

New State Ice Co. v. Liebmann

285 U.S. 262 (1932)

Mr. Justice SUTHERLAND delivered the opinion of the Court: The New State Ice Company, engaged in the business of manufacturing, selling, and distributing ice under a license or permit duly issued by the Corporation Commission of Oklahoma, brought this suit against Liebmann in the federal District Court for the Western District of Oklahoma to enjoin him from manufacturing, selling, and distributing ice within Oklahoma City without first having obtained a like license or permit from the commission. The license or permit is required by an act of the Oklahoma Legislature, chapter 147, Session Laws 1925. That act declares that the manufacture, sale, and distribution of ice is a public business; that no one shall be permitted to manufacture, sell, or distribute ice within the state without first having secured a license for that purpose from the commission; that whoever shall engage in such business without obtaining the license shall be guilty of a misdemeanor, punishable by fine not to exceed \$25, each day's violation constituting a separate offense, and that by general order of the commission, a fine not to exceed \$500 may be imposed for each violation.

Section 3 of the act provides:

“That the Corporation Commission shall not issue license to any persons, firm or corporation for the manufacture, sale and distribution of ice, or either of them, within this State, except upon a hearing had by said Commission at which said hearing, competent testimony and proof shall be presented showing the necessity for the manufacture, sale or distribution of ice, or either of them, at the point, community or place desired. If the facts proved at said hearing disclose that the facilities for the manufacture, sale and distribution of ice by some person, firm or corporation already licensed by said Commission at said point, community or place, are sufficient to meet the public needs therein, the said Corporation Commission may refuse and deny the applicant (application) for said license. In addition to said authority, the said Commission shall have the right to take into consideration the responsibility, reliability, qualifications and capacity of the person, firm or corporation applying for said license and of the person, firm or corporation already licensed in said place or community, as to afford all reasonable facilities, conveniences and services to the public and shall have the power and authority to require such facilities and services to be afforded the public; provided, that nothing herein shall operate to prevent the licensing of any person, firm or corporation now engaged in the manufacture, sale and distribution of ice, or either of them, in any town, city or community of this State, whose license shall be granted and issued by said Commission upon application of such person, firm or corporation and payment of license fee.”

The portion of the section immediately in question here is that which forbids the commission to issue a license to any applicant except upon proof of the necessity for a supply of ice at the place where it is sought to establish the business, and which au-

thorizes a denial of the application where the existing licensed facilities “are sufficient to meet the public needs therein.” The District Court dismissed the bill of complaint for want of equity, on the ground that the manufacture and sale of ice is a private business which may not be subjected to the foregoing regulation. The Court of Appeals affirmed.

It must be conceded that all businesses are subject to some measure of public regulation. And that the business of manufacturing, selling, or distributing ice, like that of the grocer, the dairyman, the butcher, or the baker, may be subjected to appropriate regulations in the interest of the public health cannot be doubted; but the question here is whether the business is so charged with a public use as to justify the particular restriction above stated. If this legislative restriction be within the constitutional power of the state Legislature, it follows that the license or permit, issued to appellant, constitutes a franchise, to which a court of equity will afford protection against one who seeks to carry on the same business without obtaining from the commission a license or permit to do so. *Frost v. Corporation Commission*, 278 U.S. 515, 519-521. In that view, engagement in the business is a privilege to be exercised only in virtue of a public grant, and not a common right to be exercised independently by any competent person conformably to reasonable regulations equally applicable to all who choose to engage therein.

The *Frost Case* is relied on here. That case dealt with the business of operating a cotton gin. It was conceded that this was a business clothed with a public interest, and that the statute requiring a showing of public necessity as a condition precedent to the issue of a permit was valid. But the conditions which warranted the concession there are wholly wanting here. It long has been recognized that mills for the grinding of grain or performing similar services for all comers are devoted to a public use and subject to public control, whether they be operated by direct authority of the state or entirely upon individual initiative. At a very early period a majority of the states had adopted general acts authorizing the taking and flowage, in invitum, of lands for their erection and maintenance. In passing these acts, the attention of the Legislatures no doubt was directed principally to grist mills; but some of the acts, either in precise terms or in their application, were extended to other kinds of mills. The mills were usually operated by the use of water power, but this method of operation has been said not to be essential. It was open to the proprietor of a mill to maintain it as a private mill for grinding his own grain, and this free from legislative control; but if the proprietor assumed to serve the general public he thereby dedicated his mill to the public use and subjected it to such legislative control as was appropriate to that status. In such cases the mills were regarded as so necessary to the existence of the communities which they served as to justify the government in fostering and maintaining them, and imposing limitations upon their operation for the protection of the public.

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The production of cotton is the chief industry of the state of Oklahoma, and is of such paramount importance as to justify the assertion that the general welfare and

prosperity of the state in a very large and real sense depend upon its maintenance. Cotton ginning is a process which must take place before the cotton is in a condition for the market. The cotton gin bears the same relation to the cotton grower that the old grist mill did to the grower of wheat. The individual grower of the raw product is generally financially unable to set up a plant for himself; but the service is a necessary one with which, ordinarily, he cannot afford to dispense. He is compelled, therefore, to resort for such service to the establishment which operates in his locality. So dependent, generally, is he upon the neighborhood cotton gin that he faces the practical danger of being placed at the mercy of the operator in respect of exorbitant charges and arbitrary control. The relation between the growers of cotton, who constitute a very large proportion of the population, and those engaged in furnishing the service, is thus seen to be a peculiarly close one in respect of an industry of vital concern to the general public. These considerations render it not unreasonable to conclude that the business "has been devoted to a public use and its use thereby in effect granted to the public." *Tyson & Bro.-United Ticket Offices v. Banton*, 273 U.S. 418, 434.

We have thus, with some particularity, discussed the circumstances which, so far as the state of Oklahoma is concerned, afford ground for sustaining the legislative pronouncement that the business of operating cotton gins is charged with a public use, in order to put them in contrast with the completely unlike circumstances which attend the business of manufacturing, selling, and distributing ice. Here we are dealing with an ordinary business, not with a paramount industry, upon which the prosperity of the entire state in large measure depends. It is a business as essentially private in its nature as the business of the grocer, the dairyman, the butcher, the baker, the shoemaker, or the tailor, each of whom performs a service which, to a greater or less extent, the community is dependent upon and is interested in having maintained; but which bears no such relation to the public as to warrant its inclusion in the category of businesses charged with a public use. It may be quite true that in Oklahoma ice is, not only an article of prime necessity, but indispensable; but certainly not more so than food or clothing or the shelter of a home. And this court has definitely said that the production or sale of food or clothing cannot be subjected to legislative regulation on the basis of a public use; and that the same is true in respect of the business of renting houses and apartments, except as to temporary measures to tide over grave emergencies. See *Tyson & Bro.-United Ticket Offices v. Banton*, *supra*, 273 U.S. 437, 438, and cases cited.

It has been said that the manufacture of ice requires an expensive plant beyond the means of the average citizen, and that, since the use of ice is indispensable, patronage of the producer by the consumer is unavoidable. The same might, however, be said in respect of other articles clearly beyond the reach of a restriction like that here under review. But, for the moment conceding the materiality of the statement, it is not now true, whatever may have been the fact in the past. We know, since it is common knowledge, that today, to say nothing of other means, wherever electricity or gas is available (and one or the other is available in practically every part of the country),

any one for a comparatively moderate outlay may have set up in his kitchen an appliance by means of which he may manufacture ice for himself. Under such circumstances it hardly will do to say that people generally are at the mercy of the manufacturer, seller, and distributor of ice for ordinary needs. Moreover, the practical tendency of the restriction, as the trial court suggested in the present case, is to shut out new enterprises, and thus create and foster monopoly in the hands of existing establishments, against, rather than in aid of, the interest of the consuming public.

Plainly, a regulation which has the effect of denying or unreasonably curtailing the common right to engage in a lawful private business, such as that under review, cannot be upheld consistent with the Fourteenth Amendment. Under that amendment, nothing is more clearly settled than that it is beyond the power of a state, "under the guise of protecting the public, arbitrarily (to) interfere with private business or prohibit lawful occupations or impose unreasonable and unnecessary restrictions upon them." *Burns Baking Co. v. Bryan*, 264 U.S. 504, 513 and authorities cited.

Stated succinctly, a private corporation here seeks to prevent a competitor from entering the business of making and selling ice. It claims to be endowed with state authority to achieve this exclusion. There is no question now before us of any regulation by the state to protect the consuming public either with respect to conditions of manufacture and distribution or to insure purity of product or to prevent extortion. The control here asserted does not protect against monopoly, but tends to foster it. The aim is not to encourage competition, but to prevent it; not to regulate the business, but to preclude persons from engaging in it. There is no difference in principle between this case and the attempt of the dairyman under state authority to prevent another from keeping cows and selling milk on the ground that there are enough dairymen in the business; or to prevent a shoemaker from making or selling shoes because shoemakers already in that occupation can make and sell all the shoes that are needed. We are not able to see anything peculiar in the business here in question which distinguishes it from ordinary manufacture and production. It is said to be recent; but it is the character of the business and not the date when it began that is determinative. It is not the case of a natural monopoly, or of an enterprise in its nature dependent upon the grant of public privileges. The particular requirement before us was evidently not imposed to prevent a practical monopoly of the business, since its tendency is quite to the contrary. Nor is it a case of the protection of natural resources. There is nothing in the product that we can perceive on which to rest a distinction, in respect of this attempted control, from other products in common use which enter into free competition, subject, of course, to reasonable regulations prescribed for the protection of the public and applied with appropriate impartiality. * *

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Decree affirmed.

Mr. Justice BRANDEIS (dissenting): * * * Under a license, so granted, the New State Ice Company is, and for some years has been, engaged in the manufacture, sale, and distribution of ice at Oklahoma City, and has invested in that business \$500,000.

While it was so engaged, Liebmann, without having obtained or applied for a license, purchased a parcel of land in that city and commenced the construction thereon of an ice plant for the purpose of entering the business in competition with the plaintiff. To enjoin him from doing so this suit was brought by the ice company. Compare *Frost v. Corporation Commission*, 278 U.S. 515. Liebmann contends that the manufacture of ice for sale and distribution is not a public business; that it is a private business and, indeed, a common calling; that the right to engage in a common calling is one of the fundamental liberties guaranteed by the due process clause; and that to make his right to engage in that calling dependent upon a finding of public necessity deprives him of liberty and property in violation of the Fourteenth Amendment. * * *

First. The Oklahoma statute makes entry into the business of manufacturing ice for sale and distribution dependent, in effect, upon a certificate of public convenience and necessity. Such a certificate was unknown to the common law. It is a creature of the machine age, in which plants have displaced tools and businesses are substituted for trades. The purpose of requiring it is to promote the public interest by preventing waste. Particularly in those businesses in which interest and depreciation charges in plant constitute a large element in the cost of production, experience has taught that the financial burdens incident to unnecessary duplication of facilities are likely to bring high rates and poor service. There, cost is usually dependent, among other things, upon volume; and division of possible patronage among competing concerns may so raise the unit cost of operation as to make it impossible to provide adequate service at reasonable rates. The introduction in the United States of the certificate of public convenience and necessity marked the growing conviction that under certain circumstances free competition might be harmful to the community, and that, when it was so, absolute freedom to enter the business of one's choice should be denied.

Long before the enactment of the Oklahoma statute here challenged, a like requirement had become common in the United States in some lines of business. The certificate was required first for railroads; then for street railways; then for other public utilities whose operation is dependent upon the grant of some special privilege. Latterly, the requirement has been widely extended to common carriers by motor vehicle which use the highways, but which, unlike street railways and electric light companies, are not dependent upon the grant of any special privilege. In Oklahoma the certificate was required, as early as 1915, for cotton gins—a business then declared a public one, and, like the business of manufacturing ice, conducted wholly upon private property. As applied to public utilities, the validity under the Fourteenth Amendment of the requirement of the certificate has never been successfully questioned.

Second. Oklahoma declared the business of manufacturing ice for sale and distribution a 'public business'; that is, a public utility. So far as appears, it was the first state to do so. Of course, a Legislature cannot by mere legislative fiat convert a business into a public utility. *Producers' Transportation Co. v. Railroad Commission*, 251 U.S. 228, 230. But the conception of a public utility is not static. The welfare of

the community may require that the business of supplying ice be made a public utility, as well as the business of supplying water or any other necessary commodity or service. If the business is, or can be made, a public utility, it must be possible to make the issue of a certificate a prerequisite to engaging in it.

Whether the local conditions are such as to justify converting a private business into a public one is a matter primarily for the determination of the state Legislature. Its determination is subject to judicial review; but the usual presumption of validity attends the enactment. The action of the state must be held valid unless clearly arbitrary, capricious or unreasonable. "The legislature, being familiar with local conditions, is, primarily, the judge of the necessity of such enactments. The mere fact that a court may differ with the legislature in its views of public policy, or that judges may hold views inconsistent with the propriety of the legislation in question, affords no ground for judicial interference. * * *" *McLean v. Arkansas*, 211 U.S. 539, 547. Whether the grievances are real or fancied, whether the remedies are wise or foolish, are not matters about which the Court may concern itself. "Our present duty is to pass upon the statute before us, and if it has been enacted upon a belief of evils that is not arbitrary we cannot measure their extent against the estimate of the legislature." *Tanner v. Little*, 240 U.S. 369, 385. A decision that the Legislature's belief of evils was arbitrary, capricious, and unreasonable may not be made without inquiry into the facts with reference to which it acted.

Third. Liebmann challenges the statute—not an order of the Corporation Commission. If he had applied for a license and been denied one, we should have been obliged to inquire whether the evidence introduced before the commission justified it in refusing permission to establish an additional ice plant in Oklahoma City. As he did not apply, but challenges the statute itself, our inquiry is of an entirely different nature. Liebmann rests his defense upon the broad claim that the Federal Constitution gives him the right to enter the business of manufacturing ice for sale even if his doing so be found by the properly constituted authority to be inconsistent with the public welfare. He claims that, whatever the local conditions may demand, to confer upon the commission power to deny that right is an unreasonable, arbitrary, and capricious restraint upon his liberty.

The function of the court is primarily to determine whether the conditions in Oklahoma are such that the Legislature could not reasonably conclude (1) that the public welfare required treating the manufacture of ice for sale and distribution as a "public business"; and (2) that, in order to insure to the inhabitants of some communities an adequate supply of ice at reasonable rates, it was necessary to give the commission power to exclude the establishment of an additional ice plant in places where the community was already well served. Unless the Court can say that the Federal Constitution confers an absolute right to engage anywhere in the business of manufacturing ice for sale, it cannot properly decide that the legislators acted unreasonably without first ascertaining what was the experience of Oklahoma in respect to the ice business. The relevant facts appear, in part, of record. Others are matters of

common knowledge to those familiar with the ice business. They show the actual conditions, or the beliefs, on which the legislators acted. In considering these matters, we do not, in a strict sense, take judicial notice of them as embodying statements of uncontrovertible facts. Our function is only to determine the reasonableness of the Legislature's belief in the existence of evils and in the effectiveness of the remedy provided. In performing this function we have no occasion to consider whether all the statements of fact which may be the basis of the prevailing belief are well-founded; and we have, of course, no right to weigh conflicting evidence.

(A) In Oklahoma a regular supply of ice may reasonably be considered a necessary of life, comparable to that of water, gas, and electricity. The climate, which heightens the need of ice for comfortable and wholesome living, precludes resort to the natural product. There, as elsewhere, the development of the manufactured ice industry in recent years has been attended by deep-seated alterations in the economic structure and by radical changes in habits of popular thought and living. Ice has come to be regarded as a household necessity, indispensable to the preservation of food and so to economical household management and the maintenance of health. Its commercial uses are extensive. In urban communities, they absorb a large proportion of the total amount of ice manufactured for sale. The transportation, storage, and distribution of a great part of the nation's food supply is dependent upon a continuous, and dependable supply of ice. It appears from the record that in certain parts of Oklahoma a large trade in dairy and other products has been built up as a result of rulings of the Corporation Commission under the act of 1925, compelling licensed manufacturers to serve agricultural communities; and that this trade would be destroyed if the supply of ice were withdrawn.¹⁴ We cannot say that the Legislature of Oklahoma acted arbitrarily in declaring that ice is an article of primary necessity, in industry and agriculture as well as in the household, partaking of the fundamental character of electricity, gas, water, transportation, and communication.

Nor can the Court properly take judicial notice that, in Oklahoma, the means of manufacturing ice for private use are within the reach of all persons who are dependent upon it. Certainly it has not been so. In 1925 domestic mechanical refrigeration had scarcely emerged from the experimental stage. Since that time, the production and consumption of ice manufactured for sale, far from diminishing, has steadily increased. In Oklahoma the mechanical household refrigerator is still an article of relative luxury. Legislation essential to the protection of individuals of limited or no means is not invalidated by the circumstance that other individuals are financially able to protect themselves. The businesses of power companies and of common carri-

¹⁴ The power of the commission to compel this service, of course, depends upon the status of the ice business as a public utility. The evidence shows that the distribution of ice in rural communities not themselves possessing ice plants has developed almost wholly since the passage of the act of 1925. There was testimony that such distribution would be impracticable without the protection afforded by the Act.

ers by street railway, steam railroad, or motor vehicle fall within the field of public control, although it is possible, for a relatively modest outlay, to install individual power plants, or to purchase motor vehicles for private carriage of passengers or goods. The question whether in Oklahoma the means of securing refrigeration otherwise than by ice manufactured for sale and distribution has become so general as to destroy popular dependence upon ice plants is one peculiarly appropriate for the determination of its Legislature and peculiarly inappropriate for determination by this Court, which cannot have knowledge of all the relevant facts.

The business of supplying ice is not only a necessity, like that of supplying food or clothing or shelter, but the Legislature could also consider that it is one which lends itself peculiarly to monopoly.¹⁸ Characteristically the business is conducted in local plants with a market narrowly limited in area,¹⁹ and this for the reason that ice manufactured at a distance cannot effectively compete with a plant on the ground.²⁰ In small towns and rural communities the duplication of plants, and in larger communities the duplication of delivery service, is wasteful and ultimately burdensome to consumers. At the same time the relative ease and cheapness with which an ice plant may be constructed exposes the industry to destructive and frequently ruinous competition. Competition in the industry tends to be destructive because ice plants have a determinate capacity, and inflexible fixed charges and operating costs, and because in a market of limited area the volume of sales is not readily expanded. Thus, the erection of a new plant in a locality already adequately served often causes managers to go to extremes in cutting prices in order to secure business. Trade journals and reports of association meetings of ice manufacturers bear ample witness to the hostility of the industry to such competition, and to its unremitting efforts, through trade associations, informal agreements, combination of delivery systems, and in particular through the consolidation of plants, to protect markets and prices against competition of any character.

¹⁸ It is noteworthy that the ice industry has the characteristic of uniformity of product or service common to most public utilities, and distinguishing it from other businesses in which differences in quality or style make difficult effective regulation. The tendency of the industry to be conducted as a public utility is reflected in the widespread entry into it in recent years of electrical, gas, and water utilities, and the like. Such companies in Oklahoma operate more than one-third of the ice plants.

¹⁹ Neither consolidation of ownership nor increase in production has had the effect of greatly increasing the size of plants in the ice business. Thus in Oklahoma in 1927 there were only twenty plants manufacturing ice for sale which had a capacity exceeding 200 tons a day, of which eight were in Oklahoma City and Tulsa.

²⁰ Several reasons were given in the testimony for this localization of the ice business. Freight rates on ice are high in proportion to value. Handling charges are doubled if the ice is put in cold storage at the point of consignment; and, if kept in the car, the ice loses in weight and deteriorates in quality during the period of a week or more before a carload will be exhausted in a small community. Shrinkage of course varies with the weather, but is at all times considerable.

That these forces were operative in Oklahoma prior to the passage of the act under review is apparent from the record. Thus, it was testified that in only six or seven localities in the state containing, in the aggregate, not more than 235,000 of a total population of approximately 2,000,000, was there “a semblance of competition”;²⁴ and that even in those localities the prices of ice were ordinarily uniform. The balance of the population was, and still is, served by companies enjoying complete monopoly. Where there was competition, it often resulted to the disadvantage rather than the advantage of the public, both in respect to prices and to service. Some communities were without ice altogether, and the state was without means of assuring their supply. There is abundant evidence of widespread dissatisfaction with ice service prior to the act of 1925, and of material improvement in the situation subsequently. It is stipulated in the record that the ice industry as a whole in Oklahoma has acquiesced in and accepted the act and the status which it creates.

(B) The statute under review rests, not only upon the facts just detailed, but upon a long period of experience in more limited regulation dating back to the first year of Oklahoma’s statehood. For 17 years prior to the passage of the act of 1925, the Corporation Commission under section 13 of the Act of June 10, 1908, had exercised jurisdiction over the rates, practices, and service of ice plants, its action in each case, however, being predicated upon a finding that the company complained of enjoyed a “virtual monopoly” of the ice business in the community which it served.²⁶ The jurisdiction thus exercised was upheld by the Supreme Court of the state in *Oklahoma Light & Power Co. v. Corporation Commission*. The court said: “The manufacture, sale and distribution of ice in many respects closely resembles the sale and distribution of gas as fuel, or electric current, and in many communities the same company that manufactures, sells, and distributes electric current is the only concern that manufactures, sells and distributes ice, and by reason of the nature and extent of the

²⁴ The Ice and Refrigeration Blue Book for 1927 shows that of 142 communities containing ice plants manufacturing ice for sale, at least 112 were served either by a single plant or by several plants of common ownership. There is evidence in the record that it was common practice for manufacturing establishments of different ownership to make use of a jointly owned delivery company. Out of 217 plants listed as engaged in manufacturing ice for sale, 101 were owned by corporations owning or controlling other plants within or without the state.

²⁶ Okla. Sess. Laws 1907-08, c. 83: “Sec. 13. Whenever any business, by reason of its nature, extent, or the existence of a virtual monopoly therein, is such that the public must use the same, or its services, or the consideration by it given or taken or offered, or the commodities bought or sold therein are offered or taken by purchase or sale in such a manner as to make it of public consequence, or to affect the community at large as to supply, demand or price or rate thereof, or said business is conducted in violation of the first section of this Act, said business is a public business, and subject to be controlled by the State, by the Corporation Commission or by an action in any district court of the State, as to all of its practices, prices, rates and charges. And it is hereby declared to be the duty of any person, firm or corporation engaged in any public business to render its services and offer its commodities, or either, upon reasonable terms without discrimination and adequately to the needs of the public, considering the facilities of said business.”

ice business it is impracticable in that community to interest any other concern in such business. In this situation, the distributor of such a necessity as ice should not be permitted by reason of the impracticability of any one else engaging in the same business to charge unreasonable prices, and if such an abuse is persisted in the regulatory power of the state should be invoked to protect the public.”

By formal orders, commission repeatedly fixed or approved prices to be charged in particular communities; required ice to be sold without discrimination and to be distributed as equitably as possible to the extent of the capacity of the plant;²⁹ forbade short weights and ordered scales to be carried on delivery wagons and ice to be weighed upon the customer’s request; and undertook to compel sanitary practices in the manufacture of ice and courteous service of patrons. Many of these regulations, other than those fixing prices, were embodied in a general order to all ice companies, issued July 15, 1921, and are still in effect. Informally, the Commission adjusted a much greater volume of complaints of a similar nature. It appears from the record that for some years prior to the act of 1925 one day of each week was reserved by the commission to hear complaints relative to the ice business.

As early as 1911, the commission, in its annual report to the Governor, had recommended legislation more clearly delineating its powers in this field:

There should be a law passed putting the regulation of ice plants under the jurisdiction of the Commission. The Commission is now assuming this jurisdiction under an Act passed by the Legislature known as the antitrust law. A specific law upon this subject would obviate any question of jurisdiction.* * *

The enactment of the so-called Ice Act in 1925 enlarged the existing jurisdiction of the Corporation Commission by removing the requirement of a finding of virtual monopoly in each particular case; by conferring the same authority to compel adequate service as in the case of other public utilities; and by committing to the commission the function of issuing licenses equivalent to a certificate of public convenience and necessity. With the exception of the granting and denying of such licenses and the exertion of wider control over service, the regulatory activity of the commission in respect to ice plants has not changed in character since 1925. It appears to have diminished somewhat in volume.

In 1916, the commission urged, in its report to the Governor, that all public utilities under its jurisdiction be required to secure from the commission “what is known as a ‘certificate of public convenience and necessity’ before the duplication of facilities.”

“This would prevent ruinous competition resulting in the driving out of business of small though competent public service utilities by more powerful corporations, and

²⁹ In most instances of complaint of insufficient ice the commission undertook to secure only the equitable distribution of the available supply; and the terms of the statute gave it no greater authority. On no occasion, before 1925, did the commission undertake to extend ice service to communities not theretofore supplied.

often consequent demoralization of service, or the requiring of the public to patronize two utilities in a community where one would be adequate.”

Up to that time a certificate of public convenience and necessity to engage in the business had been applied only to cotton gins. Okla. Sess. Laws 1915, c. 176, § 3. In 1917 a certificate from the commission was declared prerequisite to the construction of new telephone or telegraph lines. In 1923 it was required for the operation of motor carriers. In 1925, the year in which the Ice Act was passed, the requirement was extended also to power, heat, light, gas, electric, or water companies proposing to do business in any locality already possessing one such utility.

Fourth. Can it be said in the light of these facts that it was not an appropriate exercise of legislative discretion to authorize the commission to deny a license to enter the business in localities where necessity for another plant did not exist? The need of some remedy for the evil of destructive competition, where competition existed, had been and was widely felt. Where competition did not exist, the propriety of public regulation had been proven. Many communities were not supplied with ice at all. The particular remedy adopted was not enacted hastily. The statute was based upon a long-established state policy recognizing the public importance of the ice business, and upon 17 years' legislative and administrative experience in the regulation of it. The advisability of treating the ice business as a public utility and of applying to it the certificate of convenience and necessity had been under consideration for many years. Similar legislation had been enacted in Oklahoma under similar circumstances with respect to other public services. The measure bore a substantial relation to the evils found to exist. Under these circumstances, to hold the act void as being unreasonable would, in my opinion, involve the exercise, not of the function of judicial review, but the function of a super-Legislature. If the act is to be stricken down, it must be on the ground that the Federal Constitution guarantees to the individual the absolute right to enter the ice business, however detrimental the exercise of that right may be to the public welfare. Such, indeed, appears to be the contention made.

