REGIONAL TRANSMISSION ORGANIZATIONS: FEDERAL LIMITATIONS NEEDED FOR TORT LIABILITY

*Richard J. Pierce, Jr.**

I. INTRODUCTION

The purpose of this article is to explain why the federal government needs to limit the potential tort liability of Regional Transmission Organizations (RTOs) and owners of transmission lines used by RTOs for economic damages attributable to electricity outages and/or power quality disturbances. Section I describes RTOs and explains why they are critical to the successful performance of the restructured U.S. electricity market. Section II describes the liability limitations that all states have long applied to owners of electricity transmission lines and explains why those limitations have been critical to the successful performance of electricity markets. Section III describes the position of the Federal Energy Regulatory Commission (FERC) with respect to the need for federal liability limitations applicable to RTOs, *i.e.,* federal limitations are not needed because state limitations are available. Section IV explains why federal limitations on the potential tort liability of RTOs and their members are essential for the successful performance of the restructured electricity market.

II. THE ROLE OF REGIONAL TRANSMISSION ORGANIZATIONS

For several years, the FERC has been in the process of restructuring the United States' wholesale electricity market in an effort to improve its efficiency.[1] The FERC has concluded that its ability to complete the proc-

* Richard J. Pierce, Jr. is Lyle T. Alverson Research Professor of Law at George Washington University. He is also a Senior Advisor to PA Consulting Group. Professor Pierce has written over a dozen books and over eighty articles on the effects of antitrust law, government regulation, and tort law on the performance of markets, with particular emphasis on natural gas and electricity markets. Professor Pierce's writings have been relied upon scores of times by numerous agencies and courts, including the U.S. Supreme Court. He has testified in support of the need for limitations on the liability of parties that own or control transmission lines in proceedings before the Indiana Utility Regulatory Commission, the Public Utility Commission of Texas, and the Federal Energy Regulatory Commission.

1. The FERC began the restructuring process in Order No. 888, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, [Regs. Preambles 1991-1996] F.E.R.C. STATS. & REGS. ¶ 31,036, at 31,656-57, 31,818 (1996), *order on reh'g*, Order No. 888-A, F.E.R.C. STATS. & REGS. ¶ 31,048 (1997), *order on reh'g*, Order No. 888-B (1997), 81 F.E.R.C. ¶ 61,248 (1997), *order on reh'g*, Order No. 888-C (1998), 82 F.E.R.C. ¶ 61,046 (1998), *aff'd in part and rev'd in part sub nom*, Transmission Access Policy Study Group v. FERC, 225 F.3d 667 (D.C. Cir. 2000), *cert. granted*, 121 S.Ct. 1185 (Nos. 00-568 (in part) and 00-809), *cert. denied*, 121 S.Ct. 1188 (No. 00-800) (Feb. 26,

ess of socially-beneficial restructuring is critically dependent on the creation of RTOs.[2] Each RTO would exercise complete control over the operation of the many transmission lines that comprise an integrated regional grid.

It is a basic law of physics that electricity flows across an integrated grid in inverse proportion to the impedance on each line in the grid. As a result, a transaction that seems to require transmission of electricity just a hundred miles or so from point A to point B actually can effect the capability of the grid to accommodate other transactions as far as one thousand miles from A and B. Thus, for instance, a transmission transaction from Pittsburgh to Philadelphia might effect the capability of the grid to support electricity service to Boston, New York, Baltimore, and Washington. The ownership of the lines that form each integrated regional grid is extraordinarily fragmented. Twenty to fifty different utilities or governmental agencies each own lines in a typical regional grid. Traditionally, each owner (usually a vertically-integrated utility) has controlled the operation of its lines.

The balkanized pattern of ownership and control of regional grids is inherently incompatible with efficient performance of the competitive wholesale market Congress instructed the FERC to create.[3] In an important series of orders issued between 1999 and 2001, the FERC concluded that RTOs are critical to attainment of the FERC's goal in creating an efficient wholesale electricity market. RTOs are voluntary associations in which each of the owners of transmission lines that comprise an integrated regional grid cedes to the RTO complete operational control over its transmission lines. The FERC summarized its RTO initiative in an order issued July 12, 2001:

> The Commission has been attempting to facilitate the development of large, regional transmission organizations since we issued Order No. 2000. We favor the development of one RTO for the Northeast, one RTO for the Midwest, one RTO for the Southeast, and one RTO for the West. Through their independence from market participants, RTOs can ensure truly nondiscriminatory transmission service and will instill confidence in the market that will support the billions of dollars of capital investment in generation and demand side projects necessary to support a robust, reliable and competitive electricity marketplace. RTOs are the platform on which our expectations of the substantial generation cost savings to American consumers are based.[4]

As multistate entities that operate entirely in interstate commerce, RTOs

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2001) [hereinafter Order No. 888]. It took another major step in that process in Order No. 2000, F.E.R.C. STATS & REGS. ¶ 31,089 (1999) [hereinafter Order No. 2000].

2. Order No. 2000, *supra* note 1. *See also Report of the Committee on Electric Utility Regulation*, 22 ENERGY L.J. 425-439 (2001).

3. For a discussion of the manner in which Congress instructed the FERC to create a competitive wholesale market, see generally Jeffrey B. Watkiss & Douglas W. Smith, *The Energy Policy Act of 1992: A Watershed for Competition in the Wholesale Power Market*, 10 YALE J. ON REG. 447 (1993).

