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PUBLIC UTILITIES - RATE REGULATION - REPRODUCTION COST AND PRUDENT INVESTMENT AS FACTORS IN DETERMINING "FAIR VALUE"

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PUBLIC UTILITIES — RATE REGULATION — REPRODUCTION COST AND PRUDENT INVESTMENT AS FACTORS IN DETERMINING “FAIR VALUE” — At a hearing conducted by the California Railroad Commission, the existing gas rates charged by a utility were deemed unreasonable, and a new schedule of rates was prescribed. The commission, in determining the rate base, used historical cost exclusively, and refused to attach any weight to the present cost of reproducing the properties. A three-judge federal court enjoined the enforcement of the rates without making a finding that as prescribed the rates were confiscatory. *Held*, by a majority of the Court, the trial court was without power to enjoin the enforcement of the rates, regardless of the method of valuation employed by the commission, as long as the rates were not confiscatory and the company was not denied the elements of a fair hearing. *Railroad Commission of California v. Pacific Gas & Electric Co.*, (U.S. 1938) 58 S. Ct. 334.

A public utility company sought to restrain the further enforcement of water rates prescribed by a state public service commission. A master, appointed by the federal district court, employing April 1, 1933 as the date of valuation, found that the rates were not confiscatory. The district court adopted his report with some modification and denied the application for injunction on November 29, 1935, without considering an intervening rise in the price level. The circuit court of appeals reversed because it found that the omission of certain items of company property from the valuation scheme would produce an insufficient return for the company, and particularly, because the significant increase in prices had been ignored. *Held*, by a majority of the Supreme Court, the reversal should be affirmed. *Indianapolis Water Co. v. McCart*, (U. S. 1938) 58 S. Ct. 324.

By no means does the present litigation suggest the final solutions to the problem of utility rate valuation by the courts, aptly denominated “the most

speculative undertaking . . . in the entire history of English jurisprudence.”¹ Particularly, the decision in the California case would not appear to justify the sanguine popular pronouncement that it has made “prudent investment v. reproduction cost nearer to an open question than it has been for 40 years.”² Rather the decision seems to affirm the “fair value” test of *Smyth v. Ames*³ for determining whether rates are confiscatory, and the “grab-bag nature of the formula”⁴ to be used in determining such value, including the proper emphasis upon cost of reproduction as a necessary ingredient. However, the California case indicates that the court will less strenuously criticize commission technique, including failure to consider cost of reproduction as an element in the rate base, as long as there is no showing of a confiscatory result when measured by the court’s test. What the decision further accomplishes is some clarification of the federal function in state rate cases and the court’s conception of procedural due process. Following its established doctrine that the federal courts can enjoin rates established by state commissions only where actual confiscation appears,⁵ or where the hearing which determines those rates is so arbitrary and unfair as to violate the Fourteenth Amendment,⁶ the majority

¹ Justice Stone, dissenting, in *West v. Chesapeake & Potomac Telephone Co.*, 295 U. S. 662 at 689, 55 S. Ct. 894 (1935).

² *TIME*, p. 14 (Jan. 10, 1938). See also *THE NEW REPUBLIC*, p. 266 (Jan. 12, 1938). A clearer advance diagnosis of the decision appears in *THE NATION*, p. 575 (Nov. 27, 1937). See also the analysis of the decision in 15 U. S. *LAW WEEK* 515 (Jan. 11, 1938).

³ 169 U. S. 466, 18 S. Ct. 418 (1898). The course of decision following this case is extensively reviewed by Justice Butler, dissenting in the present California case (in which he was joined by Justice McReynolds) and to a lesser degree by Justice Black, in his dissent to the decision of the Court in the Indianapolis case. Recent periodicals and texts are gathered in 34 *MICH. L. REV.* 100 (1935).

⁴ *FRANKFURTER, MR. JUSTICE BRANDEIS* 84 (1932).

⁵ See *Los Angeles Gas & Electric Corp. v. R. R. Comm.*, 289 U. S. 287 at 304, 53 S. Ct. 637 (1933); *State Corp. Comm. v. Wichita Gas Co.*, 290 U. S. 561 at 568, 54 S. Ct. 321 (1934); *Clark’s Ferry Bridge Co. v. Public Service Comm.*, 291 U. S. 227 at 240, 54 S. Ct. 427 (1934); *Lindheimer v. Illinois Bell Tel. Co.*, 292 U. S. 151 at 169, 54 S. Ct. 658 (1934); *Dayton Power & Light Co. v. Public Utilities Comm.*, 292 U. S. 290 at 296, 54 S. Ct. 647 (1934); *West Ohio Gas Co. v. Public Utilities Comm.*, 294 U. S. 63, 55 S. Ct. 316 (1935). In the last case Justice Cardozo summarized (294 U. S. 70) the doctrine: “Our inquiry in rate cases coming here from the state courts is whether the action of the state officials in the totality of its consequences is consistent with the enjoyment by the regulated utility of a revenue something higher than the line of confiscation. If this level is attained, and attained with suitable opportunity through evidence and argument [*Southern R. R. v. Virginia*, 290 U. S. 190, 54 S. Ct. 148 (1933)] to challenge the result, there is no denial of due process, though the proceeding is shot through with irregularity or error.”

