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DISENTANGLING DEREGULATORY TAKINGS

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IN recent years, the United States utility industry, faced with the massive restructuring of traditional natural monopolies such as telecommunications, natural gas, and electricity,¹ has raised a novel argument in takings jurisprudence. With the onslaught of competition many United States infrastructure firms claim to have suffered

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¹ See, e.g., Joseph D. Kearney & Thomas W. Merrill, *The Great Transformation of Regulated Industries Law*, 98 Colum. L. Rev. 1323 (1998) (describing the deregulation of six core common carrier and public utility industries—railroads, airlines, trucks, telecommunications, electricity, and natural gas).

lost profits due to the past actions of government.² These lost revenues, the firms argue, interfere with reasonable investment-backed expectations and thus constitute a taking.³ “Deregulatory takings” are not only used by the industry to press judicial claims against state and federal regulators, they are also peddled to policymakers in an effort to convince them to establish “transition” surcharges that consumers or new market participants will be required to pay.⁴

While United States regulators and courts struggle with the stranded cost issue, regulators and courts in developing countries face a structurally similar issue: How does a state attract foreign investment where there is some possibility that the commitments behind its current regulatory regime may change? Like deregulation in the United States, legal, political, and regulatory transitions in developing countries pose political and regulatory risks⁵ that

² See J. Gregory Sidak & Daniel F. Spulber, *Deregulatory Takings and the Regulatory Contract: The Competitive Transformation of Network Industries in the United States* 8–9 (1997) (“[T]he predictable appeal that competition holds for legislators and regulators should not obscure the fact that the transition from regulated monopoly to competition, like the transition from dirty air to clean, is not free. . . . Electric utilities alone may face \$200 billion or more in ‘stranded costs’ as a result of the growth of independent power producers and the advent of wholesale and retail wheeling. That is a public policy challenge at least as large as the savings and loan cleanup.”) [hereinafter Sidak & Spulber, *Regulatory Contract*]. The same argument is also made in J. Gregory Sidak & Daniel F. Spulber, *Givings, Takings, and the Fallacy of Forward-Looking Costs*, 72 N.Y.U. L. Rev. 1068 (1997) [hereinafter Sidak & Spulber, *Givings*], and J. Gregory Sidak & Daniel F. Spulber, *Deregulatory Takings and Breach of the Regulatory Contract*, 71 N.Y.U. L. Rev. 851, 855 (1996) [hereinafter Sidak & Spulber, *Deregulatory Takings*]. The notion of stranded costs and the legal argument for recovery is discussed further at Part II, *infra*. The definition of stranded costs is discussed *infra* at note 82.

³ See Sidak & Spulber, *Regulatory Contract*, *supra* note 2, at 4 (“Courts will soon face a third genre of takings cases that will make the past analysis of regulatory takings seem simplistic by comparison.”).

⁴ According to a recent study by Moody’s Investors Service, “approximately \$102 billion of stranded costs are expected to be taken care of . . . via regulatory and legislative processes.” Moody’s Investors Service, *Special Comment, Smoke, Mirrors & Stranded Costs: How Stranded Cost Estimates Went from North of \$130 Billion Dollars to \$10 Billion*, at 1 (Oct. 1999); see also Robert J. Michaels, *Stranded Investment Surcharges: Inequitable and Inefficient*, *Pub. Util. Fort.*, May 15, 1995, at 21 (addressing policy problems with stranded cost surcharges).

⁵ Louis T. Wells, Jr., defines political and regulatory risks as threats to the profitability of a project that derive primarily from governmental action, rather than from market conditions, such as economic factors. See, e.g., Louis T. Wells, Jr., *God and Fair Competition: Does the Foreign Investor Face Still Other Risks in Emerging Markets?*, in *Managing International Political Risk* (Theodore H. Moran ed., 1998);

may undermine investor confidence, at great cost to those countries' economies.⁶ Also, like investors in the United States utility industry, direct foreign investors in infrastructure projects in developing countries are increasingly seeking recovery of their realized and anticipated losses in domestic and international legal tribunals.⁷

In both instances—the United States stranded cost problem and the development of standards to protect direct foreign investment in developing countries—the claims for protection are novel, since traditional legal regimes do not adequately provide for the type of remedy sought. Thus, courts are in need of standards to assist them in determining when a change in regulation warrants recovery for investors. How courts fashion these standards and remedies is of great consequence. For most countries the private infrastructure

Louis T. Wells & E.S. Gleason, *Is Foreign Infrastructure Investment Still Risky?*, *Harv. Bus. Rev.*, Sept.-Oct. 1995, at 44. Similarly, Sidak and Spulber isolate the stranded cost issue as an “endogenous” change in governmental policy, separating it from “exogenous” shocks due to changes in technology or economic conditions. Sidak & Spulber, *Regulatory Contract*, *supra* note 2, at 437.

⁶ See Witold J. Henisz & Bennet A. Zelner, *Political Risk and Infrastructure Investment* (Aug. 1999) (paper presented at Private Infrastructure for Development: Confronting Political and Regulatory Risks, international conference sponsored by the World Bank Group and the Government of Italy, Sept. 8–10, 1999, Rome, Italy [hereinafter *Private Infrastructure for Development*]) (presenting evidence that reduced risks will increase investment levels, but risks are highly correlated with micro-level institutional reforms, such as overlapping veto points, an independent judiciary, and independent regulatory agencies), available at <http://www.worldbank.org/html/fpd/risk/papers/henisz.pdf>; Mirjam Schniffer & Beatrice Weder, *Catastrophic Political Risk Versus Creeping Expropriation: What Determines Private Infrastructure Investment in Less Developed Countries?* (Aug. 1999) (draft paper, Department of Economics, University of Basel, on file with the Virginia Law Review Association) (finding that the most robust indicators of private infrastructure investment are low political and electoral uncertainties, low expectations of expropriation, and a high level of political rights).

⁷ Examples include Pakistan's renegotiation of contracts with power generators, Enron's Dabhol power agreement in India, and the fall of Suharto in Indonesia. See Part III, *infra*. With the growth of international investment, the number of disputes is proliferating across the world. For example, in Argentina the French Vivendi are pitted against the Tucuman provincial government over a water project, Houston Industries Energy is in a dispute with provincial regulators in Santiago del Estero, and international operators of the main Buenos Aires Port have charged that the government has given unfair advantages to a rival port. See Andreas Mandel-Campbell, *Trade Disputes Sour Argentine Privatisation*, *Fin. Times* (U.S. ed.), June 12, 1998, at 7; *Argentina's Model Port Sell-Off Beginning to Lose Its Lustre*, *Fin. Times* (London ed.), Mar. 3, 1998, at 8.

sector is central to broader public policy goals, including health, education, and welfare policy.⁸ A failure by courts to fashion the appropriate balance between flexibility and compensation could have serious implications for current and future investment as well as for government policy.

Any commercial enterprise is subject to changes in the state's tax and regulatory laws, but these risks loom especially large for infrastructure industries. Infrastructure projects involve considerable risk for private investors because of the high levels of fixed capital and the long payback periods. Because infrastructure industries supply basic services, government is likely to remain involved in the industry in spite of a commitment to privatization and the entry of private suppliers. Thus, investors face not just ordinary commercial risk, but also risks that flow from the actions of the state itself.

Some see the relationship between the state and regulated firms as essentially contractual—describing it as a “regulatory contract” that imposes quite specific duties on the state, in a manner identical to a contract between private parties.⁹ In reality, the situation is usually closer to the “relational contracts” described by Oliver Williamson¹⁰ where many of the terms are poorly specified because of the complexity of the underlying environment and the long-term nature of the relationship.¹¹ In a competitive contracting environment, the risks would be divided between state and firm in a way that reflects their relative abilities to diversify and control the level of risk.¹² Diversified private businesses may be the most efficient risk-bearers in many cases because they are able to spread risk

⁸ See, e.g., OECD, *Universal Service Obligations in a Competitive Telecommunications Environment* (1995).

⁹ See Sidak & Spulber, *Regulatory Contract*, *supra* note 2, at 101 (“State public utility regulation of electric power generation, transmission, and distribution and of local telephony represents a contract between the state and the regulated company. The economic functions of the regulatory contract, as well as the legal duties and remedies associated with it, are identical to those of a contract between private parties.”).

¹⁰ Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J.L. & Econ.* 233, 238 (1979); Oliver E. Williamson, *The Mechanisms of Governance* 54–87 (1996) (discussing the relational contract framework).

¹¹ See Victor P. Goldberg, *Regulation and Administered Contracts*, 7 *Bell J. Econ.* 426, 444 (1976).

¹² See Timothy J. Brennan & James Boyd, *Stranded Costs, Takings, and the Law and Economics of Implicit Contracts*, 11 *J. Reg. Econ.* 41, 48 (1997).

among their investors and over their various enterprises.¹³ In contrast, the state is likely to be best able to limit the risks that arise from its own actions. Efficient contracts are difficult to write because the entity best able to diversify is not always the same as the one best able to limit the level of risk.¹⁴

This Article focuses on the protections for infrastructure investors provided by the United States Constitution's Takings Clause and on the wisdom of incorporating such protections into the constitutions of other nation states. The Takings Clause is an example of a state-established background norm that limits the government's ability to undermine the profitability of private property. In the United States, this norm is an implicit term in every contract and provides a kind of guarantee against certain types of state actions. The state is required to pay compensation when it "takes" property for public use.

There is little dispute that the Takings Clause applies to outright government seizure or expropriation of physical property. But the allocation of the costs imposed by government regulatory or deregulatory activity is the subject of much heated debate. In the extreme, some argue that any action by government that negatively affects private property rights should count as a taking. Others exclude regulatory actions from the reach of the Takings Clause

¹³ Along these lines, a recent study finds that "creeping expropriation"—in the form of regulatory corruption, arbitrary changes in general rules, and general uncertainty—is less important than political risk for infrastructure investors. The credibility of the rulemaking process, however, does matter. See Schiffer & Weder, *supra* note 6.

¹⁴ Infrastructure firms have a number of contractual methods of responding to the risks emanating from state action. These range from project finance to joint ventures to special tax breaks and subsidies provided by host governments. International and national bodies provide guarantees and insurance, and contracts are written so that disputes are resolved in international fora using the law of developed countries. See, e.g., Gerald T. West, *Political Risk Investment Insurance: A Renaissance*, *J. Project Fin.*, Summer 1999, at 27; Nina Bubnova, *Guarantees and Insurance for Reallocating and Mitigating Political and Regulatory Risks in Infrastructure Investment: Market Analysis 2–3* (Aug. 1999) (paper presented at Private Infrastructure for Development, *supra* note 6), available at <http://www.worldbank.org/html/fpd/risk/papers/bubnova.pdf>; Louis T. Wells, *Private Foreign Investment in Infrastructure: Managing Noncommercial Risk 12–14* (Aug. 1999) (paper presented at Private Infrastructure for Development, *supra* note 6), available at <http://www.worldbank.org/html/fpd/risk/papers/wells.pdf>. We do not deal with these techniques here except to note that individualized contracts can either complement or undermine the constitutional provisions we discuss.

except in rare cases, such as when the state completely destroys the owner's use of his or her property. The actual state of American law cannot be reduced to a set of principles consistent with law and economics analysis. In the land use takings context, courts have done a poor job of articulating principled decisions. As United States courts evaluate the novel "deregulatory takings" claims, they should avoid taking a turn toward the ad hoc approach that characterizes much takings jurisprudence. Similarly, developing countries should carefully approach the issue of constitutional protections for direct foreign investment, applying a principled approach in balancing the protection of investors against the need for policy flexibility.

The approach we recommend distinguishes between government as purchaser and government as policymaker—a clear presumption in favor of compensation should govern in the former case, and a presumption against compensation should apply in the latter. We argue that this distinction is appropriate both under the United States Constitution and in emerging economies that wish to incorporate a property clause into their constitutions. The details of the doctrine might vary across regimes, but the basic principle seems a useful way to frame the debate.

Part I will briefly summarize United States takings jurisprudence with a focus on infrastructure industries. Land use takings cases decided by the Supreme Court over the past several decades—particularly landmark decisions in 1987, 1992, and 1994—leave the disposition of many regulatory takings cases subject to a highly unprincipled approach. By contrast, since the New Deal, utility regulation cases have been decided under a separate set of precedents that are predictable in both their reasoning and outcome. As Part II will argue, awarding compensation for the stranded costs of utilities undermines the precedential value of decisions addressing takings in utility regulation. We challenge the view that utility takings cases, especially in a deregulated environment, should be treated the same as land use takings cases. Part III will demonstrate the structural and economic similarities between United States takings law and the protection of infrastructure projects in developing countries. As in the United States, public utility firms and investors in developing countries are turning to courts to pro-

vide the stability that the political and regulatory regimes of the host governments often lack.

In Part IV, we will present a principled understanding of takings jurisprudence in the infrastructure context. Because the commercial and political-economic issues have a global reach, our framework is designed to assist United States courts as well as judges and constitutional reformers in developing countries that are trying to establish a credible legal framework for capital investment. For both deregulatory takings and direct foreign investment, courts need to be wary of the ad hoc approach that has characterized United States land use takings jurisprudence. Commentators addressing deregulatory takings focus almost exclusively on the efficiency of the government's regulatory decisions. A more complete analysis of the problem disentangles cases where the government is a purchaser of property from cases where it is a policymaker. We will seek to defend our claim that the government should be constitutionally required to pay compensation when it plays the role of buyer and be required to pay only limited compensation when its actions can be characterized as policymaking. Our conclusions and recommendations seek to strike a realistic balance between requiring investors to take account of government activities in planning their own actions and requiring the government to pay for the inputs it uses.

I. UNITED STATES TAKINGS LAW AND INFRASTRUCTURE INDUSTRIES

The Takings Clause of the United States Constitution requires government to pay compensation under certain conditions and thus limits the government's ability to impose costs on property owners. Central to the analysis are the complex questions of what firms can be said to have contracted for and what obligations the state should accept if it seeks to further investment without sacrificing political legitimacy. The key legal and policy issue is how to draw the line between the preservation of "investment-backed expectations"¹⁵ and the preservation of government flexibility. An

¹⁵The phrase originated with Frank I. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 Harv. L. Rev. 1165, 1213 (1967).

economic analysis of takings law does not imply that everyone harmed by government actions should be compensated. Such a conclusion would only result from a strong normative commitment not to efficiency, but to the status-quo distribution of property rights.

A. Takings Law and Land Use

The Fifth Amendment to the United States Constitution provides that private property shall not be taken for public use without just compensation.¹⁶ According to Justice Hugo Black, the “Fifth Amendment’s guarantee . . . [i]s designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.”¹⁷ In implementing this design, the Supreme Court has required compensation when tangible things are taken directly by the government, but has often refused compensation where the owner merely suffers a diminution in the value of his property. Easy cases, which require compensation, occur when the government physically invades a farmer’s land by building a highway through his cornfield or condemns a private individual’s house site for use as a public swimming pool. Hard cases, which do not usually generate compensation, arise when a superhighway keeps a gas station intact but provides no exit ramp nearby or constructs a noisy sports stadium next to an apartment complex.¹⁸ Once a “taking” is found, the level of compensation is to be set at “fair market value,” but if the owner disputes the state’s judgment on this matter, it is a court, not the market, that sets the price.¹⁹

¹⁶ U.S. Const. amend. V (“[N]or shall private property be taken for public use, without just compensation.”). Through the Fourteenth Amendment, the clause applies to state governments as well as the federal government. See *Dolan v. City of Tigard*, 512 U.S. 374, 383–84 n.5 (1994) (citing *Chicago B & Q R.R. v. City of Chicago*, 166 U.S. 226, 239 (1897) (extending the Takings Clause to the states)).

¹⁷ *Armstrong v. United States*, 364 U.S. 40, 49 (1960).

¹⁸ See Bruce A. Ackerman, *Private Property and the Constitution* 113–67 (1977) (presenting and critiquing this view); Andrea Peterson, *The Takings Clause: In Search of Underlying Principles Part I—A Critique of Current Takings Clause Doctrine*, 77 Cal. L. Rev. 1299, 1305–41 (1989) (arguing that the Supreme Court has been neither clear nor consistent in its analysis of the Takings Clause).

¹⁹ See *United States v. Miller*, 317 U.S. 369, 374–76 (1943). Some states depart from this approach, allowing property owners to recover a portion of the gain in value at-

Compensation is denied when the complainant cannot legitimately claim to be entitled to the benefits that are lost when the government acts.²⁰ For example, American courts have found that individuals do not have the right to create a nuisance under common law and cannot claim compensation for laws that limit nuisances.²¹ In practice, United States courts have not limited themselves to common law nuisances but take a broader view of the behavior that can be regulated without impinging on property rights.²² Compensation questions are resolved without giving a canonical status to the private law.

tributable to a public project. See, e.g., *Department of Transp. v. Nalven*, 455 So. 2d 301 (Fla. 1984); *Callhoun v. State Highway Dep't*, 153 S.E.2d 418 (Ga. 1967).

