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SOME COMMENTS ON RATE MAKING IN WEST VIRGINIA

CHARLES C. WISE and BEN K. BAER*

The regulation of rates is of growing concern to everyone since, directly or indirectly, the entire population is affected by the cost of water, gas, electricity and public communication and transportation. Nearly all customers have greatly increased their use of utility services in the past decade. Moreover, the problem has grown in importance because there has been a larger number of rate proceedings instituted before the Public Service Commission since the close of World War II than in any other comparable period in the history of regulation in this state.¹ Furthermore, there has been a multiplicity of rate applications by the same utilities, as for example, those engaged in the communication business, which is of such nature that the addition of each new telephone increases costs generally, and those which make use of an exhaustible natural resource such as natural gas requiring new sources of supply, often at great distances at higher costs.

The West Virginia lawyer may feel some reluctance in advising clients respecting rate proceedings for several reasons:

1. The Supreme Court of Appeals has declined to review any major rate order for twenty years,² and, in any event, the decisions of this court shed but little light on modern rate making.

2. The reports, opinions and orders of the Public Service Commission are not generally read by the profession as are the court reports.³

3. Since rate regulation is complex and essentially a legislative function, the subject is given but cursory and inadequate treatment in the usual legal texts.⁴

4. The many ramifications of a process consisting of an involved mass of accounting and engineering principles applied to the realities of variable operating problems, all of which must be viewed in the light of a rapidly changing economic climate,

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¹The reports of the commission include 192 rate orders (other than for carriers) during the period 1944 through 1952. Of these, 6 were for electric, 38 for gas, 78 for water, and 70 for telephone companies.

²The last comprehensive rate case reviewed was *City of Wheeling v. Natural Gas Co.*, 115 W. Va. 149, 175 S.E. 339 (1934).

³The reports of the commission are published annually. They contain orders, opinions and valuable statistical information.

⁴There is no text dealing with rate making in West Virginia. Public utility law treatises are of ancient vintage. For a modern, but general, source, see WELCH, *PREPARING FOR THE RATE CASE* (1954).

are somewhat forbidding to lawyers, including those who have had experience in administrative law. The traditional reliance upon general principles enunciated by the courts offers but little comfort in a rate case.

LEGAL BASES OF REGULATION

Rate regulation is, of course, founded upon the principle that "when private property is devoted to public use, it is subject to public regulation".⁵ Neither this principle nor the mechanics of rate making, however, are new; both had their origin in the common law. Rates at that time were fixed by the king's license or charter but even then subject to the requirement of reasonableness.⁶ The classical legal concept of "business affected with a public interest", which became the foundation for regulation in the United States, was first hammered out in the commentaries of the great Lord Chief Justice Hale.⁷

Regulation in this country commenced even before the Revolution when certain colonies resorted to price fixing. The tug of war between the regulators and those who opposed governmental intervention was bitter but inconclusive until 1877 when the Supreme Court of the United States in the celebrated case of *Munn v. Illinois* took Lord Chief Justice Hale's principle of public control and made it the law of the land.⁸ Modern rate regulation dates from this case.

With the constitutionality of price fixing established, regulation of utility rates was undertaken by direct legislative enactment, but this method was soon found to be burdensome and ill-suited to the expanding economy.⁹ By reason of the rapid growth of the population and the great increase in the number of public service corporations, it became impracticable for legislatures to accomplish regulation by specific enactments. These developments, coupled with the inadequacy and inequality of recovering overcharges in courts, led to a revolutionary change in the form of administrative bodies as creatures of the legislature to perform the function of regulation. State commissions were thus created and became active.¹⁰ The federal government also created regulatory com-

⁵ *Munn v. Illinois*, 94 U.S. 113 (1877).

⁶ Among those regulated were common carriers, innkeepers, ferrymen, millers, and bakers. See SMITH, A TELEPHONE RATE CASE 1 (1941).

⁷ *De Portibus Marius*, 1 HARGRAVE, LAW TRACTS 78 (1787); *De Jure Marius*, *id.* at 6.

⁸ 94 U.S. 113 (1877).

⁹ See *Trustees of Saratoga Springs*, 191 N.Y. 123, 83 N.E. 693 (1908); *Budd v. New York*, 143 U.S. 517 (1891); *Dow v. Beidelman*, 125 U.S. 680 (1887).

¹⁰ The right of a state to regulate railroad rates by a commission was upheld by the Supreme Court in 1886. *Stone v. Farmers Loan & Trust Co.*,

missions.¹¹ As a result, rate making underwent a radical transformation from the fixed standards of a franchise or legislative act or a retroactive determination of reasonableness by the courts to a method whereby rates were to be determined by a commission to operate in the future so as to secure stability and uniformity.

The growth of commissions, both federal and state, has posed constitutional problems, the resolution of which affect rate making today. The delineation of the scope of state as opposed to federal regulation has become increasingly important, since many public service corporations operate locally in a number of states and in interstate commerce, thus causing complex regulatory problems. Although it is now firmly established that state commissions retain their traditional power to regulate intrastate sales to consumers by electric, natural gas and telephone utilities, and the Federal Power Commission and Federal Communications Commission exercise the right to regulate interstate sales for resale, troublesome questions remain in this area of rate making.¹²

Rate making by both the states and the federal government is, of course, subject to constitutional restrictions. The keystone of the constitutional guaranty was stated in the case of *Munn v. Illinois*: the right of the state to regulate is based upon the general

116 U.S. 307 (1886). In 1907, Georgia, New York and Wisconsin established utility commissions with broad rate fixing powers, and other states soon followed. The West Virginia commission was created in 1913.

