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PUBLIC UTILITIES — FEDERAL POWER COMMISSION — JUST AND REASONABLE RATE — RATE BASE — GOING VALUE — ORIGINAL INVESTMENT AS AMORTIZATION BASE — *Smyth v. Ames*,[1] source of the elusive principle[2] that has pestered courts and public utility commissions

[1] 169 U. S. 466, 18 S. Ct. 418 (1898).

[2] Id. 169 U. S. at 547. In ascertaining fair value "original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case."

since 1898, is still not a dead letter. Doubtless the only reason its doctrine stands at this late date is that no recent case has forced the Court to reconsider the "fair value" rule.[3] However, in *Federal Power Commission v. Natural Gas Pipeline Company of America*,[4] decided by the Court on March 16, 1942, three justices took occasion to "lay the ghost" of the 1898 decision once and for all and to declare that the case "erases much which has been written in rate cases during the last half century."[5]

The Natural Gas Pipeline Company of America and Texoma Natural Gas Company, engaged in business as a single enterprise, produce natural gas in the Panhandle gas fields in Texas and purchase gas produced there by others. The companies transport the gas by their own pipeline in interstate commerce to Illinois, where the bulk of the gas is sold at wholesale to utilities, which sell it for domestic, commercial and industrial purposes. Consolidated proceedings growing out of separate investigations of the companies' rates by the Illinois Commerce Commission and the Federal Power Commission resulted in the issuance of an interim order by the Power Commission.[6] Briefly stated, a reduction in rates was ordered such as to achieve a reduction in revenues amounting to $3,750,000. The companies were allowed a six and one-half per cent return on a base measured in terms of reproduction cost. On review by the Circuit Court of Appeals for the Seventh Circuit the order was set aside.[7] The circuit court agreed with the Power

[3] For an excellent bibliography evidencing "the present offensive against the fair value rule" climaxing "an extended chorus of criticism," see Kauper, "Wanted: A New Definition of The Rate Base," 37 MICH. L. REV. 1209, notes 2, 3 and 4 (1939).

[4] (U. S. 1942) 62 S. Ct. 736. The writer has had an opportunity to read the briefs submitted by counsel for the Pipeline Companies, and for the Federal Power Commission and Illinois Commerce Commission, and acknowledges due credit for the use of any material contained therein.

[5] Id., 62 S. Ct. at 750, (joint concurring opinion of Justices Black, Douglas and Murphy). Their full statement is: "While the opinion of the Court erases much which has been written in rate cases during the last half century, we think this is an appropriate occasion to lay the ghost of Smyth v. Ames . . . which has haunted public utility regulation since 1898." See also the conclusion of Robert Hale in his "The 'Fair Value' Merry-Go-Round, 1898 to 1938," 33 ILL. L. REV. 517 at 531 (1939): "the ghost of Smyth v. Ames still haunts regulation, and by its fogginess prevents commissions from devoting their attention to the real problems calling for solution. Only by laying that ghost once and for all can regulation be given a chance to operate with intelligent regard for the interests of customers and investors alike."

[6] Illinois Commerce Commission v. Natural Gas Pipeline Company of America, (Fed. Power Comm. 1940) 35 P. U. R. (N. S.) 41.

[7] Natural Gas Pipeline Company of America v. Federal Power Commission, (C. C. A. 7th, 1941) 120 F. (2d) 625, noted, 55 HARV. L. REV. 299 (1941).

Commission that the Natural Gas Act of 1938 was valid[8] and that the interim order was authorized.[9] The order was held invalid, however,

[8] The Circuit Court of Appeals concluded "without much doubt" that the Natural Gas Act, 52 Stat. L. 821 (1938), 15 U. S. C. (1940), § 717 et seq., is constitutional. 120 F. (2d) 625 at 629. Nor did the Supreme Court have any doubt. 62 S. Ct. 736 at 741. The sale, transportation and delivery of natural gas from one state to distributors in any other state constitutes interstate commerce subject to regulation by Congress. Illinois Natural Gas Co. v. Central Illinois Public Service Co., (U. S. 1942) 62 S. Ct. 384. The Fifth Amendment embraces the fixing of rates of companies so engaged. It is well settled that Congress may provide for regulation of rates in the field of interstate commerce by an administrative body without regard to whether or not the business regulated is a "public utility," so long as the regulation bears a reasonable relation to a necessary and proper legislative purpose. Sunshine Anthracite Coal Co. v. Adkins, 310 U. S. 381, 60 S. Ct. 907 (1940). See also Olsen v. Nebraska, 313 U. S. 236, 61 S. Ct. 862 (1941); United States v. Darby, 312 U. S. 100, 61 S. Ct. 451 (1941); United States v. Rock Royal Co-op., 307 U. S. 533 at 569, 59 S. Ct. 993 (1939); Nebbia v. New York, 291 U. S. 502, 54 S. Ct. 505 (1934). Congress conducted extensive hearings on which it based its finding that the regulation was "necessary in the public interest." See, for example, HEARINGS ON H. R. 11662, 74th Cong., 2d sess. (1936) (House Committee on Interstate and Foreign Commerce).

