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I. INTRODUCTION

Writing a response to an article often ends up like many contract disputes: one party believes he is selling one thing and the other party believes he is buying something else. In such a situation, there may be no real joinder of the issues. Writing a rejoinder to a response compounds the risk of confusing the matter. With a recognition of this risk, and a concerted attempt not to misstate the thrust of the Brehl-Gallagher Response (the Response),[1] this rejoinder is offered.

The Brehl-Gallagher Response begins with an attempt to summarize the Louiselle-Heilman Paper.[2]

> In reality, the Louiselle-Heilman paper does not state the case for the use of an "appropriate" capital structure. It presents, rather, an argument that a capital structure hypothetically related to the capital circumstances of other companies in the industry, and not a capital structure based on the company's own financial circumstances, is the "appropriate" capital structure that should generally be used in ratemaking proceedings.[3]

Unfortunately, no such argument was presented. The Response has confused the standards by which the appropriateness of a capital structure should be measured with some of the technical analyses one may employ to apply the standard. Because the original Louiselle-Heilman Paper[4] never proferred the argument stated in the Response, the fact that it is asserted to be of "dubious validity"[5] is irrelevant and will not be discussed further.

The original Louiselle-Heilman Paper (the Paper) presented the following thesis: "Commissions have a duty and an obligation to

1. Brehl & Gallagher, *Response to* The Case for the Use of an Appropriate [Hypothetical] Capital Structure in Utility Ratemaking, 8 WM. MITCHELL L. REV. 449 (1982).
2. Louiselle & Heilman, *The Case for the Use of an Appropriate Capital Structure in Utility Ratemaking: The General Rule Versus Minnesota*, 8 WM. MITCHELL L. REV. 423 (1982).
3. Brehl & Gallagher, *supra* note 1, at 449.
4. Louiselle & Heilman, *supra* note 2.
5. Brehl & Gallagher, *supra* note 1, at 449.

set rates based on an appropriate capital structure, even if that capital structure differs from the one selected by management."[6] The Response seemingly does not take issue with the substance of this conclusion. It states, "In most cases, the actual capital structure is departed from only *after* there has been a determination that the actual capital structure is unreasonable and imprudent in some significant respect."[7]

The differences between these positions are two-fold. The first is apparent. The Response asserts a condition precedent to the use of a non-actual capital structure, to wit, a finding that the actual capital structure is unreasonable. The position espoused in the Paper is that such a condition would improperly shift the burden of proof from the company. The second difference is perhaps less apparent. The Paper asserts that the commission has an *obligation* to use only reasonable capital structures. The Response asserts only an *ability* to use non-actual capital structures.

Since the preponderance of the Response is directed at the first difference, the comments concerning the second difference will be limited. In this regard it should be noted that at no point in the Response do the authors deny the obligation of commissions to approve rates based only on reasonable capital structures. Instead, their response is directed at an attempt to establish that:

a) the "Minnesota rule" is the majority rule;
b) the use of the word "hypothetical" to describe the results of cases is misleading; and
c) the existence of a capital structure is prima facie proof of its prudence.

Each of these will be discussed in turn.

II. Discussion

Consider first the assertion that the Minnesota rule reflects a minority position,[8] a claim the Response contends is also of "dubious validity."[9] While the Paper sets forth why the Minnesota rule *and*, more importantly, its application is at variance with the majority of well-reasoned authority, perhaps it would be less self-serving to rely on authority than to merely reassert that claim. In *Communications Satellite Corp. (COMSAT) v. Federal Communications*

6. Louiselle & Heilman, *supra* note 2, at 425.
7. Brehl & Gallagher, *supra* note 1, at 451.
8. *See* Louiselle & Heilman, *supra* note 2, at 427-28.
9. *See* Brehl & Gallagher, *supra* note 1, at 449.

Commission,[10] the District of Columbia Court of Appeals extensively reviewed the capital structure issue. The court indicated that twenty-two state commissions and courts have approved the use of a hypothetical capital structure, citing two states as proponents of the minority position, Minnesota and California.[11]

The second contention of the Response is that the term "hypothetical" has been used differently in different cases.[12] As a result, a "numbers" game or count of cases is not possible merely by reference to the term "hypothetical" without examining how the term is used.[13] To paraphrase, there is no majority position, only many minority positions. This should come as a surprise to the *COMSAT* court which found it possible to describe the actions of twenty-two state commissions with a single sentence.

In support of its position, the Response offers four discrete situations in which they contend the word "hypothetical" can be differentiated.[14] First are cases in which "hypothetical" is used to describe necessary adjustments to the actual capital structure, made because the test period is not completed when the record closes in the case. In support of its position, the authors cite three cases. The first cited case is *Laclede Gas Co.*[15] The word "hypothetical," however, does not appear in *Laclede*. The commission used the actual capital structure of the company based on evidence presented prior to the closing of the record. The second case cited is *Central Maine Power Co. v. Public Utilities Commission*.[16] The authors' reliance on *Central Maine* is equally misplaced. While the commission agreed that the capital structure used could be considered a "near-term proforma" one,[17] the court denied this basis, finding the commission's use of a hypothetical capital structure to be reasonable.[18] In reaching this decision, the court quoted approvingly from the commission's brief:

> If, indeed, the Commission cannot use a 35% hypothetical equity ratio because it is too close to the "*actual*" 36.2% equity ratio, that would, perforce, imply that a 36.2% equity ratio produces "*just and reasonable*" rates. The implication is clear.

