHI. SUN TIMES, Jan. 11, 2001, at 31, available at 2001 WL 7213871 (commenting that politicians, consumers, and utility companies were all seduced by the unrealistic assumption that “energy prices would never go up again”).

12. See Michael Kahn & Loretta Lynch, REPORT TO THE GOVERNOR (Elec. Oversight Bd. & Cal. Pub. Util. Comm’n), Summer 2000, at 6-7, available at <http://www.cpuc.ca.gov> (discussing features of original legislation); see also Dan Morain, *Assembly OKs Bill to Deregulate Electricity*, L.A. TIMES, Aug. 31, 1996, at A24, available at 1996 WL 11639810 (describing how the “competition transition charge” would be used to pay off the bulk of the utilities investment that would not be viable in a deregulated environment).

wholesale prices. What actually happened in San Diego was that retail rates shot upward as wholesale prices went sharply higher.¹³

Thus, in the San Diego Gas and Electric service area, the unfrozen retail rates rose in sync with wholesale prices—sometimes by a multiple of three.¹⁴ Needless to say, consumers were outraged.¹⁵ The Federal Energy Regulatory Commission (FERC) held a hearing in San Diego in the fall of 2000, which was attended by a number of the commissioners of the California Public Utilities Commission (CPUC). One of the commissioners demanded a return of wholesale prices to a “just and reasonable” level as prescribed under the Federal Power Act.¹⁶ The commissioners did not seem to be persuaded by the FERC’s earlier determination that prices emerging from a workably competitive market were by definition “just and reasonable.”¹⁷ This issue may furnish food for debate as (or if) deregulation becomes the norm throughout the rest of the country. Of course, the issue becomes more difficult if the market is arguably distorted by market power (in California ascribed to the “gaming” of the generating companies).

13. See Joskow, *supra* note 7, at 29-30 (noting that “[d]uring the first half of 2000, SDG&E bought electricity in the wholesale spot markets and passed along the associated [and very high] wholesale market costs to its default service customers” as provided for by California Public Utility Commission regulations and the original deregulation legislation, A.B. 1890).

14. See Patrick Hoge, *Davis Neglected Key Strategy in Power Crisis/Regulators, Utilities Sought Fixed Contracts 6 Months Ago*, S.F. CHRON., Feb. 4, 2001, at A1, available at 2001 WL 3394220 (noting that when wholesale prices were permitted to be passed on to consumers, “[San Diego] residents saw their electricity bills almost triple”).

15. See Laura M. Holson, *Why San Diego, Where Rates First Rose, No Longer Conserves Energy*, N.Y. TIMES, Jan. 30, 2001, at A20 (reporting that when the San Diego Gas and Electric company was permitted to pass along its costs to consumers, “[h]omeowners took to the streets, and businesses threatened to leave the city,” causing the CPUC and the California legislature to once again cap retail prices).

16. See Bruce W. Radford, *Federalism at Work*, PUB. UTIL. FORT., Nov. 1, 2000, at 4, 6 (reporting on FERC field meeting in San Diego, California where Commissioner Carl Wood requested a return to “just and reasonable” rates under the Federal Power Act, which would include cost-based rate-making).

17. The Federal Power Act sets forth the “just and reasonable” standard. Federal Power Act, 16 U.S.C. § 824d(a) (2000).

All rates and charges made, demanded, or received by any public utility for or in connection with the transmission or sale of electric energy subject to the jurisdiction of the [FERC], and all rules and regulations affecting or pertaining to such rates or charges shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

Id. In recent years, the FERC has been willing to accept the workings of a power market as the source of a just and reasonable price. See, e.g., *Nevada Sun-Peak Limited Partnership*, 54 F.E.R.C. ¶ 61,264, 61,769, 1991 FERC LEXIS 429 (1991) (holding that statutory requirement of “just and reasonable rates” is satisfied when markets are not compromised by the influence of market power) (citing *Commonwealth Atlantic Limited Partnership*, 51 F.E.R.C. ¶ 61,368 (1990)).

Whether “just and reasonable,” the Federal Power Act standard, can be equated with the standard of the market as established in an arm’s length transaction is a fascinating and very important question.¹⁸ Historically, since the days of the Roman Empire, a “natural” price was a market price while a “*justum pretium*” or “just price” could be determined by adding to the cost of acquisition only an amount necessary for “support.”¹⁹ Traditional rate-making under the Federal Power Act attempted to base rates on cost. Prices emerging from the market, on the other hand, recognize supply and demand as interacting to produce an equilibrium, “market-clearing” price, which might not, at any particular time, be closely related to cost. Nonetheless, in recent years the FERC has deemed prices emerging from a workably competitive market to be just and reasonable.²⁰

Perhaps as surprising as what happened in California during the summer of the year 2000 was what didn’t happen in the summer of the year 2001. For that period, all of the experts were forecasting more of the same, but much worse blackouts galore and prices spiking through the roof.²¹ What actually happened in the summer of 2001, rather surprisingly, was that a relatively comfortable reserve position seemed to develop.²² There were no blackouts, and wholesale prices of electricity began to decline.²³ By the end of the summer they had declined precipitously.²⁴ Perhaps the most important reason for this radical shift was the role of conservation in producing a more than ten

18. See generally Jeffery L. Hess, Comment, *Sun-Peak—Over the Rate Regulation Edge: Are Market-Based Rates “Just and Reasonable” or De Facto Deregulation?*, 28 IDAHO L. REV. 193 (1991) (providing an interesting and thoughtful primer on this issue).

