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Revitalizing Rate Regulation:Scope and Validity of Temporary Utility Rates Under Section 114 of the New York Public Service Law

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REVITALIZING RATE REGULATION*

SCOPE AND VALIDITY OF TEMPORARY UTILITY RATES UNDER SECTION 114 OF THE NEW YORK PUBLIC SERVICE LAW.

THE early case of *Smyth* v. *Ames* laid down by way of *dictum,* the basic principles for the judicial determination of both the reasonableness of the rates to be charged by public utilities and the validity of the method to be used for ascertaining the value of the investment upon which rates are to be computed.[1] Though contrary to the earlier position held by the Supreme Court, these principles have been generally followed by state and federal courts.[2] The com-

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* Professor Robert L. Hale, of Columbia Law School, and Professor William E. Mosher, Director of the Electric Rate Survey, Federal Power Commission, have read the material of this article and made suggestions and criticisms of which I have availed myself and this assistance I gratefully acknowledge. For the contents and opinions expressed in this article I assume sole responsibility.

[1] 169 U. S. 466, 18 Sup. Ct. 418 (1898). The court said, at 546:

> "We hold, however, that the basis of all calculations as to reasonableness of rates to be charged by a corporation operating * * * under legislative sanction must be the fair value of the property being used by it for the convenience of the public. And in order to ascertain that value, the original cost of construction * * * the present as compared with the original cost of construction * * * 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."

Value for rate making is to be distinguished from exchange or commercial value under the law of eminent domain. In condemnation proceedings, for example, compensation must be made for good-will and earning power. The elements of good-will and earning power are excluded as determinants of value in rate proceedings. See dissenting opinion of Justice Brandeis in Southwestern Bell Tel. Co. v. P. S. C., 262 U. S. 276, 310-11, 43 Sup. Ct. 544 (1923).

This distinction, though generally recognized in cases involving valuation for rate-making purposes, appears to have been disregarded in the recent case of Lindheimer v. Illinois Bell Tel. Co., 54 Sup. Ct. 647, 78 L. ed. 833 (1934), in which case the court relied on the actual earning experience of the company under existing rates as a test of their reasonableness. In view of this decision, it would be more accurate to state, that where the earning experience under a schedule of rates is available, that such earning experience will not only be a relevant factor on the question of the reasonableness of the rates, but may, as in the Lindheimer case, be decisive of the question.

[2] In the earlier cases, the Supreme Court not only affirmed the right of the states to determine rates, but refused to pass on the reasonableness of rates, holding that the question of reasonableness of rates was a matter of legislative and not judicial determination. Munn v. Illinois, 94 U. S. 113, 24 L. ed. 77 (1876).

missions also adopted them as a rule and guide for administrative action in order to make sure that their determination would not be upset upon review. For, though in theory the courts recognize that rate fixing is properly a legislative function, in practice the courts have passed judgment both on the legality of the findings of the commissions and on the facts of the case.[3]

A few of the commissions, however, having found that the judicial method destroyed the effectiveness of administrative regulation, ventured to adopt simpler and more effective methods of their own. In line with this trend, the New York legislature, by a recent enactment, provided a new method for fixing temporary utility rates.[4] This new statute brings to the fore the ever recurring but interesting question whether, tested by established principles, the rates to be fixed by this method would be valid. The purpose of this paper is to examine the scope of the new statute, study its effect upon rate regulation and to discuss its validity, giving special emphasis to recent decisions bearing upon our inquiry.

I.

The conventional basis for calculation in rate determination is that rates shall be fixed at such levels that the total revenues from them shall be sufficient to cover reasonable operating expenses, plus a proper allowance for depreciation, plus a fair return upon the fair value of the property used and useful in the public service. As these elements fluctuate with changing price levels, adjustments are necessary to keep rates and price levels abreast of each other. It often becomes necessary to make temporary adjustments,

In Chicago, Milwaukee & St. Paul Railway Co. v. Minn., 134 U. S. 418, 10 Sup. Ct. 702 (1889), the court completely reversed its earlier position, and maintained its right to intervene when rates were so unreasonably low as to amount to confiscation. This inquiry, as whether legislative action has overstepped the danger line of confiscation, "has given rise to the most intricate and perplexing questions that come up before judicial tribunals." MR. CHARLES E. HUGHES, SUPREME COURT OF THE UNITED STATES, Columbia University Lectures (1928) c. 6, at 218.

[3] Ohio Valley Water Co. v. Ben Avon Borough, 253 U. S. 287, 289, 40 Sup. Ct. 527 (1920).

[4] N. Y. PUBLIC SERVICE LAW (1934) §114.

by way of temporary rates, pending the final determination of a rate proceeding. Otherwise, existing rates, no matter how excessive or inadequate they become because of changed conditions, would have to remain in effect until the final determination of the rates after a long and involved proceeding. Such conditions especially arise during periods of economic crisis. Our present depression is an example. Over night, the whole economic structure seemed to have crumbled into a junk heap. The rate schedules adjusted to fit conditions prevailing before this economic debacle became wholly out of line with the sudden and unexpected devaluation that followed. This change required immediate and drastic reduction in rate schedules as soon as it became apparent that the depression would be a prolonged one.

The New York Public Service Commission in 1933 felt the need for such an immediate reduction in gas and electric rates. It found "general dissatisfaction with existing utility rates," and a belief, "that the utilities have not borne their fair burden of the depression." [5] Accordingly the Commission determined to establish temporary rates wherever the facts justified such action. However, in ten cases where temporary reduced rates were established, "in all but two instances stays were granted by Justices of the Supreme Court, and the rates were thus prevented from going into effect immediately." [6] In sustaining the stay of the lower court and annulling the order of the Commission, the Appellate Division, in the *Matter of Rockland Light and Power Co.* v. *Maltbie,* ruled, that under Section 72, under which the Commission proceeded, the same method of evaluating property for determining final rates applied to fixing temporary rates, for "the same principles of law apply concerning confiscation as would to rates fixed after a full hearing and final determination." [7]

The inability of the Commission to effect immediate reductions of rates in cases in which such reductions seemed warranted called for a remedy that would at once remove the obstacles imposed by the drawn out and cumbersome con-

[5] N. Y. Public Service Commission Annual Report (1933) at 19.
[6] *Id.* at 9.
[7] 241 App. Div. 122, 271 N. Y. Supp. 858 (3d Dept. 1934).

