The Heritage Foundation Backgrounder

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The Thomas A. Roe Institute for Economic Policy Studies

June 23, 1997

ELECTRICITY DEREGULATION AND FEDERALISM: HOW CONGRESS AND THE STATES CAN WORK TOGETHER TO DEREGULATE SUCCESSFULLY

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INTRODUCTION

Deregulation of the $200 billion U.S. electricity sector is advancing at both the federal and state levels through a variety of liberalization plans and policies. These proposals share a common goal: bringing competition to the electricity market by guaranteeing customer choice in service. But they differ with respect to their strategies on:

- How rapidly deregulation should proceed;
- How the market power of incumbent monopolies should be minimized;
- Whether a bailout of the industry will be necessary;
- How reliability issues should be handled; and
- Whether additional environmental regulations will be required.[1]

In recent months, an even more fundamental debate has erupted over whether the states or the federal government should undertake the deregulation of the electricity market, and which has the proper jurisdiction to do so. One side, backed by an odd mix of large

1 For more information, see Adam D. Thierer, "Energizing America: A Blueprint for Deregulating the Electricity Market," Heritage Foundation *Backgrounder* No. 1100, January 23, 1997, and "Electricity Deregulation: Separating Fact from Fiction in the Debate over Stranded Cost Recovery," Heritage Foundation *Talking Points* No. 20, March 11, 1997.

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monopolistic utilities opposed to rapid deregulation and a handful of conservative groups and thinkers, argues that the states are in the best position to pursue reform, free of federal intervention or advice. Their opponents include the numerous industry groups, consumer groups, and federal legislators who argue that a federal role is needed to ensure that the transition to a more competitive market takes place rapidly and without state-by-state interference.

Most of the parties involved in this debate do not realize that the controversy involves much more than just the electricity market: It strikes at the heart of the constitutional balance of power between the federal government, the states, and individual Americans. Instead of causing the parties to study the proper constitutional jurisdiction for the administration of electricity deregulation, however, the debate has become mired in political platitudes. One side chants "states' rights" while the other preaches "economic efficiency." The issue of deregulation is much more complicated than these two philosophies, and it deserves far greater study.

The Constitutional Balance of Power: Still Relevant Today

Ultimately, the success of deregulation will depend on how well Congress adheres to the balance of power delineated in the U.S. Constitution. Today's legislators must understand the principles upon which the Founding Fathers built the constitutional framework for the American federal republic.

Federalism, in which control and jurisdiction are left primarily to states and localities, is almost always preferable to federal control; yet there are times in which congressional action may be necessary and even desirable. This is not to imply that any overreaching of the modern courts, especially in their expansionary reading of the Commerce Clause of the Constitution, is in any way justified: Congress and the courts have exceeded their constitutional authority throughout this century by using contorted legislative and judicial reasoning to bring almost every economic and social activity under the control of the federal government.

The development of this philosophy has been both unfortunate and inexcusable. Legislators (and recently even the courts) in Washington, D.C., have begun investigating a number of innovative ways to devolve federal power back to states and localities across the United States, but more needs to be done. The proper constitutional balance of power must be restored, with most of the power reserved to the states, localities, and individual citizens.

At the same time, it must be recognized that the Founders had good reason to abandon the failed Articles of Confederation, which governed the states of the Union after the Revolutionary War, and establish a federal–state system under the present Constitution. While the states retained almost unlimited power to act without federal control, the Founders realized it was vital for the country's economic development that state-based protectionism not be allowed to exist. Hence, because they revered the benefits of both federalism and capitalism, they crafted a delicate balance between the two extremes of outright state control of all commerce and complete national control of the marketplace. This balance was designed to protect the autonomy of the sovereign states while ensuring the free, unfettered flow of interstate commerce to help the country develop and grow.

Jurisdiction in the Electricity Marketplace

The challenge before legislators today is this: How can the Founders' vision of a balance of power be applied to the sophisticated, technologically advanced, and modern electricity marketplace—something the Founders could not have envisioned? Applying this balance of power to the modern electricity sector is not easy, but it can and must be done. Clearly, even though states and localities will play a preeminent role in the process, some short-term transitional federal action will be necessary, and even desirable, to assure that the electricity industry is deregulated properly and efficiently. Congressional action can be justified on several grounds:

- **The electricity market has become an increasingly seamless web of interconnected networks that cannot be carved into neatly defined or clearly distinct markets and regulatory jurisdictions.** Like the airline, trucking, and telecommunications industries that also required federal deregulatory action, the U.S. electricity market is so large and interacts so smoothly that regulation based primarily on geographic boundaries defies economic and scientific logic. When electrical current travels over state boundaries, its physical nature does not change; yet the laws governing that current do change. This results in unjustifiable differences in rates from one region to the next, and imposes other unnecessary burdens on interstate commerce. Interstate commerce is under the jurisdiction of the federal government; therefore, these burdens demand congressional attention.

- **Federal action is needed to end the exclusive franchising arrangements that allow single firms to hold monopolies over large service areas.** These areas could be served by many alternative power providers from across the United States. Implemented by states long ago to grant monopolies to large utilities in specific service areas, exclusive franchising arrangements prevent competition from improving either cost or service to consumers. These franchises represent an unjustifiable burden on interstate commerce and should be ended. As Competitive Enterprise Institute President Fred Smith has argued,

  > There is no theory of "states rights" that legitimizes a state's barring citizens within its borders from purchasing power from outside the state.... Nor is there any "right" to prohibit a generator from selling outside of its state's borders. The interstate Commerce Clause of the Constitution was intended to prohibit such restraints of trade.[2]

  If states are not willing to end these unconstitutional franchises, congressional action will be required.