19. See CHARLES F. PHILLIPS, JR., *THE REGULATION OF PUBLIC UTILITIES* 89-91 (3d ed. 1993).

20. See *Nevada Sun-Peak Limited Partnership*, 54 F.E.R.C. ¶ 61,768-61,769 (noting that “[i]n an increasing number of instances, the commission has approved rates based not on the supplier’s costs but on a competitive market rate for the supplier’s energy”).

21. See, e.g., *Killing the Golden Goose?* (Harv. Elec. Pol’y Group) April 4, 2001, at 21 (quoting one unidentified industry expert, “[b]est estimates for this summer are that California may be as much as 6,000 MW short”).

22. See Jerry Hirsch, *Sudden Power Glut Puts State in Costly Energy Bind*, L.A. TIMES, Aug. 11, 2001, at A1, available at 2001 WL 2509953 (discussing recent glut of electricity supply and possibility of relatively large surplus during the next several years).

23. See James Sterngold, *California’s New Problem: Sudden Surplus of Energy*, N.Y. TIMES, July 19, 2001, at A1 (noting that a cool summer and conservation have led to a price glut, with electricity surplus acquired through long-term contracts now being sold by the State at a significant loss).

24. See Joskow, *supra* note 7, at 45 (reporting on the decline of wholesale electricity prices throughout the summer of 2001 to pre-crisis levels and noting that “[f]orward prices for the rest of [2001] dropped dramatically”).

percent decline in electricity consumption.²⁵ All of this conservation was not the product simply of pep talks by the governor; it was significantly the result of a rate structure that featured something approximating an “inverted” rate for residential customers.²⁶ An inverted rate is one that provides a higher unit price for larger users than for smaller—the opposite of “cheaper by the dozen.” Customers whose usage dropped, therefore, might not face any increase in their bill—while, customers whose usage increased found themselves paying much more. There were also 20% rate rebates to customers who were able to achieve a 20% reduction in usage.²⁷ It now appears that one-third of the rate payers qualified for the 20% rebate.²⁸ Beside the incentives of the rate structure, we are told that Californians seemed actually to become enthusiastic about conservation.²⁹

One of the features of the California deregulation law had been the requirement that for several years utilities had to acquire their electric power only from the California Power Exchange, which made the market on a spot-price basis in the California power pool.³⁰ The utilities were, at least for the time being, prohibited from entering into

25. See *ABA Public Utility Section*, *supra* note 5, at 4 & n.18 (reporting that peak usage during the first two summer months fell by upwards of ten percent from the previous years).

26. See *California Panel Spells Out Rise in Rates for Electricity*, N.Y. TIMES, May 16, 2001, at A24, available at 2001 WL 21728275 (reporting that the new rate structure will levy the largest increase on large residential users while low-income and low-use households will, on average, have no increase at all).

27. Eddie Lau, *California Officials Discuss Rebates for Reduction of Power Usage*, SACRAMENTO BEE, Aug. 3, 2001, at A1, available at 2001 WL 25949649 (reporting that millions of customers received rebates for reducing electric consumption by more than twenty percent from the same month one year earlier, and quoting California power official, S. David Freeman, “[t]his is a remarkable achievement, and one that no one really predicted”).

28. *Id.*

29. See *The California Crisis*, ELEC. UTIL. WK., July 16, 2001, at 3, available at 2001 WL 10440436 (reporting survey by J.D. Power and Associates in which eighty-three percent of Californians were conserving electricity in order to reduce threat of rolling blackouts).

30. This provision was known as the “mandatory buy-sell” and was set forth by the CPUC in *Order Instituting Rulemaking on Commission’s Proposed Policies Governing Restructuring California’s Electric Services Industry and Reforming Regulation*, 64 C.P.U.C.2d 1, 52 (1995). In early 2001, the California legislature eliminated the mandatory buy-sell provision. See Cal. Stats. 2001, 1st Ex. Sess., c. 4 (A.B. 1), § 1 (effective Feb. 1, 2001) (repealing Cal. Pub. Util. § 355.1, which barred multiple qualified exchanges). However, the FERC rendered a decision a few weeks earlier that had already accomplished the same result. See *San Diego Gas & Electric Co. v. Sellers of Energy & Ancillary Servs. Into Markets Operated by the Cal. Indep. Sys. Operator & the Cal. Power Exchange*, 93 F.E.R.C. ¶ 61,294, 2000 FERC LEXIS 2491 (2000) (ordering the elimination of “the requirement that the investor owned utilities in California (IOUs) sell all of their generation into, and buy all their generation from, the California Power Exchange (PX”).