ventional methods for determining valuation for purposes of fixing temporary rates and at the same time safeguard the utilities against loss due to inadequate temporary rates.[8] By Section 114, the New York State Legislature aimed to provide such a remedy. This law empowers the Commission, pending the final determination of any rate proceeding to fix temporary rates "sufficient to provide a return of no less than five per centum upon the original cost, less accrued depreciation of the physical property of said utility company used and useful in the public service." For the purpose of fixing temporary rates the original cost of the physical property used in the public interest less an allowance for accrued depreciation, is regarded as the rate base or the "fair value" of the investment upon which a temporary return is to be calculated. To facilitate prompt action, the Commission is further empowered to require public utilities to provide and maintain a perpetual inventory of the property that is used in the public service and to keep records that would actually show the original cost of this property and the reserves accumulated to provide for its retirement or replacement. By this method, the rate base for the purpose of fixing temporary rates may be kept up to date and currently available. Finally, as a safeguard against temporary rates that may prove excessive or inadequate and as a check upon the reasonableness of both temporary and final rates, the Commission is further authorized to consider the effect of such temporary rates in its final determination.

Prior to the enactment of Section 114, the power of the Commission to fix temporary rates was limited by the statutory requirement that such rates should be made, "with due regard among other things to a reasonable average return upon capital actually invested and to the necessity of making reservation out of income for surplus and contingencies."[9] The courts, however, recognized as a point of difference the element of time, *i. e.*, the duration that temporary rates are to remain in effect. The fixing of an early date for final hearing was an element the courts considered

[8] *Supra* note 5, at 13.

[9] Identical provisions in respect to other classes of utilities are contained in the following sections of the N. Y. Public Service Law: omnibus, §63 b; steam, §85; water, §89 j; telephone and telegraph, §97.

in favor of sustaining the validity of temporary rates.[10] Otherwise, both temporary and final rates were alike in that they were final for the period they remained in effect and in that the method of determining the rate base and the rate of return was the same.[11]

It will prove helpful to this discussion to compare by way of illustration the basic provisions of Section 114 with those of Section 72 of the Public Service Law. This latter Section deals with the fixing of rates for gas and electricity and contains identical provisions found in sections dealing with other classes of utilities.[12] Placed in juxtaposition, these provisions appear as follows:

SECTION 72	SECTION 114
RATE BASE	
Capital actually expended and such other relevant facts as affect proper determination of the present fair value of the property.	Original cost less accrued depreciation of physical property used and useful in the public service.
RATE OF RETURN	
Must be sufficient to provide a reservation for surplus and contingencies together with a reasonable average return upon the present value of property as a rate base.	Must be sufficient to provide a return of not less than 5% on original cost of property less accrued depreciation as a temporary rate base.

[10] Prendergast v. N. Y. Telegraph Co., 262 U. S. 43, 43 Sup. Ct. 466 (1923). Though the court enjoined the enforcement of an order prescribing temporary rates which it deemed confiscatory, it held by way of dictum, that if the commission "had fixed an early date for the final hearing this might have been taken into consideration by the court as an element affecting the exercise of its discretion in the matter of granting an interlocutory injunction."

[11] *Ibid.* See also Cumberland Telephone and Telegraph Co. v. Louisiana P. S. C., 283 Fed. 215 (E. D. La. 1922).

[12] *Supra* note 9.

POWER TO OFFSET AND CORRECT ERRORS IN TEMPORARY RATES WHEN FIXING FINAL RATES

No provision. (The temporary rates being final for the period they remain in effect, cannot affect final determination.)	The effect of temporary rates are to be considered in final determination.

The vital distinction between the methods of valuation for the fixing of temporary rates provided by these sections, is that under Section 114, the original cost of the property and not the present fair value thereof is made the basis for determining rates. All that would be necessary for computing temporary rates under the new section, would be to take the original cost of property, add new money invested, provide for depreciation and obsolescence, and simply fix a rate of return not less than five per centum upon the rate base thus obtained. The temporary rate thus fixed remains in effect until the determination of the final rate pursuant to provision of Section 72, or kindred sections, with this added proviso, that proper reimbursement may be made for any errors or deficiencies resulting from temporary rates.

For administrative purposes Section 114 furnishes a mechanical formula that is definite, stable and easy of application. Its desirability as an administrative rule and guide can hardly be questioned. But will it pass judicial muster? The new statute radically changes the traditional standard for determining "fair value" for rate making purposes.[13] Such well recognized relevant elements as the present cost of construction and going value[14] are wholly eliminated in

[13] The Minnesota Rate Cases, 230 U. S. 352, 33 Sup. Ct. 729 (1913). The court said, at 454:

> "It is clear that in ascertaining the present value we are not limited to the consideration of the amount of the actual investment. * * *. The property is held in private ownership and it is that property and not the original cost of it which the owner may not be deprived without due process of law."

[14] The definition of "going value" most often cited is found in the Des Moines Gas case, 238 U. S. 153, 35 Sup. Ct. 811 (1915). The statement reads, at 165:

> "That there is an element of value in an assembled and established plant, doing business and earning money, over one not thus advanced, is self-

ascertaining the "fair value" base for the purpose of fixing temporary rates. Original cost alone is considered. In fixing final rates, it introduces and makes available the element of "actual experience" attending the temporary rate period. Will these innovations invalidate the rates thus established?

II.

The principles germane to this question have frequently been stated by the courts and recently repeated by Chief Justice Hughes in *Los Angeles Gas and Electric Corp.* v. *Railroad Commission of California.*[15] There, the court said: That, "the legislative discretion implied in the rate making power necessarily extends to the entire legislative determination as well as the determination itself;" that the court has no concern with legislative method, save only as it has "a definite bearing upon the validity of the result reached," *i. e.,* whether the rates as fixed are confiscatory. The distinctive function of the court in deciding whether rates are confiscatory is "to examine the result of the legislative action in order to determine whether its total effect is to deny to the owner of the property a fair return for its use." The standard of what is a fair return is not to be measured by "any artificial formula which changed conditions might upset," but a "reasonable judgment having its basis in a proper consideration of all relevant facts."

The applicability of the foregoing principles to the question raised in this inquiry first calls for an analysis of their applicability to the facts and issues raised in the *Los Angeles* case. There, the validity of the rates fixed by the Commission was attacked on the ground that it failed to consider and give proper weight to either the estimated present reproduction cost of the property [16] or the just and reasonable

evident. This element of value is a property right, and should be considered in determining the value of the property, upon which the owner has the right to make a fair return when the same is privately owned, although dedicated to public use."

