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# THE DEMISE OF FAIR VALUE

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# THE DEMISE OF FAIR VALUE

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Two years ago, in discussing the *Natural Gas Pipeline Company* case,[1] the writer ventured the opinion that "while it cannot be stated with certainty that the decision marks the demise of that hardy perennial—fair value—since the majority opinion did not explicitly repudiate that doctrine," there was language which indicated that such would nevertheless be the result of the decision.[2] This prophecy now appears to be substantiated by the decision of the Supreme Court on January 3, 1944, in *Federal Power Commission v. Hope Natural Gas Company*.[3] In the *Pipeline Company* case Chief Justice Stone stated significantly that "the Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas," and that "if the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end."[4] This statement is not necessarily inconsistent with the *Smyth v. Ames* doctrine,[5] however, and it was not clear in the *Pipeline Company* case whether the rate reduction ordered by the Federal Power Commission was sustained because the rate base and level of earnings allowed by the commission were higher than were required by the *Smyth v. Ames* test of confiscation, or whether the Court had substituted for that test the economic test of confiscation and had sustained the reduction because it did not prevent the company from operating profitably and successfully.

But in the *Hope* case the necessity of choosing between these two tests of confiscation was squarely presented and the Court definitely

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The views expressed in this paper are those of the writer and should not be construed as reflecting the views of any government agency.

[1] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 62 S. Ct. 736 (1942).

[2] R. W. Harbeson, "Public Utility Regulation: A New Chapter," 20 HARV. BUS. REV. 496 at 496 (1942).

[3] (U.S. 1944) 64 S. Ct. 281.

[4] Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575 at 586 (1942).

[5] 169 U.S. 466, 18 S. Ct. 418 (1898). See also R. L. Hale, "Does the Ghost of Smyth v. Ames Still Walk?" 55 HARV. L. REV. 1116 (1942).

abandoned the fair value test. The implications of this decision, in the writer's judgment, may fairly be called epochal. It removes the incubus of an illogical, uneconomic and administratively unworkable legal doctrine which has rested on state and federal commissions for nearly forty-six years and which has nullified efforts to bring about effective regulation. For the first time the possibilities of commission regulation as an alternative to public ownership may now be fairly tested.

The essential factual background of the case may be stated briefly. The Hope Natural Gas Company, a subsidiary of the Standard Oil Company of New Jersey, produces, purchases and markets natural gas in West Virginia. The great bulk of the gas is sold to five distributing companies serving eastern Ohio and western Pennsylvania. Three of these companies, including the important East Ohio Gas Company, serving Cleveland, Akron, and other large communities, are, like the Hope Company, subsidiaries of Standard Oil of New Jersey. In July 1938 the cities of Cleveland and Akron filed complaints with the Federal Power Commission alleging that the rates collected by Hope from the East Ohio Company were excessive and unreasonable. Later in 1938 the Federal Power Commission on its own motion instituted an investigation of Hope's interstate rates. In March 1939 the Pennsylvania Public Utility Commission filed a complaint similar to that filed by Cleveland and Akron. The city of Cleveland asked that the challenged rates be declared unlawful and that reasonable rates be determined from June 30, 1939, to the date of the Federal Power Commission's order. This was requested as an aid to state regulation and to afford the Public Utilities Commission of Ohio a proper basis for disposing of a fund collected under bond by the East Ohio Company since June 30, 1939. The State of West Virginia and its Public Service Commission intervened in opposition to the proposed reduction in Hope's interstate rates on grounds which will be discussed below.

The foregoing complaints were consolidated, hearings were held, and on May 26, 1942, the Federal Power Commission entered its order and made its findings.[6] Hope was required to decrease its future interstate rates so as to effect an annual reduction of not less than $3,609,857 in operating revenues. Just and reasonable average rates per thousand cubic feet of gas were established for each of the five customer companies. In response to the request of the city of Cleveland, the com-

[6] Federal Power Commission v. Hope Natural Gas Co., 44 P.U.R. (N.S.) 1 (1942).

mission also made findings as to the lawfulness of past rates, although conceding that it had no authority to fix past rates or to award reparations. The rates collected by Hope from East Ohio were found to have been excessive, unreasonable, and therefore unlawful, by $830,892 during 1939, $3,219,551 during 1940, and $2,815,789 on an annual basis thereafter.