- **Federal guidance will be essential to ensure that concerns of reciprocity are handled in an efficient and timely manner.** Even though many states may move forward with market liberalization plans in the next few years, others may delay indefinitely, or may resist opening their markets in order to protect in-state carriers from competition. If the negative effects of these anti-competitive actions were felt only within the individual states, no further congressional action would be warranted; but there are negative effects that spill over onto

2 Fred Smith, letter to Citizens for State Power, August 28, 1996.

consumers in other states, and these make congressional action necessary. Congress should not allow radical asymmetries to develop from state to state that could exclude individual citizens from the benefits of a more competitive marketplace. Furthermore, a staggered state-by-state approach would raise serious reliability concerns for the operation of regional transmission systems, as well as reciprocity concerns for utilities that may not have been afforded the same opportunities enjoyed by utilities in other states. Therefore, while allowing and encouraging continued state action, Congress will need to provide a backstop to deal with states that refuse to act.

- **Federal guidance will be required to ensure that states do not abuse the "stranded cost" recovery process to protect in-state carriers from competition.** Some state legislators, based on the mistaken notion that every investment a monopolistic utility made in the past should be reimbursed by someone else in the future when the market is deregulated, may devise various uncompetitive mechanisms to allow utilities to recover these stranded cost "losses." They also might try to pay for such a bailout by imposing discriminatory taxes on interstate activity. This would violate the Commerce Clause. Some form of federal action may be required to discourage such actions.
- **Federal action is needed because many of the problems associated with the modern electric industry were created by federal statutes and regulations.** The final and most obvious justification for federal action is that many federal statues and regulations distort or disallow competition in this industry. The Federal Power Act, the Public Utility Holding Company Act (PUHCA), the Public Utilities Regulatory Policies Act (PURPA), and other Federal Energy Regulatory Commission (FERC) orders must be repealed or radically reformed for true competition to flourish. Clearly, only the federal government can undertake this. Furthermore, only federal action can solve the problems posed by the federally owned power marketing administrations and the Tennessee Valley Authority (TVA).

Tempering the Federal Role

As definitive as the reasons for federal involvement may be, however, they are no justification for running roughshod over either the rights of the states in the restructuring process or the right of individuals to exercise their freedom of choice in electricity suppliers. Legislators should be mindful of the Founders' explicit warnings against the overcentralization of power. To manage the balance of power and the federal government's role effectively, Congress should:

1. **Encourage the states to move quickly, and in conjunction with one another, to open their markets to competition.** Congress should support voluntary state liberalization efforts wholeheartedly. Encouraging states to move forward with their plans to offer consumer choice in the electricity market is perhaps the simplest way to limit the federal government's involvement in the restructuring process.
2. **Require that sunset clauses be attached to any transitional federal rules.** Transitional rules that are deemed necessary should be, by definition, transitory in nature. They should sunset according to strict timetables—for example, over a five- or ten-year period.

3. **Restrict the powers of federal regulators and demand the periodic rescinding of rules that no longer are needed.** Congress should require the FERC, which oversees the electric industry, periodically to rescind rules that are no longer needed while consolidating or eliminating its other functions and powers. More important, Congress should not hesitate to use the appropriations process to curtail the FERC's powers while it designs a plan and timetable to sunset the commission itself.

4. **Establish a specific role for the states in activities that are solely intrastate in nature and do not allow federal regulators to interfere in those areas.** Another simple way to limit the federal role is to carve out powers that clearly lie outside federal jurisdiction and for which states and localities should have sole authority. For example, universal service or other social programs, environmental conservation, and reliability issues are local in nature and best left to state and local officials for implementation.

Congress should take these steps to ensure the development of a vibrant national electricity marketplace. Only such action by Congress can prevent radical asymmetries from developing between the states and protect the free flow of interstate commerce. With a few federal ground rules, the process of restructuring the country's last regulated monopoly can bring better service and lower costs to all Americans.

AN OVERVIEW OF AMERICAN COMMERCIAL FEDERALISM

In 1787, the Founding Fathers convened in Philadelphia and embarked upon a grand political experiment that resulted in the Constitution of the United States of America. The U.S. Constitution has withstood the test of time and has served the country well. It is important to understand, however, that this was not the Founders' first attempt to create a binding document that could guide the new nation and establish a workable system of government for the American polity.

The Articles of Confederation governed the states roughly from the period of the American Revolution until the Constitution was ratified in 1789. Understanding why the Founders abandoned the Articles is important if Americans are to comprehend how, 210 years later, the framework established by the Constitution still can be relevant and applicable to high-tech modern markets and industries like the electricity sector.

Why the Founders Abandoned the Articles of Confederation

In theory, the Articles of Confederation established an appealing form of decentralized government to ensure the states that a despotic national power similar to the one they had just defeated could not trample the rights of their citizens. In practice, however, the Articles prohibited practically any federal action, including that of a beneficial nature. This created many difficulties, including uncertainty about whether the government could raise money to support the forces needed to defend the new union. Furthermore, coinage and currency problems were preventing the development of an efficient monetary system.

Perhaps most difficult of all, the Confederation period saw the rise of state-by-state protectionism. Each state seemed to view itself as a miniature kingdom that could regulate commerce at the expense of citizens in other states and regions. The federal government was essentially powerless because the Articles had not provided for any federal role in preventing this and other undesirable state actions. According to historian Clarence B.