Fifth. The claim is that manufacturing ice for sale and distribution is a business inherently private, and, in effect, that no state of facts can justify denial of the right to engage in it. To supply one's self with water, electricity, gas, ice, or any other article is inherently a matter of private concern. So also may be the business of supplying the same articles to others for compensation. But the business of supplying to others, for compensation, any article or service whatsoever may become a matter of public concern. Whether it is, or is not, depends upon the conditions existing in the community affected. If it is a matter of public concern, it may be regulated, whatever the business. The public's concern may be limited to a single feature of the business, so that the needed protection can be secured by a relatively slight degree of regulation. Such is the concern over possible incompetence, which dictates the licensing of dentists; or the concern over possible dishonesty, which led to the licensing of auctioneers or hawkers. On the other hand, the public's concern about a particular business may be so pervasive and varied as to require constant detailed supervision and a very high de-

gree of regulation. Where this is true, it is common to speak of the business as being a “public” one, although it is privately owned. It is to such businesses that the designation “public utility” is commonly applied; or they are spoken of as “affected with a public interest.” *German Alliance Insurance Co. v. Lewis*, 233 U.S. 389, 408.

A regulation valid for one kind of business may, of course, be invalid for another; since the reasonableness of every regulation is dependent upon the relevant facts. But so far as concerns the power to regulate, there is no difference, in essence, between a business called private and one called a public utility or said to be “affected with a public interest.” Whatever the nature of the business, whatever the scope or character of the regulation applied, the source of the power invoked is the same. And likewise the constitutional limitation upon that power. The source is the police power. The limitation is that set by the due process clause, which, as construed, requires that the regulation shall be not unreasonable, arbitrary, or capricious; and that the means of regulation selected shall have a real or substantial relation to the object sought to be obtained. The notion of a distinct category of business “affected with a public interest,” employing property “devoted to a public use,” rests upon historical error. The consequences which it is sought to draw from those phrases are belied by the meaning in which they were first used centuries ago, and by the decision of this Court, in *Munn v. Illinois*, 94 U.S. 113, which first introduced them into the law of the Constitution. In my opinion, the true principle is that the state’s power extends to every regulation of any business reasonably required and appropriate for the public protection. I find in the due process clause no other limitation upon the character or the scope of regulation permissible.

Sixth. It is urged specifically that manufacturing ice for sale and distribution is a common calling; and that the right to engage in a common calling is one of the fundamental liberties guaranteed by the due process clause. To think of the ice-manufacturing business as a common calling is difficult; so recent is it in origin and so peculiar in character. Moreover, the Constitution does not require that every calling which has been common shall ever remain so. The liberty to engage in a common calling, like other liberties, may be limited in the exercise of the police power. The slaughtering of cattle had been a common calling in New Orleans before the monopoly sustained in *Slaughter House Cases*, 16 Wall. 36, was created by the Legislature.
* * *

It is settled that the police power commonly invoked in aid of health, safety, and morals extends equally to the promotion of the public welfare. * * * [W]hile ordinarily free competition in the common callings has been encouraged, the public welfare may at other times demand that monopolies be created. Upon this principle is based our whole modern practice of public utility regulation. It is no objection to the validity of the statute here assailed that it fosters monopoly. That, indeed, is its design. The certificate of public convenience and invention is a device—a recent social-economic invention—through which the monopoly is kept under effective control by vesting in a commission the power to terminate it whenever that course is required in

the public interest. To grant any monopoly to any person as a favor is forbidden, even if terminable. But where, as here, there is reasonable ground for the legislative conclusion that, in order to secure a necessary service at reasonable rates, it may be necessary to curtail the right to enter the calling, it is, in my opinion, consistent with the due process clause to do so, whatever the nature of the business. The existence of such power in the Legislature seems indispensable in our ever-changing society.

* * * As states may engage in a business, because it is a public purpose to assure to their inhabitants an adequate supply of necessary articles, may they not achieve this public purpose, as Oklahoma has done, by exercising the lesser power of preventing single individuals from wantonly engaging in the business and thereby making impossible a dependable private source of supply? As a state so entering upon a business may exert the taxing power, all individual dealers may be driven from the calling by the unequal competition. If states are denied the power to prevent the harmful entry of a few individuals into a business, they may thus, in effect, close it altogether to private enterprise. * * *

Eighth. The people of the United States are now confronted with an emergency more serious than war. Misery is widespread, in a time, not of scarcity, but of overabundance. The long-continued depression has brought unprecedented unemployment, a catastrophic fall in commodity prices, and a volume of economic losses which threatens our financial institutions. Some people believe that the existing conditions threaten even the stability of the capitalistic system. Economists are searching for the causes of this disorder and are re-examining the basis of our industrial structure. Business men are seeking possible remedies. Most of them realize that failure to distribute widely the profits of industry has been a prime cause of our present plight. But rightly or wrongly, many persons think that one of the major contributing causes has been unbridled competition. Increasingly, doubt is expressed whether it is economically wise, or morally right, that men should be permitted to add to the producing facilities of an industry which is already suffering from overcapacity. In justification of that doubt, men point to the excess capacity of our productive facilities resulting from their vast expansion without corresponding increase in the consumptive capacity of the people. They assert that through improved methods of manufacture, made possible by advances in science and invention and vast accumulation of capital, our industries had become capable of producing from 30 to 100 per cent. more than was consumed even in days of vaunted prosperity; and that the present capacity will, for a long time, exceed the needs of business. All agree that irregularity in employment—the greatest of our evils—cannot be overcome unless production and consumption are more nearly balanced. Many insist there must be some form of economic control. There are plans for proration. There are many proposals for stabilization. And some thoughtful men of wide business experience insist that all projects for stabilization and proration must prove futile unless, in some way, the equivalent of the certificate of public convenience and necessity is made a prerequisite to embark-

ing new capital in an industry in which the capacity already exceeds the production schedules.

Whether that view is sound nobody knows. The objections to the proposal are obvious and grave. The remedy might bring evils worse than the present disease. The obstacles to success seem insuperable. The economic and social sciences are largely uncharted seas. We have been none too successful in the modest essays in economic control already entered upon. The new proposal involves a vast extension of the area of control. Merely to acquire the knowledge essential as a basis for the exercise of this multitude of judgments would be a formidable task; and each of the thousands of these judgments would call for some measure of prophecy. Even more serious are the obstacles to success inherent in the demands which execution of the project would make upon human intelligence and upon the character of men. Man is weak and his judgment is at best fallible.

Yet the advances in the exact sciences and the achievements in invention remind us that the seemingly impossible sometimes happens. There are many men now living who were in the habit of using the age-old expression: "tis as impossible as flying." The discoveries in physical science, the triumphs in invention, attest the value of the process of trial and error. In large measure, these advances have been due to experimentation. In those fields experimentation has, for two centuries, been not only free but encouraged. Some people assert that our present plight is due, in part, to the limitations set by courts upon experimentation in the fields of social and economic science; and to the discouragement to which proposals for betterment there have been subjected otherwise. There must be power in the states and the nation to remold, through experimentation, our economic practices and institutions to meet changing social and economic needs. I cannot believe that the framers of the Fourteenth Amendment, or the states which ratified it, intended to deprive us of the power to correct the evils of technological unemployment and excess productive capacity which have attended progress in the useful arts.

To stay experimentation in things social and economic is a grave responsibility. Denial of the right to experiment may be fraught with serious consequences to the nation. It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country. This Court has the power to prevent an experiment. We may strike down the statute which embodies it on the ground that, in our opinion, the measure is arbitrary, capricious, or unreasonable. We have power to do this, because the due process clause has been held by the Court applicable to matters of substantive law as well as to matters of procedure. But, in the exercise of this high power, we must be ever on our guard, lest we erect our prejudices into legal principles. If we would guide by the light of reason, we must let our minds be bold.

The Six Party Contract, or Treaty of the Six Nations

Articles of Agreement for the Union, Protection and Improvement of Certain Telegraph Lines in North America, August 10, 1857; And Certain Supplemental Agreements.

ARTICLES OF AGREEMENT in Six Parts, made and concluded this Tenth Day of August, in the year of our Lord, One Thousand Eight Hundred and Fifty-seven, by and between—

1st Part. The American Telegraph Company, of the *First* Part;

2d Part. The New York, Albany and Buffalo Electro-Magnetic Telegraph Company, of the *second* part;

3d Part. The Atlantic and Ohio Telegraph Company and the Pennsylvania Telegraph Company, acting together under a contract of union, of the *Third* part;

4th Part The Western Union Telegraph Company, of the *Fourth* part;

5th Part. The New Orleans and Ohio Telegraph Lessees, of the *Fifth* part;

6th Part. The Illinois and Mississippi Telegraph Company, and the Chicago and Mississippi Telegraph Company, of the *Sixth* part;

all said parties being corporations or associations, respectively acting under and by virtue of charters, granted by the Legislature of some State of the United States, or by articles of association:—Witnesseth,

ARTICLE I. That the *five* last named parties aforesaid, hereby covenant and agree to unite with the party of the *first* part, in the payment of the purchase of the *patented invention* of David E. Hughes, called “Hughes’ Compound Magnetic and Vibrating Printing Instrument,” as conveyed by said Hughes and David W. Brodnax to Peter Cooper and others by contract, dated November 1st, 1855, (and which contract was subsequently assigned by said Cooper and others to said party of the first part,) and pay therefor the respective proportions hereinafter assigned to each, of the sum of *Fifty Thousand Dollars*, and a like *pro rata* of the sum of *Six Thousand Dollars*, to said party of the first part, for their net outlay and expenses in improving and perfecting said invention, it being hereby mutually agreed, that no party hereto shall be liable for the sums, or any part thereof, herein apportioned to any other party, nor for any other than its own percentage of said liabilities.

ART. II. Sec. 1. That the proportions of sums aforesaid, the parties hereto, hereby covenant and agree, shall be borne and paid by each, as follows, viz:—

The party of the *first* part forty-five per cent.;

The party of the *second* part thirteen per cent.;

The party of the *third* part ten per cent.;

The party of the *fourth* part fifteen per cent.;

The party of the *fifth* part twelve per cent.; and

The party of the *sixth* part five per cent.;

SEC. 2. And the payments therefor shall be made in the proportions aforesaid, as follows, to wit:—There shall be paid in cash down;

(16,000) Sixteen Thousand Dollars.

(5,000) Five Thousand Dollars on the first day of February, 1858;

(10,000) Ten Thousand Dollars on the first day of August, 1858;

(5,000) Five Thousand Dollars on the first day of February, 1859;

(10,000) Ten Thousand Dollars on the first day of August, 1859; and

(10,000) Ten Thousand Dollars on the first day of February, 1860.

\$56,000

ART. III. Sec. 1. The parties hereto hereby mutually covenant and agree with each other that each party shall own the patent rights as aforesaid, *exclusively*, in the territory hereinafter assigned and allotted to each, except for patent rights for lines as hereinafter specified, that is to say:

Sec. 2. To said party of the *first* part, all of Newfoundland, Nova Scotia, New Brunswick, the New England States, Long Island, Staten Island, the States of New Jersey, Delaware, North Carolina, South Carolina, Georgia and Florida; also, the portion of New York north of the latitude of Troy and east of the Champlain Canal, including the towns on said Canal; also, the rights for lines along the general routes of the “New York and Harlem” and the “Western” Railroads from New York city to Troy; also, the rights for northern, eastern and southern lines which enter the cities of Troy, Albany and New York; also, the rights for lines from New York *via* Philadelphia and Baltimore to Washington; also, the portion of Maryland south-east of the line from Philadelphia *via* Baltimore to Washington; also, that part of the District of Columbia and of the State of Virginia south of the latitude of Washington; also, the portion of Alabama south of the latitude of Centreville, and also the rights for lines thence to New Orleans, but not the right to receive or transmit business to or from New Orleans on the one hand, and Philadelphia or points north of the latitude thereof on the other, nor to open offices for public business in the States of Mississippi or Louisiana, except at New Orleans.

Sec. 3. To the party of the *second* part, all of New York west of the meridian of Buffalo and north of the latitude thereof, and all of New York east of said meridian and west of Lake Champlain and of the Champlain Canal, and west from, and including the cities of New York, Albany and Troy, and the routes of all the present lines of said party connecting said cities, with the exclusive right to the business between said cities; and the business of Albany and Troy for points south of New York, to be there given over to the party of the *first* part; and also, the rights to the patents on the present lines of the New York and Erie railroad, whenever said party of the *second* part shall purchase said lines or obtain the permanent control thereof, or build a line on said route; but in case any business shall be sent *via* Dunkirk, which should

be sent *via* Buffalo, according to the contract of February 15, 1856, with the party hereto of the *fourth* part, the same tariff shall be paid to them as if sent *via* Buffalo.

Sec. 4. To the party of the *third* part, all of Pennsylvania west of the meridian of Philadelphia and east of the meridian of Pittsburgh, except for lines from New York through Philadelphia to Baltimore; the portion of Maryland northwest of the line from Philadelphia *via* Baltimore to Washington; and the portion of Virginia north of the latitude of Washington, with the rights for a line across the western part of Pennsylvania, connecting Wheeling and Baltimore.

Sec. 5. To the party of the *fourth* part, all of the States of Ohio, Indiana and Michigan; the portion of New York south of the latitude of Buffalo and west of the meridian thereof; all of Pennsylvania west of the meridian of Pittsburgh, except for a line connecting Wheeling and Baltimore; the rights for lines in Illinois, on the following routes, viz:—on the Michigan Central railroad; on the Michigan Southern and Northern Indiana railroad; on the Pittsburgh, Fort Wayne and Chicago railroad; on the Railroad from Chicago to Milwaukee; on the route from Beloit and Freeport to Savannah on the Mississippi river, *via* the Racine and Mississippi railroad; on the Terre Haute, Alton and St. Louis railroad, and on the Ohio and Mississippi railroad; also all of Wisconsin, except the portion hereinafter assigned to the party of the *sixth* part; the rights for a line in the territory of Minnesota on so much of the route of the Chicago, Fon du Lac and St. Paul railroad as extends into the territory of Minnesota; the portion of Missouri south of the Missouri river; and also, the rights for their present lines to Louisville, Frankfort, Covington and Lexington, with the right to change said lines to routes substantially the same as the present, or on Railroads connecting the places last above named; and rights for their line or lines into Wheeling in the State of Virginia, excepting, however, the rights of the party of the *fifth* part for lines to Cincinnati, to Cairo and Mound City, as hereinafter provided.

Sec. 6. To the party of the *fifth* part, all of Kentucky, Tennessee, Arkansas, Mississippi and Louisiana, the portion of Alabama north of the latitude of Centerville; with the rights for their line to Cincinnati now under lease to the party of the *fourth* part, when the leases by which the latter party hold that line may be terminated, excepting, however, the rights of the party of the *fourth* part for their lines to Louisville, and the rights of the party of the *first* part for lines through Mississippi and Louisiana to New Orleans.

Sec. 7. To the party of the *sixth* part, all of the State of Iowa; all of Illinois, excepting the routes hereinbefore named, and the rights for lines which are reserved to the party of the *fourth* part; the rights for a line in Wisconsin on so much of the route of the Chicago, Fon du Lac and St. Paul Railroad, between Chicago and Janesville, as lies in Wisconsin; all of Minnesota, except the route hereinbefore named, and the rights for lines which are reserved to the party of the *fourth* part; all of the State of Missouri north of the Missouri river, with the right to cross said river below a point due west from St. Louis, and extend one or more lines therefrom to St. Louis, and

open offices on said line or lines; and also with the right to cross the Mississippi river at and north of St. Louis, and to extend such lines to St. Louis.

ART. IV. Sec. 1. In all cases in this Agreement where a city or town shall be named to indicate a dividing line of territory between any two companies, parties hereto, each of the parties named shall have the right to extend its line or lines into any part of said city or town, and be entitled to the business thereof, which may be properly sent by such line; provided, however, this permission shall not authorize any party to establish hereafter such line in competition with any then existing line of any other party hereto.

Sec. 2. And each of the parties hereto shall be entitled to the exclusive enjoyment of all telegraph business within the territory in which the patent right has been allotted to them respectively, in article *Third* of this agreement, subject only to the specific grants of rights for lines to parties therein named, and subject also to the provisions hereinafter made to prevent collision of interests by competition.

ART. V. Sec. 1. It is further mutually covenanted and agreed by and between the parties hereto, that each party shall be the exclusive owner of the patent rights aforesaid, within the territory, and for the lines designated herein in article *Third*; and upon the performance of article *Second*, said party shall be entitled to proper conveyances of the same. And the party entitled to said exclusive rights of territory and for lines, shall at their own charge and risk protect and defend the same therein and thereon, at their option; and the patents in all other territory named in said contract with Peter Cooper and others, not hereinbefore set apart and allotted to any party hereto, shall be owned in the proportions aforesaid, and *in common*.

Sec. 2. A majority in interest may sell the patent rights for lines in any such territory, held in common, under such restrictions as will protect the interests of the parties hereto in the territories respectively allotted to them; and the proceeds of any such sale or sales, or of any recovery for the use or violation of the patent therein, shall belong to the parties hereto, in the proportion which shall be paid by each therefor, as hereinbefore provided. But no sales shall be made of such rights without notice to all the parties hereto of the time and place of meeting to act upon that subject, and parties hereto shall have the privilege of purchase at the same price in preference to any other party.

ART. VI. Sec. 1. The parties hereto severally and collectively hereby covenant and agree to enter, and they do by these presents enter, into an *exclusive connection* with each other for all *telegraph* business which may hereafter pass over a portion of the lines of either, destined for points on or beyond those of the others, and which may be reached by means of them, excepting so much business as the party of the *first* part may be legally liable to give to the New England Union Telegraph Company at Boston; and excepting also so much business as the party of the second part may be legally liable to give to the New York and Washington Printing Telegraph Company, un-

der a contract between said party of the *second* part and the New York State Printing Telegraph Company, bearing date February 15th, 1856.

Sec. 2. And each of the parties hereto shall be entitled to the *exclusive enjoyment* of all Telegraph business within the territory in which the Hughes patent rights have been allotted to them, and upon such lines as specific grants of said rights have herein been made respectively to any of the parties hereto; *subject only* to the other provisions of this Agreement, if any of said provisions shall be found to conflict with the assignment or allotment or rights of territory, or grant of rights for lines, as hereinbefore described, that is to say:

ART. VII. Sec. 1. The business between New York and points northerly from Troy, east of or upon the Champlain Canal, or in Canada, east of the meridian of Belleville, or between Albany and Troy and all places east of or upon said Canal or in Canada, east of the meridian of Belleville, or in the New England States, or easterly therefrom, shall belong to the party herein of the *first* part.

Sec. 2. The business between the cities of New York, Albany and Troy, or between either of those cities, and all places in Canada, west of the meridian of Belleville, shall belong to the party herein of the *second* part.

Sec. 3. The business between Philadelphia, or points easterly and northerly therefrom, and New Orleans, or any point south of a dividing line from the city of New York to Quincy in the State of Illinois, agreed upon between the parties hereto of the *third* and *second* parts, and not in the territory allotted to the party of the *first* part shall be given to said party of the *third* part, at New York, so long as said party of the *first* part does not control a line from New York to Philadelphia. But when said party of the *first* part shall control a line from New York to Philadelphia, the said party of the *third* part shall receive the aforesaid business at Philadelphia, or deliver it to said party of the *first* part at Philadelphia, and shall not receive business in New York, nor send to New York except over the lines of said party of the *first* part; and if said party of the *third* part shall acquire the control of the existing line, or build a line between Washington, Baltimore and Wheeling, they shall have the exclusive right to the business between Washington and Baltimore on the one hand, and points in the territory allotted to the party herein or the *fourth* part, west of the States of New York or Pennsylvania, or in that allotted to the parties herein of the *fifth* and *sixth* parts, on the other hand, but they shall not receive New Orleans business at either of those cities after the party of the *first* part shall become the owners of or work a line to New Orleans.

Sec. 4. The business to and from between New Orleans and Baltimore, and all places intermediate, in the territory allotted to the said party of the first part, and not elsewhere, and the local business between New York, Philadelphia, Baltimore and Washington, or between these points and all south of Washington and easterly from New Orleans, shall belong exclusively to such line as said party of the *first* part may

own, work or control on that route, which shall not take any New Orleans business, except to and from points south of Philadelphia.

Sec. 5. The business of the party of the *second* part, and of the party of the *third* part, destined west or south, is to pass over the lines of the party of the *fourth* part, according to a geographical division indicated between said party of the *second* part and said party of the *third* part.

Sec. 6. And all business on any portion of the lines of the parties of the *second*, *third*, *fourth*, and *sixth* parts, destined for points on, or which may be reached by means of, the lines of the party of the *fifth* part, shall be given to them at Louisville, in the State of Kentucky. And the said party of the *fifth* part shall have the right to transmit business over the existing line to and from Cairo and Mound City, in the State of Illinois, and to purchase and maintain said line or build a new line to those points.

Sec. 7. All the business of Chicago and St. Louis, for New Orleans, and for all points in the territory of or which is to pass on the lines of the party of the *fifth* part, and all the business of St. Louis for Cleveland and southerly and easterly of a line from St. Louis to Cleveland; all the business of the territory of the party of the *sixth* part, or which may pass over their lines for New Orleans and for other points in the territory of the party of the *fifth* part, or which is to pass over their lines, to be given over at St. Louis or such other point as the party of the *fourth* part may direct, and the return business, to be given over at the same places; and all business of the state of Illinois taken at places therein, where the party of the *fourth* part has offices, for points in their territory and easterly thereof, except as hereinafter provided, shall belong to the party hereto of the *fourth* part.

Sec. 8. All business between Chicago and St. Louis, shall belong to the party of the *sixth* part, and all business of St. Louis for points north and west of a line from St. Louis to Cleveland, and also for Terre Haute, but when the party of the *fourth* part shall have or work a line or lines from St. Louis to Terre Haute or Indianapolis, in Indiana, or Toledo in Ohio, then the latter shall have the St. Louis business for the points on said lines, and all points south of the line to Toledo, when the line to that place shall be completed; all the business of Alton, except for points in Illinois not reached by the lines of the party of the *sixth* part, but the latter is to furnish office room, operate the instruments and do the Telegraph business of the party of the *fourth* part, without charge, if required so to do.

Sec. 9. At all other points in Illinois where the parties of the *fourth* and *sixth* parts shall each have Telegraph offices, each shall be entitled to the business for points reached exclusively by their respective lines.

Sec. 10. All Texas business to be divided upon the basis provided herein relative to the New Orleans business.

ART. VIII. The Agreement, by and between the several Telegraph Companies, constituting the *six* several parties hereto, for the mutual exclusive interchange of busi-

ness, as herein provided, binds each company to each other company, and each to all that may be affected by any failure of performance of the covenants and agreements herein contained: Wherefore the parties hereto, each for themselves, hereby further covenant and agree, with each and all the other parties, to transmit all business that may be delivered to them as herein agreed, with reasonable promptness, accuracy and dispatch, exercising all the diligence requisite to keep their lines in good, reliable, working condition. But in case a connecting line shall be down, the party having business to transmit, shall be at liberty during such disability, and it shall be their duty to send forward, if practicable, said business in some other way, without any violation of the provisions of this Agreement.

ART. IX. It is further hereby mutually covenanted and agreed by the parties hereto, that nothing in this Agreement shall supersede, modify or annul any part of any existing contract between any of the parties hereto, but no contract by any said parties with any one not a party to this agreement shall be binding upon any other party than the party making the same; nor shall either party hereto be entitled to raise its through *tariff* of charges to points reached over or by means of the lines of any other party hereto, without the consent of the party affected by such increase.

ART. X. Sec 1. And each party to this Agreement severally covenants and agrees to and with each other party hereto, not to build or in any manner encourage the building of new lines or the maintenance of old ones in opposition to or in competition with the lines of any party hereto; nor sell, lease, or in any way dispose of any line owned or controlled by such party to any person or company to be used or operated as a competing line to the lines of any party hereto, nor sell, lease or otherwise dispose of any telegraph patent or interest owned or controlled by such party to any person or company to use, or who shall propose to use, a telegraph line in competition with the lines of the parties hereto, or which shall divert any business from such line properly belonging thereto: —

Sec. 2. And in any case any party hereto, shall sell, lease or otherwise dispose of any line, telegraph patent or interest to any person or company, the instrument of conveyance by which such sale, lease or transfer shall be affected [*sic*], shall contain a covenant binding the party taking the same, to each of the parties hereto, to perform and fulfil the conditions of this article, and said instrument shall also contain a clause, that a violation of such covenant shall render such sale, lease or other transfer of any line, telegraph patent, or interest, absolutely null and void. But nothing herein contained shall be construed to prevent any party hereto from extending, by such means as each may elect, the construction of new lines or the purchase or lease of old ones, within their respective limits, provided the same shall not affect prejudicially the interests of any other party hereto.

ART. XI. It is hereby mutually covenanted and agreed by each and all the parties hereto, that patent rights for lines, from any point or points on the Mississippi river to the Pacific ocean, shall be and hereby are reserved as the common property of the parties hereto, out of the territory allotted to any of said parties respectively, but said

rights are not to come in conflict with the lines of said parties for the local business within their respective territories.

ART. XII. It is agreed that the parties of the *first* and *second* parts shall each have the right to establish as many offices in the City of New York as they may see fit, and to do city business.

ART. XIII. Sec. 1. And it is hereby covenanted and agreed, that the Montreal Telegraph Company of Canada may be admitted to a participation in the provisions of this compact, on such terms and conditions as the parties hereto of the *first*, *second* and *fourth* parts shall agree upon, anything herein contained to the contrary notwithstanding; all the parties hereto having the same voice in the disposition of the common property as in other cases.

Sec. 2. And any three of the parties hereto may hereafter agree to connect exclusively with any other existing line or lines, on such terms as they see fit, provided such agreement shall in no way be prejudicial to the interests of any one or more of the parties hereto; nor in violation of any of the provisions of this Agreement. But no agreement, in this article mentioned, shall be finally concluded and become binding, until fully thirty days after the same shall have been submitted to each of the other parties, to give them an opportunity to state their objections, if any they have, to such agreement.

ART XIV. Sec. 1. It is further mutually covenanted and agreed, by each and all of the parties hereto, that, in case either of said parties shall desire to increase the through tariffs or charges and cannot agree with the other parties affected by such increase; or in case any two parties hereto shall disagree as to the amount of tariffs, for business passing over the lines of both, or the share of such tariff to be paid to each; or in case of any dispute between any two parties hereto, growing out of this Agreement, the same shall be referred to one person or more disinterested person or persons, to be mutually chosen by said disagreeing parties:—And upon such selection the person or persons so chosen shall, on request of either party notify the other party of the time and place of the hearing in the premises, and if either after due notice shall neglect or refuse, then and there to attend, said referee or referees may, at discretion, proceed *ex-parte* the decision of whom or a major part of whom, shall be binding and conclusive upon the parties; except that such decision in respect to *tariffs* shall not be binding for a longer period than two years:—after the expiration of that period and after three months notice, that question may be again revised by the proceedings herein provided.

