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LEGAL ASPECTS OF RATE BASE AND RATE OF RETURN IN PUBLIC UTILITY REGULATION

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INTRODUCTION

The terms *rate base* and *rate of return* as used in public utility regulation engender so many diverse considerations and may be viewed from the vantage point of the accountant, the economist, the lawyer, the engineer, the utility management, the investor, the consuming public, and many others.

To simplify our task and to develop more fully the legal considerations in which we have an especial interest we have confined ourselves accordingly. We do not wish to detract in any way from the other manifold aspects but we shall emphasize throughout the legal principles as they have been developed by our courts over the past seventy-five years, and as we hope they shall develop in the era just ahead. Such other considerations as we have taken up are incidental and supplemental thereto.

In definition, the following may prove helpful:

Rate base as herein referred to is the valuation placed on utility property for purposes of arriving at a fair return.

Rate of return is the percentage of return allowed to a given utility and its investors over and above allowable deductions from gross income.

Reproduction cost or *current fair value* is the value of the utility's property less depreciation as of the date of a utility rate proceeding.

Net investment cost is the actual original cost of utility property less depreciation.

The cases in this field are without number. From the extensive reading we have done in the field we have selected those we believe to be of special significance locally and nationally in the development of the legal concepts of rate base and rate of return.

Ever since the United States Supreme Court in the famous landmark case of *Munn v. Illinois*[1] in 1877 placed the seal of its approval upon a statute fixing public utility rates and Chief Jutice Waite traced its authority back to the Lord Chief Justice Hale over three centuries before,[2] the courts of this country have without exception recognized

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[1] Munn v. Illinois, 94 U.S. 113 (1877).

[2] *De Portibus Maris,* 1 HARG. L. TR. 78.

the need for state regulation of the rates of public utilities. But just what that regulation should consist of and by whom the regulating should be done was to present many problems both from the standpoint of the industry and the governmental bodies that became involved.

The United States Supreme Court in the *Munn* case upheld the right of Illinois to pass a law regulating grain elevators under its police power, thus establishing the constitutionality of such laws. It also ruled that rate control was a legislative function and that recourse against abuses must be political and not judicial. It soon became apparent, however, that the legislature was not the proper body to exercise such control and in 1890 the United States Supreme Court handed down a decision in *Chicago, Milwaukee, and St. Paul Railway Co. v. Minnesota,*[3] in which the court reversed itself completely and stated that the reasonableness of a rate was subject to judicial review. This was the beginning of a long period in which the courts were strongly concerned with the economic aspects of public utility regulation.

In 1898 in the decision *Smyth v. Ames*[4] the United States Supreme Court for the first time seemed to emphasize the necessity of a so-called "rate base." The many factors to be considered in evaluating a public utility so as to yield a fair return on fair value of utility property were set forth in some detail. The settled principles in *Smyth v. Ames* were as follows:

> 1. A railroad corporation is a person within the meaning of the Fourteenth Amendment declaring that no state shall deprive any person of property without due process of law, nor deny to any person within its jurisdiction equal protection of the laws.
>
> 2. A state enactment, all regulations made under the authority of a state enactment, establishing rates for the transportation of persons or property by railroad that will not admit of the carrier exacting such compensation as under all circumstances is just to it and to the public, would deprive such carrier of its property without due process of law, and deny to it the equal protection of the laws and would therefore, be repugnant to the Fourteenth Amendment of the Constitution of the United States.
>
> 3. While rates for the transportation of persons and property within the limits of a state are primarily for its determination, the question whether they are so unreasonably low as to deprive the carrier of its property without such compensation as the Constitution secures, and therefore, without due process of law, cannot be so conclusively determined by the legislature of the state, or by regulations adopted under its authority, that the matter may not become the subject of judicial inquiry.[5]

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[3] 134 U.S. 418 (1890).
[4] 169 U.S. 466 (1898).
[5] *Ibid,* syllabus.

It was recognized further that regulation was a complicated process and not subject to any simple formula and the court pointed out that trained commission staffs would be needed to understand and administer it.

There has been much discussion as to the actual effect of the *Smyth* case. It can be generally said, however, that it marked the beginning of the theory of rate base and appeared to favor strong consideration of "reproduction value" of facilities in arriving at rate base. The probable reasoning behind the choice of reproduction cost was a consideration which first led our courts to regulate utilities. Regulation is a substitute for the valid and beneficial effects of competition. Competition among public utilities had proved costly and unsatisfactory to the consumer and utility alike and hence had to be eliminated but its salutary effects compensated for. To place utilities on a fair basis with other industries, the court in *Smyth v. Ames* reasoned, its property should be valued in a like manner at current cost. It should be noted that this decision coincided with a time of cyclical depression and for that reason was particularly advantageous to consumers and entirely acceptable to commissions although the valuation from the company's standpoint was lower than actual original cost of investment. The reproduction theory continued to be favored by the courts in most jurisdictions for a period of approximately fifty years. We shall note, however, certain decisions during that period which were of great importance both locally and nationally.