[15] 289 U. S. 287, 53 Sup. Ct. 637 (1933).

[16] The element of "reproduction cost" refers to the hypothetical replacement cost, as of the time of valuation. Under the "reproduction cost" theory, the

amount to cover going value. The company had submitted an estimate of $76,754,914, as the fair value figure, on the basis of reproduction cost new, using a three-year price unit, and also an estimate of $9,222,660, for going value. Both these estimates and elements the Commission rejected, and determined its rates upon a historical cost basis of $60,704,000 and a fair value basis of $64,082,282; estimating that the rates fixed would yield a return of 7.7% on the former and 7% on the latter basis.

In its report fixing the challenged rates, the Commission stated that it followed this method in fixing rates:

> "This Commission for many years, in the exercise of its jurisdiction to establish reasonable rates for utilities of this character, has fixed rates to yield upon historical or actual cost of the property, taking land, however, at current values and depreciation calculated on a sinking fund basis, a return somewhat in excess of the cost of the money invested in the property." [17]

It accounted for its fair value figure, which was higher than the historical cost figure by $4,796,000, by its finding that unit prices properly applicable in prescribing reasonable rates for the future are higher than those actually paid. It disallowed the claim for going value, because the cost of attaching business was charged to operating costs.

Notwithstanding the method used in determining "fair value," the Supreme Court sustained the validity of the rates. The majority opinion quoted with approval the following rule stated in the *Minnesota Rate Cases*: [18]

> "The cost of reproduction method is of service in ascertaining the present value of the plant, when it is reasonably applied and *when the cost of reproducing the property may be ascertained with a proper*

present value of the company's property is mainly determined by what it would cost to reproduce it at price levels and costs prevailing at the time of the investigation and during a reasonable period in the immediate future. McCardle v. Indianapolis Water Co., 272 U. S. 400, 47 Sup. Ct. 144 (1926).

[17] 36 C. R. C. 443.

[18] 230 U. S. 352, 452, 33 Sup. Ct. 729 (1913); italics mine.

> *degree of certainty. But it does not justify the acceptance of results which depend upon mere conjecture* * * *. The constitutional invalidity must be manifest and if it rests upon disputed questions of fact, the invalidating fact must be proved. And this is true of asserted value as of other facts."

Applying the foregoing rule, the Court found that the sharp decline of the price level due to depression rendered the estimates of present reproduction cost, submittd by the Company, too speculative and untrustworthy to serve as an "intelligent forecast of probable future values in order that validity of rates for the future may be determined." It concluded that the allowance of $4,796,000 to cover the difference in unit cost between historical and present cost, should not have been made in view of the Court's finding that historical cost had been taken at price levels which were higher than obtained in the period to which the prescribed rates are applicable. As to going value the Court held that the testimony of the Company's witnesses was "too conjectural" to sustain its burden of proof, and under the circumstances that the sum which the Commission added to the historical cost figure to reach its present fair value figure "may be regarded as applicable to whatever intangible value the property has as a going concern. The fact that this margin in the rate base was not described as going value is unimportant, if rate base was in fact large enough to embrace that element."

Mr. Justice Butler, in his dissenting opinion found that the refusal of the Commission to consider or allow anything for going value was contrary to law, and the amount omitted in respect to this item was large enough to invalidate the rates based on a valuation thus arrived at. He therefore concluded that "the rates should be set aside because arrived at by an arbitrary method condemned by our decisions." Had the majority of the Court approached the determination of the issues raised, from the viewpoint of the validity of method, rather than result, its conclusion would, in all likelihood, have been different. Obviously, the Commission, by excluding the element of going value, pursued a method

of valuation that admittedly was contrary to prior decisions.[19] But the prevailing opinion held that as the total effect of the method used did not result in confiscation, the Court would not invalidate that result.

The following principles may be derived from this decision:

> 1. When total effect of result is fair, the rates are not confiscatory.
>
> 2. When record on appeal discloses a rational basis for result, the judicial function in references to issue of confiscation is exhausted.
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> 3. The foregoing presupposes that the administrative process will accord a complainant a full hearing before final determination, so that all relevant facts may be available for review upon appeal.[20]

The criteria established by the decision in the *Los Angeles* case point out the approach and basis for the answer to our question. First, as to whether the total effect of the method prescribed by the new statute would result in confiscation. The answer is, no. This conclusion is based on the following considerations. The fixing of temporary rates under Section 114 is but a step in the administrative process. The first step in the process is the valuation of the Company's property on the basis of its original cost and reserves accumulated for its retirement and replacement. The rate-making period commences with the second step, when temporary or tentative rates are fixed upon the basis of this valuation. The concluding step in the process is di-

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[19] McCardle v. Indianapolis, 272 U. S. 400, 47 Sup. Ct. 144 (1926).

[20] If rates were statutory, their validity would not depend on the procedure of the enactment but on the resulting effect. Commonwealth v. Sisson, 189 Mass. 247, 75 N. E. 619 (1905). Once in effect, however, the principles of the Los Angeles case would be equally applicable to test their validity. The 75c. and 80c. per thousand cubic feet gas rates prescribed by the New York State Legislature, the validity of which was left undetermined in Wilcox v. Consolidated Gas Co., 212 U. S. 19, 29 Sup. Ct. 192 (1909) for lack of "actual experience of the practical results of such rates" were later invalidated as confiscatory when such experience became available. Invalidity was established before a Special Master after an eight-months' hearing at which all facts relevant to the issue of confiscation were made available for judicial review. Newton v. Consolidated Gas Co., 258 U. S. 165, 42 Sup. Ct. 264 (1922).

rected to determining the final rates for the entire rate-making period, including the initial period during which temporary rates were in effect.