Sec. 2. But, if the parties in controversy cannot agree to choose a tribunal for the settlement of the controversies aforesaid, the subject of their disagreement may be referred to three disinterested persons, to be selected in the manner following, to wit: The President or other officer legally acting as such, of each of the companies, parties hereto, not interested in the controversy, shall each nominate two disinterested persons, and notify the disputing parties thereof, who shall each choose one from the

persons so nominated, and the two so chosen as aforesaid, within thirty days after notice of said nomination, the other party may choose both as aforesaid, and the two so chosen shall choose the third:

Sec. 3. Provided, however, that no party shall be compelled to refer any question or dispute as above provided, until at least three of the Presidents or the Officers legally acting as such, of the companies, parties hereto, and not parties to the dispute, shall certify, in writing, that in their opinion, such question or dispute *ought*, if not settled between the parties themselves, *to be referred* to one or more disinterested persons, as hereinbefore provided.

Sec. 4. And if, after the above proceedings shall be had, any party hereto, shall *then* neglect or refuse to enter into a reference, in one of the modes aforesaid, or, entering into the same, shall neglect or refuse to attend a hearing before the tribunal thus selected, or so attending, shall neglect or refuse to comply with, abide by, or perform the decision or award of said tribunal, then the party, so neglecting or refusing, may be expelled from all participation in the provisions of this compact, whereby said party, so expelled, shall be deprived and debarred of the enjoyment of any and all of the rights, privileges and benefits, resulting therefrom.

Sec. 5. And, said expulsion shall be had in the manner following, to wit: All the parties hereto shall be notified, in writing, by the aggrieved party, of the proceedings had to settle the matter in dispute, and of the neglect or refusal of the party to comply with the provisions aforesaid:—*whereupon*, the parties hereto, not parties to the controversy, shall without delay, convene their respective boards of directors, or boards of control, who shall give reasonable notice to the party complained of, to show cause why such party should not be expelled from this association, and in case the party complained of shall neglect or refuse to appear before any of said boards, or fail to show sufficient cause, then such board shall proceed at once to act upon said question of expulsion; and if it shall be found that all of said parties, by a majority vote of their respective boards shall decide in *favor* of expulsion, the same shall be so certified to the disputing parties, and thenceforth said expelled party shall be deprived and debarred of all the rights, privileges and benefits of this Agreement: But such expulsion shall in no way affect, impair or discharge the rights or obligations, the duties or liabilities of the remaining parties thereto, but the same shall continue in full force and be as effectual and binding upon each and all of them, as if originally made by them only.

Sec. 6. All reversion of the rights and privileges of the expelled party consequent upon such expulsion, shall belong to and become the property of the remaining parties in common, in the proportions as herein before provided and agreed, and may be disposed of in the same manner as herein provided, for the disposition of other common property.

ART. XV. Sec. 1. It is finally hereby covenanted and agreed that this Agreement shall exist and continue in force for the term of *Thirty* years, and thereafter until twelve

months notice shall have been given of the intention of any one of said parties to withdraw therefrom.

Sec. 2. And this agreement shall, in each and every covenant and agreement herein contained, as effectually bind the *successors* and *assigns* of each and all the parties hereto, as if those words had been particularly recited therein.

ART. XVI. Sec. 1. It is recommended, as a matter of expediency rather than of contract, that a meeting annually—and as much oftener as any exigency may require—be held of the parties hereto, at such place as shall be designated at the prior meeting, to *consult* and *advise* upon all matters of interest to the parties to this compact, at which meetings delegates may be sent by the parties hereto, with instructions to present any matters for deliberation, or any subject for consideration; but there shall be no change of this Agreement either by addition, subtraction or revision, without the concurrence of *all* the parties hereto.

Sec. 2. The first annual meeting, as above recommended, shall be held in the city of New York, on the third Wednesday of October, 1858.

In witness Whereof, the parties hereto, by their respective and duly authorized officers or representatives, have subscribed their names to six several agreements, each a counterpart of this one, and affixed the seal of their respective Companies thereto, this tenth day of August, in the year of our Lord one thousand eight hundred and fifty-seven.

Signed and Sealed

in the presence of

[No name given in printed source]

Smyth v. Ames

169 U.S. 466 (1898)

Mr. Justice HARLAN delivered the opinion of the court: *** Each of these suits was brought July 28, 1893, and involves the constitutionality of an act of the legislature of Nebraska approved by the governor April 12, 1893, and which took effect August 1, 1893. It was an act “to regulate railroads, to classify freights, to fix reasonable maximum rates to be charged for the transportation of freights upon each of the railroads in the state of Nebraska, and to provide penalties for the violation of this act.” Acts Neb. 1893, c. 24; Comp. St. Neb. 1893, c. 72, art. 12. The act is referred to in the record as “House Roll 33.”

*** The power to enact the statute whose validity is now assailed—that is, the above statute of August 1, 1893, regulating railroads, classifying freights, fixing reasonable maximum rates, etc., in Nebraska—was referred by counsel to the general legislative power of the state, as well as to the fourth section of article 11 of the state constitution which provides: “Railways heretofore constructed, or that may hereafter be constructed in this state, are hereby declared public highways, and shall be free to all persons for the transportation of their persons and property thereon, under such regulations as may be prescribed by law. And the legislature may from time to time pass laws establishing reasonable maximum rates of charges for the transportation of passengers and freight on the different railroads in this state. The liability of railroad corporations as common carriers shall never be limited.”

*** We are now to inquire whether the Nebraska statute is repugnant to the constitution of the United States. By the fourteenth amendment it is provided that no state shall deprive any person of property without due process of law, nor deny to any person within its jurisdiction the equal protection of the laws. That corporations are persons within the meaning of this amendment is now settled. *Santa Clara Co. v. Southern Pac. R. Co.*, 118 U.S. 394, 396; *Railroad Co. v. Gibbes*, 142 U.S. 386, 391; *Railway Co. v. Ellis*, 165 U.S. 150, 154. What amounts to deprivation of property without due process of law, or what is a denial of the equal protection of the laws, is often difficult to determine, especially where the question relates to the property of a quasi public corporation, and the extent to which it may be subjected to public control. But this court, speaking by Chief Justice Waite, has said that, while the state has power to fix the charges by railroad companies for the transportation of persons and property within its own jurisdiction, unless restrained by valid contract, or unless what is done amounts to a regulation of foreign or interstate commerce, such power is not without limit; and that, “under pretense of regulating fares and freights, the state cannot require a railroad corporation to carry persons or property without reward, neither can it do that which in law amounts to the taking of private property for public use without just compensation, or without due process of law.” *Railroad Commission Cases*, 116 U.S. 307, 325, 331. ***

In view of the adjudications these principles must be regarded as settled:

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

The cases before us directly present the important question last stated.

Before entering upon its examination, it may be observed that the grant to the legislature in the constitution of Nebraska of the power to establish maximum rates for the transportation of passengers and freight on railroads in that state has reference to "reasonable" maximum rates. These words strongly imply that it was not intended to give a power to fix maximum rates without regard to their reasonableness. Be this as it may, it cannot be admitted that the power granted may be exerted in derogation of rights secured by the constitution of the United States, or that the judiciary may not, when its jurisdiction is properly invoked, protect those rights.

What are the considerations to which weight must be given when we seek to ascertain the compensation that a railroad company is entitled to receive, and a prohibition upon the receiving of which may be fairly deemed a deprivation by legislative decree of property without due process of law? Undoubtedly, that question could be more easily determined by a commission composed of persons whose special skill, observation, and experience qualifies them to so handle great problems of transportation as to do justice both to the public and to those whose money has been used to construct and maintain highways for the convenience and benefit of the people. But, despite the difficulties that confessedly attend the proper solution of such questions, the court cannot shrink from the duty to determine whether it be true, as alleged, that the Nebraska statute invades or destroys rights secured by the supreme law of the land. * * *

We turn now to the evidence in the voluminous record before us for the purpose of ascertaining whether—looking at the cases in the light of the facts as they existed

when the decrees were rendered—the Nebraska statute, if enforced, would, by its necessary operation, have deprived the companies, whose stockholders and bondholders here complain, of the right to obtain just compensation for the services rendered by them.

The first and most important contention of the plaintiffs is that, if the statute had been in force during any one of the three years preceding its passage, the defendant companies would have been compelled to use their property for the public substantially without reward, or without the just compensation to which it was entitled. We think this mode of calculation for ascertaining the probable effect of the Nebraska statute upon the railroad companies in question is one that may be properly used.

*** By like calculations, it will appear that each of the railroad companies would have conducted their local business at a loss during the periods stated, except that in the year ending June 30, 1891, and in the year ending June 30, 1893, the earnings of the Fremont Company, and in the years ending the 30th days of June 1892 and 1893, respectively, the earnings of the Union Pacific Company would have slightly exceeded their operating expenses.

*** It is said by the appellants that the local rates established by the Nebraska statute are much higher than in the state of Iowa, and that fact shows that the Nebraska rates are reasonable. This contention was thus met by the circuit court: “It is, however, urged by the defendants that in the general tariffs of these companies, there is an inequality; that the rates in Nebraska are higher than those in adjoining states; and that the reduction by house roll 33 simply establishes an equality between Nebraska and the other states through which the roads run. The question is asked, are not the people of Nebraska entitled to as cheap rates as the people of Iowa? Of course, relatively they are. That is, the roads may not discriminate against the people of any one state, but they are not necessarily bound to give absolutely the same rates to the people of all the states, for the kind and amount of business and the cost thereof are factors which determine largely the question of rates, and these vary in the several states. The volume of business in one state may be greater per mile, while the cost of construction and of maintenance is less; hence, to enforce the same rates in both states might result in great injustice in one, while it would only be reasonable and fair in another. Comparisons, therefore, between the rates of two states, are of little value, unless all the elements that enter into the problem are presented. It may be true, as testified by some of the witnesses, that the existing local rates in Nebraska are 40 per cent. higher than similar rates in the state of Iowa. But it is also true that the mileage earnings in Iowa are greater than in Nebraska. In Iowa there are 230 people to each mile of railroad, while in Nebraska there are but 190; and, as a general rule, the more people there are the more business there is. Hence a mere difference between the rates in two states is of comparatively little significance.” 64 Fed. 165. In these views we concur, and it is unnecessary to add anything to what was said by the circuit court on this point.

It is further said, in behalf of the appellants, that the reasonableness of the rates established by the Nebraska statute is not to be determined by the inquiry whether such rates would leave a reasonable net profit from the local business affected thereby, but that the court should take into consideration, among other things, the whole business of the company; that is, all its business, passenger and freight, interstate and domestic. If it be found upon investigation that the profits derived by a railroad company from its interstate business alone are sufficient to cover operating expenses on its entire line, and also to meet interest, and justify a liberal dividend upon its stock, may the legislature prescribe rates for domestic business that would bring no reward, and be less than the services rendered are reasonably worth? Or must the rates for such transportation as begins and ends in the state be established with reference solely to the amount of business done by the carrier wholly within such state, to the cost of doing such local business, and to the fair value of the property used in conducting it, without taking into consideration the amount and cost of its interstate business, and the value of the property employed in it? If we do not misapprehend counsel, their argument leads to the conclusion that the state of Nebraska could legally require local freight business to be conducted even at an actual loss, if the company earned on its interstate business enough to give it just compensation in respect of its entire line and all its business, interstate and domestic. We cannot concur in this view. In our judgment, it must be held that the reasonableness or unreasonableness of rates prescribed by a state for the transportation of persons and property wholly within its limits must be determined without reference to the interstate business done by the carrier, or to the profits derived from it. The state cannot justify unreasonably low rates for domestic transportation, considered alone, upon the ground that the carrier is earning large profits on its interstate business, over which, so far as rates are concerned, the state has no control. Nor can the carrier justify unreasonably high rates on domestic business upon the ground that it will be able only in that way to meet losses on its interstate business. So far as rates of transportation are concerned, domestic business should not be made to bear the losses on interstate business, nor the latter the losses on domestic business. It is only rates for the transportation of persons and property between points within the state that the state can prescribe; and when it undertakes to prescribe rates not to exceed by the carrier it must do so with reference exclusively to what is just and reasonable, as between the carrier and the public, in respect of domestic business. The argument that a railroad line is an entirety; that its income goes into, and its expenses are provided for, out of a common fund; and that its capitalization is on its entire line, within and without the state; can have no application where the state is without authority over rates on the entire line, and can only deal with local rates, and make such regulations as are necessary to give just compensation on local business.

*** It appears, from what has been said, that if the rates prescribed by the act of 1893 had been in force during the years ending June 30, 1891, 1892, and 1893, the Fremont Company, in the years ending June 30, 1891, and June 30, 1893, and the

Union Pacific company, in the years ending June 30, 1892, and June 30, 1893, would each have received more than enough to pay operating expenses. Do those facts affect the general conclusion as to the probable effect of the act of 1893? In the discussion of this question the plaintiffs contended that a railroad company is entitled to exact such charges for transportation as will enable it at all times not only to pay operating expenses, but also to meet the interest regularly accruing upon all its outstanding obligations, and justify a dividend upon all its stock; and that to prohibit it from maintaining rates or charges for transportation adequate to all those ends will deprive it of its property without due process of law, and deny to it the equal protection of the laws. This contention was the subject of elaborate discussion, and, as it bears upon each case in its important aspects, it should not be passed without examination.

In our opinion, the broad proposition advanced by counsel involves some misconception of the relations between the public and a railroad corporation. It is unsound, in that it practically excludes from consideration the fair value of the property used, omits altogether any consideration of the right of the public to be exempt from unreasonable exactions, and makes the interests of the corporation maintaining a public highway the sole test in determining whether the rates established by or for it are such as may be rightfully prescribed as between it and the public. A railroad is a public highway, and none the less so because constructed and maintained through the agency of a corporation deriving its existence and powers from the state. Such a corporation was created for public purposes. It performs a function of the state. Its authority to exercise the right of eminent domain and to charge tolls was given primarily for the benefit of the public. It is under governmental control, though such control must be exercised with due regard to the guaranties for the protection of its property. *Olcott v. Supervisors*, 16 Wall. 678, 694; *Sinking Fund Cases*, 99 U.S. 700, 719; *Cherokee Nation v. Southern Kan. Ry. Co.*, 135 U.S. 641, 657. It cannot, therefore, be admitted that a railroad corporation maintaining a highway under the authority of the state may fix its rates with a view solely to its own interests, and ignore the rights of the public. But the rights of the public would be ignored if rates for the transportation of persons or property on a railroad are exacted without reference to the fair value of the property used for the public, or the fair value of the services rendered, but, in order simply that the corporation may meet operating expenses, pay the interest on its obligations, and declare a dividend to stockholders.

If a railroad corporation has bonded its property for an amount that exceeds its fair value, or if its capitalization is largely fictitious, it may not impose upon the public the burden of such increased rates as may be required for the purpose of realizing profits upon such excessive valuation or fictitious capitalization; and the apparent value of the property and franchises used by the corporation, as represented by its stocks, bonds, and obligations, is not alone to be considered when determining the rates that may be reasonably charged. What was said in *Turnpike Co. v. Sandford*, 164 U.S. 578, 596, 597 is pertinent to the question under consideration. It was there

observed: "It cannot be said that a corporation is entitled, as of right, and without reference to the interests of the public, to realize a given per cent upon its capital stock. When the question arises whether the legislature has exceeded its constitutional power in prescribing rates to be charged by a corporation controlling a public highway, stockholders are not the only persons whose rights or interests are to be considered. The rights of the public are not to be ignored. It is alleged here that the rates prescribed are unreasonable and unjust to the company and its stockholders. But that involves an inquiry as to what is reasonable and just for the public. * * * The public cannot properly be subjected to unreasonable rates in order simply that stockholders may earn dividends. The legislature has the authority in every case, where its power has not been restrained by contract, to proceed upon the ground that the public may not rightfully be required to submit to unreasonable exactions for the use of a public highway established and maintained under legislative authority. If a corporation cannot maintain such a highway and earn dividends for stockholders, it is a misfortune for it and them which the constitution does not require to be remedied by imposing unjust burdens upon the public. So that the right of the public to use the defendant's turnpike upon payment of such tolls as, in view of the nature and value of the services rendered by the company, are reasonable, is an element in the general inquiry whether the rates established by law are unjust and unreasonable."

A corporation maintaining a public highway, although it owns the property it employs for accomplishing public objects, must be held to have accepted its rights, privileges, and franchises subject to the condition that the government creating it, or the government within whose limits it conducts its business, may, by legislation, protect the people against unreasonable charges for the services rendered by it. It cannot be assumed that any railroad corporation, accepting franchises, rights, and privileges at the hands of the public, ever supposed that it acquired, or that it was intended to grant to it, the power to construct and maintain a public highway simply for its benefit, without regard to the rights of the public. But it is equally true that the corporation performing such public services, and the people financially interested in its business and affairs, have rights that may not be invaded by legislative enactment in disregard of the fundamental guaranties for the protection of property. The corporation may not be required to use its property for the benefit of the public without receiving just compensation for the services rendered by it. How such compensation may be ascertained, and what are the necessary elements in such an inquiry, will always be an embarrassing question. As said in the case last cited: "Each case must depend upon its special facts; and when a court, without assuming itself to prescribe rates, is required to determine whether the rates prescribed by the legislature for a corporation controlling a public highway are, as an entirety, so unjust as to destroy the value of its property for all the purposes for which it was acquired, its duty is to take into consideration the interest both of the public and of the owner of the property, together with all other circumstances that are fairly to be considered in determining whether the legislature has, under the guise of regulating rates, exceeded its constitutional authority,

and practically deprived the owner of property without due process of law. * * * The utmost that any corporation operating a public highway can rightfully demand at the hands of the legislature, when exerting its general powers, is that it receive what, under all the circumstances, is such compensation for the use of its property as will be just both to it and to the public.”

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 property 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 a 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. But even upon this basis, and determining the probable effect of the act of 1893 by ascertaining what could have been its effect if it had been in operation during the three years immediately preceding its passage, we perceive no ground on the record for reversing the decree of the circuit court. On the contrary, we are of opinion that as to most of the companies in question there would have been, under such rates as were established by the act of 1893, an actual loss in each of the years ending June 30, 1891, 1892, and 1893; and that, in the exceptional cases above stated, when two of the companies would have earned something above operating expenses in particular years, the receipts or gains, above operating expenses, would have been too small to affect the general conclusion that the act, if enforced, would have deprived each of the railroad companies involved in these suits of the just compensation secured to them by the constitution. Under the evidence, there is no ground for saying that the operating expenses of any of the companies were greater than necessary. * * *

*** Perceiving no error on the record in the light of the facts presented to the circuit court, the decree in each case must be affirmed.

It is so ordered.

**State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public
Service Commission of Missouri**

262 U.S. 276 (1923)

[Mr. Justice McREYNOLDS's opinion for the Court is omitted.]

Mr. Justice BRANDEIS, with whom Mr. Justice HOLMES concurs: I concur in the judgment of reversal. But I do so on the ground that the order of the state commission prevents the utility from earning a fair return on the amount prudently invested¹ in it. Thus, I differ fundamentally from my brethren concerning the rule to be applied in determining whether a prescribed rate is confiscatory. The court, adhering to the so-called rule of *Smyth v. Ames*, 169 U.S. 466, and further defining it, declares that what is termed value must be ascertained by giving weight, among other things, to estimates of what it would cost to reproduce the property at the time of the rate hearing.

The so-called rule of *Smyth v. Ames* is, in my opinion, legally and economically unsound. The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the federal Constitution guarantees to the utility the opportunity to earn a fair return. Thus it sets the limit to the power of the state to regulate rates. The Constitution does not guarantee to the utility the opportunity to earn a return on the value of all items of property used by the utility or of any of them. The several items of property constituting the utility, taken singly, and freed from the public use, may conceivably have an aggregate value greater than if the items are used in combination. The owner is at liberty, in the absence of controlling statutory provision, to withdraw his property from the public service, and, if he does so, may obtain for it exchange value. But, so long as the specific items of property are employed by the utility, their exchange value is not of legal significance.

The investor agrees, by embarking capital in a utility, that its charges to the public shall be reasonable. His company is the substitute for the state in the performance of the public service, thus becoming a public servant. The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes, not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefor, the allowance for risk incurred, and enough more to attract capital. The reasonable rate to be prescribed by a commission may allow an efficiently managed utility much more. But a rate is constitutionally compensatory, if it allows to the utility the opportunity to earn the cost of the service as thus defined.

To decide whether a proposed rate is confiscatory the tribunal must determine both what sum would be earned under it and whether that sum would be a fair return. The decision involves ordinarily the making of four subsidiary ones:

¹ The term "prudent investment" is not used in a critical sense. There should not be excluded, from the finding of the base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures. Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown.

- (1) What the gross earnings from operating the utility under the rate in controversy would be. (A prediction.)
- (2) What the operating expenses and charges, while so operating, would be. (A prediction.)
- (3) The rate base; that is, what the amount is on which a return should be earned. (Under *Smyth v. Ames*, an opinion, largely.)
- (4) What rate of return should be deemed fair. (An opinion, largely.)

A decision that a rate is confiscatory (or compensatory) is thus the resultant of four subsidiary determinations. Each of the four involves forming a judgment, as distinguished from ascertaining facts; and as to each factor there is usually room for difference in judgment. But the first two factors do not ordinarily present serious difficulties. The doubts and uncertainties incident to prophecy, which affect them, can often be resolved by a test period; and meanwhile protection may be afforded by giving a bond. The doubts and uncertainties incident to the last two factors can be eliminated, or lessened, only by redefining the rate base, called value, and the measure of fairness in return, now applied under the rule of *Smyth v. Ames*. The experience of the 25 years since that case was decided has demonstrated that the rule there enunciated is delusive. In the attempt to apply it insuperable obstacles have been encountered. It has failed to afford adequate protection either to capital or to the public. It leaves open the door to grave injustice. To give to capital embarked in public utilities the protection guaranteed by the Constitution, and to secure for the public reasonable rates, it is essential that the rate base be definite, stable, and readily ascertainable, and that the percentage to be earned on the rate base be measured by the cost, or charge, of the capital employed in the enterprise. It is consistent with the federal Constitution for this court now to lay down a rule which will establish such a rate base and such a measure of the rate of return deemed fair. In my opinion, it should do so.

The rule of *Smyth v. Ames* sets the laborious and baffling task of finding the present value of the utility. It is impossible to find an exchange value for a utility, since utilities, unlike merchandise or land, are not commonly bought and sold in the market. Nor can the present value of the utility be determined by capitalizing its net earnings, since the earnings are determined, in large measure, by the rate which the company will be permitted to charge, and thus the vicious circle would be encountered. So, under the rule of *Smyth v. Ames*, it is usually sought to prove the present value of a utility by ascertaining what it actually cost to construct and install it, or by estimating what it should have cost, or by estimating what it would cost to reproduce or to replace it. To this end an enumeration is made of the component elements of the utility, tangible and intangible; then the actual, or the proper, cost of producing, or of reproducing, each part is sought; and finally it is estimated how much less than the new each part, or the whole, is worth. That is, the depreciation is estimated. Obviously each step in the process of estimating the cost of reproduction, or replacement, involves forming an opinion, or exercising judgment, as distinguished from

merely ascertaining facts. And this is true, also, of each step in the process of estimating how much less the existing plant is worth than if it were new. There is another potent reason why, under the rule of *Smyth v. Ames*, the room for difference in opinion as to the present value of a utility is so wide. The rule does not measure the present value either by what the utility cost to produce, or by what it should have cost, or by what it would cost to reproduce, or to replace it.⁵ Under that rule the tribunal is directed, in forming its judgment, to take into consideration all those and also other elements, called relevant facts.

Obviously, "value" cannot be a composite of all these elements. Nor can it be arrived at on all these bases. They are very different, and must, when applied in a particular case, lead to widely different results. The rule of *Smyth v. Ames*, as interpreted and applied, means merely that all must be considered. What, if any, weight shall be given to any one, must practically rest in the judicial discretion of the tribunal which makes the determination. Whether a desired result is reached may depend upon how any one of many elements is treated. * * *

The efforts of courts to control commissions' findings of value have largely failed. The reason lies in the character of the rule declared in *Smyth v. Ames*. The rule there stated was to be applied solely as a means of determining whether rates already prescribed by the Legislature were confiscatory. It was to be applied judicially after the rate had been made, and by a court which had had no part in making the rate. When applied under such circumstances, the rule, although cumbersome, may occasionally be effective in destroying an obstruction to justice, as the action of a court is, when it sets aside the verdict of a jury. But the commissions undertook to make the rule their standard for constructive action. They used it as a guide for making or approving rates, and the tendency developed to fix as reasonable the rate which is not so low as to be confiscatory. Thus the rule which assumes that rates of utilities will ordinarily be higher than the minimum required by the Constitution has, by the practice of the commissions, eliminated the margin between a reasonable rate and a merely compensatory rate, and, in the process of rate-making, effective judicial review is very often rendered impossible. The result, inherent in the rule itself, is arbitrary action on the part of the rate-regulating body; for the rule not only fails to furnish any applicable standard of judgment, but directs consideration of so many elements that almost any result may be justified.

The adoption of present value of the utility's property, as the rate base, was urged in 1893 on behalf of the community, and it was adopted by the courts, largely, as a

⁵ This court declared in *Smyth v. Ames*, 169 U.S. 466, 547, that "present as compared with the original cost of construction" is to be considered, and in *Minnesota Rate Cases*, 230 U.S. 352, 452, that "the cost of reproduction method is of service in ascertaining the present value of the plant, when it is reasonably applied and when the cost of reproducing the property may be ascertained with a proper degree of certainty." Reproduction cost was thus held to be evidence of value. But it has never been held to be the measure of value.

protection against inflated claims, based on what were then deemed inflated prices of the past. See argument in *Smyth v. Ames*, 169 U.S. 466, 479, 480. Reproduction cost, as the measure, or as evidence, of present value, was also pressed then by representatives of the public, who sought to justify legislative reductions of railroad rates. The long depression which followed the panic of 1893 had brought prices to the lowest level reached in the nineteenth century. Insistence upon reproduction cost was the shippers' protest against burdens believed to have resulted from watered stocks, reckless financing, and unconscionable construction contracts. Those were the days before state legislation prohibited the issue of public utility securities without authorization from state officials, before accounting was prescribed and supervised, when outstanding bonds and stocks were hardly an indication of the amount of capital embarked in the enterprise, when depreciation accounts were unknown, and when book values, or property accounts, furnished no trustworthy evidence either of cost or of real value. Estimates of reproduction cost were then offered, largely as a means, either of supplying lacks in the proof of actual cost and investment, or of testing the credibility of evidence adduced, or of showing that the cost of installation had been wasteful. For these purposes evidence of the cost of reproduction is obviously appropriate.