¹¹ Federal regulation commenced with the creation of the Interstate Commerce Commission, 49 U.S.C.A. 1, in 1887, although this commission originally did not have rate fixing authority. The Securities Act of 1933, 15 U.S.C.A. 77a, and the Securities Exchange Act of 1934, 15 U.S.C.A. 78a, regulate the issuance of securities by utilities and practices pertaining to their sale. The Federal Power Act of 1920, 16 U.S.C.A. 791, gave jurisdiction to the Federal Power Commission to regulate interstate rates for electricity. The Communications Act of 1934, 47 U.S.C.A. 151, delegated the regulation of interstate telephone and telegraph companies to the Federal Communications Commission. In 1938 Congress passed the Natural Gas Act, 15 U.S.C.A. 717, giving the Federal Power Commission jurisdiction over the sale of gas for resale in interstate commerce.

¹² The transmission of utility service from one state to another has from an early time been established to be a transaction in interstate commerce. See *Pensacola Telegraph v. Western Union*, 96 U.S. 1 (1877) (communications); *American Ex. Co. v. Iowa*, 196 U.S. 133 (1904) (gas); and *Mill Creek Coal & Coke Co. v. Public Service Comm'n*, 84 W. Va. 662, 100 S.E. 557 (1919) (electricity). States may regulate intrastate rates, *Public Utilities Comm'n v. Landon*, 249 U.S. 236 (1918); *Pennsylvania Gas Co. v. Public Utilities Service Comm'n*, 252 U.S. 23 (1919); but may not regulate interstate rates, *Missouri ex rel. Barrett v. Kansas Natural Gas Co.*, 265 U.S. 298 (1923); *Public Utilities Comm'n v. Attleboro Steam & Electric Co.*, 273 U.S. 83 (1926). The question of whether a state commission may disallow costs incurred under tariffs on file with a federal commission has not been authoritatively settled. See *Amere Gas Utilities Co.*, 1 P.U.R.3d 280 (W. Va. Public Service Comm'n 1953); and *East Ohio Gas Co. v. City of Cleveland*, 56 P.U.R. (N.S.) 89 (1945).

police power, but its exercise must be reasonable and avoid a taking of private property for public use without just compensation.¹³

The method of computing rates so as to satisfy these constitutional requirements has been a cause of never-ending litigation in the courts. It is no easy matter to give effect to the many economic, social and legal aspects underlying rate regulation so as to arrive at a rate of return to the company which fully protects its interest as well as that of the consumer and the public generally. Throughout the history of regulation, the fundamental problem has been that of developing a standard of measurement. If rates are to be above the level of confiscation, provision must be made not only for costs that are properly incurred in furnishing public service but also for a return to the investor. The determination of a proper "return" has caused considerable difficulties since it involves determination of a proper rate of return and of the basic utility investment. As a standard of measurement, commissions early adopted the rate base formula under which a public service corporation is allowed a reasonable rate of return upon the rate base plus ordinary operating expenses and depreciation.¹⁴ The determination of what component parts are to constitute the rate base and the standards to ascertain the value of the property have resulted and continue to result in wide disagreement. The use of the rate base, however, remains today as the accepted method before most commissions.¹⁵

At least six different methods of determining the rate base have been advanced from time to time: (1) rate base computed by amount and value of outstanding stocks and indebtedness;¹⁶ (2) original cost of property when first devoted to public service;¹⁷ (3) original cost less depreciation reserve;¹⁸ (4) reproduction cost

¹³ 94 U.S. 113 (1877).

¹⁴ The chief function of the rate base is to provide a basis of measurement. See *Chicago, Milwaukee & St. P. Ry. v. Minnesota*, 134 U.S. 418 (1889); *Smyth v. Ames*, 169 U.S. 466 (1897).

¹⁵ *Illinois Bell Telephone Co. v. Commerce Comm'n*, 414 Ill. 275, 111 N.E.2d 329 (1953); *City of Marietta v. Public Utilities Comm'n*, 148 Ohio St. 173, 74 N.E.2d 74 (1947); *Commonwealth Telephone Co. v. Public Service Comm'n*, 252 Wis. 481, 32 N.E.2d 247 (1941).

¹⁶ This was argued unsuccessfully in *Smyth v. Ames*, 169 U.S. 466 (1897). See also *Knoxville v. Knoxville Water Co.*, 212 U.S. 1 (1908); And *Huntington v. Public Service Comm'n*, 89 W. Va. 703, 110 S.E. 192 (1921). Although early favored as a measure of the rate base, it was soon rejected since in many instances capital stock was given as a bonus to bondholders, in others, bonds were sold at a discount, and large promotional expenses were not uncommon.

¹⁷ Original cost generally means the actual cost of properties without deduction for accrued reserves. *Railroad Comm'n of California v. Pacific Gas & Electric Co.*, 302 U.S. 388 (1937).

¹⁸ This is original cost adjusted to reflect depreciation and depletion. See *West v. C. & P. Tel. Co.*, 295 U.S. 662 (1934).

new less depreciation;¹⁹ (5) the amount "prudently" invested by the stockholders;²⁰ and (6) the fair market value of the property.²¹

The Supreme Court from 1898 until 1943 adhered to the rule that the rate base should be made up of a combination of these values or that the basis of all calculations as to the reasonableness of rates must be "the fair value of the property devoted to public service." The court's formula for the rate base was stated in the case of *Smyth v. Ames*,²² in the following language:

"We hold, however, that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway 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 amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the company under particular rates prescribed by statute 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. We do not say that there may not be other matters to be regarded in estimating the value of the property. What the company is entitled to ask is the fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are reasonably worth."