As a basis for its order the commission established an interstate rate base in the following manner. The actual legitimate cost of the plant in interstate service was found to be $51,957,416 as of December 31, 1940. This was equal to the company's book cost with minor adjustments. To this sum was added $1,392,021 for future net capital additions, $566,105 for useful unoperated acreage, and $2,125,000 for working capital. There was deducted $22,328,016 for accrued depreciation, based on the service-life principle and computed by the straight-line method. The resulting rate base totaled $33,712,526, upon which the commission allowed a six and one-half per cent return. The year 1940 was taken as a test period to estimate future revenues and expenses.

By contrast the Hope Company contended for a rate base of $66,000,000. This represented an estimated reproduction cost of the property of $97,000,000, less accrued depreciation of about 35 percent of that amount, estimated by the "percent condition," or inspection method. The company also presented a so-called "trended original cost" estimate exceeding $105,000,000, which purported to show "what the original cost of property would have been if 1938 material and labor prices had prevailed throughout the whole period of the piecemeal construction of the company's property since 1898."[7] The company's estimate of actual original cost was $69,735,000, or approximately $17,000,000 in excess of the commission's figure. The latter amount represented certain items which prior to December 31, 1938, had been charged to operating expenses, and which the commission refused to include in the rate base on the ground that "no greater injustice to consumers could be done than to allow items as operating expenses and at a later date include them in the rate base, thereby placing multiple charges upon the consumers."[8] The items in question were $12,600,000 expended in well-drilling prior to 1923, during which period the prevailing accounting practice in the industry, as well

[7] Id. at 8-9.
[8] Id. at 12.

as the policy of the West Virginia Commission, called for charging these sums as expenses rather than as additions to capital; $1,600,000 expended on properties which Hope had acquired from other utilities, the latter having in turn charged those payments to operating expenses; and $3,000,000 in various overheads which the company had likewise treated as operating costs. The commission also refused to add $632,-000 as interest during construction on the ground that no interest had been in fact paid. The company contended for a rate of return of not less than eight per cent, as compared with the six and one-half per cent fixed by the commission.

It should also be noted that the commission found that during the years when Hope was not under regulation it had not observed "sound depreciation and depletion practices" and had accumulated an excessive depreciation reserve totaling $46,000,000.[9] At the end of 1938 the reserve was about $18,000,000 in excess of the amount determined by the commission to be the proper reserve requirement, and in addition the commission found that the company had in the past transferred $7,500,000 from the reserve to surplus. Thus the reserve was excessive by $25,500,000. One member of the commission held that the entire reserve, including the excess, should be deducted from the rate base, but the majority ruled that where incorrect depreciation practices had prevailed in the past and a business is brought under regulation for the first time the actual reserve requirement rather than the excessive reserve should be deducted in order to lay "a sound basis for future regulation and control of rates."[10]

Upon appeal the commission's order was set aside by the circuit court on three grounds.[11] First, it held that the commission erred fundamentally in not finding the "present fair value" of the property, that to arrive at such a figure reproduction cost and trended original cost should have been considered, and that prudent investment was not a proper measure of fair value when price levels had charged. Second, it held that the $17,000,000 representing well-drilling costs and other items, which had previously been charged to operating expense, should be included in the rate base. Third, it held, on the authority of the *United Railways*[12] case, that both accrued depreciation and the annual

[9] Id. at 18.
[10] Ibid.
[11] Hope Natural Gas Co. v. Federal Power Commission, (C.C.A. 4th, 1943) 134 F. (2d) 287.
[12] United Railways of Baltimore v. West, 280 U.S. 234, 50 S. Ct. 123 (1930).

depreciation allowance should be related to present fair value rather than original cost. It also contended that the commission's findings with respect to depreciation were invalidated because they were based on "theoretical" service-life calculations rather than upon inspection of the current condition of the property. The lower court also held that the commission had no power to make findings as to past rates in aid of state regulation, and that, while it could properly make such findings as a step in the process of fixing future rates, the findings were invalidated by the same errors which vitiated the findings on which the rate order was based. The case was brought before the Supreme Court through petitions for writs of certiorari.