At first reproduction cost was welcomed by commissions as evidence of present value. Perhaps it was because the estimates then indicated values lower than the actual cost of installation; for, even after the price level had begun to rise, improved machinery and new devices tended for some years to reduce construction costs. Evidence of reproduction costs was certainly welcomed, because it seemed to offer a reliable means for performing the difficult task of fixing, in obedience to *Smyth v. Ames*, the value of a new species of property to which the old tests—selling price or net earnings—were not applicable. The engineer spoke in figures—a language implying certitude. His estimates seemed to be free of the infirmities which had stamped as untrustworthy the opinion evidence of experts common in condemnation cases. Thus, for some time, replacement cost, on the basis of prices prevailing at the date of the valuation, was often adopted by state commissions as the standard for fixing the rate base. But gradually it came to be realized that the definiteness of the engineer's calculations was delusive, that they rested upon shifting theories, and that their estimates varied so widely as to intensify, rather than to allay doubts. When the price levels had risen largely, and estimates of replacement cost indicated values much greater than the actual cost of installation, many commissions refused to consider valuable what one declared to be assumptions based on things that never happened and estimates requiring the projection of the engineer's imagination into the future and methods of construction and installation that have never been and never will be adopted by sane men. Finally the great fluctuation in price levels incident to the World War led to the transfusion of the engineer's estimate of cost with the economist's prophecies concerning the future price plateaus. Then the view that these estimates were not to be trusted as evidence of present value was frequently expressed, and state utility com-

missions, while admitting the evidence in obedience to *Smyth v. Ames*, failed, in ever-increasing numbers to pay heed to it in fixing the rate base. The conviction is widespread that a sound conclusion as to the actual value of a utility is not to be reached by a meticulous study of conflicting estimates of the cost of reproducing new the congeries of old machinery and equipment, called the plant, and the still more fanciful estimates concerning the value of the intangible elements of an established business. Many commissions, like that of Massachusetts, have declared recently that "capital honestly and prudently invested must, under normal conditions, be taken as the controlling factor in fixing the basis for computing fair and reasonable rates."

To require that reproduction cost at the date of the rate hearing be given weight in fixing the rate base may subject investors to heavy losses when the high war and post-war price levels pass and the price trend is again downward. The aggregate of the investments which have already been made at high costs since 1914, and of those which will be made before prices and costs can fall heavily, may soon exceed by far the depreciated value, of all the public utility investments made theretofore at relatively low cost. For it must be borne in mind that depreciation is an annual charge. That accrued on plants constructed in the long years prior to 1914 is much larger than that accruing on the properties installed in the shorter period since.

That part of the rule of *Smyth v. Ames* which fixes the rate of return deemed fair, at the percentage customarily paid on similar investments at the time of the rate hearing also exposes the investor and the public to danger of serious injustice. If the replacement cost measure of value and the prevailing rate measure of fairness of return should be applied, a company which raised, in 1920, for additions to plant, \$1,000,000 on a 9 per cent basis, by a stock issue, or by long-term bond issue, may find a decade later that the value of the plant (disregarding depreciation) is only \$600,000, and that the fair return on money then invested in such enterprise is only 6 per cent. Under the test of a compensatory rate, urged in reliance upon *Smyth v. Ames*, a prescribed rate would not be confiscatory, if it appeared that the utility could earn under it \$36,000 a year; whereas \$90,000 would be required to earn the capital charges. On the other hand, if a plant had been built in times of low costs, at \$1,000,000 and the capital had been raised to the extent of \$750,000 by an issue at par of 5 per cent 30-year bonds and to the extent of \$250,000 by stock at par, and 10 years later the price level was 75 per cent higher and the interest rates 8 per cent it would be a fantastic result to hold that a rate was confiscatory, unless it yielded 8 per cent on the then reproduction cost of \$1,750,000 for that would yield an income of \$140,000, which would give the bondholders \$37,500, and to the holders of the \$250,000 stock \$102,500, a return of 41 per cent per annum. Money required to establish in 1920 many necessary plants has cost the utility 10 per cent on 30-year bonds. These long-time securities, issued to raise needed capital, will in 1930 and thereafter continue to bear the extra high rates of interest, which it was necessary to offer in 1920 in order to secure the required capital. The prevailing rate for such investments may in 1930 be only 7 per cent., or indeed 6 per cent., as it was found to

be in 1904, in *Stanislaus County v. San Joaquin Co.*, 192 U.S. 201, in 1909 in *Knoxville v. Knoxville Water Co.*, 212 U.S. 1, and in 1912, in *Cedar Rapids Gas Co. v. Cedar Rapids*, 223 U.S. 655, 670. A rule which limits the guaranteed rate of return on utility investments to that which may prevail at the time of the rate hearing may fall far short of the capital charge then resting upon the company.

In essence, there is no difference between the capital charge and operating expenses, depreciation, and taxes. Each is a part of the current cost of supplying the service, and each should be met from current income. When the capital charges are for interest on the floating debt paid at the current rate, this is readily seen. But it is no less true of a legal obligation to pay interest on long-term bonds, entered into years before the rate hearing and to continue for years thereafter; and it is true, also, of the economic obligation to pay dividends on stock, preferred or common. The necessary cost, and hence the capital charge, of the money embarked recently in utilities, and of that which may be invested in the near future, may be more, as it may be less, than the prevailing rate of return required to induce capital to enter upon like enterprises at the time of a rate hearing ten years hence. To fix the return by the rate which happens to prevail at such future day, opens the door to great hardships. Where the financing has been proper, the cost to the utility of the capital, required to construct, equip, and operate its plant, should measure the rate of return which the Constitution guarantees opportunity to earn.

The adoption of the amount prudently invested as the rate base and the amount of the capital charge as the measure of the rate of return would give definiteness to these two factors involved in rate controversies which are now shifting and treacherous, and which render the proceedings peculiarly burdensome and largely futile. Such measures offer a basis for decision which is certain and stable. The rate base would be ascertained as a fact, not determined as matter of opinion. It would not fluctuate with the market price of labor, or materials, or money. It would not change with hard times or shifting populations. It would not be distorted by the fickle and varying judgments of appraisers, commissions, or courts. It would, when once made in respect to any utility, be fixed, for all time, subject only to increases to represent additions to plant, after allowance for the depreciation included in the annual operating charges. The wild uncertainties of the present method of fixing the rate base under the so-called rule of *Smyth v. Ames* would be avoided, and likewise the fluctuations which introduce into the enterprise unnecessary elements of speculation, create useless expense, and impose upon the public a heavy, unnecessary burden.

In speculative enterprises the capital cost of money is always high—partly because the risks involved must be covered; partly because speculative enterprises appeal only to the relatively small number of investors who are unwilling to accept a low return on their capital. It is to the interest both of the utility and of the community that the capital be obtained at as low a cost as possible. About 75 per cent of the capital invested in utilities is represented by bonds. He who buys bonds seeks primarily safety. If he can obtain it, he is content with a low rate of interest. Through a fluctuating

rate base the bondholder can only lose. He can receive no benefit from a rule which increases the rate base as the price level rises; for his return, expressed in dollars, would be the same, whatever the income of the company. That the stockholder does not in fact receive an increased return in time of rapidly rising prices under the rule of *Smyth v. Ames*, as applied, the financial record of the last six years demonstrates. But the burden upon the community is heavy, because the risk makes the capital cost high.

The expense and loss now incident to recurrent rate controversies is also very large. The most serious vice of the present rule for fixing the rate base is not the existing uncertainty, but that the method does not lead to certainty. Under it, the value for ratemaking purposes must ever be an unstable factor. Instability is a standing menace of renewed controversy. The direct expense to the utility of maintaining an army of experts and of counsel is appalling. The indirect cost is far greater. The attention of officials high and low is, necessarily, diverted from the constructive tasks of efficient operation and of development. The public relations of the utility to the community are apt to become more and more strained, and a victory for the utility may in the end prove more disastrous than defeat would have been. The community defeated, but unconvinced, remembers, and may refuse aid when the company has occasion later to require its consent or co-operation in the conduct and development of its enterprise. Controversy with utilities is obviously injurious, also, to the public interest. The prime needs of the community are that facilities be ample and that rates be as low and as stable as possible. The community can get cheap service from private companies, only through cheap capital. It can get efficient service only if managers of the utility are free to devote themselves to problems of operation and of development. It can get ample service through private companies only if investors may be assured of receiving continuously a fair return upon the investment.

What is now termed the prudent investment is, in essence, the same thing as that which the court has always sought to protect in using the term present value. Twenty-five years ago, when *Smyth v. Ames* was decided, it was impossible to ascertain with accuracy, in respect to most of the utilities, in most of the states in which rate controversies arose, what it cost in money to establish the utility; or what the money cost with which the utility was established; or what income had been earned by it; or how the income had been expended. It was, therefore, not feasible, then, to adopt, as the rate base, the amount properly invested or, as the rate of fair return, the amount of the capital charge. Now the situation is fundamentally different. These amounts are, now, readily ascertainable in respect to a large, and rapidly increasing, proportion of the utilities. The change in this respect is due to the enlargement, meanwhile, of the powers and functions of state utility commissions. The issue of securities is now, and for many years has been, under the control of commissions, in the leading states. Hence the amount of capital raised (since the conferring of these powers) and its cost are definitely known, through current supervision and prescribed accounts, supplemented by inspection of the commission's engineering force. Like knowledge con-

cerning the investment of that part of the capital raised and expended before these broad functions were exercised by the utility commissions has been secured, in many cases, through investigations undertaken later, in connection with the issue of new securities or the regulation of rates. The amount and disposition of current earnings of all the companies are also known. It is, therefore, feasible now to adopt as the measure of a compensatory rate—the annual cost, or charge, of the capital prudently invested in the utility. And, hence, it should be done.

Value is a word of many meanings. That with which commissions and courts in these proceedings are concerned, in so-called confiscation cases, is a special value for rate-making purposes, not exchange value. * * * But, obviously, good will and franchise value are important elements when exchange value is involved; and where the community acquires a public utility by purchase or condemnation, compensation must be made for its good will and earning power, at least under some circumstances. Likewise, as between buyer and seller, the good will and earning power due to effective organization are often more important elements than tangible property. These cases would seem to require rejection of a rule which measured the rate base by cost of reproduction or by value in its ordinary sense.

The rule by which the utilities are seeking to measure the return is, in essence, reproduction cost of the utility or prudent investment, whichever is the higher. *** If the aim were to ascertain the value (in its ordinary sense) of the utility property, the inquiry would be, not what it would cost to reproduce the identical property, but what it would cost to establish a plant which could render the service, or in other words, at what cost could an equally efficient substitute be then produced. Surely the cost of an equally efficient substitute must be the maximum of the rate base, if prudent investment be rejected as the measure. The utilities seem to claim that the constitutional protection against confiscation guarantees them a return both upon unearned increment and upon the cost of property rendered valueless by obsolescence.

Federal Power Comm'n v. Hope Natural Gas Co.

320 U.S. 591 (1944)

Mr. Justice DOUGLAS delivered the opinion of the Court: The primary issue in these cases concerns the validity under the Natural Gas Act of 1938, 15 U.S.C. § 717 et seq., of a rate order issued by the Federal Power Commission reducing the rates chargeable by Hope Natural Gas Co. * * *

The Circuit Court of Appeals set aside the order of the Commission for the following reasons. (1) It held that the rate base should reflect the “present fair value” of the property, that the Commission in determining the “value” should have considered reproduction cost and trended original cost, and that “actual legitimate cost” (prudent investment) was not the proper measure of “fair value” where price levels had changed since the investment. (2) It concluded that the well-drilling costs and overhead items in the amount of some \$17,000,000 should have been included in the

rate base. (3) It held that accrued depletion and depreciation and the annual allowance for that expense should be computed on the basis of “present fair value” of the property not on the basis of “actual legitimate cost”.

The Circuit Court of Appeals also held that the Commission had no power to make findings as to past rates in aid of state regulation. But it concluded that those findings were proper as a step in the process of fixing future rates. Viewed in that light, however, the findings were deemed to be invalidated by the same errors which vitiated the findings on which the rate order was based.

Congress has provided in § 4(a) of the Natural Gas Act that all natural gas rates subject to the jurisdiction of the Commission “shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.” Sec. 5(a) gives the Commission the power, after hearing, to determine the “just and reasonable rate” to be thereafter observed and to fix the rate by order. Sec. 5(a) also empowers the Commission to order a “decrease where existing rates are unjust * * * unlawful, or are not the lowest reasonable rates.” And Congress has provided in § 19(b) that on review of these rate orders the “finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive.” 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 prescription⁸ of § 4(a) and § 5(a). It has not expressed in a specific rule the fixed principle of “just and reasonable”.

When we sustained the constitutionality of the Natural Gas Act in the *Natural Gas Pipeline Co.* case, we stated that the “authority of Congress to regulate the prices of commodities in interstate commerce is at least as great under the Fifth Amendment as is that of the states under the Fourteenth to regulate the prices of commodities in intrastate commerce.” 315 U.S. at page 582. 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. 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.

⁸ Sec. 6 of the Act comes the closest to supplying any definite criteria for rate making. It provides in subsection (a) that, “The Commission may investigate the ascertain the actual legitimate cost of the property of every natural-gas company, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property.” Subsection (b) provides that every natural-gas company on request shall file with the Commission a statement of the “original cost” of its property and shall keep the Commission informed regarding the “cost” of all additions, etc.

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. Its rate-making function, moreover, involves the making of “pragmatic adjustments.” *Id.*, 315 U.S. at page 586. And when the Commission’s order is challenged in the courts, the question is whether that order “viewed in its entirety” meets the requirements of the Act. Under the statutory standard of “just and reasonable” it is the result reached not the method employed which is controlling. 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 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 then important. Moreover, the Commission’s order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

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. Thus we stated in the *Natural Gas Pipeline Co.* case that “regulation does not insure that the business shall produce net revenues.” But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. 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. 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. 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. ***

In view of these various considerations we cannot say that an annual return of \$2,191,314 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. In that connection it will be recalled that Hope contended for a rate base of \$66,000,000 computed on reproduction cost new. The Commission points out that if that rate base were accepted, Hope’s average rate of return for the four-year period from 1937-1940 would amount to 3.27%. During that period Hope earned an annual average return of about 9% on the average invest-

ment. It asked for no rate increases. Its properties were well maintained and operated. As the Commission says such a modest rate of 3.27% suggests an “inflation of the base on which the rate has been computed.” *Dayton Power & Light Co. v. Public Utilities Commission*, 292 U.S. 290, 312. The incongruity between the actual operations and the return computed on the basis of reproduction cost suggests that the Commission was wholly justified in rejecting the latter as the measure of the rate base.

*** Since there are no constitutional requirements more exacting than the standards of the Act, a rate order which conforms to the latter does not run afoul of the former.

* * *

Reversed.

Duquesne Light Co. v. Barasch

488 U.S. 299 (1989)

Chief Justice REHNQUIST delivered the opinion of the Court: Pennsylvania law required that rates for electricity be fixed without consideration of a utility's expenditures for electrical generating facilities which were planned but never built, even though the expenditures were prudent and reasonable when made. The Supreme Court of Pennsylvania held that such a law did not take the utilities' property in violation of the Fifth Amendment to the United States Constitution. We agree with that conclusion, and hold that a state scheme of utility regulation does not “take” property simply because it disallows recovery of capital investments that are not “used and useful in service to the public.” 66 Pa. Cons. Stat. § 1315.

I

In response to predictions of increased demand for electricity, Duquesne Light Company (Duquesne) and Pennsylvania Power Company (Penn Power) joined a venture in 1967 to build more generating capacity. The project, known as the Central Area Power Coordination Group (CAPCO), involved three other electric utilities and had as its objective the construction of seven large nuclear generating units. In 1980 the participants canceled plans for construction of four of the plants. Intervening events, including the Arab oil embargo and the accident at Three Mile Island, had radically changed the outlook both for growth in the demand for electricity and for nuclear energy as a desirable way of meeting that demand. At the time of the cancellation, Duquesne's share of the preliminary construction costs associated with the four halted plants was \$34,697,389. Penn Power had invested \$9,569,665.

In 1980, and again in 1981, Duquesne sought permission from the Pennsylvania Public Utility Commission (PUC) to recoup its expenditures for the unbuilt plants over a 10-year period. The Commission deferred ruling on the request until it received the report from its investigation of the CAPCO construction. That report was issued in late 1982. The report found that Duquesne and Penn Power could not be faulted for initiating the construction of more nuclear generating capacity at the time

they joined the CAPCO project in 1967. The projections at that time indicated a growing demand for electricity and a cost advantage to nuclear capacity. It also found that the intervening events which ultimately confounded the predictions could not have been predicted, and that work on the four nuclear plants was stopped at the proper time. In summing up, the Administrative Law Judge found “that the CAPCO decisions in regard to the [canceled plants] at every stage to their cancellation, were reasonable and prudent.” He recommended that Duquesne and Penn Power be allowed to amortize their sunk costs in the project over a 10-year period. The PUC adopted the conclusions of the report.

In 1982, Duquesne again came before the PUC to obtain a rate increase. Again, it sought to amortize its expenditures on the canceled plants over 10 years. In January 1983, the PUC issued a final order which granted Duquesne the authority to increase its revenues \$105.8 million to a total yearly revenue in excess of \$800 million. The rate increase included \$3.5 million in revenue representing the first payment of the 10-year amortization of Duquesne’s \$35 million loss in the CAPCO plants.

The Pennsylvania Office of the Consumer Advocate (Consumer Advocate) moved the PUC for reconsideration in light of a state law enacted about a month before the close of the 1982 Duquesne rate proceeding. The Act, No. 335, 1982 Pa. Laws 1473, amended the Pennsylvania Utility Code by limiting “the consideration of certain costs in the rate base.” It provided that “the cost of construction or expansion of a facility undertaken by a public utility producing ... electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public.” 66 Pa. Cons. Stat. § 1315. On reconsideration, the PUC affirmed its original rate order. It read the new law as excluding the costs of canceled plants (obviously not used and useful) from the rate base, but not as preventing their recovery through amortization.

Meanwhile another CAPCO member, Penn Power, also sought to amortize its share of the canceled CAPCO power-plants over a 10-year period. The PUC granted Penn Power authority to increase its revenues by \$15.4 million to a total of \$184.2 million. Part of that revenue increase represented \$956,967 for the first year of the 10-year amortized recovery of Penn Power’s costs in the aborted nuclear plants.

The Consumer Advocate appealed both of these decisions to the Commonwealth Court, which by a divided vote held that the Commission had correctly construed § 1315. The Consumer Advocate then appealed to the Supreme Court of Pennsylvania, and that court reversed. That court held that the controlling language of the Act prohibited recovery of the costs in question either by inclusion in the rate base or by amortization. The court rejected appellants’ constitutional challenge to the statute thus interpreted, observing that “[t]he ‘just compensation’ safeguarded to a utility by the fourteenth amendment of the federal constitution is a reasonable return on the

fair value of its property at the time it is being used for public service.”³ Duquesne and Penn Power appealed to this Court arguing that the effect of Act 335 excluding their prudently incurred costs from the rate violated the Takings Clause of the Fifth Amendment, applicable to the States under the Fourteenth Amendment. * * *

III

As public utilities, both Duquesne and Penn Power are under a state statutory duty to serve the public. A Pennsylvania statute provides that “[e]very public utility shall furnish and maintain adequate, efficient, safe, and reasonable service and facilities” and that “[s]uch service also shall be reasonably continuous and without unreasonable interruptions or delay.” 66 Pa. Cons. Stat. § 1501. Although their assets are employed in the public interest to provide consumers of the State with electric power, they are owned and operated by private investors. This partly public, partly private status of utility property creates its own set of questions under the Takings Clause of the Fifth Amendment.

The guiding principle has been that the Constitution protects utilities from being limited to a charge for their property serving the public which is so “unjust” as to be confiscatory. If the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments. As has been observed, however, “[h]ow such compensation may be ascertained, and what are the necessary elements in such an inquiry, will always be an embarrassing question.” *Smyth v. Ames*, 169 U.S. 466, 546 (1898).

At one time, it was thought that the Constitution required rates to be set according to the actual present value of the assets employed in the public service. This method, known as the “fair value” rule, is exemplified by the decision in *Smyth v. Ames*, supra. Under the fair value approach, a “company is entitled to ask ... a fair return upon the value of that which it employs for the public convenience,” while on the other hand, “the public is entitled to demand ... that no more be exacted from it for the use of [utility property] than the services rendered by it are reasonably worth.” 169 U.S., at 547. In theory the *Smyth v. Ames* fair value standard mimics the operation of the competitive market. To the extent utilities’ investments in plants are good ones (because their benefits exceed their costs) they are rewarded with an opportunity to earn an “above-cost” return, that is, a fair return on the current “market value” of the plant. To the extent utilities’ investments turn out to be bad ones (such as plants that are canceled and so never used and useful to the public), the utilities suffer because the investments have no fair value and so justify no return.

Although the fair value rule gives utilities strong incentive to manage their affairs well and to provide efficient service to the public, it suffered from practical difficul-

³ On October 10, 1985, too late to affect this case, the Pennsylvania Legislature enacted Act 1985-62 which added 66 Pa. Cons. Stat. § 520 to the state utility code. Under § 520, the PUC is now authorized to permit amortized recovery of prudently incurred investment in canceled generating units.

ties which ultimately led to its abandonment as a constitutional requirement.⁵ In response to these problems, Justice Brandeis had advocated an alternative approach as the constitutional minimum, what has become known as the “prudent investment” or “historical cost” rule. He accepted the *Smyth v. Ames* eminent domain analogy, but concluded that what was “taken” by public utility regulation is not specific physical assets that are to be individually valued, but the capital prudently devoted to the public utility enterprise by the utilities’ owners. *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm’n*, 262 U.S. 276, 291 (1923) (dissenting opinion). Under the prudent investment rule, the utility is compensated for all prudent investments at their actual cost when made (their “historical” cost), irrespective of whether individual investments are deemed necessary or beneficial in hindsight. The utilities incur fewer risks, but are limited to a standard rate of return on the actual amount of money reasonably invested.⁶

Forty-five years ago in the landmark case of *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), this Court abandoned the rule of *Smyth v. Ames*, and held that the “fair value” rule is not the only constitutionally acceptable method of fixing utility rates. In *Hope* we ruled that historical cost was a valid basis on which to calculate utility compensation. 320 U.S., at 605 (“Rates which enable [a] company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risk assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so called ‘fair value’ rate base”). We also acknowledged in that case that all of the subsidiary aspects of valuation for ratemaking purposes could not properly be characterized as having a constitutional dimension, despite the fact that they might affect property rights to some degree. Today we reaffirm these teachings of *Hope Natural Gas*: “[I]t 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 unreasonable, judicial inquiry ... is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.” *Id.*, at 602. This language, of course, does not dispense with all of the constitutional difficulties when a utility raises a claim that the rate which it is permitted to charge is

⁵ Perhaps the most serious problem associated with the fair value rule was the “laborious and baffling task of finding the present value of the utility.” *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm’n*, 262 U.S. 276, 292-294 (1923) (Brandeis, J. dissenting). The exchange value of a utility’s assets, such as powerplants, could not be set by a market price because such assets were rarely bought and sold. Nor could the capital assets be valued by the stream of income they produced because setting that stream of income was the very object of the rate proceeding. According to Brandeis, the *Smyth v. Ames* test usually degenerated to proofs about how much it would cost to reconstruct the asset in question, a hopelessly hypothetical, complex, and inexact process. 262 U.S., at 292-294.

⁶ The system avoids the difficult valuation problems encountered under the *Smyth v. Ames* test because it relies on the actual historical cost of investments as the basis for setting the rate. The amount of a utility’s actual outlays for assets in the public service is more easily ascertained by a ratemaking body because less judgment is required than in valuing an asset.

so low as to be confiscatory: whether a particular rate is “unjust” or “unreasonable” will depend to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and on the amount of capital upon which the investors are entitled to earn that return. At the margins, these questions have constitutional overtones.

Pennsylvania determines rates under a slightly modified form of the historical cost/prudent investment system.⁷ Neither Duquesne nor Penn Power alleges that the total effect of the rate order arrived at within this system is unjust or unreasonable. In fact the overall effect is well within the bounds of *Hope*, even with total exclusion of the CAPCO costs. Duquesne was authorized to earn a 16.14% return on common equity and an 11.64% overall return on a rate base of nearly \$1.8 billion. Its \$35 million investment in the canceled plants comprises roughly 1.9% of its total base. The denial of plant amortization will reduce its annual allowance by 0.4%. Similarly, Penn Power was allowed a charge of 15.72% return on common equity and a 12.02% overall return. Its investment in the CAPCO plants comprises only 2.4% of its \$401.8 million rate base. The denial of amortized recovery of its \$9.6 million investment in CAPCO will reduce its annual revenue allowance by only 0.5%.

Given these numbers, it appears that the PUC would have acted within the constitutional range of reasonableness if it had allowed amortization of the CAPCO costs but set a lower rate of return on equity with the result that Duquesne and Penn Power received the same revenue they will under the instant orders on remand. The overall impact of the rate orders, then, is not constitutionally objectionable. No argument has been made that these slightly reduced rates jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital. Nor has it been demonstrated that these rates are

⁷ Pennsylvania values property in the rate base according to its historical cost. * * * Having adjusted the historical cost in various ways to account for such things as depreciation and working capital, the PUC proceeds to set a rate of return based largely on the cost of capital to the enterprise. The cost of each component of the utility’s capital is considered, i.e., “the cost of debt, the cost of preferred stock, and the cost of common stock[,] [t]he latter being determined by the return required to sell such stock upon reasonable terms in the market.” *Pennsylvania PUC v. Duquesne Light Co.*, 57 Pa.P.U.C.1, 42 (1983). It then exercises “informed judgment” to set the total rate of return based on these component costs of capital. The bulk of the rate based on capital, then, represents a return (set by costs of capital) on a rate base (determined by historical cost). These are features of the historical cost/prudent investment system. Pennsylvania has modified the system in several instances, however, when prudent investments will never be used and useful. For such occurrences, it has allowed amortization of the capital lost, but does not allow the utility to earn a return on that investment. The loss to utilities from prudent but ultimately unsuccessful investments under such a system is greater than under a pure prudent investment rule, but less than under a fair value approach. Pennsylvania’s modification slightly increases the overall risk of investments in utilities over the pure prudent investment rule. Presumably the PUC adjusts the risk premium element of the rate of return on equity accordingly

inadequate to compensate current equity holders for the risk associated with their investments under a modified prudent investment scheme.⁸

It cannot seriously be contended that the Constitution prevents state legislatures from giving specific instructions to their utility commissions. We have never doubted that state legislatures are competent bodies to set utility rates. And the Pennsylvania PUC is essentially an administrative arm of the legislature. * * * This is not to say that any system of ratemaking applied by a utilities commission, including the specific instructions it has received from its legislature, will necessarily be constitutional. But if the system fails to pass muster, it will not be because the legislature has performed part of the work.