This rule of fair value was thereafter generally adopted by state commissions and courts, and rate base valuation became a conflict between the competing principles of original and reproduction cost. The Supreme Court in cases before it consistently remanded commission orders where the commission had solely considered or used one method of valuation.²³

¹⁹ Reproduction cost is an estimate of the cost to reproduce the properties now, less depreciation. See *Georgia Ry. & P. Co. v. Railroad Comm'n*, 262 U.S. 625 (1922). This method includes appreciation of property in the rate base, but has been subjected to criticism as representing mere estimates. At first reproduction cost was welcomed by commissions as evidence of value, because estimates then indicated values lower than original cost. See *McCardle v. Indianapolis Water Co.*, 272 U.S. 400 (1926).

²⁰ See the concurring opinion of Justice Brandeis in *Missouri ex rel. S. W. Bell Tel. Co. v. Public Service Comm'n*, 262 U.S. 275, 289 (1923).

²¹ This method was rejected by the West Virginia commission in the 1950 *C. & P. Telephone case*, 37 PSC REP. 32.

²² See note 14 *supra*.

²³ *Minnesota Rate Cases (Simpson v. Shepard)*, 230 U.S. 352 (1912); *St. Louis & O'Fallan Ry. v. United States*, 279 U.S. 461 (1928); *West v. C. & P. Tel. Co.*, 295 U.S. 662 (1934); *Bluefield Water Works & Imp. Co. v. Public Service Comm'n*, 262 U.S. 679 (1922); *McCardle v. Indianapolis Co.*, 272 U.S. 400

In 1943, however, the Supreme Court shifted its emphasis from the "fair value" approach to the so-called "end result" theory and held that methods used by a commission in establishing rates are not subject to review on constitutional grounds so long as the end result is just and reasonable. The new theory of the Court was stated in the celebrated *Hope Natural Gas* case:²⁴

"We held in *Federal Power Commission v. Natural Gas Pipeline Company*, 315 U.S. 575, 86 Law Ed. 1037, 62 S. Ct. 736, supra, that the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of 'pragmatic adjustments'. * * * Under the statutory standard of 'just and reasonable' it is the result reached, not the method employed, which is controlling. * * * It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not important. * * * The rate making process under the Act, i. e., the filing of 'just and reasonable' rates involves a balancing of the investor and consumer interests. * * * In view of these various considerations we cannot say that an annual return of \$291,314 is not 'just and reasonable' within the meaning of the Act. Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called 'fair value' rate base."

Theoretically, the *Hope* case may mean that a rate base is no longer necessary in computing reasonable rates. Despite the vigorous efforts of certain state commissions and the Federal Power Commission to minimize the importance of the rate base, however, the majority of commissions still make use of the formula. Since the *Hope* case, the states may in general be grouped into four categories: (1) those continuing the pre-*Hope* policy of using original cost or prudent investment; (2) those faithful to the true fair value rule of considering all elements; (3) those adopting original cost as the rate base although ostensibly adhering to the fair value rule; and (4) those adopting either original cost or

(1926); *San Diego Land & Town Co. v. Jasper*, 189 U.S. 439 (1902); *Los Angeles Gas & Elec. Corp. v. Railroad Comm'n*, 289 U.S. 287 (1932)

²⁴ *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 590 (1943). Five opinions were rendered in this case, and argument as to their meaning still continues.

prudent investment as a specific result of the *Hope case*.²⁵ It is under the third category that West Virginia should be classified.

REGULATION IN WEST VIRGINIA

The history of regulation of public service corporations in West Virginia has paralleled that of the other states in large measure. Its origin is found in the common law and in the West Virginia Constitution,²⁶ which mandatorily requires the legislature to pass laws applicable to all railroads and to establish reasonable "maximum rates or charges". The legislature at an early date classified railroads according to their gross annual earnings and set maximum limits for the charges.²⁷ Statutes were enacted containing penalties enforceable by the state.²⁸ Furthermore, since a business classified as a public utility was under an affirmative common law duty to charge "reasonable rates", a breach of such duty formed the basis for an action brought by an injured party to recover any overcharge.²⁹

In 1913, the Public Service Commission of West Virginia was established.³⁰ The validity of the act creating the commission came under immediate attack and the Supreme Court of Appeals sustained the delegation of legislative powers as to utilities generally in the case of *United Fuel Gas Co. v. Public Service Comm'n*,³¹ which remains, perhaps, the most definitive statement of the power and authority of the commission.

It is clear from the act itself and the interpretation given it in the *United Fuel Gas* case that the West Virginia commission derives its power and jurisdiction wholly from the statute. This jurisdiction is defined in Chapter 24, Article 2, Section 1 of the West Virginia Code to include all public utilities in the state. The general powers of the commission under the original act as amended are now contained in Chapter 24, Article 2, Section 2 of the West Virginia Code, as follows:

"The commission is hereby given power to investigate all rates, methods and practices of public utilities subject to the provisions of this chapter; . . . The Commission may change any intrastate rate, charge or toll which is unjust or unreason-

²⁵ For an interesting commentary of the aftermath of the *Hope case*, see Rose, *The Hope Case and Public Utility Valuation in the States*, 54 COL. L. REV. 188 (1954).

²⁶ Art. XI, § 9.

²⁷ W. Va. Acts 1872-3, c. 227.

²⁸ See *Coal & Coke Ry. v. Conley & Avis*, 67 W. Va. 129, 67 S.E. 613 (1910).

²⁹ *W. Va. Transportation Co. v. Sweitzer*, 25 W. Va. 434 (1885).

³⁰ W. Va. Acts 1913, c. 9.

³¹ 73 W. Va. 571, 80 S.E. 931 (1914).

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able or any interstate charge with respect to matters of a purely local nature which have not been regulated by or pursuant to act of Congress and may prescribe such rate, charge or toll as would be just and reasonable. . . . But in no case shall the rate, toll or charge be more than the service is reasonably worth, considering the cost thereof. . . ."