Carson, "It is even doubtful that what existed under the Articles was a general government at all."[3] Each state was free to impose unjustifiable burdens on interstate commerce, acting without regard to the concerns and rights of citizens in other states. In fact, just a few years after the Revolutionary War had ended, the states were engaging in activities that mimicked the ones that had driven the colonists to rebel against England. As John Fiske, another historian, noted in 1916:

> [T]he different states with their different tariff and tonnage acts, began to make commercial war upon one another. No sooner had...three New England states virtually closed their ports to British shipping than Connecticut threw hers wide open, an act which she followed by laying duties upon imports from Massachusetts. Pennsylvania discriminated against Delaware, and New Jersey, pillaged at once by both her greater neighbors, was compared to a cask tapped at both ends.[4]

Frederic A. Ogg and P. Orman Ray aptly summarized the overall effects of the Confederation period in their 1932 textbook *Essentials of American Government:*

> The consequences were disastrous. No money for national use could be raised from tariff duties; no uniform commercial policy could be adopted; and the states laid duties, granted favors, and set up barriers as their individual interests dictated, sacrificing by their jealousies and bickerings splendid opportunities for advancing the new nation's trade, wealth, and prosperity. Enmeshed in a network of duties and tolls, trade languished; healthy commercial competition gave way to downright commercial welfare.[5]

Both James Madison and Alexander Hamilton clearly articulated the frustration experienced by the Founders in crafting the new constitutional framework. As Hamilton noted in *Federalist Paper* No. 22:

> The interfering and unneighborly regulations of some states, contrary to the true spirit of the Union, have, in different instances, given just cause of umbrage and complaint to others, and it is to be feared that examples of this nature, if not restrained by a national control, would be multiplied and extended till they become not less serious sources of animosity and discord than injurious impediments to the intercourse between the different parts of the Confederacy.[6]

Madison concurred, noting in *Federalist Paper* No. 42 that "The defect of power in the existing Confederacy to regulate the commerce between its several members is in the number of those which have been clearly pointed out by experience."[7] More important, as he pointed out in *Federalist Paper* No. 45, "The regulation of commerce...is a new [federal] power; but that seems to be an addition which few oppose and from which no apprehensions are entertained."[8]

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3 Clarence B. Carson, *A Basic History of the United States, Volume 2: The Beginning of the Republic 1775–1825* (Wadley, Ala.: American Textbook Committee, 1991), p. 62.

4 John Fiske, *The Critical Period of American History* (New York, N.Y.: Houghton Mifflin, 1916), p. 145.

5 Frederic A. Ogg and P. Orman Ray, *Essentials of American Government* (New York, N.Y.: Appleton-Century-Crofts, Inc., 1950), p. 10.

6 Alexander Hamilton, *The Federalist Papers*, No. 22.

7 James Madison, *The Federalist Papers*, No. 42.

In other words, the members of the state delegations that wrote the Constitution recognized that something would be gained by sacrificing a small degree of autonomy over interstate commercial activity. Because the federal government had no power under the Articles of Confederation to prohibit state-based protectionism, the Founders made it clear when drafting the new Constitution that a stronger federal role was needed to protect consumer freedom and encourage the expansion of industry. To this end, they included several provisions dealing with federal oversight:

- **Article 1, Section 8, Clause 3 (the Commerce Clause),** which gives Congress the power "To regulate commerce with foreign nations, and among the several states, and with Indian tribes."
- **Article 1, Section 9, Clauses 5 and 6,** which provide that "No tax or duty shall be laid on articles exported from any state. No preference shall be given by any regulation of commerce or revenue to the ports of one state over those of another: nor shall vessels bound to, or from, one state, be obliged to enter, clear, or pay duties in another."
- **Article 1, Section 10, Clauses 2 and 3,** which specify that "No state shall, without the consent of Congress, lay any imposts or duties on imports or exports [or] lay any duty on tonnage."
- **Article VI (the Supremacy Clause),** which makes it clear that when state laws conflict with each other or with national laws, federal law prevails: "This Constitution…shall be the Supreme Law of the Land."

The combined effect of these provisions is a clear declaration by the Founders (and agreement by the state legislatures when they ratified the Constitution) that state-based protectionism would not be tolerated and that the rights of individual consumers, when threatened by unjustifiable state actions adversely affecting interstate commerce, would be protected by Congress.

Balancing the Power

The Founders went to great lengths to ensure that the power of the federal government would not become oppressive. Despising centralized power, they made it abundantly clear, both in their statements during the Constitutional Convention and in their subsequent writings, that local control was almost always preferable to federal regulation. Thus, as the Tenth Amendment made plain, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people."

The Founders also recognized that unconstrained state action and regulation could infringe upon the rights of individual Americans. Thus, the Ninth Amendment notes that "The enumeration in the Constitution of certain rights shall not be construed to deny or disparage others retained by the people," and the Tenth Amendment ends with the phrase "or to the people." In other words, to ensure that the rights of individuals were protected from state action that interfered with the free flow of interstate commerce and the voluntary interaction of producers and consumers across state boundaries, local control was to be tempered by a small degree of federal oversight.

8 James Madison, *The Federalist Papers*, No. 45.

In essence, the Constitution established a balance between federal and state responsibilities for the regulation of interstate commerce; neither extreme—absolute federal preemption or complete state control of national commercial activity—would be tolerated. The United States would be a country that respected both federalism and capitalism, and the Constitution guaranteed that the rights of the people would be protected.

The Supreme Court and the Commerce Clause

For many years after the adoption of the Constitution, this intricate yet clear balance of power was preserved and protected by fairly sensible applications of the Commerce Clause in Supreme Court cases. Chief Justice John Marshall, who served from 1801 to 1835, wrote a number of important decisions that applied the balance of power to difficult commercial disputes developing in the young country. In such cases as *McCulloch* v. *Maryland* (1819), *Cohens* v. *Virginia* (1821), *Gibbons* v. *Ogden* (1824), *Brown* v. *Maryland* (1827), *Willson* v. *Blackbird Creek Marsh Co.* (1829), and *Weston* v. *Charleston* (1829), Marshall worked to preserve the balance of power by striking down state actions that unduly affected interstate commerce.

In *Gibbons* v. *Ogden*, the first and most important case dealing directly with the reach of the Commerce Clause, Marshall authored a unanimous decision striking down a New York law that granted a steamboat operator a monopoly in using the Hudson River. Holding for Thomas Gibbons, who was represented by noted statesman Daniel Webster, the Supreme Court agreed with Webster's reasoning during argumentation that, wherever state laws came into conflict with each other or with national laws, federal action was required to settle the matter. Marshall further noted that for the Commerce Clause to have its intended effect—the restriction of state-based protectionism—the term "commerce" would have to be defined to include more than just goods transported across state boundaries; it would have to include other activities and entities, such as steamboats and the individuals they transported.