²⁰ In upholding a fee charged to Sperry Corporation for use of the Iran-United States Claims Tribunal, the Supreme Court found that "Sperry has not identified any of its property that was taken without just compensation." *United States v. Sperry Corp.*, 493 U.S. 52, 59 (1989).

²¹ As the Supreme Court has stated, "[A]ll property in this country is held under the implied obligation that the owner's use of it shall not be injurious to the community." *Mugler v. Kansas*, 123 U.S. 623, 665 (1887) (quoted by Justice John Paul Stevens in his opinion in *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 488-89 (1987), and in his dissent in *First English Evangelical Church v. County of L.A.*, 482 U.S. 304, 326 (1987) (Stevens, J., dissenting)).

²² See Joseph Sax, *Takings and the Police Power*, 74 *Yale L.J.* 36, 48-50 (1964). In *Kansas* a constitutional amendment prohibited the manufacture and sale of intoxicating liquors and thus made brewery property valueless. The Supreme Court denied a firm's claim for compensation in broad language:

The power which the States have of prohibiting such use by individuals of their property as will be prejudicial to the health, the morals, or the safety of the public is not—and, consistently with the existence and safety of organized society, cannot be—burdened with the condition that the State must compensate such individual owners for pecuniary losses they may sustain, by reason of their not being permitted, by a noxious use of their property, to inflict injury upon the community.

Mugler, 123 U.S. at 669. Some Justices accept the broad reading of state power implied by this quotation while others would read the nuisance exception quite narrowly to accord more closely with common-law doctrine. For example, Justice Stevens quoted this passage in two recent cases, while then-Justice William H. Rehnquist argued that "[t]he nuisance exception to the taking guarantee is not coterminous with the police power itself." *Penn Cent. Transp. Co. v. New York*, 438 U.S. 104, 145 (1978) (Rehnquist, J., dissenting). It is instead a "narrow exception allowing the government to prevent 'a misuse or illegal use.'" *Keystone*, 480 U.S. at 512 (Rehnquist, C.J., dissenting) (quoting *Curtin v. Benson*, 222 U.S. 78, 86 (1911)). A similar contrast in views is evident in *Nollan v. California Coastal Commission*, 483 U.S. 825 (1987). Justice Antonin Scalia argued that the state had taken an "essential stick[] in the bundle of rights," *id.* at 831 (Scalia, J.), while Justice William J. Brennan found that the owners had no legitimate claim. See *id.* at 856-57 (Brennan, J., dissenting).

The Supreme Court has had several opportunities to address the regulatory takings issue in the land use context in recent years, but its jurisprudential position is far from clear. Some commentators purport to find a pattern.²³ However, the cases do not appear to represent orderly doctrinal development.²⁴ Since the Court's 1978 decision in *Penn Central Transportation Co. v. City of New York*,²⁵ the Court has approached regulatory takings as "essentially ad hoc, factual inquiries."²⁶ In deciding whether a regulatory taking has occurred, the Court has focused on balancing three factors: the "character of the governmental action," the extent to which the action interferes with "distinct investment backed expectations," and the degree of diminution in value.²⁷

In the nineties the Court continued the trend of ad hoc balancing in the broad range of regulatory takings cases.²⁸ In 1992, the

²³ See, e.g., Frank Michelman, Takings, 1987, 88 Colum. L. Rev. 1600 (1988).

²⁴ See Susan Rose-Ackerman, Against Ad Hocery: A Comment on Michelman, 88 Colum. L. Rev. 1697 (1988) [hereinafter Rose-Ackerman, Against Ad Hocery]; Susan Rose-Ackerman, Regulatory Takings: Policy Analysis and Democratic Principles, in Taking Property and Just Compensation: Law and Economic Perspectives of the Takings Issue (Nicholas Mercurio ed., 1992) [hereinafter, Rose-Ackerman, Regulatory Takings]. Rose-Ackerman argues that there is no consistent theory behind the cases decided in the 1987 and 1988 terms: *Nollan*, *First English*, *Keystone*, and *Hodel v. Irving*, 481 U.S. 704 (1987). *Pennell v. City of San Jose*, 485 U.S. 1 (1988) was decided the next year. The takings cases decided in the 1990 term did not clarify Supreme Court jurisprudence on the regulatory takings issue. The first case, *Preseault v. ICC*, 494 U.S. 1 (1990), dealing with the status of private landholders' claims when a rail bed is used as a hiking trail, was judged not ripe for decision. The plaintiffs were required first to pursue their suit in the Court of Claims. A concurrence by three Justices, including Sandra Day O'Connor and Scalia, who both dissented in *Pennell*, argued that in determining whether a taking has occurred state law should determine the character of the property entitlement. See *id.* at 20-24 (O'Connor, J., concurring). The second case, *Sperry*, concerned a fee charged by the government for use of the Iran-United States Claims Tribunal that was judged a user fee, not a taking. See *Sperry*, 493 U.S. at 59. In 1992 the Supreme Court held in *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003 (1992), that "when the owner of real property has been called upon to sacrifice all economically beneficial uses in the name of the common good, that is, to leave his property economically idle, he has suffered a taking." *Id.* at 1019. As is discussed *infra*, however, the *Lucas* test does not address the issue of partial takings, which is often the case in the regulatory takings context, and still requires significant ad hoc adjudication regarding the nature of the nuisance exception.

²⁵ 438 U.S. 104 (1978).

²⁶ *Id.* at 124.

²⁷ *Id.*

²⁸ For a fuller treatment of this issue that reaches the same conclusion based on earlier cases, see Peterson, *supra* note 18, at 1304 ("[I]t is difficult to imagine a body of

Supreme Court attempted to bring formalism and predictability to its takings jurisprudence with its decision in *Lucas v. South Carolina Coastal Council*.²⁹ *Lucas* holds that there is a presumption that regulatory action that totally eliminates the economic value of private property is a taking.³⁰ Although representing a victory for the property owner, the decision does not articulate a per se rule for partial regulatory takings cases and leaves a broad gray area where courts must struggle to adjudicate.³¹ Even in total deprivation cases, the *Lucas* majority left open two broad categories of exceptions: uses of private property that contravene “existing rules or understandings,” as defined in state law,³² and the “nuisance exception,” allowing for deference to government action intended to address key public health, safety, and welfare concerns.³³ Inquiries

case law in greater doctrinal and conceptual disarray.”); see also Richard A. Epstein, Takings, Exclusivity and Speech: The Legacy of *PruneYard v. Robins*, 64 U. Chi. L. Rev. 21, 21 (1997) (“The law of takings, with its ever expanding subject matter, is a sprawling affair with little intellectual coherence.”). In a later article, however, Peterson argues that “takings decisions can best be explained by saying that a compensable taking occurs whenever the government intentionally forces A to give up her property, unless the government is seeking to prevent or punish wrongdoing by A.” Andrea L. Peterson, The Takings Clause: In Search of Underlying Principles. Part II—Takings as Intentional Deprivations of Property Without Moral Justification, 78 Cal. L. Rev. 53, 59 (1990). She argues that the federal courts define wrongdoing by looking to “societal judgments.” *Id.* at 86. The courts themselves have failed to supply a consistent rationale for their decisions, but she is able to infer one from an evaluation of the outcomes. Peterson’s analysis is purely positive. Even if she is correct as a descriptive matter, however, we would still argue for the reformed approach outlined in this Article.

²⁹ 505 U.S. 1003 (1992). For criticism of *Lucas*, see William W. Fisher, III, The Trouble With *Lucas*, 45 Stan. L. Rev. 1393 (1993); Eric T. Freyfogle, The Owning and Taking of Sensitive Lands, 43 UCLA L. Rev. 77, 118–27 (1995); John A. Humbach, Evolving Thresholds of Nuisance and the Takings Clause, 18 Colum. J. Envtl. L. 1 (1993).

³⁰ Justice Scafia, writing for the majority, articulated that “confiscatory regulations” require compensation unless the governmental limitation somehow inhered in the title to land itself, “in the restrictions that background principles of the State’s law of property and nuisance already place upon land ownership.” *Lucas*, 505 U.S. at 1029.

³¹ Here, the ad hoc balancing approach of *Penn Central* continues to apply. See David L. Callies, Regulatory Takings and the Supreme Court: How Perspectives on Property Rights Have Changed from *Penn Central* to *Dolan* and What State and Federal Courts Are Doing About It, 28 Stetson L. Rev. 523, 575 (1999).

³² *Lucas*, 505 U.S. at 1027–28, 1030.

³³ See *id.* at 1027. Although the Court recognized the intersection of nuisance law and takings jurisprudence over a century ago, in *Mugler v. Kansas*, 123 U.S. 623 (1887), “the *Lucas* majority transformed the nuisance exception into a true, categorical exception to the Takings Clause.” Scott R. Ferguson, The Evolution of the

regarding “existing rules and understandings,” as well as the definition of “nuisance,”³⁴ create substantial uncertainty for lower courts, which need to define the scope of these exceptions on a case-by-case basis.³⁵

In 1994, the Court handed down its decision in *Dolan v. City of Tigard*,³⁶ another substantial victory for the owner. *Dolan* continues and expands upon the Court’s application of a due process test that would invalidate land use regulations “not substantially advanc[ing] legitimate state interests.”³⁷ Although an earlier case had required an “essential nexus” between the dedication of property and a legitimate state interest,³⁸ *Dolan* demands only “rough proportionality” between the dedication and the impacts of the proposed development.³⁹ Taken together, *Lucas* and *Dolan* might be seen as the Court responding to prior requests for “a good dose of formalization,”⁴⁰ but the application of the cases is narrow and both cases leave substantial issues to be adjudicated. Thus, it is questionable whether the post-1987 cases have changed much in the Court’s ad hoc approach; at best, they stand for a symbolic formalism of limited applicability.⁴¹

“Nuisance Exception” to the Just Compensation Clause: From Myth to Reality, 45 *Hastings L.J.* 1539, 1553 (1994).

³⁴ In his majority opinion for the Court, Justice Scalia noted that relevant factors in assessing a nuisance include

the degree of harm to public lands and resources, or adjacent private property, posed by the claimant’s proposed activities, the social value of the claimant’s activities and their suitability to the locality in question, and the relative ease with which the alleged harm can be avoided through measures taken by the claimant and the government (or adjacent private landowners) alike

Lucas, 505 U.S. at 1030–31. Such nuisances must be recognized under preexisting state law, see *id.* at 1029, and the application of nuisance principles must be “objectively reasonable.” *Id.* at 1032 n.18.

³⁵ See Robert Meltz et al., *The Takings Issue: Constitutional Limits on Land-Use Control and Environmental Regulation* 189 (1999); Humbach, *supra* note 29, at 12–13.

³⁶ 512 U.S. 374 (1994).

³⁷ *Agins v. City of Tiburon*, 447 U.S. 255, 260 (1980).

³⁸ *Nollan v. California Coastal Comm’n*, 483 U.S. 825, 837 (1987).

³⁹ As Justice Rehnquist stated, the *Dolan* test goes beyond the nexus required by *Nollan*, focusing on “whether the degree of the exactions demanded . . . bears the required relationship to the projected impact” from the proposed development. *Dolan*, 512 U.S. at 388.

⁴⁰ *Rose-Ackerman, Against Ad Hocery*, *supra* note 24, at 1700.

⁴¹ See Gregory S. Alexander, *Ten Years of Takings*, 46 *J. Legal Educ.* 586, 594 (1996).

By inviting additional takings claims,⁴² the recent cases will ensure that the ad hoc approach continues. In fact, the approach of lower appellate courts continues to be ad hoc. Consider, for example, how lower courts are adjudicating the issue of the “relevant parcel”—the relevant increment of property for purposes of analysis under the Takings Clause. If, for example, a developer owns nine acres of land, divided into three equal but neighboring (separately purchased) parcels, and the development potential of one acre confined to a single three-acre parcel is destroyed due to government classification as a wetland, it is uncertain what the relevant parcel is. A court must assess whether the relevant parcel for takings analysis is the one acre of wetlands, the three-acre parcel containing the wetland, or the entire nine acres. In *Florida Rock Industries v. United States*,⁴³ the Federal Circuit reversed and remanded a lower court’s finding of a taking, suggesting that the relevant property interests be construed to limit takings claims, including government actions that destroy part of the land’s value to the claimant.⁴⁴ The Federal Circuit has consistently embraced an ad hoc, fact-based inquiry into the relevant parcel.⁴⁵

The Supreme Court seems to be inordinately proud of the ad hoc nature of its takings opinions and has reiterated its support of case-by-case balancing in recent opinions. For example, Chief Justice William H. Rehnquist argues that “questions arising under the Just Compensation Clause rest on ad hoc factual inquiries, and must be decided on the facts and circumstances in each case.”⁴⁶

⁴² In *Dolan* the Court stated, “We see no reason why the Takings Clause of the Fifth Amendment, as much a part of the Bill of Rights as the First Amendment or Fourth Amendment, should be relegated to the status of a poor relation” *Dolan*, 512 U.S. at 392.

⁴³ 18 F.3d 1560 (Fed. Cir. 1994), cert. denied, 513 U.S. 1109 (1995).

⁴⁴ See *id.* at 1572.

⁴⁵ See, e.g., *Loveladies Harbor, Inc. v. United States*, 28 F.3d 1171, 1181 (Fed. Cir. 1994), cert. denied, 120 S. Ct. 1554 (2000); *Tabb Lakes, Ltd. v. United States*, 10 F.3d 796 (Fed. Cir. 1993). A test using fact-specific criteria for determining the relevant parcel was articulated by the U.S. Claims Court in *Ciampitti v. United States*, 22 Cl. Ct. 310, 318 (1991).

⁴⁶ *Keystone Bituminous Coal Ass’n v. DeBenedictis*, 480 U.S. 470, 508 (1987) (Rehnquist, J., dissenting). Similar language is found in Justice Brennan’s majority opinion in *Andrus v. Allard*, 444 U.S. 51, 65 (1979) (“There is no abstract or fixed point at which judicial intervention under the Takings Clause becomes appropriate. Formulas and factors have been developed in a variety of settings. Resolution of each

One of the only exceptions occurs in a partial dissent by Justice Antonin Scalia, attempting to articulate a theory of takings law.⁴⁷

The Supreme Court's glorification of ad hoc balancing is impossible to reconcile with its interest in preserving investment-backed expectations,⁴⁸ especially when the investments are long lived and special purpose. To preserve investment-backed expectations, takings law should be predictable so that private individuals can confidently commit resources to capital projects. Predictability does not, of course, require compensation in all cases. It only requires that investors be able to predict what might or might not happen. As many economically oriented writers have argued, no taking can legitimately be claimed if the property owner anticipated that an uncompensated state action was possible and if this belief affected the price paid for the asset. Property values "are enjoyed under an implied limitation and must yield to the police power," according to Justice Oliver Wendell Holmes.⁴⁹ No government could or should indemnify investors against all of the hazards of business life.⁵⁰

case, however, ultimately calls as much for the exercise of judgment as for the application of logic.") (citations omitted).

⁴⁷ See *Pennell v. City of San Jose*, 485 U.S. 1, 16 (1988) (Scalia, J., concurring in part and dissenting in part).

⁴⁸ Frank Michelman's view that Takings Claims should preserve "investment-backed expectations," see Michelman, *supra* note 15, is supported by *Penn Central*, where the Supreme Court endorsed "interfere[nce] with distinct investment-backed expectations" as one factor in its ad hoc assessment of regulatory takings. *Penn Cent. Transp. Co. v. New York*, 438 U.S. 104, 124 (1978); see *supra* text accompanying note 27. In addition to *Penn Central*, Michelman's position has been picked up by the Supreme Court in *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979). See also *Keystone*, 480 U.S. at 493, 499 (considering investment-backed expectations in analysis of potential regulatory taking).

⁴⁹ *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 413 (1922).