The argument was made by the companies that the situation here called for a different result than that reached in previous cases because of the fact that wholesale rates were involved. In accord with Illinois Natural Gas Co. v. Central Illinois Public Service Co., supra, the Court found that this fact presented "no differences of significance to the protection of the public interest which is the subject of price regulation." Principal case, 62 S. Ct. at 741.

[9] The companies contended before the Circuit Court of Appeals and the Supreme Court that the Power Commission had no authority to enter an interim order. Section 5(a) of the Natural Gas Act of 1938, 52 Stat. L. 821, 15 U .S. C. (1940), § 717d(a), provides that "Whenever the Commission, after a hearing . . . shall find that any rate . . . is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate . . . and shall fix the same by order. . . ." Section 16 of the act provides that "The Commission shall have power to . . . issue . . . such orders . . . as it may find necessary or appropriate to carry out the provisions of this act." The sole limitation upon the kinds of rate orders which the Power Commission is authorized to issue is that the order must be made after "a hearing." The proceedings before the Power Commission in the principal case were not concluded by the interim order, but the record in the case discloses that the companies had every opportunity to present all their evidence on the jurisdictional and substantive aspects of the problem, to cross-examine witnesses, and to offer rebuttal testimony before the order was entered. Power Commission Brief, p. 27. It is clear, therefore, that the order was supported by substantial evidence.

The use of the interim or temporary order is not a novel procedure. Barnes, "Temporary Rates in Utility Regulation," 34 ILL. L. REV. 929 (1940); comment, 38 MICH. L. REV. 72 (1939). The need for this type of order grows out of the very nature of the problem involved in establishing a rate. This problem is two-fold: adjusting the general revenue level to the demands of a fair return, and adjusting the rate schedule to the rate level in order to achieve fairness. The procedure permits the Power Commission to lower rates to a level which appears reasonable in light of the evidence, such rates to be effective while the Power Commission continues the hearing to determine whether or not a further reduction is necessary.

The purpose of using such orders is to achieve greater responsiveness and ef-

on the ground that it did not provide a "just and reasonable" rate as required by statute, because the Power Commission did not consider going concern value as a separate item in arriving at the rate base. The companies put it down at $8,500,000, or about fourteen per cent of the total reproduction cost figure used by the Power Commission as the rate base.[10] The circuit court also found the amortization allowance inadequate, as original cost was used as a base instead of reproduction cost.[11]

On certiorari, the Supreme Court unanimously reversed the Circuit Court of Appeals and upheld the Power Commission on all the issues.

ficiency in the regulatory process. This is especially true when the "fair value" rule is used and adjustments to changing economic cycles must be made. As a matter of policy, the use of the interim order is desirable. Much of rate-making is experimental in character. It involves the use of trial-and-error methods. Interim orders permit voluntary adjustments by the utility along lines suggested by a commission. The scope of the whole regulatory scheme is made more elastic and realistic. It permits the making of thorough inquiries, often taking many months, with valuable adjustments in operation during the pendency of such investigations. The administrative process becomes a flexible organ more readily adjusted to changing circumstances and conditions. The interest of the public and the interest of the utility are balanced without unnecessary delay. 2 SHARFMAN, THE INTERSTATE COMMERCE COMMISSION 381 (1931).

Recognizing the nature of the problem, Congress gave authority to the Interstate Commerce Commission in the Transportation Act of 1920, 41 Stat. L. 484 (1920), 49 U. S. C. (1940), §§ 13, 15, to take the above-mentioned two steps in establishing a rate. Section 5(a) of the Natural Gas Act resembles the provisions of the 1920 act. The validity of this procedure under the 1920 act was apparently settled in the New England Divisions Case, 261 U. S. 184 at 201, 43 S. Ct. 270 (1923). That the interpretation of the present act should be the same was to be expected. Such an order appears to be in harmony with the purposes of the Natural Gas Act and within the discretion of the commission.

This construction appears authorized as against the companies' contention that the failure of Congress to include in the Natural Gas Act power to enter orders fixing a temporary rate in the manner of the New York and Pennsylvania statutes [Driscoll v. Edison Light & Power Co., 307 U. S. 104, 59 S. Ct. 715 (1938); Bronx Gas & Electric Co. v. Maltbie, 271 N. Y. 364, 3 N. E. (2d) 512 (1936)] shows a contrary intention. Companies' Original Brief, pp. 225-234.

Moreover, in the principal case there was sufficient evidence to issue a final order. This is vastly different from the issuance of a temporary order based on partial evidence. In the present case the Power Commission did not fix a level of rates on any basis that would not be equally applicable to a final order. The validity of such an order on its merits is to be tested by the same principles which would govern the validity of any final rate order. There was evidence to support the order, the amenities of due process were observed, and the need for some device to protect the companies from any errors of the Power Commission in establishing rates insufficient to afford a nonconfiscatory return is not present as it was in the Driscoll and Maltbie cases, supra, because the order was identical with a final order in so far as the supporting evidence is concerned.