long-term contracts with generating companies.³¹ Apparently the reason for this restriction was the feeling that existing long-term deals with independent plants had inflated California's power costs.³² But when the situation reversed and spot prices went sky high, one of the remedies appeared to be a greater reliance on long-term contracts.³³ So FERC ruled against the restriction on long-term contracts,³⁴ and S. David Freeman, a long-time mover and shaker in the public power sector, undertook to negotiate such contracts on behalf of the State.³⁵ In fact, the State found itself, for better or for worse, getting more and more into the electric power business.³⁶

Both of the two largest utilities in the state, Pacific Gas & Electric Company in the north and Southern California Edison in the south, had been reduced to financial basket cases—caught as they were between rising wholesale prices and frozen retail rates.³⁷ Since their credit was no longer good, and they were in debt to the generators, the State undertook to become the purchaser of power on behalf of the utilities.³⁸ The State ran up a tab of approximately \$11 billion for electric power in

31. See Joskow, *supra* note 7, at 42 (discussing the inability of investor-owned utilities to enter into long-term contracts and how this prohibition exacerbated the coming crisis).

32. At the time the California deregulation law was passed in 1996, long-term contracts with independent power producers (pursuant to federal law) were singled out as one of the reasons that the state had one of the highest electric rates in the country. See, e.g., Harold B. Ray, Letter to the Editor, *If Nothing Else, Nuclear Power Has a Future as a Debate Topic*, L.A. TIMES, Nov. 3, 1996, at D13, available at 1996 WL 12752703. Harold B. Ray, the executive vice president of Southern California Edison, stated that “[i]ndependent power costs are the biggest reason that California electric rates exceed the national average by almost 50%. Utilities were required—under state and federal laws—to enter into these very expensive, long-term contracts with independent power producers.” *Id.*; see also Jon Steinman & Jill Leovy, *Jolt Coming for Utilities, Customers*, L.A. TIMES, Nov. 3, 1997, at B1, available at 1997 WL 13996617 (noting that “utilities’ outstanding debt is primarily the result of long-term contracts that are forcing the utilities to continue paying for power at inflated rates so power plants can recoup their construction costs”).

33. See Laura M. Holson & Richard A. Oppel, Jr., *Long-Term Power Deals Scrutinized in California*, N.Y. TIMES, June 16, 2001, at A10, available at 2001 WL 23823086 (reporting on details of \$43 billion in long-term contracts with power generators).

34. See *supra* note 30 (discussing the FERC ruling).

35. See Holson & Oppel, *supra* note 33 (discussing the state of California’s use of long-term contracts).

36. Cf. Joskow, *supra* note 7, at 49 (observing that the State had “effectively taken over many key components of the electric power industry in California and has replaced the nascent competitive wholesale and retail power markets with state power procurement and regulated retail prices for power driven by the state’s financial needs”).

37. See ABA *Public Utility Section*, *supra* note 5, at 7 (discussing the financial status of these two investor-owned utilities and their inability, by January 2001, to purchase power since they were no longer creditworthy).

38. See *id.*

its role of power acquirer.³⁹ The thought was that this sum of money, which was initially paid out of the State general fund, would be permanently financed by the sale of bonds, which would be redeemed in the future out of electric power revenues.⁴⁰ The Public Utilities Commission torpedoed this scheme by declining to guarantee future revenues adequate to fund the bonds.⁴¹ The Commission majority felt that the proposal violated sound regulatory principles (which it in fact appeared to do).⁴² It isn't clear currently how the large advance out of the State's general fund is to be funded. If it cannot be specially financed so as ultimately to be charged to electric ratepayers, it will remain an obligation of taxpayers. Although taxpayers and ratepayers may be pretty much the same people, the politics of a taxpayer obligation would be far more difficult.

The State of California also endeavored to buy the transmission systems in the state from the investor-owned utilities for the purpose of infusing some cash into the cash-strapped utilities⁴³ and apparently substituting the State as the maintainer and developer of the State transmission system. There were even proposals that the State acquire

39. James Sterngold, *Panel Rejects Electricity Plan Favored by California Leader*, N.Y. TIMES, Oct. 3, 2001, at A14, available at 2001 WL 29155740 (reporting that the State had thus far spent \$11 billion on power purchases, "under the assumption that the costs would be covered by rate payers, a part of whose monthly payments would be sent to the state, and the sale of bonds").

40. See Miguel Bustillo & Julie Tamaki, *Effort to Repay State for Power is Delayed*, L.A. TIMES, May 8, 2001, at B1, available at 2001 WL 2485213 (reporting that Governor Davis "plans to replenish state coffers and stop using taxpayer money on power purchases by floating a record bond issue, which would be repaid by utility ratepayers out of their monthly bills"); Miguel Bustillo & Julie Tamaki, *State Budget Revision Seen as a Possibility*, L.A. TIMES, Oct. 2, 2001, at B7, available at 2001 WL 2522550 (reporting that the California Public Utilities Commission "has repeatedly delayed taking a series of actions that [the state treasurer] needs to float bonds, which will be repaid by utility customers as part of their power bills").