The decision of the Supreme Court resulted in five opinions. Justice Douglas wrote the opinion for a majority of five, Justices Black and Murphy wrote a brief concurring opinion, while Justices Reed, Frankfurter and Jackson each wrote a dissenting opinion. Justice Roberts took no part in the case. The opinion of Justices Black and Murphy may be quickly dismissed. They stated that they agreed with the opinion of Justice Douglas and would have added nothing to what had been said "but for what is patently a wholly gratuitous assertion as to constitutional law in the dissent of Mr. Justice Frankfurter," namely, his statement that "Congressional acquiescence to date in the doctrine of Chicago, etc. R. Co. v. Minnesota, supra, . . . may fairly be claimed."[13] This was, of course, the decision which extended the meaning of due process from a protection against procedural irregularities only to matters of substantive law, and thereby enabled the courts to veto economic legislation. The two justices stated that it was not their understanding that Congress had voluntarily acquiesced in that principle and that they personally never had acquiesced in it and did not now. We turn next to a consideration of the issues discussed in the other opinions.

The portion of the majority opinion dealing with the all-important question of the validity of the commission's rate order is brief and the steps in the argument may be easily traced. The Court considered first the statutory basis for the commission's action. Section 4 (a) of the Natural Gas Act[14] provides that all natural gas rates subject to the commission's jurisdiction shall be just and reasonable. Section 5 (a) gives the commission power, after hearing, to determine the just and reasonable rate to be thereafter observed and to fix the rate by order.

[13] Federal Power Commission v. Hope Natural Gas Co., (U.S. 1944) 64 S. Ct. 281 at 296.

[14] 52 Stat. L. 833 (1938); 15 U.S.C. (1940) §§ 717-717w.

This section also gives the commission power to decrease existing rates where these are unjust, unlawful or not the lowest reasonable rates. Finally, section 19 (b) provides that on review of these rate orders the "finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." With regard to these statutory provisions, Justice Douglas observed that "Congress, however, has provided no formula by which the 'just and reasonable' rate is to be determined. It has not filled in the details of the general prescription of § 4(a) and § 5(a). It has not expressed in a specific rule the fixed principle of 'just and reasonable'."[15]

Next the Court referred briefly to the grounds upon which it had sustained the constitutionality of the Natural Gas Act in the *Pipeline* case, making the following significant comment:

> ". . . Rate-making is indeed but one species of price-fixing. Munn v. Illinois, 94 U.S. 113, 134. The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid. Block v. Hirsh, 256 U.S. 135, 155-157; Nebbia v. New York, 291 U.S. 502, 523-539, and cases cited. It does, however, indicate that 'fair value' is the end product of the process of rate-making not the starting point as the Circuit Court of Appeals held. The heart of the matter is that rates cannot be made to depend upon 'fair value' when the value of the going enterprise depends on earnings under whatever rates may be anticipated."[16]

This statement, among other things, would seem to dispose of the fallacy of the eminent domain analogy resorted to by the Court in connection with the development of the fair value doctrine. In several cases the Court indicated that fair value for rate-making purposes was analogous to the value sought in condemnation proceedings, while simultaneously taking the inconsistent position that rate reductions which operated to destroy part of the "value" of the property were nevertheless permissible.[17]

[15] Federal Power Commission v. Hope Natural Gas Co., (U.S. 1944) 64 S. Ct. 281 at 287.

[16] Ibid.

[17] See Ames v. Union Pacific Ry. Co., (C.C. Neb. 1894) 64 F. 165; West v. Chesapeake and Potomac Tel. Co., 295 U.S. 662, 55 S. Ct. 894 (1935); Denver Union Stockyard Co. v. United States, 304 U.S. 470, 58 S. Ct. 990 (1938). See also R. L. Hale, "The 'Fair Value' Merry-Go-Round, 1898 to 1938: A Forty-Year

Justice Douglas next stated the principles by which the Court would be governed in passing upon the validity of the commission's order. This is the heart of the decision, and because of its very great importance the pronouncement is quoted at length:

> "We held in Federal Power Commission v. Natural Gas Pipeline Co., supra, that the Commission was not bound to the use of any single formula or combination of formulae in determining rates. . . . Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling. Cf. Los Angeles Gas & Electric Corp. v. Railroad Commission, 289 U.S. 287, 304-305, 314; West Ohio Gas Co. v. Commission (No. 1), 294 U.S. 63, 70; West v. Chesapeake & Potomac Tel. Co., 295 U.S. 662, 692-693 (dissenting opinion). It is not 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 unreasonble, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important. . . . Cf. Railroad Commission v. Cumberland Tel. & T. Co., 212 U.S. 414; Lindheimer v. Illinois Tel. Co., supra, 292 U.S. at pages 164, 169; Railroad Commission v. Pacific Gas & E. Co., 302 U.S. 388, 401.
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> "The rate-making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests. . . . From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. Cf. Chicago and Grand Trunk Ry. Co. v. Wellman, 143 U.S. 339, 345-46. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. See State of Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Commission, 262 U.S. 276, 291 (Mr. Justice Brandeis concur-

Journey from Rates-Based-on-Value to Value-Based-on-Rates," 33 ILL. L. REV. 517 (1939). In Los Angeles Gas & Electric Co. v. R.R. Commission of California, 289 U.S. 287, 53 S. Ct. 637 (1933), Chief Justice Hughes stated that when rates are in dispute "earnings produced by rates do not afford a standard for decision." Id. at 305. But his accompanying comments leave it uncertain whether he rejected market value for rate base purposes because evidence of market value was ordinarily lacking in the case of public utility properties or because he was aware of the circular reasoning involved if it were used. See 2 BONBRIGHT, VALUATION OF PROPERTY 1117 (1937).

ring). The conditions under which more or less might be allowed are not important here. Nor is it important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at. For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the investor or company viewpoint."[18]

The Court then reviewed the impressive evidence upon the basis of which it had reached the latter conclusion. During the first forty years of its operation the Hope Company had paid over $97,000,000 in cash dividends. Down to 1940 it earned twenty per cent per year on the average annual amount of its capital stock issued for cash or other assets, and it earned about twelve per cent per year on an average invested capital of $23,000,000. During the years 1939, 1940 and 1941 its dividend rate was ten per cent and in 1942, during about half of which the lower rates were in effect, it paid dividends of seven and one-half per cent. In addition it had an earned surplus of $13,700,000 at the end of 1942, which was equal to almost half the par value of its outstanding stock, and a depreciation reserve of $46,000,000, which was greatly in excess of what the commission had found to be the actually accrued depreciation. The commission likewise, after extensive study of the company's financial history and of the natural gas industry, pointed out that the company's risk had been minimized by adequate depreciation and depletion allowances, and that "the company's efficient management, established markets, financial record, affiliations, and its prospective business place it in a strong position to attract capital upon favorable terms when it is required."[19] After reviewing this evidence, Justice Douglas summed up the Court's view of the meaning of confiscation in the statement that "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."[20]

[18] Federal Power Commission v. Hope Natural Gas Co., (U.S. 1944) 64 S. Ct. 281 at 287-288.

[19] Federal Power Commission v. Hope Natural Gas Co., 44 P.U.R. (N.S.) 1 at 33 (1942).

[20] Federal Power Commission v. Hope Natural Gas Co., (U.S. 1944) 64 S. Ct. 281 at 289.

Three observations may be made concerning the foregoing doctrine of the majority. First, it once more makes controlling the position taken by the Court a decade ago in the *Lindheimer*[21] and *Dayton Power and Light*[22] cases which were cited by Justice Douglas in support of the statement just quoted. It is true that in several important decisions subsequent to the *Lindheimer* and *Dayton* cases the Court reverted to the fair value doctrine,[23] and that nowhere in either the *Pipeline* case or the present decision is there any statement to the effect that *Smyth v. Ames* is overruled. But in view of the changed personnel of the Court and the statements contained in the foregoing quotations from the present case, the prospects for continued adherence to the new test of confiscation are, in the writer's opinion, greatly improved.

In the second place, the new test is not so precise and objective that there could be no question as to whether its requirements had been met by a regulatory body in any given case. In both the *Pipeline* and *Hope* cases, as well as in the earlier *Lindheimer* case, the companies involved were so profitable that it would have been almost impossible for the Court in applying the new test of confiscation to have reached a different conclusion. But in the future we may expect marginal cases to arise, where it would be debatable whether or not a given level of rates was resulting in confiscation as measured by the new test. The application of the new test will demand insight and caution on the part of commissions and restraint on the part of the courts if satisfactory regulation is to be achieved. Judgment concerning the administrative workability of the new test must therefore be reserved until it is given concreteness through application in marginal cases in the future. But it would be almost impossible for the new test not to be a vast improvement over the fair value doctrine.