[10] Natural Gas Pipeline Co. of America v. Federal Power Commission, (C. C. A. 7th, 1941) 120 F. (2d) 625 at 634.

[11] Id., 120 F. (2d) at 636.

Chief Justice Stone wrote the opinion of the Court;[12] Justices Black, Douglas and Murphy concurred in a separate opinion;[13] Justice Frankfurter concurred briefly with a crisp footnote of history.[14]

The press and "liberal" utility group have interpreted the decision to mean the overthrow of *Smyth v. Ames* and the adoption by the Court of the prudent investment rate base.[15] The joint concurring opinion gives much comfort to those taking this view. And no doubt the Power Commission will order further reductions on the basis of the decision.[16] However, it does seem clear that the case did not turn on the constitutional issue of confiscation.

In its discussion of the relative positions of Congress, the power commission and the Court in the rate regulation picture, the joint concurring opinion marks a distinct point of departure. The three justices subscribing to this opinion would reduce judicial review even as authorized by statute to the barest minimum and apparently deny any constitutional requirement of review in the name of due process.[17] True, "this historic controversy over the constitutional limitations upon the power of courts in rate cases is not presented here,"[18] but by raising the question obiter dicta, as it were, the salty[19] joint opinion furnishes an interesting commentary on the tendency of some members of the Court to seek a return to early and "pure" constitutional principles. The result of such a reversal by the Court would be to write off a half century or more of super-legislation by the Court under the due process clauses.

The Court is urged to return "to the constitutional principles which prevailed for the first hundred years of our history,"[20] in accordance with other recent cases cited in the opinion[21] as permitting price fixing by legislation unhampered by the due process clause. Amounting to a return to the doctrine of *Munn v. Illinois*,[22] in which Chief Justice Waite declared rate making to be a matter entirely for the legislature, beyond judicial review or revision, this position would require a repudi-

[12] Federal Power Commission v. Natural Gas Pipeline Co. of America, (U. S. 1942) 62 S. Ct. 736.

[13] Id., 62 S. Ct. at 749.

[14] Id., 62 S. Ct. at 753.

[15] NEW YORK TIMES, Mar. 22, 1942, § 3, p. 1:8. For a brief summary of interpretations in the commercial press, see 29 PUB. UTIL. FORTNIGHTLY 505 (1942).

[16] NEW YORK TIMES, Mar. 22, 1942, § 3, p. 1:8.

[17] Principal case, 62 S. Ct. 736 at 750.

[18] Concurring opinion of Justice Frankfurter, 62 S. Ct. at 754.

[19] The flavor is reminiscent of Justice Black's dissent in McCart v. Indianapolis Water Co., 302 U. S. 419 at 423 et seq., 58 S. Ct. 324 (1938).

[20] Principal case, 62 S. Ct. at 749.

[21] Id., note 1.

[22] 94 U. S. 113 (1877).

ation of the long standing, but somewhat later developed view,[23] that due process requires the Court to determine whether or not a rate is reasonable in the sense of nonconfiscatory. The issue is sharply drawn: is the legislature or the judiciary to determine what is reasonable? Justices Black, Douglas and Murphy would leave it to the legislature or its duly authorized agency. And even when the statute authorizes judicial review, they believe it should be scraped to the bone.

It takes the mere twinkle of the legal eye at this point to precipitate the whole problem of *Smyth v. Ames.* The notion that a rate must not be confiscatory in a constitutional sense and that "fair value" is the test for confiscation is part and parcel of the whole doctrine that the question of reasonableness must be determined by the Court. The "fair value" rule apparently springs from the misconception that regulation of rates has its source in the law of eminent domain.[24] It is true that under the classic concept of *Munn v. Illinois* a utility is a business enterprise devoted to the public use and subject to public regulation, but this limited "taking" of property for a public use should not be confused with the traditional condemnation concept. The concurring justices are mindful of the fallacy of this analogy.[25] They point to the exercise of police power in the public interest as the natural basis for utility regulation.[26]

Once the problem is squarely viewed in terms of police power regulation, the constitutional issue comes to be stated in terms of reasonableness. Under this view it is a legislative function and not a judicial function to determine what is the best rate policy. The problem for the Court to determine is whether rates fixed pursuant to statutory authority by a commission, regardless of the theory of the rate base underlying the statute or commission order, are unreasonably low or arbitrarily determined. And the joint concurring opinion goes further to point out to commissions that they may adhere to the prudent investment theory and reject all others and be absolved of worry over any constitutional objections to their so doing:

> "As we read the opinion of the Court, the Commission is now freed from the compulsion of admitting evidence on reproduction

[23] Railroad Commission Cases, 116 U. S. 307 at 325, 331, 6 S. Ct. 334, 348, 349, 388, 391, 1191 (1886); Chicago, Milwaukee & St. Paul Ry. v. Minnesota, 134 U. S. 418, 10 S. Ct. 462, 702 (1890).