4. *Bangor Hydro-Electric Co.*, F.E.R.C. Docket No. RT01-86-000, at 2 (July 12, 2001). For discussion of the critical role of RTOs, see generally Richard J. Pierce, Jr., *Why FERC Must Mandate Efficiently-Structured ISOs—Now!*, 12 ELEC. J. 49 (Jan./Feb. 1999).

are necessarily subject to exclusive federal regulatory jurisdiction.[5]

III. LIABILITY LIMITATIONS ON TRANSMISSION LINES

A. *Historical Liability Limitations Before RTO Formation.*

Before the restructuring process created the need for RTOs, delivery service (transmission and distribution) was subject primarily to state regulatory jurisdiction.[6] As a consequence, states have long recognized the need for limitations on the potential tort liability of owners of transmission lines and other similar regulated assets, and have included such limitations in the tariffs of the owners of lines located within the state.[7] There is some variation among the limitation of liability provisions in state-approved tariffs, but the typical tariff precludes a damage award against an owner of a transmission line when the damages are economic, as opposed to damages for physical injury, and when the claim for damages is based on alleged negligence.[8] The U.S. Supreme Court has upheld such limitation of liability provisions.[9]

A leading treatise on tort law summarizes the applicable law and reasoning: "The consequential damages from a blackout . . . can be enormous and most regulatory agencies take this into account in establishing limitations on liability."[10] The Oregon Court of Appeals has described the applicable law at the state level: "Courts are virtually unanimous [in holding] that provisions limiting a public utility's liability are valid so long as they do not purport to grant immunity or limit liability for gross negligence."[11]

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5. 15 U.S.C. § 824(b) (2001). *See generally* FPC v. Florida Power & Light Co., 404 U.S. 453 (1982).

6. Before restructuring, virtually all electricity service was provided on a fully-bundled basis through integrated electric utilities who simply included the cost of transmission in their retail rates. Transmission Access Policy Study Group v. FERC, 225 F.3d 667, 727 (D.C. Cir. 2000).

7. *Id.* at 727.

8. Thus, for instance, the Texas Supreme Court upheld the following tariff provision in Houston Lighting & Power Co. v. Auchan, 995 S.W.2d 668, 669-670 (Tex. 1999):

> Company [HL & P] will make reasonable provisions to supply steady and continuous electric service, but does not guarantee the electric service against fluctuations or interruptions. Company will not be liable for any damages, whether direct or consequential, including, without limitation, loss of profits, loss of revenue, or loss of production capacity, occasioned by fluctuations or interruptions unless it be shown that Company has not made reasonable provisions to supply steady and continuous electric service, consistent with the Customer's class of service, *and in the event of a failure to make such reasonable provisions (whether as a result of negligence or otherwise), Company's liability shall be limited to the cost of necessary repairs of physical damage proximately caused by the service failure* to those electrical facilities of Customer which were then equipped with the protective safeguards recommended or required by the then current edition of the National Electrical Code. (emphasis original)

9. Southwestern Sugar & Molasses Co. v. River Terminals Corp., 360 U.S. 411 (1959); Western Union Tel. Co. v. Esteve Bros. & Co., 256 U.S. 566 (1921); Hart v. Pennsylvania R.R. Co., 112 U.S. 331 (1884).

10. PROSSER & KEETON, THE LAW OF TORTS 663 (5th ed. 1984).

11. Garrison v. Pacific Northwest Bell, 608 P.2d 1206, 1211 (Or. Ct. App. 1980). *See also Transmission Access Policy Study Group*, 225 F.3d at 727 ("Prior to unbundling, retail tariffs were primarily a matter for state regulation, and most states had approved tariff provisions permitting utilities to limit

B. State Law Recognizing Liability Limitations

The state-approved liability limitation provisions vary to some extent by jurisdiction and even among different utilities in the same jurisdiction. Generally, however, they protect owners of transmission lines from potential awards of damages caused by interruptions of, or fluctuations in, electricity service due to alleged negligence.[12]

For decades agencies and courts have given the same basic reasons for limiting the potential liability of owners of transmission lines. It is easiest to describe those reasons by tracking the relevant decision-making in a single jurisdiction. On February 9, 2001, the Public Utility Commission of Texas (PUCT) issued a complete set of new rules applicable to transmission of electricity in the newly restructured Texas electricity market.[13] Texas is the only state in the contiguous forty-eight states that has an independent, electrically isolated transmission grid. Thus, it is the only state that has regulatory jurisdiction over a transmission grid in the restructured United States electricity market (ERCOT). The PUCT uses an RTO-type structure to regulate the Texas grid in the same basic manner that the FERC proposes to regulate the multi-state RTOs. The PUCT reconsidered all of its rules applicable to transmission lines when it used the RTO model to restructure its electricity market. The PUCT changed many of its rules, but it decided to retain the same limitation of liability it has long applied to owners of transmission lines.[14]

The history of Texas's treatment of this issue illustrates particularly well the typical reasoning of agencies and courts with respect to this issue. In 1981, the PUCT conducted a proceeding to determine whether and to what extent to limit the liability of owners of transmission lines. After hearing extensive testimony from a wide variety of parties, Examiner Ricketts wrote a well-reasoned report on June 22, 1981, in which he con-

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their liability for service interruptions to instances of gross negligence or willful misconduct.").

12. For examples of the many different forms of liability limitation provisions that courts have upheld, see generally Los Angeles Cellular Tel. Co. v. Superior Ct., 65 Cal. App. 4th 1013 (1998); Woloshin v. Diamond State Tel. Co., 380 A.2d 982, 984-85 (Del. Ch. 1977); Ill. Bell Switching Station Litig., 641 N.E.2d 440, 441-45 (1994); Angelo Pavone Enters. v. South Cent. Bell Tel. Co., 459 So. 2d 1223, 1226 (La. Ct. App. 1984); Wilkinson v. New England Tel. & Tel. Co., 97 N.E.2d 413, 416 (Mass. 1951); Montana *ex rel.* Mountain States Tel. & Tel. Co. v. Dist. Ct., 503 P.2d 526, 529 (Mont. 1972); Allen v. General Tel. Co., 578 P.2d 1333, 1336-37 (Wash. Ct. App. 1978); Olson v. Mountain States Tel. & Tel. Co., 580 P.2d 782, 784 (Ariz. Ct. App. 1978); Shoemaker v. Mountain States Tel. & Tel. Co., 559 P.2d 721, 724 (Colo. Ct. App. 1976); Southern Bell Tel. & Tel. Co. v. Invenchek, Inc., 204 S.E.2d 457, 460 (Ga. Ct. App. 1974); Burdick v. Southwestern Bell Tel. Co., 675 P.2d 922, 925 (Kan. Ct. App. 1984); Computer Tool and Eng'g. Inc. v. Northern States Power Co., 453 N.W.2d 569, 573 (Minn. Ct. App. 1990); Bulbman, Inc. v. Nev. Bell, 825 P.2d. 588, 590 (Nev. 1992); Coachlight las Cruces, Ltd. v. Mountain Bell Tel. Co., 664 P.2d 994, 1000 (N.M. Ct. App. 1983); Lee v. Consolidated Edison Co., 413 N.Y.S.2d 826, 823 (1978); Garrison v. Pacific Northwest Bell, 608 P.2d 1206, 1211 (Or. Ct. App. 1980); Behrend v. Bell Tel. Co., 363 A.2d 1152, 1166 (Pa. Super. Ct. 1976), *vacated,* 374 A.2d 536 (Pa. 1977), *aff'd,* 390 A.2d 233 (Pa. Super. Ct. 1978).