There is no such finality in these tentative rates as to preclude the Commission from thereafter disregarding its findings or changing the entire basis of its order upon its final hearing. On the contrary, such a change is anticipated first, by the fact that final rates are to be determined upon the basis of Section 72, and kindred Sections of the Public Service Law; and second, by the requirement of the new statute, that the effect of such tentative rates must be considered and adjusted upon the final determination. Until such final determination the status of the temporary rates is not fixed. When fixed, the final rates embrace results arising from temporary rates and relate back to the date when they first came into effect. If, for example, it appears that the "fair value" base entitles a utility to a return of $100,000 more than it derived from temporary rates, then the final rates may be increased so that the total result will embrace the deficiency. This method is analogous to that pursued in the *Los Angeles* case. To be sure the state did not, as in the given example, deprive the investor of something he was entitled to and restore it later. To that extent the situations differ.[21] But as far as the validity of the final result is concerned the principle applicable is the same. In the *Los Angeles* case the Court examined the administrative process as a whole, and though it found that the Commission omitted from the "fair value" base the element of "going value," the Court sustained the result because in its total effect "the rate base was in fact large enough to embrace" the deficiency arising from the exclusion of the element of "going value." So, in the example given, since the temporary rates are but a component part of the rate making process, and the final rates may be used to compensate for any errors or deficiencies, the total effect of the result is to assure against confiscation.

This is especially true of Section 114. Its most vital provision is one that empowers the Commission to consider

[21] The validity of temporary rates during temporary rate period is discussed in Part III of this article.

and allow for results that actually attend the temporary rates. This provision may not only be used to cure any errors shown by the results but also adds a relevant fact heretofore unavailable in process of rate fixing. It may be designated as the experience factor, in that the reasonableness of the rates is to be tested by "actual experience." Its function is twofold: first, the actual experience of the Company during the period the tentative rates are effective will serve as a check upon any claim of confiscation based on other calculations, and second, it will provide a reliable standard to test the reasonableness of the final rates to be established. The vital importance of "actual experience" as a decisive element in rate making was forcibly demonstrated in the recent case of *Lindheimer* v. *Illinois Bell Telephone Co.*[22]

This case involved the reasonableness of the reduced rates ordered by the Commission in the year 1923. The Company contested the rates on the ground that the reduced rates were confiscatory. The lower court, on the basis of original cost, market value of the land, estimate of reproduction cost new, going value and working capital, found that the average fair value of the Company's property ranged from $124,200,000 in 1923 to $165,500,000 in 1932. By means of available experience records, the amount of Company's net revenue under existing rates and resulting reduction under the new rates was calculated. For example, it was found that for the year 1923 the actual net revenue available for return would have been $5,104,515 under reduced rates and $6,646,183 on the basis of a fair return on the "fair value" figure accepted by the Court. This would make a difference of $1,541,668 between the fair return to which it was entitled for the year 1923 and the amount it would have received, if the reduced rates had been effective. Discrepancies in greater and lesser amounts were found for subsequent years. The lower court therefore concluded that reduced rates were confiscatory in effect and annulled the order of the Commission.

Upon appeal, the Supreme Court held that, "the findings if accepted would compel the conclusion that when the

[22] 54 Sup. Ct. 658, 78 L. ed. 845 (1934).

Commission's order was made in 1923, not only the new rates, but the existing rates as well, were grossly confiscatory." But it refused to accept these findings, on the ground that the financial history of the Company showed that during the period the alleged existing confiscatory rates were in effect, the Company, among other things, "paid 8% dividends on its stock," though its stock rose from $70,000,000 in 1923 to $150,000,000 in 1930; that its "fixed capital reserves" rose from $37,575,004 in 1923 to $69,242,667 in 1931, and its surplus and undivided profits, over and above these capital reserves increased from $5,600,326 in 1923 to $23,767,381 in 1931. It therefore concluded,

> "This actual experience of the Company is more convincing than tabulations of estimates. In the face of that experience, we are unable to conclude that the Company has been operating under confiscatory intrastate rates. Yet, as we have said, the conclusion that existing rates have been confiscatory would have been inescapable if the findings below were accepted. In that event, the Company would not only be entitled to resist reduction through rates in suit, but to demand, as a constitutional right a large increase over the rates which have enabled it to operate with outstanding success. Elaborate calculations which are at war with realities are of no avail. The glaring incongruity between the effect of the findings below as to the amounts of return that must be available in order to avoid confiscation and the actual results of the Company's business makes it impossible to accept those findings as a basis of decision." [22a]

The trustworthiness of the evidence in support of its claim that the new rates were confiscatory having been destroyed, the Company could not sustain the burden of satisfactorily proving the invalidity of the rates. In the absence of such a showing, the decree of the lower court was reversed and the reduced rates sustained.

[22a] *Id.* at 663.

Professor Robert L. Hale,[23] analyzing the decisions in the *Lindheimer* case, *supra,* and in *Dayton P. & L. Co.* v. *Public Service Commission,*[24] reached the conclusion that by these decisions the Supreme Court has "substituted a new test of 'confiscation' for the conventional fair return on 'fair value' of *Smyth* v. *Ames.*" In the *Dayton* case, the Commission rejected the new schedule of increased rates submitted by the utility Company. Its order was upheld upon appeal, in the face of evidence showing that "the rate of return under the new schedule is set to be 1 28/100 per cent of the fair value of the property," and that revenue under existing schedule was even less. Mr. Justice Cardozo delivering the opinion of the Court, said:

> "So modest a rate suggests an inflation of the base on which the rate has been computed. It is a strain on credulity to argue that the appellant, when putting into effect a new schedule of charges, was satisfied with one productive of so meager a return. * * * The argument proves too much; the valuations are discredited by the teachings of experience. * * * We shall hardly go astray if we prefer the test of conduct."

If the new standard of "actual experience" or "test of conduct" will sustain the validity of rates proved confiscatory by application of old standard of "fair value" then for all practical purposes the new standard when available alone controls. To quote from the article of Professor Hale:

> "Since the Court prefers conclusions reached by these 'other avenues of approach' to those reached by the avenue of *Smyth* v. *Ames,* the use of the latter would prove futile to litigants provided the new avenues are available."

The test applied in the *Lindheimer* case, however, in so far as it may be reduced to a formula, has apparent limita-

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[23] Robert L. Hale, *The New Supreme Court Test of Confiscatory Rates* (Aug. 1934) JOUR. OF LAND AND PUBLIC UTILITY ECONOMICS.