41. See Sterngold, *supra* note 39 (reporting a 4-1 vote by the CPUC against the bond).

42. *Id.*

[The] main objection to the rate plan was that it essentially took the power to review rate increases from the utilities commission and handed it to the Department of Water Resources, the state agency that has been buying the power. It would also have insured that the state remain the principal buyer of power for 15 years, the term of the bonds.

Id.

43. See V. Dion Haynes, *California Reaches Deal to Aid Utility*, CHI. TRIB., Apr. 10, 2001, § 1, at 11, available at 2001 WL 4060784 (reporting on the Southern California Edison deal and noting that a bankruptcy filing by Pacific Gas and Electric blocked the Governor's attempt to "purchase Pacific Gas and Electric's power grid to help finance the bailout"); Laura M. Holson, *Deal Struck With Utility, California Governor Says*, N.Y. TIMES, Apr. 10, 2001, at A12, available at 2001 WL 18770336 (reporting on pending deal between the State and Southern California Edison, the state's second largest utility, to infuse company with needed cash by purchasing its transmission lines for \$2.76 billion).

the water power generation sites owned by the utilities,⁴⁴ but this idea appears not to have been pursued very vigorously. State officials, of course, implored the FERC to place caps on wholesale power prices in order to protect the California consumer.⁴⁵ President Bush did not react favorably to this proposal, which, in terms of free market orthodoxy, would be counterproductive toward investment in additional electric generating plants.⁴⁶ However, the California congressional delegations from both parties were sufficiently vociferous to elicit a response from the FERC. That agency installed something looking suspiciously like price controls but carrying the more innocent-sounding designation of “price mitigation.”⁴⁷

This development and the State’s activities as purchaser of power, coupled with efforts by the California Public Utilities Commission to raise retail rates, helped the utilities to stem their cash hemorrhage but did not succeed in rescuing them from financial embarrassment. Pacific Gas & Electric Company had actually gone into bankruptcy;⁴⁸ but Southern California Edison, answering the pleas of the governor, somehow carried on outside it.

44. See Vincent J. Schodolski, *California Floats Plan to Buy Some Power Plants*, CHI. TRIB., Jan. 24, 2001, § 1, at 1, available at 2001 WL 4033417 (reporting on proposal in California legislature which would finance the purchase of the hydroelectric facilities of Pacific Gas & Electric and Southern California Edison in order to provide cash to pay down their mounting obligations).

45. See, e.g., Gray Davis, Op-Ed, *White House Hands-Off Policy Hurts*, L.A. DAILY NEWS, May 31, 2001, at N15, available at 2001 WL 6059257 (stating, as the Governor of California, that price caps are necessary to resolve the State’s energy crisis and quoting a letter from ten economists to the effect that the FERC’s “failure to act now will have dire consequences for the state of California and will set back, potentially fatally, the diffusion of competitive electricity markets across the country”); Michael Janofsky, *California Official Spars with U.S. on Power Policy*, N.Y. TIMES, Apr. 10, 2001, at A10, available at 2001 WL 18770339 (reporting on the terse exchange between Steve Larson, executive director of the California Energy Commission, and Curt Hebert, Chairman of the FERC, and the role of price caps in resolving the California energy crisis).

46. See James Sterngold, *In a State Short of Power, Scant Praise for Bush Plan*, N.Y. TIMES, May 18, 2001, at A16, available at 2001 WL 21728809 (discussing the unwillingness of the Bush administration or the FERC to impose price caps on wholesale electricity).

47. See Joseph Kahn, *Energy Agency is Set to Monitor Prices in West*, N.Y. TIMES, June 14, 2001, at A1, available at 2001 WL 23822899 (discussing the embrace of “price mitigation” by the FERC, which would entail “monitoring and potentially curtailing all wholesale electricity prices that generating companies charge California and 10 nearby states”); see generally Nicholas W. Fels, *Issues on Appeal of FERC’s “Price Mitigation” and Refund Orders for California Wholesale Electricity Markets*, 1 ELEC. L. REP. 9 (2001) (providing a comprehensive treatment of this topic).