13. 26 Tex. Reg. 1310 (2001).

14. *Id.* at 1315-1319.

cluded that the PUCT should approve liability limitations applicable to transmission lines and gave reasons in support of that conclusion.[15] In 1999, a party challenged the validity of a liability limitation provision similar to the provision the PUCT approved in 1981. The Texas Supreme Court upheld that liability limitation provision as reasonable.[16] The Court found the PUCT's reasons for limiting the liability of owners of transmission lines persuasive.[17] It noted, however, that the PUCT was in the process of restructuring the Texas electricity market, and it suggested that the PUCT might want to reconsider the issue in light of the changed conditions created by its then-ongoing restructuring process.[18]

The PUCT took that suggestion seriously and reconsidered the need for, and appropriate scope of, liability limitation provisions applicable to transmission lines in a restructured electricity market. After considering extensive evidence on that issue, the PUCT concluded that a liability limitation tariff provision identical to the provision the Texas Supreme Court upheld was appropriate in the context of the restructured Texas electricity market.[19] The reasons given by Examiner Ricketts, by the PUCT, and by the Texas Supreme Court explain why states have long concluded that liability limitations applicable to transmission lines are essential to the efficient performance of electricity markets. The evidence presented to the PUCT in 2000 persuaded the PUCT that those limitations are even more essential to the performance of the newly restructured electricity markets that the FERC and the PUCT are in the process of creating.

C. *Public Policy Rationale for Limitation of Liability*

In its 1999 opinion,[20] the Texas Supreme Court gave the following reasons in support of its conclusion that it is reasonable to include a limitation of liability provision in a transmission tariff:

- It produces lower rates;
- It provides fair and reasonable treatment of all customers, including avoidance of small customers having to subsidize disproportionately large damage awards to large customers;[21]
- It protects the utility from potential catastrophic losses and financial distress, thereby making it easier and less expensive for the utility to attract sufficient capital;[22]
- Large customers are in a better position than a utility to esti-

15. Application of Cent. Power & Light Co. for Approval of Tariff Amendment, Docket No. 3198, 7 Tex. P.U.C. Bull. 53 (1981).

16. Houston Lighting & Power Co. v. Auchan, 995 S.W.2d 668 (Tex. 1999).

17. *Id.* at 673-675.

18. *Houston Lighting & Power Co.*, 995 S.W.2d at 675.

19. 26 Tex. Reg. 1310, 1315-1319 (2001).

20. *Houston Lighting & Power Co.* v. Auchan, 995 S.W.2d 668, 673 (Tex. 1999).

21. *Id.* at 673.

22. *Houston Lighting & Power Co.*, 995 S.W. 2d at 674.

mate their exposure to losses attributable to a potential loss of power and to protect their own interests; and[23]

- A utility is a regulated monopoly that cannot pick and choose its customers or vary its rates to reflect differential damage exposures.[24]

Not surprisingly, the public policy reasons the Texas Supreme Court recognized in 1999 in support of a broad limitation of liability provision paralleled the public policy reasons recognized in 1981 by the PUCT.[25]

D. Arguments Supporting Limiting Liability

The testimony the PUCT found persuasive in 2000 used a two-step process to explain why the restructuring process has not eliminated, or reduced the strength of, any of the reasons given by the Texas Supreme Court or by the PUCT in support of the need for broad liability limitation provisions.[26] First, it explained why each of the reasons in support of liability limitation provisions existed when the PUCT authorized those provisions in 1981. Second, it explained why the restructuring process and other changes in conditions have not reduced the strength of the reasoning in support of limitations on liability. Indeed, the recent changes in electricity markets have increased the need for liability limitation provisions.

1. Lower Utility Rates

The PUCT and the Texas Supreme Court referred to lower rates as one of the reasons supporting a limitation of liability.[27] The relationship between a liability limitation provision and a utility's rates is readily apparent. Without a strong liability limitation provision, a utility would be exposed to potentially enormous damage awards and large legal fees that would be reflected in its rates. Both the PUCT and the Court referred to the litigation that arose from the 1977 New York blackout to illustrate that risk.[28] More recently, litigation has been spawned by blackouts in the midwest in 1998, in the northeast in 1999, and in California in 2000 and 2001.[29] Moreover, the risk of incurring costs attributable to damage actions will

23. *Id.* at 674.

24. *Houston Lighting & Power Co.*, 995 S.W. 2d at 674.

25. 7 Tex. P.U.C. Bull. 53.

26. *See generally* Testimony of Richard J. Pierce, Jr., before the Pub. Util. Comm'n of Tex., Project No. 22187, Terms and Conditions of Transmission and Distribution Utilities Retail Distribution Service (Sept. 1, 2000).

27. Houston Lighting & Power Co. v. Auchan, 995 S.W.2d 668, 673 (Tex. 1999); 7 Tex. P.U.C. Bull. 53, 59.

28. *Houston Lighting & Power Co.*, 995 S.W. 2d at 674 (Tex. 1999); 7 Tex. P.U.C. Bull. 53, 59.