[24] 54 Sup. Ct. 647, 78 L. ed. 833 (1934).

tions of availability. It was through mere chance that the appeal in the *Lindheimer* case was delayed for over ten years so that the experience of the Company under existing rates became available for comparison. Had the case come up for final review at an earlier date the "new avenue of approach" would not have been available and the result would have been different, for in the absence of the experience factor there would be no basis for rejecting the findings of the lower court. The challenged schedule of rates and the "actual experience" of the Company were concurrent. This circumstance made the experience factor a reliable judicial yardstick to measure the Company's claim of confiscation. Under normal conditions the experience of successful operation under old rates —such as paying interest on debts and dividends on stock, increasing surplus and attracting capital for needed expansion—may show with a sufficient degree of certainty that the past net earnings are so much more than enough to operate successfully, that a reduction in future net earnings will be justified. But changed conditions may void the probative value of past experience. New elements, such as sudden fluctuations in the purchasing power of money and reduced income due to increased taxes, higher operating expenses, decreased demand or competitive enterprises, may render the results of past experience too conjectural to afford a basis for an intelligent forecast of the Company's ability to operate successfully under reduced rates and changed conditions. When past experience under such circumstances fails as a guide the "avenue of approach" which was used in the *Los Angeles* case, *supra,* may be the one to be preferred. In view of the Court's policy not to adopt "any artificial rule or formula which changed conditions might upset" it is most likely that the judicial method of approach applied in the *Lindheimer* case will only serve as an additional test of "confiscation" except as in the latter case, where "reasonable judgment having its basis in a proper consideration of all relevant facts" made the available experience the only reliable test.

One of the advantages to which Section 114 may be put is that it makes the experience factor available in all rate

cases before the determination of the final rates.[25] Under the new statute the rates are only tentative until their effect may be measured by actual results. If conclusions based on other calculations prove contrary to the actual experience attending the temporary rate period, the calculations will be disregarded. On the other hand, actual experience may indicate a more reliable basis for fixing final rates. It may show that lower rates have so stimulated and increased use as to result in lower unit costs. Obviously, the sending of more gas through existing mains or more electricity over existing wires may more than compensate for the losses caused by lower rates and result in the same or increased net earnings.[26] If, however, actual experience shows a loss

[25] The application of the test of "actual experience" must necessarily vary with circumstances. In the Los Angeles case, *supra,* the court intimated that "actual experience in the construction and the development of the property, especially experience in a recent period may be an important check upon extravagant estimates." In the Dayton case, *supra,* it was the acquiescence of the utility company in rates which their calculations proved confiscatory, that discredited the valuations based upon them. In both of the foregoing cases as well as in the Lindheimer case, the test applied was judicial, *i. e.,* whether in the light of actual experience the final result may be deemed confiscatory. The new statute sets up actual experience as an administrative guide for constructive action. The fact that this administrative yardstick approximates the judicial yardstick applied in the Lindheimer case, in measuring the actual yield the new rates are likely to give and their sufficiency to maintain adequate service, attract fresh capital and meet such other demands upon the company as seem just and reasonable, tends to bring the administrative and judicial processes in closer harmony and thereby makes more certain the validity of the final result as a constitutional question.

[26] Frank R. McNinch, Chairman of the Federal Power Commission, cites by way of illustration the experience of the District of Columbia. The method there used is based on an agreed valuation of the company's property and a sliding scale of rates. Whenever the company earns a return of more than 7½% in any year, it must devote half of the excess the next year to reduced rates. By means of this sliding scale the domestic rates in the national capital have been gradually reduced within the past ten years from 10 cents to 3.9 cents per kilowatt hour. During the same period the annual kilowatt consumption per customer increased from 456 to 868 or almost double. Notwithstanding this reduction, the increased consumption enabled the company to increase net earnings on its common stock from $26 to $68, and the company's annual return on its investment has averaged 10%. 78 CONG. REC. (1934) 9311.

Though the sliding scale method has proved successful in Washington, it is well to bear in mind the peculiarly favorable conditions there prevailing. Washington is a compact residential city. The cities in New York are industrial. It is doubtful whether promotional rates will increase industrial consumption as they do domestic consumption.

In view of this essential difference and the difficulty of agreeing upon a valuation of the company's property (see Power Authority Report, N. Y. Times, March 5, 1935, p. 8), it is submitted that New York utilize the method of temporary rate fixing contained in the new statute to accomplish the beneficial effects of the so-called Washington Plan.

in net revenue, the extent of the loss will be definitely known and given proper effect in the final determination. In either event accuracy takes the place of surmise and factual data replaces expert guesswork. An experimental device is made available whereby the relationship of lower rates and increased use may be tested and the interests of both consumer and investor against loss safeguarded during the experimental or temporary rate period. Finally, a relevant fact is introduced for the consideration of both the commission and the court of review, that will not only aid in reaching a fair result but may be decisive of the validity of the result as a constitutional question.

III.

Thus far the inquiry has been confined to the ultimate effect of the new statute upon permanent rates. The remainder of this discussion shall concern the validity of the new method in determining temporary rates. On its face, the new statute limits the hearing for the fixing of temporary rates to a consideration of a return of not less than five per centum upon the original cost of the company's physical property less accrued depreciation. What the fair rate of return should be, on the basis of the present "fair value" of the property is left for subsequent determination. Should the company appeal from the order establishing temporary rates, the record on appeal would be limited to the proof embraced within the provisions of the statute, *i. e.,* the return on the original cost of the company's investment less accrued depreciation and the court of review could not tell therefrom whether the return upon the basis of the present fair value of the investment is confiscatory. If such be the necessary effect of the statute, does it not come within the condemnation of the rule, "that if the company is deprived of the power of charging reasonable rates for the use of its property, and such deprivation takes place in the absence of an investigation by judicial machinery it is deprived of the lawful use of its property and thus in substance and effect of the property itself without due process of law." [27] The

[27] Chicago, M. & St. Paul Ry. Co. v. Minn., 134 U. S. 418, 10 Sup. Ct. 702 (1889).

question thus raised brings the discussion to the inquiry, whether the Legislature in the exercise of its police power, in order to prevent the charging of unreasonable rates during the pendency of a rate proceeding, may accomplish that purpose by requiring a public utility to accept, subject to subsequent adjustment, less than a fair return upon the present "fair value" of its property in the public use.

The function of the court in dealing with new legislation has often been stated and applied. The earlier view was well expressed in *Matter of Jacobs*,[28] where the court said,

> "In order that a statute or ordinance *may be sustained* as an exercise of the police power, the Courts must *be able to see* that the enactment has for its object the prevention of some offense or manifest evil or the preservation of the public health, safety, morals, or the general welfare; that there is some clear, real and substantial connection between the assumed purpose of the enactment and the actual provisions thereof."