48. See *Pacific Gas Files for Chapter 11*, N.Y. TIMES, Apr. 6, 2001, available at 2001 WL 17992315.

One of the great debates sparked by the California fiasco involved the question whether generating companies had been “gaming the system” by deliberately keeping power plants off the line during times of system peak in order to drive prices higher.⁴⁹ This, of course, was what they were accused of doing by California officialdom⁵⁰ (as confirmed by some economists),⁵¹ and there were numerous lawsuits, investigations and attempts at settlement by the FERC of claims arising from this alleged practice—as well as of other claims of wholesale price excesses.⁵² After intense scrutiny had been directed at the alleged “gaming” problem, the number of plants off the line declined—giving credence to the accusations.⁵³ The FERC eventually adopted a rule requiring plants that were physically operational to submit bids offering their power to the California system.⁵⁴

49. See Paul Krugman, Editorial, *Turning California On*, N.Y. TIMES, June 27, 2001, at A23 (noting that many economists now acknowledge that “[g]enerators deliberately withheld electricity from the market in order to drive high prices even higher”); see also Joskow, *supra* note 7, at 23 (“All of the studies that were conducted prior to the crisis found that during very high demand periods, unilateral behavior leads to prices that are significantly above competitive levels.”). Similar accusations were made against natural gas suppliers.

50. See Jeff Gerth & Lowell Bergman, *Power Concern Offers California a Secret Deal*, N.Y. TIMES, May 2, 2001, at A1 (reporting on negotiations between Governor Davis and Duke Energy to settle alleged overcharges in exchange for ending all State inquiries into Duke’s pricing during the preceding months and noting that during the previous week Davis had called the generators “‘the biggest snakes on the planet Earth’ for their pricing practices”); James Sterngold, *5 Power Generators Sued in California*, N.Y. TIMES, May 3, 2001, at A21, available at 2001 WL 20058333 (reporting on suit by Lieutenant Governor Cruz M. Bustamante and Assemblywoman Barbara Matthews, in their capacity as private citizens, against five power generators accused of price gouging and noting that Bustamante “said he hoped the suit would lead to criminal charges and jail terms for the 14 top executives it listed”).

51. See Krugman, *supra* note 49 (reporting that economists have concluded that prices were driven up when generators withheld electricity); see also Michael M. Weinstein, *Econ 101: It’s Right and It’s Wrong*, N.Y. TIMES, June 3, 2001, Week in Review, at 18, available at 2001 WL 22566526 (discussing the views of ten noted economists who asserted that price caps in California would result in increased supplies of natural gas and electricity and that current market imperfections may permit generators to extract windfalls).

52. See ABA Public Utility Section, *supra* note 5, at 13 (reporting that as of September 2001, six lawsuits had been filed against generators and/or wholesale electricity marketers, and three purported to be class actions).

53. Cf. Joskow, *supra* note 7, at 47.

It is fairly clear that FERC’s latest price mitigation program, and the intense scrutiny that suppliers are now under in the regulatory arena, the courts and the media, have provided powerful incentives for the suppliers to be on their best behavior during summer 2001 as generating unit availability has been relatively high and bidding behavior is generally more competitive.

Id.

54. See Jeff Gerth, *U.S. Agency Widens Its Curbs on Price of Power in West*, N.Y. TIMES, June 19, 2001, at A1, available at 2001 WL 23824031 (discussing the FERC order requiring

Several of the most prominent unintended consequences of the California crisis were the enhanced prestige and popularity of public power, on the one hand,⁵⁵ and, on the other, the increasing role of federal regulation at the expense of state authority in regulating the electric power industry.⁵⁶ The boost for public power was particularly ironic, since public power had, up until the California crisis, been something of an orphan in the deregulatory picture.

The Los Angeles Department of Water and Power opted out of deregulation, and during the whole period of turmoil in the deregulated system, the Los Angeles power utility operated without any problems.⁵⁷ And, besides that, it was able to sell a lot of electricity to the deregulated grid at very fancy prices.⁵⁸ Sacramento also had a large publicly-owned electric utility, which survived the crisis in the best of spirits.⁵⁹ The citizens of San Francisco seriously considered taking over the electric distribution plant owned by Pacific Gas & Electric Company to serve their city, but this effort to create a municipal power enterprise failed by the most minuscule of margins in the November 2001 election.⁶⁰ Certainly the events of the last couple of years in California have boosted the standing and prestige of public power arrangements within the state and elsewhere. And to make things even

generators to supply all of their available electricity and making the withholding of power subject to possible penalties).

55. See, e.g., Todd S. Purdum, *California's Leader in Singing the Praises of Public Power*, N.Y. TIMES, Jan. 27, 2001, at A8, available at 2001 WL 11224804 (reporting that a municipal utility in Los Angeles kept the city from experiencing any blackouts during the crisis while also selling surplus energy to power traders at a profit); Barbara Whitaker, *Los Angeles Gains Attention and Money with Its Own Power*, N.Y. TIMES, Dec. 22, 2000, at A16, available at 2001 WL 30526397 (reporting that Los Angeles Department of Water and Power experienced an energy surplus during the recent crisis and that rates were 20% to 25% lower than other utilities throughout the state; noting that the success of public power in Los Angeles has prompted several other cities to consider creating a municipal system).

56. See Cudahy, *supra* note 2 (discussing how deregulation necessarily involves a greater role for FERC since an effective market depends on expanding interstate transmission facilities).

57. See Whitaker, *supra* note 55 (reporting that while the state as a whole was in an energy crisis, Los Angeles had more energy than it needed).