Third, the effect of the *Pipeline* and *Hope* cases is to reduce the exaggerated importance which attached to the rate base during the ascendancy of the fair value doctrine. The cases in question do not

[21] Lindheimer v. Illinois Bell Telephone Co., 292 U.S. 151, 54 S. Ct. 658 (1934).

[22] Dayton Power and Light Co. v. P.U. Com. of Ohio, 292 U.S. 290, 54 S. Ct. 647 (1934).

[23] West v. Chesapeake and Potomac Tel. Co., 295 U.S. 662 (1935); McCart v. Indianapolis Water Co., 302 U.S. 419, 58 S. Ct. 324 (1938); Denver Union Stockyard Co. v. United States, 304 U.S. 470 (1938); Driscoll v. Edison Lt. and Pr. Co., 307 U.S. 104, 59 S. Ct. 715 (1939).

approve, much less require, prudent investment or any other type of rate base. The emphasis on the level of earnings permitted is altogether sound and logical, and one consequence may be that the hitherto neglected factor of the rate of return will achieve, and properly, an importance comparable to that of the rate base in rate regulation.

Justice Jackson in his dissenting opinion agreed that "the theory of the court below that ties rate-making to the fair-value-reproduction-cost formula should be overruled as in conflict with Federal Power Commission v. Natural Gas Pipeline Co." [24] Presumably, this was also Justice Frankfurter's view, inasmuch as he expressed agreement with Jackson's opinion. However, Justice Jackson objected to the reasoning upon which the majority sustained the commission's rate order, as well as to other aspects of the majority opinion which will be considered below. With regard to the rate order, he complained that "the Court sustains this order as reasonable, but what makes it so or what could possibly make it otherwise, I cannot learn. . . . The Court does lean somewhat on considerations of capitalization and dividend history and requirements for dividends on outstanding stock. But I can give no real weight to that for it is generally and I think deservedly in discredit as any guide in rate cases." [25]

In the writer's view this is not a fair or accurate statement of the majority's position. It is true that ordinarily capitalization cannot be taken as equivalent of investment, but the majority say nothing to the contrary. It is also true that inability to pay dividends does not necessarily indicate that rates are too low but may result from such factors as inefficient management, excessive capitalization, faulty capital structure, improper financial practices, or declining markets. But the majority clearly permits commissions to consider such factors. In the portion of Justice Douglas's opinion quoted above it will be noted that, after stating the general rule that companies are entitled to revenues which will cover both operating expenses and capital costs, including interest and dividends, and will enable the companies to attract capital

[24] Federal Power Commission v. Hope Natural Gas Co., (U.S. 1944) 64 S. Ct. 281 at 300.

[25] Id. at 308. Justice Jackson cited in support of this statement 2 BONBRIGHT, VALUATION OF PROPERTY 1112 (1937). But Bonbright merely says, on the page referred to, that the par value of a company's securities is not acceptable evidence of the commercial value of the company or even of the securities themselves.

on favorable terms, he adds that "the conditions under which more or less might be allowed are not important here."[26]

Justice Jackson also contended that while the regulation of earnings with reference to a rate base was appropriate in the case of the transmission of natural gas, this procedure was not suitable in the fixing of compensation for the production of such gas. The reason he advanced in support of this conclusion was that in the transmission of gas and in other utility enterprise there is a fairly close relationship between the amount of service rendered and the magnitude of the investment, while in the production of natural gas "there is little more relation between the investment and the results than in a game of poker."[27] He contended, furthermore, that, by whatever method found, a rate base is of little help in determining the reasonable price of gas because the "present value" of the intangible rights to capture gas—leaseholds and freeholds—depended on the value assigned to the gas when captured; that the Hope Company had not asked that its gas fields be appraised on the present value basis; and that in earlier natural gas cases the chief issue between companies and commissions was the "value" to be assigned to gas leaseholds. Therefore, in Justice Jackson's view, gas can be directly priced more reasonably and easily than the components of a rate base can be valued, and commissions should be free "to fix the price of gas in the field as one would fix the maximum prices of oil or milk or coal, or any other commodity. Such a price is not calculated to produce a fair return on the synthetic value of a rate base of any individual producer, and would not undertake to assure a fair return to any producer. The emphasis would shift from the producer to the product, which would be regulated with an eye to average or typical producing conditions in the field."[28]

Once again, the writer fails to find Justice Jackson's argument convincing. It is true, of course, that in an aleatory business, such as natural gas production, there are very wide variations in the return secured on a given investment by different producers, but the difference between the natural gas business and other businesses in this respect is one of degree only and not of kind. There would seem to be no reason why those who assume the risk of securing a meager return, or no return at

[26] Federal Power Commission v. Hope Natural Gas Co., (U.S. 1944) 64 S. Ct. 281 at 288.