29. *See generally* Richard J. Pierce, Jr., *How Will the California Debacle Affect Energy Deregulation?*, 54 ADMIN. L. REV. 379 (2002) (describing California blackouts); Carl J. Levesque, *Outage Management: Liability or Marketing?*, PUB. UTIL. FORT. 56 (Feb. 15, 2000) (describing midwest and northeast blackouts). *See also* Muise v. GPU, 753 A.2d 116 (N.J. Super. Ct. 2000) (allowing class action to proceed against utility for damages attributable to 1999 blackout).

will increase a utility's cost of capital, thereby further increasing its rates.

2. Fairness to Customers

The PUCT and the Court referred to fairness to all customers as another reason in support of a liability limitation provision.[30] This requires a bit of explanation. Utilities provide service to a large number of customers which are characterized by a high degree of heterogeneity with respect to the damages each would suffer as a result of a power outage. Generally, large industrial and commercial customers who have not taken steps to protect themselves from a potential outage would be exposed to potential losses disproportionate to the potential losses that residential customers would suffer. Even within each of those categories, there would be extremely large variations in resulting losses, depending on factors like the precise use of electricity by each, the activities each was engaged in at the time of the outage, the ability to defer those activities, the cost of such deferral, and the nature and efficacy of the self-protection measures taken by each. Thus, without a liability limitation provision, the cost of providing service would vary greatly both among and within customer classes. Yet it would be extremely difficult to establish a rate structure that reflected accurately (or even approximately) the resulting wide variation in cost of service. Many small customers would be required to pay rates significantly higher than their cost of service in order to provide revenues sufficient to recover the disproportionately high liability component of the cost of serving relatively few large customers.

3. Protection from Catastrophic Losses

The PUCT and the Court referred to the need to protect a utility from potential catastrophic losses and financial distress, thereby rendering it easier and less expensive for the utility to attract sufficient capital.[31] The relationship between a liability limitation provision and the potential for catastrophic losses and financial distress is direct and obvious. It would be extremely difficult to make a reasonably accurate estimate of any utility's actual level of exposure in the event of an outage in the absence of a liability limitation provision. The process of making such an estimate would be complicated and would require access to a great deal of information that is available only to the utility's individual customers. It is apparent, however, that a prolonged systemwide outage would expose a utility to potential catastrophic damages and would require it to expend substantial sums on legal services even if it was successful in contesting its liability for damages. A study completed after the PUCT reaffirmed its decision to authorize the inclusion of broad liability limitation provisions in utility tariffs estimated that power outages and disturbances across the country cause damages of

30. *Houston Lighting & Power Co.*, 995 S.W. 2d at 673; 7 Tex. P.U.C. Bull. 53, 59.

31. *Id.* at 673; 7 Tex. P.U.C. Bull. 53, 59.

$119 billion to $188 billion per year.[32] The relationship between exposure to potential damage actions and a utility's cost of capital is also direct and obvious. Any prospective investor would view a utility as a high risk investment in the absence of a liability limitation provision. Investors would require a large risk premium to invest in such a utility if they were willing to make such an investment at all.

4. Ability to Insure Against Losses

The PUCT and the Court also referred to the fact that large customers are in a better position than a utility to protect their own interests by estimating their exposure to losses attributable to a potential power outage and protecting themselves from those potential losses.[33] This is because large customers are in a better position to estimate their exposure, because only they have access to the data about the nature of their uses of electricity and the likely consequences of outages. Most large commercial or industrial customers would be unwilling to provide that information to a utility.

Customers can protect themselves from an outage in two ways. First, they can make capital investments and adopt operating protocols that minimize their damages in the event of an outage, for example, they can install backup generating equipment. Indeed, in many cases, industrial and commercial customers can simply make use of their existing backup generating equipment, as they currently do for outages. Obviously, large customers are in a much better position to take such protective measures than are small customers. That reinforces the inequity of requiring small customers to pay higher rates in order to accommodate large customers who have the potential for disproportionately large damages in the event of an outage but who also have the capability to protect themselves from the potential effects of such an outage. Second, customers can protect themselves through insurance. Large customers are in a much better position to insure against the risk of a power outage than a utility.[34]

5. Effects of Being a Regulated Monopoly

The PUCT and the Court referred to the fact that a utility is a regulated monopoly.[35] That regulated status has significant implications for a deci-

32. Primen, *The Cost of Power Disturbances to Industrial and Digital Economy Companies* (June 29, 2001).

33. Houston Lighting & Power Co. v. Auchan, 995 S.W.2d 668, 673-674(Tex. 1999); 7 Tex. P.U.C. Bull. 53, 58.

34. Indeed, utilities would experience extreme difficulties obtaining insurance adequate to cover their potential liability for outages and disturbances at reasonable cost, particularly in the wake of the World Trade Center tragedy. That incident has placed enormous stress on global insurance and reinsurance markets and has induced insurers and reinsurers to reconsider their actuarial evaluations of many potential catastrophic risks.

35. *Houston Lighting & Power Co.*, 995 S.W. 2d at 674; 7 Tex. P.U.C. Bull. 53, 59.

sion with respect to the desirability of a liability limitation provision. An unregulated firm can protect itself from potentially unacceptable liability exposure vis-a-vis its customers in at least three ways: (a) it can bargain for a contractual liability limitation provision; (b) it can charge a higher price to reflect its liability exposure, and (c) it can simply decline to provide service to a customer if it perceives an unacceptable level of liability exposure. A regulated monopoly has none of those options. A utility is required to serve all prospective customers at rates set by an agency and on terms and conditions set by an agency, such as the FERC.[36]

6. Continued Need for Liability Limitations

After describing the reasons traditionally given by the PUCT and the Texas Supreme Court in support of the need for liability limitation provisions, which are virtually identical to the reasons traditionally given by agencies and courts in the other forty-nine states, the testimony before the PUCT explained why the restructuring process has not eliminated or reduced the need for such provisions. The detailed regulatory rules applicable to owners of transmission lines necessarily will change in the restructuring process, but owners of transmission lines will continue to be subject to the basic rules applicable to a regulated monopoly. They will have a duty to serve all customers at rates, terms, and conditions set by an agency. Thus, there will not be any change in the environment in which owners of transmission lines will operate in the restructured industry that would eliminate, or reduce the strength of, any of the reasons in support of inclusion of a limitation of liability provision in a transmission line owner's tariff.