[24] For discussions of this misconception, see Kauper, "Wanted: A New Definition of the Rate Base," 37 MICH. L. REV. 1209 at 1216 et seq. (1939); three articles by Robert Hale, "The 'Physical Value' Fallacy in Rate Cases," 30 YALE L. J. 710 (1921); "What is a 'Confiscatory' Rate?" 35 COL. L. REV. 1045 (1935); and "Conflicting Judicial Criteria of Utility Rates—The Need for a Judicial Restatement," 38 COL. L. REV. 959 (1938). See also 2 BONBRIGHT, VALUATION OF PROPERTY 1094 et seq. (1937).

[25] Principal case, 62 S. Ct. at 751.

[26] Id. See also the suggestion to the same effect by Kauper, "Wanted: A New Definition of the Rate Base," 37 MICH. L. REV. 1209 at 1229 (1939).

> cost or of giving any weight to that element of 'fair value.' The Commission may now adopt, if it chooses, prudent investment as a rate base...."[27]

Having enunciated a rule of hands-off and clear sailing for commissions in rate-making policy, the concurring justices then proceed to entangle themselves by admonishing policy makers that the requirements of a "just and reasonable" rate under the statute embrace two factors of public interest which should be considered—namely, investor interest and consumer interest.[28] The purpose of their admittedly going afield is to put in a good word for the consumer and to de-emphasize the interest of the investor. Justice Frankfurter chides them roundly for telling the Power Commission how it shall determine its policy:

> "... if it be deemed that courts have nothing to do with rate-making because that task was committed exclusively to the Commission, surely it is a usurpation of the Commission's function to tell it how it should discharge this task and how it should protect the various interests that are deemed to be in its and not in our keeping."[29]

Justice Frankfurter also lectures his brethren on Court history. It is his assertion that the whole theory of confiscation springs not from *Smyth v. Ames*, but from Chief Justice Waite's opinion in *Stone v. Farmers' Loan and Trust Co.*[30] Reading history this way, Chief Justice Waite is the father of both the concepts here involved: legislative freedom from court limitations in rate regulation matters and the confiscation theory with its concomitant judicial review.

Regardless of who is the better historian, the joint concurring opinion of the Court "rebels" and the short concurring opinion of Justice Frankfurter suggest a sharp cleavage in the new Court. Nowhere in the majority opinion of Chief Justice Stone is there a suggestion that judicial review of rate regulation as a constitutional requirement is to be abandoned, and surely it is implicit in the majority opinion as well as in Justice Frankfurter's concurring opinion that statutory review is not to be diluted or minimized simply because the judges think it unwise or undesirable. On the other hand, three of the Justices favor a return to the concept of *Munn v. Illinois*.[30a] Despite the fact that

[27] Principal case, 62 S. Ct. at 752.

[28] Id., 62 S. Ct. at 753.

[29] Id., 62 S. Ct. at 754.

[30] 116 U. S. 307, 6 S. Ct. 334, 388, 1191 (1886).

[30a] Even Justice Brandeis, whose thinking has in many ways set the pace for the liberalism of these three justices (62 S. Ct. at 752) would not go so far. In his brilliant argument against the "fair value" rule in Houston v. Southwestern Bell Telephone Co.,

a majority of the present Court[31] are apparently ready to scuttle *Smyth v. Ames*, it does not appear at present that a majority will accept the view that judicial review of rate regulation was judicial error at its inception. However, acceptance of the idea that utility regulation is based on police power instead of eminent domain may be accepted by the Court when it finally comes to grips with *Smyth v. Ames*.

Attention may now be given to the Chief Justice's opinion. In addition to the discussion of the statute's validity[32] and the lawfulness of the interim order procedure,[33] consideration is there given to the questions of the scope of judicial review, going concern value, amortization and rate of return.

Determining that the principal case turns on whether or not the rates are just and reasonable in the statutory sense instead of upon the issue of confiscation, the Court precludes a reconsideration of *Smyth v. Ames*. The Chief Justice draws the distinction that is to be made between the statutory standard of reasonableness and the constitutional test of confiscation.[34] This has an important effect on the scope of judicial review in the rate-making process. Recognizing the distinction, the Court fails to carry it into practical application, for the conclusion reached is that the constitutional minimum and the minimum level under the statutory standard are one and the same.[35] This result worked no hardship in the present case, as reproduction cost was used as the rate base and the companies were earning an abundant return. However, if the rate base used was other than the cost of reproducing the service and the revenue was less ample, this construction could work a serious hardship. Moreover, if a utility makes a profit due to the best use of its plant and through efficient management, a continuous paring of rates to the constitutional minimum would produce an unhealthful result. New investors would be discouraged by such a drastic overemphasis of the consumer interest at the expense of the investor.