Although *Gibbons* v. *Ogden* remains somewhat controversial in its application of the Founders' balance of power principles,[9] legal and economic experts agree that its significance in assisting the development of a vibrant American commercial sector is considerable and should not go unappreciated. As Ezra Parmalee Prentice and John G. Egan note in their seminal 1898 study, *The Commerce Clause of the Federal Constitution,*

> In reading that momentous decision, apprehending, as we do now, the interests which were at stake…one cannot help pausing to wonder what might have been the result had that decision been in any way different from what it was. Had the utterance of the court upon the powers of the States been more ambiguous; had the expression upon the relation of the States to the Federal government been avoided, and the element of nationality involved been less explicitly disclosed and asserted; had it been allowed to cripple the commercial power of the nation in any way—where would the influence of that decision have led us now?[10]

9 For a critique of Marshall's reasoning, see Raoul Berger, "The Commerce Clause," in *Federalism: The Founders' Design* (Norman, Okla.: University of Oklahoma Press, 1987), pp. 120–157.

10 Ezra Parmalee Prentice and John G. Egan, *The Commerce Clause of the Federal Constitution* (Chicago, Ill.: Callaghan and Company, 1898), p. 16.

Although the general thrust of most Marshall-era decisions echoed *Gibbons* v. *Ogden*, some feared the pro-nationalist forces might be moving too far. Balance was restored under the guidance of Chief Justice Roger Brooke Taney, who served from 1835 to 1864. Under Taney, a number of important decisions were handed down that attempted to clarify how the Founders' balance of power would apply as national commercial markets grew larger and the overall number of states in the Union multiplied. Key Taney-era cases relating to this issue include *New York* v. *Miln* (1837), *Bank of Augusta* v. *Earle* (1839), *Swift* v. *Tyson* (1842), the *License Cases* (1847), the *Passenger Cases* (1849), *Genesee Chief* v. *Fitzhugh* (1852), and *Cooley* v. *Board of Wardens of the Port of Philadelphia* (1852).

In *Cooley*—probably the most important Taney-era decision relating to the Commerce Clause—the Supreme Court upheld a Pennsylvania law regulating vessels entering or exiting the port of Philadelphia on the grounds that the matter was local in nature. The Supreme Court went on to argue that, even though such a law could stand, other laws and issues that were clearly national in scope would demand federal attention. This decision is known as the Cooley doctrine of selective exclusiveness: In select commercial areas in which national uniformity may be needed, Congress has exclusive jurisdiction to legislate if it so desires; when the commercial activity is local in character, however, or when Congress has not acted, the states are free to legislate. Prentice and Egan summarize this doctrine as follows:

> In matters admitting uniform regulation throughout the country and affecting all the States, the inaction of Congress is to be taken as a declaration of its will that commerce shall be "free and unrestricted" so far only as concerns any general regulation by the States.... On the other hand, in matters of local nature, such as are auxiliary to commerce rather than part of it, the inaction of Congress is to be taken as an indication that for the time being, and until it sees fit to act, they may be regulated by State authority.[11]

Although the Taney Court leaned toward guaranteeing state sovereignty over commercial affairs before allowing or encouraging federal action, its decisions continued to balance the two in the interest of promoting the commercial development of the nation. As University of Missouri–St. Louis Professor of History and Education Walter Ehrlich has noted:

> Contrary to popular misconception, then, Taney did not reverse the Marshall trend and institute radical agrarian egalitarianism and state sovereignty. On the contrary, he preserved and redefined the main lines of Marshall's constitutional law, opened economic opportunities for many Americans, and retained a strong national power redefined to accommodate a judicious dual sovereignty.[12]

In this sense, the Founders' delicate balance between unfettered, nationally enforced capitalism and outright state-based control was preserved through the evolution of American common law court cases. This trend lasted roughly until the time of the New Deal. For the most part, even though the federal government created a handful of new powers for itself in the post–Civil War Reconstruction years, the Founders' balance of power was

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11 *Ibid.*, pp. 27–28.

12 Walter Ehrlich, "Roger Brooke Taney," in Kermit L. Hall, ed., *The Oxford Companion to the Supreme Court of the United States* (New York: Oxford University Press, 1992), p. 859.

Ironically, state regulators and officials who have testified before Congress in recent months have all but admitted that such a federal backstop will be required eventually, despite their initial resistance to a strong federal role. Many states that already have initiated their own reform plans realize that reciprocity will be needed at some point in the future if producers in their respective states are to have the ability to sell power on equal and fair terms in neighboring states.

For example, if State A opens its market and allows customers to purchase power from competing utilities, including utilities located out of state, many customers might switch to an out-of-state utility; if neighboring States B, C, and D have not opened their markets to competition, however, or plan to do so over a much longer time period, the utilities located in State A will decry the unfair playing field. Utilities from States B, C, and D will be able to compete for customers in State A's market, but utilities in State A will be unable to offer services to customers in neighboring states.

Such concerns eventually will demand federal attention. Even those who argue against establishing a federal mandate to declare the exact date on which retail competition takes effect (known as a "date certain" requirement) do not deny that they lack the jurisdictional authority to deal with such reciprocity issues. State regulators and officials across the country believe Congress most likely will have to deal with this problem in some way if nationwide competition is to emerge in the near future. However implicitly, they are seeking a federal backstop role in this process.

Indeed, there is not much difference between the argument that Congress should establish a date certain by which full nationwide retail competition will be insured and the argument that Congress will need to settle reciprocity issues. The simplest way to guarantee reciprocity is to require that competition and customer choice go into effect by a date certain. This would make the playing field level nationwide and ensure that uncompetitive asymmetries do not develop from one state to the next. The only question that remains, if one accepts the logic of such an approach, is how long Congress should wait before demanding that nationwide competition and customer choice take effect in every state.