Despite the *Smyth* decision and subsequent decisions in other jurisdictions the Wisconsin Public Service Commission as early as 1923 espoused the investment cost method of establishing rate base.[6] Under this method the original cost of plant and plant additions less depreciation is the rate base used.

In 1924 the Wisconsin Supreme Court became the first jurisdiction to advance the so-called "end result theory" which was to develop into a source of controversy almost twenty years later.[7] In that case the court stated that "It is not its method that is to be reviewed but the result reached by the commission." It stated further that under the Wisconsin Statutes[8] the commission was charged with the duty of ascertaining and declaring a reasonable rate; if that is done, the method by which the commission arrives at its result is "not subject to criticism." Under this view review by the courts should only take place where there has been such an obvious abuse of discretion by the commission

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[6] Waukesha Gas Electric Co. v. Railroad Commission, 181 Wis. 281, 301, 194 N.W. 846 (1923).

[7] Wisconsin-Minnesota Light and Power Co. v. Railroad Commission, 183 Wis. 96, 99, 197 N.W. 359 (1924).

[8] WIS. STATS. §§196.03 and 196.37 (1957).

that the constitutional property rights of the utility have been jeopardized.

In 1923, the United States Supreme Court handed down another decision which was to become important in determining rate of return.[9] The court therein warned against speculative profits but found that a utility was entitled to a rate permitting to its investors earnings equal to those actually 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. Judicial recognition was given to the fact that utilities must compete for capital in the same market as unregulated industries. The court said further that the return should be sufficient to insure confidence in the financial soundness of the utility and pointed out that reasonableness of a rate of return would change as changes occurred in investment opportunities, the money market, and general business conditions.

The United States Supreme Court in *McCardle v. Indianapolis Water Co.*[10] during a period of inflationary prices laid down the rule which had the effect of requiring commissions to consider reproduction value in arriving at a proper rate of return and the rule of the Smyth case became mandatory.

Based upon this decision our own Wisconsin Supreme Court modified the Wisconsin rule to conform thereto and to "give due consideration to " cost of reproduction new less depreciation because of the apparent constitutional requirement.[11]

In a subsequent case, *Pabst Corporation v. Railroad Commission,*[12] the Wisconsin Supreme Court ameliorated the reproduction cost theory of rate base espoused in the *Waukesha Gas and Electric Co. v. Railroad Commission* case.[13] The Wisconsin Supreme Court stated in the *Pabst* case that two factors are to be considered by the commission in determining a rate base, to wit: present day reproduction costs and prudent investment.

In 1933 and the early years of the depression, a doctrine found its way into the United States Supreme Court rulings which was new to all but the Wisconsin Supreme Court.[14] In *Los Angeles Gas and Electric Corp. v. California Railroad Commission,*[15] the Supreme Court held that where a utility could not prove confiscation of its property,

[9] Bluefield Waterworks and Improvement Co. v. West Virginia Public Service Commission, 262 U.S. 679 (1923).
[10] McCardle v. Indianapolis Water Co., 272 U.S. 400 (1927).
[11] Waukesha Gas and Electric Co. v. Railroad Commission, 191 Wis. 565, 211 N.W. 760 (1927).
[12] 199 Wis. 536, 227 N.W. 18 (1929).
[13] *Supra* note 11.
[14] Wisconsin-Minnesota Light and Power Co. v. Railroad Commission, *supra* note 7.
[15] 289 U.S. 287 (1933).

the procedure and method of determining reasonable rates should be within the commission's jurisdiction. The "shackles of the rule of *Smyth v. Ames*" were discarded and the highest court of the land went on record as stating that only in cases of obvious injustice would the court interfere with the rulings of regulatory bodies. Gradually the close rein which the courts had held on utility regulation since 1890 was loosening.