Today, outages have the potential to be the basis for damage awards of hundreds of millions, or even billions of dollars. In the absence of a limitation of liability provision, the magnitude of this risk would increase the problems an owner or operator of transmission lines would encounter in attracting capital at a reasonable cost; it would increase the rates all customers would have to pay; and it would increase the degree of inequity that would result from requiring customers with low potential damage claims to bear the cost of subsidizing customers with disproportionately high potential damage claims.

Owners of transmission lines will continue to need to attract capital in the future. Demand for electricity is growing rapidly, and the new reliance on markets to govern generation and sales is both increasing the amount of electricity that must be transmitted and distributed across grids and changing the patterns of flows across grids.[37] Taken together, these changes will

36. 16 U.S.C. §§ 824-824(m) (2002). The rates, terms, and conditions set by the agency, necessarily are uniform among broad classes of customers. An agency would find it extremely difficult to establish rates, terms, and conditions that are specifically tailored to each customer's unique and highly variable exposure to potential losses attributable to a potential loss of power.

37. *See generally* Eric Hirst & Brendan Kirby, *Transmission Planning: Weighing Effects on Congestion Costs*, PUB. UTIL. FORT. 56 (July 15, 2001).

require major new investments to expand the capacity of transmission grids. A study, completed after the PUCT issued its decision, found that massive investments in grid capacity expansion projects are essential to avoid severe price increases attributable to growing grid congestion.[38] If owners of transmission lines are unable to attract sufficient capital, service reliability will suffer and rates will increase. If they are able to attract sufficient capital only by paying a risk premium attributable to exposure to potential catastrophic damage awards, rates will increase.

Moreover, technological advances, such as improvements in the efficiency of small gas turbines, have made it much easier and less expensive for large customers to protect themselves from the adverse effects of a potential power outage by, *inter alia*, installing backup generating capacity that is sufficient to cover at least their most critical, time-sensitive needs. These advances, in turn, increase still further the disparity between the ability of a large customer to protect itself and the ability of an owner of transmission lines to protect a large customer. They also increase the inequitable effect of requiring small customers to subsidize large customers by paying the higher rates that would be attributable to large customers' disproportionately larger damage awards in the event of a system outage.

IV. LIABILITY LIMITATION PROVISIONS FOR RTOS

The FERC has concluded that federally regulated RTOs are essential to the creation of efficiently functioning restructured electricity markets in the United States.[39] It has strongly urged all owners of transmission lines outside of Texas to transfer complete control over their lines to one of four RTOs.[40] Since each RTO is a multistate entity that operates exclusively in interstate commerce, each necessarily is subject to plenary and exclusive regulation by the FERC.[41]

The FERC had authorized owners of transmission lines to include liability limitation provisions in their tariffs prior to the FERC's initiation of its restructuring efforts. As the U.S. Court of Appeals for the D.C. Circuit recognized in 2000: "In the past, [the] FERC . . . allowed electric utility tariffs to explicitly limit a utility's liability for service interruptions to instances of gross negligence or willful misconduct."[42] The FERC changed its historic practice and announced that it would not authorize inclusion of liability limitation provisions in utility tariffs in Order Nos. 888-A and 888-B.[43] Since then, the FERC has declined to authorize inclusion of a liability

38. *Id.*

39. Order No. 2000, *supra* note 1. *See also Report of the Comm. on Elec. Util. Regulation*, 22 ENERGY L.J. 425-439 (2001).

40. *Bangor Hydro-Electric Co.*, 96 F.E.R.C. ¶61,063, at 61,254 (2001). For discussion of the critical role of RTOs, *see generally* Richard J. Pierce, Jr., *Why FERC Must Mandate Efficiently-Structured ISOs—Now!*, 12 ELEC. J. 49 (Jan./Feb. 1999).

41. 15 U.S.C. § 824(b)(2000). *See generally* FPC v. Fla. Power & Light Co., 404 U.S. 453 (1982).

42. Transmission Access Policy Study Group v. FERC, 225 F.3d 667, 727 (D.C. Cir. 2000).

43. Order No. 888-B, *Promoting Wholesale Competition Through Open Access Non-*

limitation provision in any RTO tariff.[44]

The FERC has not explained why it changed its policy, and now refuses to authorize inclusion of liability limitation provisions in RTO tariffs. The FERC has inserted boilerplate language that refers briefly to two reasons for its decision in the orders in which it has rejected a proposed liability limitation provision. First, the FERC has stated that RTOs can rely on "state laws . . . protecting utilities . . . from claims founded in ordinary negligence."[45] The flaws in that assertion are discussed discussed in Section IV. For now, it is enough to note the irony of the FERC's positions. The FERC is replacing the system of dual state and federal jurisdiction over transmission lines with a new system of exclusive federal jurisdiction at the same time that it is relying on the existence of state regulation of transmission lines to justify its refusal to continue its historic practice of limiting the liability of owners of transmission lines. Second, the FERC cites some of its orders directed to gas pipelines to support its assertion that it lacks authority to approve liability limitation provisions applicable to RTOs.[46] Those orders do not support the FERC's position. Each of the FERC's orders, directed to gas pipelines, cited a single judicial decision to support the FERC's apparent belief that it lacks authority to limit the liability of RTOs.[47]

A. The FERC's Basis for Authority

The sole judicial decision that the FERC cited to support its refusal to include liability limitation provisions in RTO tariffs is Judge Higginbotham's decision in *United Gas Pipeline Co. v. FERC*.[48] *United* is one of scores of judicial decisions that addressed the relationship between contracts and regulation in governing the performance of the natural gas market.[49]

Discriminatory Transmission Servs. by Pub. Utils, 81 F.E.R.C. ¶ 61,248 (1997); *order on reh'g.*, 82 F.E.R.C. ¶ 61,046 (1998).