The slow pace of congressional action, however, and the vehement opposition to a federal role by state regulators and some policy groups may force Congress to accept that a "date certain" approach is unworkable. A sensible compromise might be to encourage the states to pursue their own reforms aggressively but also to put in place a federal backstop for any states that, for whatever reason, have not acted after a majority of the others have. In other words, once a majority of the states have acted (say 33 of the 50), a federal backstop plan could be triggered for the stragglers. Once this trigger number is reached, the remaining states would have one year to put a plan into place before a federal default plan was set in motion. Such a "majority trigger mechanism" would ensure that deregulation unfolded in a harmonious and reliable manner and that no Americans were excluded from the benefits of a competitive national marketplace.

To summarize, the nature of the electrical transmission network and the physics of electricity make this industry national in character. Although the physical nature of electrical current does not alter as it flows across state lines, the laws governing it do change in ways that are detrimental to the free flow of commerce and consumer welfare. Congress must address this problem by outlawing uncompetitive restraints on the free flow of electrons. Similarly, state action alone cannot deregulate the industry in an efficient, harmonious manner without creating a host of consumer and company equity concerns as well as

reliability questions; congressional action is needed to complement state actions and carry the comprehensive reform of the country's electricity sector through to completion.

National Need and Substantial Interstate Spillover

For many reasons, including those discussed above, there is a clear and overriding national need for congressional action in this field. But this action must be limited in scope, and it must be aimed at preserving the freedom of interstate commerce by restraining any form of state-by-state protectionism.

As Wendell L. Willkie II and Alden F. Abbott, former general counsel and counselor to the general counsel, respectively, of the U.S. Department of Commerce, argued in a 1992 study:

> The federal government should only regulate when there is a demonstrated national need, such as when a state law imposes substantial economic burdens on out-of-state consumers and producers greater than any benefits that may be bestowed on in-state citizens.... [T]he principle must only be applied where state action results in a major negative effect on commerce.[16]

Would a state-by-state approach to electricity deregulation have such a negative effect on national commerce? In some ways, it could. Most notably, if states used the stranded cost loss compensation process to create new protectionist burdens on interstate commerce, some form of federal action might be required. For example, many states already are debating proposals to provide their in-state utilities with generous compensation before they enter a competitive future. Almost all of these plans involve the creation of new discriminatory transitional charges (in other words, taxes) on consumers or potential competitors, and the effects of these taxes could be felt well beyond the borders of the states which impose them.

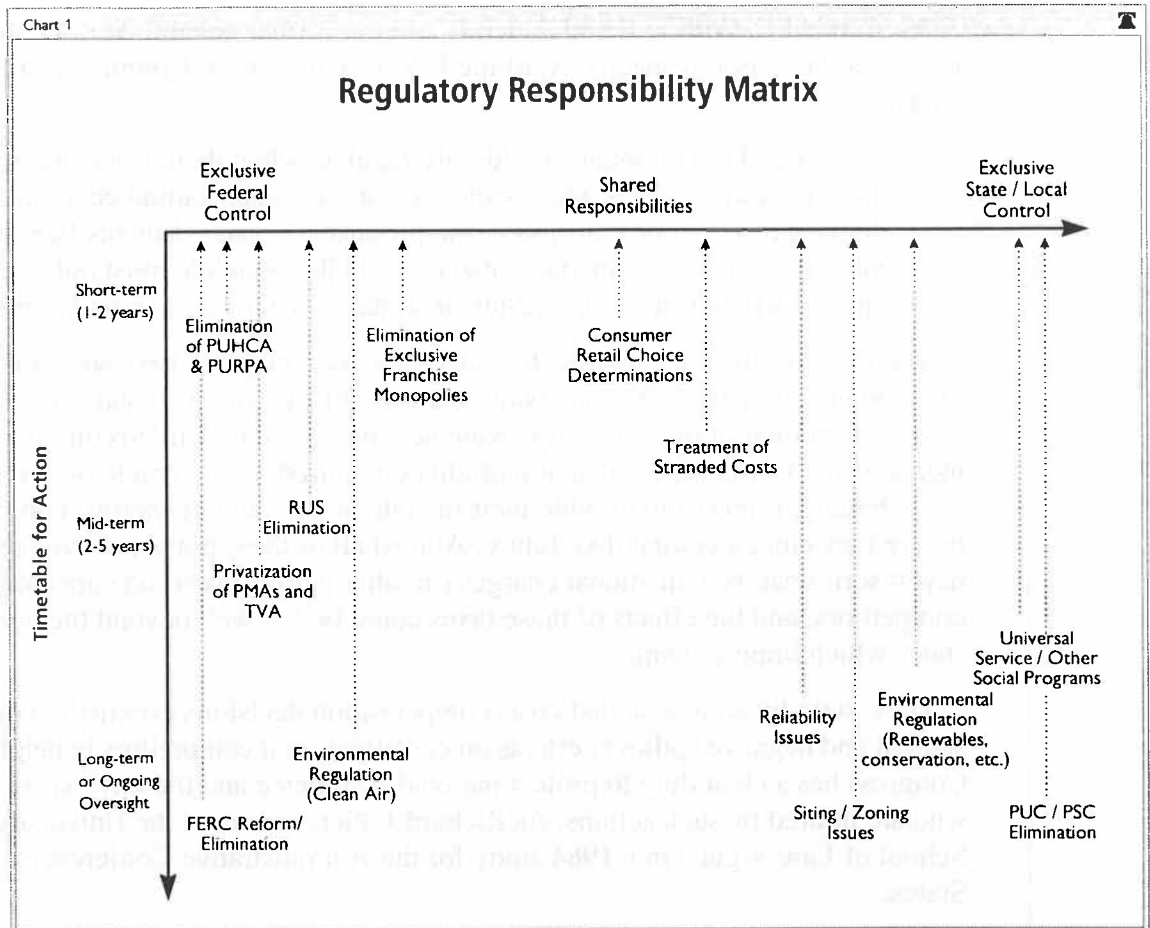
Thus, state-by-state stranded costs compensation decisions eventually could have substantial and negative spillover effects on consumers and competitors in neighboring states. Congress has a clear duty to protect national commerce and the interests of consumers who are injured by such actions. As Richard J. Pierce, dean of the University of Pittsburgh School of Law, argued in a 1984 study for the Administrative Conference of the United States:

> It is in the national interest to permit each state to adopt its own regulatory policy to the extent that such state decisions affect only, or predominately, the interests of state residents. States should not be permitted, however, to make regulatory decisions that create substantial interstate spillovers.... Congress has the power under the Supremacy Clause to limit the ability of each state to adopt regulatory policies that create substantial interstate spillovers.[17]

16 Wendell L. Willkie II and Alden F. Abbott, "Who Should Regulate Business?: Assessing the Federal–State Balance of Power," Washington Legal Foundation *Critical Legal Issues: Working Paper Series* No. 48, August 1992, pp. vi–vii.

17 Richard J. Pierce, *Regulation, Deregulation, Federalism and Administrative Law*, Report to the Administrative Conference of the United States, October 1984, p. 74.

It is clear that some federal activity is justified under this general theory of deregulatory federalism. Therefore, how should Congress, the states, or a combination of both be involved in implementing the legislative actions that are necessary to liberalize the electricity sector properly? The Regulatory Responsibility Matrix schematically illustrates the jurisdiction of the different levels of government over electricity deregulation issues. It also provides a rough timeline for when these actions should take place.



- **Eliminate unnecessary federal regulations like the PUHCA and the PURPA (*Congress*).**

The PUHCA and PURPA are federal statutes that only Congress can eliminate. It should consider doing so as retail customer choice plans are introduced because these costly statutes will not be needed in a competitive future.

- **Eliminate exclusive franchise monopolies (*Congress and states*).**

There is little controversy surrounding proposals that Congress end the state-created exclusive franchising arrangements that grant geographic service monopolies that allow individual utilities to serve all customers in a given region free from the threat of competition. For competition to be possible, these legal constructs must be eliminated. Congress should eliminate them because they pose a clear barrier to the free flow of interstate commerce. As Michael K.

Block and Thomas M. Lenard, senior fellows at the Progress and Freedom Foundation, argue:

> Exclusive [franchise] territories clearly constitute protected markets and are the equivalent of a tax on the interstate movement of electricity. As such, according to both judicial precedent and constitutional history, they are inconsistent with the commerce clause. There is, therefore, ample basis in the constitution for federal preemption of the states' authority to establish local power monopolies.[18]

Paul Ballonoff, president of Ballonoff Consulting Services, concurs:

> The role of the federal government, the very meaning of the Commerce Clause as applied to federal-state relations, is that the Congress should open markets closed by [state] action in granting exclusive franchise territories. This should be the federal role in electricity markets, as well as any other market. The proper institutional framework for energy "regulatory reform" is therefore an easy issue, if the structure of the American Constitution is carried out.... The role of the federal government in such circumstances is to open the markets by removing state restrictions.[19]

The states should be allowed and encouraged to take steps to eliminate these franchise monopolies unilaterally before federal action is finalized.

- **Enable retail customer choice and open transmission access (*states and Congress*).**

Congress must play an important backstop role in guaranteeing the development of nationwide consumer choice and competition. As William S. Armistead, vice president for federal and state campaigns at the Citizens for a Sound Economy Foundation, and Ross B. Bell, director of the Energy, Environment, Natural Resources, and Agricultural Task Force at the American Legislative Exchange Council (ALEC), have noted, "While clearly states' rights ought to be preserved and protected, it is also vital to understand that both federal and state efforts are necessary to give consumers access to a wide array of electricity generators throughout the several states in order to achieve the full benefits of competition."[20]

ALEC, a think tank representing state legislators, recently passed a resolution not only supporting a strong federal role in electricity deregulation, but also advocating a federal date certain by which the states must have a competition plan in place.[21] Supporters argue that a federally mandated date certain gives

18 Michael K. Block and Thomas M. Lenard, *Creating Competitive Markets in Electric Energy*, Conference Draft (Washington, D.C.: Progress and Freedom Foundation, March 17, 1997), p. II–9.

19 Paul Ballonoff, "The Deregulatory Constitution," *Regulation*, Vol. 19, No. 2 (1996), p. 7.

20 William S. Armistead and Ross B. Bell, *Consumers Shouldn't Be Fooled by Pro-Monopoly Arguments*, Citizens for a Sound Economy Foundation, 1997.

21 See "ALEC Panel Passes Resolution Requiring Federal Date Certain for Electricity Restructuring," *White House Bulletin*, March 25, 1997, p. 3.

the states an incentive to advance deregulation plans more rapidly; in the absence of such a deadline, some states might delay enacting restructuring legislation indefinitely in an effort to shield their utilities from the onset of competition.

A date certain, however, could prove politically unworkable and become moot if the congressional process moves too slowly. Therefore, a compromise plan, such as the majority trigger mechanism described above, might be more workable. Because reliability and the continuous provision of service are vital to electricity consumers, such a federal backstop would be needed to ensure the harmonious and relatively uniform development of competition nationwide. A prolonged and staggered state-by-state approach, by interfering with the development of efficient and reliable transmission standards and pricing policies, could have an adverse effect on overall system reliability.

Furthermore, a staggered state-by-state approach would leave many companies and consumers powerless if their states or neighboring states have not adopted pro-competitive policies on a fairly even timetable. Therefore, although Congress should allow and encourage all 50 states to open their markets to competition voluntarily and simultaneously, those that refuse to come into the fold will need to be pushed to do so shortly after a majority of their peers have acted.

