1957

Public Utilities--Rate Base--The Aftermath of the Hope Case (I)

Glenn L. Greene Jr.
University of Kentucky

Follow this and additional works at: https://uknowledge.uky.edu/klj

Part of the Energy and Utilities Law Commons

Right click to open a feedback form in a new tab to let us know how this document benefits you.

Recommended Citation
Available at: https://uknowledge.uky.edu/klj/vol46/iss2/4

This Note is brought to you for free and open access by the Law Journals at UKnowledge. It has been accepted for inclusion in Kentucky Law Journal by an authorized editor of UKnowledge. For more information, please contact UKnowledges@lsv.uky.edu.
PUBLIC UTILITIES—RATE BASE—THE AFTERMATH
OF THE HOPE CASE (I)*

Historical Development of the Rate Base

The stage was set for state regulation of public utility rates in *Munn v. Illinois* when the Supreme Court of the United States, speaking through Mr. Chief Justice Waite, held that the Fourteenth Amendment did not prohibit state regulation of public utilities, since they were businesses “affected with a public interest.” However, the Court failed to point out the limits of the state power to regulate rates. It was not until the 1890's that the Supreme Court held that the rates fixed by state commissions or legislatures could be overthrown if, on appeal to the courts, they were found to be confiscatory rather than reasonable. Thus, the judiciary was established as the final authority on the question of whether the rates fixed by state authorities were reasonable.

Rates fixed by the state, in order to be reasonable under the above rule, must yield a fair return on the value of the property devoted to public service at the time of the determination of the rates. The exact method of determining the value of the utility’s property has been the subject of much litigation since *Smyth v. Ames* was decided in 1898. It is the purpose of this note to make a survey of some of the more important aspects of this litigation, especially with regard to federal decisions since 1944.

A judicial guide as to what constitutes a reasonable rate was set out in *Smyth v. Ames*. The Supreme Court held that the utility was entitled to a fair return on the fair value of its property devoted to public service. Exactly what constituted the fair value of the utility’s property was to be determined by considering the cost of reproducing the property at the time of valuation as compared with the original value.

---

* This note, treating the rate base problem from a federal and Supreme Court perspective, is Part I of a two-part survey. Part II, to be published in the Spring issue of the Kentucky Law Journal, will be primarily concerned with the rate base problem as it is presented to Kentucky courts.

1 94 U.S. 113 (1876).
2 Id. at 134, where it is said, “We know that this is a power which may be abused; but that is no argument against . . .”
5 169 U.S. 466 (1898).
6 This year marked the decision of Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944).
7 Supra note 5 at 546.
cost of the property. Thus, the Court clearly pointed out that reproduction new was one of the elements to be given consideration in the determination of the rate base.

In 1903, the original cost was expressly rejected as the sole method of valuation and reproduction new received even stronger recognition as a positive factor in the determination of the rate base when the Supreme Court said:

The main object of the attack is the valuation of the plant. It no longer is open to dispute that under the Constitution 'what the company is entitled to demand, in order that it may have just compensation, is a fair return upon the reasonable value of the property at the time it is being used for the public.' That is decided, and is decided as against the contention that you are to take the actual cost of the plant, annual depreciation, etc., and to allow a fair profit on that footing over and above expenses.

World War I ushered in a period of rapidly rising prices which was to last until the depression of 1929. During this period the theories of reproduction cost and original cost were sharply distinguished. The utility companies were constantly advocating reproduction new as the most important or sole factor in determining the value of their property because this would give the utility a larger rate base, since the difference between original cost and reproduction new is much greater during a period of ascending values. On the other hand, commissions, in safeguarding the public interest, were urging that original cost be given primary weight since, in an inflationary period, original cost is more favorable to the consumer.

Although the reproduction new theory was approved during this period, apparent dissatisfaction of a minority of the Supreme Court with the reproduction new test was clearly seen in 1923. Mr. Justice Brandeis in the celebrated case of Southwestern Bell Telegraph Co. v. Public Service Commission, although concurring with the result reached by the majority, expressed disapproval of reproduction new in the following language: "The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital

---

8 Barnes, The Economics of Public Utility Regulation 406-7 (1947). Original cost may be defined as the actual money cost of the existing property at the time when the property was first applied to public service.
9 Smyth v. Ames, supra note 5 at 547.
10 Barns, supra note 8 at 420. Reproduction cost is the cost to reconstruct an identical or substantially similar plant under present conditions and prices.
12 Barns, supra note 8 at 382-3.
14 Ibid.
15 262 U.S. 276 at 289 (1923). Justice Holmes joined with Justice Brandeis in his concurring opinion.
He pointed out that reproduction new was in effect a product of the times since, in 1898, when *Smyth v. Ames* was decided, there was no accurate way of showing the actual cost of establishing the utility because there were no definite or formal accounting requirements. But as a result of the uniform system of accounts and the commission's control of stock issuance, which had come into common use by 1923, the amount expended was easily ascertainable.  