As a blanket proposition the Court's approach seems unsound. The practice of interpreting the statutory standard in terms of nonconfisca-

259 U. S. 318, 42 S. Ct. 486 (1922), the constitutional necessity of judicial review in rate cases goes unchallenged.

[31] Justices Black, Douglas and Murphy express their views in the principal case. Justice Frankfurter condemned the rule as "mischievous" in Driscoll v. Edison Light & Power Co., 307 U. S. 104 at 122, 59 S. Ct. 715 (1939). Chief Justice Stone indictated his antagonism in his dissent in West v. Chesapeake & Potomac Tel. Co. of Baltimore, 295 U. S. 662 at 689, 55 S. Ct. 894 (1935): "In assuming the task of determining judicially the present fair replacement value of the vast properties of public utilities, courts have been projected into the most speculative undertaking imposed upon them in the entire history of English jurisprudence."

[32] Note 8, supra.

[33] Note 9, supra.

[34] Principal case, 62 S. Ct. at 742.

[35] Id., 62 S. Ct. at 743.

tion is attributable to the fact that the eyes of utility commissions have been frozen on the rule of *Smyth v. Ames*, with the result that the statutory and constitutional inquiries have merged into the identical one of determining the present fair value of the utility. As to this misconception, Justice Brandeis observed in his concurring opinion in *Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission:*[36]

> ". . . The rule there stated [in *Smyth v. Ames*] was to be applied solely as a means of determining whether rates already prescribed by the legislature were confiscatory. It was to be applied judicially after the rate had been made; and by a court which had had no part in making the rate. When applied under such circumstances the rule, although cumbersome, may occasionally be effective in destroying an obstruction to justice, as the action of a court is, when it sets aside the verdict of a jury. But the commissions undertook to make the rule their standard for constructive action. They used it as a guide for making, or approving, rates. And the tendency developed to fix as reasonable, the rate which is not so low as to be confiscatory."

Although the Court recognizes "there is a zone of reasonableness within which the Commission is free to fix a rate varying in amount and higher than a confiscatory rate,"[37] the language of the opinion is not much comfort to those who would have the court make clear the distinction between the statutory standard and the constitutional test and emphasize that a rate may be the "lowest reasonable rate" under the statute even though not as low as constitutionally permissible.

Perhaps it is the Court's keen sense of the need for restricting its consideration to the issues in the case which prevents a thorough condemnation of the traditional practice under *Smyth v. Ames*. That this may be the case is indicated by the Court's statement that:

> "The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances."[38]

In other words, in determining what is a just and reasonable rate under a statute, the commissions are not bound to follow the "mis-

[36] 262 U. S. 276 at 296, 43 S. Ct. 544 (1923).

[37] Principal case, 62 S. Ct. at 743.

[38] Principal case, 62 S. Ct. at 743.

chievous formula"[39] of *Smyth v. Ames*. The Court keeps the door open for commissions to adopt the base best fitted to the particular utility. It is to be expected, as the concurring justices point out, that wide acceptance of the prudent investment theory will flow from the decision.[40] To be emphasized, however, is the fact that the Court prescribes no formula, nor does it reject the reproduction cost base used by the commission in the present case. On the contrary, it leaves the matter of policy entirely in the discretion of the commission.

On the assumption that a rate order which is nonconfiscatory and hence constitutional is necessarily "just and reasonable" within the meaning of the statute, the majority discuss the questions of going value, amortization and fair return in the light of the ideas previously expressed by the Court in confiscation cases. However, the function of reproduction cost as an element of "fair value" is not discussed, since the Power Commission's use of it as the rate base was not questioned by the companies. There is some force to the point made in the joint concurring opinion that the majority continue to give vitality to *Smyth v. Ames*, since the constitutional decisions furnish the context of thought for discussion of the statutory issue. It is true that what the majority really do is to find first that the order is nonconfiscatory and from this conclude that it is "reasonable" within the meaning of the statute. However, it does not follow that the majority would have given continued vitality to the old "fair value" idea if it would have required an adjudication that the rate order was invalid.

Going concern value as an element of the rate base has been loosely handled by the Court for over a quarter of a century.[41] In the instant case, affirmance of the original point of view is indicated.[42] The Court has said frequently that going value must be given consideration. In the *Denver Water Company* case[43] and in the *McCardle* case,[44] a decree was sustained enjoining a rate as confiscatory because, along with other reasons, it was insufficient to allow a return on going value. In the latter of these two cases, the Court indicated that an allowance separate from and in addition to that for the physical properties was

[39] Coined by Justice Frankfurter in his concurring opinion in Driscoll v. Edison Light & Power Company, 307 U. S. 104 at 122, 59 S. Ct. 715 (1939).

[40] See note 27, supra.

[41] For discussions of "going value" and its treatment by the Court, see Lewis, "Going Value and Rate Valuation," 26 MICH. L. REV. 713 (1928); Bemis, "Going Value, in Rate Cases in the Supreme Court," 27 COL. L. REV. 530 (1927).

[42] The position of Justice Holmes, speaking for the Court in Cedar Rapids Gas Light Co. v. City of Cedar Rapids, 223 U. S. 655, 32 S. Ct. 389 (1912), in which the Court refused to overrule the Supreme Court of Iowa for excluding going value.