⁶ See *Interstate Commerce Comm. v. Louisville & N. R. R.*, 227 U. S. 88 at 91, 33 S. Ct. 185 (1913); *Baltimore & Ohio R. R. v. United States*, 264 U. S. 258 at 264-265, 44 S. Ct. 317 (1924); *Northern Pacific R. R. v. Dept. of Public Works*, 268 U. S. 39, 45 S. Ct. 412 (1925); *Chicago, Milwaukee & St. Paul R. R. v. Pub. Util. Comm.*, 274 U. S. 344, 47 S. Ct. 604 (1927); *Morgan v. States*, 298 U. S. 468 at 479-480, 56 S. Ct. 906 (1936); *Ohio Bell Tel. Co. v. Pub. Util. Comm.*, 301 U. S. 292, 57 S. Ct. 724 (1937); Beutel, “Valuation as a Requirement of Due Process,” 43 *HARV. L. REV.* 1249 (1930); Barnes, “Federal Courts and State

of the Court finds no ground for an injunction in the present case.⁷ The dissenting judges assert that arbitrary action was present.⁸ In addition, the majority curbs, impliedly, the radius of effect of *West v. Chesapeake & Potomac Telephone Co.*,⁹ where it was sought to employ original cost adjusted to current price levels by means of commodity indices; the Court there held that the "entire method of the Commission was erroneous and its use necessarily involved unjust and inaccurate results."¹⁰ Although it was generally believed to go beyond any previous doctrine of the Court,¹¹ the majority opinion in the *Pacific Gas & Electric Co.* case indicates briefly that the *West* case was based on recognized conceptions of procedural due process, the employment of the method there being arbitrary in itself.¹² Even if this is accepted as a satisfactory explanation, there is still a wide area of unpredictability as to the scope to be given to the *West* case on the one hand, and the instant *California* decision on the other. No wholesale abandonment of "fair value" by the state commissions, with any assurance as to the consequences, is foreseen. The trending device of the *West* case appeared as reasonable to the minority of the Court there as did the action of the commission loom capricious to the present minority.¹³ But whether the

Regulation of Utility Rates," 43 YALE L. J. 417 (1934); 44 YALE L. J. 119 (1934); 35 MICH. L. REV. 159 (1936); 35 MICH. L. REV. 274 (1936); 21 ST. LOUIS L. REV. 168 (1936).

⁷ Cf. *United Fuel Gas Co. v. R. R. Comm.*, 278 U. S. 300 at 310, 49 S. Ct. 150 (1929). "As the court below held, appellants, as public service companies, are bound by the common law, if not by statute, to render their service at reasonable rates. If the rates are not shown to be confiscatory they cannot complain that the order purporting to impose them was void, for they have suffered no injury even though the order was unauthorized."

⁸ One of the principal differences between the two opinions was whether the commission had "considered" evidence of present reproduction value since it rejected the company's estimates as wholly unreliable. The majority concluded, "The Commission was entitled to weigh the evidence introduced, whether relating to reproduction cost or to other matters. . . . There is no principle of due process which requires the rate-making body to base its decision as to value, or anything else, upon conjectural and unsatisfactory estimates." *Railroad Commission of California v. Pacific Gas & Electric Co.*, (U. S. 1938) 58 S. Ct. 334 at 339-340. See *Dayton Power & Light v. Pub. Util. Comm.*, 292 U. S. 290 at 299-302, 54 S. Ct. 647 (1934); *Idaho Power Co. v. Thompson*, (D. C. Idaho, 1927) 19 F. (2d) 547 at 552. The minority observed no valid attempt by the commission to find fair value.

⁹ 295 U. S. 662, 55 S. Ct. 894 (1935).

¹⁰ *Ibid.*, 295 U. S. at 675.

¹¹ See Hale, "What is a 'Confiscatory' Rate?" 35 COL. L. REV. 1045 (1935); 34 MICH. L. REV. 100 (1935); Bauer, "Supreme Court Limits Public Utility Valuations," 24 NAT. MUN. REV. 440 (1935); 49 HARV. L. REV. 297 (1935); and particularly 21 ST. LOUIS L. REV. 168 (1936).