⁵⁰ For another example, consider the German Constitution under which the right to hold property is guaranteed but "property imposes duties" and its use shall "serve the public weal." Grundgesetz art. 14(2). Property may be taken by the state but only for a public purpose and only if compensation is paid. See Grundgesetz arts. 14, 19; see also David P. Currie, *The Constitution of the Federal Republic of Germany 291-99* (1994) (summarizing German takings law); Donald P. Kommers, *The Constitutional Jurisprudence of the Federal Republic of Germany 250-66* (2d ed. 1997) (discussing leading Constitutional Court Cases); A.J. van der Walt, *Constitutional Property Clauses: A Comparative Analysis 121-63* (1999) (summarizing Germany's constitutional property clause). Compensation is required to avoid imposing undue sacrifices on individuals for the sake of the common good. See BVerfGE 24, 367 (1968), *in* Kommers, *supra*, at 250-52; see also van der Walt, *supra*, at 130-31 (comparing the German approach for determining when compensation is required with the Austrian

The problem of judicially created uncertainty is exacerbated by the ex post nature of court decisions. Federal judges are reluctant to decide cases until someone has “actually” been harmed. Not only are judges reluctant to articulate general principles of takings law, but they are also unwilling to make general rulings on the status of state actions under individual statutes.⁵¹ In the field of regulatory takings, where the future direction of the law is unclear, economic actors cannot obtain a prospective ruling from the court on whether a particular law will effect a taking. They must wait until a concrete harm has occurred before the statute can be tested. In the face of this uncertainty, investors may forgo otherwise profitable activities, and thus, the current state of the law may produce an inefficiently low level of investment.⁵²

If takings jurisprudence is both ad hoc and ex post, investors may have a very difficult time knowing whether a particular state action will or will not be judged a taking. Therefore, even if the menu of possible state actions is known and probabilities can be as-

and Swiss approaches to this issue). However, because of the social obligations of property ownership, the state can impose some limitations on the use of property without having to pay compensation. Property owners do not have a right to create a public nuisance, but the noncompensable restrictions go beyond the prevention of harm to others. A range of regulatory restrictions has been found not to raise takings claims. See Currie, *supra*, at 294–96. Older understandings of property rights can be modified by law so long as owners had time to adjust to the new state of affairs. See BVerfGE 58, 300 (1981), *in* Kommers, *supra*, at 257–61; see also Van der Walt, *supra*, at 142 (discussing this case).

⁵¹ Thus, in *Keystone*, Justice Stevens dismissed Justice Holmes’s analysis in *Pennsylvania Coal* of the general validity of the act as an “advisory opinion.” *Keystone*, 480 U.S. at 484. Justice Stevens then went on to argue that no taking had occurred under the similar Pennsylvania law at issue in *Keystone* because at the time of the lawsuit no company could actually demonstrate that it had been harmed. See *id.* at 495–96. The companies were asking the Court to pass on the general legitimacy of the statute, which the majority declined to do. Justice Rehnquist, in dissent, was willing to do this. He argued that in *Pennsylvania Coal* the general validity of the act “was properly drawn into question.” *Id.* at 507 (Rehnquist, C.J., dissenting). Similarly, in *Pennell*, an association of landlords was given standing to challenge a portion of San Jose’s rent control ordinance, but their claim that a taking had occurred was dismissed as “premature” because no landlord had actually suffered harm from the disputed provision. *Pennell v. City of San Jose*, 485 U.S. 1, 5–11 (1988). The partial dissent, in contrast, would have reached the merits of the takings claim. See *id.* at 16–19 (Scalia, J., concurring in part and dissenting in part).

⁵² In contrast, the constitutional systems in some other countries permit constitutional courts to rule on the content of controversial doctrines in “abstract norm control” actions that do not require one to wait for the presentation of a concrete case. On the German system, see Kommers, *supra* note 50, at 13–14.

signed to each policy, investors will not be able to make informed choices because the Court has not given them clear standards to determine when compensation will be paid. The shifting doctrines of takings law introduce an element of uncertainty into investors' choices that has nothing to do with the underlying economics of the situation. This uncertainty creates two problems. First, investors do not know whether damages will be paid. Second, in the event damages are not paid, investors may be left bearing the costs of an uninsurable risk. The investment-backed expectations discussed in the American cases are themselves affected by the nature of takings law. To the extent that investors are risk averse, the very incoherence of the doctrine produces inefficient choices.

Investors are not the only ones adversely affected by the incoherence and unpredictability of takings law. Government officials may be affected as well since the vagueness of the doctrine may act as a force for conservatism among public officials. Risk-averse officials facing the possibility of compensation suits against their jurisdictions may restrict their activities simply because they dislike uncertainty. As Justice John Paul Stevens notes:

It is no answer to say that “[a]fter all, if a policeman must know the Constitution, then why not a planner?” To begin with, the Court has repeatedly recognized that it itself cannot establish any objective rules to assess when a regulation becomes a taking. How then can it demand that land planners do any better?⁵³

In short, the ad hoc nature of the Court's opinions is itself troubling and is impossible to reconcile with a belief in the importance of preserving investors' expectations, especially for infrastructure investments that are long lived and special purpose. To the extent that investors are risk averse, the very incoherence of judicial doctrine produces inefficient choices. American courts are interpreting a constitutional provision, justified as a way to reduce risks for investors, in a way that increases uncertainty. This is hardly a model for governments in emerging markets that are searching for a legal template.

⁵³ *First English Evangelical Lutheran Church v. County of L.A.*, 482 U.S. 304, 341 n. 17 (Stevens, J., dissenting) (citations omitted).

B. Regulatory Takings in Infrastructure Industries

In infrastructure industries, compensation obviously would be required under the United States Constitution if the government expropriated the assets of a private power company or a port facility to use as a nationalized facility. Of course, nationalizations seldom occur in the United States, but requiring compensation in such cases is an easy application of existing law. Similarly, if a government sought to attract investment by offering cleared parcels of privately-owned land to investors, it would have to compensate those whose property was destroyed in the process.

In contrast, construction of a state-owned facility that competes with a private firm would be unlikely to trigger the Takings Clause.⁵⁴ The electric power projects constructed by the government-owned Tennessee Valley Authority (“TVA”) are a case in point. Many private utilities (as well as coal and ice companies) challenged TVA on the ground that government-produced electricity would cause irreparable economic harm to them. Constitutional challenges against TVA were mounted, but the appellate courts rejected these challenges. Although not expressly framed as takings cases, a trial court hearing a series of challenges by nineteen utilities took the position that the utilities were threatened with future economic harm; however, the court also noted that the injury would be *damnum absque injuria* unless TVA itself were unlawful.⁵⁵

⁵⁴ Government competition is not as uncommon in the United States as it may seem: Many local governments provide utility services, such as electricity and cable television, to their citizens. Municipal territory expansion or outright municipalization may lead government to compete with private firms in the provision of services.

⁵⁵ The court reasoned,

Since the United States has acquired these dam sites and constructed these dams legally, the water power, the right to convert it into electric energy, and the energy produced constitute property belonging to the United States. This electric energy may be rightfully disposed of. . . . While the Government, in selling property of the United States, performs many functions that would be performed in the operation of a private business trading in similar property, inasmuch as the energy sold is created at dams lawfully erected within the Federal power, the Government in performing these functions is not entering into private business. It is merely using an appropriate method of disposing of its property. The Government may sell land belonging to the United States in competition with a real estate agency, carry parcels in competition with express companies, and manage and control its thousands of square miles of national

In considering this matter on appeal, the Supreme Court reasoned,

The local franchises, while having elements of property, confer no contractual or property right to be free of competition either from individuals, other public utility corporations, or the state or municipality granting the franchise. The grantor may preclude itself by contract from initiating or permitting such competition, but no such contractual obligation is here asserted.⁵⁶

Competing private power projects were not compensated for their loss of business.

The interaction between the state and private infrastructure projects is not limited to the possibility of nationalization, which requires compensation, or state competition, which generally does not. Because infrastructure firms frequently have monopoly power in the markets where they operate, public regulation is a condition for such firms to operate at all.⁵⁷ But over time changes in regulatory policy can become more or less favorable to the regulated industry. This produces a set of takings law issues that cannot be characterized as either nationalization or state competition with private firms. If public regulation limits the value of someone's property, should the Takings Clause entitle the owner to obtain compensation? Conversely, if firms obtain windfall gains as a result of government action, should they be required to turn them over to the state?

In the case of infrastructure regulation, particularly of utilities, takings law challenges have produced a line of opinions that is largely distinct, in terms of both precedential value and reasoning, from other regulatory and land use takings cases. The courts treat

parks even as a private company. The Government has an equal right to sell hydro-electric power, lawfully created, in competition with a private utility. *Tennessee Elec. Power Co. v. TVA*, 21 F. Supp. 947, 960-61 (E.D. Tenn. 1938) (citations omitted), *aff'd*, 306 U.S. 118 (1939).

⁵⁶ *Id.* at 139 (citing *Charles River Bridge v. Warren Bridge*, 36 U.S. (11 Pet.) 420 (1837) and other cases). For discussion of the *TVA* cases, see George D. Haimbaugh, Jr., *The TVA Cases: A Quarter Century Later*, 41 *Ind. L.J.* 197 (1965); Joseph C. Swidler & Robert H. Marquis, *TVA in Court: A Study of TVA's Constitutional Litigation*, 32 *Iowa L. Rev.* 296 (1947).

⁵⁷ Property values "are enjoyed under an implied limitation and must yield to the police power," according to Justice Holmes. *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 413 (1922).

these cases separately from other takings cases because most utilities are subject to government regulation of prices. Since the New Deal, takings cases addressing utility price regulation have been much clearer—and better justified—than the ad hoc line of opinions addressing takings in the land use regulation context.

In the early days of utility regulation at the end of the nineteenth century, the Supreme Court endorsed a “fair value” test, an approach that thrust courts into the business of valuing utility rates on substantive due process grounds.⁵⁸ Much like the current line of land use cases, these early ratemaking cases, decided largely during the *Lochner* era,⁵⁹ took an ad hoc approach to adjudicating whether government-set rates were constitutional. During that era, ratemaking controversies were arguably “[t]he most significant cases in the Court’s campaign to expand the definition of property and takings.”⁶⁰ The cases of the period have been described as ad hoc and unpredictable, leading to “endless litigation” and calling into question the role of courts in reviewing economic matters.⁶¹

The Court repudiated this activist position in the 1940s, adopting instead an “end results” test. In *Federal Power Commission v. Hope Natural Gas Co.*,⁶² the Court indicated that it would focus on the result rather than the method of ratemaking. According to Justice William O. Douglas, “It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot

⁵⁸ See *Smyth v. Ames*, 169 U.S. 466, 546–47 (1898).

⁵⁹ See, e.g., Morton J. Horwitz, *The Transformation of American Law, 1870–1960*, at 160–61 (1992); Stephen A. Siegel, *Understanding the Lochner Era: Lessons from the Controversy over Railroad and Utility Rate Regulation*, 70 Va. L. Rev. 187, 216–23 (1984); see also Robert L. Hale, *Does the Ghost of Smyth v. Ames Still Walk?*, 55 Harv. L. Rev. 1116, 1120 (1942) (arguing that ascertaining value under *Smyth* calls for analysis of several enumerated factors unrelated to value).

⁶⁰ Molly S. McUsic, *The Ghost of Lochner: Modern Takings Doctrine and Its Impact on Economic Legislation*, 76 B.U. L. Rev. 605, 616 (1996).

⁶¹ Jim Chen, *The Second Coming of Smyth v. Ames*, 77 Tex. L. Rev. 1535, 1556–57 (1999); see also *Missouri ex rel. S.W. Bell Tel. Co. v. Public Serv. Comm’n*, 262 U.S. 276, 299–301 (1923) (Brandeis, J., concurring in the judgment) (noting the gradual realization that calculations rested on shifting theories); John Bauer, *The Establishment and Administration of a “Prudent Investment” Rate Base*, 53 Yale L.J. 495, 498–501 (1944) (noting that objections to the standard were premised on indefiniteness and difficulties of application and administration); cf. Gerard C. Henderson, *Railway Valuation and the Courts* (pt. 2), 33 Harv. L. Rev. 1031, 1051 (1920) (describing the fair value rule as a “juristic myth”).

⁶² 320 U.S. 591 (1944).

be said to be unjust and unreasonable, judicial inquiry . . . is at an end.”⁶³ This approach is consistent with the New Deal Court’s repudiation of *Lochner* and its generally deferential judicial review of economic regulations.⁶⁴

The Supreme Court has reaffirmed this deferential approach to reviewing utility price regulation in every case decided since 1944. In *Market Street Railway v. Railroad Commission*,⁶⁵ the Court refused to require compensation where the government did not authorize full recovery of the costs of obsolete technology.⁶⁶ Later, in the *Permian Basin Rate Cases*,⁶⁷ the Court rejected a challenge to the Federal Power Commission’s ability to set area-wide rates, reasoning that there is no constitutional obligation to determine individual rates on a cost-of-service basis.⁶⁸ The most recent rate-making case considered by the Court, *Duquesne Light Co. v. Barasch*,⁶⁹ upheld a lower court’s disallowance of non-“used and useful” nuclear assets and expressly reaffirmed *Hope*: “[T]oday we reaffirm these teachings of *Hope Natural Gas*.”⁷⁰ Although the Court frequently does review the procedures used by regulatory bodies, it continues to be reluctant to review the economic reasoning behind regulatory decisions involving public utilities.

Three rationales, which are not as prominent in the land use context, explain the Court’s deferential approach to utility rate-making takings cases. First, the ratemaking process is self correcting. Regulators may underestimate the cost of capital in one year, but through modifications in a later year, they can correct any

⁶³ *Id.* at 602.

⁶⁴ See, e.g., *Nebbia v. New York*, 291 U.S. 502, 537 (1934) (signaling a shift towards more deferential judicial review, upholding regulated prices so long as they have a “reasonable relation to a proper legislative purpose, and are neither arbitrary nor discriminatory”).

⁶⁵ 324 U.S. 548 (1945).

⁶⁶ See *id.* at 557, 564–65 (1945) (deferring to regulators’ decision not to allow recovery of San Francisco street cars and bus lines valued by regulators at less than one-third the amount at which they would have been valued using historical or reproduction costs).

⁶⁷ 390 U.S. 747 (1968).

⁶⁸ See *id.* at 769.

⁶⁹ 488 U.S. 299 (1989).

⁷⁰ *Id.* at 310.

deficiency in utility earnings and revenues by adjusting cost of capital.⁷¹ Hence, judicial review does little to increase accuracy.

Indeed, there may be significant costs to judicial review of utility ratemaking, given its complex technical nature. A second rationale for deference to regulators' decisions is that judicial review of ratemaking "impose[s] high error costs and high judicial resource costs."⁷² Courts do not have nearly the same expertise or access to complex accounting and economic information as do regulators, and are more prone to embrace a "science charade" as they review complex technical matters.⁷³ This not only creates a high cost for courts, but the uncertainty it creates may deter regulators from innovating or slow the pace of regulatory change.

Third, the political process provides adequate protections for utilities and their investors. Utility ratemaking and other regulatory processes, which tend to be transparent and well developed, provide a forum for regulators to balance the interests of investors, firms, consumers, and the state. According to Richard Pierce,

Detailed judicial review of ratemaking has little, if any, effect in constraining the political process. . . . [T]he "end result" test announced in *Hope* can be seen as a decision to allocate to the political institutions of government near total power to protect the constitutional values underlying the takings clause in the ratemaking context. This is required by the severe institutional limitations of the judiciary as a potential source of protection of those values.⁷⁴

Since legislators and regulatory officials are more politically accountable than judges, judicial interference with regulators' decisions may thwart democratic values. Courts are best left to review the quality of regulators' decisionmaking process, not the substance of their decisions.

For these reasons, we argue that in utility regulation controversies—including controversies about deregulation—courts should

⁷¹ See Charles F. Phillips, Jr., *The Regulation of Public Utilities: Theory and Practice* 196 (3d ed. 1993).

⁷² Richard J. Pierce, Jr., *Public Utility Regulatory Takings: Should the Judiciary Attempt to Police the Political Institutions?*, 77 *Geo. L.J.* 2031, 2046 (1989).

⁷³ E.g., Wendy E. Wagner, *The Science Charade in Toxic Tort Risk Regulation*, 95 *Colum. L. Rev.* 1613 (1995).

⁷⁴ Pierce, *supra* note 72, at 2046.

use the deferential approaches of cases like *Hope*, *Market Street Railway*, *Permian Basin*, and *Duquesne* as opposed to the more activist review approach of the recent land use takings cases. Justice Black's articulation of the purpose of regulatory takings—"to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole"⁷⁵—is not a central concern in utility regulation. As Richard Goldsmith argues, "Rate regulators do not allocate burdens between the 'public' on the one hand and the 'few' on the other," but balance "the cost of utility service between large classes of investors and consumers."⁷⁶ It would be particularly odd to invoke takings protections to the advantage of investors and the utility industry since here—unlike in the land use context—they have an overwhelming advantage in information, wealth, and political power and "boast a superior ability to bear risk and to mitigate damage from unforeseen contingencies—the precise economic attributes that justify the imposition of liability in virtually every other legal context."⁷⁷ In fact, given their institutional disadvantage in promoting political accountability, courts generally defer to regulators and avoid active involvement in the policing of utility rate regulation.⁷⁸

This is not to suggest that the Takings Clause is without *any* application to utility price regulation. In *Duquesne*, the Court expressly recognized that there is a constitutional limit in setting utility prices: If regulators threaten the financial integrity of a utility or provide inadequate compensation to current equity owners for the risks associated with their investments, they may effectuate a taking.⁷⁹ Although lower courts occasionally raise such concerns,⁸⁰

⁷⁵ *Armstrong v. United States*, 364 U.S. 40, 49 (1960).