[43] Denver v. Denver Union Water Co., 246 U. S. 178, 38 S. Ct. 278 (1918).

[44] McCardle v. Indianapolis Water Co., 272 U. S. 400, 47 S. Ct. 144 (1926).

required. However, in decisions rendered both before[45] and after[46] the *McCardle* case the Court held a valuation based on the physical assets in actual operation to be sufficient, since a plant without business would be worth much less. The Court has declined to consider either past success[47] or past deficits[48] in determining present value, though it has said that going concern value depends on the history of the utility involved.[49] Furthermore, since the *McCardle* case, the Court has been consistent in rejecting every estimate of going concern value devised by experts as lacking the "requisite persuasiveness."[50]

In the present case the commission, in issuing the interim order, fixed the rate base on the companies' estimate of reproduction cost, but refused to make a separate allowance of $8,500,000 claimed as "going value" by the utility. In so doing, the commission declared the rate base to be "liberal," allowing "more than an adequate amount to cover all elements of value."[51] The companies asserted this to be error, as their estimate of reproduction cost was based solely on the cost of replacing the physical elements, excluding any element of intangible value. The right to capitalize costs allegedly incurred during the early period of operations prior to development of a so-called normal operating level was claimed by the companies. The companies' argument that there was a real risk, and that early deficits due to development costs could not be amortized out of subsequent earnings appears to be exploded by the facts as to the companies' financial condition pointed out in the Power Commission's brief before the Supreme Court.[52]

[45] Cedar Rapids Gas Light Co. v. City of Cedar Rapids, 223 U. S. 655 at 669, 32 S. Ct. 389 (1912); Des Moines Gas Co. v. Des Moines, 238 U. S. 153 at 171, 35 S. Ct. 811 (1915).

[46] Dayton Power & Light Co. v. Public Utilities Commission, 292 U. S. 290 at 309, 54 S. Ct. 647 (1934); Columbus Gas & Fuel Co. v. Public Utilities Commission, 292 U. S. 398 at 411, 54 S. Ct. 763 (1934); Denver Union Stock Yard Co. v. United States, 304 U. S. 470 at 479, 58 S. Ct. 990 (1938).

[47] Newton v. Consolidated Gas Co., 258 U. S. 165 at 175, 42 S. Ct. 264 (1922).

[48] Galveston Electric Co. v. City of Galveston, 258 U. S. 388, 42 S. Ct. 351 (1922).

[49] Houston v. Southwestern Bell Telephone Co., 259 U. S. 318 at 324, 42 S. Ct. 486 (1922); Los Angeles Gas & Elec. Corp. v. Railroad Commission, 289 U. S. 287 at 314, 53 S. Ct. 637 (1933). See also 2 WHITTEN, VALUATION OF PUBLIC SERVICE CORPORATIONS, 2d (Wilcox) ed., 1369 (1928).

[50] See Los Angeles Gas & Elec. Corp. v. Railroad Commission, 289 U. S. 287 at 317, 53 S. Ct. 637 (1933). See also the cases cited in note 46, supra and Driscoll v. Edison Light & Power Co., 307 U. S. 104 at 117, 59 S. Ct. 715 (1939); Hale, "The 'Fair Value' Merry-Go-Round, 1898 to 1938," 33 ILL. L. REV. 517 at 525-531 (1939).

[51] Illinois Commerce Commission v. Natural Gas Pipeline Co. of America, (Fed. Power Comm. 1940) 35 P. U. R. (NS) 41 at 51.

[52] Power Commission Brief at pages 43-44.

The Chief Justice, in affirming the position of the commission disallowing the claim for going concern value, restates the original position taken by Justice Holmes in 1911:[53]

> "The novel question is thus presented whether confiscation . . . results from the exclusion from the rate base of the previous costs of maintaining excess plant capacity and of getting new business. . . .
>
> "There is no constitutional requirement that going concern value, even when it is an appropriate element to be included in a rate base, must be separately stated and appraised as such."[54]

Referring to the interim order, the Chief Justice continues:

> ". . . If rightly included, as the Commission has assumed for purposes of the order, the companies would have been entitled to earn a fair return upon its value, had the business been regulated from the start. But it does not follow that the companies' property would be confiscated by denying to them the privilege of capitalizing the maintenance cost of excess plant capacity . . . costs which the companies fail to show have not already been recouped from earnings before computing the substantial 'net profits' earned during the first seven years."[55]

The conclusion that the Constitution does not require going concern value as a separate item to be included in a rate base makes for simplicity in rate regulation. Looking upon going concern value as developmental cost, it is obviously not a proper item in a present value base. Such a base seeks to set value without special regard to historical cost. Furthermore, the reproduction cost idea is based on the presumption of existence and continuance of present demand through the development period, otherwise the inclusion of the plant in full completeness at valuation date would be unreasonable. Hence, there remains no need for further assumed expenditures to develop such demand and full efficiency to supply it. If going concern value is viewed as a separate and additional value above the appraised property, it is really based on earning power, which should be excluded from value for rate-making purposes.