Similarly, an otherwise reasonable rate is not subject to constitutional attack by questioning the theoretical consistency of the method that produced it. "It is not theory, but the impact of the rate order which counts." *Hope*, 320 U.S., at 602. The economic judgments required in rate proceedings are often hopelessly complex and do not admit of a single correct result. The Constitution is not designed to arbitrate these economic niceties. Errors to the detriment of one party may well be canceled out by countervailing errors or allowances in another part of the rate proceeding. The Constitution protects the utility from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the utility's property if they are compensated by countervailing factors in some other aspect.

Admittedly, the impact of certain rates can only be evaluated in the context of the system under which they are imposed. One of the elements always relevant to setting the rate under *Hope* is the return investors expect given the risk of the enterprise. *Bluefield Water Works & Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679, 692-693 (1923) ("A public utility is entitled to such rates as will permit it to earn a return ... equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties"). The risks a utility faces are in large part defined by the rate methodology because utilities are virtually always public monopolies dealing in an essential service, and so relatively immune to the usual market risks. Consequently, a State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions. But the instant case does not present this question. At all relevant times, Pennsylvania's rate system has been predominantly but not entirely based on historical cost and it has not been shown that the rate orders as modified by Act 335 fail to give a reasonable rate of return on equity given the risks under such a regime. We therefore hold that Act 335's limited effect on the rate order at issue does not result in a constitutionally impermissible rate.

⁸ Duquesne's embedded cost of debt was 9.42%.

Finally we address the suggestion of the Pennsylvania Electric Association as amicus that the prudent investment rule should be adopted as the constitutional standard. We think that the adoption of any such rule would signal a retreat from 45 years of decisional law in this area which would be as unwarranted as it would be unsettling. *Hope* clearly held that “the Commission was not bound to the use of any single formula or combination of formulae in determining rates.” 320 U.S., at 602. More recently, we upheld the Federal Power Commission’s departure from the individual producer cost-of-service (prudent investment) system. In *Wisconsin v. FPC*, 373 U.S. 294, (1963), the FPC had concluded after extensive hearings that “the individual company cost-of-service method, based on theories of original cost and prudent investment, was not a workable or desirable method for determining the rates of independent producers and that the ‘ultimate solution’ lay in what has become to be known as the area rate approach: ‘the determination of fair prices ... based on reasonable financial requirements of the industry.’” *Id.*, at 298-299. In upholding the FPC’s area rate methodology against the argument that the individual company prudent investment rule was constitutionally required, the Court observed: “[T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court’s consistent and clearly articulated approach to the question of the Commission’s power to regulate rates. It has repeatedly been stated that no single method need be followed by the Commission in considering the justness and reasonableness of rates.” *Id.*, at 309 (collecting cases).

The adoption of a single theory of valuation as a constitutional requirement would be inconsistent with the view of the Constitution this Court has taken since *Hope Natural Gas*, *supra*. As demonstrated in *Wisconsin v. FPC*, circumstances may favor the use of one ratemaking procedure over another. The designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors.¹⁰ The Constitution within broad limits leaves the States free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public.

Affirmed.

¹⁰ For example, rigid requirement of the prudent investment rule would foreclose hybrid systems such as the one Pennsylvania used before the effective date of Act 335 and now uses again. It would also foreclose a return to some form of the fair value rule just as its practical problems may be diminishing. The emergent market for wholesale electric energy could provide a readily available objective basis for determining the value of utility assets.

State of North Carolina Utilities Commission v. Thornburg

325 N.C. 463 (N.C. 1989)

FRYE, Justice: The questions presented on this appeal are: (1) whether the Commission erred as a matter of law by authorizing a utility to amortize cancellation costs as operating expenses for ratemaking purposes; and (2) whether the Commission's treatment of cancellation costs in prior orders is *res judicata* as to issue one. We answer both issues in the negative and affirm the Commission's order.

I.

This is an appeal from an order of the Commission in a general rate case involving Carolina Power and Light Company (CP & L). CP & L is a public utility organized and existing under the laws of North Carolina and is engaged in the business of developing, generating, transmitting, distributing, and selling electric power and energy to the general public within a broad area of North Carolina and South Carolina.

Procedurally this case comes to this Court as follows:

On 6 January 1987 CP & L in Docket No. E-2, Sub 526 filed an application with the Commission for authority to adjust and increase electric rates and charges for certain of its North Carolina customers. The application sought the Commission's approval of rates that would produce approximately \$173.4 million in additional annual revenues from CP & L's operations for an approximate 13.07% increase in total retail rates and charges. One of the principal reasons set forth in CP & L's application as necessitating the requested increase was the need to include in rates a portion of the costs associated with the abandoned construction of the Shearon Harris Nuclear Power Plant (Harris Plant). * * *

The case in chief came on for hearing before the Commission on 9 June 1987. On 5 August 1987, the Commission issued a Notice of Decision and Order which ordered that CP & L be allowed an opportunity to earn a rate of return of 10.45% on its investment used and useful in providing electric utility service in North Carolina. In order to have the opportunity to earn this rate of return, CP & L was authorized to adjust its electric rates and charges to produce an increase in gross revenues of \$92,467,000 on an annual basis.

On 10 August 1987, CP & L filed proposed rates and charges to reflect the authorized increase. Upon examining CP & L's proposal, its application, the testimony and exhibits received into evidence at the hearings, the briefs submitted by the parties, and the entire record involved in this proceeding, the Commission on 27 August 1987 entered an Order Granting Partial Increase In Rates And Charges. The Commission's order reviewed the history of the ratemaking treatment of the Harris Plant abandonment losses, noting:

The ratemaking treatment of the Harris abandonment losses has been considered by the Commission in previous general rate cases of CP & L. In Docket No. E-2, Sub 444, the Commission allowed a recovery of the cost associated with cancelled Harris Units 3 and 4 over a ten-year period with inclusion of the interest

arising from the debt financing portion of the unamortized balance. In Docket No. E-2, Sub 461, the Commission reexamined the ratemaking treatment of abandonment losses in order to develop a more consistent and equitable approach. The Commission determined that CP & L should be allowed to continue amortization of the Harris abandonment losses, but that no ratemaking treatment should be allowed which would have the effect of allowing CP & L to earn a return on the unamortized balance. The Commission concluded that this treatment provided the most equitable allocation of the loss between the utility and its ratepayers. In CP & L's last general rate case, Docket No. E-2, Sub 481, the Commission dealt with CP & L's decision to cancel the construction of Harris Unit 2. Consistent with its treatment of the earlier Harris cancellations, the Commission ruled that the abandonment losses of Harris Unit 2 should be amortized over ten years with no return allowed on or with respect to the unamortized balance. Consistent with these previous orders, CP & L proposes in this case to include in operating expenses the amortization of the three abandoned Harris units.

In this order the Commission reaffirmed its previous treatment of the Harris Plant abandonment losses allowing CP & L to continue to recover as operating expenses an amount reflecting an amortization of the cost of these abandoned units. The Attorney General now appeals from this order.

II.

On appeal the Attorney General presses two basic contentions. First, he argues the Commission erred by permitting CP & L to continue to include as an allowable expense for ratemaking purposes costs associated with the abandonment of the company's Harris Plant. Second, he argues the determination of the first contention is not barred by the doctrine of *res judicata*. We will address these arguments in reverse order.²

² In order to properly address each side's contentions on each of these issues, we think it is helpful to review the public utility ratemaking formula found in N.C.G.S. § 62-133. This statute requires the Commission to determine the utility's rate base (RB), its reasonable operating expenses (OE), and a fair rate of return on the company's capital investment (RR). These three components are then combined according to a formula which can be expressed as follows: $(RB \times RR) + OE = \text{REVENUE REQUIREMENTS}$. The rate base is the reasonable cost of the utility's property which is used and useful in providing service to the public, minus accumulated depreciation, and plus the reasonable cost of the investment in construction work in progress. See N.C.G.S. § 62-133(b)(4). Operating expenses generally include costs for fuel, wages and salaries, and maintenance, as well as annual depreciation charges and taxes. The rate of return is a percentage multiplier applied to the rate base to produce the amount of money the Commission concludes should be earned by the utility, over and above its reasonable operating expenses. See N.C.G.S. § 62-133(b)(4). Per an exhibit of CP & L witness Paul S. Bradshaw, Vice President and Controller of CP & L, the Commission's order at issue in this proceeding allows CP & L to include \$26,776,643 of unamortized Harris Plant abandonment costs in the OE component of the ratemaking formula.

A.

*** We hold that on this record the Commission's treatment of cancellation costs in prior orders is not *res judicata* in this proceeding.

B.

The Attorney General's main contention in this appeal is that North Carolina law does not allow recovery by CP & L, or any utility, of its investment in generating facilities which were cancelled prior to completion and operation. The Attorney General summarizes his argument by stating:

The plain language of N.C.G.S. § 62-133(c)—the “operating expense” subsection—as well as cases interpreting it, make it clear that in North Carolina there must be a nexus between allowable operating expenses/revenues and property used and useful in providing service during the test year. Cancelled nuclear units are property which will never be used and useful in providing electrical service. Therefore, the investment in them does not qualify for inclusion in rate base and is equally unqualified for treatment as the source of an operating expense. Finally, any change in the regulatory scheme to authorize charges for cancelled plant to ratepayers may only be accomplished by the General Assembly.

The Attorney General also contends that both analogous decisions from other jurisdictions and public policy support his position. CP & L counters, claiming the language of N.C.G.S. § 62-133 does not prohibit amortization of cancellation costs and such amortization is supported by the state's utility policy, as declared by the General Assembly, and by universally accepted principles of statutory construction. CP & L also claims that its position on this issue is supported by the overwhelming weight of authority in other states and by most academic commentators. We agree with CP & L's position on this issue.

The question we must decide is not one of constitutional proportions, but one of statutory construction. The United States Supreme Court has clearly held that a state scheme of utility regulation does not “take” the utility's property in violation of the fifth and fourteenth amendments simply because it disallows recovery of capital investment in cancelled plant not “used and useful in service to the public,” even though the expenditures were prudent and reasonable when made. *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989). The question is whether the North Carolina statutes authorize the Commission to permit a utility to recover capital invested in cancelled plant by amortizing such costs as “reasonable operating expenses” under N.C.G.S. § 62-133(b)(3) without allowing a return on any part of the cancellation costs.***

For a proper understanding of the parties' contentions on this issue, it is necessary to set forth the provisions of N.C.G.S. § 62-133(a) through (d) in their entirety:

(a) In fixing the rates for any public utility subject to the provisions of this Chapter, other than bus companies, motor carriers and certain water and sewer utili-

ties, the Commission shall fix such rates as shall be fair both to the public utilities and to the consumer.

(b) In fixing such rates, the Commission shall:

(1) Ascertain the reasonable original cost of the public utility's property used and useful, or to be used and useful within a reasonable time after the test period, in providing the service rendered to the public within the State, less that portion of the cost which has been consumed by previous use recovered by depreciation expense plus the reasonable original cost of investment in plant under construction (construction work in progress). In ascertaining the cost of the public utility's property, construction work in progress as of the effective date of this subsection shall be excluded until such plant comes into service but reasonable and prudent expenditures for construction work in progress after the effective date of this subsection may be included, to the extent the Commission considers such inclusion in the public interest and necessary to the financial stability of the utility in question, subject to the provisions of subparagraph (b)(4a) of this section.

(2) Estimate such public utility's revenue under the present and proposed rates.

(3) Ascertain such public utility's reasonable operating expenses, including actual investment currently consumed through reasonable actual depreciation.

(4) Fix such rate of return on the cost of the property ascertained pursuant to subdivision (1) as will enable the public utility by sound management to produce a fair return for its shareholders, considering changing economic conditions and other factors, as they then exist, to maintain its facilities and services in accordance with the reasonable requirements of its customers in the territory covered by its franchise, and to compete in the market for capital funds on terms which are reasonable and which are fair to its customers and to its existing investors.

(4a) Require each public utility to discontinue capitalization of the composite carrying cost of capital funds used to finance construction (allowance for funds) on the construction work in progress included in its rate based upon the effective date of the first and each subsequent general rate order issued with respect to it after the effective date of this subsection; allowance for funds may be capitalized with respect to expenditures for construction work in progress not included in the utility's property upon which the rates were fixed. In determining net operating income for return, the Commission shall not include any capitalized allowance for funds used during construction on the construction work in progress included in the utility's rate base.

(5) Fix such rates to be charged by the public utility as will earn in addition to reasonable operating expenses ascertained pursuant to subdivision (3) of this subsection the rate of return fixed pursuant to subdivisions (4) and (4a) on the cost of the public utility's property ascertained pursuant to subdivision (1).

(c) The original cost of the public utility's property, including its construction work in progress, shall be determined as of the end of the test period used in the hearing and the probable future revenues and expenses shall be based on the plant and equipment in operation at that time. The test period shall consist of 12 months' historical operating experience prior to the date the rates are proposed to become effective, but the Commission shall consider such relevant, material and competent evidence as may be offered by any party to the proceeding tending to show actual changes in costs, revenues or the cost of the public utility's property used and useful, or to be used and useful within a reasonable time after the test period, in providing the service rendered to the public within this State, including its construction work in progress, which is based upon circumstances and events occurring up to the time the hearing is closed.

(d) The Commission shall consider all other material facts of record that will enable it to determine what are reasonable and just rates.

N.C.G.S. § 62-133(a)-(d).

Our statutory scheme of utility regulation does not contain a definition of "reasonable operating expenses" as that term is used in N.C.G.S. § 62-133(b)(3). It does not expressly permit or prohibit the inclusion of cancellation costs associated with abandoned plant in the calculation of reasonable operating expenses. Thus, interpretation and analysis of the statutory regulatory scheme is necessary in order to determine if the Commission has exceeded its authority in allowing the recovery of such costs through amortization as a reasonable operating expense.

Our statute provides that "the Commission shall fix such rates as shall be fair both to the public utilities and to the consumer," N.C.G.S. § 62-133(a), and, in fixing such rates, the Commission shall: "(5) Fix such rates to be charged by the public utility as will earn in addition to reasonable operating expenses ascertained pursuant to subdivision (3) of this subsection the rate of return fixed pursuant to subdivisions (4) and (4a) on the cost of the public utility's property ascertained pursuant to subdivision (1)." N.C.G.S. § 62-133(b)(5). While this statute makes clear that the rates to be charged by the public utility allow a return on the cost of the utility's property which is used and useful within the meaning of N.C.G.S. § 62-133(b)(1), the statute permits recovery but no return on the reasonable operating expenses ascertained pursuant to subdivision (3). The real question in this appeal is whether the utility may be permitted to recover all or any part of the cancellation costs from the ratepayers through the operating expense category or whether the entire cancellation costs must be borne by the stockholders.

In interpreting N.C.G.S. § 62-133 in prior decisions we have noted:

Certain fundamental legal principles are applicable and must be adhered to in applying the statute.... We begin with the proposition that the Commission is vested with the power to regulate the rates charged by utilities. The General Assembly has delegated to the Commission, and not to the courts, the duty and power to establish rates for public utilities. The rates fixed by the Commission must be just and reasonable. Rates fixed by the Commission are deemed prima facie just and reasonable. The burden of showing the impropriety of rates established by the Commission lies with the party alleging such error. The rate order of the Commission will be affirmed if upon consideration of the whole record we find that the Commission's decision is not affected by error of law and the facts found by the Commission are supported by competent, material and substantial evidence, taking into account any contradictory evidence or evidence from which conflicting inferences could be drawn.

Utilities Commission v. Duke Power Co., 287 S.E.2d 786, 791-92 (1982) (citations omitted.)

With these statutory provisions and principles in mind we hold that the Commission's order does not err as a matter of law in authorizing CP & L to continue to recover a portion of the cancellation costs of the abandoned Harris Plant as operating expenses through amortization. The Commission's determination was supported by several findings and conclusions. First, the Commission found that although "[t]his case must of course be decided on the basis of North Carolina statutes" the "majority of courts and commissions that have dealt with this issue have allowed ratemaking treatment of abandonment losses, usually as operating expenses." Second, the Commission concluded "that a liberal interpretation of the operating expense element of ratemaking so as to include the Harris abandonment losses is appropriate herein." * * *

The Attorney General's contrary position on this issue must fail. First, we disagree with the Attorney General's contention that "[t]he plain language of G.S. § 62-133(c) ... as well as cases interpreting it, make it clear that in North Carolina there must be a nexus between allowable operating expenses ... and property used and useful in providing service during the test year." The Commission's conclusion rejecting this argument is not erroneous as a matter of law. We believe the plain language of N.C.G.S. § 62-133(c) merely provides that the components of the ratemaking formula are to be determined based on a historical test period. See N.C.G.S. § 62-133(c). This provision does not require a nexus between operating expenses and "property used and useful." *Id.* The statute reserves this requirement solely to the reasonable original cost of the public utility's property, the ratebase component which is described in N.C.G.S. § 62-133(b)(1). In contrast, the statute's description of operating expenses in N.C.G.S. § 62-133(b)(3) simply provides that these expenses must be "reasonable." As the Commission's order points out, "[m]any reasonable operating expenses cannot be tied to specific utility property." Examples include the costs of

planning and forecasting, research and development, tort claims, and the salaries of administrative employees.

In *Utilities Comm. v. Edmisten*, Attorney General, 294 N.C. at 606-07, 242 S.E.2d at 868, this Court considered the scope of the operating expense component of the ratemaking formula. In that decision we allowed certain natural gas distribution companies to include approved exploration costs in the operating expenses they passed on to ratepayers. We stated:

When a narrow construction of the operating expense element of a regulatory act would frustrate the purposes of the act ... the term should be liberally interpreted and applied.... [O]ne of the primary policies set out in [the legislature's explanation of its objectives in N.C.G.S. § 62-2] is to promote adequate utility services.... Id. N.C.G.S. § 62-2, entitled "Declaration of policy," provides, in part: Upon investigation, it has been determined that the rates, services and operations of public utilities as defined herein, are affected with the public interest and that the availability of an adequate and reliable supply of electric power and natural gas to the people, economy and government of North Carolina is a matter of public policy. It is hereby declared to be the policy of the State of North Carolina: (3) To promote adequate, reliable and economical utility service to all of the citizens and residents of the State....

In the instant case, both the construction and the cancellation of the Harris Plant were approved by the Commission and the Attorney General does not in this proceeding dispute the validity of this approval. The recovery of these costs through a liberal interpretation of the operating expense component is, like the recovery of exploration costs in *Edmisten*, consistent with the act's purpose as set forth in N.C.G.S. § 62-2.

On this record the Commission's decision to allow the recovery of Harris Plant cancellation costs through the operating expense component was within the Commission's power and was supported by competent, material, and substantial evidence. This Court is therefore without authority to disturb that decision. * * *

Last, we disagree with the Attorney General's contention "that strong policy considerations support the disallowance of [cancellation] expenses." We note that jurisdictions have generally dealt with the allocation of cancelled plant costs in one of the following three ways: (1) recovery of all of the costs from ratepayers, by allowing amortization of the investment plus a return on the unamortized balance; (2) recovery of all costs from shareholders through a total disallowance of recovery in rates, instead requiring the utility to write off the entire amount in a single year; or (3) recovery from ratepayers and shareholders through amortization of costs in rates over a period of years, with no return on the unamortized balance. Strong policy considerations support the Commission and commentators who have concluded that method three is the best of the three alternatives in that it promotes "an equitable sharing of the loss between ratepayers and the utility stockholders." See *Pierce*, *The Regulatory*

Treatment of Mistakes in Retrospect: Cancelled Plants and Excess Capacity, 132 U. Pa. L. Rev. 497, 558 (1984); Sommers, Recovery of Electric Utility Losses from Abandoned Construction Projects, 8 Wm. Mitchell L. Rev. 363, 374 (1982). Method two, argued by the Attorney General, though initially placing the entire cost upon the shareholders, may actually in the long term be less favorable to the ratepayers than method three. The Attorney General conceded during oral argument that method two would allow the Commission to reevaluate CP & L's rate of return. * * * On this record, the Commission's continued use of method three is within the Commission's discretion, and this Court will not disturb that decision. * * *

Based on our review of the whole record, we conclude that the Commission's order is supported by competent, material, and substantial evidence and is not erroneous as a matter of law in authorizing CP & L to continue to recover a portion of the cancellation costs of the abandoned Harris Plant as operating expenses through amortization.

In conclusion and for the reasons stated, we hold that the Commission did not err in this proceeding. Its order is, therefore,

AFFIRMED.

MARTIN, Justice, dissenting in part: I cannot agree with the approval by the majority of the Commission's inclusion of the cost of the abandoned Units 2, 3 and 4 of the Shearon Harris nuclear plant as operating expenses under N.C.G.S. § 62-133. The law does not permit, for ratemaking purposes, a utility to earn a return on property not used or useful in rendering services to the public.

N.C.G.S. § 62-133(b) prescribes the formula which the Commission is required to follow in fixing rates for service to be charged by a public utility. The effect of the entire statute is to impose "used and useful" or "operational" limitations on plant costs, revenues and expenses. Therefore, allowable operating expenses must have a nexus with "used and useful" property. The abandoned units have no value. These cancelled nuclear units will never be "used and useful" in providing electrical service to the customers of CP & L.

Thus, the Attorney General is correct in his argument that only those costs associated with operational plants are to be considered expenses. The Commission, by including the costs of the abandoned units in its operating expenses, violates these statutory requirements. The costs of abandoned property, however prudently scheduled at the outset of the project, cannot be recovered under our statute. This may indeed produce a harsh result at times, but it is the result required under the law, the Commission having no equitable powers. The utility must look to resources other than the Commission in its efforts to recoup its losses. * * *

Of course, the utility does not contend that the abandoned plant costs were for plant which is now "used and useful" in providing electric service. North Carolina does not recognize such property as "used and useful." Nor can such capital expenditures be recovered through amortization as operating expenses incurred in rendering

service to customers. In so doing the Commission acted beyond its statutory authority. This the Commission may not do.

These enormous expenses are not operating expenses under the statute—rather, they are capital costs. Without legislative action, cancelled plant costs may not be correctly allowed as operating expenses. The Commission only has its statutory authority which may not be extended by inference for reasons of convenience or necessity. * * *

The majority recognizes that the Commission in the entry of its order was exercising what it perceived to be its equitable authority. The Commission has no equitable authority, but can only exercise such powers as are expressly delegated to it by the legislature. By using equitable principles in its order, the Commission arrived at the incongruous result of allowing the utility to recoup some, but not all, of its expenditures incurred by the abandonment of the nuclear units. Under the statute granting the Commission its authority, the utility was either entitled to recover all of these losses or none. I find that the Commission erred as a matter of law by including as operating expenses CP & L's costs of the abandoned Units 2, 3 and 4 of the Shearon Harris nuclear plant. * * *

State of North Carolina Utilities Commission v. Thornburg

325 N.C. 484 (N.C. 1989)

FRYE, Justice: This is a general rate case in which CP & L sought to include in the rate base the full costs of the Shearon Harris Nuclear Power Plant (Harris Plant), which became operational in May, 1987. Approximately \$570,000,000 of the total costs of constructing Unit 1 was quantified as the cost of constructing common facilities to service abandoned Units 2, 3, and 4.

The essential questions presented for our review are whether the Commission erred in allowing CP & L to include in its rate base costs of \$389,442,000 of the approximately \$570,000,000 invested in plant facilities to service abandoned Units 2, 3, and 4 and in allowing CP & L to amortize the remaining \$180,558,000 as cancellation costs. In order to answer these questions, we must examine two statutes, N.C.G.S. § 62-94, which establishes the standard of review for an appeal from a decision by the Commission, and N.C.G.S. § 62-133, which sets out the rate making process for the Commission to follow when deciding a general rate case. We hold that the orders of the Commission were affected by an error of law, N.C.G.S. § 62-94(b)(4), requiring that this case be remanded to the Commission with instructions to remove approximately \$389,000,000 from the rate base and include it with the approximately \$181,000,000 to be treated as cancellation costs because the former amount was not spent for property that is "used and useful" in providing electric service to the consumers as required for inclusion in the rate base under N.C.G.S. § 62-133(b)(1). Our decision further requires that the Commission on remand determine whether a new rate of return must be fixed in accordance with N.C.G.S. § 62-

133(b)(4) in order that the rates fixed by the Commission shall, pursuant to N.C.G.S. § 62-133(a), be fair to CP & L and to the consumer.

I.

On 10 September 1987 CP & L filed an application with the Commission for a rate increase which would include the full construction costs of the Harris Plant. The Commission entered an order on 9 October 1987 declaring the application a general rate case. * * *

When the Harris Plant was originally designed in 1971, it included four nuclear generating units with one unit scheduled to be brought on line each year from 1977 through 1980. CP & L based its plans for this plant on projected growth rates which would require construction of all four nuclear generating units at the Harris Plant to meet the projected electric needs of its customers. However, the 1973 OPEC oil embargo changed the projected demands for electricity. New studies showed that CP & L would not need the four units originally planned for the Harris Plant. Therefore, CP & L decided to cancel the plans for Units 2, 3, and 4.

The initial cost estimate to build Harris Unit 1 was approximately \$315,000,000. Harris Unit 1 actually came into commercial operation in 1987 at a cost of approximately \$3,900,000,000. The original plans for the Harris Plant, adopted in 1971, called for a cluster design with the four units sharing certain common plant facilities such as the fuel handling building and waste processing building. The purpose of the cluster design was to save money overall by sharing common facilities rather than building these facilities separately for each unit. However, with the cluster design, the first unit built would be more costly than follow-up units because certain structures and systems needed to operate the first unit are sized to be shared with the other units. Since construction on Unit 1 was begun before the other units were cancelled and because the original cluster design was not altered, these common facilities were built to service Unit 1 alone. Thus, the support facilities for Unit 1 were larger than necessary to serve that single unit since they were built to serve all four units.

As a result of the delays and cost overruns on Harris, the Public Staff filed a motion requesting a prudence audit of the plant's construction costs. The Commission issued an order suggesting that the Public Staff oversee such an audit. The Public Staff hired Canatom, Inc., an international engineering and consulting firm with extensive experience in nuclear power plant implementation, to investigate the reasonableness of management decisions and costs related to Unit 1. Canatom spent a year conducting this study and presented its findings in a three-volume report. This report was filed with the Commission in this rate case.

The only part of Canatom's report which is of concern on this appeal is its finding of imprudence on the part of CP & L on the "redesign" issue. Canatom's report indicates that CP & L itself conducted a study to estimate the cost impact of shared or common facilities on Harris Unit 1 due to the original four unit design. The CP & L study quantified approximately \$570,000,000 as the value of the additional burden

assumed by Unit 1 in anticipation of reducing the costs of the remaining three units which were later cancelled. Canatom reported that \$180,558,000 of this amount could have been saved if CP & L had abandoned the cluster design in 1975 and implemented a different design. Canatom concluded that the failure to redesign in 1975 constituted imprudence on the part of CP & L.

