

# Michigan Law Review

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Volume 63 | Issue 2

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1964

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Michigan Law Review

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### Recommended Citation

Michigan Law Review, *Actual Expenses of Ohio Utility Are Considered in Computing Rates Even Though the Hypothetical Company Technique Is Used-General Tel. Co. v. Public Util. Comm'n*, 63 MICH. L. REV. 406 (1964).

Available at: <https://repository.law.umich.edu/mlr/vol63/iss2/11>

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**Actual Expenses of Ohio Utility Are Considered in Computing Rates Even Though the Hypothetical Company Technique Is Used—*General Tel. Co. v. Public Util. Comm'n***

The Public Utilities Commission of Ohio<sup>1</sup> established rates for plaintiff telephone company. In determining the gross annual revenues to which the company was entitled, the Commission allowed, as an item of expense, 112 thousand dollars less for federal income tax than the company would actually be required to pay during the year in question. The allowance for taxes was calculated by following the so-called "hypothetical company" formula as apparently required by a recent line of Ohio Supreme Court decisions.<sup>2</sup> On direct appeal to the Ohio Supreme Court, *held*, order reversed, two judges dissenting. The utility company should be allowed to consider as an item of expense the federal income tax amount which it will actually have to pay, based upon its computed annual dollar return. Use of the "hypothetical company" method in calculating the allowable expense for income tax is contrary to the law of Ohio because it results in an arbitrary reduction in the determined fair rate of return to the utility. *General Tel. Co. v. Public Util. Comm'n*, 174 Ohio St. 575, 191 N.E.2d 341 (1963).<sup>3</sup>

The Ohio Revised Code provides that the basic theory to be used by the Commission in fixing public utility rates is the "fair value" theory;<sup>4</sup> that is, a utility is to be allowed a reasonable yearly return on the fair value of its property used for public service. The statute provides that the fair value of the utility's property for rate-making purposes shall be the cost of constructing new facilities identical to those in service, less depreciation.<sup>5</sup> This reconstruction-cost-new-less-depreciation (RCNLD) computation constitutes the statutory rate base in the utility rate-making process; and the yearly reasonable dollar return on the property is computed by multiplying this statutory rate base by a percentage figure established by the Com-

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1. Hereinafter called the Commission.

2. *Ohio Edison Co. v. Public Util. Comm'n*, 173 Ohio St. 478, 184 N.E.2d 70 (1962); *Cincinnati Gas & Elec. Co. v. Public Util. Comm'n*, 173 Ohio St. 473, 184 N.E.2d 84 (1962); *Ohio Fuel Gas Co. v. Public Util. Comm'n*, 171 Ohio St. 10, 167 N.E.2d 496 (1960); *City of Cleveland v. Public Util. Comm'n*, 164 Ohio St. 442, 132 N.E.2d 216 (1956). Apparently, Ohio is the only state which has adhered to the hypothetical company method of rate-making. This theory is explained in detail in the text accompanying notes 9-14 *infra*.

3. Two companion cases presenting the identical issue were similarly decided. *City of Dayton v. Public Util. Comm'n*, 174 Ohio St. 604, 190 N.E.2d 913 (1963); *Ohio Fuel Gas Co. v. Public Util. Comm'n*, 174 Ohio St. 585, 191 N.E.2d 347 (1963).

4. OHIO REV. CODE ANN. §§ 4909.04-.05, .15 (Page 1954). See note 10 *infra*.

5. OHIO REV. CODE ANN. § 4909.05 (Page 1954).

mission as representing a fair rate of return.<sup>6</sup> To the resulting dollar amount are added all the operating expenses for the year (including the expense of federal income tax) in order to obtain the company's annual revenue requirement. Rates are then fixed to assure the company of collecting that amount.<sup>7</sup> While this mathematical procedure is simple enough, the "fair value" approach frequently presents problems in practical application.<sup>8</sup> The primary weakness of the method is that in times of inflation the rate base is higher than the book value, or actual amount invested in the company, and in times of depression the opposite will occur, thus rendering illusory a standardized concept of "fair return" on the property.

In *City of Cleveland v. Public Util. Comm'n*,<sup>9</sup> the court construed the language of the Ohio statute<sup>10</sup> as requiring that the dollar amount of the statutory rate base of any Ohio public utility be taken, for rate-making purposes, to represent an equal amount of capital invested in a hypothetical company. The hypothetical company was held entitled to earn on this amount a return reasonable in light of the projection of the actual company's debt-equity ratio upon the amount of the hypothetical company's capital. This method of rate-making, accepted without serious objection<sup>11</sup> until the decision in the principal case, is simply illustrated. Assume that actual invest-

6. *City of Cleveland v. Public Util. Comm'n*, 164 Ohio St. 442, 443, 132 N.E.2d 216, 217 (1956).