Prior to the *Hope* case, the West Virginia commission had been firmly committed to the fair value basis of rate making. The adoption of the Uniform System of Accounts in 1937 foreshadowed the possibility of the use of an original cost rate base, but just as in the federal sphere, apparently no one anticipated that original cost would become within a short period of time the chief, if not the only, standard of fixing rates.³² From 1939 up to World War II, nearly all of the cases before the commission were on its own initiative to reduce rates, and in nearly every instance fair value was predicated upon cost of reproduction new less depreciation.³³ The chief issue in these earlier cases centered around differences in estimates of the reproduction cost. The original cost concept for rate purposes stems from the Uniform System of Accounts, but regulatory bodies at that time generally insisted that a system of accounts requiring the original cost method could not be conclusive for rate purposes.³⁴ However, once the United States Supreme Court had sanctioned the "end result" theory, the Federal Power Commission began to use the net original cost rate base exclusively³⁵ and what began as an act of refinement or reformation for accounting purposes in 1937 gradually became in West Virginia the approved method of the commission for computing the rate base. As early as 1941, the West Virginia commission began to write in terms of "original investment",³⁶ but the first case appearing in the commission reports and indicating an exclusive original

³² The West Virginia commission has prescribed uniform systems of accounts for all major utility classifications.

³³ See *Black Diamond Power Co.*, 26 PSC REP. 76 (1939); *Appalachian Electric Power Co.*, 28 PSC REP. 49 (1940).

³⁴ Mr. Charles W. Smith, Chief, Bureau of Accounts, Finance and Rates, of the Federal Power Commission, and a leading exponent of original cost during the period of its intensified promotion, did not contend that the accounting result would be synonymous with value but rather a check on other evidence of value in a rate proceeding. See *American Telephone & Telegraph Co. v. United States*, 299 U.S. 232 (1936).

³⁵ In 1952 NARUC reported that "a rate base consisting of depreciated original cost or net investment plus working capital still receives exclusive or substantial weight in most final determinations."

³⁶ See *Chesapeake Light & Water Co.*, 29 PSC REP. 4 (1942); *Mountain State Gas Co.*, 29 PSC REP. 36 (1942); *Interstate Utilities Co.*, 30 PSC REP. 40 (1943).

cost basis is that of *Beckley Water Company* in 1943.³⁷ The reports show numerous succeeding orders where the commission adhered strictly to an original cost rate base.³⁸

The most comprehensive discussion of a rate base found in the reports of the West Virginia commission occurs in the 1949 *Chesapeake & Potomac Telephone Company* case,³⁹ where the commission states:

"Utility rates are generally conceded to be just and reasonable if they beget operating revenues sufficient to pay operating expenses including provision for depreciation and taxes and a reasonable return on the fair value of the property devoted to public use and, in West Virginia, 'in no case shall the rate, toll, or charge be more than the service is reasonably worth, considering the cost thereof', (Chapter 24, idem, article 2, section 2). In order to determine whether an increase in the existing rates of respondent is warranted, it is necessary first to determine the fair value of its property devoted to public use and whether its present net operating income constitutes a reasonable return thereon."

In the proceeding before the commission, evidence was offered by the company as to: (1) prudent investment, (2) original cost, and (3) reproduction cost. The commission states that it considered all three theories, but concluded that the average of the original cost studies for the test year represented the fair value of the property devoted to public service and was adopted as the rate base.

That the West Virginia commission is now firmly committed to the original cost base may be seen by its recent statement in the *Amore Gas Utilities Company* case in 1953:⁴⁰

"The respondent's rate base, as set forth in its exhibits, is based upon original cost of the property. * * * This method of arriving at the value of the gas plant in service is the same as that used by the commission in recent years in all of the rate proceedings before it involving major utilities. It is also the same method followed by the Federal Power Commission and a great majority of state regulatory agencies. The use of this method at the present time results in placing a lesser value on the utility's property than would be arrived

³⁷ 30 PSC REP. 45 (1943).

³⁸ *Town of Eastbank*, 31 PSC REP. 62 (1944); *Wayne Gas Co.*, 33 PSC REP. 11 (1945). In *Webster Springs Telephone Co.*, 34 PSC REP. 35 (1946), the commission found it was in a position to ascertain "from the accounting records . . . its investment in the property. . . ." See also *C. & P. Tel. Co.*, 35 PSC REP. 17 (1948); *Morgantown Water Co.*, 36 PSC REP. 26 (1949); *Monongahela Power Co.*, 36 PSC REP. 44 (1948); *W. Va. Water Service Co.*, 36 PSC REP. 63 (1949), 38 PSC REP. 24 (1950); *Bluefield Telephone Co.*, 38 PSC REP. 33 (1951); *C. & P. Tel. Co.*, 38 PSC REP. 80 (1950), 39 PSC REP. 67 (1951).

³⁹ 37 PSC REP. 32 (1950).

⁴⁰ 1 P.U.R.3d 280 (1953).

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at if a reproduction new or fair value rate base were established, but the commission believes the original cost rate base to be the fairest means of valuing a utility's property and not subject to the constant variations inherent in the reproduction new method, which variations may, from time to time, depending on current economic conditions, unduly favor either the utility or the consumer."

The Supreme Court of Appeals of West Virginia has done nothing to disturb the original cost formula of the commission. In the first case concerning the constitutionality of the Public Service Commission statute,⁴¹ the court established narrow confines for judicial intervention in the rate making process. Rates established by the commission are final and not subject to review by the court unless (1) beyond the power which the commission could constitutionally exercise, (2) beyond its statutory power, or (3) based upon a mistake of law. The court has consistently adhered to its original position and has declined to determine whether rates are confiscatory if based upon supporting evidence.⁴² The result has been that since the creation of the commission, the court has reviewed rates on only eight occasions and has declined to review any major rate order in recent years. Of the eight major cases, only three contain substantial interpretative language. In the first of these, *City of Huntington v. Public Service Comm'n*,⁴³ the court announced its allegiance to the rate base method of fixing rates and the fair value rule of *Smyth v. Ames*.⁴⁴ Some foreshadowing of the *Hope* rationale appears in the court's opinion, however, in the statement:

"There is no immutable standard for the measurement of the income a company serving the public is entitled to under all circumstances and conditions, and in the very nature of things there could not be. The facts of each case differ from the facts of every other case. No two of them are any more alike than are two or more faces."