The period of the 1930's was a very difficult one for public utilities. They were faced for the first time with serious federal competition in many fields and they were regulated in the strictest fashion in their history. The case of *Federal Power Commission v. Natural Pipeline Co. of America* decided in 1942,[16] was a good indication of the change in thinking relative to valuation of utility property for rate making purposes. Smyth v. Ames was not overruled entirely but stress was laid to the precept that commissions were not bound to any one formula in arriving at the result of a fair return. It was left for the decision of the *Federal Power Commission v. Hope Natural Gas Co.* in 1944,[17] to overturn judicial precedence in the rate making field. Whether or not the Hope case actually "laid the ghost" of the Smyth case is a question which has been argued by authorities in the field for years. It certainly started the chain reaction which is still being felt in the field of utility regulation. The Supreme Court in the Hope case did not approve any particular method of rate base determination but said in effect that the end result and not the method by which the result was arrived at was of utmost importance. This decision was to be roundly criticized by many eminent jurists, among them Justice Jackson who said in a separate opinion in the same case that if the court were to hold a given rate reasonable just because the commission had called it reasonable, review becomes "a costly time-consuming pageant of no particular value."[18] Justice Jackson stated further that

> We need not be slaves to a formula but unless we can point out a rational way of reaching conclusions, the conclusions can only be accepted as resting on intuition or predilection.

In our own State of Wisconsin the *Hope* decision was received with complete accord. On the strength of the *Hope* decision and its own prior decision in 1923[19] and the Wisconsin Supreme Court decision of 1924,[20] the Wisconsin Commission in 1947 came out emphatically favoring the "end result" theory of regulation and rejecting any rate base. In the case of The Commonwealth Telephone Co., it was stated:[21]

[16] 315 U.S. 575 (1942).
[17] 320 U.S. 591 (1944).
[18] *Ibid.*
[19] Waukesha Gas and Electric Co. v. Railroad Commission, *supra* note 6.
[20] Wisconsin-Minnesota Light and Power Co. v. Railroad Commission, *supra* note 7.
[21] City of Two Rivers v. Commonwealth Telephone Co., 70 P.U.R. (n.s.) 5 (Wis. Comm. 1947).

> The rates prescribed are arrived at without determining any rate base, and without determining any specific figure as constituting a "fair rate of return" on anything that may be claimed to be a proper rate base.

The Commission merely allowed a return which it felt would be reasonable and would allow the company a reasonable profit. The Wisconsin Commission's decision was overruled by Judge Reis of the Dane County Circuit Court in one of the most scathing opinions ever delivered by a jurist.[22] Judge Reis said in part that the commission found nothing except that a certain amount of dollars represent a reasonable profit.

> . . . Reasonable profit ON WHAT? That is the trouble with the commission's decision. It has no bottom. It has a numerator but no denominator. For a long time, Wisconsin believed in the "prudent investment" theory of rate making. A utility was entitled to a fair return on the amount of money prudently invested in the enterprise, it was said. That sounded fair. That is the universal standard. Every businessman expects to receive a fair return on the money which he has put into his business whether he runs a hardware store or an apartment building or a bowling alley. Our Supreme Court of Wisconsin approved the prudent investment theory.

Judge Reis went on to comment upon reproduction theory vs. prudent investment theory of rate base. Unlike the Wisconsin Commission Judge Reis interpreted the *Hope* decision as indicating that the United States Supreme Court had rejected the reproduction theory and returned to the *prudent investment theory.* Apparently many other Commissions and jurists interpreted the Hope case as did Judge Reis for there was a great swing throughout the country to the investment cost theory in the years immediately following.

In conclusion of his opinion Judge Reis pointed out:

> The Public Service Commission's *error* in the case before us is its misconstruction of the Hope decision. Somehow or other our commission gets out of that decision the idea that there need not be a base rate at all. That sequiter. [It follows] We just do not follow. The Federal Power Commission in the Hope case expressedly *found* a base rate of $33,712,526 and engaged a fair rate of return at 6½ percent. *Here were both numerator and denominator.*[23]

The opinion of Judge Reis was upheld by the Supreme Court of Wisconsin in 1948.[24] Speaking for the court Justice Hughes stated that in fixing rates for the telephone company the Public Service Commis-

[22] Commonwealth Telephone Co. v. Wisconsin Public Service Commission, 71 P.U.R. (n.s.) 65 (Wis. Cir. Ct. 1947).
[23] *Ibid.*
[24] Commonwealth Telephone Co. v. Wisconsin Public Service Commission, 252 Wis. 481, 32 N.W. 2d. 247 (1948).

sion must file findings of fact embracing the essentials upon which it bases the reasonableness of its rate order and it must determine and set forth the relevant facts and circumstances determinative of the rate base; otherwise its order is arbitrary and unlawful. This opinion marks the end of the "end result" doctrine in the State of Wisconsin and it represents the last specific ruling by our Supreme Court on this subject. It is significant to note that the court said nothing about what the rate base should consist of beyond the fact that there should be one and that it should be apparent from the findings of fact.