[27] Id. at 310.

[28] Id. at 311.

all, on a given investment in natural gas production could not be satisfactorily compensated by an allowance in the permitted rate of return appropriate to the degree of risk involved. Justice Jackson correctly criticizes the appraisal of gas leaseholds and freeholds on the "present value" basis as illogical and unworkable, but this difficulty has been removed by the majority opinion in the present case, as a result of which commissions will now be able to put this item into the rate base at actual cost.

It is also true that the principle of rate-making applied to Hope's own gas could not be applied to the gas which it purchased from independent producers, which amounted to two-thirds of the total delivered. But the return allowed Hope was a net return over and above its outlays for purchased gas, and Justice Douglas specifically stated that the producing states were free to protect the interests of those who sold to interstate pipelines. Finally, in view of the concentration of pipeline systems in the hands of a few companies, which also in many cases control large gas-producing acreage, the bargaining advantage which these organizations have in dealing with small independent producers, and the need for maintaining production by marginal operators, it does not seem to the writer that it would be feasible to fix the maximum price of gas in the same manner "as one would fix the maximum price of oil or milk or coal, or any other commodity."[29] Nor is it clear to the writer that the price of gas could be fixed directly more satisfactorily than by reference to an actual cost rate base.

Justice Reed, in his separate dissenting opinion, disagreed with the majority's doctrine that it made no difference how the commission reached its conclusions with respect to the appropriate level of earnings so long as the result was fair and reasonable. He held that when the phrase "just and reasonable" was used in the Natural Gas Act to describe allowable rates "it had relation to something ascertainable," namely, rates which would produce a fair return on the fair value of the property.[30] Furthermore, in his view, the decision as to a reasonable return had not been a source of much difficulty. "And although the determination of fair value had been troublesome, its essentials had been worked out in fairness to investor and consumer by the time of the enactment of this Act. Cf. Los Angeles G. & E. Corp. v. Railroad

[29] Ibid.
[30] Id. at 297.

Comm., 289 U.S. 287, 304, et seq. The results were well known to Congress and had that body desired to depart from the traditional concepts of fair value and earnings, it would have stated its intention plainly. Helvering v. Griffiths, 318 U.S. 371."[31] Hence, the commission was required to consider historical cost, prudent investment, and reproduction cost in arriving at its determination, but was free to give such weight as it deemed reasonable to these and other factors. He concluded that the commission had observed this duty and that the level of earnings which it prescribed did not indicate confiscation or unreasonableness; not, however, on the grounds stated by the majority, but because, in his view, the commission had found the fair value of the property and had allowed a fair return thereon.

In view of its conclusions as to the adequacy of the rates prescribed by the commission to protect the financial integrity of the Hope Company the majority found it unnecessary to consider the merits of the commission's action in refusing to include in the rate base the $17,000,000 of well-drilling outlays and other items which had previously been charged to operating expense. Both Justice Reed and Justice Jackson dissented vigorously to this action of the majority on the ground that exclusion of these items violated the logic of the prudent investment principle, that, in Justice Jackson's words, it gave "a significance to formal classification in account keeping that seems inconsistent with rational rate regulation,"[32] and, by implication, that it constituted inequitable treatment of the company.

In the writer's view, considerations of logic with respect to the rate base should not be allowed to prevail when these conflict with policies necessary for equitable treatment of either companies or consumers. In the present case the commission was clearly correct in holding that the exclusion of the $17,000,000 was necessary to avoid inequitable double charging of consumers. At the same time this action worked no hardship on the company, in view of the fact that during the preregulation period its earnings were in excess of a normal competitive return and that after paying generous dividends it had accumulated a substantial surplus in addition to an excessive depreciation reserve. The company had no claim to earnings in excess of a normal competitive return and, considered retroactively, the commission's action did not reduce the company's earnings below that level in the preregulation period. Had

[31] Ibid.
[32] Id. at 307.

the company's financial history been of the opposite sort through no fault of its own, equity would have required a different treatment of the items in question.

