The Private Interest & the Public Interest

Merton H. Miller

Economists and lawyers tend to come at some subjects from fundamentally different perspectives. The law's, or at least the civil law's, central concern is with *private* interests – with protecting the property rights of specific individuals. Economics worries more about the *public* interest, a concept which doesn't fit the standard legal categories. The *public* has no "standing," as you lawyers might put it.

In most litigation, the public interest doesn't surface explicitly. It's there, of course, but buried in the deep background. Sometimes, though, broader public interests do intrude even in intensely private litigation and when that happens, the lawyers and the economists can come into serious conflict. One such bitter showdown between the economist's public interest perspective and the lawyer's private interest perspective will be the subject of this essay.

I happened to blunder into the conflict by accident a year or so ago, when a pipeline company informed my wife of its proposal to run a 24-inch line carrying heavy crude oil from Canada right through the living room of her McHenry County family home, now a working farm (though not worked by us) and serving, or so we hoped, as our calm country weekend retreat. (I don't mean the pipeline would run through our living room, literally, of course, but it might just as well have because it would be sited only 200 yards or so from our back door!)

Before you can actually put a pipeline on someone else's private property, however, you must get the necessary easements from the impacted landowners. Those landowners, in turn, may well be reluctant to sell even if the pipeline offers them "fair market value" (that is, pre-pipeline land prices) for the narrow strip of acreage in the easement corridors. For the landowners, after all, value of the land "in use" exceeds its "fair" market value virtually by definition. And, more important, the impacted owners, even if compensated for the

Merton Miller is the Robert R. McCormick Distinguished Service Professor Emeritus of The University of Chicago Graduate School of Business. He received the Nobel Prize in 1990 for his work in the field of finance. This paper is based on a talk delivered to The University of Chicago Law School Alumni on May 8, 1997.

market value of the *easement* strip, face the likely adverse effects on the value of the *rest* of the property of a pipeline carrying hazardous and toxic products.

This potential destruction of property values is what economists call a negative externality of the pipeline. If the pipeline company had sought voluntary agreement from the landowners, it might have internalized that externality by invoking the Coase Theorem, buying up the entire properties, taking out their easement strips, and then selling off the rest of the property. The pipeline company and not the landowners would then be bearing the costs and risks of any destruction of property values attributable to the pipeline. But the pipeline company must have decided that for that approach, the transaction costs were too high, as Ron Coase might put it. Why even consider bearing the risks when the pipeline company had a far cheaper alternative: it could bludgeon the landowners into assuming them by invoking the State of Illinois' sovereign powers of eminent domain? Those powers would *force* the landowners either to sell out at the company's bid or face the costly and uncertain prospects of seeking a better settlement in court.

To capture the state's powers of condemnation, the pipeline company must first petition the Illinois Commerce Commission for a certificate of convenience and necessity which, if granted, entitles the company to apply for and in practice, always to get the power of eminent domain. Faced with this coercive threat of eminent domain from the pipeline, the citizens of the four affected counties – including not just the impacted owners, but many others throughout the area whose property values were threatened by the pipeline and to whom no "compensation" of any kind would be paid – reacted in the fashion that De Tocqueville many years ago had noted was so characteristically American: they formed a volunteer association. They called it CAP (Communities Against the Pipeline); they raised money, hired lawyers and prepared to take on the pipeline and its high-powered Chicago law firm before the Illinois Commerce Commission. (I won't mention the name of the high-powered Chicago law firm involved. I'll just call It by our code name for it: Goliath.)

Under the statutes of Illinois, a private company proposing a pipeline can obtain a certificate of convenience and necessity (and with it use of the State's sovereign eminent domain powers) only after showing, among other things, that a *public* – emphasis *public* – need for its proposed pipeline exists. Public need? That's an *economic* question, reasoned CAP and its attorneys. And, as the senior resident economic guru of Seneca Township in McHenry County, I was delegated the task – *pro bono*, I need hardly add – of preparing a formal cost-benefit analysis of the proposed pipeline.