44. *See, e.g. Cambridge Elec. Light Co.*, 95 F.E.R.C. ¶ 61,339, at 62,280 (2001); *Grid Florida*, 94 F.E.R.C. ¶ 61,363, at 62,334 (2001).

45. *Avista Corp.*, 95 F.E.R.C. ¶ 61,114, at 61,337(2001).

46. Thus, for instance, in Order No. 888, the FERC cited *Pacific Interstate Offshore Co.*, 62 F.E.R.C. ¶ 61,260, at 62,733 (1993), to support its position that it lacks authority to approve a liability limitation provision. Order No. 888, *supra* note 1, at 31,765.

47. The other gas cases rejecting such provisions include: *Arkla Energy Resources Co.*, 64 F.E.R.C. ¶ 61,166, at 62,490 (1993); *National Fuel Gas Supply Corp.*, 63 F.E.R.C. ¶ 61,291, at 63,021 (1993); *National Fuel Gas Supply Corp.*, 64 F.E.R.C. ¶ 61,276, at 62,951 (1993); *Alabama-Tennessee Natural Gas Co.*, 49 F.E.R.C. ¶ 61,127, at 61,540-41 (1989); *Sea Robin Pipeline Co.*, 46 F.E.R.C. ¶ 61,061, at 61,284-85 (1989); *Kentucky West Virginia Gas Co.*, 45 F.E.R.C. ¶ 61,134, at 61,397 (1988); and *Texas E. Transmission Corp.*, 44 F.E.R.C. ¶ 61,413, at 61,325 (1988). In each case, the FERC supported its position by citing United Gas Pipeline Co. v. FERC, 824 F.2d 417 (5th Cir. 1987).

48. United Gas Pipeline Co., 824 F.2d 417.

49. That relationship was a major focus of my teaching and scholarship during the 1980s. *See, e.g.*, Richard J. Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345 (1983); Pierce, *Natural Gas Regulation, Deregulation, and Contracts*, 68 VA. L. REV. 631 (1982). The FERC and the courts relied on my writings on that issue as part of the

Judge Higginbotham's opinion in *United* does not support the FERC's position with respect to inclusion of liability limitation provisions in RTO tariffs. It addresses a different issue in a different context in a different industry. There are two holdings in *United* that have some relevance to the present issue. First, the court upheld the FERC's decision to insulate a gas pipeline from potential liability for interrupting gas service where the interruption is attributable to the pipeline's compliance with a FERC-prescribed set of service priorities.[50] Second, the court upheld the FERC's decision to decline to insulate a gas pipeline from potential liability for interrupting gas service if a customer could prove that the interruption was due to a shortage that the pipeline caused through its "negligence or willful misconduct . . . ."[51] Thus, the court merely held that the FERC had the discretion to decline to limit a gas pipeline's liability in the circumstances presented.

The second holding in *United* can be understood only from the circumstances in which the issue of the FERC's exercise of its discretion arose. The Fifth Circuit's opinion in *United* was one of three closely-related court decisions that addressed the FERC's power to limit the liability of gas pipelines. As Judge Higginbotham recognized in *United*,[52] the most influential opinion on that issue was Judge Brown's concurring opinion in *International Paper Co. v. FPC*,[53] followed in importance by Judge Leventhal's opinion in the companion case of *Monsanto Co. v. FPC*.[54]

The facts of the *United* case provide a helpful perspective. During the late 1960s, United engaged in an aggressive campaign to market natural gas. It entered into a large number of potentially lucrative contracts in which it committed to sell large volumes of gas directly to industrial customers for ten to twenty years.[55] Many of those contracts included provisions in which United agreed to pay liquidated damages if it failed to fulfill its contractual commitments.[56] A couple of years after it conducted that aggressive marketing campaign, United announced that it had a shortage of gas and stated its intention not to comply with the contractual commitments it had just made.[57] Many of United's direct industrial customers sued United for breach of contract and for fraud.[58] United's customers al-

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basis for restructuring the natural gas market in the 1980s. *See, e.g.*, Associated Gas Distributors Ass'n v. FERC, 981 F.2d 981 (D.C. Cir. 1987); Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1985).

50. United Gas Pipeline Co., 824 F.2d at 425.

51. *Id.* at 425-427.

52. United Gas Pipeline Co. v. FERC, 824 F.2d 417, 422, 427, 429 (5th Cir. 1987).

53. 476 F.2d 121, 129 (5th Cir. 1973).

54. 463 F.2d 799 (D.C. Cir. 1972). I taught both opinions for years and included both in my first casebook on energy regulation. *See generally* RICHARD J. PIERCE, JR. ET. AL., ECONOMIC REGULATION: ENERGY, TRANSPORTATION AND UTILITIES 591-595 (1980).

55. *United Gas Pipeline*, 824 F.2d at 427.

56. *International Paper Co.*, 476 F.2d at 123.

57. United Gas Pipeline Co. v. FERC, 824 F.2d 417 (5th Cir. 1987).

58. *Id.* at 422-423.

leged, *inter alia*, that United knew that it had a shortage of gas at the time it entered into the contracts, which had resulted from its aggressive marketing campaign.[59] United attempted to defend against the actions for breach of contract and for fraud by arguing that it had been rendered unable to perform its contractual obligations by an intervening governmental order.[60] That order was issued by the Federal Power Commission (FPC), the FERC's predecessor agency. The FPC order required United to allocate its available gas supply in a manner that produced some interruptions of service to United's direct industrial customers.