With respect to depreciation the majority achieved a notable advance by accepting actual cost as the proper depreciation base and specifically overruling *United Railways v. West.*[33] Another point of the first importance is that the Court expressed no objection to the commission's use of the service-life method of computing accrued depreciation despite the contention of the company that the "percent-condition," or inspection, method should be used. Thus the Court has once more indicated that it will accept the service-life method where, as here, it is developed on the basis of a careful study of the experience of the particular property in question.[34] The way is thus open to commissions to remedy the inadequate allowances for depreciation which characteristically result from reliance on the inspection method.

Only one important legal obstacle to effective regulatory treatment of depreciation remains. The decision in *Board of Public Utility Commissioners v. New York Telephone Co.*,[35] which holds that a company's depreciation reserve is its unrestricted property, fails to recognize the inseparable connection between the annual depreciation allowance and accrued depreciation and prevents commissions from correcting or deducting excessive reserves. It is probable that the commission refused to deduct the Hope Company's entire reserve, including the excess over the actual accrued depreciation as found by the commission, primarily in deference to the *New York Telephone* ruling, and perhaps secondarily to offset possible criticism of the disputed elimination of $17,000,000 from the rate base.[36] Equity requires that, with one exception,

[33] 280 U.S. 234 (1930).

[34] For statements in support of the service-life method see Knoxville v. Knoxville Water Co., 212 U.S. 1, 29 S. Ct. 148 (1909); Kansas City Southern Ry Co. v. United States, 231 U.S. 423, 34 S. Ct. 125 (1913), and The Minnesota Rate Cases, 230 U.S. 352, 33 S. Ct. 729 (1913). The criticisms of this method in Pacific Gas and Electric Co. v. San Francisco, 265 U.S. 403, 44 S. Ct. 537 (1924) and McCardle v. Indianapolis Water Co., 272 U.S. 400, 47 S. Ct. 144 (1926) probably should be construed as criticisms of the faulty use of this method.

[35] 271 U.S. 23, 46 S. Ct. 363 (1926). This decision is inconsistent with an earlier ruling in R.R. Com. of La. v. Cumberland Tel. and Tel. Co., 212 U.S. 414, 29 S. Ct. 357 (1909).

[36] For an interesting suggestion to overcome the adverse effects of the New York Telephone ruling through the establishment of a statutory recapture clause apply-

the full depreciation reserve, including the excess, be deducted from the rate base to avoid an overcharge on consumers. The exception is the case of a company with an excessive reserve which through no fault of its own had failed to earn a fair return during the period in which the excessive reserve was accumulated. In this case the amount by which the company failed to earn a fair return may properly be deducted in computing the amount of the excess reserve.

The State of West Virginia and its Public Service Commission filed a brief *amicus curiae* and participated in the argument before the Supreme Court. They opposed the commission's rate order on the ground that it would reduce the value of Hope's gas leaseholds and thereby cost the state many thousands of dollars in taxes; that conservation policies would be jeopardized by the discouragement of exploratory development of new fields, hastening the abandonment of low-yield marginal wells and hampering the recovery of secondary oil; and that the lowering of the price of gas, by causing consumers to turn to it in preference to other fuels, would adversely affect the important West Virginia oil and coal industries. The Court found no statutory evidence requiring the commission to take account of these considerations, nor any suggestion "that the exploitation of consumers by private operators through the maintenance of high rates should be allowed to continue provided the producing states obtain indirect benefits from it."[87] The Court pointed out that section 1 (b) of the Natural Gas Act[88] gave the commission no authority over "the production or gathering of natural gas," but that Congress recognized the interests of the states in the conservation of natural gas by the provisions in section 11 instructing the commission to report on, and to recommend legislation in aid of, interstate compacts dealing with the conservation of gas. It also pointed out that the commission had considered the necessity of maintaining and encouraging production by including allowances for delay rentals and exploration and development costs in operating expenses.

An important issue was raised by the contention that the low rates

ing to excess depreciation reserves see P. M. Berkson, "Excess Depreciation Reserve and Rate Control," 36 COL. L. REV. 250 (1936). For another approach see 2 BONBRIGHT, VALUATION OF PROPERTY 1135 (1937), and New York Telephone Co. v. Prendergast, (D.C.N.Y. 1929) 36 F. (2d) 54.