7. For example:

	Reconstruction cost new .....	\$1,200,000
(minus)	Existing depreciation .....	200,000
	RCNLD .....	1,000,000
(times)	Annual fair rate of return .....	6%
	Annual dollar amount of return .....	60,000
(plus)	Annual operating expenses .....	50,000
	Allowable gross annual revenues .....	\$110,000

Rates are then fixed to allow the company this final figure.

8. See *Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 289 (1923) (dissenting opinion of Brandeis, J.); BONRBIGHT, *PRINCIPLES OF PUBLIC UTILITY RATES* 227 (1961); Rose, *Confusion in Valuation for Public Utility Rate-Making*, 47 MINN. L. REV. 1 (1962); Smith, *The Reality of the Public Utility Rate Base*, 67 DICK. L. REV. 83 (1962); Note, 22 MONT. L. REV. 65 (1960).

The OHIO LEGISLATIVE SERVICE COMMISSION RESEARCH REPORT No. 9 at 1 (1955) suggests that accurate and consistent valuation of property and depreciation is nearly impossible because of the large volume of work the Commission must handle. Consequently, valuation often approaches guesswork.

9. 164 Ohio St. 442, 132 N.E.2d 216 (1956).

10. OHIO REV. CODE ANN. § 4909.15 (Page 1954), which reads in part: "[T]he Commission shall, with due regard among other things, to the value of all property of the public utility actually used and useful for the convenience of the public, . . . with due regard to the necessity of making reservation out of the income for surplus, depreciation, and contingencies, and with due regard for all such other matters, as are proper . . . fix and determine the just and reasonable rate . . . to be . . . charged. . . ."

11. See, e.g., *Ohio Edison Co. v. Public Util. Comm'n*, 173 Ohio St. 478, 184 N.E.2d 70 (1962); *Ohio Fuel Gas Co. v. Public Util. Comm'n*, 171 Ohio St. 10, 167 N.E.2d 496 (1960).

ment in an existing utility is 500 thousand dollars, composed half of debt capital and half of common stock.<sup>12</sup> Assume further, however, that, due to inflation, the assets purchased with the 500 thousand dollars are now valued at one million dollars, the latter figure representing the assets' reconstruction cost new less depreciation. One million dollars, then, is the rate base established under the Ohio statute for the actual utility. Next, assume the existence of a hypothetical company which (1) has an investment equal to the actual company's statutory rate base, (2) has a debt-equity ratio equal to that of the actual company, and (3) pays a historical interest rate on its hypothetical debt capital and a rate of return on its hypothetical equity capital identical to the rates at which the Commission determines the actual company should pay its real investors. From the foregoing data, the overall return required by the hypothetical company is calculated. This is accomplished by projecting the debt-equity ratio of the actual utility onto the amount of the capital invested in the hypothetical company. Thus, fifty per cent of the hypothetical company's one million dollar capital must provide a return to its mythical bondholders and fifty per cent of its capital must provide a return to its mythical stockholders. Under the *City of Cleveland* rule, the Commission is required to award the actual company the same overall fair return which the Commission would be required to allow the hypothetical company in order for the latter to be able to pay the return thus calculated to the imaginary bondholders and stockholders who have invested one million dollars in the hypothetical company. The amount which the actual company *needs* in order to pay its flesh-and-blood investors a return at the same rates on the five hundred thousand dollars, which is in fact invested in that company, is immaterial in fixing rates by this method. An example of the calculation of the return to which each of the companies—actual and hypothetical—is entitled is as follows (assuming that the Commission has found the historical interest rate on the debt to be four per cent and a reasonable rate of return to the stockholders to be ten per cent):

\$500,000 hypothetical debt capital
× 4% interest rates
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\$20,000 for return to bondholders
\$500,000 hypothetical equity capital
× 10% rate of return on equity
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\$50,000 for return to stockholders

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12. That is, assume that half the company's capital has been provided by debt, such as by sale of long-term bonds, and half by the issuance of common stock.

$$\begin{aligned} \$20,000 \text{ plus } \$50,000 &= \$70,000 \text{ annual return to company} \\ &= 7\% \text{ overall rate of return}^{13} \end{aligned}$$

Of course, since the actual company will pay its real investors an overall return of approximately seven per cent on only the five hundred thousand dollars actually invested in the company, it need pay out only about thirty-five thousand dollars, and, other things being equal, the company is free to retain the remaining thirty-five thousand dollars which it will receive from consumers. It is in this fashion, at least in theory,<sup>14</sup> that the hypothetical company formula operates.