The Wisconsin Administrative Procedure Act requires every decision of an agency in a contested case shall be in writing accompanied by findings of fact and conclusions of law.[25]

Prior to the act and to the *Hope* case the Wisconsin Supreme Court frequently instructed agencies regarding this requirement and insisted upon compliance.[26]

Decisions subsequent to the act indicate the Wisconsin Supreme Court considers the statutory provisions of the Administrative Procedure Act a mandate for well drafted, specific and carefully considered findings.[27]

Wisconsin was not the only jurisdiction which rejected the "end result"[28] theory as apparently espoused by the *Hope* case. The Vermont court stated in a 1949 telephone company case that the usual and reasonable method for a commission to adopt in fixing rates is to determine a proper rate base and then a proper rate of return.[29] It cited considerable authority on this subject[30] and pointed out that the *Hope* case[31] did not change this rule and ". . . did not reject judicial right of review as to reasonableness of rates and, obviously, if it be held that no yardstick is necessary whereby to test this question, then judicial review as to reasonableness of rates would become utterly meaningless."[32]

As we have noted previously the courts in Wisconsin although requiring specific findings of fact in the determination of a rate base and rate of return have left the actual decision as to what the rate base

[25] WIS. STAT. §227.13 (1943).
[26] Tesch v. Industrial Commission, 200 Wis. 616, 229 N.W. 194 (1930); Wisconsin L. R. Board v. Fred Rueping Leather Co., 228 Wis. 473, 494, 279 N.W. 673, 117 A.L.R. 398 (1938); Folding Furniture Works v. Wisconsin L.R. Board, 232 Wis. 170, 180, 285 N.W. 851, 286 N.W. 875 (1939).
[27] Clintonville Transfer Line v. Public Service Commission, 248 Wis. 59, 80-81, 21 N.W. 2d. 5 (1945); Commonwealth Telephone Co. v. Public Service Commission, *supra* note 24; Motor Transport Co. v. Public Service Commission, 253 Wis. 497, 34 N.W. 2d. 787 (1948); Green Bay & W.R. Co. v. Public Service Commission, 269 Wis. 178, 68 N.W. 2d. 828 (1955); Bell v. Personnel Board of Wisconsin, 269 Wis. 602, 49 N.W. 2d. 889 (1951).
[28] Federal Power Commission v. Hope Natural Gas Co., *supra* note 17.
[29] Re New England Telephone & Telegraph Co., 115 Vt. 494, 66 A. 2d 135 (1939).
[30] West Ohio Gas Co. v. Ohio Public Utilities Commission, 294 U.S. 63 (1935).
[31] Federal Power Commission v. Hope Natural Gas Co., *supra* note 17.
[32] Re New England Telephone & Telegraph Co., *supra* note 29.

should be in the hands of the commission. In accord with the dicta in Judge Reis's opinion[33] the Wisconsin Public Service Commission regarded the *Hope* case as overruling the requirement of consideration of reproduction cost as laid down in the *McCardle* case[34] leaving Public Service Commissions free to return to the investment cost theory. In a 1952 case involving the Wisconsin Telephone Co., the Commission in a lengthy opinion declined to consider current value in arriving at a rate base.[35] In this case the Wisconsin Telephone Co. applied to the Commission for an investigation of its rates and for an order fixing reasonable rates. It introduced as a part of its exhibits to the case certain information concerning the current value of its property. The Commission reviewed in some detail the history of controversies on the subject of rate making since the *Smyth* case[36] and referred to the *Hope* case[37] as follows:

> . . . The *Hope* case gave recognition to the importance of the result to be reached, that is the opportunity for a utility to reasonable profits sufficient to attract capital rather than the mechanics employed in reaching such results. Commissions were not bound to a single formula or a combination of formulas. If a commission can do a good job as well as a quicker and less expensive one, in a rate case by the adoption of any method which would retain the fundamentals of fair play, due process, and provide fair and reasonable results, it is now free to do so under the Federal Constitution. . . .

The Commission explained that it did not wish to be arbitrary in rejecting a current value theory and adhering to the net investment cost theory. But that it was motivated primarily by pracical considerations. The commission argued that the reproduction cost theory lacks both definiteness and stability and ". . . The use of current value would reintroduce the wild uncertainty and recurrent rate controversies which characterized the reproduction cost era." It stated further that the reproduction cost standard was so variable that it would never lead to any type of stability. It quoted an early Wisconsin case[38] to the effect that rates should be permanent as is possible and that frequent changes are disturbing both to the companies and to their customers. To this effect it cited also the authority of Justice Brandeis in *Missouri ex. rel. Southwestern Bell Telephone Company*[39] and Justice Rosen-