⁷⁶ Richard Goldsmith, *Utility Rates and "Takings,"* 10 *Energy L.J.* 241, 255 (1989).

⁷⁷ Chen, *supra* note 61, at 1558–59.

⁷⁸ See Pierce, *supra* note 72, at 2046.

⁷⁹ See *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 312 (1989) ("No argument has been made that these slightly reduced rates jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital. Nor has it been demonstrated that these rates are inadequate to compensate current equity holders for the risk associated with their investments under a modified prudent investment scheme.").

⁸⁰ See, e.g., *Jersey Cent. Power & Light Co. v. Federal Energy Regulatory Comm'n*, 810 F.2d 1168, 1181–82 (D.C. Cir. 1987) (reversing and remanding the Federal Energy Regulatory Commission's ("FERC") disallowance of unamortized nuclear investment

the Supreme Court has not applied these limits in the utility rate setting context, and its cases over the past fifty years do not suggest any eagerness to engage in a more activist review of utility price-setting. In fact, despite *Duquesne's* anticipation that takings claims may legitimately be asserted against regulators' price-setting, some lower courts interpret the cases as allowing a significant public interest to justify the financial destruction of a regulated utility.⁸¹

However, a new issue has now arisen in the regulation of United States public utilities—widespread deregulation. As deregulation of utility industries proceeds apace, a self-correcting and relatively stable regulatory process is no longer the norm. Without such a process, stakeholders in the industry are increasingly pressing claims based on land use takings cases, threatening the certainty that has characterized this line of opinions for the past fifty years. We turn now to consider how this issue of deregulatory takings is being framed in the context of the restructuring of United States public utility markets.

II. THE STRANDED COST PROBLEM IN THE UNITED STATES

Many American infrastructure industries currently face increased competitive pressures through restructuring and deregulation. This has produced a new set of takings law claims, largely untested in United States courts. Utilities assert that deregulation has produced “stranded costs.” The definition of stranded costs is by no means settled because it is a term with both legal and political implications for utilities and governments. Indeed, the term itself has a normative loading that may hinder an objective assessment of the problem. By calling costs “stranded” those who argue for compen-

from the rate base for failure to provide an explanation); *id.* at 1188–89 (Starr, J. concurring) (arguing that a “reasoned consideration” of investor interests requires more than a mechanical application of rules but requires consideration of what expectations exist under a regulatory compact).

⁸¹ See *Gulf State Utils. Co. v. Louisiana Pub. Serv. Comm'n*, 578 So. 2d 71, 106 (La. 1991) (holding that a taking will be found only when the state “failed to consider the legitimate interests of the utility and its investors in a higher rate of return, and to weigh those interests against the competing concerns of the ratepayers”), cert. denied, 502 U.S. 1004 (1991); *Ohio Edison Co. v. Public Utils. Comm'n*, 589 N.E.2d 1292, 1300 n.8 (Ohio 1992) (boldly asserting that “the Constitution no longer provides any special protection for the utility investor”) (quoting *Dayton Power & Light Co. v. Public Utils. Comm'n*, 447 N.E.2d 733, 740 (1983), quoting Neil N. Bernstein, *Utility Rate Regulation: The Little Locomotive that Couldn't*, 1970 Wash. U. L.Q. 223, 259–60).

sation imply that the costs are “shipwrecked”—that is, investors are the victims of misadventure brought about by government action. Economically, stranded costs occur when the costs to the incumbent exceed the costs to new entrants because of the actions of the state, not because of changes in technology or other exogenous economic shocks. These costs reflect the fact that some investments cannot earn a fair rate of return in the deregulated marketplace.⁸²

Initial estimates of stranded costs in electrical utility deregulation in the United States ranged from \$34 billion to \$210 billion, according to one report.⁸³ Given these large estimates, pressures to provide the industry recovery of some, if not all, of these costs are obvious. The United States Energy Information Administration estimated that stranded costs could lead to an increase in bankruptcies in the industry if regulators did not address them.⁸⁴ Not

⁸² Sidak and Spulber define stranded costs as the “inability of utility shareholders to secure the return of, and a competitive rate of return on, their investment.” Sidak & Spulber, *Regulatory Contract*, supra note 2, at 29. Sidak and Spulber’s definition includes operating expenditures required by regulators as well as capital investments. Brennan and Boyd identify four types of stranded costs in the electric power sector:

1. Undepreciated investments in power plants that are more expensive than generators available today.
2. Long-term contracts—most if not all mandated by the 1978 Public Utility Regulatory Policies Act (PURPA)—with high-priced independent generators, mostly using renewable energy technologies.
3. Generators built but not used, primarily nuclear.
4. Expenses related to “demand-side management” (DSM) and other conservation programs that, as substitutes for new plant construction, were charged to the generation side of the business.

Brennan & Boyd, supra note 12, at 45 (footnote omitted). Other definitions focus more on capital outlays and do not necessarily include other expenses. Herbert Hovenkamp defines stranded costs as “investments in specialized, durable assets that may have seemed necessary, or at least justifiable, when constructed and placed into service under a regime of prices and entry controls but that have become underutilized or even useless under deregulation.” Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 *Yale L.J.* 801, 802–03 (1999). Jim Rossi focuses on assets that are unable to recover their remaining capital costs after deregulation. See Jim Rossi, *The Irony of Deregulatory Takings*, 77 *Tex. L. Rev.* 297, 301–02 (1998).

⁸³ These estimates represent the after-tax discounted present value of the reduced contributions to cost recovery. See Eric Hirst & Lester Baxter, *How Stranded Will Electric Utilities Be?*, *Pub. Util. Fort.*, Feb. 15, 1995, at 30–32, cited in Brennan & Boyd, supra note 12, at 45–46.

⁸⁴ See U.S. Department of Energy, Energy Information Administration, *Electricity Prices in a Competitive Environment: Marginal Cost Pricing of Generation Services*

surprisingly, utilities are making vigorous policy arguments in favor of full or near-full recovery of stranded costs. A recent study suggests that utilities have used political and regulatory processes to obtain recovery in many states. Moody's Investors Service now estimates that stranded costs will total just \$10 billion.⁸⁵ In 1995 they estimated these costs at \$130 billion.⁸⁶ According to their estimates, \$102 billion of the reduction in the total was due to regulatory and legislative relief.⁸⁷

In recent years, the argument for stranded cost recovery has moved beyond policy to take on the rhetoric of legal entitlement, invoking the Contracts Clause and the Takings Clause of the United States Constitution. Although the cases regarding the regulation of utility prices are deferential to regulators, rate regulation is not the same as the deregulation of a formerly regulated industry where a competitive market will displace the regulator in setting prices. In such contexts, "deregulatory takings" challenges asserting interference with "investment-backed expectations" may still

and Financial Status of Electric Utilities: A Preliminary Analysis Through 2015, at xvi (1997).

⁸⁵ See Moody's Investor Service, *supra* note 4, at 1.

⁸⁶ See *id.*

⁸⁷ See *id.* The study is summarized in Andrew Taylor, *Debate on U.S. Deregulation Hots Up*, *Financial Times*, Survey: World Energy (London Ed.), Dec. 8, 1999, at 1. Some states are even allowing for stranded cost recovery even though they have not implemented retail competition in electricity. Florida, for example, has adopted a wait-and-see approach to retail deregulation of the electric utility industry. See *Electric Restructuring: Before, During and After*, *Pub. Util. Fort.*, Nov. 15, 1999, at 26 (comments of Florida Public Service Commission chairman Joe Garcia). Although postponement of deregulation has kept the stranded cost issue off the public political agenda, regulators have quietly allowed utilities to accelerate depreciation and recovery of power plants. By the time Florida deregulates the industry, some utilities will have recovered the costs of their plants, so the stranded cost issue may not materialize. For example, Florida Power and Light has struck a deal with state regulators that allows it to accelerate \$100 million a year in depreciation expenses for plants over the next three years. See *Rate Deal Brightens Outlook for FPL; Utility Has Better Deal Against Competition*, *Sun-Sentinel*, Mar. 28, 1999, at 1F, available in Lexis (noting that "FPL has been able to speed up these reported reductions of its plants through a special agreement with state regulators that was set to expire at the end of the year. The idea behind this was to reduce the company's exposure to 'stranded costs,' or money spent on power plants that won't be recovered when greater competition leaves the older assets obsolete"); see also Florida P&L *Dodges a Rate Case with Deal to Cut Rates \$1 Billion Over Three Years*, *Electric Util. Wk.*, Mar. 15, 1999, at 13 ("FP&L was also directed to accelerate depreciation of its nuclear and fossil assets by \$100-million each year, which is down from the average of \$250-million a year the PSC allowed during the past four years."), available in 1999 WL 12165227.

arise. According to J. Gregory Sidak and Daniel Spulber, who advocate a legal entitlement to recovery of stranded costs in the United States:

The competitive transformation of local exchange telecommunications and the electric power industry raises significant questions about whether regulators should give a public utility the opportunity to recover its stranded costs. As regulators mandate the unbundling of basic network elements in local telephony or mandate wholesale and retail wheeling in the electricity industry, they introduce competitive rules that potentially deny incumbent utilities the opportunity to recover the cost of service. While competition presents incumbents with opportunities to serve customers in new ways, regulators often leave untouched the utility's preexisting incumbent burdens. Such regulatory action threatens to confiscate private property—shareholder value—for the promotion of competition, without just compensation.⁸⁸

Those arguing for widespread compensation claim both that the government has made an implicit (if not explicit) contract with the utilities to guarantee them a competitive rate of return on their capital and that it has induced them to invest on those terms.⁸⁹ If deregulation lowers the expected value of the firm's assets, these commentators claim that a breach of contract has occurred that violates the Contracts Clause of the Constitution and may also amount to an unconstitutional taking of property.

Implicit in this deregulatory takings argument is the suggestion that courts should turn away from the deferential review of *Hope*, *Market Street Railway*, and *Duquesne* towards the more rigorous review seen in recent land use decisions—if not a complete return to *Smyth v. Ames*.⁹⁰ Sidak and Spulber's approach gives central importance to the investment-backed expectations variable in the ad hoc *Penn Central* calculus. According to them, investment-backed expectations do "all the heavy lifting in a regulatory takings case."⁹¹ In addition, Sidak and Spulber cite in support of their argument

⁸⁸ Sidak & Spulber, *Regulatory Contract*, supra note 2, at 19.

⁸⁹ See *id.*

⁹⁰ See Chen, supra note 61, at 1536.

⁹¹ Sidak & Spulber, *Regulatory Contract*, supra note 2, at 224.

many of the Court's recent land use takings cases, including *Lucas* and *Dolan*.⁹²

Given the many doctrines implicated, the legal argument for recovery of stranded costs warrants critical examination. We begin with a critique of the claim that the Contracts Clause of the United States Constitution requires compensation. We then focus on the Takings Clause. We argue that courts should not turn away from the deferential approach to review that has characterized their takings jurisprudence in the public utility context since *Hope*. However, to the extent that courts do look to land use takings cases as an analogy in evaluating deregulatory takings, under a framework presented later in the Article, we argue that only limited compensation of stranded costs is warranted.

A. The Contracts Clause

The Contracts Clause of the United States Constitution reads: "No State shall . . . pass any . . . Law impairing the Obligation of Contracts . . ." ⁹³ Although the clause is sometimes read to apply only to private contracts, a considerable body of case law and academic commentary applies the clause in some fashion to contracts between the state and private individuals and firms.⁹⁴ Even for those who would give the clause a strong reading, the protection is not absolute. The Takings Clause permits the state to condemn property it has conveyed by contract so long as it pays just compensation.⁹⁵ Richard Epstein views both the Takings Clause and the Contracts Clause as protections against rent seeking and political intrigue. According to him, if government wants to take action, it must compensate the losers unless it can justifiably invoke the police power.⁹⁶

⁹² See *id.* at 250 (citing *Lucas's* "invigoration of regulatory takings law" in support of more rigorous judicial review of state commission interconnection pricing determinations); *id.* at 2, 219 n.14 (citing *Lucas*); *id.* at 255–56 (discussing *Dolan*).

⁹³ U.S. Const. art. I, § 10, cl. 1.

⁹⁴ See Richard Epstein, *Toward a Revitalization of the Contract Clause*, 51 U. Chi. L. Rev. 703, 718–21 (1984); Sidak & Spulber, *Regulatory Contract*, *supra* note 2, at 145, 161.

⁹⁵ See Epstein, *supra* note 94, at 719.

⁹⁶ See Richard Epstein, *Takings: Private Property and the Power of Eminent Domain* 178–81 (1985).

There are two problems with this view. First, even in Epstein's own terms, it ignores the possibility that the original contract may itself have been the result of a rent-seeking deal. Perhaps a person with powerful political connections or a willingness to bribe obtained the contract from compliant officials. "White elephant" infrastructure projects are archetypal examples of rent seeking by politicians and private investors. Epstein's "police power" exception may be designed to cover this case, but he does not develop the argument fully.

Second, Epstein takes an overly narrow view of legitimate government. He wants a broad range for compensation and complains that one important case is "far too muddy in leaving open the possibility that contracts could be impaired if the impairment were 'reasonable and necessary' to accomplish some important public purpose."⁹⁷ His skepticism of government actions leads him to be *more* protective of private parties who contract with government compared with those involved in private contracts.

We express a more nuanced view. We agree that when government has made an explicit contract with a private party, the economic arguments for treating the contract as analogous to a private contract are strong. Under the Contracts Clause, the state cannot unilaterally void a particular contract unless it pays damages analogous to those faced by private parties.⁹⁸ However, the state can take actions that affect a multitude of contractual relations without being accused of "impairing the obligations of contracts." For example, it can enact a general tax increase or can change policy so that an industry faces new regulatory costs.

The application of Epstein's view to regulated public utilities is particularly problematic. Even when there is no explicit contract, some, including Sidak and Spulber,⁹⁹ have suggested that the relationship between a utility and the state is based on an implied

⁹⁷ Epstein, *supra* note 94, at 720 n.45; see *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977) (holding that the Contract Clause prohibits the retroactive repeal of a statutory covenant made between the states of New York and New Jersey to limit the ability of the Port Authority to subsidize rail passenger transportation from revenue and reserves).

⁹⁸ The exception would be the case in which the present government argues that no valid contract exists because of corruption or obvious indicia of unconscionability.

⁹⁹ See Sidak & Spulber, *Regulatory Contract*, *supra* note 2, at 101-77.

regulatory contract. Judge Kenneth Starr wrote in a concurrence to a D.C. Circuit case:

The utility business represents a compact of sorts; a monopoly on service in a particular geographical area (coupled with state-conferred rights of eminent domain or condemnation) is granted to the utility in exchange for a regime of intensive regulation, including price regulation, quite alien to the free market. Each party to the compact gets something in the bargain. As a general rule, utility investors are provided a level of stability in earnings and value less likely to be attained in the unregulated or moderately regulated sector; in turn ratepayers are afforded universal, nondiscriminatory service and protection from monopolistic profits through political control over an economic enterprise.¹⁰⁰

Borrowing from this notion, Sidak and Spulber see failure to compensate utilities for stranded costs as analogous to a breach of contract against the industry.¹⁰¹

Notwithstanding such statements, there is little legal support for viewing the relation between private firms and the regulatory agencies as analogous to private contracts. Sidak and Spulber discuss historical situations concerning bridges and public works where *explicit* contracts existed.¹⁰² They also refer to *United States v. Winstar Corp.*,¹⁰³ a recent case in which the Supreme Court decided that the United States government could be sued for breaching contracts that the Federal Home Loan Bank Board had signed with thrifts to encourage healthy thrifts to merge with failing ones during the savings and loan crisis of the 1980s.¹⁰⁴ However, *Winstar* does not support their view. The ruling reaffirmed the unmistakability doctrine—that promises by the government to forgo certain types of future regulatory action will be enforced by courts

¹⁰⁰ *Jersey Cent. Power & Light v. Federal Energy Regulatory Comm'n*, 810 F.2d 1168, 1189 (D.C. Cir. 1989) (Starr, J. concurring) (citation omitted).

¹⁰¹ See Sidak & Spulber, *Regulatory Contract*, supra note 2, at 179 (“Given that the utility incurred its costs under the regulatory contract, the opening of the utility’s market to competition—that is, the termination of the exclusivity of the utility’s franchise—is a breach of a material term of that contract if not accompanied by an offsetting removal of incumbent burdens.”).

¹⁰² See *id.* at 140–60.

¹⁰³ 518 U.S. 839 (1996).