The court, however, interprets the rule of fair value in this and other cases⁴⁵ as excluding any one method. In the last major rate

⁴¹ *United Fuel Gas Co. v. Public Service Comm'n*, 73 W. Va. 571, 80 S.E. 931 (1914).

⁴² *Huntington v. Public Service Comm'n*, 101 W. Va. 378, 133 S.E. 144 (1926); *Pittsburgh & W. Va. Gas Co. v. Public Service Comm'n*, 101 W. Va. 63, 132 S.E. 497 (1926); *Bluefield Waterworks & Imp. Co. v. Public Service Comm'n*, 89 W. Va. 736, 110 S.E. 205 (1921).

⁴³ 89 W. Va. 703, 110 S.E. 192 (1921).

⁴⁴ 169 U.S. 466 (1897).

⁴⁵ *City of Charleston v. Public Service Comm'n*, 86 W. Va. 536, 103 S.E. 673 (1920); *Bluefield Waterworks & Imp. Co. v. Public Service Comm'n*, 89 W. Va. 736, 110 S.E. 205 (1921).

case reviewed by the court, *City of Wheeling v. Natural Gas Co.*,⁴⁶ the court strongly indicated that the commission should give more consideration to original cost and less to reproduction cost:

"This Court, since its decision in *Huntington v. Public Service Commission*, 89 W. Va. 703, 110 S. E. 192, down to the present, has repeatedly expressed the view that experts' testimony on reproduction new, etc., is at best most unsatisfactory, and that at least some consideration should be given original cost, where the conditions justify it. The Court, speaking through Judge Hatcher, in *Charleston v. Public Service Commission*, 110 W. Va. 254, 159 S. E. 38, calls attention to the fact that the United States Supreme Court in reversing this court in *Bluefield Water Works and Improvement Company v. Public Service Commission*, 263 U. S. 679, 43 S. Ct. 675, 67 L. Ed. 1176, did not say that evidence of reproduction costs, less depreciation, should be given even controlling much less exclusive weight. And that statement is amply supported by the recent opinion of Mr. Chief Justice Hughes in *Los Angeles Gas & Elec. Corp. v. Railroad Commission of California*, 289 U. S. 287, 53 S. Ct. 637, 77 L. ed. 1180.

"We, therefore, direct that the commission review its finding on present fair value, giving due regard to the original cost of the property. And, at this juncture, suggest that the enhanced values at which the purchases of other gas properties have been entered upon the books of the utility be carefully scrutinized."

This opinion is the sole comprehensive analysis of rate making by our Supreme Court of Appeals.

In general, the decisions of the Supreme Court of Appeals have furnished little assistance to the commission in fulfilling its duties of establishing reasonable rates. Although both the court and commission have consistently stated adherence to the rule of fair value, they have not in practice followed the holding of *Smyth v. Ames*. Evidencing an early preference for original cost, the commission has in practical effect ruled out all other methods of establishing the rate base, thus modifying the traditional concept of fair value—all apparently without disapproval of the court. Both commission and court have in reality adopted the principles of the *Hope* case rather than that of *Smyth v. Ames*. For in the last analysis, the Supreme Court of Appeals has based its determinations upon pragmatic results and not upon methods, and this has given the West Virginia commission practically unlimited prerogative in rate making. Although the commission continues

⁴⁶ 115 W. Va. 149, 175 S.E. 339 (1934).

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to proclaim its faithfulness to the principles of fair value, original cost remains the sole determinant of the rate base in West Virginia.

A RESUME OF A RATE CASE

Proceedings for rate increases may be initiated either by filing a formal petition, under rules of the commission,⁴⁷ or a new rate schedule, as provided by *Code* 24-2-4. Statutory requirements for notice to the public must be complied with, and are generally specified in the order of the commission setting a case for hearing. Throughout the proceeding, the company has the burden of proof. The first stage in preparing and presenting a rate case is the development of a *cost of service* for a so-called test period which is generally the preceding twelve months. This cost of service customarily is made up of four major factors: (1) operating expenses, (2) depreciation and depletion allowances for property consumed in providing service, (3) taxes, and (4) return to the investor for the use of his money computed by the rate base—rate of return formula. The commission staff often makes independent study and offers evidence.

THE ORIGINAL COST RATE BASE

The original cost for rate making purposes is established by the books and records of the company according to the classification of accounts required by the commission.⁴⁸ Where original cost figures are not available, an estimated original cost study is made and then booked. The customary test of whether property may properly be included in the rate base depends on whether it can be said to be "used or useful" in rendering public service. Property held for future use is often challenged by protestants. In addition to the original cost of plant, the commission allows as part of the rate base, materials and supplies required in day to day operations and a sum for working capital computed on the basis of forty-five days for gas and electric utilities which bill subsequent to the rendering of service, and, on a basis of fifteen days for utilities which bill in advance, such as telephone companies.

⁴⁷ See "Rules and Regulations for the Government of the Construction and Filing of Tariffs of Public Utilities and Common Carriers", promulgated by the commission in 1940.

⁴⁸ Original cost, sometimes referred to as "aboriginal cost", is defined in the Uniform System of Accounts for Electric Utilities, prescribed by the commission, as the cost of utility plant "at the time it was first placed in service, whether by the accounting utility or by a predecessor or constituent public utility or non-utility". The commission's practice is to average the plant account for the year rather than accept or use the year end figure.