[33] Commonwealth Telephone Co. v. Wisconsin Public Service Commission (Wis. Cir. Ct. 1947), *supra* note 22.
[34] McCardle v. Indianapolis Water Commission, *supra* note 10.
[35] Complaint of Wisconsin Telephone Company concerning its rates and application for an investigation of its rates and for an order fixing reasoable rates. Docket 2-U-3573, Vol. 37, P.S.C. of W.R. (April 9, 1952).
[36] Smyth v. Ames, *supra* note 4.
[37] Federal Power Commission v. Hope Natural Gas Co., *supra* note 17.
[38] Hill v. Antigo Water Co., 3 W.R.C. 623, 639.
[39] Mo. ex rel. S.W. Bell T. Co. v. Public Service Commission, 262 U.S. 276, 308 (1923).

berry of our own Supreme Court[40] in justifying its opinion regarding investment cost as the proper rate base. With respect to reproduction cost it quoted Justice Rosenberry as follows:

> 'It is difficult to see why the valuation arrived at by guess on the basis of estimate should form the legal basis of depriving a litigant of its property or be the justification for excessive charges to the public.'[41]

In further justification of the refusal to consider current value or reproduction cost in determining a rate base the commission said:

> During the present period of inflation, the commission is being urged to consider the rate bases which are geared to the present purchasing power of the dollar rather than original cost. While it may be possible to estimate with a considerable degree of accuracy how much existing plant would cost in terms of present day dollars, what do you have when you obtain that amount? It certainly does not represent past dollar investments; it is claimed that it represents in terms of today's dollars what it would have cost to build the plant as it was built over a period of many years. While such information is interesting and certainly demonstrates the extent to which the purchasing power of the dollar has declined because of current inflation, it affords no basis whatsoever for the establishment of public utility rates. . . .[42]

And later on in its opinion "the commission is willing to go on record at this time that it will approve any rate of return on a net investment cost rate base which is deemed necessary to achieve the reasonable end result required under the *Hope* case."[43]

This has remained the commission rule to the present date. Another 1952 case involving the rates of Wisconsin Electric Power Company[44] quotes extensively from the *Telephone Company* opinion and finds an investment cost rate base in spite of the fact that counsel for the Electric Company had strongly urged the commission to consider standards of valuation other than investment cost. In answer to company counsel, and as a preface to what was said in the Telephone Company opinion, the commission pointed out the following statement of the Wisconsin Supreme Court in the *Pabst* case[45] decided in 1929.

> . . . Shortly after the commission filed that decision [*Pabst Corp.*], this court in *Waukesha Gas and Electric,* 191 Wis. 565,

[40] Wisconsin Telephone Co. v. Public Service Commission, 232 Wis. 274, 358, 287 N.W. 122 (1939).
[41] Complaint of Wis. Tel. Co., *supra* note 35.
[42] *Ibid.*
[43] *Ibid.*
[44] Investigation on Commission's Motion of Electric Rates, Charges, Rules, Practices, and Operation of Wisconsin Electric Power Co., Docket 2-U-3691, 37 P.S.C. of W.R. 221 (April 25, 1952).
[45] Pabst Corp. v. Railroad Commission, *supra* note 12.

> modified its expressions in the earlier case of *Waukesha Gas and Electric Co. v. Railroad Commission,* 181 Wis. 281 but did not intend to withdraw what was said in that case any further than was necessary to conform to the Federal Rule announced in *McCardle v. Indianapolis W. Co.,* 272 U.S. 400. So far as the conclusion in *Waukesha Gas and Electric Co. v. Railroad Commission,* 181 Wis. 281, was out of the harmony with that Federal Rule, it was modified; otherwise the conclusions reached in that case stand.

The commission concluded that the statement of the Wisconsin Supreme Court in the *Pabst* case when considered in conjunction with the other cases cited, effectively refuted the contention of the counsel for the company that the commission is required by law to give consideration in rate cases to standards of value other than investment cost.

In a more recent case decided the following year,[46] the Wisconsin Commission exclusively approved net investment cost as a rate base standard when it said:

> This commission approves net investment cost as a rate base standard. Other standards of value need not be given consideration. Cost of reproduction or trended present-day costs as a factor in rate regulation was discussed in considerable detail by this commission in *Re Wisconsin Telephone Company,* Docket 2-U-3575 (April 9, 1952) (37 PSCW 166), and *Re Wisconsin Electric Power Company,* Docket 2-U-3691 (April 25, 1952) (37 PSCW 216).
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> In the language of Chief Justice Rosenberry in *Wisconsin Telephone Company v. Public Service Commission,* 232 Wis. 274, 355 (1939):
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> 'It is difficult to see why a valuation arrived at by guess on the basis of estimate should form the legal basis of depriving a litigant of its property, or be the justification for excessive charges to the public.'