[87] Federal Power Commission v. Hope Natural Gas Co., (U.S. 1944) 64 S. Ct. 281 at 292.

[88] 52 Stat. L. 833 (1938); 15 U.S.C. (1940) §§ 717-717w.

charged by Hope to East Ohio on gas for resale to certain industrial users were contrary to the public interest in the conservation of gas and also violative of the provisions of section 4 (b) prohibiting unjust discrimination as between localities and classes of service. The majority dismissed the former contention on the ground that there was nothing in the history or provisions of the Natural Gas Act to suggest that the standard of "just and reasonable" was intended to sanction the maintenance of high rates for the purpose of restricting certain uses of gas. With regard to the latter contention, the majority merely pointed out that the commission had made no findings under section 4(b), that its failure to do so was not challenged in the petition to review and that therefore the problem of discrimination had no proper place in the present decision.

Both Justice Frankfurter and Justice Jackson dissented vigorously to the majority's treatment of this issue, on the ground that it was based on too narrow an interpretation of the phrase "public interest" as used in the Natural Gas Act. In Justice Frankfurter's words, "The objection to the Commission's action is not that the rates it granted were too low but that the range of its vision was too narrow."[39] And Justice Jackson, after pointing out that the commission's concept of the public interest included only the investor interest and the consumer interest to the exclusion of all others added these words:

> ". . . Both producers and industrial consumers have served their immediate private interests at the expense of the long-range public interest. The public interest, of course, requires stopping unjust enrichment of the owner. But it also requires stopping unjust impoverishment of future generations. The public interest in the use by Hope's half million domestic consumers is quite a different one from the public interest in use by a baker's dozen of industries."[40]

Accordingly Justice Jackson was of the opinion that "the great volume of gas now being put to uneconomic industrial use should either be saved for its more important future domestic use or the present domestic user should have the full benefit of its exchange value in

[39] Federal Power Commission v. Hope Natural Gas Co., (U.S. 1944) 64 S. Ct. 281 at 299.

[40] Id. at 313.

reducing his present rates."[41] Furthermore, he held that in order to make this policy effective it would only be necessary to modify Hope's contract with East Ohio to provide that domestic users receive the full benefit of the rate reduction in the present order and any further reductions made possible by increasing industrial rates, and that the price of gas delivered under the contract for industrial purposes shall be fixed at such a figure as the commission might find to be in the public interest —defined presumably to include considerations of conservation.

It may be debatable whether or not Justices Frankfurter and Jackson were correct in their interpretation of the commission's duty to take account of these considerations under the Natural Gas Act in its present form. The writer feels, however, that it would be desirable to amend the act to provide that the commission, with due regard for vested interests and the financial soundness of the pipeline companies, should establish rates which would reserve as much of the available gas as practicable for domestic users and those industrial uses in which gas has a special technical advantage over other fuels.

Last of all, the majority held that the findings of the commission as to the lawfulness of past rates, which were made in aid of state regulation, were not reviewable under the provisions for review in section 19(b) of the statute, and that the doctrine of *Rochester Telephone Corp. v. United States*[42] was applicable, namely, that an order is not reviewable which "does not of itself adversely affect complainant but only affects his rights adversely on the contingency of future administrative action."[43]

In conclusion it may be appropriate to indicate, in the light of the removal of the obstacles presented by the fair value doctrine, some directions in which effort should be directed to improve the principles and procedure of public utility regulation. First, there must be more general recognition of the fact that it is ordinarily neither possible nor desirable for a company to earn a normal competitive return in each and every year, and that the companies are entitled to an opportunity to earn the so-called fair return only in the long run and on the average of good and bad years taken together. Second, there must be recog-

[41] Id. at 314.

[42] 307 U.S. 125, 59 S. Ct. 754 (1939).

[43] Id. at 130.

nition of the importance of short-run changes in the level and structure of rates which would be designed to mitigate the maladjustments incident to cyclical fluctuations in business and to encourage the fullest use of utility services. Finally, closer and more systematic attention should be given to the propriety of the sums claimed by the utilities as operating expenses and to the development of effective incentives to management to increase the efficiency of utility operations. The decision in the *Hope* case presents a challenge to regulatory bodies to make full use of their new opportunities for progress in these directions.