¹⁰⁴ See Sidak & Spulber, *Regulatory Contract*, supra note 2, at 171–77.

only if these are set forth in unmistakably unambiguous language, which a plaintiff bears the burden of proving.¹⁰⁵ Classic cases, such as *Charles River Bridge v. Warren Bridge*,¹⁰⁶ in which the Court refused to imply a protection against new competitors for a chartered bridge, advise against recovery.¹⁰⁷ In the general case of a regulated public utility, there is no explicit contract guaranteeing the firm a set rate of return on each specific investment. Instead, there is nothing but a history of statutes and regulatory orders. From these alone, it is difficult to infer *ex post* what the firm's legitimate expectations might have been.¹⁰⁸

Furthermore, even if one is convinced that the relationship should be seen as contractual, it does not follow that Epstein's view of the obligations of the state must be accepted. One could make an argument that deregulation is a policy believed to have broad social benefits and that the regulated firms should not be protected from the costs of moving to this policy. One would then read the contracts as failing to protect the firms from the costs of having to face a competitive environment. In other words, contracts with the

¹⁰⁵ *Winstar* can hardly be said to represent a judicial consensus on the issue. Although Justices Stevens, O'Connor, and Stephen Breyer joined the portion of Justice David Souter's plurality opinion that recognizes a general exception to the unmistakability doctrine for government indemnification agreements, see *id.* at 871-87 (plurality opinion), five justices rejected this exception. Justices Anthony Kennedy and Clarence Thomas joined in a concurrence by Justice Scalia, see *id.* at 919-24 (Scalia, J., concurring), and Justice Ruth Bader Ginsburg joined in Chief Justice Rehnquist's dissent (Rehnquist, J., dissenting). See *id.* at 924-31. For further discussion of *Winstar* and its implications for government contract defenses, see Gillian Hadfield, *Of Sovereignty and Contract: Damages for Breach of Contract by Government*, 8 S. Cal. Interdisc. L.J. 467, 479-88 (1999); Michael P. Malloy, *When You Wish Upon Winstar: Contract Analysis and the Future of Regulatory Action*, 42 St. Louis U. L.J. 409 (1998); Joshua I. Schwartz, *Assembling Winstar: Triumph of the Ideal of Congruence in Government Contracts Law?*, 26 Pub. Cont. L.J. 481 (1997); Thomas J. Gilliam, Jr., Note, *Contracting With the United States in its Role as Regulator: Striking a Bargain with an Equitable Sovereign or Capricious Siren?*, 18 Miss. C. L. Rev. 247 (1997).

¹⁰⁶ 36 U.S. (11 Pet.) 420 (1837).

¹⁰⁷ For discussion of the relevance of this case to the stranded cost issue, see Hovenkamp, *supra* note 82, at 808-12.

¹⁰⁸ Under United States case law, there is a presumption that general language in statutes and regulations "is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise." *National R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry. Co.*, 470 U.S. 451, 466 (1985) (quoting *Dodge v. Board of Educ.*, 302 U.S. 74, 79 (1937)).

state can be read to contain an implicit public welfare condition, including a commitment to widespread competition.

B. The Takings Claims

The takings argument might therefore seem the more plausible argument in favor of legal recovery of stranded costs. But those making the claim for deregulatory takings face several daunting obstacles.

First, as discussed above, United States takings jurisprudence has not found that regulatory actions in infrastructure industries demand compensation. Procedural guarantees and political accountability are sufficient, although those pressing for deregulatory takings also argue that this approach is in need of reform. Supporters of a legal entitlement to compensation would abandon the deferential tradition of *Hope*, *Market Street Railway*, *Permian Basin* and *Duquesne*, instead treating deregulatory takings cases as similar to land use takings. The land use cases are weak precedents, however, because unlike individual property owners, utility investors appear to be adequately protected in the political and regulatory process. It is not clear that deregulation has challenged this rationale. The Takings Clause should not be used to protect those who have had a chance to influence policy or who are in a position to anticipate future changes in policy and take them into account in their investment decisions.¹⁰⁹

Second, as we argued above, there are seldom explicit contracts guaranteeing regulated firms a certain rate of return on their assets or promising to indemnify them against future changes in policy.¹¹⁰ Thus, firms should have internalized these risks in making their in-

¹⁰⁹ A recent empirical study suggests that in another context, nuclear cost overruns, regulator disallowance of costs did not have widespread adverse reputation effects on firms' access to investment funds. See Thomas P. Lyon & John W. Mayo, *Regulatory Opportunism and Investment Behavior: Evidence from the U.S. Electric Utility Industry* (June 2000), available at <http://papers.ssrn.com>. Their findings suggest that disallowance of stranded costs associated with power generation will not significantly affect investors' willingness to back new transmission and distribution projects.

¹¹⁰ See Hovenkamp, *supra* note 82, at 814 (observing that very few regulated firms have contracts with the state and that courts have interpreted the explicit language of contracts that do exist literally but have not gone further); Rossi, *supra* note 82, at 309 (observing that only "unmistakably unambiguous" government promises create legally binding contracts and that most utility regulation is not in this form).

vestment choices. Supreme Court opinions in ratemaking cases generally require utility owners to accept the risks of unsuccessful investments.

Third, it is not at all clear that utilities were induced to invest by eager regulators, only to be surprised when regulators changed the rules for rate recovery in mid-course. Instead, some commentators argue that firms, as well as regulators, supported high levels of investment, fully aware of the risks of less than full recovery of the costs.¹¹¹ Indeed, if firms anticipate that their costs will be reimbursed no matter what the competitive environment, they have an incentive to overinvest. Assured compensation affects the incentives for strategic behavior inherent in the relationship between the regulated firm and the regulatory agency officials.¹¹² One result may be to exaggerate the Averch-Johnson effect under which firms select inefficiently high capital/labor ratios.¹¹³

To date, no court has accepted the sweeping deregulatory takings argument advocated by the industry. Where the breach of contract claim has been raised, courts have uniformly required clear and explicit contracts as a basis for protection of the utility's interest in stranded cost recovery.¹¹⁴ Outside of cases involving

¹¹¹ See Hovenkamp, *supra* note 82, at 825; Rossi, *supra* note 82, at 316. One author argues that utilities have been aware of the risks of disallowance of recovery for certain types of investments since the 1950s. See Martin B. Zimmerman, *Regulatory Treatment of Abandoned Property: Incentive Effects and Policy Issues*, 3 *J.L. & Econ.* 127, 129–31 (1988) (arguing that regulatory treatment of cancelled nuclear plants in the 1980s was similar to that afforded manufactured natural gas plants in the 1950s).

¹¹² See Oliver E. Williamson, *Deregulatory Takings and the Breach of the Regulatory Contract: Some Precautions*, 71 *N.Y.U. L. Rev.* 1007, 1012–14 (1996); see also Zimmerman, *supra* note 111, at 144 (concluding that firms subject to rate regulation “in most circumstances, will seek to continue projects regardless of the social efficiency”).

¹¹³ See Harvey Averch & Leland L. Johnson, *Behavior of the Firm Under Regulatory Constraint*, 52 *Am. Econ. Rev.* 1052 (1962); Robert J. Michaels, *Stranded Investments, Stranded Intellectuals*, 19 *Reg.* 47 (1996); Williamson, *supra* note 112, at 1012–14.

¹¹⁴ In *Energy Association v. Public Service Commission*, 653 N.Y.S.2d 502 (Sup. Ct. 1996), the court rejected a utility's argument that the “failure to guarantee full recovery of stranded costs constitutes breach of contract.” *Id.* at 513. Instead, the court held “‘just and reasonable’ rates do not necessarily . . . immunize utilities from the effects of competition.” *Id.* at 514. Thus, only those utilities expressly contracting for monopolies will probably be able to have such monopolies recognized and enforced. See also Hovenkamp, *supra* note 82, at 811 & n.42 (citing *In re Binghamton Bridge*,

physical invasion for access to network wires,¹¹⁵ the takings claims have been rejected by the courts.¹¹⁶ Even though the courts have re-

70 U.S. (3 Wall.) 51, 82 (1865) (“enforcing an explicit monopoly provision in a corporate charter”). In another case, the Public Service Company of New Hampshire (“PSNH”) had been promised by the State of New Hampshire recovery of a specific investment of \$2.3 billion in a bankruptcy proceeding. PSNH successfully obtained an injunction against a New Hampshire restructuring plan that did not guarantee recovery of the costs of this investment. In reviewing the district court injunction, the U.S. Court of Appeals for the First Circuit determined that there was a likelihood of success on the merits, given the specific agreements between the utility and state and federal regulators. The court also noted that the possibility of irreparable harm from bankruptcy made issuance of a preliminary injunction appropriate. See *Public Service Co. of N.H. v. Patch*, 167 F.3d 15 (1st Cir. 1998). However, the First Circuit held that the district court was incorrect in its decision to issue an injunction against implementation of New Hampshire’s plan for all New Hampshire utilities:

The district court’s extension of the injunction to protect all other New Hampshire electric utilities is more troublesome. Although the other utilities have joined in attacks on the Final Plan similar to those made by PSNH, it is not clear that they can assert the Contracts Clause or bankruptcy reorganization arguments that made PSNH’s case so appealing to the district court. Nor is it evident that utilities are constitutionally insulated against losses that result merely from a change in rate regulation that introduces competition.

Id. at 28; see also *Public Service Co. of N.H. v. Patch*, 167 F.3d 29 (1st Cir. 1998), cert. denied 525 U.S. 1066 (1999) (rejecting a federal preemption claim based on the “filed rate doctrine,” arguing that tariffs filed with FERC preclude New Hampshire from denying stranded cost recovery, and rejecting injunction claims by utilities that lack a clear contract guaranteeing recovery from previous bankruptcy reorganization).

¹¹⁵ Notions of physical invasion hold a grip on the definition of what constitutes a taking in the American legal mind. In *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982), the Supreme Court found that the use of a few square inches of property on the outside of a building for a cable television cable connection constituted a taking. The smallest physical invasion, according to *Loretto*, can constitute a taking. Thus, mandated open access of network facilities, such as power transmission lines, without compensation may be held to be a taking. When a physical occupation is present, some courts have required compensation for a taking in the deregulation context, although the basis for the taking is a per se physical invasion, not interference with investment-backed expectations. See *Gulf Power Co. v. United States*, 998 F. Supp. 1386, 1394–95 (N.D. Fla. 1998) (relying upon *Sidak & Spulber* to support the proposition that a permanent physical occupation of property constitutes a per se taking); *GTE Southwest v. Public Util. Comm’n of Texas*, 10 S.W.3d 7, 10–14 (Tex. Ct. App. 1999) (finding a taking based on *Loretto* where the Commission ordered GTE to revise its tariff to ensure reasonable, nondiscriminatory bases for decisions affecting access to customers by alternate service providers, including “the relocation of multiple demarcation points to a single point of demarcation on multi-unit premises”).

¹¹⁶ See, e.g., *In re Energy Ass’n v. Public Serv. Comm’n*, 653 N.Y.S.2d 502, 515 (Sup. Ct. 1996) (rejecting a deregulatory takings argument against stranded cost recovery, stating, “The rule of *Smyth v. Ames* . . . does not prevail today.”); *In re Retail Wheeling Tariffs*, 575 N.W.2d 808 (Mich. Ct. App. 1998) (finding that retail competition

fused to accept deregulatory takings claims, deregulatory takings lawsuits have resulted in settlements—sometimes imposing transition surcharges that will cost consumers billions¹¹⁷—and have influenced the adoption of consumer surcharges and access charges at the state and federal levels.¹¹⁸ The very success of public utilities in having their interests heard at the state level is an argument against applying the Takings Clause to require compensation. Although the firms will not always win all the compensation they want, utilities are clearly an important force in state politics that are well able to raise their concerns within existing institutions and procedures.

III. POLITICAL RISK AND DIRECT FOREIGN INFRASTRUCTURE INVESTMENT IN EMERGING ECONOMIES¹¹⁹

We turn now to a very different kind of investment environment, but one that raises some of the same problems as the deregulation of electric power and telecommunications in the United States. Investing in infrastructure anywhere in the world is risky because of the high fixed costs required in most projects. In general, capital cannot simply be shipped out if the investment climate turns sour. Although risk-taking is an inevitable part of any major project, po-

requiring utilities to provide third-party access does not constitute an unconstitutional taking); see also *In re Public Serv. Elec. and Gas Co.'s Rate Unbundling*, 748 A.2d 1161 (N.J. Super. Ct. App. Div. 2000) (rejecting a customer's takings claim based on the argument that stranded cost surcharges unconstitutionally impair the preexisting contract with the utility). In those rare instances where there is a specific agreement between utilities and regulators, utilities have had more success with the claim. See *supra* note 114.

¹¹⁷ See Steve Isser & Steven A. Mitnick, *Enron's Battle With PECO*, *Pub. Util. Fort.*, Mar. 1, 1998, at 38 (discussing Pennsylvania litigation over stranded costs, which raised the deregulatory takings argument and resulted in a multi-billion dollar settlement).

¹¹⁸ See Chen, *supra* note 61, at 1542–43 (discussing how the argument has played out in the context of the Federal Communications Commission). Based in part on policy arguments similar to Sidak and Spulber's, FERC has allowed for full recovery of stranded costs in its wholesale electricity restructuring order, but only partial recovery of stranded costs in restructuring the natural gas industry. See John Burritt McArthur, *The Irreconcilable Differences Between FERC's Natural Gas and Electricity Stranded Cost Treatments*, 46 *Buff. L. Rev.* 71 (1998). Some states, such as California and Rhode Island, have provided for full recovery of stranded costs in their plans to restructure the retail electricity industry. See also *supra* note 87 and accompanying text.

¹¹⁹ Jonathan Rodden provided research assistance on this portion of the Article.

litical risks are often a function of variables under the control of governments. Firms may invest only to find their investments “stranded” because of subsequent changes in the legal and regulatory environment. Thus, the stranded cost issue—by bringing to the fore the tension between compensation to the industry and flexibility and innovation in regulatory policy—bears structural and economic similarities to a much larger problem of the political risk of investing in emerging markets.

It is one thing to locate an analogy between conditions in the United States and abroad and quite another to recommend the importation of legal doctrines. Legal transplants are commonplace, but they are always problematic since one cannot know for sure how a legal form taken from one environment will function in another. Nevertheless, if a state wishes to attract international business investment, the borrowing of legal forms has the benefit of creating a legal environment familiar to investors from the developed world. Commercial codes have sometimes been imported wholesale from developed countries into emerging economies for this purpose.¹²⁰ Bilateral investment treaties provide a set of background conditions for all contracts between firms from the treaty states. Another option is to leave one’s own laws intact and encourage investors to make their own arrangements under which the law of a developed country applies and disputes are to be settled through international arbitration. There are weaknesses inherent in all of these possibilities, not the least of which is the creation of a two-track system under which foreign investors are treated differently from domestic investors—better in some ways and worse in others. Thus it makes sense to consider alternatives that lower the risks created by public actions for all investors, domestic and foreign. In seeking to create a strong environment for foreign investment, a country’s goal should *not* be to maximize foreign investment but to attract productive, competitively priced projects. This suggests that a balance needs to be struck between providing security to investors and discouraging projects that generate monopoly gains.

¹²⁰ See, e.g., Philip M. Nichols, *The Viability of Transplanted Law: Kazakhstani Reception of a Transplanted Foreign Investment Code*, 18 U. Pa. J. Int’l Econ. L. 1235 (1997).

The reduction of political risk is an important issue since much foreign direct investment over the last two decades has been in infrastructure industries. For example, private electric power projects are of growing importance with 140 plants under construction, 211 in operation, and 486 under development as of 1998.¹²¹ The total value of investment in private infrastructure projects in developing countries in 1997 exceeded \$100 billion.¹²² Infrastructure deals cover the range of possible government/private sector relationships, including simple construction contracts; build, operate, and transfer (“BOT”) projects;¹²³ purchases of public firms; and build, operate, and own investments operating under state regulatory authority. Behind many of these deals are power purchase agreements which are long-term agreements with the buyers of a project’s service—such as a commercial purchaser of electricity—that provide funds for payment of project expenses, repayment of the project’s debts, and dividends or distributions to those who hold equity in the project.

Historically, many infrastructure firms were state-owned enterprises. The move to privatize these firms and to permit private investment is occurring simultaneously with the creation of national regulatory frameworks. This trend contrasts with the situation in the United States, where private firms have always been an important factor even in monopolistic infrastructure industries. Public firms are often saddled with inefficient capital stock, and the costs of disposing of these assets are borne by the state (or the taxpayer) as part of the “restructuring” process that precedes the sale of the assets. Restructuring is often just a polite way of saying that the state will take over and liquidate loss-making portions of the firm in order to increase the value of the assets to be privatized.

¹²¹ See *The Balance of Power*, *Economist*, June 6, 1998, at 59.

¹²² See Theodore H. Moran, *Political and Regulatory Risk in Infrastructure Development in Developing Countries: Introduction and Overview 7* (Aug. 1999) (paper presented at *Private Infrastructure for Development*, *supra* note 6).