- **Move to privatize the power marketing administrations and the TVA, and to eliminate the Rural Utilities Service (*Congress*).**

Privatization of the power marketing administrations and the TVA, as well as elimination of the Rural Utilities Service, are tasks for federal officials. Such reforms must be undertaken immediately if the electricity market is to become truly competitive. If federal policy makers fail to address public power reform as they initiate other market-based reforms, these subsidized, inefficient entities will enjoy an unfair competitive advantage against private utilities, and U.S. taxpayers will be forced to continue paying for their operations.

- **Target universal service and other social programs (*states and localities*).**

There is no justification for federal involvement in universal service issues. They are uniquely local in character, and state and local officials are in a much better position to target individuals and households who need assistance and to design mechanisms to ensure that they are provided with the services they require. As electricity becomes more affordable in the competitive future, such programs are less likely to be needed.

- **Oversee environmental regulation (*primarily the states*).**

Besides certain regulations governing interstate clean air quality, the vast majority of environmental regulations and issues can be handled by state and local officials. Solutions to renewable energy, conservation, and other environmental concerns that are local in character should be tailored to the specific circumstances faced by individuals, communities, or states. National mandates and programs are not needed. Even clean air regulations—primarily national in character—often are administered better by states and localities. (This is not to

argue, however, that any expansion of current clean air statutes or regulations is needed.)

- **Address reliability concerns (*states and regional authorities*).**

The continued reliability of the integrated U.S. electrical system is a major state and federal concern. Although federal officials certainly should encourage every possible step to preserve and protect the integrity of the system, however, they should be aware that reliability issues already are handled quite well by the North American Electric Reliability Council and other industry-sponsored regional organizations. Any additional guidance that is deemed necessary can be handled by the states or by such regional authorities.

- **Address site and zoning issues (*states and localities*).**

Regulations governing the location of electrical plants, poles, or lines are handled best by state, local, or regional authorities. Nuclear generating plants may be more problematic because they have been regulated heavily by federal authorities, but states and localities should assume greater control over them as well.

- **Address stranded cost issues (*states and Congress*).**

The most difficult and controversial issue involved in the debate over electricity deregulation undoubtedly will be stranded cost loss recovery. Although states clearly have the right to study the future health of in-state utilities, they do not have the right to impose discriminatory taxes on out-of-state consumers or competitors in order to bail out in-state utilities.

Yet this is exactly what many states across the country are thinking of doing. Following the disastrous example established by California, states like Illinois, Michigan, Ohio, Pennsylvania, and Texas have been considering plans to bail out their utilities, potentially at the expense of a competitive future. The rough tally for the bailout in these six states is approaching a staggering $80 billion to $90 billion. California's bailout alone totals over $28 billion, while the size of its current market is only $23 billion. Estimates of Michigan's proposed bailout run as high as $9 billion, while the size of that market is only $6 billion.

If state-by-state electricity utility bailouts continue at this pace (and the trend is rising), the aggregate cost could equal or exceed the savings-and-loan bailout of the early 1990s. A more important question, however, is whether the manner in which states are proposing to pay for this corporate welfare poses a potentially unconstitutional threat to interstate commerce. This is because many states are considering paying for stranded cost losses through cost recovery mechanisms that could impose discriminatory taxes on out-of-state carriers, such as so-called securitization plans.

For example, a number of states are considering higher fees and taxes on transmission line transactions that often are interstate in nature. The revenues generated by these fees and taxes—which most likely would take the form of a per-kilowatt-hour line charge—would be funneled into a state account and then distributed to in-state carriers to pay for their potential future losses. Producers operating outside California, for example, could be forced to pay discrimina-

tory transmission charges on power they wheel into the state to help bail out their potential competitors. The market price of power would be raised artificially, and new entry into the market would be discouraged.

This situation has led many critics to predict that the constitutionality of stranded cost bailout mechanisms will be tested in the courts. A recent white paper issued by IPALCO Enterprises, Inc., a utility based in Indianapolis, Indiana, argues that "state-by-state stranded cost recovery schemes, especially securitization, represent an unreasonable burden on national commerce. Because of this, many state stranded cost recovery schemes will be subject to lengthy legal challenges, because they ultimately violate the Commerce Clause of the U.S. Constitution."[22] To support this assertion, IPALCO cites a number of Supreme Court decisions in which state laws granting preferential treatment to in-state interests over out-of-state competitors have been found to be unconstitutional.[23]

This presents a troubling question for Congress: Because stranded cost recovery mechanisms may create new forms of state protectionism, should Congress attempt to constrain the stranded cost recovery process in order to ensure that interstate commerce is not affected adversely by the rising tide of discriminatory state-by-state bailout schemes? From a legal standpoint, even though a federal prohibition on any stranded cost recovery would make good economic sense, the states probably cannot be restricted from making certain compensatory determinations on their own. Yet Congress should be willing at least to set parameters on how state-level decisions on stranded cost compensation are made, to ensure that such interstate commerce issues (and their attendant court battles) do not arise.

Congress could demand that any compensation deemed necessary by a state is distributed to utilities directly from general treasury revenues that the state collects from its own citizens. This would ensure that the taxes being imposed to pay for a bailout were non-discriminatory. That is, taxpayers in the state would pay directly for the bailout of their own in-state utilities; out-of-state residents or competitors would not be forced to bail out firms that have not served them. Such a loss recovery method has the added advantage of discouraging extravagant bailouts because most state legislatures will be operating under tight budget constraints.

Beyond this reasonable, commerce-enhancing requirement, Congress should work with the states to develop loss recovery guidelines for the correct identification of assets or investments for which utilities should be compensated. Congress could work with state policy makers to establish "competitive cost recovery guidelines" that delimit those assets or investments they regard as "clearly unrecoverable" or "potentially recoverable." This delineation would help constrain the overall size of any future bailout.[24]

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22 *The Securitization Swindle*, A White Paper by IPALCO Enterprises, Inc. (Indianapolis, Ind.: May 1997), p. 30.