58. See Purdum, *supra* note 55 (reporting that Los Angeles sold surplus energy to power traders at a profit during the recent crisis).

59. See Evelyn Nieves, *San Francisco Is Considering Its Own Utility*, N.Y. TIMES, Jan. 19, 2001, at A22, available at 2001 WL 2012896 (reporting that reliability and surplus of public power in Sacramento and Los Angeles fueled popular sentiment for municipal system in San Francisco, where the issue was placed on the November 2001 ballot).

60. See *id.* (discussing Pacific Gas & Electric's authority to run San Francisco's power supply); see also *San Francisco Voters Defeat Two Measures About Energy*, N.Y. TIMES, Nov. 13, 2001, at A14, available at 2001 WL 30061146 (reporting that Proposition F, which would have created a municipal power authority in San Francisco, failed by a margin of 49.8% to 50.2%).

more interesting, the State has set up a power agency (the California Conservation and Power Development Authority) authorized to buy and finance various utility facilities and to engage in financing to the tune of five billion dollars.⁶¹ Thus, public power, which right along has had some difficulty trying to divine how it would fit into a world characterized by deregulation and competition, finds its own standing enhanced by the difficulties in California.

Another aspect of the California problems has been the apparent enhancement of federal regulatory authority over the electric power system, inevitably at the expense of the state. This development is more or less inherent in the scheme of deregulation and competition, which depends for its functioning upon widespread access to the transmission network. The FERC, under the Federal Power Act, has exclusive jurisdiction over transmission, as well as over sales at wholesale of electric power.⁶² The FERC, therefore, had, in the crisis, jurisdiction over the California power pool and the agencies (the ISO and the CPX) that were operating it.⁶³ The FERC now has plans for the creation of so-called Regional Transmission Organizations in various parts of the United States as a basis for structuring competition.⁶⁴ To the extent that these Regional Transmission Organizations become central to the operation of an electric power system in the United States, the authority of the FERC will be enhanced, probably at the expense of the states.⁶⁵

It's too early to tell exactly how the California experience will impact on the rest of the country. Already it has slowed down the process of

61. See *ABA Public Utility Section*, *supra* note 5, at 9 (discussing recent California legislation that authorizes new agency to issue up to \$5 billion in bonds for the purchase or financing of generating plants, transmission lines, and other utility assets); Joskow, *supra* note 7, at 2 (discussing a new California agency that would "contract for new generating plants to assure adequate supplies for the state").

62. Federal Power Act, 16 U.S.C. § 824(b)(1) (2000). The Federal Power Act "shall apply to the transmission of electric energy in interstate commerce and to the sale of electric energy at wholesale in interstate commerce," subject to certain specified exemptions. *Id.*

63. See *id.*

64. See, e.g., Regional Transmission Organizations, 65 Fed. Reg. 12,088 (Mar. 8, 2000) (to be codified at 18 C.F.R. pt. 35) (reaffirming Order 2000, which requires that "each public utility that owns, operates, or controls facilities for the transmission of electric energy in interstate commerce make certain filings with respect to forming and participating in a Regional Transmission Organization (RTO)").

65. Cf. *FERC Needs More Authority Under Deregulation, Lawmakers Told*, ENERGY REP., Sept. 18, 2000, at 1, 5, available at LEXIS, Energy Library, General News/Information File (quoting congressional testimony of Enron official Steve Kean, stating, "'FERC must require the nation's transmission owning utilities to join regional transmission organizations, which will ensure that this access and interconnection continue to occur on a nondiscriminatory basis'").

deregulation in the states that have not already adopted it.⁶⁶ And one wonders whether a simple but severe problem like the excess of demand over supply can be adequately dealt with by competition. Certainly to the extent that electricity prices remain high there will be an incentive for generators to build and acquire plants to satisfy the increased demand. However, the California experience demonstrates that consumers, and the political bodies that are responsive to their needs, are not going to wait in times of crisis for markets to work things out. If consumers are suffering from rolling blackouts and spiking rates, they will demand regulatory intervention to relieve their pain.⁶⁷ As California was a model for the country in pursuing deregulation, it will also be a model for recourse to regulation if and when deregulation fails. The regulatory measures that California adopted with some help from the FERC were relatively successful in the short run, which was the perspective of most ratepayers.⁶⁸ These measures will be closely scrutinized if and when things go awry in other venues. The chances that deregulation will be punctuated, in the event of need, by emphatic regulatory interventions, have greatly increased.

In addition to these factors, the CPUC has now imposed a ban on retail wheeling (and hence retail competition) in California.⁶⁹ To the extent California may be a model for the rest of the country, this regulatory action may have an important impact elsewhere. And, in a parallel development, Enron, a large-scale trader and the “flagship” of deregulation, has collapsed and entered bankruptcy.⁷⁰ This may have

66. See *supra* note 5 and accompanying text (discussing reports of delays or deceleration in other states’ movements toward unregulated generation due to the California situation).