We have examined carefully and extensively every volume of the Public Service Commission Reports of Wisconsin and the Public Utility Reports to determine whether or not the Wisconsin Commission has deviated at any time from this rule. The cases indicate an expressed intention on the part of the commission to consider such factors as cost of money, increased operating costs, need for more working capital, the problem engendered by regulatory lag (delay from the time of a company's request for a rate increase until the Commission reaches a decision), and many other factors, but the basic premise of investment cost rate base has remained. In a most recent case of the Wisconsin Telephone Co.,[47] in spite of the fact that

[46] City of Racine v. Wisconsin Natural Gas Co., 38 P.S.C. of W.R. 314, 2-U-3842 and 2-U-3876 (August 4, 1953); see also Re Village of Shorewood, 2-U-4827 (September 12, 1957).

[47] Re Wisconsin Telephone Co., Docket 2-U-4904 (April 18, 1958).

the Wisconsin Telephone Company put in a complete case for reproduction value, the commission refused to consider it and found a rate base as always founded upon investment theory. The commission did point out, however, that it took into consideration in this case the new doctrine of attrition. Under this doctrine a certain percentage is allocated into the rate to make up for the "regulatory lag" which takes place between the time that the company applied for an increase in rates and the time when such increase is granted. This new doctrine emphasizing the loss in return due to inflationary cost increases occurring after the completion of the rate proceeding was emphasized this year by a number of commissions in determining their rates, and each of them allowed higher rates of return upon this basis.[48]

Since the *Hope* case a number of commissions have, like Wisconsin, interpreted the Federal Constitution to allow a commission to choose its own rate base according to what appears to it to be most fair. In point of fact, a great majority of the commissions switched after the *Hope* case from the reproduction theory to the original investment cost theory as a proper basis for determining a fair rate of return. Some jurisdictions, of course, continued to adhere to the current value or reproduction cost theory of the *Smyth*[49] case. Among these were Illinois, Maine (since changed), Maryland, Minnesota, New Jersey, North Dakota, Ohio, Pennsylvania, South Dakota, Vermont and Washington.[50] The pioneer state allowing reproduction theory and calling for consideration of reproduction value in the statutes regulating commissions was the state of Ohio and the theory has apparently worked out in Ohio to the great satisfaction of both companies and customers. Another early state requiring consideration of reproduction cost was the state of Maine which in 1957 oddly

[48] Re Southern California Gas Co. (October 1, 1957) 21 P.U.R. 3d 1; Re Southern California Edison Co., (October 15, 1957) 21 P.U.R. 3d 15; Re Southern Bell Telephone and Telegraph Co., (Kentucky) 18 P.U.R. 3d 113; Re Chesapeake and Potomac Telephone Co. v. Maryland (Md.) Case No. 537 (February 11, 1958); Re Northwestern Bell Telephone Co. (Neb.) 19 P.U.R. 3d 233; Re New York Telephone Co., (N.Y.) 20 P.U.R. 3d 129; Re Chesapeake and Potomac Telephone Co. of Virginia (Va.) 23 P.U.R. 3d 239 (December 23, 1957); Re Chesapeake and Potomac Telephone Co. of West Virginia, (W. Va.) Case No. 4570 (March 4, 1958); Re: Wisconsin Telephone Co. (Wis.) Docket 2-U-4904 (April 18, 1958); Re Mountain States Telephone and Telegraph Co., Docket 4548, order 2719 (April 30, 1958) (Montana) 23 P.U.R. 3d 252; Chesapeake and Potomac Telephone Co. of West Virginia (1958) 23 P.U.R. 3d 344; *attrition denied*: Re New England Telephone and Telegraph Co. (1958) 23 P.U.R. 3d 510.

[49] Smyth v. Ames, *supra* note 4.

[50] Illinois Bell Teleph. Co. v. Commerce Commission (Ill. Sup. Ct. 1953) 98 P.U.R. (n.s.) 379, 11 N.E.2d 329; New England Teleph. & Teleg. Co. v. Public Utilities Commission, (Me. Sup. Jud. Ct. 1953) 98 P.U.R. (n.s.) 326, 94 A.2d 801; Chesapeake & P. Teleph. Co. v. Public Service Commission, (Md. Ct. App. 1952) 97 P.U.R. (n.s.) 50, 93 A.2d 249; Re Minneapolis Street R. Co., (1949) 228 Minn. 435, 79 P.U.R. (n.s.) 407; Re New Jersey Power & Light Co., (N.J. Sup. Ct. 1952) 95 P.U.R. (n.s.) 467, 89 A.2d 26; Northern States Power Co. v. Public Service Commission, (1944) 73 N.D. 211, 53

enough repealed the statute which required consideration of reproduction theory.[51]