In *Monsanto*[61] and *International Paper*,[62] the D.C. and Fifth Circuits, respectively, held that the FPC order had the effect of insulating United from liability for damages attributable to its compliance with the FPC order. The courts went on, however, to note that the FPC order did not necessarily insulate United from liability if a customer could prove that United had engaged in "bad faith" by knowingly committing to sell more gas than it had.[63] In Judge Brown's words, United "might" be liable for damages if a customer could prove that United acted in "bad faith."[64] Judge Brown emphasized "might."[65] He stated unequivocally that it would not be appropriate to require United to pay damages, even if it acted in bad faith, if United could collect the resulting damages from its other customers by including them as costs to be recovered in its rates.[66]

B. Material Differences in Issues Between United and Current RTO Structure

There are five differences between the issues raised in *United* and the issues raised by a request to include a federal liability limitation provision in an RTO tariff. First, United voluntarily entered into the contracts that it later attempted to avoid. Thus, it voluntarily assumed all of the obligations created in those contracts, including the explicit obligation to pay liquidated damages if it failed to comply with the obligations it undertook. By contrast, an RTO has no discretion with respect to its obligations. All of its obligations are imposed on it by federal law.[67]

Second, United had both discretion with respect to its sources of supply and a duty to acquire enough gas to fulfill the contractual commitments it made. By contrast, an RTO provides only a transmission function. An RTO has no control over the sources of the electricity it transmits or the

59. *United Gas Pipeline Co.*, 463 F.2d at 427.
60. *Id.* at 422-424.
61. *United Gas Pipeline Co.*, 463 F.2d 799.
62. International Paper Co. v. FPC, 476 F.2d 121 (5th Cir. 1973).
63. *Id.* at 126; *United Gas Pipeline Co.*, 463 F.2d at 808.
64. *International Paper Co.*, 476 F.2d at 131-132.
65. *Id.* at 131-132.
66. *International Paper Co.*, 476 F.2d at 132.
67. Order 2000, *supra* note 1.

adequacy of that supply to meet the electricity demand on the grid.

Third, the main issue in *United* was whether the pipeline would be liable for damages for fraudulent or bad faith conduct. By contrast, RTOs are requesting only that they be protected from damages in instances of negligence.

Fourth, the relationship between a pipeline and a direct industrial customer to whom it has agreed to sell gas is subject only to potential state regulation. It is explicitly exempt from federal regulation.[68] That jurisdictional situation played a major role in persuading the *United* court that the FERC had the discretion not to impose broader federal limits on United's liability.[69] By contrast, RTOs are subject to exclusive federal regulatory jurisdiction.

Finally, it was unclear whether United would be required to pay any damages awarded against it out of its profits, or whether it would be able to recover those damages from its other customers in its rates. If United had been determined to have acted in bad faith or fraudulently, it is possible that United would not have been allowed to recover any damages awarded against it in its rates. Absent a finding of fraud or bad faith, however, United almost certainly would have been allowed to include any damages it had to pay in the rates it charged its other customers. All courts agreed that it would be totally inappropriate to allow one customer to obtain damages from United if other customers would then be required to pay higher rates to reflect United's payment of those damages.[70] Damages awarded against an RTO for an interruption allegedly attributable to negligence would be recoverable in the rates of the RTO. Thus, courts agree that it would be totally inequitable to require some customers to subsidize other customers by allowing certain customers to recover disproportionately large damages for interruptions in service.[71]

IV. RTOs NEED FEDERAL LIABILITY LIMITATIONS

The FERC has never attempted to defend the merits of its refusal to authorize liability limitations applicable to RTOs as an exercise of its discretion. It has attempted to justify that refusal based solely on its belief that it lacks authority to approve liability limitations in RTO tariffs and on its unsupported assertion that RTOs do not need federal liability limitations because of the existence of state liability limitations.[72] That assertion is wrong, and RTOs need federal liability limiations.

The logical starting point is to recognize that all of the reasons that state

68. 15 U.S.C. § 717(b) (2001); FPC v. La. Power & Light Co., 406 U.S. 621, 647 (1972). In the case of United's contracts with its direct customers, the state with jurisdiction, Louisiana, chose not to regulate direct pipeline sales to industrial customers.

69. *See generally* United Gas Pipeline Co. v. FERC, 824 F.2d 417, 426-430 (5th Cir. 1987).

70. *Id.* at 429-430.

71. *See generally* discussion at *supra* notes 30-31.

72. *See generally supra* notes 41-44.

agencies and courts have long given, in support of the need for liability limitations applicable to the state-regulated functions performed by owners of transmission lines, apply with at least equal strength to the new federally-regulated functions of owners of transmission lines when their lines are used by an RTO. Thus, effective liability limitation provisions applicable to RTOs and owners of transmission lines used by RTOs are essential for all of the reasons discussed in section II:

- They produce lower rates;
- They provide fair and reasonable treatment for all customers and avoid the inequity of requiring small customers to subsidize large customers;
- They protect owners of transmission lines from potential catastrophic losses and financial distress, thereby making it easier and less expensive for them to attract the large amounts of capital required to make much-needed investments in expansion of the capacity of transmission grids;
- Large customers are in a better position than owners of transmission lines to estimate their exposure to losses attributable to a potential loss of power and to protect their own interests; and
- Owners of transmission lines are regulated monopolies that cannot pick and choose their customers or vary their rates to reflect differential damage exposures.

A. Lack of State Authority

The FERC has taken the position that federal limitations on the liability of RTOs are unnecessary because of the pre-existing state limitations on the liability of owners of transmission lines.[73] State agencies and courts routinely justify state-imposed limitations on the liability of owners of transmission lines as an integral part of the state's overall system of regulating transmission lines, e.g., state courts reason that the state utility commission is justified in limiting a utility's transmission liability because it can and does regulate the utility's transmission rates and terms and conditions of service.[74] That justification for state-imposed limitations becomes questionable if a utility gives an RTO complete control over its transmission lines, as the FERC has repeatedly urged all utilities to do.[75] RTOs and owners of transmission lines used by RTOs are subject to exclusive federal regulation.[76] Once a transmission line owner cedes control over its lines to an RTO, no state has power to regulate the RTO or the transmission lines that are controlled by the RTO. It is far from clear that state-imposed limitations on the liability of transmission owners will be the given effect where the state has no power to regulate the owners of transmission lines

73. *Avista*, 95 F.E.R.C. ¶ 61,114, at 61,345 (2001)

74. *See generally supra* note 8 & 12.