67. Cf. Session One, Speaker Three, Harvard Electricity Policy Group, Twenty-Fourth Plenary Session: *Moving Towards Markets in the Face of Surprises and Mistakes*, Feb. 1-2, 2001, at 5. One unidentified industry expert stated, “[m]arkets for a basic necessity, like electricity, must produce prices that, over time, are politically acceptable. We all have to come to grips with that, because we’re not talking about pork bellies.” *Id.*

68. See, e.g., Joskow, *supra* note 7, at 42 (discussing how California’s commitment to purchase up to \$60 billion in power over the next few years ensures higher prices than those that would have prevailed if the utilities had been permitted to enter into long-term contracts in 1999 or early 2000).

69. See *id.* at 49 (reporting that as of September 2001, “the California Public Utilities Commission finally terminated the retail competition program that was the primary motivation for the restructuring and deregulation program initiated in the mid-1990s”).

70. See Oppel & Sorkin, *supra* note 1 (reporting on the precipitous fall of Enron and its subsequent bankruptcy filing); see also Neela Banerjee, *The Energy Industry Gauges the Enron Damage*, N.Y. TIMES, Feb. 18, 2002, at C1, available at 2002 WL 13357662 (reporting that the recent plight of Enron has “cast a pall” on a conference of energy executives, as they contemplated the industry’s failure); Kirk Johnson, *Turn Out the Lights: The Party’s Over; After Enron, Deregulation is Looking Less Sexy*, N.Y. TIMES, Feb. 10, 2002, at A17, available at 2002 WL 13355027. Harvard public policy professor William Hogan stated, “[t]he Enron mantra that

no immediate impact on deregulation, but it has left energy companies waiting nervously for other shoes to drop.

III. AIRLINE PROSPECTS

The other formerly regulated industry that certainly bears attention at this juncture, particularly after the events of September 11, is the airline industry. One of the largest players among the airlines, United Airlines, has made statements about the possibility that it might “perish,” perhaps not immediately, but in the foreseeable future.⁷¹ Other airlines are at least equally concerned about their financial future, and the government has provided the airlines with a subsidy (in light of the events of September 11) without very much public discussion, which has subsequently generated a lot of debate about its propriety.⁷² The airlines, like electric power, natural gas, telecommunications and other like essential industries are commonly called infrastructure industries.⁷³ They are part of the infrastructure of the economy. The ability of the rest of the economy to function depends upon the adequacy and health of its infrastructure. For example, the economy cannot function without an adequate system of transportation. The airlines are part of the transportation infrastructure. Does this mean that, if a financial crisis impends, they properly can be subsidized? This is not a question to be

government can screw up anything it touches and markets are superior—this argument no longer has any credibility whatsoever. . . . If you stand up after Enron and 9/11 and say something like that, people look at you like you’re crazy.” Johnson, *supra* (quoting William Hogan).

71. This statement caused United stock to drop abruptly. CEO James E. Goodwin, who sent a letter to employees warning of the dire financial circumstance of the carrier, was forced out. Laurence Zuckerman, *UAL Board Ousts Chief Unexpectedly*, N.Y. TIMES, Oct. 29, 2001, at C1, C6, available at 2001 WL 29616287 (“In a letter set to employees on Oct. 18, Mr. Goodwin warned that United’s costs were outstripping its revenue at four times the rate before Sept. 11 and he hinted that its unions would need to make sacrifices or the airline would ‘perish.’”).

72. See, e.g., Lizette Alvarez & Stephen Labaton, *A Nation Challenged: The Bailout; An Airline Bailout*, N.Y. TIMES, Sept. 22, 2001, at A1, available at 2001 WL 28005480. Representative Roy Blunt, “If we hadn’t passed this [\$15 billion] package today, by Wednesday of next week, because of insurance questions and liability questions, a number of airlines would have had a number of their airplanes firmly on the ground. . . . And they would have never gone up again.” *Id.*; see also Lizette Alvarez & Laura M. Holson, *White House to Seek \$5 Billion as Part of Airline Rescue Plan*, N.Y. TIMES, Sept. 20, 2001, at C1, available at 2001 WL 28004816 (discussing massive layoffs, unknown financial liability due to Sept. 11, 2001 hijackings, and reduced credit ratings among major airlines, prompting industry to request immediate federal aid).

73. Richard D. Cudahy, *The FERC’s Policy on Electric Mergers: A Bit of Perspective*, 18 ENERGY L.J. 113, 120 (1997) (listing the following as examples of capital-intensive infrastructure industries: passenger air travel, less-than-truckload motor carriage, air cargo, railroads, natural gas and even telecommunications); see also Richard D. Cudahy, *Retail Wheeling: Is This Revolution Necessary?*, 15 ENERGY L.J. 351, 354-57 (1994) (discussing features that comprise an infrastructure industry).

answered here; but we may be certain that, one way or another, they are going to be kept from abandoning service.