¹²³ Under a BOT arrangement, the contractor builds the plant and then sells the power that is produced for a period of time. Once one is committed to a risky environment, more control over the environment may be preferred to less. In some cases the firm may only consider the extremes of equipment sales or a BOT project. An intermediate case where the firm accepts much of the risk and has little control over its magnitude may be the worst possible strategy. Thus the structure of the deals reflects guesses about the stability of the political regime and the legal system.

In the ideal case, the assets are sold to investors who have good information about the structure of the regulatory environment in the post-privatization world. The reality is not so simple. Regulatory structures are seldom transparent, stable, and credible, and investors complain loudly about *ex post* changes in the rules.¹²⁴ However, anyone with experience in the countries involved ought to predict instability in the political/regulatory environment. The business environment is risky in most emerging markets, and an investor would be foolish to ignore that fact when bidding on a privatizing firm or organizing an investment project. Finance markets already incorporate risk premia that reflect regulatory uncertainty in the United States,¹²⁵ and the same is true in emerging and developing economies where a number of private advisory services provide information on economic and political risk.¹²⁶ However, because uncertainty about the legal and policy environment in developing countries may lead to extremely high risk premia,¹²⁷ countries that wish to reduce these costs would benefit from increasing the credibility of their commitments.

A basic risk that investors fear is outright expropriation. Bilateral investment treaties and international guarantee agencies outlaw expropriation and impose sanctions.¹²⁸ In practice, the like-

¹²⁴ See Sanford V. Berg, *Priorities in Market Reform: Regulatory Structures and Performance*, 7 *Pac. & Asian J. Energy* 89, 89 (1998), available in Lexis.

¹²⁵ See A. Lawrence Kolbe & William B. Tye, *The Duquesne Opinion: How Much "Hope" Is There for Investors in Regulated Firms?*, 8 *Yale J. on Reg.* 113, 115 (1991).

¹²⁶ For example, risks are quantified in *The International Country Risk Guide* ("ICRG"), created in 1980 by the editors of *Interuational Reports*. See Robin L. Diamente et al., *Political Risk in Emerging and Developed Markets*, *Fin. Analysts J.*, May/June 1996, at 71, 75 ("Banks, multinational corporations, importers, and exporters, among others, use the ICRG model to determine the risks of operating in, investing in, or lending to particular countries.").

¹²⁷ Claire Hill notes that political risk differs from the other risks investors face in that it attaches to heterogeneous events and involves higher levels of uncertainty. See Claire A. Hill, *How Investors React to Political Risk*, 8 *Duke J. Comp. & Int'l L.* 283, 288 (1998).

¹²⁸ For discussion of such protections, see Giorgio Sacerdoti, *The Sources and Evolution of International Legal Protection for Infrastructure Investment Confronting Political and Regulatory Risks* (Aug. 1999) (paper presented at *Private Infrastructure for Development*, *supra* note 6); Thomas W. Waelde, *International Treaties and Regulatory Risk: The Effectiveness of International Law Disciplines, Rules and Treaties in Reducing the Political and Regulatory Risk for Private Infrastructure Investment in Developing Countries* (Aug. 1999) (paper presented at *Private Infrastructure for Development*, *supra* note 6).

likelihood of expropriation has fallen dramatically in recent years, although the trend could be reversed.¹²⁹ Political and regulatory risks short of outright expropriation, however, are among the most costly to the foreign investor and are not covered by contractual provisions outlawing expropriation. The problem for government policymakers is to decide when to indemnify firms against such risks and when to treat the risks as part of the *ex ante* calculations of investors. These risks fall into several categories.

One risk is the introduction of local competitors into a market that the investor thought had been awarded as a monopoly franchise. Particularly in network industries, modification of franchise terms may have major implications for investors and the firm.¹³⁰ Sometimes countries have made very generous deals with incumbent firms in the process of opening their markets. For example, in early 1998 the Hong Kong Government reached an agreement with Hong Kong Telecom to terminate its exclusive license more than eight years ahead of its scheduled expiration date. In return for this deal with regulators, Hong Kong Telecom received US\$866 million (HK\$6.7 billion) and the right to increase local charges.¹³¹ Although the buyout of Hong Kong Telecom's franchise may seem extrava-

¹²⁹ Outright expropriation is of diminishing importance in international business dealings. Defining an act of expropriation as a government takeover of all the firms in the same industry in the same country in the same year, expropriations reached a modern high in 1974 and 1975 and fell to single digits in 1980. Between 1987 and 1992, none took place. See Michael S. Minor, *The Demise of Expropriation as an Instrument of LDC Policy, 1990-1992*, *J. Int'l Bus. Stud.*, First Quarter 1994, at 177, 178-80; Michael Minor, *LDCs, TNCs and Expropriation in the 1980s*, 25 *The CTC Reporter* 53, 53-55 (1988). Philip R. Stansbury, writing at a time when expropriation risk seemed close to zero, explains how to structure deals to minimize the risks and costs of expropriation. See Philip R. Stansbury, *Planning Against Expropriation*, 24 *Int'l Law* 677, 677-88 (1990). His discussions suggest that expropriation is uncommon, not only because of changing perceptions of the value of state takeovers, but also because multinationals have learned how to organize their businesses to limit the assets at risk. Stansbury's proposals seem to reflect common practice in international business deals even in countries where the risk of outright expropriation is small. For example, he recommends minimizing the assets under the corporate umbrella that could be an expropriation target. See *id.* at 678-83.

¹³⁰ In network infrastructure industries, two issues that raise uncertainty are unbundling, or conditions on vertical integration, and third-party access to network facilities. See Pierre Guislain, *The Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience* 262 (1997).

¹³¹ See *HK Telecoms Industry Enters New Era of Competition*, *Asia Pulse*, Apr. 1, 1998, at 1, available in Lexis.

gant,¹³² it bears some similarity to the way regulators often compensate the stranded costs of utilities in the United States. The main difference seems to be that in the Hong Kong case an explicit contract did exist, and the new regime was eager to maintain continuity with the previous government by honoring its contracts.

Elsewhere, governments have not been so generous.¹³³ In deciding on a policy, a country needs to consider the calculations of prospective investors. Guarantees can work to attract investment, but if they are too strong, moral hazard could lead to overinvestment. A government that gives overly generous guarantees to monopolists may find itself swamped with investments that earn monopoly rents and do little to improve the country's development prospects.

A second risk is the opportunistic behavior of joint venture partners, especially when the partner is a state-owned firm or one with close political connections to the regime in power. A study by the International Finance Corporation concludes that joint ventures are likely to be fragile if they depend only on the local firm's "intimate knowledge of government affairs or familiarity with local financial markets."¹³⁴ As the authors of the study point out, this "intimate knowledge" may imply corruption or conflicts of interest between the partners.¹³⁵ According to some research, few multina-

¹³² Following this deal, Kong Telecom's profit rose by 52%. See HK\$ 6.7b Compensation Lifts HK Telecom Profit by 52%, *Bus. Times* (Singapore), May 5, 1998, at 16, available in Lexis.

¹³³ The monopoly franchise of the Philippine Long Distance Telephone Company was dismantled by President Fidel Ramos, and the firm now faces rigorous new competition. See Hadi Salehi Esfahani, *The Political Economy of the Telecommunications Sector in the Philippines*, in *Regulations, Institutions, and Commitment* 145, 196-97 (Brian Levy & Pablo T. Spiller eds., 1996); Belltel Licence Spells 'Havoc' But May End PLDT Monopoly, *Asia Pac. Telecoms Analyst*, Nov. 17, 1997, at 9. Singapore has indicated that it will end Singapore Telecom's monopoly on local and international services in 2000, seven years earlier than planned. See Mark L. Clifford, *Asia's Furious Phone Derby*, *Bus. Wk.*, Feb. 24, 1997, at 122. Although Singapore Telecom received some compensation for its franchise, the deal with Singapore Telecom was for substantially less than the Hong Kong deal. See *Early End to HK Telecom's Monopoly Gives HK the Edge*, *Bus. Times* (Singapore), Feb. 5, 1998, at 1, available in Lexis.

¹³⁴ Robert R. Miller et al., *International Joint Ventures in Developing Countries: Happy Marriages?* 23 (International Finance Corporation Discussion Paper No. 29, 1996).

¹³⁵ See *id.* at 19.

tionals prefer local partners because of the potential for conflicts over objectives. But many must accept them as part of the bargaining process that leads to investment.¹³⁶

Third, a new regime may seek to void or renegotiate a contract on the grounds that it provides an unconscionable level of profits to the private firms and/or was the result of corrupt payoffs or inappropriate influence by those close to the previous rulers. Deals meant to isolate a multinational from risk may not be politically sustainable if the profits turn out to be too high. Recent examples involve projects in Pakistan, India, and Indonesia.

Pakistan attracted foreign power plant contractors by promising to buy their power at a fixed price per kilowatt hour during the 1993–96 government of former premier Benazir Bhutto. This seemed at the time a clever way to isolate foreign firms from the vagaries of local electricity demand and the politically freighted nature of electric rates. As it turned out, the price appears to provide generous profits to investors and threatens to impose a large cost on the Pakistani treasury, since the country will not be able to sell the power to consumers for the contract price.

Officials allege corruption in the original contracts signed with the Bhutto government and are seeking to renegotiate the contracts to cut the tariffs. Pakistan is using its own courts to pursue this matter, and the Supreme Court of Pakistan has barred the investors from referring one dispute to international arbitration.¹³⁷ The World Bank and the International Monetary Fund are pushing for a settlement.¹³⁸ Nawaz Sharif, the Prime Minister deposed in 1999, also had been urging a settlement to create a better foreign investment climate.¹³⁹ Under the new administration, headed by

¹³⁶ See Stephen J. Kobrin, *Testing the Bargaining Hypothesis in the Manufacturing Sector in Developing Countries*, 41 *Int'l Org.* 609, 623–24 (1987). In Papua New Guinea, for example, the government normally exercises its option to participate in mining and petroleum projects. Sometimes the government has purchased increased shares of projects under the implicit threat of expropriation. See Papua New Guinea Investment Climate Statement for 1997, *Int'l Market Insight Rep.*, July 15, 1997, ¶ 27, available in Lexis.

¹³⁷ See *Pakistan Court Bars International Arbitration in Power Tariff Row*, Agence France Presse, November 3, 1999, available in Lexis.

¹³⁸ See *World Bank Energy Mission in Pakistan for Talks*, Agence France Presse, Nov. 1, 1999, available in Lexis.

¹³⁹ See *Fate of Hubco Rests with the IMF: Talks Start Today Over the Impending Debt Crisis in Pakistan, Which Could Prevent the Electricity Generator from Paying*

General Pervez Musharraf, allegations of corruption remain in the air.¹⁴⁰ Nevertheless, the World Bank has succeeded in resolving some of the disputes, although allegations of corruption against investors in several large independent power projects remain points of contention.¹⁴¹ One investor in a major project, for example, insists that it will not negotiate over reductions in power tariffs unless corruption charges are dropped.¹⁴²

Similar problems arose in India concerning the Dabhol electric power project in the state of Maharashtra where Enron was the lead contractor. The contract was negotiated with one state government, and when a new political party took control, it canceled the project, arguing that corruption had produced a deal that was too favorable to the foreign investors. No corruption was proved, but the deal was eventually renegotiated in a way that permitted each side to claim victory.¹⁴³

Its Foreign Creditors, *Fin. Times*, July 13, 1998, Companies & Finance Section, at 23; Pakistan Pledges to Seek Power Companies Deal, *Fin. Times*, August 4, 1999, Asia-Pacific Section, at 4; Sharif Orders Speedy End to Power Dispute, *Fin. Times*, August 14–15, 1999, Asia-Pacific Section, at 5.

¹⁴⁰ See Christine Hill, *Power Failure*, Institutional Investor, Nov. 1999, at 109.

¹⁴¹ See Pakistan's IPP Disputes Resolved Except Hubco, *Kapco*, Asia Pulse, Nov. 22, 1999, available in Lexis; Row With IPPs Holding Up ADB Lending for Pakistan, *Asia Pulse*, May 3, 2000, available in Lexis; Hubco to Seek Compensation from Pakistan, *Agence France Presse*, June 21, 2000, available in Lexis.

¹⁴² See Hubco Links Power Tariffs Talks to Withdrawal of Charges by Pakistan, *Agence France Presse*, Dec. 11, 1999, available in Lexis.

¹⁴³ A critical report from the federal government's Comptroller and Auditor General, however, casts doubt on the State of Maharashtra's claims. See Frank Gray, *Enron Slammed by Aud-Gen Report*, *Power in Asia*, May 4, 1998, available in Lexis; Comptroller and Auditor General of India Debunks Maharashtra Govt.'s Claim on Enron, *The Hindu*, Apr. 26, 1998, available in Lexis. One structural problem that may have influenced the terms of the original deal concerns the pricing practices of the State Electricity Boards ("SEB"). The SEBs routinely subsidize farmers and domestic power users, and as a result, most are insolvent. To bring in foreign investors the federal government provided counter-guarantees to power producers who participated in state projects. In the Dabhol case, after the contract was canceled, the federal government made it clear that it would deduct any payments made under the guarantee from funds transferred to the state the following year. Perhaps as a result of this experience, the federal government at first was unwilling to provide counter-guarantees for future deals. In August 1998, however, the federal government issued counter-guarantees for three stalled projects, but the terms are less generous than those given to Enron in 1994. The goal is to permit the projects to go forward while still giving the SEBs an incentive to reform their tariff structures. See Shekhar Hattangadi, *State Willing to Renegotiate with Euron*, *Platt's Oilgram News*, Aug. 24, 1995, at 2, available in Lexis; *Uphill Task for Reformers*, *Fin. Times*, January 21, 1998, Survey—India

With the fall of former President Suharto, the new Indonesian government is seeking to void or renegotiate a number of infrastructure contracts that gave Suharto's children and close associates ownership stakes in joint ventures with foreign companies. The contracts were awarded without open competitive bidding, and the current government argues that the terms of the contracts are overly generous to investors given the costs of comparable projects in nearby countries. Not surprisingly, the companies are complaining about breach of contract. The United States government, which supported the overthrow of Suharto and has criticized the corruption of his regime, is backing its own investors, perhaps because it had insured some of the deals.¹⁴⁴ Although one interim settlement has been reached,¹⁴⁵ other disputes between Indonesia and investors remain unresolved.¹⁴⁶

The cases of Pakistan, India, and Indonesia represent complex mixtures of opportunism and outrage. Corruption may have occurred but has obviously proved difficult to document. Even if no bribes were paid, the fact that the contracts look like giveaways of state funds to outsiders makes them vulnerable to renegotiation. Our discussion of takings law as a way to create credible commitments should be read in light of a basic assumption of state legitimacy. If the state writes contracts that its citizens do not accept as fair, no formal legal requirement is likely to provide sufficient protection for foreign investors.

Other regulatory risks may be less blatant, but no less costly to investors. Regulators may modify the terms of cost-of-service regulation for privately-owned natural monopolies. They may make a transition from cost-of-service regulation to alternatives, such as price caps, benchmark regulation, or negotiated franchise agreements. As with the termination or modification of franchises, many of these regulatory changes can result in heavy costs for infrastructure projects and may influence the behaviors of investors and the firm. In Jamaica, following the transition from a franchise-based

Power Section, at 1: Guarantees Ignite Flurry of Indian Power Plant Activity, *Fin. Times*, August 26, 1998, World Trade Section, at 4.

¹⁴⁴ See Jay Solomon, Sweetheart Contracts: U.S. Is Pressing Indonesia to Honor Suharto-Era Deals, *Asian Wall St. J.* July 22, 1999, at 1.

¹⁴⁵ See Interim Deal in Indonesian Power Dispute, *Fin. Times*, March 10, 2000, at 10.

¹⁴⁶ See Indonesia Power Plant Project Could Cost Germany Millions, *Deutsch Presse-Agentur*, May 27, 2000, available in Lexis.

structure to commission regulation in 1962, Jamaica Telephone Company stopped all investment in infrastructure expansion. The Jamaican network was not expanded until the 1980s.¹⁴⁷ In some contexts, investment risks also can be influenced by decisions of regulators in non-host countries that share revenues to pay for infrastructure in telecommunications¹⁴⁸ or that provide fuel for the energy sector.

Obviously, the complex of problems outlined here cannot be remedied with a single instrument. Furthermore, constitutional guarantees mean little in some emerging economies where new constitutions have appeared at frequent intervals and amendments are commonplace. Nevertheless, constitutional law usually has some special status, and, at least in countries where this is so, constitutional property protections may make sense. The risk, however, is that countries will adopt a rigid solution that is interpreted by the courts in ways that severely limit democratic accountability. Reformers need to keep the dual goals of investment security and policy flexibility in balance. In the next Part of this Article we provide some general guidance that is derived from the United States experience. As should be clear from the first Part of the Article, however, we by no means recommend the wholesale adoption of United States law. Instead, each country will need to consider the factors we discuss and make its own decisions.