75. *See generally* discussion at *supra* notes 1-5.

76. 16 U.S.C. § 824(b) (2001).

in other respects.

In the absence of a federal limit on liability, any doubt with respect to the continued effectiveness of state-imposed limits on liability once a utility cedes control of its transmission lines to an RTO will create a powerful disincentive for utilities to allow RTOs to exercise control over their transmission lines. Without a federal liability limitation, an owner of transmission lines knows only that it is completely insulated from liability if it declines to allow an RTO to control its lines and that it might, or might not, be insulated from liability if it cedes control to an RTO. Utilities will be extremely reluctant to allow RTOs to control their lines in that legal environment. The risk of potential catastrophic damage awards is intolerably high and growing.

Even if some state-imposed liability limitations continue to apply to owners of transmission lines that cede control of their lines to an RTO, the absence of a uniform federal liability limitation will give rise to a host of difficult legal questions. Suppose, for instance, that there is an eight-hour blackout on a portion of the western grid that includes parts of California, Oregon, and Nevada. In the absence of a federal liability limitation provision, it is easy to predict that adversely affected customers in those three states would file multi-billion dollar damage actions against RTO West—the RTO that will control the transmission grid in the western U.S. RTO West would then try to use the state-authorized liability limitations to defend itself. That effort would raise numerous issues, including whether any state's liability limitation applies, and, if so, which state's limitations apply. The damages were suffered in three states, but the myriad of actions that had some causal relation to the damages undoubtedly took place in several other states. Each state has approved liability limitations that differ somewhat in language and scope. Moreover, some states are likely to conclude that their state limitations apply to a federally regulated RTO, while others are likely to reach the opposite conclusion.

That single hypothetical outage would raise many other issues as well. Since RTO West is a thinly-capitalized member organization, the customers damaged by the outage would be certain to sue the corporations and government agencies that own the transmission lines used by RTO West, as well as the RTO. Depending on the underlying facts and the state whose tort law is determined to apply to the case, the plaintiffs would have access to a variety of potential theories of recovery against the individual owners of lines, e.g., principal-agent, joint venture, arguable need to pierce the corporate veil, alleged causal responsibility through inadequate maintenance, or alleged causal responsibility through concurrent use of lines for other purposes. In the absence of a federal liability limitation provision, each owner would be in a different legal position in that incredibly complicated litigation.

The owner with the most miles of transmission lines in the western grid is the Bonneville Power Administration (BPA). As an agency of the federal government, BPA would potentially be liable only to the extent that the United States has waived its sovereign immunity. BPA's conduct

in operating its transmission assets is highly likely to be held to be within the scope of the discretionary function exception to federal liability under the Federal Tort Claims Act.[77] With the largest owner of transmission lines used by RTO West insulated from liability, the customers would attempt to maximize their recovery from the other governmental and non-governmental owners. That effort, in turn, would raise extraordinarily difficult issues with respect to allocation of damages among multiple defendants. In recent years, that has become an extraordinarily complicated and dynamic area of tort law in which states differ significantly with respect to the basic principles each applies.[78] With respect to each issue raised in the litigation, the court would have to determine which of the many western states' laws apply in the absence of a federal limit on the liability of the RTO. Even if each owner ultimately was determined not to be liable, each would be required to spend large sums of money defending itself in protracted litigation. It would then have to increase its rates to reflect those wasteful expenditures.

Ironically, the only judicial decision the FERC cites to support its position with respect to federal liability limitations demonstrates the need for those limits.[79] In its opinion in *United*, the Fifth Circuit applied an excellent analytical framework for determining whether the FERC was justified in declining to apply a broad federal limitation to the potential liability of a pipeline that violated its contracts with its direct industrial customers. The FERC had limited United's liability, but United argued that the FERC should have imposed a broader and more protective limit on its liability. The court evaluated that argument by considering "the comprehensiveness of the federal regulation, the federal interest in the regulated subject matter, and the need for uniform results."[80] The court concluded that FERC's decision to impose only a relatively modest federal limit on United's liability was reasonable.[81] Federal regulation of pipeline direct industrial sales is severely limited. Such sales are regulated primarily by the state in which the sale takes place. It follows that the federal interest in limiting a pipeline's liability to a direct industrial customer is also limited. Moreover, the FERC had imposed a uniform federal standard; *United* argued only that the FERC should have imposed a more protective standard.

V. CONCLUSION

Application of the Fifth Circuit's analytical framework in *United* to the question whether the FERC should impose a federal limit on the potential liability of an RTO yields a clear affirmative answer. Federal regu-

77. *See generally* RICHARD J. PIERCE, JR., III ADMINISTRATIVE LAW TREATISE, sec. 19.4 (4th ed. 2001).

78. *See generally* AMERICAN LAW INST., A CONCISE RESTATEMENT OF TORTS THIRD 229-266 (2000).

79. *See generally* discussion at *supra* notes 41-47.

80. United Gas Pipeline Co. v. FERC, 824 F.2d 417, 426 (5th Cir. 1987).

81. *Id.* at 426-430.

lation of RTOs is exclusive and comprehensive.[82] RTOs are essential to the success of the federal government's effort to restructure the United States wholesale electricity market.[83] Moreover, the federal government has a powerful interest in ensuring that RTOs operate efficiently at low rates and in a manner that ensures fair treatment of all customers. Federal limits on RTO liability will allow RTOs to operate efficiently and at low rates by protecting RTOs from the risk of catastrophic damage awards in the event of outages or disturbances. Federal limits on RTO liability also will ensure fair treatment of all customers by avoiding the inequity of forcing small consumers to subsidize large consumers by allowing large consumers to collect disproportionately large damage awards that small consumers then must pay in the form of higher transmission rates. In short, principles of federalism, combined with the reasons states have long given to explain the need for state-authorized limitations on liability, support the critical need for federal limitations on the liability of RTOs and owners of transmission lines used by RTOs.

82. *See generally* discussion at *supra* notes 3-5.

83. *See generally* discussion at *supra* notes 1-3.