23 *Hughes* v. *Oklahoma*, 441 U.S. 322, 336 (1979); *Maine* v. *Taylor*, 477 U.S. 131, 138 (1986); *City of Philadelphia* v. *New Jersey*, 437 U.S. 137, 142 (1970); *Wyoming* v. *Oklahoma*, 502 U.S. 437, 443–444 (1992); *West Lynn Creamery* v. *Healy*, 512 U.S. 186 (1994).

24 For more information, see Thierer, "Electricity Deregulation: Separating Fact from Fiction," pp. 12–13.

Constraining the Role of the Federal Government

Having examined why some action by Congress is needed to ensure the rapid and complete deregulation of the electricity market, it is important to qualify this call for federal action with appropriate constraints on federal authority. Critics of a strong federal role (especially conservatives) will argue quite logically that one of the down sides of federal action is the effects brought on by the law of unintended consequences: Allowing federal officials to exercise a certain amount of authority over the states typically leads to additional attempted power grabs by federal regulators.

Congress should ensure that deregulation occurs at all levels and as rapidly as possible. To ensure the success of this process, however, it is vital that Congress limit not only its own authority, but also the authority of federal regulators. It can do this by taking the following steps:

1. **Encourage the states to move quickly, and in conjunction with one another, to open their markets to competition.** Congress must be unwavering in its support for voluntary state-based deregulation. Perhaps the best constraint on federal action will be the realization that the states are moving forward aggressively with consumer choice plans while Congress appears mired in endless debates and squabbles with industry lobbyists. Congress eventually will need to deal with interstate reciprocity and other issues over which it clearly has jurisdiction; in the meantime, its wholehearted endorsement of state liberalization plans will help limit federal involvement.

2. **Require that sunset clauses be attached to any transitional federal rules that are established.** Although some transitional rules will be necessary to ensure the development of customer choice for all electricity consumers, these rules should be sunset as rapidly as possible. Legislation should include strict timetables for the elimination of most rules within five to ten years, or should turn such powers over to regional, state, or local authorities.

3. **Restrict the powers of federal regulators and demand the periodic rescinding of rules that are no longer needed.** Wherever the market is functioning in a relatively efficient manner, federal regulators should be required to exercise restraint. Because regulators rarely have incentives not to regulate, more congressionally imposed constraints will be required.

   To accomplish this goal, Congress should demand the periodic rescinding of rules that are no longer necessary; it also should work to consolidate the functions and powers of the FERC. Congress must make it clear that transitional rules (such as transmission access requirements) may not be used to expand the FERC's authority into new areas.

   Congress also can use the appropriations process ("deregulation by defunding") to cut back agency spending and curtail undesirable FERC activities. To that end, Congress should establish not only a sunset for the transitional rules, but a sunset plan and timetable for the FERC itself. Once transitional rules have sunset and a competitive market has developed, the FERC should be closed to ensure that it cannot re-regulate the industry in the future.

4. **Carve out a specific role for the states in activities that are purely intrastate in nature and do not allow federal regulators to interfere in those areas.** Finally, and most important, the best way to limit the federal role is simply to lay out what is clearly outside federal jurisdiction. For example, universal service programs or other social programs that are intended to assist needy electricity consumers should be handled entirely at the state or (preferably) the local level. There is no justification for federal action on any issue that is purely local in character.

   Most environmental programs also fall into this category. Each state has different environmental concerns (for example, conservation, water, habitat protection, and siting or zoning) that are handled best by state authorities, although clean air regulation will require a certain amount of federal oversight because of its interstate nature. Most reliability concerns are handled efficiently by state or regional decision-making authorities. Multi-state, regional reliability coalitions, many of which already exist, are best equipped to carry out reliability efforts.

CONCLUSION

It may be difficult, and even controversial, to apply the Founding Fathers' eighteenth-century thinking about the proper balance between state and federal jurisdiction to twentieth-century industries and technologies.[25] Thanks to the wisdom of the Founders and the strengths of America's constitutional framework, however, it can and must be done.

Both the framework of the U.S. Constitution and America's common law history clearly illustrate the need to balance the often competing values of capitalism and states' rights in any discussion of national commerce. The Founders believed in a federal government of limited, enumerated powers, with all other power "reserved to the states respectively, or to the people." Yet they also understood that some level of federal oversight would be necessary and even desirable to keep state-based protectionism from impeding the country's economic development.

For the modern electricity market, the Founders' balanced constitutional framework means that deregulation will need to be a shared responsibility, administered by both state and federal officials. The goal should be clear: to ensure the nationwide development of competition and consumer choice on the most rapid timetable possible to benefit all Americans.

State officials and regulators should welcome federal efforts that complement or expand the deregulatory initiatives they are undertaking in their own states. Such cooperation is essential if electricity consumers are to reap the benefits that competitive choice can offer. If the success of deregulation in the areas of natural gas, aviation, railroad, trucking, and telecommunications is to be repeated in the electricity industry, Congress will need to step in once again and play a central role in the process.

Federal action, however, must have its limits. Congress's role must be limited and transitory, allowing the states to remain in the deregulatory driver's seat. Once competitive choice is guaranteed, unnecessary or outmoded regulations repealed, and public power

25 As Supreme Court Chief Justice William Rehnquist has noted in discussing the evolution of Commerce Clause jurisprudence and thinking throughout American history, "These are not precise formulations, and in the nature of things they cannot be." *United States* v. *Lopez, op. cit.*

entities privatized, very little federal responsibility will remain. By working together in the short term, Congress and the states can bring about the development of a competitive, efficient, and reliable nationwide electricity market that ensures a brighter electricity future for all Americans.

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