IV. DEVELOPING A PRINCIPLED TAKINGS JURISPRUDENCE

A constitutional takings clause provides protection for private property rights by requiring government compensation under certain conditions, and thus limits the government's ability to impose costs on property owners. A takings provision is "an attempt to find some fair balance between the forces of change and the secu-

¹⁴⁷ See Esfahani, *supra* note 133, at 23.

¹⁴⁸ For example, the United States Federal Communications Commission has moved toward making foreign telecons pay more in the long distance charges they share with United States telecom operators. Some foreign telecons, such as Phillipine Long Distance Telephone, Hong Kong Telecom, and Indosat of Indonesia derive 19% to 46% of their profits from these payments. See Clifford, *supra* note 133, at 122. Developing countries receive more long distance calls than they make, adding to the impact their telecom sector will suffer as such charges are modified. See *Crossed Wires in Global Telecons*, UNESCO Courier, Nov. 1, 1998, at 1, available in Lexis.

riety of established interests.”¹⁴⁹ For us, the basic tension in articulating a consistent doctrine is between the government as purchaser and the government as policymaker. Government can affect private property owners both when it seeks to obtain resources for a public project using the power of eminent domain and when it exercises policymaking authority. A key issue for takings jurisprudence is where to draw the line between these two types of state action. We argue that in the former case, compensation should be required under a constitutional takings clause. In the latter case, it should not be required, although it may be justified in particular instances.¹⁵⁰ Central to our argument is the recognition that the government has sources of power independent of the market. If reformers propose a constitutional takings clause, then they must ask how strong a role it ought to play in limiting government policy. We believe that our proposed framework is consistent with the United States Constitution and also argue that it is appropriate for countries considering constitutional and regulatory reform.

The basic problem is to distinguish between situations where the state should operate under the same constraints as private market actors and other situations where it ought to be excused from these constraints. This is a question that each state needs to answer on its own. It cannot be derived from takings law doctrine standing alone but is at the heart of a nation’s view of the relationship between public power and private rights. Just as a takings clause cannot solve the problems raised by an unaccountable and illegitimate state, so too it cannot determine which property entitlements are democratically legitimate and which violate underlying concepts of ownership. These issues must be faced head-on both by policymakers in emerging economies seeking to establish a rule of law and by federal judges in the United States seeking a way through the thicket of American jurisprudence. The most appropriate takings rule is a function of other features of the political/economic environment. In developing countries, attempts to create strong constitutional protections for private property must go along with

¹⁴⁹ Sax, *supra* note 22, at 48.

¹⁵⁰ Joseph Sax articulates a related but somewhat different view. He distinguishes between the government as market participant and the government as mediator of competing economic claims. For him, compensation would be required only in the former case where the public action benefits a government enterprise. See *id.* at 62–64.

reforms in the operation of the state. A state that has a strong underlying commitment to the market economy need not be overly worried about establishing sweeping constitutional protections against government actions—witness the United States' weak and unclear constitutional restraints on regulatory incursions.

Even if one accepts our basic distinction between the government as purchaser and the government as policymaker, this does not resolve all questions of when a taking should be found and how much compensation should be paid. There still remain issues that turn on the insurance function of takings law and on its impact on the fairness and political legitimacy of alternative rules. We discuss these issues at the end of this Part.

A. Government as Buyer

If the government is a purchaser, this implies that, when possible, the state ought to act like any other market participant. It should pay its employees the market wage and purchase inputs at market prices. Private actors can then ignore the fact that the government might in the future be a purchaser, since it acts just like anyone else.¹⁵¹

Under an extreme version of this view, the government could not obtain property for public use unless the seller agreed. When the government purchases a good or service in a competitive private market, the seller's consent is a condition of the purchase. When the state is trying to assemble a parcel of land for a public project, however, requiring consent would give individual property holders the power to extract excess rents. To overcome this problem, most governments have the power of eminent domain. That is, they can take property to fulfill public purposes. The uniqueness of land parcels means that this kind of taking will frequently involve real estate.

¹⁵¹ Cf. Michelman *supra* note 15 at 1230–32 (noting the government obligation to pay market value); see also Ackerman, *supra* note 18, at 52–53 (arguing that compensation is required to limit corruption and the partisan imposition of costs); Sax, *supra* note 22, at 64–65, 75–76 (arguing that compensation should be paid to limit unfairness and prevent individualized cost-bearing in the public interest); Saul Levmore, *Just Compensation and Just Politics*, 22 *Conn. L. Rev.* 285, 308 (1988) (arguing that market mechanisms may provide a sufficient check on the political process in this context).

When eminent domain is used, payment of compensation at market rates gives property owners the incentive to invest based on estimates about future market conditions without also having to guess the likelihood that the state will seize their assets. In other words, compensation is justified for the same reason that government is required to pay for any inputs it uses. The goal is to make private investors indifferent between whether the government or a private buyer obtains their assets. The government's demand for resources should not interfere with market tests on the margin. In short, the *ex ante* probability that the government will coercively take any particular piece of property is small in this first class of cases, making it appropriate for the government to imitate private market purchasers as much as possible. Compensation is required independent of any special features of the owner or the property itself. In principle, since the government is forcing a "sale" by its condemnation procedures, the owner should be compensated for any idiosyncratic value attached to the property. This is an impractical demand, however, because it would give the owner an incentive to inflate his valuation to obtain excess compensation.

Even here, we would add one caveat. If a state has an anti-monopoly law along the lines of American antitrust statutes, the government should be authorized to appropriate profits that result from monopoly power.¹⁵² The practical problem is distinguishing between monopoly rents and the return to risk-taking. Investors in emerging or unstable markets often incur extraordinary risks. If they are unable to shift these risks to others, they should be able to earn supra-normal profits if their investments turn out to be successful. There is, however, a circularity here. Political risk may be one reason that profit rates on successful projects are so high in the

¹⁵² See Rose-Ackerman, *Against Ad Hocery*, *supra* note 24, at 1710; Rose-Ackerman, *Regulatory Takings*, *supra* note 24, at 37. A willingness to refuse to pay compensation for monopoly rents is consistent with the United States Supreme Court's refusal to find a taking in some recent cases. The opinions are *Keystone Bituminous Coal Association v. DeBenedictis*, 480 U.S. 470, 496 (1987); Justice Brennan's dissent in *Nollan v. California Coastal Commission*, 483 U.S. 825, 854 (1987) (Brennan, J., dissenting); and *Pennell v. City of San Jose*, 485 U.S. 1, 10-15 (1987). See also Levmore, *supra* note 151, at 313 & cases cited n.61. This principle is implicit in interpretations of the United States antitrust laws that give consumers a property right in competitively priced goods and services. See *Reiter v. Sonotone Corp.*, 442 U.S. 330, 342 (1979).

first place. If so, a compensation policy that credibly reduces political risk should not be applied retroactively to reimburse firms for lost excess profits. Conversely, if the state has a good record of compensating investors for losses incurred by state actions, then the rate of return should reflect that fact, and compensation should be based on a judgment of whether monopoly profits are being earned and on whether the government was acting as a buyer or a policymaker.

B. Government as Policymaker

Government policy may change as new political groupings come to power and new information influences the policy debate. To what extent should a takings clause protect private property owners from the vagaries of government actions? We argue that this should not be an independent goal of takings law once the basic distinction between the government as buyer and the government as power-wielder has been clarified.¹⁵³ The government pays for inputs at market prices but does not guarantee investors that its own priorities will not shift over time. For example, if the government changes regulatory priorities, no compensation should be due. To the extent that the state needs to hire more lawyers and economists to staff its agencies, it ought to pay them market rates, not dragoon them into government service. However, if a new regulatory regime affects the overall profitability of an industry and changes the relative positions of firms in the industry, this should be viewed as an exercise of government power that private firms have an obligation to take into account in their own planning for the future. A regulation that is cheaper for one firm to comply with than another should not give rise to a compensation claim by the disadvantaged firm.¹⁵⁴

¹⁵³ In the United States a historical analysis reveals that the takings clause was not to be "a bulwark for the maintenance of the established distribution of wealth." Sax, *supra* note 22, at 53.

¹⁵⁴ The case would be different if the government had signed an explicit contract with the private firm not to compete with it and then entered the market. In that case the firm might demand damages under breach-of-contract principles. The issue for the courts would be to decide whether to require the payment of damages or to declare the contract itself void on the ground of public policy. The issue would be one of contracts law, not takings jurisprudence.

In addition, following the lead of American doctrine, compensation should not be paid if the government action is analogous to a private action that is one of the ordinary risks of economic life. The distributive consequences produced by market pressures are a cost of maintaining the incentives needed to make markets work efficiently. For example, if the government competes with a private business by selling surplus equipment or producing electricity, this should not produce a takings claim because competitive losses do not give rise to damage claims in the private sector.¹⁵⁵

Under this view, takings law should aim to provide optimal incentives to private investors, not deter opportunistic or predatory state actors. In other words, its goal is to protect private property conditional on the power of the state. It takes as given the imperfections in the government sphere and helps encourage efficient *private* investment. Suppose, for example, that a regime is predatory in the sense that rulers use their power to enact policies that provide private benefits to themselves, their families, and their close associates. If a state has this character, takings law should not insulate investors from this influence. If it does, the costs of state overreaching will simply be shifted to other groups in the population, and an inefficient level of private investment will occur. Of course, it is not only predatory states that impose costs. Democratic governments, in permitting policies to be adopted by majority votes in representative assemblies, do not contemplate that all statutes will meet with unanimous approval. The status quo has no special legitimacy except to the extent that the constitution establishes rights that cannot be violated by ordinary legislation. This fundamental feature of democratic government should not be undermined by a takings doctrine that forbids majoritarian policies.

This framework leads us to the following conclusion. If the government needs to tear down your house in order to fulfill some broader public goal, it must compensate you at market rates. How-

¹⁵⁵ According to Sax, the essence of property

is not fixity at all, but fluidity. Property is the end result of a process of competition among inconsistent and contending economic values. Instead of some static and definable quantity, property really is a multitude of existing interests which are constantly interrelating with each other Property is thus the result of the process of competition.

Sax, *supra* note 22, at 61 (footnote omitted).

ever, if the government determines that a dangerous microbe can be rooted out only by burning down everyone's house, then no compensation is required, since this is a policy applied across the board. In other words, the takings law that we favor is not designed to solve the deep problems that arise from a dysfunctional and predatory state. Neither is it meant to undermine the possibility for democratic decisions that impose costs as well as benefits. Instead, if obviously inefficient state actions are a feature of the investment climate, these government policies should be taken into account by private investors. If investors were fully compensated for such losses, they would overinvest in durable capital. Takings jurisprudence should not make investors indifferent to the government's capital-destroying actions. A no-compensation rule for broad policy initiatives would encourage investors to lobby the state to refrain from its wasteful policies.

Compensation need not, in practice, equal zero, but the state should only pay compensation for investments that would have been efficient in the absence of compensation. Investors must receive a lump sum payment, not a share of the existing capital investment. Of course, we are not recommending that states be permitted to act with impunity. We are only claiming that *if* they do so, private firms ought to take this behavior into account in planning their investment strategies. Otherwise, the costs of the ill-advised state policies will be compounded by inefficient private investment decisions. If a firm expects to be fully compensated for a public policy that destroys its property, it will invest too much in the property.¹⁵⁶

Even in the policymaking category there are times when the government should pay compensation if it wishes to encourage efficient private investment. Sometimes the government takes private property and does not destroy it but instead converts it to

¹⁵⁶For a fuller discussion of the issue of overinvestment, see Lawrence Blume & Daniel L. Rubinfeld, *Compensation for Takings: An Economic Analysis*, 72 Cal. L. Rev. 569, 618–620 (1984); Lawrence Blume et al., *The Taking of Land: When Should Compensation be Paid?*, 77 Q. J. Econ. 71, 71–92 (1984). As Blume and Rubinfeld argue, “Whatever the exact determination of compensation, it is important that the measure be one that cannot be directly affected by the behavior of the individual investors, since any compensation measure which can be affected by private behavior will create the possibility of inefficiency due to moral hazard.” Blume & Rubinfeld, *supra*, at 618 n.144.

its own use. In that case, full compensation should be paid, since efficiency requires the private investor to take this possibility into account. A firm should be compensated both when the state nationalizes the firm's factory and when the state passes a regulation requiring the factory to produce a certain mix of products to be sold at state-determined prices.

This analysis suggests the following resolution of the takings law controversies surrounding the deregulation of public utilities. Deregulation is clearly a policymaking activity. Thus there is a presumption against compensation. However, the government should pay for investments that it required under the old regulatory regime that were not expected to be profitable for the private firm. The most straightforward examples are the legal obligations taken on by American electrical utilities to purchase power from solar or wind sources. In those cases firms made legal commitments that were not always economically efficient, with the understanding that they would be reimbursed by the regulatory authorities.¹⁵⁷ If some of a firm's assets are useful to the industry as a whole—for example, the subscriber lists maintained by telephone companies—compensation should be paid to provide an incentive for firms to develop such assets.¹⁵⁸ United States courts should also look at the adequacy of compensation for sharing bottleneck facilities.¹⁵⁹ Com-

¹⁵⁷ See Brennan & Boyd, *supra* note 12, at 49–50. Some nuclear facilities may be in this category as well, although a recent paper by Lyon and Mayo, see *supra* note 109, casts doubt on that claim.

¹⁵⁸ In the United States, the Telecommunications Act of 1996 requires that new entrants pay for these benefits, although there is a good deal of controversy over the contractual mechanism established by the Act and the resulting levels of payments. See Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996). The interconnection obligations are at 47 U.S.C. § 251(c) (Supp. III 1997). Earlier Federal Communications Commission ("FCC") attempts to require local exchange carriers to interconnect were struck down by the courts as beyond the jurisdiction of the FCC. See, e.g., *Bell Atlantic Telephone Co. v. FCC*, 24 F.3d 1441, 1444–47 (D.C. Cir. 1994). The court in *Bell Atlantic* held that the FCC action raised takings issues. The 1996 Act required interconnection and established a negotiation and arbitration procedure to determine the payment due local telephone companies. See Duane McLaughlin, Note, FCC Jurisdiction Over Local Telephone Under the 1996 Act: Fenced Off?, 97 Colum. L. Rev. 2210, 2224–28 (1997). The Supreme Court resolved jurisdictional disputes raised under the 1996 Act in favor of the FCC in *AT&T v. Iowa Utilities Board*, 525 U.S. 366 (1999).

¹⁵⁹ In *AT&T*, the Supreme Court remanded to the Federal Communications Commission a proceeding to determine the prices at which local exchange carriers can sell network elements to their competitors.

pensation requirements should be imposed if the state requires “open access” to facilitate the deregulation of telecommunications or electric utility industries elsewhere in the world.

In general, the compensation decision ought to depend on a two-step analysis. First, can the government action be analogized to a government purchase of an input in the market? If so, compensation should be paid at “fair market value.” If not—that is, if the harm to private property owners is part of a policy initiative—then compensation should depend only on the future use of the property. The aim in the latter case is to produce optimal investment decisions by private owners given some probability of government actions that will reduce (or enhance) property values. In both cases, the economic status of the owner and the magnitude of the loss should be irrelevant. We do not, of course, claim that the distinction between government as buyer and government as policymaker will always be easy to make or that a predatory state might not carry out its aims simply by buying up properties on an individual basis. Rather, we suggest that our distinction is one way to strike a balance between giving some assurance to private investors, on the one hand, and limiting the moral hazard produced by an overly broad takings clause, on the other. We do not believe that a strong property clause, taken by itself, can be an effective method of reforming a state that is otherwise illegitimate and unaccountable.

Furthermore, the framework seems consistent with the basic principles of the American Constitution. United States law, however, is not a complete model of the rule we advocate. Compensation is routinely paid in cases that fit the first model—that is, government use of the power of eminent domain to take individual land parcels. But the American courts have not clearly distinguished between government as purchaser and government as policymaker. Furthermore, United States courts have not dealt well with the moral hazard issue. Instead, they argue that if the state destroys your “thing” for whatever reason, it usually will be required to pay you for it.¹⁶⁰ In contrast, if it merely uses your assets without taking title to them by, for example, requiring you to comply with historical preservation standards, the state generally will

¹⁶⁰ See the critical analysis of this doctrine in Ackerman, *supra* note 18, at 130–36.

not be required to compensate you.¹⁶¹ This gives owners of buildings that might in the future be declared landmarks an incentive to tear them down quickly so that the issue will not arise.¹⁶²

C. *The Insurance Issue*

Under the proposed doctrine developed so far, the extent and limits of compensation are designed to influence the investment choices of private individuals and firms, but the doctrine is indifferent to the overall economic status of investors. As a general matter, we support this view with the one exception developed here. Given the uncertainty that is an inherent feature of government, the insurance branch of the efficiency analysis may be important if private insurance markets do not fill the gap. Private property owners might want to purchase insurance if they view government as an essentially random and unpredictable enterprise, at least in its impact on particular persons.¹⁶³ If the *ex ante* probability of being harmed is distributed broadly and if *no* compensation is paid, two different results are possible. On the one hand, if investors are risk neutral, they all rationally cut back their investments just enough to compensate for the risk of expropriation. On the other hand, if they are risk averse, the uncertainty created by the threat of harm may lead them to invest less and to hold their assets in a form that is unlikely to be affected by the public program. For international investors this may mean that they do not invest in the country at all.