Repeatedly through the years utilities have attempted to emphasize the inflationary trends since World War II and consequent hardship resulting to them in the commissions' insistence upon use of the net investment theory. Gradually, perhaps due to commission insistence, there has been a gradual shift toward reproduction cost in very recent years. In 1957 although the legislature of the state of Maine repealed its statute requiring consideration of reproducion cost, two new states, Iowa[52] and Missouri,[53] shifted to the reproduction cost theory, thus bringing the total to 17. The Iowa court cited the depreciated dollar and spiraling costs as its reason for considering new value levels, and the Missouri court completely reversed its previous reliance on the *Hope* case and reversed and remanded an order of the Public Service Commission based on net investment cost. The court cited inflation as a major reason for its changed stand.

In another recent case the New York Court of Appeals interpreted the Public Service Law as requiring the commission to receive evidence of reproduction cost.[54] On rehearing the commission received the evidence on reproduction cost but was dissatisfied with it and used investment cost although it promised to give due consideration to inflationary factors and increased cost of capital.[55] A 1956 Indiana case requires consideration of reproduction cost less depreciation in arriving at a fair value determination.[56]

Recently commissions in California Florida, Indiana, Missouri, North Dakota, Wyoming, and West Virginia recognized and cited inflationary problems of a utility in grating higher rates of return.[57]

P.U.R. (n.s.) 143; Marietta v. Public Utilities Commission, (1947) 148 Ohio St. 173, 71 P.U.R. (N.S.) 186; Pittsburgh v. Public Utility Commission, (Pa. Super. Ct. 1951) 88 P.U.R. (n.s.) 70; Equitable Gas Co. v. Pennsylvania Public Utility Commission, (1947) 160 Pa. Super. Ct. 458, 68 P.U.R. (n.s.) 65; Re Northwestern Bell Teleph. Co., (S.D. Sup. Ct. 1950) 85 P.U.R. (n.s.) 368, 43 N.W. 2d 553; Re New England Teleph. & Teleg. Co., (1949) 115 Vt. 494, 79 P.U.R. (n.s.) 508; State v. Pacific Teleph. & Teleg. Co., (1947) 27 Wash. 2d 893, 70 P.U.R (n.s.) 250.

[51] Ashby, *Keeping Up With Public Utility Rate Regulation,* P.U. FORT. 74 (July 1958).

[52] Iowa-Illinois Gas and Electric Co. v. City of Fort Dodge, 20 P.U.R. 3d 159.

[53] Missouri ex rel Missouri Water Co. v. Public Service Commission, 22 P.U.R. 3d 254.

[54] New York Teleph. Co. v. New York Public Service Commission, 12 P.U.R. 3d 399.

[55] Re New York Teleph. Co., 20 P.U.R. 3d 129.

[56] Indiana Public Service Commission v. City of Indianapolis, (1956) 12 P.U.R. 3d 320.

[57] Re Empire District Electric Co., (Mo.) (January 24, 1958) 22 P.U.R. 3d 399; Re Southern California Gas Co., *supra* note 48; Re New York Telephone Co., 20 P.U.R. 3d 129; Re Southern California Edison Co., *supra* note 48; Re Florida Power and Light Co., (August 22, 1957) 19 P.U.R. 3d 417; Re Missouri Power and Light Co., (December 17, 1957) 21 P.U.R. 3d 404; Re Montana-Dakota Utilities Co., (Wyo.) (February 28, 1958) 18 P.U.R. 3d 166;

Interest cost of money commenced an upswing in the year of 1955 reaching an all time 20 year high in November of 1957. A change in credit policy by the Federal Reserve Board set a decline in cost of money thereafter to a level approximating cost in the latter part of 1956. The increasing cost of money combined with attrition and inflation during 1956 and 1957 caused a steady upward trend in rate of return.[58]

The Federal Power Commission has not based many recent decisions on the factors of cost of money, attrition and inflation. In one recent case[59] the commission allowed an increased rate of return to a pipeline company. It is too early to determine at this time what effects lower cost of money will have on attrition and inflation in the determination by the various commissions of a higher rate of return in the future. The West Virginia Commission allowed an increased rate of return in 1958 even though it took judicial notice of the fact that interest rates had decreased since the time when the hearings were completed.[60]

The North Dakota Commission refused a higher rate of return although the applicant presented evidence of higher interest costs during a preceding three and four year period. The commission emphasized lower money costs since November of 1957 as a factor in refusing a higher rate.[61] The New Mexico Commission decided that debt service requirements, providing a reasonable return to its investors, maintenance of a utility's credit standing and the ability to attract new capital were factors to be considered in the increase of rate return.[62] Anticipated higher cost of capital was denied consideration in Michigan[63] and Massachusetts[64] during the year.