However, the hypothetical company method as set forth in the *City of Cleveland* case has not been restricted to use in computing the percentage rate of return. In calculating allowable revenue, income tax is includable as an item of expense,<sup>15</sup> and interest paid on debt is deductible for federal income tax purposes.<sup>16</sup> Under the hypothetical company concept, the amount deducted for interest payments in calculating income tax requirements is the *fictitious* cost of the debt, regardless of whether it equals the actual amount of interest which the company has to pay. Generally, the fictitious amount of interest will be greater than the actual amount paid to bondholders and other lenders;<sup>17</sup> the result is that a sum greater than that actually expended is deducted in determining the expense to be allowed for the hypothetical federal income tax. Thus, the amount of tax which the hypothetical company would pay is smaller than the amount which the actual company owes, and the former is the amount allowed by the Commission as a tax expense if the hypothetical method is used in all steps of the rate-making process.

13. Or, of course, the overall rate of return to which the company is entitled may be calculated directly, as follows (assuming the same figures as have been used in the text):

$$\begin{array}{l} 50\% \text{ debt ratio} \\ \times 4\% \text{ interest rate} \\ \hline 2\% \text{ of rate base must provide for interest on hypothetical debt capital} \\ 50\% \text{ equity ratio} \\ \times 10\% \text{ rate of return on equity} \\ \hline 5\% \text{ of rate base must provide for return on hypothetical equity capital} \\ 2\% \text{ plus } 5\% = 7\% \text{ fair overall rate of return on hypothetical capital} \\ \qquad \qquad = 7\% \text{ fair overall rate of return on actual company's statutory rate} \\ \qquad \qquad \qquad \text{base} \\ 7\% \times \$1,000,000 \text{ hypothetical capital (statutory rate base)} = \$70,000 \text{ overall return} \end{array}$$

14. *But see* dissenting opinion of Judge Gibson in *Ohio Fuel Gas v. Public Util. Comm'n*, 174 Ohio St. 585, 602, 191 N.E.2d 347, 357 (1963), indicating that, in fact, the Commission does not apply the hypothetical company theory until after the dollar amount of the return has been determined by other methods.

15. See *City of Cincinnati v. Public Util. Comm'n*, 153 Ohio St. 56, 90 N.E.2d 681 (1950).

16. INT. REV. CODE OF 1954, § 163.

17. Because of inflation, the reconstruction cost figure will usually be greater than the amount of the original investment.

Proponents of the hypothetical company method<sup>18</sup> contend that a hypothetical, rather than actual, tax expense must be used because in computing allowable expenses and the rate of return the company is nearly always allowed more than it will actually have to pay for interest on its debt.<sup>19</sup> Therefore, in effect, use of the lesser hypothetical income tax allowance helps to balance the gross return and to keep the total reasonable. However, it was this step which was disapproved by the court in the principal case.<sup>20</sup> The hypothetical company method is admittedly complicated and cumbersome, but it is an attempt to meet the problem of arriving at a rationally evolved rate of return figure in the context of disparity between the utility's reconstruction cost and actual investment cost. It affords the Commission a tangible basis for computing the percentage rate of return by formula; at the same time, when the hypothetical amounts are used throughout, it prevents the company from receiving more than it needs to acquire a reasonable surplus and pay a reasonable return on its capital.<sup>21</sup> Moreover, the use of the method throughout allows its logic to cut both ways with consistency by reducing the gross revenues in times of inflation and increasing them in times of depression.<sup>22</sup> Thus, the majority opinion disallowed what had become a "check" on the RCNLD system without specifically alleviating the need for such a check. Apparently the percentage rate of return must still be figured on the basis of an amount of invested capital equal to the statutory rate base.<sup>23</sup> But in the subsequent steps in calculation, such as the figuring of taxes and other expenses, only actual figures are to be used.