The implication is that the Court assumes to judge whether the object or intent of the enactment is actually to correct some offense or manifest evil and that there is a real connection between the provision of law and such assumed purpose. Such was the view expressed in the dissenting opinion of Mr. Justice McReynolds, in the recent case of *Nebbia* v. *New York*,[29]

> "But plainly, I think, this Court must have regard to the wisdom of the enactment. At least we must inquire concerning its purpose and decide whether the means proposed have reasonable relation to

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[28] 98 U. S. 98, 24 L. ed. 112 (1884) (italics mine).

[29] 291 U. S. 502, 539, 54 Sup. Ct. 505 (1934). Pursuant to a New York statute which established a Milk Control Board and empowered it "to fix minimum and maximum retail prices to be charged by stores to customers," the Board fixed nine cents as the minimum price to be charged by a store for a quart of milk.

The order of the Board was attacked as repugnant to the due process clause of the Fourteenth Amendment.

> something within legislative power—whether the end is legitimate and the means appropriate."

As against this is the view expressed in the prevailing opinion in the *Nebbia* case, wherein the court said at page 537:

> "So far as the requirements of due process are concerned, and in the absence of other constitutional restrictions, a state is free to adopt whatever economic policy may reasonably be deemed to promote public welfare, and to enforce that policy by legislation adapted to its purpose. The Courts are without authority either to declare such policy, or, when it is declared by the legislative arm, to override it. If the laws passed are seen to have a reasonable relation to a proper legislative purpose and are neither arbitrary nor discriminatory the requirements of due process are satisfied, and judicial determination to the effect renders a court functus officio. * * *"

Here are sharply and clearly brought out two recurring conflicting views as to law. One, the rule in the *Nebbia* case, that the court will not assume to determine whether the enactment is necessary or the policy adopted wise, or the means used adequate or practicable—that is the positive function of legislature; the negative function of the court is simply to determine that the enactment is not unreasonable, arbitrary or capricious, and that the means selected has a real and substantial relation to the object sought to be attained. The other view—that the court "should interfere and balance its judgment against that of the legislature as to the tendency of the legislation in question to meet existing evils" and that therefore it has the positive duty in determining not only whether the end is legitimate but also whether the means are appropriate.[30]

The new statute comes within the operation of the prevailing opinion in the *Nebbia* case. Its purpose is "to facili-

[30] John B. Cheadle, *Government Control of Business* (1920) 22 COL. L. REV. at 576.

tate prompt action by the Commission in proceedings involving the reasonableness of rates." This appears both from the wording of the statute itself and the report of the Commission recommending its enactment.[31] To be sure, commissions generally aim to base future rates upon a forecast of future values and thereby anticipate the need for frequent and prompt rate changes. But recent experience has shown how unreliable forecasts made by the conventional method of rate making prior to the period of depression are for conditions now prevailing. Even in normal times, rate schedules often become obsolete after a short period of time. This may be due to technological advances, which may reduce operating costs, or shifts of industries and population, or new types of competition, or changes in property values. According to the Tennessee Railroad Commission any value arrived at as of a particular time would not necessarily be true one year or even six months hence.[32] William A. Prendergast, former chairman of the New York Commission, estimated the probable life of a rate valuation between five and six years, adding that "the period of validity would necessarily depend on whether prices remain stable or not." [33] It therefore follows, that when price levels are not stable—and such has been the condition during the war and post-war period and since 1930,[34] that rate changes must be made every two to three years, and when price levels are stable, every five to six years.

The present cumbersome method of fixing temporary rates prevents prompt action when it is most needed. According to the New York Public Service Commission, the sharp decline in prices would have entitled the consumers of gas and electricity to a reduction of $28,000,000 from rates in effect in 1930.[35] Yet the Commission was able to effect but a part of this reduction, and that mainly by negotiation

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[31] *Supra* note 5, at 13, 14.
[32] 18th Biennial Report (1930) at 58.
[33] N. Y. Commission on Revision, Hearings, Vol. I at 382.
[34] Bulletin on Wholesale Prices: U. S. Dept. of Labor, June, 1934. The dollar fluctuated so much in its buying power that $1.00 of 1926 had a value of $1.46 in 1914; $1.17 in 1916; $.85 in 1917; $.64 in 1919; $1.03 in 1921; it was fairly stable for the years 1921-1929 and began to again fluctuate at $1.15 in 1930; $1.32 in 1931; $1.54 in 1932; $1.51 in 1933; and $1.34 in June, 1934.
[35] *Supra* note 5, at 25.

and voluntary reductions rather than by statutory methods. The sum of $9,500,000 is tied up in litigation, the outcome of which is problematical. The orders affecting this total sum have been attacked on the ground that the methods used were unlawful and arbitrary and the results reached confiscatory. The Appellate Division, in the *Matter of Rockland Light and Power Co.* v. *Maltbie*,[36] by a unanimous opinion sustained the Company on both grounds and annulled the order affecting an annual reduction of $119,000. It is quite possible that if the proceedings were as comprehensive as the law requires, the result would have been different. But the Commission was bent on immediate reductions and adopted a method which though suitable for its needs was condemned by the court.[37] In either event the ratepayer is out of pocket. If the Commission awaited a complete investigation the ratepayer meanwhile would have to pay prevailing rates until new ones were established, no matter how excessive the existing rates were. Having instead proceeded in the manner stated in its announcement and followed in the *Rockland* case, it invited annullment of its order upon appeal, so that

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[36] 241 App. Div. 122, 271 N. Y. Supp. 858 (3d Dept. 1934). In its annual report (1933) the New York Commission had commented on a similar holding as follows, at p. 13:

> "As pointed out in the opinions adopted by the Commission, this doctrine would practically nullify the power of the Commission to fix temporary rates, for if a value must be found before a temporary rate can be fixed, action by the Commission will be delayed until the case is nearly or quite ready for final adjudication." *Supra* note 5, at 13.

[37] The Commission announced the method which it pursued in fixing temporary rates, as follows:

> "After careful consideration the Commission has determined to establish temporary emergency rates wherever the facts relating to a company, set forth in the sworn reports to the Commission, seem to justify such action. It is contemplated in the establishment of such rates that a valuation of the property as required by the courts for a final determination will be made. Such valuations require lengthy procedure, wearisome hearings, and often extended litigation. As a result regulation is frequently characterized as dilatory and cumbersome, and commissions are blamed for lack of prompt action when they are helpless to remedy the situation." *Supra* note 5, at 18.