If the airlines are really threatened with economic ruin, there are a number of possible remedies, ranging from subsidies at one end of the spectrum to nationalization at the other end. A system of airline regulation was instituted in 1938, under the Civil Aeronautics Act ("1938 Act"), which created the Civil Aeronautics Board to regulate the airlines.⁷⁴ The principal purpose of this regulatory regime was to keep the airlines in business—to allow an infant industry to grow and to prosper in an orderly fashion.⁷⁵ Before regulation was instituted, there had been a history of heavy financial loss and failure by companies in the airline business.⁷⁶ So, at least in the case of airlines, it was correct to say that the regulatory scheme was instituted for the benefit of the regulated industry, rather than directly or primarily for the benefit of the consumer. Obviously, however, the consumer is benefited by measures that keep an airline industry in existence. So, I dare say, if the existence of the airline industry really becomes threatened, a regulatory regime may be resurrected to help it survive.

Of course, the hope is that the industry can continue under private ownership on a profitable basis and in a competitive environment, as has been more or less the case for almost twenty-five years.⁷⁷ The evolution of the industry and of its regulatory environment may show that prosperity is the handmaiden of deregulation while regulation is a necessary recourse in difficult times. Regulation of the airlines under the 1938 Act resembled what many thought to be a government-managed cartel.⁷⁸ And hard times for the carriers may resurrect something like this mode of control. Of course, heavier traffic or a drop

74. Civil Aeronautics Act of 1938, Pub. L. No. 57-706, 52 Stat. 973 (codified at 49 U.S.C. §§ 1301-1542 (1988)).

75. SAMUEL B. RICHMOND, REGULATION AND COMPETITION IN AIR TRANSPORTATION 29 (1961) (noting that one of the primary purposes of the Civil Aeronautics Act "was to promote air transportation through regulated competition").

76. See Richard D. Cudahy, *The Folklore of Deregulation (with Apologies to Thurman Arnold)*, 15 YALE J. ON REG. 427, 431 (1998). Before 1938, "there was not much of an [airline] industry. . . . Profitable operation before [regulation] had been very sporadic. The thought was that regulation could manage competition so as to keep the competitors out of bankruptcy." *Id.*

77. The deregulation era in the airline industry began with the passage of the Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (codified as amended in scattered sections of 49 U.S.C.).

78. See STEVEN A. MORRISON & CLIFFORD WINSTON, THE EVOLUTION OF THE AIRLINE INDUSTRY 3 (1995). In 1934, government investigators charged "the newly created big four airlines-American, Eastern, United, and Trans World-with colluding to monopolize the nation's airways. . . . The 1938 Civil Aeronautics Act was to regulate air fares and routes with a heavy hand for the next forty years." *Id.*

in fuel prices may render academic any return to regulation. However, if conditions worsen substantially, the government might very well resort first to re-regulation as an alternative to bankruptcy and an effort under Chapter 11 to continue operations in that mode. Another, and currently unimaginable, step would be a resort to nationalization of failing carriers.

In any event, it is pretty clear that the government is not going to sit idly by while the airlines cease to provide transportation service, or for that matter, while the electric power suppliers of the country become financially incapable of supplying electricity. So far the latter situation has not surfaced as a problem of any sort, and there is little concern that it might surface in the future. But, it is conceivable that regulation might be re-introduced for any infrastructure industry, should it become financially unviable for any reason. It is perhaps ironic that re-regulation is always a prospect if (1) the public rebels in the face of high prices and unreliable service (à la California) or (2) to the contrary, the industry sees unreliable service looming with prices and revenues inadequate to sustain operations.⁷⁹ And it may be a sign of the times that the public certainly favored a government-manned security operation at airports in preference to competition among private operators.⁸⁰ Perhaps, there was a fear that in private hands price competition would undermine quality; and in this context a degraded quality was a threat to life itself.

79. A recent example of pervasive financial distress is the near collapse of Swissair, which was briefly grounded in early October of 2001, prompting the Swiss government to initiate an immediate bailout. See Elizabeth Olson, *Governments Intervene to Prop Up Ailing Airlines*, N.Y. TIMES, Oct. 4, 2001, at W1, available at 2001 WL 29155954 (reporting that the Swiss government "agreed to lend Swissair \$280 million to pay back fuel bills, airport fees and other costs because the airline's banks did not want the airline to use their money to resume flying"). On the same day, the government of Belgium engineered a similar bailout of Sabena. See Paul Meller, *Sabena of Belgium Gets Loan and Asks For Court Protection*, N.Y. TIMES, Oct. 4, 2001, at W1, available at 2001 WL 29155953.

80. See Robert Pear, *A Nation Challenged: Flight Safety Legislation; Congress Agrees to U.S. Takeover for Air Security*, N.Y. TIMES, Nov. 16, 2001, at A1, available at 2001 WL 30062117 (reporting on an agreement between the House and the Senate on a major aviation bill that requires the federal government to hire 28,000 airport security personnel and noting that "[o]pinion polls have shown that the public favors a federal takeover of airport security").