10. 611 F.2d 883 (D.C. Cir. 1977).
11. *Id.* at 904-05.
12. Brehl & Gallagher, *supra* note 1, at 452.
13. *Id.*
14. *Id.* at 452-53.
15. 27 P.U.R.4th 241 (Mo. P.S.C. 1978).
16. 405 A.2d 153 (Me.), *cert. denied*, 447 U.S. 911 (1979).
17. *Id.* at 180.
18. *Id.* at 179-84.

> Under such reasoning the Commission would not have regulatory control over companies as long as the equity ratio rises by small increments.[19]

The third case cited in the Response, *South Central Bell Telephone Co. v. Louisiana Public Service Commission*,[20] is even more inappropriate. In *South Central*, the commission specifically adopted a hypothetical capital structure that contained more debt than the company (the Bell System) had, and more debt than the company planned to have. It noted, however, that the one adopted had only 1.1% less equity than the actual capital structure used in the preceding case.[21]

The *South Central* court actually articulated our position quite well:

> [It is not] incumbent on the Commission to find the company's actual capital structure unreasonable before it could set a rate of return on the basis of a hypothetical structure. Such a requirement would be anomalous, since South Central Bell is requesting the rate increase and, therefore, *bears the burden of proving that the increase is justified*. If the company's request for the increase is due, in part, to its capital structure, the company should also bear the burden of justifying the portion of the increase attributable to its management's choice of capital structure.[22]

In sum, the cases cited in the Response do not support the contention for which they were offered.

The second discrete, but not typical, situation in which the word hypothetical might be used is to describe adjustments to an actual capital structure to eliminate non-utility activities. None of the cases offered in the Paper relate to such a situation. The third discrete situation involves "double leverage" cases. The cases cited in the Paper, however, did not involve "double leveraging." Consequently, the second and third discrete situations do not support the admonition not to engage in a " 'numbers' game or count of cases."[23]

The fourth and final listed situation is "cases which involve adjustments to the actual capital structure of a utility for specific rea-

19. *Id.* at 183.
20. 373 So. 2d 478 (La. 1979).
21. *Id.* at 484-85.
22. *Id.* at 483 (emphasis added).
23. Brehl & Gallagher, *supra* note 1, at 452.

sons found by the regulatory authority involved."[24] The Response neither describes the "specific reasons" in a generic sense nor provides examples of the specific reasons by reference to even a single case. Consequently, there is no way to discern whether this contention has any merit or whether it is like the prior three.

Perhaps the most significant area of disagreement discerned by a comparison of the Paper to the Response centers on the question of who bears the burden of proof. The authors of the Response state the positions of the parties:

> Louiselle and Heilman erroneously argue that, since all rates must be "just and reasonable," the actual capital structure of the utility cannot be deemed to be prima facie reasonable and prudent. They insist that the utility must carry the initial burden of proving that its capital structure is reasonable and prudent. To the contrary, substantial authority holds that a utility's expenses are presumed prudently incurred, with the burden upon intervenors to show unreasonableness or imprudence.[25]

In support of its position, Brehl-Gallagher offers one Federal Energy Regulatory Commission case and two citations from that case.[26]

Reliance on *Anaheim v. Federal Energy Regulatory Commission*[27] is misplaced. In that case, the company had requested the write-off of an abandoned nuclear plant. While recognizing that the company does not need to prove the reasonableness of all expenditures in its direct case, the court pointed out that this presumption of validity will not survive evidence of others who cast doubt on this presumed reasonableness.[28] In affirming the commission's disallowance of these expenses, the court noted that the company's evidence "merely consisted of vague generalizations" that such abandonments are normal, stating, "Further, the Commission has held as sufficient to raise such a doubt evidence that a state public service commission has disallowed an expense as improvident."[29]

In sum, the Response clearly overstates the holding in *Anaheim*. While the two cited cases (from the 1920's and 1930's) do affirm the concept that it is to be presumed that expenses have been in-

24. *Id.* at 453.
25. *Id.* at 458.
26. *Id.* at n.21.
27. 669 F.2d 799 (D.C. Cir. 1981).
28. *Id.* at 809.
29. *Id.*

curred in good faith absent a showing to the contrary, they are without force. In *West Ohio Gas Co. v. Public Utilities Commission*,[30] the commission made an adjustment to an expense without any record evidence suggesting or contending that the incurred level was not appropriate, nor was any evidence presented supporting what the appropriate level of the expense was.