It was therefore feasible by that time to adopt as the rate base the annual cost or charge of the capital prudently invested in the utility.

Some of the weaknesses in the reproduction new theory were thus seen more clearly as the result of the kind of reasoning exhibited by Justice Brandeis. By 1942, the Supreme Court was suggesting that the *end result* was the important factor to be considered when a rate base determination was subjected to judicial review, and that a rate-fixing group could constitutionally fix rates without being bound by any particular formula.  

In 1944, these suggestions became "law" when the Court in *Federal Power Commission v. Hope Natural Gas Co.* held that if the rates fixed by the commission permitted the company "to operate successfully, to attract capital, and to compensate its investors," then such rates were to be deemed just and reasonable, and the method of arriving at such rates was not to be the subject of review by the Court. Although reproduction new was rejected as the sole method of property valuation, the Court did not dictate any other particular method of valuation, leaving the particular commission free to value the property as it saw fit. The end result or "reasonableness" of the rates fixed was thus made paramount and not the method by which the rate base was determined.

---

16 Id. at 290.
17 Id. at 309.
18 Barnes, supra note 8 at 406. Prudent investment and original cost are sometimes thought to be synonymous, but there is a distinction between the two. "Prudent investment differs from original cost in that it imports an element of judgment, involving the elimination from the total of original cost of those expenditures which were improper, improvident, or unnecessary in the light of the conditions prevailing when the expenditures were made."
19 Southwestern Bell Telegraph Co. v. Public Service Commission, supra note 15 at 310.
**Apparent Confusion as to Whether Some Method Must Be Used**

The attempt of the Court to give effect to a more sound and more intelligent rate base regulation by the adoption of the end result test was commendable. However, decisions subsequent to the *Hope* case are illustrative of confusion in federal courts as to whether the commission must still use *some* method or formula in determining the rate base. The Supreme Court in *Colorado-Wyoming v. Federal Power Commission*23 rejected the order of the commission since it could not determine from the findings the method used. However, in *Panhandle Eastern Pipe Line Co. v. Federal Power Commission*24 it was stated that the *result* of the commission's order was all important rather than the *choice of a formula* or the propriety of the method employed by it in reaching its conclusion. If, in the latter case, the Court means to imply that the commission must use *some* formula or method in its determination of the rate base, the two cases are in accord. If otherwise, the cases are in direct conflict.

The decisions in the lower federal courts are in a state of confusion as to whether the use of a method is required. In *Mississippi River Fuel Corp. v. Federal Power Commission*25 the utility contended that the court was limited to reviewing only the end result of the commission's rate order. In rejecting this contention the court said,

> The discretion and judgment confided in the commission must be exercised upon facts and for reason. The duty of review imposed upon the courts require that the facts be found and the reasons stated. Otherwise, the courts cannot determine whether a given action is or is not arbitrary.26

Similarly, in *State Corp. Commission of Kansas v. Federal Power Commission*27 the court, in rejecting the order of the commission, said that the reasonableness of the end result could not be determined since the court knew only the rate of return but not the findings and reasoning of the commission. In pointing out the need for accurate and clear findings the court in *Washington Gas Light Co. v. Baker*28 said,

> We think the commission should keep in mind its obligation to facilitate judicial review of its orders and should assemble a record and make findings which cover all the relevant issues. Unless the commission tells us what formula or formulae it has chosen and makes clear the evidentiary support for its findings under whatever formula adopted, we are handicapped in applying even the limited judicial review left us by the *Hope* case.

---

23 324 U.S. 626 (1946).
24 324 U.S. 635 (1945).
25 183 F. 2d 493 (CCA D.C. 1947).
26 Id. at 499.
27 206 F. 2d 690 (CCA8 1953).
28 188 F. 2d 11 at 23 (CCA D.C. 1950).
On the other hand in *Interstate Natural Gas Co. v. Federal Power Commission*\(^2\) it was said that the fact that some particular item in the rate base appeared to be too low was immaterial since "it is not theory but the impact of the rate order which counts. . . ." Likewise another court has held that the commission is not required to annotate to each finding the evidence supporting it or point out the economic factors considered.\(^3\)

These last-mentioned decisions clearly illustrate the vagueness of the end result test, and the courts, with regard to the requirements of the test, are in a state of confusion. Some courts require the use of a formula in order to enhance judicial review while others accept rather loose findings of commissions. Some indication as to the methods employed by the commission is definitely needed. When courts do not require commissions to point out the methods used in rate determination "review becomes a costly, time-consuming pageant of no practical value to anyone."\(^3\)