Cost-benefit analyses can often be tedious in the extreme, but this cost-benefit calculation, I am happy to say, turned out to be surprisingly easy. Little more than the simple supply and demand analysis from an introductory economics course was needed to show that this pipeline offered absolutely no *public* benefits whatever. None. Zero. No *public* benefits large enough to justify invoking the public's sovereign condemnation powers. And certainly no public benefits to counter the potentially huge environmental risks that a pipeline carrying a toxic substance like heavy crude oil imposes not just on the impacted landowners and their immediate neighbors, but on everyone else living on the ecologically fragile, gravelly soils of Northern Illinois.

It's as certain as death and taxes, after all, that pipelines will leak, sometimes catastrophically, with a small, though certainly not zero probability; but more frequently in dribs and drabs of 8–10 barrels at a time – amounts of little significance from a macro perspective, perhaps, but large enough to worry all of us in Northern Illinois who draw our drinking water not from Lake Michigan, but from shallow wells sunk into the local aquifers. Leaks even as small as one barrel a day can be a problem there, particularly if they're not detected immediately and generate what hydrologists call a "plume" into the aquifer. To prevent those plumes from spreading unnoticed, the pipeline company told us that we impacted landowners should regard ourselves as the last line of defense in its leak-detection system, supplementing its battery of higher-tech electronic devices and weekly aerial flyovers.

In practice, our participation in their leak monitoring would come down essentially to this. I go to the sink for a glass of water and I say to my wife: "Honey, does this water taste funny to you? It does? Well, not to worry. The company says that benzene is lighter than water and will float to the top. All we have to do is dig another well a bit lower. And if the oily taste doesn't go away, we can always call Hinkley and Schmitt!"

But enough of these hydrological horrors, of which there are many, connected with petroleum pipelines. We in CAP never intended to rest our case against the pipeline primarily on environmental grounds. We are not the anti-development Greens that Goliath has tried to picture us to be. We proposed, rather, to fight mainly on the economics front, on the *public need* issue. Our point was that whatever your views about the environmental risks and costs – and everybody concedes they are greater than zero – there are no *public* benefits on the other side of the ledger to offset them.

But surely, you'll say, there must be benefits. otherwise, why would a company be willing to invest $300 million of society's scarce resources in the project? Benefits from the pipeline do exist, of course, but they are purely *private* benefits accruing as increased tolls to the pipeline and as increased sales by Canadian oil shippers. Such benefits are not only *private* benefits, but are strictly *producer* benefits at that. They generate no *consumer* benefits, for reasons I'll explain in a minute. And for purposes of measuring *public* or *social* benefits, economists insist we must always look to *consumer* benefits – to consumer surplus, as economists say, not producer surplus.

That point, let me emphasize, is not something I'm making up just for the occasion tonight. It's a fundamental part of economics, going way back, even before Ron Coase, all the way to Adam Smith. Smith's essential message (followed by 200 years of elaboration by the rest of the profession) is that the consumer standard of living is the natural, and really the only, consistent metric of economic well-being. The members of the public after all have one thing in common: they are all consumers. A showing that consumers are made better off by a new pipeline is clear evidence, therefore, that the *public* has benefited. And conversely, a showing that consumers do not benefit implies no benefits to the general *public*.

But why wouldn't consumers benefit from more pipeline capacity? More pipeline capacity means more supply of crude oil to the Chicago market. And more supply means lower prices of crude, and ultimately of refined products for consumers. Doesn't the law of supply and demand tell us that?

No. And here's where you lawyers need an economist. The Law of Supply and Demand, properly understood, tells us only that an increase in supply will never *raise* prices. It does not rule out the possibility, which is the relevant one in this case, that the added supply will have *no effect* whatever on the prices consumers pay. Chicago refiners currently get most of their crude from sources other than Canada – from Mexico, Venezuela or elsewhere in the world, reaching Chicago via the ample pipeline capacity from the Gulf ports in Louisiana and Texas. World supply (virtually unlimited relative to Midwest demand) sets the price of crude in Chicago which is, and will remain, the posted Gulf (i.e., world) price of crude plus the cost of shipping up from the Gulf ports. The attempt by the landlocked Canadian producers to slip a bit more crude into Chicago under the Gulf price umbrella, as it were, would serve merely to *displace* an equivalent amount of crude now coming via the Gulf ports from somewhere else in the world, leaving the price level and hence the total quantity of crude used in Chicago unchanged. And if the prices and aggregate quantities of the crude don't change, neither will the prices and quantities of gasoline, heating oil and other refined products. Nothing here for us consumers!