In its Order Granting Partial Increase in Rates and Charges filed on 5 August 1988, the Commission made certain findings of fact. Among these findings were:

7. CP & L has met the prudence standard in its financing of the Shearon Harris plant. CP & L's financial management practices relating to Shearon Harris were generally reasonable and efficient.

8. Except as hereinafter found and discussed, the costs of the Shearon Harris nuclear plant are reasonable and were prudently incurred.

....

11. CP & L should be allowed to recover as an expense its abandonment loss sustained as a result of the Company's having cancelled and abandoned its Mayo Unit No. 2 in March 1987. Recovery of the investment in that unit should be accomplished over a ten-year amortization period. CP & L should be allowed to continue to recover the cancellation costs of Harris Units 2, 3, and 4. Costs of \$180,558,000 (\$98,340,000 on a North Carolina retail jurisdictional basis) proposed for inclusion in rate base as part of Harris Unit 1 should be reallocated and assigned as cancellation costs of Harris Units 2, 3, and 4; these costs should be excluded from rate base and should be treated in a manner consistent with the other CP & L cancellation costs discussed herein.

....

17. CP & L's reasonable original cost rate base used and useful in providing service to its North Carolina retail customers is \$3,677,225,000, consisting of electric plant in service of \$4,869,311,000, net nuclear fuel investment of \$133,271,000, and an allowance for working capital of \$114,033,000, reduced by accumulated depreciation of \$949,412,000 and accumulated deferred income taxes of \$489,978,000. * * *

Both the Public Staff and the Attorney General made motions for reconsideration by the Commission, and these motions were denied in an Order Denying Motions for Reconsideration filed on 1 September 1988. In this order, the Commission again restated its position that CP & L's decision to use the cluster design, which resulted in the building of excess facilities at a cost of \$570,000,000, was prudent. The Commission further explained its decision to divide this amount into \$389,442,000 which would be included in the rate base and \$180,558,000 which would be treated as cancellation costs. The Commission noted, "this was a ratemaking adjustment that was, in effect, adopted by the Commission on its own motion since no party to this proceeding proposed such an adjustment. We adopted this treatment for reasons of fairness and equity."

The Attorney General, the Public Staff, and CP & L all appealed from the Commission's order of 5 August 1988. Only the Attorney General and the Public Staff appealed from the order denying reconsideration. The Attorney General contends that the Commission erred in concluding that CP & L's choice of a cluster design in 1971 was prudent. We find no error in this portion of the Commission's order. The Public Staff contends that the Commission erred in quantifying the cancellation costs for common facilities built to serve Harris Units 2, 3, and 4 at \$180,558,000 instead of \$570,000,000. We agree. CP & L contends that the entire \$570,000,000 should be included in the rate base because the Commission found that these expenses were prudently incurred. We do not agree with CP & L's position on this issue.

II.

The Utilities Commission is charged with the duty of "fixing such rates as shall be fair both to the public utility and to the consumer." N.C.G.S. § 62-133. Section 62-133 provides a step-by-step procedure for the Commission to follow in fixing these rates. We reviewed the public utility ratemaking formula in *Utilities Comm. v. Thornburg*, 385 S.E.2d 451 (1989) (*Thornburg II*). This statute requires the Commission to determine the utility's rate base (RB), its reasonable operating expenses (OE), and a fair rate of return on the company's capital investment (RR). These three components are then combined according to a formula which can be expressed as follows: $(RB \times RR) + OE = \text{REVENUE REQUIREMENTS}$. The rate base is the reasonable cost of the utility's property which is used and useful in providing service to the public, minus accumulated depreciation, and plus the reasonable cost of the investment in construction work in progress. See N.C.G.S. § 62-133(b)(4). Operating expenses generally include costs for fuel, wages and salaries, and maintenance, as well as annual depreciation charges and taxes. The rate of return is a percentage multiplier applied to the rate base to produce the amount of money the Commission concludes should be earned by the utility, over and above its reasonable operating expenses. See N.C.G.S. § 62-133(b)(4).

In this portion of the appeal, we are concerned with the procedure for determining what goes into the rate base. In determining what goes into the rate base, the statute directs the Commission to (1) Ascertain the reasonable original cost of the public utility's property used and useful, or to be used and useful within a reasonable time after the test period, in providing the service rendered to the public within the State.... N.C.G.S. § 62-133(b)(1).

The statute sets out a two-part test for the Commission to use in deciding what goes into the rate base for all costs except costs of construction work in progress. The Commission must: (1) determine the reasonable original cost of the property and (2) determine if the property is "used and useful, or to be used and useful within a reasonable time after the test period." If the costs in question do not meet both parts of the test, the costs may not be included in the rate base for rate making purposes. N.C.G.S. § 62-133(b)(4) and (5).

In contending that the Commission erred in its finding, the Attorney General argues CP & L's decision to use the cluster design was not prudent and does not meet the first part of the test and, therefore, none of the \$570,000,000 can be included in rate base. While we agree with the Attorney General's conclusion that the approximately \$570,000,000 cannot be included in rate base, we do so, not on the basis of the reasonableness of the costs, i.e., prudence, but on the basis that the property does not meet the second part of the test, i.e., the "used and useful" test. * * *

The Attorney General contends that the Commission's finding of prudence on the part of CP & L violates subsections (4), (5), and (6) of N.C.G.S. § 62-94(b). The Attorney General claims that the Commission did not consider uncontested evidence in the whole record which indicated that CP & L's circumstances and problems in 1971 should have prevented it from selecting the cluster design because it was a high risk choice. We conclude that the Commission's finding that CP & L's costs in building the Harris Plant were prudently incurred is supported by competent, material, and substantial evidence in view of the whole record and is not arbitrary or capricious. In its discussion found in the Order of 5 August 1988 under Evidence and Conclusions For Finding of Fact No. 8, the Commission discusses its finding that selection of the cluster design in 1971 was prudent. In support of this finding, the Commission states:

CP & L's choice of the cluster design was a prudent decision. CP & L considered a number of different alternative plant layouts and eventually selected the cluster design. The Company's decision to use the cluster design was based on specific and identified design criteria. The cluster design did meet the specific and identified design criteria. The cluster design did meet the specific design criteria better than the alternatives. These design criteria were consistent with the Company's long held philosophy of using common facilities at its plants in order to reduce material quantities, construction duration capital costs and total life cycle costs of its plants.

In discussing the Attorney General's contention that choice of the cluster design was not prudent, the Commission states,

the Attorney General's proposed disallowance of \$560 million on this issue is premised on the assumption that the only prudent choice in 1971 was the slide-along arrangement. In cross-examination, however, Attorney General witness Marvetich refused to take a position on the prudence of selecting a twin-unit design in 1971. Evidence in this case indicates that CP & L would have selected the twin unit as its second choice, and the twin unit also would have caused the construction of common facilities for one unit.

The Commission further explains its finding that the choice of the cluster design was prudent: "The testimony of Canatom and CP & L Direct Panels, I, II, IV, CP & L Rebuttal Panel II, and CP & L Rebuttal witnesses Reinsch and Boyd are more than ample to support the finding that the choice of the cluster design was prudent."

While contrary evidence was presented, the record contains sufficient evidence to support the Commission's finding that CP & L's choice of the cluster design was prudent, and this finding will not be disturbed on appeal.

III.

The Public Staff contends that the Commission erred in allowing \$389,442,000 in the rate base rather than including this amount with the \$180,558,000 which the Commission treated as cancellation costs. As stated earlier, to be included in the rate base, the cost must be both reasonable and incurred for property that is "used and useful" in providing service to the customers. N.C.G.S. § 62-133(b)(1). The public staff contends that the amounts in controversy cannot be included in the rate base because they were not incurred for property that is "used and useful." CP & L contends that the costs were prudently incurred for property that is "used and useful" and that the Commission, in Finding of Fact No. 17, implicitly, if not specifically, found this to be true.

A fair reading of the Commission's Finding of Fact No. 17, quoted in full earlier in this opinion, would indicate that the Commission found that \$389,442,000 of the \$570,000,000 construction costs was incurred for property that was "used and useful" in providing electric service to its customers as is required by N.C.G.S. § 62-133(b)(1).¹ However, in reading the Evidence and Conclusions For Finding Of Fact No. 11 and the Order Denying Motions For Reconsideration, we find that the evidence showed and the Commission actually found that the \$570,000,000 figure represented costs of construction of excess common facilities. In the Evidence and Conclusions For Finding Of Fact No. 11, the Commission stated:

Nevertheless, the Commission further concludes that CP & L's utilization of the cluster design, while prudent in 1971 and 1974 and thereafter, has in fact resulted in the construction of *excess common facilities* at the Harris Plant in the fuel handling building, the waste processing building, the water treatment building, and the diesel generator and fuel oil tank building. These buildings were designed and built to serve *four* nuclear units. [(Emphasis added.)]

In its Order Denying Motions For Reconsideration, the Commission was even clearer that the total cost for the excess common facilities was the \$570,000,000 figure. In that Order, the Commission quotes from the Canatom Report:

¹ Notwithstanding the contest over proper treatment of the approximately \$570,000,000, neither this figure nor the \$389,442,000 figure is referred to by the Commission in its twenty-eight Findings of Fact. However, when the Commission, in Finding of Fact No. 17, found that "CP & L's reasonable original cost rate base used and useful in providing service to its North Carolina retail customers is \$3,677,225,000," having excluded only \$180,558,000 (Finding of Fact No. 11) of the \$570,000,000 (See Order Denying Motions for Reconsideration) from the rate base, it is clear that the remaining \$389,442,000 of the \$570,000,000 is included in the \$3,677,225,000 cost rate base found by the Commission to be used and useful.

CP & L conducted a study to estimate the cost impact of shared common facilities on Harris Unit I due to the original four unit design. Specifically, the study sought to arrive at a value for the additional burden assumed by Unit 1 (the common facilities burden) in anticipation of reducing the costs of the follow-on units. This cost has been determined to be approximately \$570,000,000. [(Emphasis added.)]

The Commission then goes further to state:

While the Commission clearly recognized the extent of CP & L's total investment in common facilities to serve Harris Units 2, 3, and 4 as reflected in the Canatom Report and Witness Schlissel's testimony, we decided that it was appropriate to treat only a "reasonable portion" of the Company's *total investment* in those common facilities as cancellation costs. The intent of our decision was to arrive at an "equitable sharing" of the costs of common facilities between CP & L's shareholders and its North Carolina retail ratepayers. [(Emphasis added.)]

While the Commission's findings of fact are conclusive when supported by "competent, material, and substantial evidence," *Utilities Commission v. Telephone Co.*, 189 S.E.2d 705, 717 (1972) (General I), all the evidence in this case tends to show that the \$570,000,000 was spent to build excess common facilities. If the facilities are excess, as a matter of law, they can not be considered "used and useful" as that term is used in N.C.G.S. § 62-133(b)(1). Since the excess common facilities are not "used and useful", they cannot be included in the rate base. N.C.G.S. § 62-133(b)(1). The Commission committed an error of law in including \$389,442,000 in the rate base because this amount was part of the \$570,000,000 used to construct the excess common facilities to serve abandoned Harris Units 2, 3, and 4.

IV.

Since the Commission erred in placing \$389,442,000 in the rate base, the next question we must answer is the proper treatment of this amount. The \$389,442,000 figure is part of the \$570,000,000 figure which was given as the value of the additional burden assumed by Unit 1 in anticipation of building Harris Units 2, 3, and 4. After removing the \$389,442,000 from the \$570,000,000, the Commission majority classified the remaining \$180,558,000 as cancellation costs.

As we have already discussed, the Commission found that the entire \$570,000,000 spent to build this excess facility was prudently incurred. We have also held that the excess common facilities cannot be considered "used and useful" so as to be included in rate base. The Public Staff argues that the entire \$570,000,000 should be included in the cancellation costs of the abandoned Units 2, 3, and 4. We agree.

The Attorney General contends that the Commission has acted in an arbitrary and capricious manner by classifying the \$180,558,000 figure as an abandonment loss subject to amortization as operating expenses. The Attorney General argues that the Commission acted in excess of its statutory authority to find that the \$180,558,000 is excess common facilities and then to classify it as abandonment loss. The Attorney

General cites General I, 189 S.E.2d 705; State ex rel. Utilities Commission v. Mebane Home Telephone Company, 257 S.E.2d 623 (1979); and State ex rel. Commission v. General Telephone Company, 208 S.E.2d 681 (1974) (General II), for the proposition that excess capacity cannot statutorily be charged to ratepayers. The Attorney General reads these cases too broadly. They do not hold that costs incurred for excess capacity cannot be recovered in rates—only that such costs may not be charged to ratepayers by including them in the rate base upon which the utility is permitted to earn a return on its investment. * * *

In *Thornburg II*, we held that the Commission did not err in authorizing CP & L to continue to recover a portion of cancellation costs of the abandoned Harris Plant as operating expenses through amortization. * * * Here the Commission concluded that CP & L's utilization of the cluster design resulting in excess common facilities was prudent in 1971, in 1974, and thereafter. It further found that "the additional burden assumed by Unit 1 (the common facilities burden) in anticipation of reducing the costs of the follow-on units" was "approximately \$570,000,000." The Commission also "clearly recognized the extent of CP & L's total investment in common facilities to serve Harris Units 2, 3, and 4 as reflected in the Canatom report and Witness Schlissel's testimony," but decided "that it was appropriate to treat only a 'reasonable portion' of the company's total investment in those common facilities as cancellation costs." A fair reading of the Commission's findings and conclusions is that the \$570,000,000 represents cancellation costs attributable to abandoned Harris Units 2, 3, and 4. This is in essence the same as the cancellation costs held to be appropriately amortized as operating expenses in *Thornburg II*. Therefore, the Commission should have treated approximately \$570,000,000 as cancellation costs of abandoned Harris Units 2, 3, and 4 to be recovered as operating expenses through amortization. * * *

A fair reading of the findings and conclusions of the Commission in this case makes it clear that if Harris Units 2, 3, and 4 had never been undertaken, CP & L would have avoided the approximately \$570,000,000 in costs for the common facilities to serve the abandoned Units 2, 3, and 4. The Commission having found that the decision permitting the incurring of these costs was prudent, it is appropriate that these costs be treated as cancellation costs of the abandoned units and recovered as operating expenses through amortization.

In conclusion, we hold that the Commission's order of 5 August 1988 granting partial increase in rates and charges and its order of 1 September 1988 denying reconsideration are affected by an error of law, and for that reason:

1. We reverse the Commission's decision to include \$389,442,000 in rate base;
2. We affirm the Commission's decision excluding from rate base \$180,558,000 cancellation costs associated with abandoned Harris Units 2, 3, and 4, and treating that amount in a manner consistent with the other CP & L cancellation costs; and

3. We remand this case to the Commission with instructions to remove the approximately \$389,000,000 from the rate base and include it with the approximately \$181,000,000 to be treated as cancellation costs.

Since our decision results in the removal of approximately \$389,000,000 from the rate base, N.C.G.S. § 62-133(b)(1), it will be necessary for the Commission, on remand, to determine whether a new rate of return must be fixed in accordance with N.C.G.S. § 62-133(b)(4) in order that the rates fixed by the Commission will be fair to CP & L and to the consumer as required by N.C.G.S. § 62-133(a).

The orders of the Commission are:

AFFIRMED IN PART, REVERSED IN PART AND REMANDED.

MARTIN, Justice, dissenting: At the outset, I do not find that the evidence, viewed upon the whole record test, supports the findings by the Commission that the use of the cluster design by CP & L was prudent. N.C.G.S. § 62-94(b)(5). When the contradictory evidence and the inferences therefrom are considered, the finding of prudence is just not supported by competent, material and substantial evidence. It would serve little purpose to marshal the evidence again, but any ordinary citizen, working to pay his light bill, knows that choosing a construction design which results in the building of excess facilities costing \$570,000,000 is not a prudent action—especially when your design engineers have recommended against it. CP & L compounded this error by refusing to seize the opportunity to redesign the facility in 1975.

I agree with the majority that excess facilities, as here, cannot be considered “used and useful” under the law. Again, I agree that no part of the \$570,000,000 can be included in the rate base but dissent from the majority’s allowing these costs to be recovered as operating expenses through amortization. See *Utilities Commission v. Thornburg*, 385 S.E.2d 451 (Martin, J., dissenting (1989)).

I find that the proper disposition of the \$570,000,000 is to classify the amount as excess plant or plant held for future use rather than cancellation costs. As plant held for future use, if all or any part of the present excess facility or plant becomes “used and useful” in the future, it can be placed into the rate base at that time with the consequent benefits to CP & L and its stockholders. If past history is any prologue to the future, this method should allow CP & L to recoup these expenses in a reasonable time and do so within the existing statutory law.

MITCHELL, Justice, dissenting: * * * As I read the record on appeal, the Commission did not conclude that any of the common facilities were not used and useful in the generation of electric power at the Harris Plant. Indeed, it does not appear that any party to these proceedings contended before the Commission that the common facilities were not used and useful. Instead, the dispute before the Commission involved whether Carolina Power & Light Company (hereinafter “CP & L”) had incurred costs associated with the common facilities prudently, not whether any facility of the plant was used and useful.

The Commission made findings and concluded that the costs incurred in building the Harris Plant were prudently incurred, a conclusion with which the majority of this Court agrees. Nevertheless, although no one appears to have raised the issue, the Commission further concluded that some of the common facilities were “excess common facilities.” Even if it is assumed—erroneously in my view—that the Commission had the authority to treat part of the prudently incurred costs for the used and useful common facilities as “excess,” I do not believe that its findings and conclusions in this regard were supported by the evidence presented.

CP & L offered evidence, which appears to have been uncontroverted, that none of the fuel handling building is unused, because portions of it not presently needed for fuel handling are being used to house other plant facilities. The Technical Support Center is a computer-equipped area located in the fuel handling building that is kept available for use by engineering and technical support personnel in the event of a plant emergency. Under Nuclear Regulatory Commission (hereinafter “NRC”) regulations, this center must be housed in a building with eighteen-inch-thick reinforced concrete walls. CP & L would have had to construct such a building at the Harris Plant for the Technical Support Center, had space not been available in the fuel handling building. Although other portions of the common facilities were larger than absolutely necessary, uncontroverted testimony was introduced by CP & L to the effect that the larger facilities would “be of great benefit in the event of an emergency requiring quick repairs on a large scale” at the Harris Plant, a nuclear powered electric generating plant within thirty miles of the State Capitol at Raleigh.

Further, CP & L offered uncontroverted evidence that after the decision not to complete other nuclear units at the Harris Plant had been made, it sought and obtained studies to determine whether portions of the common facilities could be eliminated. These studies revealed that while it would be physically possible to delete portions of the common facilities, they would respond differently to seismic stresses. If CP & L made such changes, it would be required to perform new seismic studies to satisfy the NRC that the modified facilities at the nuclear plant would not be damaged in the event of an earthquake. Such studies could have revealed that major modification of plant equipment and supports already in place would be necessary in order to ensure seismic stability of the modified facilities.

Based on such information, CP & L determined that it would be cheaper to build the common facilities as originally designed and use any extra space for other plant-related purposes than to delay construction yet again during times of rapidly rising construction costs while it initiated and carried out the procedures necessary to gain NRC approval for smaller facilities. Given the long history of regulatory delay in the approval and construction of the various phases of the Harris Plant—well documented in the Reports of this Court over a period of almost two decades—it is to be doubted that evidence supporting any other rational decision was available. In my view of the record, none was introduced. I conclude that the evidence before the Commission would not support a determination that any of the used and useful

common facilities at the Harris Plant, or any of the prudently incurred costs of such facilities, were “excess.”

In my view, the Commission has no authority in law to exclude any portion of the prudently incurred construction costs of used and useful facilities from the rate base. N.C.G.S. § 62-133(b)(1) requires that the Commission determine in every general rate case “the reasonable original costs of the public utility’s property used and useful ...” in providing the service rendered to the public. Such costs constitute the utility’s rate base. Under N.C.G.S. § 62-133(b)(4) and (5) the Commission must set rates which will allow the utility to earn a fair return on its rate base. The use of the phrase “reasonable original costs” in N.C.G.S. § 62-133(b)(1) seems to me to require that costs for the construction of the used and useful facilities of a completed nuclear power plant be included in the rate base when, as here, those costs have been determined to have been prudently incurred. Therefore, I conclude that all such costs incurred in the construction of the Harris Plant common facilities must be included in the rate base.

For the foregoing reasons, I believe that the Commission erred in excluding a portion of the costs of common facilities from the rate base and that this Court has compounded that error by excluding all such costs from the rate base and treating them as cancellation or abandonment costs. Therefore, I dissent.

National Rural Telecom Association v. Federal Communications Commission

988 F.2d 174 (D.C. Cir. 1993)

WILLIAMS, Circuit Judge: At issue in this appeal are two Federal Communications Commission orders implementing “price cap” rate regulation for the interstate services of local telephone exchange companies (“LECs”). Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786 (1990) (“LEC Price Cap Order”), on reconsideration, 6 FCC Rcd 2637 (1991) (“LEC Reconsideration Order”). Under the orders, all the Bell and GTE companies must shift to price cap regulation; all other LECs may but need not make the change. Although no party challenges the Commission’s basic decision to move to price caps, petitioners here attack special aspects of the plan.

* * * MCI, a major user of LEC’s services, attacks the rules on the ground (in essence) that the Commission has failed to preserve certain restraints provided by rate-of-return regulation. We start by briefly stating the overall purposes of the Commission in shifting from rate-of-return to price cap regulation and then turn to the specific challenges. Finding the Commission orders neither arbitrary nor capricious, we affirm.

Background

Rate-of-return regulation is based directly on cost. Firms so regulated can charge rates no higher than necessary to obtain “sufficient revenue to cover their costs and achieve a fair return on equity.” Policy and Rules Concerning Rates for Dominant Carriers, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195, 3211 (1988) (“Further Notice”). As one virtue of perfect competition is that it drives prices down to cost, rate-of-return regulation seems on its face a promising way to regulate natural monopolies, in principle roughly duplicating the benefits of competition.

By the late 1980s, however, the FCC began to take serious note of some of the inefficiencies inherent in rate-of-return regulation. First, the resulting cost incentives are perverse. Because a firm can pass any cost along to ratepayers (unless it is identified as imprudent), its incentive to innovate is less sharp than if it were unregulated. There is even a temptation toward “gold-plat[ing]”—using equipment or services that are not justifiable in purely economic terms, especially when their use improves the lot of management (elegant offices, company jets, etc.).

Second, rate-of-return regulation creates incentives for cost shifting that may defeat the regulatory purpose and have other ill effects. Firms can gain by shifting costs away from unregulated activities (where consumers would react to higher prices by reducing their purchases) into the regulated ones (where the price increase will cause little or no drop in sales because under regulation the prices are in a range where demand is relatively unresponsive to price changes). See Policy and Rules Concerning Rates for Dominant Carriers, Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 2924 (1989) (“Second Further Notice”). Third, rate-of-return regulation is costly to

administer, as it requires the agency endlessly to calculate and allocate the firm's costs.

In 1987, then, the FCC began proceedings to explore price cap regulation as an alternative. Policy and Rules Concerning Rates for Dominant Carriers, Notice of Proposed Rule Making, 2 FCC Rcd 5208 (1987) ("First Notice"). Under a price cap scheme, the regulator sets a maximum price, and the firm selects rates at or below the cap. Because cost savings do not trigger reductions in the cap, the firm has a powerful profit incentive to reduce costs. Nor is there any reward for shifting costs from unregulated activities into regulated ones, for the higher costs will not produce higher legal ceiling prices. Finally, the regulator has less need to collect detailed cost data from the regulated firms or to devise formulae for allocating the costs among the firm's services.

The above somewhat overstates the differences. Under rate-of-return regulation, the regulator sets ceilings on the basis of cost estimates, in turn based in large part on past costs. To the extent that a firm in any single period (i.e., between rate filings) can beat the estimates, it can keep the savings. Thus "regulatory lag" creates some incentive to economize under a rate-of-return scheme. But the incentive is muted, as a saving in one period will cause lower ceilings thereafter. On the other side, price cap regulation cannot quite live up to its promise as stated above. The Commission must select a formula for the cap—here it chose existing rates, plus an escalator based on general price inflation, minus an annual percentage reduction for expected savings from innovation and other economies. Obviously no such formula can be perfect, so ultimately the Commission must check to see whether the cap has gotten out of line with reality. The prospect of that next overview may dampen firms' cost-cutting zeal.

In any event, the FCC in 1989 concluded that price cap regulation would on balance be an improvement over rate-of-return in terms of meeting its statutory goals. Policy and Rules Concerning Rates For Dominant Carriers, 4 FCC Rcd 2873, 2876 (1989) ("AT & T Price Cap Order"). Although the initial order applied price cap regulation only to AT & T, it made clear that the Commission also had the LECs in mind for future application. Then, in 1990 and 1991, the Commission extended price cap regulation to the LECs, though with a "more cautious and careful approach" in light of the variety of companies and the differences between the markets affected. LEC Price Cap Order, 5 FCC Rcd at 6787. That involved, for example, making the shift optional for all but the Bell and GTE LECs. We will discuss other details in the context of the challengers' claims.

To understand MCI's claims we must first examine some of the mechanics of the price cap scheme and their relation to the Commission's concerns. A price cap enables a firm to raise the price of a product or service, so long as the firm offsets any increase for one service with decreases for others within the comparison group se-

lected by the regulator. Thus, if the firm in the benchmark period² provided 100 units of service A for \$1 each and 100 units of service B for \$2 each, for a total of \$300, it could thereafter choose any A-B price combination that, at the benchmark volume of sales, would yield no more than \$300. (For example, it could sell the A services at \$.75 each and the B services at \$2.25 each. $100 \times \$.75 = \75 ; $100 \times \$2.25 = \225 ; $\$75 + \$225 = \$300$.) All the LECs provide multiple services. The broader the comparison group within which an LEC may use offsets, the greater its price-changing flexibility. At one extreme, the Commission could have imposed a single price cap reflecting the prices for all of an LEC's services, weighted for the volume of sales of each service in the initial benchmark period. At the other extreme, the FCC could have imposed a price cap on each individual service that an LEC provides, giving the LEC no flexibility whatever. In fact the Commission chose a middle course, dividing LEC services into four product "baskets".³ A basket is a broad grouping of LEC services subject to its own price cap. The Commission set separate price caps for each basket in order to limit an LEC's ability to cross subsidize among groups of services.

We here use the term cross-subsidization simply but consistently to refer to prices that are not based on each specific service's average costs, or, in the jargon of the trade, "fully distributed costs" or "FDCs". In a company producing multiple services, FDCs are computed by allocating to each service any costs exclusive to it, plus a share of joint costs (e.g., operating overhead) deemed proportionate by the regulator. Whereas above we consistently used the term cost shifting in contexts where the conduct was likely to be harmful (e.g., between differently regulated affiliates), something that any regulator would properly seek to reduce, we here use "cross-subsidization" as an entirely neutral term describing any deviation from fully distributed cost pricing.