In the field of economic depreciation the Iowa Supreme Court stated that the allowance for depreciation as an operating expense should be based on present reproduction value rather than an original cost. The court said:[65]

> It would do the utility company no good to set its rates on the fair present value base if the base is then to be ignored and the value represented in the base annually eroded away by refusal of adequate depreciation expense allowance.

Re Chesapeake and Potomac Telephone Co. of West Virginia, *supra* note 48; Re Midwest Telephone Co., Inc., (Ind.) (March 7, 1958) No. 27409, 23 P.U.R. 3d 35; *Contra*: Riverton Water Co. v. Penn P.U.C., (Pa. Super. Ct.) (March 24, 1958).

[58] *Supra* notes 48 and 57.

[59] Re Gulf Interstate Pipeline Co. (F.P.C.) Docket G-12863 (April 11, 1958).

[60] Re Hope Natural Gas Company, (April 18, 1958) 23 P.U.R. 3d 394.

[61] Re Montana-Dakota Utilities Company, (January 24, 1958) 22 P.U.R. 3d 505.

[62] Re Lea County Gas Co., (N.M. 1958) 22 P.U.R. 3d 212.

[63] Re Michigan Consol. Gas Co., (1958) 22 P.U.R. 3d 369.

[64] Re New England Teleph. & Tel. Co., (1958) 22 P.U.R. 3d 470.

[65] Iowa-Illinois Gas & Elec. Co. v. City of Fort Dodge, *supra* note 52, at 190.

It is difficult to determine the most appropriate method of arriving at a proper rate base. The Wisconsin Commission in choosing net investment cost has stated that it is simpler, less speculative, and does not leave so many factors open to conjecture. It is further argued by those opposed to the use of the reproduction cost theory or current value theory that even the utilities themselves do not wish to use it except in times of inflation and that it requires commission staffs to be so well trained and to engage in long and costly studies which are not productive either to the utility or to the customer. The use of book value on the other hand, it is said, gives the commission staff some definite figure from which to work. The Wisconsin Commission contends that using this definite investment figure and giving consideration to such other factors as cost of money, attrition, current operating cost, need of working capital, and other factors, it can arrive at a fairer base of return for all concerned. It claims that a definite percentage figure need not govern and that it is willing to allow any return upon the investment basis which is necessary to satisfy the other factors under consideration.[66] In actuality the allowed percentage has not increased sufficiently to offset these rising cost problems.

It would seem to us that there is some validity to the contention that reproduction value is a more difficult basis requiring greater training as well as greater effort upon the part of commission staffs. Conversely, if the commissions are to give sensible consideration to such concepts as cost of money, need of current working capital, increased operating expenses, attrition factors, inflation, and so forth, the staff is still going to have to engage in a very extensive study if it is to be fair to all concerned. It appears to us, therefore, that whichever method is chosen the commission must employ or continue to employ persons who are well trained in accounting and economics, who recognize the problems of public utilities, and who have the vision to understand that it is to the benefit of the customer as well as the utility that the utility be in a healthy financial condition so as to attract capital and to compete with other businesses for new investors.

It is apparent from our review of the cases that the courts have generally abdicated their review of commission rulings in the matter of rate base in the State of Wisconsin and generally throughout the country except where there is actual confiscation of property. It is our feeling that the courts have erred in so doing. We do not wish to minimize the efforts of commissioners themselves nor do we wish to slur the staff of experts whom they employ but we wish to point out that public utility rate regulation involves important legal and con-

[66] Complaint of Wisconsin Tel. Co., *supra* note 35.

stitutional rights. Public utility corporations are individual persons before the law.

CONCLUSION

We are in an era of dynamic progressivism and prosperity, despite the present cyclical recession. Commissions and courts in the field of utility regulation and review have a duty to adopt forward views, theories and methods in the formulation of a rate base and rate of return. The approach and duty is a forward looking, positive one, rather than backward looking and regressive. We believe the original investment cost theory of rate regulation to be repressive, regressive and backward looking. Its use defeats the original purpose of utility regulation. The original investment cost theory is lacking in vision and short sighted and can do irreparable harm to the public and the utility in the future. Utilities must be favored with a climate in which they can continue to expand, provide adequate service to the public, meet the problems of progressive inflation, higher cost of money, attrition, higher cost of doing business, and attraction of capital. Commissions and courts must be visionary and far sighted in their approach to these problems so that a utility may be properly equipped to meet these challenges in the future. We submit the reproduction theory of determination of rate base and rate of return based upon present day actual value is the best approach to the challenge.