Under a prudent investment theory, going concern value as a separate and additional item is excluded because a value concept has no place there. Even as developmental cost it should not be required unless the Constitution guarantees a utility its maximum earning power instead of a fair return. However, if a fair return is not realized in the developmental period, it can be argued that a utility should be allowed

[53] See note 42, supra.

[54] Principal case, 62 S. Ct. at 744.

[55] Id. at 745.

to recoup this deficit. But this does not necessarily require that developmental cost be included in the investment. The investor only need be given a fair opportunity to recoup these costs. The proper method to achieve this is to fix the rate of return at such a figure as to take account of the risk of loss in the development period. As Justice Brandeis observed in the *Galveston* case,[56] the risk of early losses is "a reason for allowing a liberal return on the money invested in the enterprise." The place, then, for early deficits is in the return and not in the base, regardless of the rate base theory. This is the Power Commission's conclusion and the Court concurs therein.

The Power Commission and the companies disagreed on three questions regarding the annual charge for amortization[57] or depreciation: (1) The Power Commission used investment as the amount to be amortized; the companies urged that the present value of the properties be amortized. (2) The Power Commission fixed the entire life of the enterprise as the period of amortization; the companies urged that the period of amortization should commence either as of the date of the passage of the Natural Gas Act or as of the date of entry of the rate order. (3) The Power Commission computed the amortization allowance on the basis of a six and one-half per cent interest rate; the companies urged that it should have used a two per cent interest rate.[58] The Court sustained the Power Commission on all three questions.

During the period 1932 to 1938, the companies had amortized by depreciation, depletion and retirement charges more than one-fourth of their investment. The Power Commission used as the rate base reproduction cost new, but fixed the amortization base at total investment cost less salvage value. The annual allowance for amortization was computed on the entire life expectancy of the properties, a twenty-three year period from the beginning of operations to 1954, when the utility estimated its gas sources would be exhausted. The Court found no violation of due process[59] in not permitting the companies to recover through amortization allowance the present value of its properties at the date it became subject to regulation. This is in accord with several state commissions' decisions involving previously unregulated gas companies fixing the amortization base for the remaining life expectancy at total investment cost less the proportion of the cost fairly allocable

[56] Galveston Electric Co. v. City of Galveston, 258 U. S. 388 at 395, 42 S. Ct. 351 (1922).

[57] See treatment of this feature of the case in the circuit court of appeals, 55 HARV. L. REV. 299 (1941).

[58] Power Commission Brief, p. 70.

[59] "The Constitution does not require that the owner who embarks in a wasting-asset business of limited life shall receive at the end more than he has put into it." Principal case, 62 S. Ct. at 746.

to functioning prior to regulation.[60] Likewise in cases where the utility previously had been subject to regulation, a similar result has been reached by using the method of computing amortization allowance adopted by the Power Commission in the principal case, irrespective of the utility's past amortization practice.[61] The propriety of using an original-investment amortization base regardless of the valuation used for the rate base has been upheld in natural gas utility cases where there had been previous regulation.[62] Since the investor should recover only his original investment, the original-investment amortization base seems fair and desirable.[63]

In the analogous case of depreciation, the Supreme Court held in *United Railways & Electric Co. of Baltimore v. West*[64] that if reproduction cost is used as a rate base, consistency requires that the periodical allowance for depreciation be based also on reproduction cost. Justices Brandeis, Holmes and Stone dissented in the *United Railways* case.[65] In effect, *Lindheimer v. Illinois Bell Telephone Company*[66] reached the same result as did the dissenting justices in the *United Railways* case.[67] The universal practice of businessmen and government departments[68] is contrary to the *United Railways* decision. Hence, in rejecting the previous pronouncement of the Court, the Chief Justice was well sheltered by respectable judicial opinion and orthodox business practice:

[60] Clarksburg Light & Heat Co. v. Public Service Commission, 84 W. Va. 638 at 650, 100 S. E. 551 (1919); Oklahoma Natural Gas Co. v. Corporation Commission, 90 Okla. 84 at 92, 216 P. 917 (1923). Cf. Re Ashtabula Gas Co., (Ohio Pub. Util. Comm.) P. U. R. 1917D 790 at 796.

[61] United Fuel Gas Co. v. Railroad Commission, (D. C. Ky. 1925) 13 F. (2d) 510 at 523, affd. 278 U. S. 300, 49 S. Ct. 150 (1929); see Re Iroquois Natural Gas Co., (N. Y. Pub. Serv. Comm.) P. U. R. 1919D 76 at 93. Cf. Wheeling v. Natural Gas Co., (W. Va. Pub. Serv. Comm.) P U R 1933D 1 at 17; Re Cumberland & Allegheny Gas Co., (W. Va. Pub. Serv. Comm.) P. U. R. 1928B 20 at 80.