In *State of Missouri* ex rel. *Southwestern Bell Telephone Co. v. Missouri Public Service Commission*,[31] Justice Brandeis, concurring and dissenting, stated in a footnote, "There should not be excluded . . . investments which, under ordinary circumstances, would be deemed reasonable. . . . Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown."[32] To see that this dicta is not contrary to our position a further clarification is necessary. It is agreed that, absent evidence to the contrary, it can be assumed that the actual capital structure is reasonable. In other words, if no evidence were presented on the issue, a commission would be required to use the actual capital structure. If, however, evidence is presented which calls into question the reasonableness of the actual capital structure, the burden of proving its reasonableness lies with the company and the existence of the actual capital structure is not evidence of its reasonableness. Recent cases support this proposition. These cases were set forth in the Paper and will not be repeated.[33]

A final matter is an evaluation of the reasons advanced by the Response in support of its position.[34] The first reason advanced is that a Minnesota commission rule requires a utility to show the cost of capital based on "the proposed capital structure and the average capital structure for the most recent fiscal year and the projected fiscal year" when it files a rate case.[35] Apparently, the requirement that the utility disclose its actual capital structure becomes evidence not only of existence but also reasonableness, a conclusion without merit.

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30. 294 U.S. 63 (1935).

31. 262 U.S. 276 (1923).

32. *Id.* at 289 n.1.

33. *See, e.g.*, South Cent. Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n, 373 So. 2d 478 (La. 1979); Northwestern Bell Tel. Co. v. Minnesota Pub. Util. Comm'n, File Nos. 446272, 445940 (Minn. 2d Dist. Ct. Sept. 8, 1981) (discussed at notes 66-68 and accompanying text in Louiselle-Heilman Paper).

34. Brehl & Gallagher, *supra* note 1, at 460-62.

35. 13 MINN. CODE AGENCY R. PSC 405(D)(1) (1982).

The second reason advanced is that all financing must be approved by the commission. While such approvals specifically reserve judgment as to the reasonableness of these financings for ratemaking purposes, such reservations should be disregarded. The Response fails to distinguish between the right to err and the right to charge customers for the errors. As the District of Columbia Public Service Commission has held:

> While we clearly recognize that the composition of the capital structure is a matter for the utility's management to decide, and that a utility has a right to maintain a low debt ratio for its own purposes, we also perceive that it is our duty in ratemaking proceedings to ignore any capital structure which is not conducive to the lowest cost of service that is consistent with a sound financial posture.[36]

The third reason offered, that utilities' actions should be presumed legal and proper, has been discussed previously. The fourth reason is that *Bluefield* and *Hope* require that the actual capital structure be used. This is a most curious contention given the fact that nearly every decision affirming the use of a hypothetical capital structure cites these cases. For example, the court in *COMSAT* stated, "Perhaps the ultimate authority for imputing debt when necessary, to protect ratepayers from excessive capital charges, is the Supreme Court's statement in *Hope Natural Gas*."[37]

The fifth and sixth reasons advanced relate to supposed difficulties the utility would have were a hypothetical capital structure used. Once it is admitted that such a capital structure is appropriate, and Brehl-Gallagher admit that possibility exists, the fact that there are consequences is irrelevant.

The seventh reason advanced as to why a presumption of reasonableness attaches to management's discretion is that since management has the responsibility to make capital structure decisions, they are accountable for these decisions. This accountability apparently creates the presumption of propriety. Yet, if in fact the presumption were acceded to, then there would be no accountability because it is the customers and not the investors who incur the costs of management decisions.

The eighth reason is that, since the actual capital is a fact, it is

36. Chesapeake & Potomac Tel. Co., 57 P.U.R.3d 1, 39 (D.C. P.S.C. 1964), *aff'd sub nom.* Telephone Users Ass'n v. Public Serv. Comm'n, 271 F. Supp. 393 (D.C. Cir. 1967), *cert. denied*, 395 U.S. 910 (1969).

37. 611 F.2d at 904.

those who object to its use that have the burden of proving contrary facts. Brehl-Gallagher confuse what the relevant fact is. The issue is not what the actual capital structure is; the fact in issue is whether that capital structure is reasonable. The assertion of existence does not answer that question.

The ninth reason is that since "no single ideal capital structure exists," the actual capital structure should be presumed reasonable. An equally valid conclusion, given that premise, is that the actual capital structure is *not* reasonable. In other words, since the ideal capital structure does not exist, and since the actual capital structure exists, it cannot be ideal. Therefore, since it is other than ideal, assume it to be unreasonable. Both presumptions, as conclusions, are non-sequitors.

The remaining three reasons advanced to support the presumption are merely variations on themes previously discussed and require no further comment.

III. CONCLUSION

The Minnesota approach to the capital structure issue reflects the minority position and places the burden of proof of the appropriate capital structure on parties other than the utility seeking the rate increase. This position ignores the constitutional and statutory constraints that place the responsibility on the commission to insure that rates are "just and reasonable." It further ignores the fact that the capital structure used is a critical element in the determination of "just and reasonable" rates.

In the final analysis, it must be recognized that the Brehl-Gallagher Response has failed to effectively challenge the basic premise of the Paper: The commission has both an obligation and a duty to adopt a capital structure that fairly balances the interests of the utility and its consumers. The commission abdicates its responsibility when it shifts the burden of proof from the utility proposing the rate increase to other parties in the proceeding in its determination of the appropriate capital structure.