**The Trend Toward Exclusive Use of Original Cost**

Cases since the *Hope* decision seem to indicate that the federal courts are now moving toward the approval of original cost as the sole method of utility property valuation. However, the Supreme Court in *Market Street Railway Co. v. Railroad Commission of California*\(^2\) upheld a rate apparently determined by the so-called "fair value" of the utility's property. The commission used as a rate base the price at which the property had been offered for sale to the city whereas the original cost of the property was greatly in excess of this price. The company contended that the order was confiscatory under the tests of the *Hope* case, which would entitle it to a return sufficient to maintain its financial integrity, to attract capital, and to compensate its investors. However, the Court denied the claim of confiscation and upheld the rate base adopted by the commission saying that the considerations advanced in the *Hope* case were inapplicable to a company whose financial integrity was hopelessly undermined. However, an apparent explanation for the Court's approval of the "fair value" method rather than original cost is the impaired financial condition of the utility. Had the financial integrity of the utility not been so undermined the commission would undoubtedly have used original cost as the rate

\(^{20}\) 156 F. 2d 949 (CCA5 1946).


\(^{31}\) See Mr. Justice Jackson's dissent in the Hope Case, supra note 22 at 645.

\(^{32}\) 324 U.S. 548 (1945).
base. As the Court pointed out, "the due process clause . . . has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces."33

In Panhandle Eastern Pipe Line Co. v. Federal Power Commission,34 petitioner contended that if its leaseholds were to be included in the rate base they should be included not at cost but at their current market value. However, the Court resorted to the end result test saying that the commission was not bound to use any single formula for fixing rates and could therefore use actual legitimate cost. A similar result was reached in Colorado Interstate Gas Co. v. Federal Power Commission.35

In Cities Service Gas Co. v. Federal Power Commission36 the commission rejected certain evidence tending to show the "fair value" of certain leaseholds. The circuit court on appeal said that fair value was no longer an essential ingredient of the rate base and that the court has no right to intervene unless it is conclusively shown that failure to give weight to the fair value of property will prevent the utility from operating successfully.

It was the contention of the utility in Pichotta v. City of Skagway37 that the rate base should be measured by the capital invested by the last purchaser. The court overruled this contention saying that original cost, as defined by the Federal Power Commission, was "the cost of the property to the person who first devotes it to the public service, regardless of the number of times the utility has changed hands."38 The court pointed out that this was a necessary rule in order to avoid conversion of original cost into "fair value." And when the utility sought to have included in the rate base money expended by the Army in rehabilitating petitioner's plant, the court refused saying that original cost did not embrace a gratuitous contribution to capital made at the taxpayer's expense.

A recent federal case has apparently held that original cost is mandatory rather than directory. In City of Detroit v. Federal Power Commission39 the commission, in allowing a rate increase, computed a "field price" for the gas obtained from the utility's producing property, which constituted slightly more than twenty-two percent of its total gas supply. The remainder of its gas supply was computed on

33 Id. at 567.
34 Supra note 24.
35 324 U.S. 581 (1945).
36 155 F. 2d 694 (CCA10 1946).
38 Id. at 1005.
an original cost basis. This "field price" was based upon the "weighted average arm's length prices" established by unregulated bargaining for similar gas in the fields. The commission then multiplied the volume of production by that "field price" and included the result in operating expenses as an amount to be recovered through the rates. At the same time the commission excluded from the rate base the cost of the properties which produced this gas and excluded from recoverable operating expenses the cost of producing it. The commission said that its purpose was to allow the utility to receive for its own produced gas "a price reflecting the weighted average arm's length payments for identical natural gas in the fields where it is produced," instead of a return on its legitimate investment in the properties and equipment used in producing this gas. This method allowed $3,571,448 more than would have been allowed under the original cost method. In reversing the commission's order the court said that the commission must guard the consumers against excessive rates and to do so any method which would award an increase must be compared with the conventional rate base method. By remanding the order for comparison of the "field price" with original cost, the circuit court apparently has once again shackled the commission to rigid adherence to a specific rate base formula—original cost.

It thus seems that the lower federal courts show a decided tendency toward the approval of original cost as the specific rate base formula. At least one circuit court, in requiring the use of original cost, has apparently contravened the intended result of the Hope case, which was to allow flexibility in the determination of public utility rates and to utilize administrative experience by allowing the particular commission to adopt the rate base method it deems most desirable and most suitable to the needs of a particular case. Whether or not the Supreme Court would now consider original cost mandatory in the determination of utility rates remains to be seen. It is to be hoped that it would not.

Glenn L. Greene, Jr.

40 When the court uses the phrase "conventional rate base method", the court is referring to the original cost method.