[62] United Fuel Gas Co. v. Railroad Commission, (D. C. Ky. 1925) 13 F. (2d) 510 at 518; Homing Light & Gas Co. v. State, 130 Okla. 258 at 262, 267 P. 235 (1928). *Contra*: Re United Fuel Gas Co., (W. Va. Pub. Serv. Comm.) P. U. R. 1925B 705 at 745 (West Virginia), upheld sub nomine United Fuel Gas Co. v. Public Service Commission, (D. C. W. Va. 1926) 14 F. (2d) 209, affd. 278 U. S. 322, 49 S. Ct. 157 (1929).

[63] Comment, 43 YALE L. J. 483 at 485 (1934).

[64] 280 U. S. 234 at 253, 50 S. Ct. 123 (1930).

[65] Id., 280 U. S. at 259, 289.

[66] 292 U. S. 151 at 168, 176, 54 S. Ct. 658 (1939).

[67] See also Alexandria Water Co. v. City Council of Alexandria, 163 Va. 512, 177 S. E. 454 (1934). Federal and state commission decisions rejecting the United Railways decision and following cost accounting for depreciation are numerous; see exhaustive note on pages 78-79 of the Power Commission Brief.

[68] JONES AND BIGHAM, PRINCIPLES OF PUBLIC UTILITIES 491 (1931); Telephone and Railroad Depreciation Charges, 177 I. C. C. 351 at 372-382 (1931).

"... This [the use of the original-investment base] was in conformity with the established business practice, in the case of unregulated as well as regulated businesses. . . .

"The companies are not deprived of property by a requirement that they credit in the amortization account so much of the earnings received during the prior period as are appropriately allocable to it for amortization. Only by that method is it possible to determine the amount of earnings which may justly be required for amortization during the remaining life of the business."[69]

The sinking-fund method of formulating the amortization rate of interest used by the Power Commission amounted to this: the companies were allowed to include each year in their operating expenses an amount which, with interest compounded annually during the remaining service life of the property at a rate identical with the rate of return, would yield a sum equal to the total amount to be amortized.[70] The amortization reserve thus accumulated was not deducted from the rate base. The companies[71] urged that the interest rate should be two per cent, compounded semi-annually, on the assumption that a fund of segregated risk-free securities could at the present time earn only some such lower rate of interest. The companies' conception of the allowance was that of an actual sinking fund, while the Power Commission used an accounting process patterned after a sinking fund. If an actual sinking fund had been established, and the amount therein withdrawn from the rate base, the companies' contentions would have been valid. But since the commission was using an unamortized base on which a six and one-half per cent return was allowed to the companies, it was not unfair to employ the same rate in estimating the annual increase in the amortization reserve through the compounding of interest.

The six and one-half per cent fair annual rate of return allowed by the Power Commission on the rate base[72] is not the lowest return that the Court has upheld.[73] The six and one-half per cent return satisfies the test for a proper return as laid down by the Court in *Bluefield Waterworks & Improvement Company v. Public Service Commission.*[74]

[69] Principal case, 62 S. Ct. at 747.

[70] Id.

[71] Companies' Original Brief, pp. 130-144.

[72] Illinois Commerce Commission v. Natural Gas Pipeline Co. of America, (Fed. Power Comm. 1940) 35 P. U. R. (N. S.) 41 at 54.

[73] In Driscoll v. Edison Light & Power Co., 307 U. S. 104 at 120, 59 S. Ct. 715 (1939), a 6 per cent return was held not to be confiscatory.

[74] 262 U. S. 679 at 692-693, 43 S. Ct. 675 (1937), stating: "A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but

The evidence to support this rate of return was substantial. In the period involved, utility corporation profits declined from 7.2 per cent to 5.1 per cent. Interest rates were at a low level. Nor were the companies subject to any extraordinary risks. The companies have a legal and practical monopoly in their market, metropolitan Chicago. The companies which service this area own twenty-six per cent of the investment in the pipeline companies. One company alone takes ninety per cent of the pipeline supply. This contract is to run to 1946 or until 1951 at the companies' option.[75] This is unusual protection against the risk of losing the market. The fact the supply will exhaust itself was considered in the amortization figure so that it should not be reflected in the rate of return. The Court, as well as the power commission, was convinced that in view of the current level of interest rates, the relative security of the investment and the exceptionally strong position of the companies, six and one-half per cent was a reasonable rate of return. On the basis of reproduction cost, the present level of interest rates alone would seem to justify the result in the case of a flourishing enterprise.

Indicating a more businesslike approach to the problem of rate regulation, the Court in the principal case clears away some of the judicial underbrush that has grown up under *Smyth v. Ames*, but the forecasted demise of the troublesome "fair value" rule is still no more than a prophetic wish.*

it has no constitutional rights to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and to enable it to raise the money necessary for the proper discharge of its public duties." See also Willcox v. Consolidated Gas Co., 212 U. S. 19 at 48-50, 29 S. Ct. 192 (1909); Lincoln Gas & Electric Co. v. Lincoln, 250 U. S. 256 at 268, 39 S. Ct. 454 (1919); Driscoll v. Edison Light & Power Co., 307 U. S. 104 at 119-120, 59 S. Ct. 715 (1939).

[75] Power Commission Brief, pp. 103-104.

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