The commission at the present time refuses to include in the rate base, over protest of many utilities, acquisition adjustments and construction work in progress.

Acquisition adjustments represent the difference between the actual cost of property to the utility and its historical "original cost". Many public utility systems in the state today are comprised of a number of small operating companies acquired over many years at an actual cost greatly exceeding the original cost of perhaps a half century ago. The failure of the commission to allow this differential for rate making purposes excludes a substantial portion of the actual cost to the utility of acquiring and putting together the systems which permit cheaper and more efficient service. The treatment given to acquisition adjustments stems in part from the Uniform System of Accounts which requires their segregation for accounting purposes.⁴⁹ The initial Federal Power Commission regulations made it clear that the segregation of such adjustments was not to be construed as determining or controlling their consideration in rate proceedings. Likewise, the West Virginia commission has stated that the accounting requirements should not be controlling for rate making purposes, but in no case has the commission allowed acquisition adjustment items as part of the rate base.⁵⁰ Where these adjustments represent sound investment in the interest of better and more economical public service based upon arms-length transactions, a large number of other regulatory bodies hold that they should be included in the rate base as a part of the utility's investment in property devoted to public use.⁵¹

The position of the commission with regard to construction work in progress likewise may be inconsistent with the original cost rate making concept which the commission has adopted, and work a hardship in times such as these. Public service corporations today have large amounts invested at all times in facilities in various stages of construction known as "construction work in progress". The utility is permitted to charge interest on such work but usually at a rate substantially less than a proper return, and it is often impracticable for the company to charge interest on all

⁴⁹ For example, electric utilities were required to reclassify the plant investment to: Account 100.1—plant account, Account 100.5—plant acquisition adjustments, and Account 100.7—plant adjustments.

⁵⁰ *Re* Wheeling Electric Co., 31 PSC REP. 49 (1944); *Re* Monongahela Power Co., 33 PSC REP. 34 (1945).

⁵¹ *Re* Arkansas Power & Light Co., 55 P.U.R. (N.S.) 129 (1944); Louisiana Pub. Serv. Comm'n v. Louisiana P. & L. Co., 65 P.U.R. (N.S.) 18 (1946); *Re* Michigan Ass'n Telephone Co., 88 P.U.R. (N.S.) 15 (1951); *Re* Southern Bell Telephone & Tel. Co., 91 P.U.R. (N.S.) 97 (1951).

construction. The refusal of the commission to include the uncompleted construction work in the rate base appears to stem from the theory that such property is not "used and useful". This test originated in cases where the utility challenged rates as confiscatory in the formative years of regulation when the reproduction cost was the favored method for determining the rate base and the "used and useful" standard was appropriate to this particular method of valuation.⁵² Under the original cost approach, however, the concept of "used and useful" in its traditional sense has little, if any, relevancy.⁵³ The propriety of including construction work in progress in the rate base under circumstances where interest is not charged has been approved by many regulatory commissions in recent cases.⁵⁴

OPERATING EXPENSES

The valuation of the rate base was for many years the principal area of dispute in rate proceedings. Recent cases, however, indicate a shift from rate base to operating expenses as the area of controversy. Computation of expenses is likewise influenced by the required accounting classifications. The test period is generally the most recent twelve months' experience for which figures are available, adjusted for changes which are known and measurable with reasonable accuracy. Known nonrecurring items are eliminated in an attempt to "normalize" the cost for the so-called test period.

Two troublesome problems concerning the allowance of operating expenses confront utilities under the jurisdiction of the West Virginia commission. The first affects utilities which operate in several jurisdictions and involves the proper allocation of costs and expenses. Utilities, like many other businesses, have grown across state lines. Under present day regulation, the federal commissions have jurisdiction over interstate rates and the rates for local service within a state are subject to the jurisdiction of the particular state in which the service is rendered.⁵⁵ For rate making purposes, costs of service must be allocated to interstate and intrastate operations. The principle underlying a proper allocation is the apportionment of costs which fairly measures the real use of the facilities by customers in the respective jurisdictional areas.

⁵² See *Washington Gas Light Co. v. Baker*, 188 F.2d 11, 89 P.U.R. (N.S.) 177, cert. denied, 340 U.S. 952 (1951).

⁵³ *Ibid.*

⁵⁴ *Re Potomac Electric Power Co.*, 89 P.U.R. (N.S.) 483 (1951); *Re Southern Utah Power Co.*, 78 P.U.R. (N.S.) 432 (1949); *Re Jamaica Water Supply Co.*, N.Y.P.S.C. Case No. 14296 (decided July 13, 1949); *Public Utilities Comm'n v. Bangor Hydro-Elec. Co.*, 92 P.U.R. (N.S.) 46 (1952).

⁵⁵ See note 12 *supra*.

Allocations of cost must necessarily be dependent upon operating and engineering data and many other factors. Since the Federal Power Commission has tended to apply rather rigid formulas of allocations by the grouping of operating expenses and costs of facilities by service functions,⁵⁶ and since some state commissions have frequently adopted a different formula, it is not uncommon that a utility fails to recover its total cost of service. Moreover, the West Virginia commission on occasion has accentuated the problem by disallowing costs actually incurred pursuant to rates subject to Federal Power Commission tariffs.⁵⁷

The second problem, and one which affects all utilities subject to the commission's jurisdiction, results from the rigid use of the test period. Whereas rates are made for the future, they must under the West Virginia commission's rule be based upon past experience. Costs must be experienced to be included in the cost of service, thereby creating a regulatory lag. The operating expenses of a utility are not stable but subject to continuing fluctuation, whereas rate proceedings before the commission approach the purported goal of reasonableness only for the period covered by the cost of service. Whereas rates may be just and reasonable at a given time, the dollar earnings that they, in fact, produce are actually fictitious, since, with constantly rising costs for labor and materials, coupled with continuous necessary expansion of plant facilities, there is chronic attrition in earnings. A utility never realizes all of its given rate of return, and as a result to protect its economic position it must file again and again for rate relief. It would, therefore, appear that the use of an inflexible test period is inequitable and outmoded. A proper and fair cost of service is not something that can be delicately balanced on scales: Rates cannot be fixed with mathematical precision, but should be established within a sensible zone of reasonableness. A step taken in this direction by some commissions is the allowance of commodity and other escalator clauses which provide the utility with some hedge against inflation and the serious problems of regulatory lag.⁵⁸ Other commissions give consideration to items of cost which, although they are not reflected during the test period, may reasonably be expected to occur in the future.⁵⁹

⁵⁶ See *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930).