This method, however, comes within the condemnation of the decision of Atchison, T. & S. F. Ry. Co. v. United States, 284 U. S. 248, 54 Sup. Ct. 146 (1932), wherein Mr. Chief Justice Hughes, writing for the court, said:

> "And the prospect that a hearing may be long does not justify its denial if it is required by the essential demands of justice."

the reductions again must await the date of final determination. Irrespective of the final determination, there is no way to reach the surplus profits of the Company or to reimburse the ratepayer for his losses. This arises from the rule that "temporary rates fixed by Commission are final legislative acts as to the period during which they are to remain in effect." [38] Being final, the surplus gains derived from temporary rates cannot be used to sustain future final rates, that standing by themselves, are confiscatory.[39]

The present method of regulating temporary rates, being inadequate and ineffective, the Legislature was justified in seeking an appropriate remedy. The difficulty lay in devising a means that would accomplish the desired result and at the same time be flexible enough to safeguard the property interests of the investor. It is apparent that such is the intended object of Section 114 and that there is a real and substantial relation between the provisions of the law and the object sought to be obtained. Provision is made for three separate steps in the process of fixing temporary rates. The first or preliminary step in the process is the preparation of an inventory of the Company's property. For that purpose the Company is required to maintain a perpetual inventory of property which currently shows the book or original cost of the Company's property and accrued depreciation reserves accumulated for its replacement and retirement. By this method there is established a rate base currently available to fix temporary rates. This requirement is not arbitrary. One of the principal causes of delay in a rate case is the preparation of inventories, for such inventories are a prerequisite to the making of a valuation and in some instances their preparation is not begun until the rate proceedings are started and in case of a large company a considerable time is required for its preparation.

The second step is the ascertainment of a tentative base upon which to calculate the temporary rate of return. The statute designates the original cost of the Company's prop-

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[38] *Supra* note 10.

[39] Board of Public Utility Commissioners v. N. Y. Tel. Co., 271 U. S. 23, 46 Sup. Ct. 363 (1926); Newton v. Consolidated Gas Co., 258 U. S. 165, 42 Sup. Ct. 264 (1922).

erty used in the public service, less accrued depreciation, as such rate base. The choice is not arbitrary. Original cost though not conclusive is always a factor in every valuation.[40] Of all the elements considered in determining fair value, it is the most definite, stable and easily ascertainable. It constitutes a rough index to fair value upon which the final rate of return is to be computed. When price levels are stable it fairly represents the present fair value of the Company's property. In *Clark's Ferry Bridge Co.* v. *Public Service Commission,*[41] the order fixed rates on the basis of original cost of production. Upon appeal, the Supreme Court held that the Commission correctly followed the rule in *McCardle* v. *Indianapolis Water Co., supra,* which held, "that actual costs will continue fairly well to measure the amount to be attributed to physical elements of the property so long as there is no change in the level of applicable prices." In periods of price decline, original cost will obviously be a fair basis to a utility to measure the present "fair value" of its property. The recent case of *Los Angeles Gas & Electric Co.* v. *Railroad Commission of California, supra,* sustained rates based on historical or original cost figures, on the ground that the serious price decline made original cost estimate more trustworthy as a basis for present fair value than the present reproduction cost estimate. It is only in periods of rising prices, when original costs being less than reproduction cost, may therefore not fairly represent present "fair value." This contingency may be met by the third step, which consists in fixing a temporary rate of return.

The only limit imposed upon the Commission in fixing such rate of return is that it must not be less than five per cent. There is no limit placed upon the maximum rate of return. Heretofore, utility Commissions usually treated the rate of return as the static and fixed factor in rate making.[42]

[40] Los Angeles Gas & Electric Corp. v. Railroad Commission, 289 U. S. 287, 53 Sup. Ct. 637 (1933).

[41] 290 U. S. 632 (1934).

[42] The summary submitted by the Public Service Commission of New York and published in the report of the New York Commission on Revision, Vol. 3, pp. 2826-2830, shows that in the war and post-war period of 1916-1921, in spite of abnormal fluctuations in price levels (see note 34, *supra*) a flat rate of 8% was prescribed in over 70% of all cases decided in formal rate proceedings. It is to be further noted that cases related to all types of utilities.

The new statute in order to facilitate prompt action, makes the rate base the stable element. Of necessity, the rate of return must become the variable and adjustable factor. By this means high price levels may be offset by appropriate upward adjustment in rate of return. As was stated in the dissenting opinion of Mr. Justice Brandeis: "Either increase in the rate of return or increase of the base on which return is measured would have served to adjust compensation to higher price levels." [43] This flexible medium of control may also be used to assure an operating company a net revenue that is sufficient to attract capital for needed improvements and to enable it to properly discharge its public duties during the pendency of proceedings. If, for example, at the hearing for the fixing of temporary rates, the utility shows that a five per cent rate of return on basis of book value of its property would impair its credit or be insufficient to maintain a proper standard of service, or result in the deterioration of its property, it would be comparatively a simple matter to adjust the rate of return to avoid such injury to either the investor or the ratepayer.

What has been said as to the use of original cost as a basis for determining value is equally applicable to its use as a basis for calculating depreciation. Though accounting practice treats depreciation as part of the original cost of fixed assets retired or to be retired from service, the law requires that depreciation equal the cost of wornout equipment at the time of replacement.[44] When book cost and value are

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[43] St. Louis & O'Fallon Ry. Co. v. United States, 279 U. S. 461, 488, 49 Sup. Ct. 384 (1929).

[44] United Railways v. West, 280 U. S. 234, 50 Sup. Ct. 123 (1930). The reasoning and conclusions reached by the majority opinion were forcibly assailed in the dissent of Mr. Justice Brandeis. Mr. Justice Stone, in a separate dissent, summed up the objections as follows:

> "To say that the present price level is necessarily the true measure of future replacement cost is to substitute for a relevant fact, which I should have thought ought to be established as are other facts, a rule of law which seems not to follow from Smyth v. Ames, and to be founded neither upon experience, nor expert opinion and to be unworkable in practice."