¹² The Court thus disregarded its passing reference to the *West* case as one involving confiscation, *Baltimore & Ohio R. R. v. United States*, 298 U. S. 349 at 368, 56 S. Ct. 797 (1936), on which basis counsel for the commission sought to rationalize it. Brief for Appellants (manuscript copy), p. 13.

¹³ In the *West* case the commission based its valuation on historical cost adjusted to contemporary price levels by trending from commodity indices, after examining and rejecting the company's evidence of reproduction cost. *West v. Chesapeake & Potomac Telephone Co.*, 295 U. S. 662 at 668, 55 S. Ct. 894 (1935). In the *California* case

force of the *West* case will be further weakened is subject for prophecy only. It may well be that the hour of decision between prudent cost of investment and fair value is imminent, but its hastening must be attributed less to legal than to political and economic factors, including strong executive agitation for adoption of the prudent historical cost rule¹⁴ and its sanction by Congress in the Federal Power Act,¹⁵ as well as the almost inevitable changes in ideology concomitant to alteration of Supreme Court personnel.¹⁶ At present, however, the Court seems reconciled to its position in *Los Angeles Gas & Electric Corp. v. Railroad Commission*.¹⁷ The decision in the *Indianapolis* case is not inconsistent with the rule laid down. In effect, the district court is directed to consider evidence of rising prices in determining whether rates, set by a commission and under which the company has been operating, are in fact confiscatory. The position is not that the commission failed to consider price levels for the ensuing three years, which at the time its schedules were set was a matter of guess, but that the court should not ignore the present price level in determining whether the company is now operating under confiscatory rates.¹⁸ Obviously, there is no need to find confiscation as a condition precedent to objecting to the

the commission similarly rejected the company's evidence and based value on historical cost without price level revision.

¹⁴ The President has consistently urged adoption of the original prudent investment test by the utilities. See, for example, N. Y. TIMES 1:6 (Nov. 10, 1937); *ibid.*, 1:7 (Nov. 12, 1937); *ibid.*, 1:8 (Nov. 24, 1937).

¹⁵ 41 Stat. L. 1077, § 3 (1920) [amended by 49 Stat. L. 838, § 201 (1935)], 49 Stat. L. 838, § 213 (1935); 16 U. S. C., §§ 796 (13), 824g (Supp. 1936).

¹⁶ The California case was affirmed last June by a divided court, Justice Sutherland not sitting. The instant decision is a rehearing, Justice Black concurring in the result. The latter's vehement dissent in the Indianapolis case commits him to the historical cost view. See NATION, p. 58 (Jan. 15, 1938).

¹⁷ 289 U. S. 287, 53 S. Ct. 637 (1933). The optimism expressed at this decision [e.g., Collins, "Trend of the U. S. Supreme Court Decisions Affecting Rates of Public Utilities," 20 A. B. A. J. 535 (1934)], as well as that engendered by *Lindheimer v. Illinois Bell Tel. Co.*, 292 U. S. 151, 54 S. Ct. 658 (1934) [e. g., 48 HARV. L. REV. 83 (1934)] was shattered by the appearance of the *West* case. For this reason, the California case is likely to be received by the profession with more cautious enthusiasm.

¹⁸ Cf. *McCardle v. Indianapolis Water Co.*, 272 U. S. 400 at 424, 47 S. Ct. 144 (1926), where Justice Brandeis, dissenting, said "When a court declares the rate base shall be the value, instead of the historical cost, or the amount prudently invested in the enterprise, it selects the standard for measuring the property on which compensation is to be paid. It lays down a rule of law, and in the performance of that function there is always a legitimate field for theory. But when, having selected value as the standard for the rate base, the court undertakes to find what that value is at the date of the rate hearing, it purports to make a finding of fact. The process of determining facts will inevitably be misleading, unless each step bears a close relation to the realities of life." Interestingly, the circuit court of appeals judicially noticed the rise in commodity prices by means of indices similar to those condemned in the *West* case, although no specific application was here attempted. *Indianapolis Water Co. v. McCart*, (C. C. A. 7th, 1937) 89 F. (2d) 522 at 528. For discussion of such device, see 34 MICH. L. REV. 100 at 106-112 (1935); 49 HARV. L. REV. 297 (1935).

methods of the trial court, since the effect of its decision was to "freeze" an artificial valuation as of a given date. It is true, as Justice Black maintains in his dissent,¹⁹ that the temptation for the district court to find confiscation in the light of the opinions in the appellate courts, with its attendant lengthening of the litigation, is undeniable. But this is an infirmity deeper than can be rectified simply by affirming a decree of the trial court which time already appeared to have outmoded.

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¹⁹ *Indianapolis Water Co. v. McCart*, (U. S. 1938) 58 S. Ct. 324 at 326.