The fundamental purpose of rate regulation is the duplication, as nearly as possible, of the effect of competition in a naturally monopolistic setting.<sup>24</sup> Beyond this generally accepted premise, however, lies one of the most vexing and unsettled areas of the law, a situation probably attributable to the fact that no one has yet dis-

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18. See dissenting opinion of Mr. Chief Justice Taft in the companion case of *Ohio Fuel Gas Co. v. Public Util. Comm'n*, 174 Ohio St. 585, 589, 191 N.E.2d 347, 350 (1963).

19. On the other hand, if a severe economic recession should cause the reconstruction-cost figure to fall below the amount originally invested, the company would be allowed less for interest than it actually had to pay. In that event, use of the hypothetical company concept throughout the rate-making process would allow the utility more for income tax expense than it actually owned for taxes and would minimize its loss.

20. Principal case at 578-80, 191 N.E.2d at 343-44.

21. Mr. Chief Justice Taft did not propose that the company be restricted to an amount which is barely enough to pay interest on the debt and a minimum return on equity, since such a course might stifle growth. But he did contend that the majority opinion would result in allowing the utility much more than a *reasonable* return, and that this construction was contrary to law.

22. See note 19 *supra*.

23. See principal case at 581, 191 N.E.2d at 345; *Ohio Fuel Gas Co. v. Public Util. Comm'n*, 174 Ohio St. 585, 588, 191 N.E.2d 347, 349 (1963).

24. See BONBRIGHT, *op. cit. supra* note 8, at 10-13.

covered a satisfactory substitute for actual competitive conditions. The fair value principle is only one of the three basic theories frequently used in rate-making, and both the original cost or prudent investment theory and the end-result theory also have proponents. Under the original cost theory, the public utility is entitled to a return based only upon its actual investment, represented by that amount of capital prudently put into the business.<sup>25</sup> Under the end-result theory, the concept of a fair return on a rate base is discarded, and the regulatory body, in its discretion, simply sets a figure that will allow the utility what is considered to be a reasonable profit.<sup>26</sup> Each of these other two theories also has disadvantages. The end-result theory gives a wide authority to the commission and is seemingly subject to supervision only on the vague ground of abuse of discretion. The original cost theory produces a low rate base because, if followed without modification, it does not allow for the actual *increase* in value of the original investment due to inflation.<sup>27</sup> Nevertheless, use of various versions of the original cost concept seems to be in the ascendancy in this country.<sup>28</sup> Ohio has, by statute, elected to retain a fair value theory of rate-making, thus disregarding the trend toward the original cost theory; it has also maintained as its sole measure of valuation the RCNLD basis, an approach which, under the present-day conditions of continuous inflationary trends, may lead to unrealistic results.

Given Ohio's statutory rate base technique, the approach of the court in the principal case did little to clear the air, either in terms of the court's rationale or in practical terms of policy. The majority, apparently believing the Ohio statute required the Commission to allow the utility the amount of income tax it actually had to pay as an expense, argued that since the company must pay 112,017 dollars more for income tax than allowed, it would not, in effect, be realizing a return on the full amount of the rate base.<sup>29</sup> Or viewed another way, the company would receive only a 5.61 per cent return

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25. See, e.g., *Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 289 (1923) (dissenting opinion of Brandeis, J.).

26. See, e.g., *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

27. See O'Connor, *Some Critical Thoughts on Cost of Capital*, 62 *PUB. UTIL. FORT.* 93 (1958). But see BONBRIGHT, *op. cit. supra* note 8, at 184-86.

28. See BONBRIGHT, *op. cit. supra* note 8, at 232-37. The reconstruction-new method of valuation as used in Ohio was first given major impetus in *Smyth v. Aymes*, 169 U.S. 466 (1898), decided in a period when the cost to reconstruct the plant was equal to, or less than, the actual amount invested in the company. Since then, however, economic advancement has almost always caused the investment figure to be considerably less than the cost of reconstruction. Although reconstruction-cost remains a part of some state proceedings, the United States Supreme Court has acknowledged the theory's weakness in valuation and disavowed the fair value method as necessary in rate-making. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

29. Judge O'Neill reasoned that, since the Commission found the company entitled to a rate of return of 5.8% on a rate base of \$59,827,440, it should be allowed a dollar return of \$3,469,922. But, under the Commission's order, the company would

on the rate base, rather than the 5.8 per cent which the Commission had set as the reasonable rate of return. What the majority failed to state (or, perhaps, to realize) was that the 5.8 per cent figure was itself a reasonable rate of return *only* with reference to a uniform hypothetical company formula. While the 5.8 per cent figure was a fair return rate for the *hypothetical* company, it was not necessarily fair for General Telephone Company.<sup>30</sup>