⁵⁷ *Re Amere Gas Utilities Co.*, 1 P.U.R.3d 280 (1953).

⁵⁸ See *The Adjustment Clause, an Aid to Rate Regulation*, 53 P.U. FOR. 465 (1954).

⁵⁹ See *Re Indiana Gas & Water Co.*, 77 P.U.R. (N.S.) 1 (1949); *Re Pennsylvania P.U.C. v. Pennsylvania Tel. Corp.*, 86 P.U.R. (N.S.) 292 (1950). The West Virginia and Federal Power Commissions strictly adhere to the test

RATE MAKING

DEPRECIATION

The subject of depreciation is both complicated and controversial. The classic definition of its meaning is "the loss, not restored by current maintenance, which is due to all factors causing the ultimate retirement of the property, embracing wear and tear, decay, inadequacy and obsolescence".⁶⁰ Unlike other utility expenses or deductions, it has a two-fold place in a rate case: (1) as an annual charge or expense to prevent final consumption of the utility investment; and (2) as an accrued reserve representing an adjustment to the rate base for depreciation taken in prior years. Since the early development of rate making, the necessity of making adjustments for depreciation has never been seriously questioned, but the method of computation often remains a disputed problem in a rate case.

Originally, the West Virginia commission did not allow depreciation as an operating cost, but considered it as a part of the allowance made to the utility for return upon investment and risks incident to the business.⁶¹ Utilities were required to keep their depreciation accounts on a sinking fund basis, and no annual charge was permitted. Since the late 1920's, however, the commission has recognized that an annual operating charge should be allowed to take care of depreciation so that a sufficient balance will accrue in the depreciation reserve for the purpose of protecting the investor against loss occasioned by retirements.⁶²

The commission's present views on depreciation are largely influenced by original cost accounting and stem from the Uniform System of Accounts. Whereas originally fair value was the basis for computation rather than book cost, the commission now requires that original cost be amortized through an annual allowance for depreciation and depletion.⁶³ The so-called "straight line" method has become the accepted method of computing both the annual charge and the reserve. By this method, the estimated age-life of depreciable property is estimated and from this the salvage value is deducted. The estimated life of the property must be taken into account in determining the amortization rate

period and refuse to allow prospective expenses even if measurable by contractual commitments.

⁶⁰ *Lindheimer v. Illinois Bell Tel. Co.*, 292 U.S. 151 (1934).

⁶¹ *Re Southside Water Works Co.*, P.U.R. 1920D 752 (1920).

⁶² *Re United Fuel Gas Co.*, P.U.R. 1924A 357 (1923); *Re W. Va. Central Gas Co.*, P.U.R. 1924E (1924); *Re Clarksburg Light & Heat Co.*, P.U.R. 1928B 290 (1927).

⁶³ *Re United Fuel Gas Co.*, P.U.R. 1925B 705 (1925); *Re Cumberland & Allegheny Gas Co.*, P.U.R. 1928B 20 (1927).

and not the remaining life at the time of the rate case. The original cost is then divided by the estimated age-life to determine the permissible annual depreciation charge, which is usually computed and allowed on the basis of a composite depreciation rate for all depreciable property in the several plant accounts. This composite rate varies among utilities. The depreciation reserve established by the utility is adjusted to reflect proper accrued depreciation when the rate base is first determined in a commission proceeding, booked and kept current by the commission's accounting requirements. This method assumes that depreciation progresses yearly on a uniform basis, which is often contrary to fact.

Although the commission has recognized that the purpose and function of the depreciation reserve and annual charge is to protect the investment in utility plant and proper maintenance thereof for public service, the purported accomplishment is illusory under present commission practice. The use of the original cost for amortization purposes fails to protect plant investment during periods of sustained inflation. The "straight line" method computed according to original cost is fair to both investor and consumer in periods of stable currency, but is grossly unfair in times of rising costs for replacements must be bought with inflated dollars and effective purchasing power is diminished. A depreciation reserve to replace an item of plant costing many times its cost of ten years ago, is obviously inadequate, and the equity of the investor is in large measure confiscated. The inequitable results currently reached would seem to require a reappraisal of permissible depreciation charges and reserve balances by the commission.

RATE OF RETURN

The rate of return is a judgment figure selected by the commission to produce reasonable earnings by the utility on a predetermined rate base. Operating expenses, taxes and depreciation are deducted from revenues produced by existing rates. The net revenue is then divided by the rate base which gives a percentage figure, which is called the rate of return. If this return fails to equal what is considered a "fair" return by the commission, tariffs may be increased sufficiently to raise the rate of return to the percentage considered proper.

Historically, the return is legally "fair" unless it results in confiscation. The United States Supreme Court has required that all relevant facts be considered in fixing the annual rate.⁶⁴ The

⁶⁴ See *Bluefield Waterworks & Imp. Co. v. Public Service Comm'n*, 89 W. Va. 736, 110 S.E. 205 (1921).