As the Commission plainly and explicitly recognized, deviations from fully distributed costs are in certain respects highly desirable and may tend to maximize the consumer welfare created by a regulated natural monopoly. While in a competitive market consumer welfare is maximized by marginal cost prices, that option is not realistically available for regulators of a natural monopoly. Because a natural monopolist is operating in a range where average costs are declining, and therefore where marginal costs are below average costs, marginal cost pricing would not permit the firm to recover its total costs. Thus the so-called "first best" efficient outcome is impossible, as its implementation would put the regulated firm out of business. As the Commission recognized, however, a regulator can realistically seek to achieve "second best" efficiency: the set of prices that allows the firm to recover its total costs while mini-

² I.e., the period to which the regulator looks for the market prices and quantities used to set the initial price caps.

³ The baskets are (1) common line services, (2) traffic sensitive services, (3) special access services, and (4) interexchange services.

mizing adverse effects on consumer surplus—the difference between the price of a good and what consumers would be willing to pay for that good.

The orthodox concept of second best pricing is the inverse elasticity principle, or Ramsey pricing. The price increments over marginal cost are allocated in inverse proportion to the price elasticity of demand for the good or service, with the increments relatively high for services for which demand is inelastic, low for those for which demand is elastic. The upshot is to minimize the aggregate impact of the price increments on consumer demand and thereby maximize consumer surplus. As the Commission noted, a price cap regime is likely to induce companies to set Ramsey prices. Within the comparison group for which the price cap is defined (in the Commission's terms, within a "basket"), a firm can enhance its profits by increasing (as compared to fully distributed cost pricing) the proportion of shared costs borne by the inelastic services; the effect of the decrease in sales there will (up to a point) be more than offset by the effect of the increase in sales due to corresponding price decreases for the price-elastic service. The same price changes increase consumer surplus as well.

The Commission clearly adopted this basic understanding. It said, for example, that "the goal is to determine the 'second best' pricing methodology, one that permits the recovery of total company costs while minimizing the adverse impact on consumers' surplus." *Id.* at 3257 (footnote omitted). It observed that price cap regulation "encourages efficient pricing by providing regulated carriers a measure of flexibility to adjust their rates to conform with prevailing market demand." *Id.* It also noted that "a carrier's ability to adjust prices constitutes one of the major benefits of incentive regulation." Second Further Notice, 4 FCC Rcd at 2924.

The Commission, however, was unwilling to embrace the efficiency goals of inverse elasticity pricing without limit. First, it expressed some concern about possible anti-competitive consequences, see, e.g., LEC Price Cap Order, 5 FCC Rcd at 6811-12, though never spelling these out in any detail. It also identified two side effects that it wished to limit—"subjecting ratepayers to precipitous changes in the prices for LEC services," *id.* at 6811, and, as it expressed the point, "enabling LECs to disadvantage one class of ratepayers to the benefit of another class", *id.*

The second side effect requires an extra word of explanation. If one takes fully distributed cost pricing as a norm, it is true by definition that any shift in the direction of Ramsey pricing will enable "LECs to disadvantage one class of ratepayers to the benefit of another class." Customers purchasing services for which aggregate demand is inelastic will face price increases, while those who purchase products for which demand is elastic will benefit from price decreases. The Commission's discussions of Ramsey pricing manifest its understanding that this was necessary. In context, then, the Commission's reference to price changes that "disadvantage one class of ratepayers to the benefit of another" can only mean that the Commission was concerned about possible unfairness to buyers whose demand was inelastic—an entirely understandable distributive concern, as by definition such buyers are ones whose alternative

options are relatively limited. In short, then, the Commission set out to balance efficiency goals with distributive concerns relating to abruptness of price changes and burdens on consumers with limited choices.

The devices used to achieve the balance were “baskets” and “bands”. Baskets are subsets of LEC services to which the price caps are applied; if services A and C are in different baskets, an LEC cannot justify an increase in the price of A by a decrease in that of C. Bands are still further subdivisions, “service categories” within a basket. An LEC may raise the aggregate prices of services grouped in a band (subject of course to compliance with the basket price cap), but any use of “streamlined” review procedures for such changes is limited to changes of no more than plus or minus 5% a year.

We now turn to MCI’s complaints about the Commission’s decisions as to the relation between baskets and its “sharing” rule.

Sharing. The price cap is annually reduced by 3.3% to reflect the Commission’s estimate of obtainable efficiency gains, based on historic industry efficiency gains of 2.8% plus a “consumer productivity dividend” of 0.5%. But as a “backstop” to prevent LECs that greatly exceed that productivity goal from earning what it viewed as excessive profits, the Commission established a “sharing rule”. Under the rule an LEC may keep all profits within 1% above a specified rate of return, must rebate half of the profits between 1% and 5% above that rate, and must rebate all profits exceeding it by more than 5%.

What MCI disputes is the Commission’s decision that sharing should be calculated on overall firm profits, not on the profits from individual baskets. In rejecting MCI’s proposal that sharing be triggered by “excess” returns within each basket, the Commission explained that as the productivity index was based on overall trends, not basket trends, basket-based sharing measures would not fit the origins of the sharing theory. Moreover, since the Commission recognized that any sharing scheme would tend to dampen the cost-reducing incentives sought by the price cap scheme, the more stringent the sharing rule the fewer the cost-saving benefits. Finally, basket-level sharing would require continued application of existing fully distributed cost methodologies, thereby preventing prices from moving toward efficient (i.e., second best efficient, Ramsey) levels. The possible stakes of the last point were considerable; the Commission noted studies suggesting that insistence on fully distributed cost pricing in the telecommunications industry was reducing consumer surplus by perhaps \$3 billion a year in 1985 dollars. ***

MCI’s basic argument is that overall sharing does not retain as much of rate-of-return regulation as sharing by basket would have, and that therefore it is arbitrary. The first part of the proposition is clearly correct, the second a complete non sequitur. MCI tries to achieve its goal by transparent verbal manipulations. Since the Commission said that the quest for just and reasonable rates called for use of baskets (to limit “discrimination” and cross-subsidization), and since basket sharing would

more effectively limit discrimination and cross-subsidization, MCI claims that the Commission has been internally inconsistent.

As we have said, some of the Commission's language is confusing. But its basic trade-off is clear, and MCI never adduces a single argument as to why MCI's favored balance—weighted much more heavily against cost-reduction incentives and against inverse elasticity pricing—was so clearly preferable as to render the Commission's choice arbitrary. That the Commission was somewhat concerned about deviations from fully distributed cost pricing did not require it to abandon its concern for cost incentives and for second best efficiency. To the extent that MCI is obliquely making a claim that the statutory "just and reasonable" rate requirement mandates use of fully distributed costs and bars moves toward inverse elasticity prices, our precedent is squarely against it. See, e.g., *Associated Gas Distributors v. FERC*, 824 F.2d 981, 1010-11 (D.C. Cir. 1987), and cases cited therein. As MCI has failed to show anything arbitrary in the point selected by the Commission to balance its conflicting goals, or anything fundamentally wrong with the Commission's reasoning process, we reject MCI's claim. * * *

The petitions for review are
DISMISSED.

Bell Atlantic Telephone Companies v. Federal Communications Commission

79 F.3d 1195 (D.C. Cir. 1996)

RANDOLPH, Circuit Judge: Petitioners, a group of local telephone exchange carriers, seek review of two orders of the Federal Communications Commission. These orders—the Performance Review Order¹ and the Add-Back Order²—made several changes to the Commission's scheme for regulating prices charged by local telephone companies for interstate access services. We deny the petitions for review because the orders are neither arbitrary nor capricious and have no impermissible retroactive effects.

I

A. Background

In 1990, the Commission implemented a price cap plan for regulating rates charged by local telephone exchange carriers for interstate access services. Under the price cap plan, the carriers' services are grouped into baskets. For each basket, the Commission established a maximum price, called the price cap index. As long as a carrier's tariffed rates remain below the price cap index, its rates go into effect after substantially

¹ Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 10 F.C.C.R. 8961 (1995) ("Performance Review Order").

² Price Cap Regulation of Local Exchange Carriers: Rate-of-Return Sharing and Lower Formula Adjustment, Report and Order, 10 F.C.C.R. 5656 (1995) ("Add-Back Order").

streamlined review. Price cap regulation is intended to provide better incentives to the carriers than rate of return regulation, because the carriers have an opportunity to earn greater profits if they succeed in reducing costs and becoming more efficient. See generally *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

The price cap rules required annual adjustments to the carriers' price cap indices for inflation and certain "exogenous" changes outside the carriers' control, coupled with a percentage offset for anticipated productivity gains. The productivity offset was necessary because the telecommunications industry had experienced faster productivity growth than the economy generally. As adopted in 1990, the price cap rules required the carriers to use a minimum productivity offset (or "X-factor") of 3.3 percent. ***

The Commission expected, however, that incentive regulation would result in greater productivity gains than rate of return regulation, and therefore added a 0.5 percent "consumer productivity dividend" to the original X-factor, for a total of 3.3 percent. No party to the original proceeding challenged either the overall method for determining the productivity offset, or this specific component of that offset.

The Commission was concerned that these offsets might not accurately reflect the local exchange carriers' productivity growth. *** In order to reduce this risk, the Commission adopted as a backstop program the sharing adjustment, the general validity of which is not disputed here. Sharing entails a one-time adjustment to a local exchange carrier's price cap index when its rate of return for the previous year has been abnormally high.⁴ The Commission reasoned that, in a year in which a local exchange carrier's earnings are particularly high, the carrier's productivity offset will probably have understated that local exchange carrier's actual gains in efficiency. Therefore, a correction in the price cap index for future rates is necessary in order to allow consumers to "share" in this additional, unanticipated productivity gain in the succeeding year. The Commission uses a percentage (usually 50 percent) of the local exchange carrier's earnings over a certain threshold as a proxy for determining this additional productivity gain, and requires that the local exchange carrier's price cap index (though not necessarily its rates) be reduced by this amount during the following year.

The Commission established a minimum X-factor of 3.3 percent, but allowed carriers to choose each year between a 3.3 percent offset and a 4.3 percent offset. If a carrier chose the higher 4.3 percent offset its price caps would increase less, but it

⁴ In addition to the sharing adjustment, the Commission adopted a mechanism known as the "low-end" adjustment. This mechanism mirrors the sharing adjustment: When a local exchange carrier's earnings are particularly low, the productivity offset has likely overstated the local exchange carrier's actual efficiency gains, and the local exchange carrier is therefore permitted to correct for that overstatement by increasing the following year's price cap index.

would be subject to a higher sharing threshold, allowing it to retain more of its earnings.⁵

The Commission did not envision that sharing would be routine. In practice, however, sharing became routine: in 1993 alone, the great majority of price cap local exchange carriers were in the sharing zone, including all seven Bell Operating Companies.

B. The Performance Review Order

In the original price cap orders, the Commission stated that it would undertake a thorough “performance review” after the first four years of price cap regulation to evaluate how well the system had worked. Accordingly, in 1994 the Commission initiated a rulemaking proceeding that produced the Performance Review Order.

The Commission sought comment on what local exchange carrier productivity had been under price caps and what the X-factor should be in the future. In response, United States Telephone Association (“USTA”), on behalf of most local exchange carriers, submitted a study that proposed to determine the productivity factor based on a “total factor productivity” method (“TFP”). According to the USTA study (as revised), local exchange carrier productivity growth had been 2.3 percent. Other parties challenged USTA’s proposal, contending that there were serious conceptual and methodological problems with its proposed TFP methodology.

MCI also submitted a study based on a correction of what it saw as errors in the Commission’s original determination of the X-factor. *** MCI thus concluded that local exchange carrier productivity was actually around 5.9 percent.

In the Performance Review Order, the Commission reached two principal conclusions with respect to the determination of the X-factor. First, the Commission concluded that the record developed in the Performance Review was insufficient to make a final or permanent determination about local exchange carrier productivity under price caps. *** The Commission analyzed all of the proposed methodologies for determining local exchange carrier productivity and decided that there were too many outstanding questions to render any final judgment. Without a methodology to determine productivity, the Commission could not determine a new, permanent X-factor. Therefore, the Commission decided to issue a further notice of proposed rulemaking to explore these issues and to set a permanent X-factor for the future.

⁵ For example, under the original LEC Price Cap Order if a local exchange carrier chose the 3.3 percent offset, it was required to “share” 50 percent of any returns above 12.25 percent, and 100 percent of any returns above 16.25 percent. Thus, if a local exchange carrier chose the 3.3 percent offset and achieved a 13.25 percent return in a given year, it would be allowed to keep the entire profit from that year, but it would have to make a one-time reduction in its price cap index the following year in order to recognize the fact that its productivity had increased faster than the Commission had predicted. For local exchange carriers that chose the 4.3 percent productivity offset, 50 percent sharing began at 13.25 percent and 100 percent sharing at 17.25 percent.

Second, having concluded that it was presently unable to determine a permanent X-factor, the Commission chose an interim offset to be used while the further rule-making was pending. ***

The Commission made one change to the original X-factor. During the first four years of incentive regulation, the local exchange carriers' earnings routinely reached the sharing levels. The Commission had not anticipated this, and the local exchange carriers' consistently increasing earnings were an indication that the Commission's original X-factor had been set too low. *** In light of actual experience under price caps, *** the Commission established an interim, minimum X-factor of 4.0 percent (rather than the old 3.3 percent).

Because the Commission determined that it had erred in 1990 in its selection of the minimum X-factor, it also ordered a one-time price cap adjustment for all local exchange carriers that had chosen the 3.3 percent offset. For each year a carrier had elected the 3.3 percent offset between 1990-1994, the Commission ordered the carrier to take a 0.7 percent reduction in its price cap index prospectively. The adjustment placed a local exchange carrier's future price cap index where it would have been had the X-factor been 4.0 percent all along.

The Commission also established two other X-factor options for the interim period: 4.7 percent and 5.3 percent. If a local exchange carrier chooses 4.7 percent, its sharing thresholds are higher; if a local exchange carrier chooses 5.3 percent, it will have no sharing requirements. * * *

II

Section 201(b) of the Communications Act, 47 U.S.C. § 201(b), declares that charges for interstate or foreign communications "shall be just and reasonable," and § 202(a) of the Act, 47 U.S.C. § 202(a), prohibits carriers from engaging in "unreasonable discrimination," giving "any undue or unreasonable preference," or subjecting persons or localities "to any undue or unreasonable prejudice or disadvantage." *** Whether we examine only the "end result" of the Commission's ratemaking in this case, see *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944), or each of its contested elements, see *Public Service Comm'n v. FERC*, 813 F.2d 448, 465 & n. 27 (D.C. Cir. 1987), we come to the same conclusion. Petitioners have failed to establish any clear error underlying the Commission's orders.

A. The Performance Review Order

1. The Interim X-Factor. To sustain petitioners' attack on the interim X-factor we would have to determine that the Commission committed a clear error in judgment in selecting 4.0 as the factor needed to produce just and reasonable rates. ***

The Commission originally predicted that sharing would be rare, serving merely as a backstop "in the event that unanticipated errors in the price cap formula, or circumstances peculiar to a particular company, rendered the formula inaccurate for a company at a given time." Performance Review Order, 10 F.C.C.R. at 9051-52 ¶ 203. In practice, however, sharing had become routine. By 1993, all seven Bell

Operating Companies were in the sharing zone, leading the Commission to believe that the original X-factor had been too low. ***

Having rejected the new studies on the ground that the record was insufficient to make a permanent judgment about productivity, the Commission reasonably decided to continue the present system during the interim period. ***

Petitioners also protest the 0.5 percent consumer productivity dividend included in the interim X-factor. It is true that the Commission provided no specific reason for retaining a consumer productivity dividend or for setting the figure at 0.5 percent. But as we have already discussed, the Commission offered a thorough and convincing explanation of why it was retaining its original methodology on an interim basis. The 0.5 percent consumer productivity dividend was part of that original methodology and neither AT & T nor the local exchange carriers contested it before it went into effect pursuant to the 1990 order.

Having found the record insufficient to select a new methodology and having issued a Further Notice of Proposed Rulemaking, the Commission continued using its current methodology in the interim with two changes. The Commission adjusted the historical component of the X-factor upward and gave local exchange carriers a wider range of X-factors from which to choose. The local exchange carriers' experience under price caps indicated that these aspects of the original plan demanded immediate attention. With so many local exchange carriers in the sharing zone, the Commission had good reason to believe that the original X-factor had been too low and therefore adjusted it upward. And because so few local exchange carriers had chosen the optional X-factor and in light of the diversity of local exchange carrier performance under price caps, the Commission decided to change the options available to local exchange carriers. With the exception of those two changes, the Commission retained the same X-factor methodology on an interim basis and deferred other major changes until the record was more complete. Its decision in this respect was within the bounds of the discretion entrusted to it.

3. Retroactivity. The Performance Review Order required local exchange carriers to make two adjustments to their price cap indices. Carriers who had chosen the 3.3 percent X-factor had to adjust their price cap indices downward so that their future rates would be at the level they would have been if the X-factor had been 4.0 percent all along. And carriers who had adjusted their price cap indices upward to reflect changes in their accounting for other post employment benefit costs were required to adjust their price cap indices downward to eliminate the previous change. Petitioners think the Commission engaged in impermissible retroactive rulemaking when it required these adjustments. We think not.

In both instances the Commission stated that the changes would affect future rates only and were not intended to reclaim revenues carriers had earned in previous years. The one-time adjustments brought the price cap indices to a level that—according to the Commission—accurately reflected the carriers' costs and productivity, and pre-

vented past Commission mistakes from being embedded in future rates. As the Commission put it, the “one-time adjustment merely ensures that, in the future, higher earnings must be attained through actual improvements in productivity and will not continue to accrue as a result of administrative error.” The adjustments therefore have no retroactive effect. And they do not upset petitioners’ reliance interests. In 1990, the Commission announced its plan to conduct a performance review in 1994 to assess how well the price cap system had worked. Petitioners made all of their X-factor elections with that in mind. Petitioners could not have reasonably assumed that the price cap index would not be altered. ***

Because we find that the Commission’s decisions in the Performance Review Order *** were reasonable and supported by the record *** the petitions for review are Denied.

U.S. Telephone Ass’n v. FCC

188 F.3d 521 (D.C. Cir. 1999)

STEPHEN F. WILLIAMS, Circuit Judge: Long-distance telephone traffic is ordinarily transmitted by a local exchange carrier (“LEC”) from its origin to a long-distance carrier (or interexchange carrier or “IXC”). The IXC carries the traffic to its region of destination and hands it off to the LEC there. The IXC charges the customer for the call and pays “access charges” to the LECs at either end. In a 1997 rulemaking the Federal Communications Commission amended its methodology for limiting these charges, as applied to the largest LECs. The rule is challenged on one side by a group of LECs, and on the other by one IXC, namely MCI, and an Ad Hoc Telecommunications Users Committee (collectively referred to here as MCI).

In regulating access charges the FCC currently uses a “price cap” method—mandatory for the largest LECs (the regional Bell operating companies and GTE) and optional for others. Under traditional rate-of-return regulation an agency sets rates calculated to allow the utility to recover its costs, including a reasonable rate of return on investment, with adjustment as needed to reflect cost changes; here, however, it sets rate ceilings and, with some qualifications, allows the utilities to keep whatever profits they can make while charging rates at or under the cap. (A LEC may also file rates above the caps, but for these the review process is cumbersome and the substantive standards stringent.) The price cap system is intended (among other things) to improve the utility’s incentives to cut costs and refrain from overinvestment, incentives that are more blunted under the traditional method. See generally *National Rural Telecom Ass’n v. FCC*, 988 F.2d 174, 177-79 (D.C. Cir. 1993).

The price caps were initially set at the levels of each carrier’s rates on July 1, 1990. From the outset they have been subject to various annual adjustments, including reduction by a “productivity offset,” or “X-Factor.” See 47 CFR § 61.45. In the order under review, the agency revised the method for determining the X-Factor, eliminated a “sharing” mechanism that forced LECs to return some or all of the profits above

specified levels to ratepayers, and required “reinitialization,” i.e., a reduction in the price caps applicable after July 1, 1997 so that they would be calculated as if the new X-Factor had been in effect for the LECs’ 1996 tariff filings. In the Matter of Price Cap Performance Review for Local Exchange Carriers, Fourth Report & Order, 12 FCC Rcd 16,642 (1997) (“1997 Order”). Because the access charges are in the aggregate so enormous, even small changes in the X-Factor have a large monetary value; the LECs claim (without dispute) that each 0.1% change in the factor represents a \$23 million change in the industry-wide access charge.

I. The historic productivity component of the X-Factor

The X-Factor is aimed at capturing a portion of expected increases in carrier productivity, so that these improvements, as under competition, will result in lower prices for consumers. Apart from a “consumer productivity dividend” (“CPD”) described below, it is based on an assumption that historic productivity increases will be matched in the future. The agency resolved in the 1997 Order that the X-Factor (apart from the CPD) should be calculated as the sum of the difference in productivity growth and the difference in input price growth between the LECs and the economy as a whole. It can thus be expressed as follows: $X = (\Delta\% \text{ LEC TFP} - \Delta\% \text{ TFP}) + (\Delta \text{ U.S. input prices} - \Delta\% \text{ LEC input prices})$, where TFP = total factor productivity.¹ The formula may be more readily conceptualized as $X = (\Delta\% \text{ LEC TFP} - \text{LEC input prices}) - (\Delta\% \text{ U.S. TFP} - \Delta\% \text{ U.S. input prices})$.

Several parties submitted estimates of historical X-Factors. In a determination unchallenged here, the FCC accorded the greatest weight to its own estimates, although it also gave “some weight” to AT&T’s estimates ***. The estimates the FCC considered, and the averages of those estimates over specified periods, are the following:

Table 1		
Year	FCC	AT&T

¹ This equation is apparently derived as follows from the FCC’s general rule that the X-Factor is to “provide a reliable measure of the extent to which changes in the LECs’ unit costs have been less than the change in level of inflation,” see 1997 Order, 12 FCC Rcd at 16,647, ¶ 5: The general rule yields $X = U - L$, where U is the “change in level of inflation,” and L is the change in the LECs’ unit costs. The FCC then observes that “changes in a firm’s unit costs come from two sources: (1) changes in productivity, and (2) changes in input prices,” id. at n. 16. Thus, $L = \Delta\% \text{ LEC input price} - \Delta\% \text{ LEC productivity}$. Reading “change in level of inflation” as “change in unit costs in the economy as a whole,” we get the similar expression: $U = \Delta\% \text{ U.S. input price} - \Delta\% \text{ U.S. productivity}$. Substituting these values into the equation $X = U - L$, using “TFP” for productivity, and performing a little algebraic manipulation yields the equation in the text.

As the Commission also increases the cap by general price inflation, the net effect of these adjustments is (roughly, subject to effects of the use of different indices) to increase the cap by the LECs’ estimated change in unit costs. It is somewhat as if the overall adjustment (“A”) were (using the terms of the prior paragraph) $A = U - X = U - (U - L) = L$.

1986	-0.5%	0.2%
1987	5.0%	4.1%
1988	5.0%	6.4%
1989	7.9%	8.8%
1990	8.8%	11.0%
1991	5.8%	6.0%
1992	3.4%	4.1%
1993	4.7%	6.0%
1994	5.4%	5.9%
1995	6.8%	9.4%
Ave (86,95)	5.2%	6.2%
Ave (87,95)	5.9%	6.9%
Ave (88,95)	6.0%	7.2%
Ave (89,95)	6.1%	7.3%
Ave (90,95)	5.8%	7.1%
Ave (91,95)	5.2%	6.3%
Range of Averages	5.2-6.1	6.2-7.3

The FCC consulted the moving averages to establish a range of reasonableness from 5.2% to 6.3% and then selected 6.0% as the historical (i.e., non-CPD) component of the X-Factor. The LECs argue that the FCC did not give a rational explanation of that choice, and we agree. None of the reasons given for choosing 6.0% holds water.

A. Devaluation of 1986-95 and 1991-95 averages

First, in choosing a point within the range of reasonableness, the FCC determined that it was “reasonable to place less weight” on two lowest averages, the ones for 1986-95 and 1991-95. It said that the first, 1986-95, “is heavily influenced by the improbably low 1986 estimate of -0.5 percent.” But the Commission gave no reason for condemning the 1986 estimate as “improbable,” and mere divergence from the other numbers does not justify such a conclusion. The FCC invokes our cases upholding the elimination of outlying data points, but in them the agency explained why the outliers were unreliable or their use inappropriate.

As to the 1991-95 average, the Commission said it was the one “most affected by the low 1992 estimate,” which it in turn diagnosed as “an artifact of a one-year jump in the measured productivity of the national economy as economic activity increased, rather than a change in the growth rate of LEC productivity or input prices.” This is mystifying. If the productivity component of the X-Factor is to reflect the difference

between LEC and overall productivity growth, a proposition that is built into the Commission’s formula, there seems no reason to slight a datum because its anomalous character stems from the unusual magnitude of the second term rather than of the first.

B. Alleged upward trend

In justification of its choice of 6.0% the FCC also cites an upward trend in the X-Factor during the last years it surveyed. The FCC’s reliance on the upward trend necessarily reflects the (unexplained) assumption that the trend will continue, at least in the immediate future. Explanation might be reasonably omitted if there were no obvious reason to doubt continuation of an observed trend. But two such reasons exist.

First, the trend appears to be part of a cyclical pattern. Although the X-Factor did increase steadily in the 1992-95 period, it also decreased from 1990 to 1992, after rising from 1986 to 1990. See Table 1, *supra*. Perhaps there was reason to believe that there would be no cyclical downturn during the expected life of this X-Factor determination, which was to be reviewed about two years after being made. But the FCC offered no such reason.

Second, the X-Factor is calculated as the sum of two components, neither of which followed a trend during the period in question. In fact, their year-to-year fluctuations swamped the trend increments:

Table 2		
<i>Year</i>	<i>Difference between LEC & US changes in total factor productivity</i>	<i>Difference between LEC and U.S. changes in input prices</i>
1992	0.21	3.21
1993	1.44	3.26
1994	3.69	1.71
1995	1.78	5.04

Where’s the trend? As the underlying variables appear to be thrashing about wildly, the FCC’s conclusion that the trend in the difference between the two had some predictive value requires explanation. ***

The Commission having failed to state a coherent theory supporting its choice of 6.0%, we remand for further explanation.

II. Consumer productivity dividend

The second component of the X-Factor is a “consumer productivity dividend” (“CPD”) of 0.5%. At the time of the 1990 order instituting price-cap regulation, the FCC “expected ... that incentive regulation would result in greater productivity gains than rate of return regulation,” Bell Atlantic, 79 F.3d at 1198, and instituted the

CPD, as it said, to “assure that the first benefits of price caps flow to customers in the form of reduced rates.” In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786, 6799, ¶ 100 (1990) (“Price Cap Order”). It retained the 0.5% CPD without specific explanation in a 1995 interim rule and retained it again in the current rule.