A very pointed and logically unassailable criticism of the rule which requires the public to amortize on the basis of reproduction cost is contained in the opinion of Commissioner Maltbie, *In re* Yonkers Railroad Co., P. U. R. (1933) B., pp. 61, 84.

not materially different in amount then book cost may conveniently and with approximate accuracy be used to measure value and depreciation. When, however, cost and value are materially different in amount, then, the difference in both value and depreciation may be properly adjusted during the pendency of proceeding by a higher or lower rate of return, or be offset by higher or lower final rates. By proper accounting practice, a fair net result may be obtained for the entire rate making period.

It is conceivable that during periods of rising operating costs and price levels, such as we experienced in 1922 and to some extent are now experiencing, that the Commission, after a preliminary hearing such as is provided by Section 114, may order a temporary rate reduction that will impair the credit and ability of the company to render adequate and efficient service. To be sure the Commission may abuse the powers conferred upon it by the new statute as it may abuse its other regulatory powers. In the advance of such abuse the court will not pronounce anticipatory judgment. As the court said in an earlier case:

> "It is not our province * * * to pronounce anticipatory judgments. We must wait for the instance. Our present duty is to pass upon the statute before us, and if it has been enacted upon a belief of evils that is not arbitrary, we cannot measure their extent against the estimate of the legislature." [45]

When the "instance" does arise, the utility is not left without a remedy. It may avail itself of the remedy provided by Section 23 of the Public Service Law, whereby a court may stay or annul an order fixing inadequate rates upon a showing that great and irreparable damage would otherwise result. Or it may resort to the provisions of Section 72, and kindred sections, whereby an immediate temporary increase in rates may be allowed when such increase is necessary to provide adequate and efficient service or to preserve the property. Even in the absence of these provisions the rate of return under Section 114 may be shown to

[45] Tanner v. Little, 240 U. S. 369, 385, 36 Sup. Ct. 379 (1916).

be inadequate for the present needs of the company. Though the hearing provided by the new statute sets a limit to the minimum rate of return and also limits the Commission to a consideration of the original cost of the property as the temporary rate base, it sets no limit to the maximum rate of return. Whether the temporary rate of return shall be the minimum of 5 per cent or higher is left to the discretion of the Commission. What shall control the exercise of this discretion? Obviously, the experience of the company showing its actual cost of operation, upkeep, capital charges and capital for needed expansion. The preliminary hearing will necessarily deal wtih all such matters and the company's right to appeal will be co-extensive with the scope of hearing.

The one important matter, however, that the preliminary hearing will not consider is whether the temporary rates standing by themselves are confiscatory for the period they are to remain in effect. That issue must await the final determination. At this point the private advantage of the investor conflicts with the public need. But as the object of the new statute is to assure more effective rate regulation by means reasonably deemed by the legislature to be justifiable and appropriate, this private advantage should give way to the public interest. The reasoning of the majority opinion in the *Nebbia* case lends support to this view. Mr. Justice Roberts speaking for the court, said:

> "These correlative rights, that of the citizen to exercise exclusive dominion over property and freely contract about his affairs, and that of the state to regulate the use of property and the conduct of business, are always in collision. * * * But subject only to constitutional restraint the private right must yield to the public need." [46]

And again in the same case, he said:

> "But if, as must be conceded, the industry is subject to regulation in the public interest, what constitutional principle bars the state from correcting exist-

[46] *Supra* note 29, at 524.

> ing maladjustments by legislation touching prices? We think there is no such principle. The due process clause makes no mention of sales or prices any more than it speaks of business or contract or buildings or other incidents of property." [47]

If there is nothing sacrosanct about the prices which may be charged by those engaged in the milk industry—not commonly regarded as a public utility—there should be nothing sacrosanct about the temporary rates which may be charged by those engaged in an industry that is a public utility. Just as the private right of the dairy farmer must give way to the need of the consuming public, "in order to correct existing maladjustments," so the private advantage of the investor in a public utility should for like reasons give way to the public interest. Considering the safeguards with which Section 114 has buttressed the investors' rights, the grounds for his objection seem even less tenable.

IV.

The new statute marks a forward step in rate regulation. It reinforces the regulatory authority at one of its weakest points. Heretofore, the Commission was at a disadvantage in fixing temporary rates. It lacked the data and therefore the means to uphold its mandates against attack. As a result it was often obliged to resort to compromise in order to obtain for the ratepayer some measure of immediate relief. Commendable and necessary as that practice was under the circumstances, it was nevertheless a confession of the impotency of the power of the Commission to carry out its mandate to establish a "fair return on fair value." The power now given to the Commission to command as well as to advise does away with the need for makeshift compromise.

In making the experience factor available in rate fixing, the new statute makes possible more accurate and scientific rate making. How helpful that factor can be and what credence the Supreme Court will give it, clearly appears

[47] *Id.* at 531.

from the decisions in the *Lindheimer* and *Dayton* cases, *supra*. In the light of these decisions, experience and original cost factors, taken together, might well provide a factual and stable basis for rate making in periods of stable and fluctuating prices.

Finally, by means of the adjustable rate of return in fixing temporary rates and adjustment to be made upon final determination, a "fair return on fair value" may be kept currently up to date. Such continuous adjustments are made necessary because of fluctuating price levels so that net revenue will keep abreast of the purchasing power of money. Temporary rates, easily established, scientifically checked and adjusted upon a factual basis, may effectively be used to attain this result.

In the introduction to their valuable book,[48] to which this writer is greatly indebted, Messrs. William E. Mosher and Finla G. Crawford, make this observation: "The outlook for constructive action is not unpromising, because of the aggressive action being taken by a few pioneering Commissions, because of the attitude adopted by some of our influential public officials, because of bills proposed in several legislatures. * * *" The new statute is one of these bills. It was wrought with skill and foresight and promises to revitalize the whole process of rate regulation.

PINCUS M. BERKSON.

New York City.

[48] WILLIAM E. MOSHER AND FINLA G. CRAWFORD, PUBLIC UTILITY REGULATION (1933) New York.

OLIVER WENDELL HOLMES

Illustrious son, to your illustrious sire
You now ascend. Farewell. Long did you stand
A glowing light. A scintillating strand
Of erudition. Sanguine hopes retire
To grieve, and wait, and sue that time inspire
Another champion for the mute demand
Of future years, when all our stone is sand
And all our hatchments sunk in time's soft mire.

Now to your last account you turn your pace,
From man-made wings; to don a golden wreath
And lend, to fair Justitia's court, your grace.
While to a peering world, do you bequeath
Perception, in perpetual estate,
That future forces may articulate.

Hyman Frank