West Virginia commission, with judicial sanction, has approached the problem pragmatically.⁶⁵ The orders of the commission indicate that fair return is to be based upon existing circumstances and not upon an arbitrary percentage. The rate of return has varied from case to case,⁶⁶ and few conclusions can be drawn from the results other than the fact that this component of the rate formula seems the most flexible in application. Generally, the commission has used earnings of other regulated companies with comparable risk instead of unregulated industry as the yardstick.

In recent years a shift has occurred in the meaning of "rate of return". The West Virginia commission, along with others, now considers return as an expense of doing business and thus an essential part of the cost of service. This result has been caused in large measure by the tremendous expansion of utility services in the last two decades. The increased demands for service have necessitated additional capital as a recurring item and the cost of obtaining new money has, in effect, constituted an operating expense. Rate of return has thus become a judgment figure stated in a percentage which is designed to yield an amount to those who have capital invested in the utility enterprise and constitutes payment for three things: (1) the risk taken by the investor; (2) the cost incurred in marketing securities and raising new capital; and (3) pure interest. Among the problems encountered in arriving at the proper rate are the historical cost of money for the particular utility as compared with the present and prospective costs of money for future financing, the difficulty of maintaining a proper debt-equity ratio, and the elusive problem of compensation for the element of risk. Moreover, the return should be sufficient to permit adequate maintenance and reasonable additions to surplus to permit expansion and provide a hedge against inflation. The majority of the orders of the commission appear to limit rate of return to bare costs of money without recognition of the need of appropriate transfers to surplus.

As long as the commission follows the principle of limiting the rate of return to the historical cost of money, a utility has great difficulty in improving its debt-equity ratio, and manifestly, the attraction of new equity capital for expansion or other proper purposes may be seriously impaired. Stocks of utilities often sell

⁶⁵ See *C. & P. Tel. Co.*, 38 P.S.C. REP. 80 (1950), 39 P.S.C. REP. 67 (1951); *Huntington v. Public Service Comm'n*, 101 W. Va. 378, 133 S.E. 144 (1926); *Wheeling v. Natural Gas Co.*, 115 W. Va. 149, 175 S.E. 339 (1934).

⁶⁶ Although 6% appears to constitute the present norm, the rate varies according to utility, capital structure, market conditions, and expediency.

below current market trends under these circumstances, and, sometimes, even in the case of a well managed company, at less than book value. The commission, in recognition of these problems, has in a few recent cases, departed in some measure from its rather fixed views as to rate of return and has allowed net earnings slightly in excess of six per cent.

CONCLUSION

Original cost rate making presents serious problems, only a few of which have been mentioned. In most respects, original cost accounting, as the fixed standard for rate making, is both reasonable and appealing. Since utilities are required to keep their accounts upon such basis, many complexities and delays inherent in the controversial reproduction cost new rate base are avoided. The chief difficulty with original cost, as the sole standard for rate making, is its inflexibility to meet rapidly changing economic conditions. It involves a backward look whereas rates must be made for the future. In a period of rapid inflation or deflation, as the case may be, original cost is likely to be too fixed and inflexible for arriving at fair and just rates. The period of stable economic conditions is seldom of long duration, and during the current period of rising prices since World War II, the common stockholder of a utility has lost heavily on two counts because of the original cost formula. The investors' real capital is not maintained intact because the consumer pays rates that do not compensate fairly for the value of property used in rendering the service and the equity investor faces the necessity in an expanding business of either providing new capital or taking on new partners to finance high cost construction. Secondly, the shareholder loses because of inflation: he invested a 100 cents dollar and receives only a 48 cents dollar in the form of dividends. While not yet apparent in this state, some courts in other jurisdictions have recently appeared to be more aware of the equity in the true fair value concept.⁶⁷

It is submitted that as long as the current rate making philosophy of the West Virginia commission is purely a mechanical process, geared solely to a strict bookkeeping basis, an ominous threat exists to realistic regulation which is necessary to sustain the growth of the utility business with fair and equal treatment to both the investor and consumer. Anyone who intelligently invests in a utility is concerned not only with the quantity of dividends

⁶⁷ See note 15 *supra*.

but the quality thereof and the regulatory climate has much to do with an investor's willingness or unwillingness to provide equity capital for the tremendous expansion common to all utilities during the past ten years. It has become increasingly more difficult to finance such growth and if the inflationary trend continues, strict adherence to the original cost concept could cripple, if not ultimately destroy, private enterprise in the utility field.

That the commission is confronted with a formidable task in rate regulation cannot be gainsaid. Irrespective of the formulas and procedures followed, it is impossible to fix a rate which is perfectly fair to both the consumer and the utility. The commission must weigh countless factors, tangible and intangible. The general economic outlook must be appraised, as well as the economics peculiar to the business of the applicant. No two rate cases are alike because of wide variations in plant, sales, growth potential and financial and operational problems even among utilities engaged in the same public service within a similar area. In these times of rapid expansion of public services at highly inflated cost the commission has been deluged with an unprecedented number of rate cases, many of which have raised difficult questions of first impression in this state. Its technical staff is overworked. The commission is plagued by the pleas of the utilities, on the one hand, and the clamor of the consumer and public, on the other. Mayors and other politicians sometimes see advantages to intervening in rate cases. The public generally is inclined to oppose rate increases, particularly since it gives vicarious relief to the frustrating experience of encountering inflated prices at every turn.

These factors, coupled with the reluctance of the Supreme Court of Appeals to establish guiding principles for the benefit of the commission and parties in interest, have understandably resulted in a conservative and rather inflexible regulatory climate in this state.⁶⁸ The consumer may get an immediate advantage, but in the long run, service is likely to be impaired by curtailment of additions and betterments. There are no ready panaceas and the complexities are formidable. The problem demands continuing study by the commission, practitioners and the informed public.

⁶⁸ It now appears that the commission will no longer grant interim rate relief, despite its former practice, sanctioned by the Supreme Court of Appeals.