The LECs challenge the 0.5% CPD as based on an “obsolete” justification. The Commission’s earlier data on historic productivity improvement derived from the rate-of-return era, so an adjustment to reflect the expected incentive effects of price caps was in order; but the post-1990 data presumably reflect those effects.

FCC counsel responds that the agency believes that an innovation in the current rule—the Commission’s elimination of the “sharing” of profits exceeding certain benchmarks—will give the LECs still further productivity incentives, and that the FCC relied on that in retaining the CPD. Even if the agency relied on this justification (which the LECs dispute), it never explained retention of the old percentage, a retention that required some comparison of the current change with the initial one in terms of their likely impacts on productivity. Thus we must remand for an explanation of the Commission’s choice of the amount—0.5%.

The LECs claim that the FCC did not rely on the expected effects of sharing elimination and that it gave no other reason justifying the retention of any CPD. We do not reach these arguments because the FCC will be able to give a clearer statement of its reasons in the remand on the amount and since the LECs do not dispute the argument FCC’s counsel is presently making—that it is defensible to include a CPD corresponding to whatever productivity increase may be expected from the elimination of sharing.

III. Elimination of sharing

Before the rule at issue in this case, the FCC’s price cap regime included a “sharing” mechanism, which mandated LEC rate reductions sufficient to return profits above specified levels to their customers, the IXCs. The most recent sharing regime, enacted in the 1995 interim order, made the sharing obligation dependent on the X-Factor, imposing no obligation on firms choosing a 5.3% X-Factor, and the following on ones choosing 4.7% and 4.0%:

Table 3		
<i>Chosen X-Factor</i>	<i>50% Give-back required for rate-of-return over</i>	<i>100% Give-back required for rate-of-return over</i>
4.7%	13.25%	17.25%
4.0%	12.25%	16.25%

In the Matter of Price Cap Performance Review for Local Exchange Carriers, 10 FCC Rcd 8961, 9058, ¶ 222 (“Performance Review Order”) (1995). Attacking the Commission’s elimination of the “sharing” mechanism, MCI first claims that the statutory mandate of “just and reasonable” rates, 47 U.S.C. § 201(b), requires the FCC to impose a mechanism to prevent “unreasonable” returns. In the absence of any indication that Congress directly addressed the issue, we defer to the FCC’s interpretation of the Communications Act unless it is unreasonable. See *Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837 (1984). MCI cites no authority rejecting an FCC interpretation of the statute contrary to the one MCI advances, and in *Time Warner Entertainment Co. v. FCC*, 56 F.3d 151 (D.C.Cir. 1995), we endorsed a pure price cap regime with no sharing provision in the face of a statutory mandate to ensure “reasonable” basic cable rates.

Next, MCI argues that elimination of sharing was arbitrary and capricious. But the agency advanced two sound rationales for its decision. First, it found that “sharing severely blunts the efficiency incentives of price cap regulation by reducing the rewards of LEC efforts and decisions.” When all profits are taken away, a firm has no incentive to make them; when some proportion is taken away, firms will avoid at least some otherwise desirable choices with a prospect of enhancing profit but a risk of loss. Second, the FCC found that eliminating sharing would remove the incentive to shift costs to services that are subject to sharing and away from services that are not, thus cross-subsidizing the latter. MCI does not contest these effects, nor does it question the Commission’s argument that monitoring to catch them would be administratively burdensome and would increase its reliance on obsolete embedded accounting costs.

Finally, MCI contends that it was arbitrary and capricious for the FCC to scuttle sharing but at the same time retain its “low-end adjustment,” which gives the LECs some pricing leeway to prevent their returns from falling below a given level. There is clearly a literal asymmetry in protecting LECs in lean conditions while not constraining them in unexpectedly fat ones. But the FCC gave a good reason for creating this asymmetry—the Constitution’s takings clause, which forbids the imposition of confiscatory rates without just compensation. See *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307-08 (1989). The Commission thus avoided raising a non-trivial constitutional question, one that has no analogy at the upper end of the range of allowable rates. ***

V. Reinitialization

“Reinitialization” is the name for the Commission’s setting a current price cap at what it would have been if past X-Factors had been different. For instance, if the price cap starts at 100 and the X-Factor is 1% for the first three years, the cap would stand at approximately 97 at the end of those years. $100 - (3 \times 1) = 97$. (The figure is only approximate because of compounding.) If the regulator then changes the X-

Factor to 2% and imposes full reinitialization, it would revise the cap to about 94 for the year immediately following. $100 - (3 \times 2) = 94$. In the 1997 Order, the FCC ordered reinitialization for one year, 1996. Under our simple example, then, the cap would fall to approximately 96. $100 - (2 \times 1)$ [two years' reduction of 1%] - (1×2) [one year's reduction of 2%] = 96.

Both the LECs and MCI challenge this decision, seeking to have it modified to favor their respective interests.

A. Reinitialization based on CPD

The LECs challenge the FCC's requirement that they include the CPD in the X-Factor used for reinitialization. In Part II, we explained the need to remand the case for further explanation of size of the CPD. We agree with the LECs that if the FCC retains the CPD because of the productivity benefits expected from the elimination of sharing, no element of reinitialization based on the CPD will be appropriate in the absence of evidence linking productivity gains to the anticipation of sharing's elimination; the companies could not have responded to that incentive before its creation.

C. Reinitialization for only one year

MCI claims that the FCC should have reinitialized the X-Factor all the way back to 1991 (the first year of the price-cap regime). It says the agency has a policy of correcting errors in X-Factor determinations and that it decided in the current rule that prior determinations were in error. In the alternative, MCI argues that the FCC should reinitialize back to 1995, the year in which the previous X-Factor was adopted.

In the 1995 interim price cap review, the FCC determined that a single year's productivity estimate generated by its former method was understated, based in large part on the estimate's discrepancy with the results of a TFP study. It then calculated a new X-Factor designed to eliminate the effects of the understatement and required LECs to set their price caps as though the new X-Factor had been in effect since the advent of price cap regulation. In 1997 the Commission determined that its former method had systematically understated productivity relative to the TFP method, but required reinitialization for one year only.

The situations are somewhat similar, but the FCC adequately distinguished them. It rested its 1997 decision to limit reinitialization on the need to "limit harm to LEC productivity incentives that could result from the perception that our regulatory policies unnecessarily lack constancy." It seems clear that a second extensive reinitialization would considerably aggravate such a perception. Universal, complete reinitialization would impair the supposed incentive advantages of price caps—which derive from firms' supposing that their efficiencies will not come back to haunt them. ***

Conclusion

The FCC's decisions to select 6.0% as the first component of the X-Factor and to retain the 0.5% CPD are reversed and remanded to the agency for further explanation;

the FCC may of course request a stay of this order pending its reconsideration. The petitions for review are otherwise denied.

So ordered.

Texas Office of Public Utility Counsel v. Federal Communications Commission

265 F.3d 313 (5th Cir. 2001)

EMILIO M. GARZA, Circuit Judge: This petition for review of the CALLS Order¹ represents the latest challenge to the Federal Communication Commission's implementation of the Telecommunications Act of 1996, Pub.L. No. 104-04, 110 Stat. 56 (codified as amended in scattered sections of title 47, United States Code) ("1996 Act"). We affirm the CALLS Order in most respects, but we remand for further analysis the portions regarding *** the X-Factor.

*** We also remand the X-Factor issue, finding that the FCC lacked a rational basis in the record to support the 6.5 percent figure. Prior to the CALLS Order, the FCC had designated the X-Factor as a proxy for the increase in the LECs' productivity minus the rate of inflation. The price caps for local services were reduced each year by the percentage represented by the X-Factor. The X-Factor thus had the effect of passing down to consumers the savings from increased productivity. In 1997, the FCC set the X-Factor at 6.5 percent. On a petition for review, the D.C. Circuit reversed and remanded the X-Factor issue, holding that there was no rational relationship between the 6.5 percent figure and the alleged increase in productivity. *See USTA*, 188 F.3d at 525.

In its CALLS Order, the FCC reintroduced the same 6.5 percent X-Factor, but stated that the revamped X-Factor serves a different function as a "transitional mechanism that operates to reduce rates at a certain pace, and [is no longer] ... linked to a specific measure of productivity." CALLS Order, ¶ 140. Therefore, the FCC argues that the CALLS Order does not conflict with the D.C. Circuit's remand order in *USTA*, because the court had only required further justification of the 6.5% figure in light of its role as a productivity proxy. Now that the X-Factor no longer is tied to productivity, the FCC claims that the 6.5 percent figure is acceptable. We disagree.

The new X-Factor suffers from the same infirmity as the prior one: the FCC has failed to show a rational basis as to how it derived the 6.5 percent figure. Even if the X-Factor is no longer tethered to any productivity measure, the FCC still needs to

¹ The CALLS Order is officially named In the Matter of Deployment of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Low-Volume Distance Users, and Federal-State Joint Board on Universal Service, Sixth Report and Order in CC Docket No. 96-262 and 94-1, and Report and Order in CC Docket 99-249, and Eleventh Report and Order in CC Docket 96-56, 15 FCC Rcd. 12962 (released May 31, 2000). The order derives its appellation from the Coalition of Affordable Local and Long Distance Service ("CALLS"), a group of local and long-distance providers that helped draft the initial proposal.

provide a rational explanation of how it derived the precise percentage. Otherwise, the FCC would have free reign to set the X-Factor arbitrarily and capriciously. It must justify why a 6.5 percent X-Factor is a more appropriate rate reduction measure, than, say, a .065 percent or 65 percent X-factor. ***

In the Matter of Price Cap Performance Review for LECs

FCC 03-164 (July 10, 2003)

By the Commission: In this order, we address two issues before the Commission on remand from the United States Court of Appeals for the Fifth Circuit.¹ In the *CALLS Order*, the Commission adopted comprehensive reforms to the interstate access charge regime and universal service support for price cap carriers, based in part on a proposal submitted by the Coalition for Affordable Local and Long-Distance Service (CALLS). On September 10, 2001, the Fifth Circuit affirmed the *CALLS Order* in most respects, but remanded for further analysis and explanation the decisions *** to adopt the 6.5 percent X-factor. *** We also conclude that the record supports the adoption of a 6.5 percent X-factor to achieve the Commission's target rate levels for price cap carriers.

*** The only issue related to the X-factor remanded by the court for further explanation was the Commission's basis for picking the precise figure of 6.5 percent as the transitional X-factor.

Using 6.5 percent as a transitional X-factor was the Commission's reasoned approach to reconciling the competing goals of moving traffic-sensitive access charges closer to cost-based rates while avoiding a flash cut. The Commission wanted to ensure that average traffic sensitive (ATS) rates reached the target levels within a reasonable period of time to ensure that consumers reaped the benefits of the *CALLS Order* as soon as possible. *** Moreover, the Commission previously has held that flash cuts in access rates should be avoided to provide LECs, IXC's, and end users time to adjust to changes in rate structures. Thus, the Commission adopted a transitional X-factor to reduce ATS rates, in order to avoid the harms associated with a flash cut.

Having rejected an immediate reduction to target levels, the Commission then had to determine the most reasonable X-factor to apply. In doing so, it was necessary for the Commission to consider a number of criteria: which factor would work best for the broadest range of carriers; which factor could be most easily understood and implemented; and which factor was best supported by record evidence submitted by all parties. The 6.5 percent X-factor best fit these criteria, and was thus the most reasonable choice for the Commission to make. The 6.5 percent X-factor had been in place, although subject to a remand order, since 1997. Indeed, commenters in the *CALLS Order* proceeding did not propose any amount other than 6.5 percent for the transitional X-factor. The Commission determined that the transitional mechanism, fea-

¹ Texas Office of Public Utility Counsel v. FCC, 265 F.3d 313 (5th Cir. 2001) (TOPUC).

turing a 6.5 percent X-factor, would achieve the goal of reducing rates over a reasonable time period, without reducing rates too quickly so as to harm LECs. The Commission was able to rely on the fact that the 6.5 percent transitional X-factor was proposed by CALLS, a group that included both price cap LECs and IXC, as evidence that it reduced rates at a reasonable pace, i.e., not too quickly so as to harm LECs, but fast enough that the benefits of the rate reductions would flow to IXCs and their end-user customers in a timely manner.

The court has recognized the legitimacy of the Commission's reliance on its expertise in setting rates. *** In the case of the 6.5 percent X-factor, the record did not provide any number other than 6.5 percent as the transitional mechanism. No party argued that 6.5 percent was an unreasonable number for the Commission to use as a transitional mechanism. Furthermore, the Commission had experience with using a 6.5 percent X-factor previously. It was therefore familiar with the types of reductions that could be expected from using this number, as opposed to some other number that no party had proposed, and that had not been used previously to reduce rates. As discussed above, the Commission relied on its expertise in determining that the 6.5 percent X-factor would achieve the policy goals of reducing ATS rates to target levels in a timely manner that would not harm LECs.

Before adoption of the *CALLS Order* in 2000, Commission staff analyzed the potential effects of adopting the CALLS plan when compared to the access charge regulations in existence at the time. In that analysis, the Common Carrier Bureau's Industry Analysis Division (IAD) predicted when price cap carriers would reach their target rates using a 6.5 percent X-factor. According to the IAD CALLS Study, carriers representing the following percentages of total access lines would reach their target rates: 6 percent in 2000; another 42 percent for a total of 48 percent in 2001; another 26 percent for a total of 74 percent in 2002; and another 22 percent for a total of 96 percent in 2003. The application of the 6.5 percent X-factor has yielded results strikingly similar to those predicted by IAD in 2000. Price cap LEC companies that met their target ATS rates immediately upon filing their 2000 annual access filings represent approximately 58 million access lines, or 36 percent of the approximately 163 million total access lines. In 2001, companies representing another 39 percent met their ATS target rates, for a total of 75 percent. In 2002, companies representing another 21 percent met their ATS target rates, for a total of 96 percent. There are only approximately 6 million lines, or 4 percent of the total, served by price cap LEC companies that have not yet met their target ATS rates. These companies will continue to apply the 6.5 percent transitional X-factor to reduce their ATS rates. We note that companies representing approximately 3 million access lines were very close to meeting their ATS target rates in their 2002 annual access filings, and it is likely that these companies will meet the target rates in their 2003 access filing. Therefore, we expect that, after the 2003 access filing, price cap LECs that have not reached their ATS target rates will represent fewer than 3 million lines, or 2 percent of total access lines, with companies representing 98 percent at their target rates.

Actual application of the 6.5 percent X-factor generally followed Commission staff's predictions on when companies would reach their target rates, establishing a timely transition path and bringing benefits to consumers in a timely manner.

Application of a significantly different X-factor would have had very different consequences. A higher X-factor would have reduced the price cap companies' ATS rates to the target levels at a faster rate, thereby possibly harming those smaller price cap companies that have not yet met the target rates. A lower X-factor would have reduced price cap companies' ATS rates to the target levels at a slower rate; therefore, IXCs and their end-user customers would not have received the benefits of these lower rates in as timely a manner. The Commission relied on the record before it and its expertise in selecting a 6.5 percent X-factor in 2000, and this X-factor has achieved the Commission's policy goals of reducing ATS rates in a timely manner without harming price cap companies by cutting rates too quickly.

The Commission's selection of a 6.5 percent X-factor as a transitional mechanism for moving to ATS target rates was based on the record before it. Indeed, the Commission was without a reasoned basis for selecting an alternative, transitional X-factor. The Commission's selection of a 6.5 percent X-factor in 2000 will bring ATS access charges to the target levels for price cap LECs representing at least 98 percent of total price cap access lines after the July 2003 annual access filing. This percentage represents reasonable levels of lines reaching the ATS target rates during the third and fourth years of the five-year CALLS proposal. The benefits of lower access charges are being provided to consumers in a timely manner as envisioned by the Commission in the *CALLS Order*. The remaining carriers continue to move toward the target rates in a manner that provides meaningful consumer benefits, while avoiding the kind of dramatic rate cut that, as the Commission previously discussed, could harm LECs. Although 6.5 percent is not the only possible transitional mechanism that the Commission could have adopted, for the reasons articulated above, it represents a reasonable exercise of the Commission's discretion in setting rates.

Verizon Telephone Companies v. Federal Communications Commission

453 F.3d 487 (D.C. Cir. 2006)

GRIFFITH, Circuit Judge: This matter involves the use of an accounting rule, "add-back," in a complex area of regulation addressing the rates charged by local telephone exchange carriers for access to their networks. Its resolution, however, is relatively straightforward because, at its core, petitioners' challenge cannot overcome the broad delegation of power Congress has given the Federal Communications Commission ("FCC" or "Commission") to suspend petitioners' rates and determine whether they are "just and reasonable." Petitioners contend that the FCC unreasonably required their 1993 and 1994 tariffs to comply with the add-back rule years after those tariffs were filed. But Congress has expressly authorized the FCC to do what petitioners

urge it cannot: suspend petitioners' tariffs upon their filing, subject petitioners to an accounting order to track revenue earned under the tariffs, and determine at a later date whether petitioners' tariffs contain "just and reasonable" rates. 47 U.S.C. § 204(a)(1). ***

I.

Significant background is needed to understand the issue before us. *** Sharing and low-end adjustments were first applied to the LECs' 1992 access tariffs. Some LECs had to lower their price caps based upon 1991 earnings, while others were permitted to increase price caps for 1992. One year later, those adjustments raised an issue not addressed by the Commission in promulgating its price cap plan: what effect should the adjustments made to 1992 price caps based upon over- or under-earnings from 1991 have in calculating the rates of return for 1992 (and thereby determining the rates to be charged for 1993)? In calculating the rates to be charged for 1993, LECs had to determine whether (1) to "add back" the adjustment made to rates for 1992 in calculating the rate of return for 1992, as occurred prior to price cap regulation or (2) to calculate the rate of return for 1992 without considering the effect of sharing or low-end adjustments made because of earnings from 1991. Perhaps not surprisingly, LECs that could achieve higher rates for 1993 by applying add-back chose to apply add-back, and LECs that could achieve higher rates for 1993 by not applying add-back chose not to apply add-back. Thus, each LEC took the position on add-back that would allow it to maximize its price caps for 1993.

This selective use of an accounting rule by the LECs did not go unnoticed by the Commission. The Commission initiated a rulemaking regarding add-back, proposing that its price cap regime include a specific rule mandating add-back. Soon thereafter, noting that the add-back issue was unresolved and pending in the rulemaking proceeding, the Commission suspended 1993 tariffs for one day, issued an accounting order, and set for investigation all 1993 access tariffs for carriers that benefitted from a low-end adjustment or were subject to sharing for 1992. When price cap LECs filed 1994 tariffs, the Commission suspended those rates as well, issued an accounting order, and broadened the scope of the 1993 investigation to include 1994 tariffs.

In the *Add-Back NPRM*, the Commission indicated that no "commenters in the LEC Price Cap rulemaking or in the subsequent reconsideration proceeding discussed the details of rate of return calculations, or requested that [it] eliminate add-back from the rate of return calculations of the LEC price cap plan." *Id.* at 4416 ¶ 10. The Commission, "[h]owever, ... recognize[d] that this issue was neither expressly discussed in the LEC price cap orders nor clearly addressed in [its] Rules." *Id.* at 4415 ¶ 4. The Commission "believe[d] that [add-back] continue[d] to be an appropriate and indeed probably necessary component of the [price-cap] backstop." *Id.* at 4416 ¶ 11. Because "[t]he amounts of sharing or lower formula adjustment implemented in one year ... relate to productivity performance in a prior year[,] ... unless add-back occurs, the relationship between rate of return and productivity growth becomes hidden." *Id.* Furthermore, an "unadjusted rate of return effectively double-

counts the amount of the backstop adjustment, once in the base year and then again in the tariff year.” *Id.* at 4416 ¶ 12. Finally, without add-back, the Commission believed that “the effective rate of return [for LECs] over time could fall outside the range of returns [it] judged to be reasonable.” *Id.* at 4416 ¶ 13.

After receiving and addressing comments, the Commission adopted a new regulation that explicitly required add-back under its price cap rules. *See Price Cap Regulation of Local Exch. Carriers*, 10 F.C.C.R. 5656, 5657, 5659 ¶ ¶ 4, 16 (1995) (the “*Add-Back Rulemaking Order*”). *** After a lengthy analysis, the Commission concluded that adding back a sharing adjustment “ensures that the earnings thresholds applied to determine price cap LECs’ sharing obligations are those [the Commission] intended when [it] adopted” the price cap plan, *id.* at 5660 ¶ 22, and that adding back any low-end adjustment was also necessary for essentially the same reason.

Several parties petitioned for review of the *Add-Back Rulemaking Order* in this Court, arguing that “the add-back requirement is arbitrary and capricious because it requires carriers to recognize ‘phantom’ earnings and because it requires carriers to share more than the original price cap rules intended.” *Bell Atl.*, 79 F.3d at 1205. We rejected those arguments and held that the Commission reasonably applied add-back, noting that add-back “provides useful information about the carrier’s productivity because it reflects what the carrier could have earned but for the sharing obligation.” *Id.* at 1206. The Commission also reasonably determined that add-back “resulted in the right level of sharing, and ... was a necessary part of the sharing mechanism.” *Id.* We also rejected petitioners’ argument that adopting an add-back rule would result in retroactive rulemaking. We noted that (1) “[t]he sharing rules do not regulate past transactions; they regulate future rates;” and (2) “the add-back rule does not change the past legal consequences of carriers’ decisions to choose the 3.3 percent X-factor rather than the 4.3 percent X-factor” because “[t]he state of the law has never been clear, and the issue has been disputed since it first arose in 1993,” meaning that the “rule does not upset ... reasonable reliance interests.” *Id.* at 1207.

Five days after initiating notice and comment proceedings, the Commission entered its order suspending and opening an investigation of 1993 tariffs for LECs that benefitted from a low-end adjustment or were subject to sharing in 1992 and, as noted, took the same approach to 1994 tariffs. For both matters (the “1993 and 1994 investigations”), the Commission entered an “accounting order,” so that the LECs’ access charges for 1993 and 1994 could be tracked and refunds could be ordered if those tariffs were found to be unlawful. ***

III.

Section 201(b) of the Communications Act (the “Act”), 47 U.S.C. § 201(b), provides that charges for interstate or foreign communications “shall be just and reasonable.” Section 204(a)(1) of the Act, 47 U.S.C. § 204(a)(1), directs that “[w]henver there is filed with the Commission any new or revised charge,” the Commission may investigate “the lawfulness” of the charge and immediately “suspend the operation of

such charge” for a “period [of up to] five months beyond the time when [the charge] would otherwise go into effect.” If the Commission’s hearing has “not been concluded,” the Act allows the “the proposed new or revised charge ... [to] go into effect” after five months, but the Commission may require a carrier to “keep accurate account of all amounts received” under the potentially unlawful charge (*i.e.*, order an accounting). *Id.* In determining whether a new or revised charge is lawful under § 204(a)(1), the Act provides that “the burden of proof ... shall be upon the carrier.” *Id.*

Section 201(b) also authorizes the Commission to “prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions of this chapter.” The Commission did just that in 1995 when promulgating its add-back rule through the *Add-Back Rulemaking Order*. ***

A. Suspension, Accounting, and Refunds under 47 U.S.C. § 204(a)(1).

Petitioners argue that applying add-back to their suspended tariffs “impose[s] new substantive obligations that had not previously existed,” “penalizes LECs for reasonable choices they made without any rule or agency guidance as to whether add-back was required,” and impermissibly results in finding the 1993 and 1994 tariffs “unlawful [even though] they [did not] violate some legal rule in place at the relevant time.” These retroactivity arguments ignore the elephant in the room: the suspension, accounting, and refund process authorized by 47 U.S.C. § 204(a)(1), pursuant to which the Commission acted, and its place in the ratemaking process.

As we have previously summarized:

Under section 203 [of the Act, 47 U.S.C. § 203], carriers initiate the ratemaking process by filing tariffs which may take effect after prescribed notice periods. The FCC may reject a tariff outright if it is patently unlawful. Alternatively, the Commission may set the rates for investigation and hearing. 47 U.S.C. § 204(a).

In addition, the Commission may suspend the effective date of a filed tariff for a period of up to five months. After the five-month period has elapsed, the rates become effective, and a customer is obliged to pay at the designated rate. In the event the rates are later found unlawful, the Commission may require the carrier to effect a refund. 47 U.S.C. § 204(a).

TRT Telecomm. Corp. v. FCC, 857 F.2d 1535, 1538 (D.C. Cir. 1988) (citation and quotation marks omitted). If the Commission “fails to order a suspension,” that failure “does not mean that the Commission cannot take action to correct an unreasonable rate.” *Ill. Bell Tel. Co. v. FCC*, 966 F.2d 1478, 1481 (D.C. Cir. 1992). In “§ 205 Congress provided the mechanism for prospective relief from unreasonable rates.” *Id.* at 1482. “In § 204,” however, “it provided the mechanism for preventing an unreasonable rate from being filed, or at least from taking effect only subject to an accounting order and such further order as would be required. The one supposes prospective relief, the other the possibility of refund.” *Id.*

Petitioners' retroactivity arguments ignore the reality that their 1993 and 1994 tariffs were suspended and subjected to an accounting order. Petitioners have been on notice, since the time those tariffs were filed, that the tariffs' lawfulness is in doubt and that they may not contain just and reasonable rates. ***

B. Applying Add-Back to the 1993 and 1994 Tariffs was Neither Arbitrary Nor Unreasonable.

Petitioners argue that "in all events," the "absence of guidance from the FCC in the years preceding the issuance of the *Add-Back [Rulemaking] Order*" means that "it was entirely reasonable for carriers to decide not to use an add-back methodology." That is, even if the Commission's § 204 determination was not retroactive, it was arbitrary and unreasonable for the Commission to require add-back under its authority to set "just and reasonable" rates, 47 U.S.C. § § 201(b), 204(a)(1), "given the uncertainty that characterized the law at the time and the plausible arguments against using add-back." This argument need not detain us long. Petitioners' argument is not faithful to § § 201 and 204. Section 204(a)(1) places the burden of proving that petitioners' revised charges are just and reasonable upon the LECs, and § 201 mandates that the FCC only accept charges that are just and reasonable. The Communications Act does not contemplate that any choices the LECs make will be immunized from § 204(a)(1) and deemed "just and reasonable" absent explicit guidance to the contrary from the FCC.

We fail to see how the FCC's determination on add-back was arbitrary. Given the conflicting uses of add-back by various LECs depending upon whether add-back would contribute to their financial well-being, the Commission sought to take a uniform, fair position on add-back, and reasonably chose the position most consistent with its price cap regime. ***

For the foregoing reasons, we deny in part and dismiss in part the petitions for review.

So ordered