¹⁶¹ See *Penn Cent. Transp. Co. v. New York*, 438 U.S. 104, 122–38 (1978). But see the New York State Court of Appeals decision in *Seawall Assoc. v. City of New York*, 542 N.E.2d 1059 (N.Y. 1989). The New York high court found that both a physical and a regulatory taking had occurred when New York City attempted to aid the homeless by requiring owners of single-room-occupancy facilities to keep them fully rented. See *id.* at 1062–69. Exemptions and buyout provisions in the law did not overcome this finding. Although the court did not use our reasoning, the result is consistent with our framework because the city law was designed to make use of existing buildings to further a public purpose.

¹⁶² Cf. William A. Fischel, *The Economics of Zoning Laws* 174 (1985) (giving an example).

¹⁶³ Cf. William A. Fischel & Perry Shapiro, *Takings, Insurance, and Michelman: Comments on Economic Interpretation of "Just Compensation" Law*, 17 *J. Legal Stud.* 269 (1988) (analyzing situations in which government actions produce demoralization costs).

At one level, the insurance rationale is simply another justification for compensation when the government is a market participant or “buyer.” A free market combined with well-enforced property rights and a law criminalizing theft insures owners that no private individual can legally take their property without their consent. They can insure against floods, hurricanes, and theft, but they do not need to insure against the possibility that someone will assert an interest in their property. Because the government can exercise its eminent domain power, however, it may appear more like a hurricane than a market participant, and hence people may demand insurance if compensation is not paid. Takings law would not need to be concerned with this problem if private insurance were available, but the risks discussed here are not always insurable because of the problems of moral hazard and adverse selection.¹⁶⁴

Moral hazard occurs when the existence of insurance leads the insured person to take actions that increase the probability or the magnitude of the loss. In this context, it occurs if property owners secretly lobby to have their property taken or at least do not actively oppose a policy that will produce that result. Although such lobbying is possible when the government pays compensation, the obvious budgetary consequences of such behavior will help to check abuses. Adverse selection occurs if insurance companies cannot adequately sort property owners into risk classes. If high-risk and low-risk owners are charged the same rate, low-risk owners may decide to self insure. The remaining pool of insured owners becomes riskier and premiums must rise. The remaining low-risk owners may then opt out of the pool. If the insurance companies have less information about risks than property owners, profitable insurance contracts may be impossible to write.¹⁶⁵ For both of these reasons, when the state acts as a purchaser of inputs, it may sometimes be a more efficient provider of such insurance through the payment of compensation than the private market.

¹⁶⁴ But cf. Thomas Merrill, *Rent Seeking and the Compensation Principle*, 80 *Nw. U. L. Rev.* 1561, 1581 (1987) (“[I]t is not clear why adverse selection and moral hazard are more serious problems in this area than in any other area where risks arise primarily from acts by human agents (rather than from natural disasters).”).

¹⁶⁵ See Blume & Rubinfeld, *supra* note 156, at 584–99.

However, we need to consider whether compensation should be paid, not just when the government acts as a buyer, but also when it acts as a policymaker. In considering the likelihood that property owners would demand insurance, the degree of harm is a central concern, but courts must decide what standard of comparison to use.¹⁶⁶ A generally accepted rule of thumb is that individuals behave in a risk-averse way when a major portion of their total wealth is threatened. Because owner-occupied housing represents a large proportion of most owners' personal wealth, the insurance rationale implies that the government should compensate homeowners when it takes their houses either as a buyer or a policymaker.¹⁶⁷ The standard of comparison should be the individual's total wealth, not just the property "affected" by the taking.

In developing countries, one particularly perverse result of foreign investment in infrastructure has sometimes been state expropriation of private property to help the investor amass a large land parcel for development. A takings clause could require the state to pay compensation when it condemns private houses for such purposes. Takings law can then provide security to ordinary people whose houses or small businesses stand in the way of large-scale infrastructure development projects. Unfortunately, there can be a conflict here. The insurance rationale would counsel in favor of compensation for households who lose their homes to state action whether the state is a buyer or a policymaker. Yet if full compensation is paid, homeowners will have an incentive to overinvest in their properties. Thus the compensation formula should be calculated to provide some risk sharing with property owners through deductible or co-payment options and through rules that do not pay for idiosyncratic values.

The insurance rationale is much stronger for government takings of family homes than for actions that harm broadly-held corporations.¹⁶⁸ There are two reasons for this. First, large diversified

¹⁶⁶ For example, should the courts define the plaintiff's property as the coal that cannot be mined because of the regulatory statute, so that 100% of it has been taken, or as the firm's entire mining operation, so that only a small share has been lost? See *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470 (1987).

¹⁶⁷ See Blume & Rubinfeld, *supra* note 156, at 582-99 (making this argument and discussing several examples).

¹⁶⁸ Cf. Hanoch Dagan, *Takings and Distributive Justice*, 85 Va. L. Rev. 741 (1999) (exploring distributive justice perspectives on takings law).

corporations ought to be risk neutral even toward relatively large losses, because shareholders and other investors can insure by holding a diversified portfolio of investments. Private firms can diversify their risks more effectively than even many wealthy individual investors and may also be in the position to exert leverage based on international ratings of country risk.¹⁶⁹ Second, political risk insurance is available from both public and private sources. Increasingly, private insurers are offering political risk insurance that supplements that offered by public agencies such as the World Bank Group's Multilateral Investment Guarantee Agency ("MIGA"). Insurance provided by multilateral agencies deters governmental breach of commitments since host countries risk losing certain valuable benefits if they breach.¹⁷⁰ Private firms also monitor the behavior of states where they have exposure and can discipline states through higher rates or denial of coverage. Thus a country with a poor risk rating might want to establish a strong takings doctrine as a warranty that it will not take advantage of investors in fixed capital.¹⁷¹ This is the final issue to which we now turn.

D. Private Investment and Public Sector Opportunism

Often, constitutional property clauses are justified as a way to deter a predatory state from interfering with the development of a favorable climate for private investment. The property clause provides a warranty or guarantee that the state will indemnify investors against certain state actions. We have already argued that compensation should be paid when the state is a purchaser of inputs, and these payments may have an indirect impact on government decisionmaking. A compensation requirement can

¹⁶⁹ German constitutional law has reached a similar conclusion but for different reasons. See van der Walt, *supra* note 50, at 135–36 (discussing the issue and citing relevant cases). Focusing on the role of property in furthering personal freedom, the German Constitutional Court distinguishes between organizational landowners where no issue of personal freedom arises and individual lessees where it does.

¹⁷⁰ MIGA may suspend on-going credit or loan activity when it has a dispute with a host country. MIGA offers political and regulatory risk insurance up to \$200 million per project and \$620 million per country. See West, *supra* note 14, at 34.

¹⁷¹ Political risk insurance can facilitate leveraging since many lending institutions that underwrite debt in project financing are also regular buyers of political risk insurance. See *id.*

limit government opportunism by forcing public policymakers to consider the opportunity costs of their proposed actions. Like any other purchase of inputs, policies that “take” private property would then have concrete budgetary impacts that are immediately reflected in tax bills or borrowing capacity.

We do not believe, however, that an expansive takings doctrine is a suitable tool to deter an overreaching state in the policymaking context. If public choices are the result of the competition of various groups for political benefits, powerful groups will not need a constitutionally mandated takings doctrine to preserve their interests. Conversely, a compensation requirement is unlikely to be an effective check on the power of those groups. They are still likely to be able to obtain an overall legislative package that is beneficial to them. Those who decide on government policies do not pay the compensation themselves and suffer few negative consequences from imposing costs on those with little political clout.

Thus, a state with a strong and credible takings doctrine but with no other checks on its power can still operate with a good deal of impunity. Consider, for example, a government without an independent judiciary, in which judges are beholden to the executive or legislative branch. Such a state can manipulate the takings doctrine to compensate cronies for property taken for unproductive public projects. Ordinary people suffer both because the state engages in projects that are wasteful on their own terms and because taxpayers must pay the cost of compensation. Furthermore, investors who should be taking into account the risks of government actions in planning their own investments will not do so. The citizenry is left paying for private capital investments that are not economically justified given the likelihood that the property will be taken and destroyed by the government. In short, a regime that seeks to amass private benefits for its rulers and their associates should not be encouraged to establish a strong constitutional compensation requirement unless other reforms are carried out that increase the overall accountability of the state to its citizens. A property clause can be part of a general move to a more democratic system; it should not be a stand-alone response to an uncertain investment environment.

In this context, consider again the United States Supreme Court’s generally deferential approach to takings law claims in the

area of public utility regulation. The general stance of United States courts fits our distinction between state as purchaser and state as policymaker, but with one additional twist. Given a democratic government whose claim to legitimacy rests on its accountability to its citizens, policies are justified if they are the result of an accountable process—legislative, administrative, or judicial. Such policies should not give rise to takings claims beyond the requirement that the state pay for inputs. Effectively, a showing that the state has established fair processes is a defense against a takings claim. Thus the adequacy of regulatory procedures provides a justification for the United States courts' refusal to find that takings have occurred in the context of public utility regulation. Courts defer to government decisions on the ground that the legislature has established fair procedures for executive actions that impose costs and benefits on individuals and firms. Rather than go into the details of individual decisions, the court evaluates the overall fairness of the process established by law and the workings of the system in practice. As we argued above, public utilities are active participants in political and administrative processes and so can hardly be seen as innocent, uninformed outsiders.¹⁷² They are part of the political bargaining that produces regulatory policies, and if they do not obtain one hundred percent of their goals, that is hardly a reason to pay compensation.

In any state with a basically democratic structure, standard principles of administrative law could be applied to decide whether an independent takings claim should be considered in the regulatory context. A country's courts would have to decide what procedures are necessary and sufficient to void a claim for compensation. One model for reformers in other democracies is the United States Administrative Procedure Act, which provides for notice, a hearing, and a reasoned opinion.¹⁷³ Similar issues of regulatory accountability will arise in democratic developing countries

¹⁷² See Brennan & Boyd, *supra* note 12, at 49–50; Pierce, *supra* note 72 at 2034. Especially since the 1978 passage of a federal law permitting competition, electrical utilities have been on notice that increased competition was likely. Similar inferences would seem reasonable in telecommunications, at least since the breakup of AT&T. Among the stakeholders in the industries involved, it is the private firms who seem to have disparate political power, not other concerned groups, such as residential consumers.

¹⁷³ See 5 U.S.C. §§ 551–59 (1994 & Supp. III 1997).

for infrastructure projects operating under regulatory statutes. In general, such countries need to improve the quality of their administrative processes to make them both more dependent on technical expertise and more open and transparent to the citizens and firms interested in the outcome. A takings doctrine cannot generate such developments on its own. The administrative process should be a separate focus of reform. In the absence of procedural safeguards, however, courts could impose a higher burden of proof on the state to demonstrate that it is acting as an accountable policymaker as opposed to a purchaser. The distinction between government as purchaser and government as policymaker might be influenced by the process used to determine the government's choice.

This last proposal, however, only makes sense if a government has an underlying commitment to popular sovereignty and accountable government so that the executive is likely to respond to a finding of procedural deficiency by seeking to reform the process.¹⁷⁴ This is unlikely to be the case in countries with undemocratic constitutions or autocratic traditions. In those cases, takings law should not be used to encourage administrative reform since the doctrine is unlikely to generate real change on its own.

As a way of understanding our skepticism about the use of takings law as a hammer to induce reform in undemocratic or weak states, consider a takings doctrine that requires the state to pay compensation when it acts as a policymaker. If takings law were to cover these cases, consistency implies a doctrine of "reverse takings." In other words, the government should claim reimbursement from individuals or firms that receive windfalls from government actions.¹⁷⁵ Such claims are not part of American constitutional ju-

¹⁷⁴ In the United States, the failure to establish fair procedures could implicate the Due Process Clause of the Constitution as well as the Takings Clause. In one recent case, the Justices split on whether a retroactive conferral of greater benefits on retired coal employees constituted a taking or violated due process. The Court struck down a 1992 law, but its majority was split between four votes for a takings violation (Rehnquist, C.J. and O'Connor, Scalia, & Thomas, JJ.), see *Eastern Enterprises v. Apfel*, 524 U.S. 498 (1998), and one vote for a due process violation (Kennedy, J.), see *id.* at 539 (Kennedy, J., concurring in the judgment and dissenting in part).

¹⁷⁵ See Eric Kades, *Windfalls*, 108 *Yale L.J.* 1489, 1494-501 (1999).

risprudence,¹⁷⁶ yet they are a logical extension of the argument that compensation should be paid when *policymaking* activities harm some groups. Of course, a windfall tax would be difficult to administer since it would require government to distinguish between fairly and unfairly earned profits, impose high administrative costs, introduce the possibility of government mistakes, and raise investor uncertainty. The principle, however, is clear. For the reasons outlined above, we do not support this extension of takings law either in developed countries such as the United States or in developing countries with weak legal and political institutions. Rather than set up conditions that restrict government actions to those that benefit all property owners, we believe that governments need the flexibility to set policies that impose both benefits and costs. Those dissatisfied with the outcome should resort to the political process. If the political process is unresponsive, this is a troubling result, but it cannot be remedied through the quick fix of requiring compensation for all state-administered costs.

CONCLUSION

We have outlined what seems to us to be a reasonable constitutional takings doctrine that could be applied both within and outside of the American context. Whenever the government acts as the buyer of a particular asset, it should pay compensation at “fair market value.” The courts would be the final arbiter of this value based on data from private market activity. When the government is best characterized as a policymaker, compensation should not be the general rule. Government policies that influence market rates of return would not give rise to takings claims unless the government plans to use the private property in its existing form or unless risk-averse individuals would demand insurance that is unavailable in the private market. The doctrine thus balances some certainty for investors against the preservation of government policy flexibility. The government should pay compensation whenever it takes resources as part of the process of producing public goods and services. However, there would be a rebuttable presumption against

¹⁷⁶ But see *Dolan v. City of Tigard*, 512 U.S. 374, 399–400 (Stevens, J., dissenting) (suggesting that regulatory takings should be factored into the takings equation).

compensation for losses connected with the overall implementation of a public policy—however misguided or predatory.

The United States provides an illustration of a highly developed country whose constitution leaves open a wide range of regulatory and policy options. We do not recommend adoption of all of the details of the United States system, but it should reassure countries that flexible rules can be consistent with growth if the government is otherwise viewed as accountable and legitimate. In the American context, federal court review of public utility deregulation should not depart from the distinct line of cases addressing public utility price regulation. These cases suggest deference to regulators' decisions regarding compensation, given the democratic political process behind regulatory reform and the relative wealth and power of investors claiming injury. In our view, the courts should treat the deregulation of public utilities as an exercise of government policymaking authority that does not require compensation of "stranded costs" under the United States Constitution. The only exception would be for clearly uneconomic investments required by government policy objectives, such as the encouragement of alternative energy sources.

In countries with well-established democracies, a demonstration that the administrative structure was not fair and transparent could generate a claim for compensation under regulatory laws. We would only recommend this extension of takings law in the small number of countries where it is plausible to think that such claims will help generate reform. Such subtleties are likely to be beyond the capacity of most countries' courts and to provide only weak incentives for reform in predatory states. Regimes with a strong commitment to reform should not put their energies into refining a takings doctrine beyond a basic rule requiring compensation for inputs. Takings law is a weak tool for protecting property rights in infrastructure under changing political conditions. Reformers should instead focus on more fundamental weaknesses in political institutions and should promote the enforcement of contracts, including those to which the state is a party.

Officials in developing countries who are eager for foreign investment need to look far enough ahead to ask if the generous terms they are offering to investors will backfire in the future when citizens perceive the costs they must bear. This concern ought to

temper the officials' support of either very strong guarantees of compensation for future state actions or of contract terms that leave too little flexibility to the state to respond to future conditions. In the privatization of infrastructure, this may mean that a country accepts some reduction in the sales prices of public firms in return for the preservation of policy options. Property rights protection will not aid growth if it encourages inefficient levels and types of investment. Developing countries should be wary of incorporating too sweeping a set of protections into constitutions, individual contracts, or investment treaties, especially if they are still in the process of developing effective state institutions.

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