The decision in the principal case will permit Ohio utilities a greater gross annual return on the rate base than has been given them since the *City of Cleveland* case.<sup>31</sup> The Court has opened the door to the potential practical evil of the RCNLD method—allowing more to the utility than is reasonably needed—with a consequent increase of the ratepayers' burden. Moreover, this about-face by the Court is likely to hamper seriously the fundamental reasons for having a regulatory agency rather than the courts set rates. Not only must the Commission adjust its present procedure of computing rates, but, more importantly, it must remain ready for possible additional judicial changes in the rate-making process if the present approach proves unsound or is itself misconstrued by the courts.<sup>32</sup> The hypothetical company principle was originally used to rationalize the RCNLD method of computing a rate base. Since uniform application of the hypothetical company principle had been employed as a check on utility revenues, the breakdown in its consistent use throughout the rate-making process may cause a rash of "too high" returns, thus forcing the Commission to search for another control to serve the same purpose as that rejected by the Court in the principal case. If it becomes apparent that the decision is producing unreasonable, and therefore unsatisfactory, results, the Commission has available at least three other computational controls to replace the check on utility revenues that the Court condemned. It could (1) consider only the interest the company actually has to pay on its debt when figuring the percentage rate of return, or (2) set a rate of return that in its opinion appears reasonable in light of current economic conditions and evidence of the company's financial status, or (3) cut the allowance for equity return to a lower figure. Probably

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have to divert \$112,017 to pay for income tax that it was not being allowed as an expense. Therefore, the company's effective rate base was only \$57,896,121.

30. The Commission was aware that the hypothetical tax would reduce the effective rate of return. If it had intended the company to realize an actual rate of return of 5.8%, it could have adjusted its computations to allow a higher rate, perhaps above 6%, to the hypothetical company.

31. This is assuming, of course, that the reconstruction cost remains higher than the amount of original investment in the companies. The converse is not likely. See dissenting opinion of Judge Gibson in *Ohio Fuel Gas Co. v. Public Util. Comm'n*, 174 Ohio St. 585, 603, 191 N.E.2d 347, 358 (1963).

32. See the dissenting opinion of Mr. Chief Justice Taft in *Ohio Fuel Gas Co. v. Public Util. Comm'n*, 174 Ohio St. 585, 589, 191 N.E.2d 347, 350 (1963).

none of these would be acceptable to the company involved. Reducing the interest allowance to the actual cost of the debt would probably result in a smaller return to the utility than was realized under the hypothetical company concept. Moreover, in *Ohio Fuel Gas Co. v. Public Util. Comm'n*,<sup>33</sup> the court expressly held that reduction of interest allowance to actual cost was contrary to Ohio law. Nor does the second alternative seem feasible. Although Judge Gibson, a former member of the Commission, suggested in his dissent that the Ohio Commission in fact does set a rate of return which appears reasonable to it,<sup>34</sup> the agency has outwardly adhered to formula in determining the rate of return. If it should now attempt to espouse what amounts to the end-result theory, it will surely be met with vigorous charges of abuse of discretion if a lower return is ordered. Finally, reducing the equity return allowance may cause the utility to lose potential investors to non-regulated industries at the time of a new stock issue and thus provide the utility with further ground for complaint.

Perhaps the decision in the principal case is most important in a pedagogical sense. It should serve to alert the state legislature to the fact that the courts are not satisfactorily equipped to deal with changes in conditions and circumstances in the public utilities field.<sup>35</sup> The Ohio General Assembly owes the utilities and the rate-payers the duty to investigate and appraise thoroughly—either by itself or through the Commission—the fair value theory of rate-making and the RCNLD method of valuation to determine whether they are properly serving their intended purpose of effective public utility regulation. If they are not, the methods should be modified or even completely discarded in favor of some form of original cost or end-result concept.<sup>36</sup>

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33. 171 Ohio St. 10, 167 N.E.2d 496 (1960).

34. See note 14 *supra*.

35. For a criticism of the Ohio court's role in the rate-making process, see dissenting opinion of Judge Gibson in *Ohio Fuel Gas Co. v. Public Util. Comm'n*, 174 Ohio St. 585, 601, 191 N.E.2d 347, 357 (1963); Note, 25 Ohio St. L.J. 314 (1964).

36. See notes 25-27 *supra* and accompanying text.