The pipeline company has conceded that its proposed new line will bring no product-price benefits to the *general* consuming public, but insists that for purposes of granting certification, a word like *public* should not be taken in its "generic" sense (their term) as encompassing *all* segments of the public. The pipeline, the shippers and their refiner customers are part of the public too, aren't they? So once they decide that *they* need, or at least want, a pipeline, isn't the *public* need requirement automatically satisfied?

In years past, the Commission might well have bought into this kind of sophistry, even though it reduced the Commission, in effect, to a mere rubber stamp for granting certificates. The public-need phrase had been in the statute for generations, after all, and had never before been used to block an application for anything. It had become mere empty legal boilerplate. Why then should a commissioner now suddenly take the heat of turning down an application for a pipeline by invoking the absence of a public need, laying himself or herself open thereby to the charge, completely false though we know it, of leaving Illinois citizens "freezing in the dark"?

Normally, commissioners *wouldn't* be expected to stick their necks out by setting major new precedents. But this time the Chairman of the Commission, with great courage, refused to back away from the challenge posed by the words *public need*. Those words, he noted, have not only long been in the relevant statutes covering the granting of certifications, but have recently been reenacted explicitly by the Illinois legislature in amendments of the Commission's enabling statutes. The legislature wouldn't have done it, reasoned the Chairman, unless they wanted the Commission to confront the issue of defining public need.

And confront it the Commission finally has. I am pleased to report that the Commission after much heated argument has essentially adopted CAP's position (confirmed independently by the researches of the Commission's own staff) that the proposed pipeline would have no effect on the prices consumers pay for refined petroleum products. Therefore, on May 7, 1997, the Commission voted (3 to 2) to deny the application for the proposed pipeline on the grounds that the applicant had failed to show a *public need* for the pipeline.

But while the Commission's order to deny certification was certainly a victory over Goliath for the David's in CAP and for their feisty law firm Ansel, Glink, Diamond, Cope and Bush, the case is far from closed. Appeals from the Commission's order will certainly be filed to the state, and possibly the federal courts as well, as they probably should be, because defining so fundamental a concept as *public need* is too important and pervasive to be left solely to the rulings of a regulatory commission.

The legal burden of defending the Commission's view of public need in the higher courts will now be borne, of course, mainly by the Commission itself rather than by intervenors such as CAP. But additional help is always welcome, particularly when the public policy issues involved are so important. I propose, therefore, to take advantage of this platform, by issuing an open invitation to all legal eagles, both those in law schools and those in private practice. Come and join us in the attempt to define the long-neglected term *public need* in a way that truly does protect the public interest. Come and join us, I say. But, of course, *pro bono*!

Postscript: Current Status of the Pipeline Case

Having been denied certification and attendant eminent domain privileges by the Illinois Commerce Commission, the pipeline company is dutifully contesting the Commission's ruling before the Illinois Court of Appeals. But knowing that appellate courts rarely overturn a Commission's administrative judgment, the pipeline company has come up with a fall-back strategy: forget about eminent domain and, instead, seek to acquire 100 percent of the right-of-way entirely by *voluntary* purchases, as described on page 34 above. The effects of this change in company policy are already apparent. Prices for easements have risen by a factor of ten!

The strategy of freely negotiating easements is feasible because the pipeline company, by foreswearing eminent domain, gains at least a partially compensating negotiation advantage. Because a Commission certificate is no longer sought, an official route need not be specified. The pipeline company can thus threaten to reroute its line to a neighbor's adjacent property leaving each landowner with a hard choice: accept the company's offer; or turn it down and wind up with virtually the same effective exposure to pipeline leaks, but no cash compensation for the easement.

Will this end run around the Commerce Commision's approval authority really work? We don't know yet. Note, however, that whether it works or not, the company's seemingly "free-market" approach does not change the fundamental point of my essay (and testimony). The pipeline still does not pass the social "need" test; it remains infra-marginal with no effect on the prices consumers pay for petroleum products. The voluntary purchases of right-of-way mean only that the pipeline owners are no longer using the State's sovereign powers to low-ball the landowners, but are now sharing with them more of their private pecuniary gains from the pipeline.